BEHIND
THE NUMBERS
Quality of Earnings Analysis

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International Business Machines Corporation (IBM)
Earnings Quality Update

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

We maintain our earnings quality rating of IBM at 2- (Weak)

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

Executive Summary

- IBM's 1Q22 non-GAAP EPS beat the consensus by a penny. However, we identified over 16 cps in unusual items. We will need the 10-Q to assess the impact of workforce rebalancing charges and a decline in depreciation.

- Sales to spun-off Kyndryl continue to account for the bulk of revenue growth, providing $685 million of IBM's total sales growth of $1.01 billion. However, Kyndryl's own revenue is declining and IBM is forecasting for sales growth provided by Kyndryl to shrink later this year.

- Consulting margins are falling and this could worsen as the company hires more higher-skilled labor.

Unusual Items More Than Outweigh the Earnings Beat

IBM's adjusted EPS of $1.40 beat forecasts for 1Q22 by only 1 cent. Given the number of short-term earnings items used regularly by IBM, that is essentially a miss in our opinion. The 10-Q is not out so here is what we can see on earnings quality at this point:

- The tax rate is at least 90 bps below forecast which added 1.5 cents

- R&D fell as a percentage of sales from 12.7% to 12.1%, which added 7.0 cents for a company going more heavily into cutting-edge products. We have seen R&D spending growth slow as IBM acquires its R&D – which makes acquisitions essential spending and should be subtracted from free cash flow.

- SG&A declined by $88 million – that's where workforce rebalancing and advertising are located and we know IBM has seen large reductions there tied to the large 4Q20 charge. We will check when the 10-Q is available. That is a potential 8.1 cents

- We want to review depreciation more closely as depreciation/amortization dropped by $415 million y/y. We know much of that should be from the separation of Kyndryl, and adjusted EPS adds back amortization, but we need 10-Qs for both IBM and KD.

- The one change we saw that worked against IBM's EPS was stock compensation, which rose $21 million and was a 1.9-cent headwind

The revenue is where IBM is raving about its results with a beat of $353 million and boosting guidance from mid-single-digit to the high end of mid-single-digits. This is where we will focus this update until we can review the 10-Q on cost items.

Sales to Kyndryl Are a Major Part of Revenue Growth

We cannot help but notice that the business IBM got rid of for lack of growth continues to play an important part of its growth today. We noted in 4Q21 that IBM beat revenue guidance with

Kyndryl providing $549 million of the $1.013 billion sales increase at IBM and adding 3.5% to total sales growth. During 4Q, Kyndryl sales declined by 6.1%.

For 1Q22, IBM reported that more than 5% of sales came from Kyndryl – at 5.2% that would make Kyndryl $685 million of the sales increase of $1.01 billion (up 8% which is 11% less 3% FX). Kyndryl is guiding to 5% negative growth for its 1Q22. We already question how sustainable getting a larger share of a shrinking business really is. IBM says that Kyndryl will only make up about 3.5% of total sales for 2022 so even they expect this source of growth to wane.

We believe the Kyndryl sales are actually a larger percentage of sales because they are concentrated in a few areas. IBM says there is no Kyndryl revenue going to the Consulting Unit and we doubt it makes up much of Financing or Other as well. That leaves us with Software and Infrastructure:

Revenues	**1Q22**	**1Q21**
Software	$5,772	$5,138
Infrastructure	$3,219	$3,293
Operating Profit	$8,991	$8,431

Sales in these two units grew by $560 million and Kyndryl likely added about $685 million.

IBM's breakdown of sales further in these units illustrates this as well:

- Software was up 15.4% before -3% FX. Kyndryl was more than 8%. From the $5.138 billion base, the growth was $791 million. That breaks down to $419 million from Kyndryl and $372 million from other IBM sources.

- Transaction Processing within Software was up 31% with Kyndryl accounting for 28% of that growth. Hybrid Platform withing Software was up 10.5% with Kyndryl adding 1.5%.

- Infrastructure overall was up only 0.3% before -2% FX – only $10 million. Kyndryl was over 8% of the total. Using 8.2% is $266 million from Kyndryl.

- Within Infrastructure, Support was up 4% before FX losses, Kyndryl was more than 8% of the growth. Hybrid Infrastructure saw -2% growth and Kyndryl provided 8%.

Our conclusion is that Kyndryl has been the source of a material amount of revenue growth. We also know that Kyndryl is not forecasting much growth and IBM is forecasting Kyndryl's influence will be lighter going forward.

Easy comps on Transaction Processing from 1Q21 also helped Software sales growth. This is 25%-30% of Software sales and was down 15% in 1Q21 before rising 31% in 1Q22. Of that 31%, 28% came from Kyndryl.

IBM is buying some of its growth too. Acquisitions are about 1.0-1.5% of sales growth and Management noted that range was seen in 1Q22 also. So of the $1.01 billion in growth y/y, $132-$198 million came from purchases in addition to the $685 million from Kyndryl. The acquisitions were in the Consulting and Software.

Consulting Gross Margin Is Worth Watching

Consulting is the one area of growth for IBM that is not piggybacking off Kyndryl. The gross margin has been falling for several quarters.

Consulting Gross	**4Q**	**3Q**	**2Q**	**1Q**
2022				24.3%
2021	27.0%	29.8%	27.9%	27.8%
2020	29.7%	32.9%	28.4%	27.2%
2019	27.6%	31.1%	26.0%	26.2%

IBM is blaming the drop on tight labor markets causing higher wages for 1Q22 and 4Q21. We can certainly accept that as an explanation. However, the company believes it will take enough price hikes to offset the wage inflation going forward. One issue we see is management made it sound like it is more than wage inflation – they are adding higher-skilled people, which could raise wages compared lower-skilled people regardless of inflation:

From 1Q22 call:

> *"And we are investing in talent across our workforce, up-skilling existing resources, adding certifications and bringing in technical skills in areas of hybrid cloud and AI."*

If IBM takes price increases, it will help revenue growth – and seems to be what the market is mostly focused upon. However, we don't see much reason to expect wage growth to slow either, which could keep margins under pressure. That could mean flat to negative profit growth despite higher revenues:

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Consulting	1Q22	1Q21	4Q21	4Q20
Sales	$4,829	$4,262	$4,746	$4,196
Gross Margin	24.3%	27.8%	27.0%	29.7%
Gross Profit	$1,173	$1,185	$1,281	$1,246

We also know before higher labor costs, margins were declining in 3Q21 because new offerings and partnerships were lower-margin. In 2Q21, IBM noted consulting margins were under pressure too. This was after 2020 when margins were increasing due to some higher value offerings and some operating leverage.

Another issue is that a contract often has a defined cost. IBM may not be able to raise prices to offset the current wage hikes. That means the margin may only improve on a lagging basis and the comps are still very tough coming up on margins for the rest of 2022. If they raise prices too much, does new contract signings slow down?

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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