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BEHIND THE NUMBERS

Quality of Earnings Analysis

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International Business Machines Corporation (IBM)
Earnings Quality Update- 3/22 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 rating of IBM at 2- (Weak).

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

Summary

This is part two of our 1Q22 review of IBM's earnings. Because IBM releases its 10-Qs and 10-Ks on a delayed basis, it is difficult to fully see some issues on earnings day. Our review last week focused on how dependent IBM remains on its spun-off Kyndryl unit.

We were already skeptical when IBM only beat forecasts by 1 cent as they have been pulling several earnings levers in recent quarters. We found evidence of that happening again in the 1Q22 10-Q:

- SG&A decline was full of items that in total provided 2 cents to adjusted EPS
    - IBM saw workforce rebalancing continue to be an earnings driver off the huge charge taken in 4Q20. It fell $89 million y/y and added 8.2 cents in 1Q22.
    - Advertising was down y/y another $9 million – to add 0.8 cents to 1Q22 EPS.
    - Bad debt expense rose to $18 million from a $28 million credit. This $44 negative change hurt EPS by 4.1 cents in 1Q22.
    - Stock Compensation (we had this as a potential 1.9-cent headwind) – now that we can see all the data, this rose a new $28 million or a 3.1 cent headwind to EPS.
- Depreciation declined by $421 million y/y in 1Q22. Much of that change was Kyndryl being spun off. However, Kyndryl's depreciation was only $295 million in 4Q21 and $365 million in 4Q20. The range of the decline for IBM was $56-$126 million to add 5.2-11.6 cents.
- Retirement costs declined by $23 million y/y too – this added 2.1 cents to EPS.
- We are still concerned that IBM's R&D spending declined 60bp as a percentage of sales which added 7.0 cents to the 1Q EPS.
- The Free Cash Flow definition IBM uses leaves out acquisitions and includes selling used PP&E. We believe it already benefits from lower capital spending and IBM's business requires acquisitions for incremental sales growth and to keep R&D expenses modest.

Workforce Rebalancing Is Returning and Unlikely to Add As Much EPS

We have talked about this in several updates. The key points to remember are IBM does not adjust for this recurring charge in non-GAAP earnings – except in 4Q20. We think 4Q20 set IBM up for many quarters of abnormally low workforce rebalancing charges, even reaching a credit in 4Q21 that added to EPS that period. With workforce rebalancing now an expense again, comps should get tough for the rest of 2022 and could be a headwind for EPS:

Workforce Rebalancing	4Q	3Q	2Q	1Q
2022				$5
2021	-$60	$0	$95	$146
2020	$1,157	$18	$137	$728

All periods prior to 2022 include Kyndryl in the results. For the 1Q21, without KD – the expense was $94 million compared to $5 million for 1Q22. The $89 million YOY decline in workforce rebalancing charges in 2Q22 produced 8.2 cents in EPS for 1Q22.

Kyndryl reported only $39 million in total workforce rebalancing in 2021 and $40 million after 3 quarters. We expect IBM's y/y change to be lower than $89 million in 2Q22 producing less of a boost to EPS and likely turn into a headwind to EPS growth in 3Q and 4Q.

Will Bad Debt Expense become Larger a Headwind?

We noted above that bad debt expense hurt EPS by 4.1 cents in 1Q22. IBM had $16 million in expense vs. a $28 million credit in 1Q21 for a $44 million negative swing. We noticed that in the last quarter, receivables more than 90 days old are increasing:

IBM Fin. Receivables	1Q22	4Q21	3Q21
Total Fin. Rec.	$11,349	$12,397	$11,687
Over 90 days	$498	$312	$296
	4.39%	2.52%	2.53%

How Much Longer Can Depreciation Decline and Help EPS?

In years past, IBM's capital spending exceeded its depreciation figure. As they added more of a software focus this changed in 2019. However, it was still spending above 50% of depreciation on new equipment:

	1Q22	1Q21	2021	2020	2019	2018	2017
Depreciation	$631	$1,052	$3,888	$4,227	$4,209	$3,127	$3,021
Cap. Exp.	$281	$494	$2,062	$2,618	$2,286	$3,395	$3,229
Net PP&E	$5,559	$9,452	$5,694	$10,040	$10,010	$10,782	$11,116

Remember, the Kyndryl units are in these figures except 1Q22. KD has not released its 10-Q yet so we don't know what KD depreciation expense was for 1Q22. However, we know that KD's depreciation was $295 million in 4Q21 and $365 million in 4Q20. If we assume KD's depreciation fell somewhere in that range in 1Q22, that gives us a range of decline for IBM's standalone 1Q22 depreciation expense of between $56-$126 million, or 5.2 to11.6 cents per share.

This is still a tech company, right? Capital spending is now only 45% of depreciation at the start of 2022. IBM was spending over 100% before Red Hat and over 50% after Red Hat. It used to be that IBM was replacing its net PP&E in just over 3 years, now it's 5 years.

We believe falling depreciation will remain a source of earnings in 2022, but expect the size of the contribution to decline.

Adjusted Retirement Costs Helped EPS

Like many companies, IBM's adjusted EPS excludes many of the one-time items from pension accounting such as actuarial losses. When we look at retirement costs and then adjusted costs – IBM picked up 2 cents in EPS for 1Q22:

	1Q22	1Q21
Retirement Costs	$510	$663
Adjustments	-$202	-$332
Non-GAAP Costs	$308	$331

The $23 million difference is 2.1 cents in EPS and remember- IBM only beat by 1 cent.

But, we also noticed that the basic components of retirement costs: Service Cost + Interest Cost – Expected Rate of Return show a declining source of income. One quarter isn't a trend, and there could be some Kyndryl stuff in this too, but this caught our eye as something to monitor.

	1Q22	1Q21
Service Cost	$66	$68
Interest Cost	$468	$409
Expected Return	-$749	-$731
Retirement Benefit	-$215	-$254

Questions about R&D and Free Cash Flow

In the 1Q21, we noticed that while R&D rose slightly in dollar terms, it declined noticeably as a percentage of sales – (we are using sales less financing revenue). EPS would have been 7 cents lighter had R&D held at the same level:

	1Q22	1Q21
Sales w/o Financing	$13,819	$12,695
R&D Exp.	$1,679	$1,616
% of Sales	12.1%	12.7%

We noticed that for a company that is focused more heavily on software and cloud applications, R&D really hasn't grown much in dollar terms. From 2010-2012, IBM was spending $6.0-$6.3 billion on R&D. Before adding Red Hat, IBM was spent $5.4-$5.6 billion in 2017 and 2018. Then in 2020-2021, R&D spending rose back to $6.3-$6.5 billion – basically flat with 2010-2012.

Moreover, IBM is under 12% of sales for R&D per year (11.5% in 2021). Oracle is normally 16%, Adobe is 16%, and Microsoft is about 13% - on triple the amount of IBM sales.

What's happening is IBM is buying some of its R&D via acquisitions. IBM has completed 197 acquisitions since 2003. We would argue that much of those businesses could have been built in-house for IBM. That would have required more R&D spending, more employees, more hardware. All of that would have cost cash and would have been expensed on the income statement. Instead, IBM is spending cash on the cash flow statement. But, it allocates the purchase price very heavily to Goodwill – which is not expensed. More of the purchase price is assigned to intangible assets such as trademarks, customer relationships, and in-process tech. Those intangibles are amortized on the GAAP income statement. However, IBM treats that amortization as a non-cash expense and adds it back to non-GAAP income. So, IBM gets new products, systems, customers and as far as non-GAAP income is concerned – it was all free.

Here are some recent examples:

- 1Q22 – IBM spent $698 million on acquisitions. $649 million went to Goodwill, $184 million to other intangibles, and $2 million to PP&E to be depreciated.

- In 2021 – IBM spent $3.293 billion on acquisitions. $2.549 billion went to Goodwill, $851 million to other intangibles, and $12 million to PP&E which will be depreciated.

This is a significant part of non-GAAP EPS. IBM reported $1.40 in EPS in 1Q22, with 39 cents due to adding back acquisition costs which is mostly the amortization of other intangibles. Now consider that goodwill isn't even going into GAAP EPS and is often 3x the size of assets assigned to other intangibles.

Why is this important?

- IBM also tells investors that it grows revenues at mid-single digits – but of that, 1-1.5% comes from acquisitions.

- IBM is keeping significant expenses off its income statement by recording those acquired sales.

- IBM does not list acquisition payments as a necessary recurring cash outflow for the business model it operates.

FCF ($ bill)	1Q22	1Q21	2021	2020	2019
Cash Ops	$3.2	$4.9	$12.8	$18.2	$14.8
Less Fin Rec. chg	$1.6	$2.9	$3.9	$4.3	$0.5
Less Cap Ex	$0.3	$0.5	$2.1	$2.6	$2.3
Less Software Inv	$0.2	$0.2	$0.7	$0.6	$0.6
Plus Sale PP&E	$0.1	$0.1	$0.4	$0.2	$0.5
Free Cash Flow	$1.2	$1.5	$6.5	$10.9	$11.9
Acquisitions	$0.7	$1.1	$3.3	$0.3	$32.6
Dividend	$1.5	$1.5	$5.9	$5.8	$5.7

- In 2021, IBM notes there were $1.4 billion of one-time Kyndryl costs that lowered FCF from $7.9 billion

- IBM has been letting its finance receivables run down, which adds to cash flow. We think it is proper to consider that non-operating cash flow, which IBM does here.

IBM is guiding to $10.5 billion of Free Cash Flow for 2022. That sounds great against a dividend of $6.0 billion. But consider the following:

- We already think IBM is underspending on capital spending – that may need to rise

- With lower PP&E (and perhaps older PP&E), the salvage value may also decline

- Acquisitions are a substantial item in many years. We didn't want to overload the table above, but acquisitions were $5.9 billion in 2016, $3.3 billion in 2015, $3.1 billion in 2013, and $3.7 billion in 2012.

- There just isn't much cushion for free cash flow when viewed in terms of $6 billion in dividends and $3 billion in acquisitions that IBM needs to avoid R&D spending.

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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