BEHIND THE NUMBERS
Quality of Earnings Analysis

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# International Business Machines Corp. (IBM)
# Earnings Quality Update- 6/21 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).*

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

## Summary

After waiting a week for IBM's 10-Q to do some analysis on the 2Q21, we believe IBM missed forecasts by a wide amount. From the press release, IBM beat estimates by 4-cents for Non-GAAP EPS of $2.33. Here is what was not mentioned in the press release or the conference call at all and we needed the 10-Q to find it:

- We see that the company had a credit for bad debt expense of -$43 million in 2Q21 vs. a $70 million charge in 2Q20. The $113 million positive swing added 10.4 cents to EPS.

- As we pointed out after 4Q20 results, we believed IBM put a large amount of workforce rebalancing charges into a $2 billion charge that was excluded from non-GAAP EPS. This has been a quarterly expense for more than 15 years and was always part of GAAP and non-GAAP earnings. With the first part of Covid in 2Q20 (before the $2 billion charge) IBM was set up for a big headwind here because in 2Q20, the workforce charge was only $137 million. However, the company still managed to come in below that in 2Q21 at $95 million. The $42 million gain added 3.9 cents to EPS.

- There was no mention of travel expense or Covid expense in the 2Q call or earnings release. In the 10-Q, we saw again that IBM benefitted from travel expenses coming in lower y/y – but again it was not quantified.

- Advertising increased by $36 million and was a 3.3 cent headwind. The tax rate was another 3.1 cent headwind rising from 15.9% to 17.0%.

- Taken as a whole, IBM picked up a net 8-cents from these areas plus something from lower travel expenses against a beat of 4-cents. Compared to 1Q21, IBM beat by 12-cents and added 74-cents from lower bad debt, lower advertising, and lower workforce charges.

- Again, we see that IBM is touting its cost cutting with adjusted SG&A falling by $43 million y/y from $4.962 billion to $4.919 million. The bad debt, advertising, and workforce charges added $119 million to the $43 million improvement with lower travel adding more too. Are costs actually going down? Or did IBM put a bunch of expenses in the giant 4Q20 charge that may resume in a couple of quarters?

- We again saw the income on direct financing leases looks odd. IBM touted that its adjusted gross margin improved by 30bp in 2Q21. If we look at direct financing leases, gross profit jumped from 59% in 2Q19 to 68% in 2Q20 to 74% in 2Q21. Using the change from 2020, this is 15bp of the margin gain and added 2.1 cents to EPS in 2Q21. Using the change from 2019, that is a 31bp change and added 5.4 cents to EPS. We know the accounting rule in this area was changed in 1Q19 which led to exclusion of unguaranteed portions of residual value. However, the last three periods all include this change. Yet IBM is seeing a big increase in profitability here:

| **Income on Direct Fin. Leases** | **2Q21** | **2Q20** | **2Q19** |
|---|---|---|---|
| Sales price | $394 | $368 | $179 |
| less inventory value | $103 | $117 | $74 |
| Gross Profit | $291 | $251 | $105 |
| Interest income on leases | $47 | $68 | $73 |
| Income on Direct Fin. Leases | $338 | $316 | $178 |

- The 110bp improvement in gross margin at GTS should also be looked at from a standpoint of the $2 billion charge in 4Q20. At that time, IBM enticed clients to restructure lower-margin deals. It appears that they pulled some future operating costs into that charge, which effectively boosted gross margin at that division going forward. The gross margin was up 70bp in 4Q, 60bp in 1Q21, and now 110bp in 2Q21. IBM should see another benefit from this process in 3Q21. This added 6.4 cents to EPS in 2Q21.

Our understanding is that IBM also gave customers the ability to access more services and technical assistance as part of these reworked contracts. That could mean that by putting costs into 4Q20, this unit will show improved results for all of 2021 as it spins off by year-end. Going forward, GTS could see costs increase as clients use additional services. At the time IBM discussed this with investors it noted that GTS clients will have access to services of both the spun-off GTS and the remaining IBM company.

- One more point on gross margin. Global Business Systems (23% of sales) saw gross margin fall 60bp, which IBM attributed to a decline in its consulting margin. But, we're supposed to believe that GTS's margins are increasing for some reason other than the 4Q reworking of contracts. The Systems unit (9% of sales) saw gross margin fall 270bp compared to the first big quarter of Covid. It blamed lower margins on both software and hardware offerings.

- IBM continues to acquire its R&D in our opinion. The company spent $2.94 billion on deals so far in 2021. Of that total, 77% was assigned to goodwill and will not be expensed. The remaining amount will be expensed over just under 7 years and will be added back to non-GAAP earnings. While investors can look at R&D of $1.657 billion in 2Q21 rising from $1.582 billion in 2Q20 and it was 10bp higher at 9.0% - the company spent twice that amount buying other companies to add to its intellectual property that will have no expense on the non-GAAP EPS. In 2Q21, IBM's $2.33 in EPS had 42-cents of that income in the form of amortization of acquired intangibles added back. That's 18% of 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.

# Disclosure

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