BEHIND THE NUMBERS
Quality of Earnings Analysis
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International Business Machines Corporation (IBM)
Earnings Quality Update- 12/21 Qtr. part 1

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of IBM of 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

IBM beat 4Q21 EPS estimates by 6-cents and cheered its stronger revenue growth. As usual, IBM did not file its SEC documents with earnings so we will need to do this update in two parts after we check if it continued to gain earnings in several additional areas such as cutting bad debt reserves, cutting advertising, changes in workforce rebalancing charges, assumptions for the pension, etc. We can already see enough evidence that IBM did not have a quality beat and the revenue growth was helped by a horrible 4Q20 as an easy comp:

- IBM guided to a high-teens tax rate for 4Q21. Instead of 17%-18%, it came in at 14.2%. 300bp of tax rate is worth 11.8 cents – that's double the earnings beat already.

- Pension income rose from $122 million to $206 million – that added another 9.4 cents. It is worth noting that 4Q generated half the pension income gain for the full year: $84 million in 4Q vs. $167 million for all of 2021.

- Stock compensation declined by $15 million in the quarter, adding another 1.4 cents.

- IBM continues to buy its R&D via acquisitions – $3 billion for 15 deals in 2021 with 5 in the 4Q. Our earnings quality issue with this remains that IBM adds back the full cost of the deals. Its non-GAAP EPS adds back the amortization, transaction charges, and impairments from acquisitions. Had they built in-house, IBM would have seen higher wages and R&D reducing earnings. This adjustment is a meaningful part of IBM's non-GAAP EPS:

	4Q	3Q	2Q	1Q
Acq. Addbacks to EPS 2021	$0.39	$0.41	$0.41	$0.37
Acq. Addbacks to EPS 2020	$0.40	$0.40	$0.41	$0.42

- Revenue growth was 8.6% without the FX drag for 4Q21. That was fueled by 10% gains in Software, 16% growth in Consulting, 2% in Infrastructure, and 18% for Hybrid Cloud. After accelerating growth, guidance is for mid-single-digit growth going forward that may fall to 3% with FX. How is this possible?

    - 4Q20 saw horrible sales. Total sales were down 8%, Cloud & Software down 6.6%, Global business services down 5.2%, and systems down 19.4%. Arguably, 4Q21 should have been even stronger than an 8.6% figure against a -8.0% figure. All this growth is not even a wash against 2021's figure.

    - In 4Q20, IBM took a $2 billion charge that largely went to Kyndryl before the spin-off. Much of that charge was devoted to reworking uneconomic contracts at that unit. One of the incentives offered to Kyndryl customers was access to IBM's remaining units also as part of the new deals. Here is what the CEO said last year,

      "*We have by and large gotten very positive feedback over 98% of them are quite satisfied with our description of what'll happen both in terms of their contracts, the service they'll get from us and the assured guarantee of access to technical resources, both from the new company and from IBM over time.*"

      Here's the deal- Kyndryl related sales were a meaningful part of the total in 4Q21. Total sales growth of 8.6% becomes 5.1% without Kyndryl. Software's 10% growth becomes 5% without Kyndryl. Infrastructure goes from 2% to -3% without Kyndryl.

      We also see that gross margins were down y/y. Is that due to Kyndryl sales coming in at lower margin as part of those deals? That seems possible. Software gross margins were 80.9% vs. 80.5%, but consulting was down at 27.0% vs. 29.7% and infrastructure was down to 54.8% vs. 60.1%.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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