BEHIND THE NUMBERS
Quality of Earnings Analysis
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International Business Machines Corporation (IBM)
Earnings Quality Update- 9/21 Qtr.

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 coverage of IBM at 2- (Weak) and maintain our Top Sell rating.

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

Summary

Without the 10-Q, we can not do a full review of IBM's 3Q results because we want to see if the company gained more income from cutting bad debt reserves, from having income on direct financing leases remain far higher than in 2020 and 2019, and the y/y change in workforce rebalancing that had been running lower and adding to income.

With what we have at the moment, IBM's $2.52 of non-GAAP EPS beat by 1-cent. IBM guided to an effective tax rate for 3Q21 of about even with 2Q21, which was 17.0%. The tax rate for 3Q was 4.8% and added 32-cents to non-GAAP EPS. Of that total, 26-cents came from tax benefits from the separation of Kyndryl. While we think IBM should have been able to forecast that, there was still another 6-cents from other items that lowered taxes and that wipes out the 1-cent beat too. There are three main points that we think should concern investors:

- The GTS segment that will be Kyndryl on the spin-off showed weakness in 3Q21 sales. Since announcing the spin-off and the huge write-off in 4Q20 to rework contracts with customers, sales growth was -1.5% in 1Q, then 0.4% in 2Q – when IBM said:

“In GTS, really what we're seeing is a good performance overall. Leveraging our incumbency position and ***driving strong renewals. We're seeing with that incumbency position finally a turnaround with an encouraging trend on client base business volumes*** *and project-based services that they are engaging in project-based services and* ***our incumbency accounts were up 20% here in the second quarter, but as expected the new logos. While we have a very healthy pipeline*** *in new logos out there, the sales cycles are elongated as we said in the prepared remarks.* ***So we see some nice acceleration continuing in GTS overall,”***

The GTS unit just reported -4.8% sales growth for 3Q21. They blamed the spin-off news for slowing client signings due to clients waiting for the spin-off. That would indicate sales could have stayed weak in October too.

- The GTS spinoff is supposed to come with higher margins. This was keyed by reworking less profitable contracts in the giant $2 billion 4Q20 charge. We actually expected IBM to show positive margin results in 3Q just going against the poor contracts from 3Q20. It pulled that off with gross margin up y/y 120bp in 3Q21, 110bp in 2Q21, and 50bp in 1Q21. We think 4Q will be a tough comp in this area and all of 2022 will be tough. IBM noted that essentially all the contract reworking is complete. We think it is a red flag also that pretax margin was flat year y/y at 5.9% and actual dollar income was down. The growth path through reorganization may be over.

- IBM announced on its call that it still expects mid-single-digit growth for the business without GTS. It grew at only 1.9% on easy comps in 3Q. In walking their way to how they will meet future forecasts, IBM said flat out – it will rely on making more acquisitions and will need completed acquisitions to grow at double-digit rates. That is a huge issue for earnings quality and free cash flow. We have pointed out that acquiring companies lets IBM spend less on R&D and that grows income. However, the non-GAAP earnings add back all the amortization of acquired intangibles and other integration costs. That was 41-cents of non-GAAP’s $2.52 in 3Q21.

  Also, if the company views acquisitions as a key to its growth – that is not discretionary spending. Acquisition costs need to come out of free cash flow. IBM is touting Free Cash Flow of $11 billion for the last year, which adds back $1.8 billion of the charges for GTS. However, it is ignoring $3.3 billion in acquisitions which makes the real Free Cash Flow either $7.7 billion or $5.9 billion if the charges aren’t added back. The spin-off will cut Free Cash Flow another $0.7 billion too. That’s 84% of FCF going to the $5.9 billion dividend best case or the dividend already exceeds 100% if the charges are not added back. That FCF is also helped because capital spending is down $0.4 billion this year.

- IBM also announced it is ramping up sales commissions and sales incentives to restart sales growth in the 4Q and 2022. That sounds like higher costs to bring in lower revenue sales to us. That may set up IBM and Kyndryl for tough comps going forward.

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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