BEHIND
THE NUMBERS
Quality of Earnings Analysis

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International Business Machines Corporation (IBM)
Earnings Quality Update- 3/21 Qtr.

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 on IBM of 2- (Weak).

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

Summary

IBM's non-GAAP EPS of $1.77 beat estimates by 12-cents in 1Q21. The non-GAAP EPS was already lower by 7-cents y/y from 1Q20 so investors were not expecting too much. We found several areas of non-recurring items that were material benefits to 1Q21 results and account for far more than the EPS beat. Now that we have the 10-Q, we can identify these issues and the tame ones like cutting bad debt expense and marketing along with some apples-to-oranges cost comparisons that total 27-cents in EPS in our opinion. There is another 58-cents from dumping a large amount of the recurring workforce rebalancing into a 4Q charge plus 37-cents from acquisition items being added back that allows IBM to keep R&D expense off the non-GAAP income statement.

IBM did not expand guidance after its reported beat. It still expects to produce free cash flow of $11-$12 billion before $3 billion in cash costs for restructuring. There is a $6 billion dividend, the company has already spent $1 billion on acquisitions and already reduced capital spending by over $200 million in the 1Q. There are still financing receivables to sell to offset the cash spending.

- IBM picked up 8-cents in both non-GAAP and GAAP EPS by reporting a credit of $29 million for bad debt expense in 1Q21 vs. a $56 million charge in 1Q20.

- IBM added 8-cents more in both non-GAAP and GAAP EPS by spending $76 million less on advertising and promotional programs y/y. These expenses fell in 2020 after COVID started and we would expect a headwind for IBM going forward.

- **We noted in the original report that IBM had taken $11 billion in charges for workforce rebalancing over the years.** Our concern was the spin-off may cause charges of this nature to start being considered restructuring items and be added back as one-time in nature. This happened in 4Q20 with a large part of $2 billion going to workforce rebalancing and the street ignored it. However, now in 1Q21, the ongoing workforce charges that have been happening for over 15 years dropped to $146 million from $721 million in 1Q20. **Both non-GAAP and GAAP EPS had these charges and the drop added 58-cents to 1Q21 EPS.** The huge workforce rebalancing in 1Q20 resulted in a loss at GTS – the business being spun-off and Systems. The much lower charge in 1Q21, allowed both units to post a profit.

- **What was not quantified is IBM also benefited in 1Q21 from lower travel costs and lower COVID costs as well.** For the talk about IBM cutting costs, we see that SG&A costs were essentially flat y/y if we adjust for the items above. They came in at $5,174 million vs. $5,212 million and lower COVID and travel costs may have accounted for that. Going forward, there should be a tailwind from COVID but travel should increase. Lower travel was listed as a key reason the GBS unit had a better margin.

- **R&D continues to be acquired by IBM. We noted in the original report that IBM has been an acquisition machine making 172 deals in the past 20 years. It added another 6 purchases since mid-December 2020 and the cost was another $1 billion in 1Q.** Of the companies acquired, IBM assigned $746 million of the $987 million cost to goodwill that will not be amortized – thus no expense on earnings. Another $114 million was assigned to developed tech and will be amortized over 3-7 years. Finally, $134 million was listed as client relationships and is amortized over 7 years. **HOWEVER – for non-GAAP EPS, IBM adds the two amortization expenses of acquisitions back. Thus, IBM is reporting largely flat R&D as amortization costs rise but are ignored.** The cash flow statement shows the cash outflow for mergers, but earnings are being elevated by ignoring the cost:

	1Q21	1Q20	1Q19	1Q18
R&D Expense	$1,630	$1,625	$1,433	$1,405
R&D % Sales *	9.3%	9.4%	8.3%	7.7%
Amort. Acquired Intang.	$453	$473	$173	$203
EPS from adding back Acq	$0.37	$0.42	$0.18	$0.17

R&D % Sales excludes revenue from Global financing and Other

This table shows the acquisition of RedHat during 2019 leading to higher total R&D spending. RedHat was spending about $600 million per year on R&D, or about 18% of its $3.4 billion in sales. **R&D was basically flat y/y in 1Q21 and down slightly as a percentage of sales. But it looks to us that non-GAAP EPS is gaining about 40-cents per quarter because IBM is ignoring the cost of buying the new technologies.**

- Direct Financing Lease business also looked out of the ordinary in 1Q21. The accounting policy changed on January 1, 2019, whereby the lessor excludes the unguaranteed portion of the residual value from the cost of inventory at the time of sale. It used to be that IBM would evaluate the residual value each year for impairments. Now, the gross profit on a direct financing lease is the sales price of the product less the cost of the inventory, which excludes the unguaranteed residual value. The 1Qs for the last three years should be apples-to-apples.

Income on Direct Fin. Leases	**1Q21**	**1Q20**	**1Q19**
Sales price	$363	$211	$149
less inventory value	$59	$76	$55
Gross Profit	$304	$135	$94
Interest income on leases	$51	$74	$79
Income on Direct Fin. Leases	$355	$208	$172

Looking at 1Q21, we can understand sales picking up. However, the cost of inventory without the unguaranteed residual value dropped noticeably. This cost of goods sold was 37% and 36% of sales in 1Q19 and 1Q20. This year it fell to 16%. We could not find an explanation for this in the 10-Q. IBM is touting that it grew its gross margin by 110bp from 46.2% to 47.3% which is $272 million. Higher revenues accounted for $81 million and the margin increase added $191 million. We think $73 million of the $191 million came from this sudden 20% increase in gross margin in new finance leases due to the drop in reported cost of goods sold. That $73 million is 7-cents in EPS.

- We know that part of the 4Q20 restructuring activities involved reworking contracts at the GTS (Global Technologies) unit. The goal was to cull lower margin areas and offer customers more future services for higher payments. In 4Q20, IBM reported that this grew gross margins at GTS by 70bp. In 1Q20, IBM said these deals grew gross margins by 60bp but the positive impacts have not been fully seen yet. We found that odd given that 1Q should have had a full quarter with most of the reworked deals and yet the gross margin gain was lower. We also think offering customers the ability to add new services and support to the deals in return for altering contracts sets up IBM and the GTS spin-off for higher costs in the future. In 1Q21, the 60bp of gross margin gain in this area added $38 million or 4-cents to EPS.

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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