



International Business Machines Corp. (IBM)

Updated August 1st, 2021 by Prakash Kolli

Key Metrics

| | | | | | |
|-----------------------------|-------|--|-------|----------------------------------|----------|
| Current Price: | \$141 | 5 Year CAGR Estimate: | 5.2% | Market Cap: | \$126.4B |
| Fair Value Price: | \$121 | 5 Year Growth Estimate: | 4.0% | Ex-Dividend Date: | 08/09/21 |
| % Fair Value: | 116% | 5 Year Valuation Multiple Estimate: | -3.0% | Dividend Payment Date: | 09/10/21 |
| Dividend Yield: | 4.7% | 5 Year Price Target | \$148 | Years Of Dividend Growth: | 26 |
| Dividend Risk Score: | B | Retirement Suitability Score: | A | Last Dividend Increase: | 0.6% |

Overview & Current Events

IBM is a global information technology company that provides integrated enterprise solutions for software, hardware, and services. IBM's focus is running mission critical systems for large, multi-national customers and governments. IBM typically provides end-to-end solutions. In the services business, IBM is the world's largest IT provider with ~5.5% market share. In software, IBM's software business is mostly middleware, which is the software layer that connects applications and devices to each other. In hardware, IBM sells the z15 mainframes, storage, and the Power-based servers. The company has five business segments: Cloud & Cognitive Software, Global Business Services, Global Technology Services, Systems, and Global Financing. IBM generated annual revenue of ~\$73.6B in 2020.

IBM reported better than expected results for Q2 2021 on July 19th, 2021. Companywide revenue increased 3% to \$18,745M from \$18,123M while diluted adjusted earnings per share rose 7% to \$2.33 from \$2.18 on a year-over-year basis. Diluted GAAP earnings per share fell (-3%) to \$1.47 in the quarter from \$1.52 in the prior year.

Revenue for Cloud & Cognitive Software increased 6.1% to \$6,098M from \$5,748M in comparable quarters due to 12% growth in Cloud & Data, 12% growth in Cognitive but offset by a (-7%) decline in Transaction Processing. Global Business Revenue increased 11.6% to \$4,341M from \$3,890M due to 16% growth in Consulting, 28% rise in Global Process Services, and 5% growth in Application Management. Revenue for Systems fell 7.3% to \$1,717M from \$1,852M due to declines for all business lines. Revenue for Global Technology Services was up 0.4% to \$6,342M from \$6,316M due to flat sales in Infrastructure & Cloud Services and Technology Support Services.

IBM ended Q2 2021 with a backlog of \$103.7B. The company paid down about \$6B in total debt in the first half. IBM is expecting to grow revenue in 2021 but did not provide guidance. IBM is making acquisitions to reinforce its product and services offerings and has spent ~\$2.9B on 7Summits, Bluetab, Boxboat, Turbonomic and other companies.

IBM is splitting into two companies a new IBM with ~\$59B in revenue and Kyndryl (Managed Infrastructure Services) with ~\$19B in revenue. The spin off should be completed by end of CY 2021.

Growth on a Per-Share Basis

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2026 |
|---------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|--------|----------------|----------------|
| EPS | \$13.06 | \$14.37 | \$14.94 | \$15.59 | \$13.60 | \$12.39 | \$13.66 | \$13.81 | \$12.81 | \$8.67 | \$11.03 | \$13.42 |
| DPS | \$2.90 | \$3.30 | \$3.70 | \$4.25 | \$5.00 | \$5.50 | \$5.90 | \$6.21 | \$6.43 | \$6.51 | \$6.56 | \$7.98 |
| Shares¹ | 1163 | 1117 | 1054 | 990 | 965 | 946 | 922 | 892 | 892 | 893 | 893 | 807 |

IBM's core operations are profitable. But IBM has had difficulty generating growth in the past several years due to the transition to cloud and SaaS in the IT industry and IBM's late emphasis on this market. However, IBM is now focusing on cloud and SaaS and intends to be a major player in hybrid cloud as illustrated by the Red Hat acquisition. Earnings in 2020 were impacted by COVID-19 and non-operating pre-tax charges for business simplification. The impending spinoff of Kyndryl will affect future earnings, debt, and dividend growth estimates. Due to the Red Hat acquisition and impact of the coronavirus we are not expecting any share buybacks in 2021 as the company deleverages.

¹ Share count in millions.

Disclosure: This analyst is long IBM.



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Valuation Analysis

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Now | 2026 |
|-----------|------|------|------|------|------|------|------|------|------|------|-------------|-------------|
| Avg. P/E | 13.1 | 13.7 | 13.0 | 11.7 | 11.4 | 12.1 | 11.6 | 10.4 | 11.2 | 14.4 | 12.8 | 11.0 |
| Avg. Yld. | 1.7% | 1.7% | 1.9% | 2.3% | 3.2% | 3.7% | 3.7% | 5.8% | 4.5% | 5.2% | 4.7% | 5.4% |

IBM's stock price is little changed since our last report. The company had two improved expected quarters in 2021 but the Kyndryl spinoff adds uncertainty. Our fair value estimate is \$121 using our fair value multiple of 11X. Our five-year price target is now \$148 share. The current dividend yield is still well above the market average.

Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2026 |
|--------|------|------|------|------|------|------|------|------|------|------|------------|------------|
| Payout | 22% | 23% | 25% | 27% | 37% | 44% | 43% | 45% | 50% | 75% | 59% | 59% |

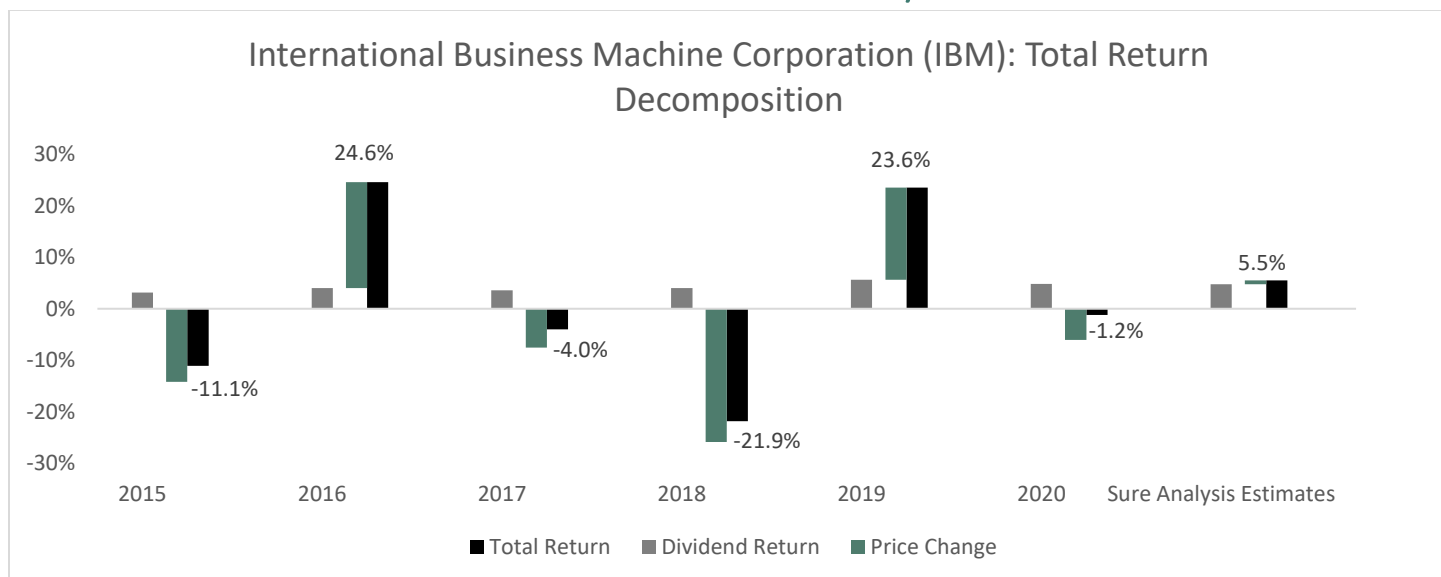
IBM's competitive strength is its brand, entrenched customer relations and extensive patent portfolio. IBM is also the market leader in mainframe computers where it has little competition. IBM is a surprisingly recession-resistant company since the company has long-term service and maintenance contracts leading to recurring revenue and cash flows. The nature of mission critical IT enterprise systems makes this unlikely to change in the near future. However, the company does face risks in that many of its competitors have emphasized the cloud earlier and are growing faster.

IBM is deleveraging after increasing debt for acquiring Red Hat. IBM divides its debt into core debt and financing debt. Debt is down \$17.9B since the acquisition and core debt is now \$37.7B and is offset by \$8.3B in cash, equivalents, and securities. Global Financing debt is \$17.9B and it is decreasing due to winding down of OEM financing.

Final Thoughts & Recommendation

At present we are forecasting a 5.5% annualized total return for the next five years. IBM has now had two consecutive quarters of revenue growth (not including currency effects). IBM's performance is improving with growth in hybrid cloud, higher operating margins, and declining debt. The impending spinoff of Kyndryl will alter IBM as it becomes more of a software and cloud company rather than a services company. Income investors may want to consider this stock for the yield and decent safety. At the current price, we rate this stock a hold.

Total Return Breakdown by Year



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Income Statement Metrics

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|------------------|--------|--------|-------|-------|-------|-------|-------|-------|-------|-------|
| Revenue (\$B) | 106.92 | 102.87 | 98.37 | 92.79 | 81.74 | 79.92 | 79.14 | 79.59 | 77.15 | 73.62 |
| Gross Profit | 50138 | 50361 | 48684 | 46407 | 40684 | 38516 | 36943 | 36936 | 36488 | 35575 |
| Gross Margin | 46.9% | 49.0% | 49.5% | 50.0% | 49.8% | 48.2% | 46.7% | 46.4% | 47.3% | 48.3% |
| SG&A Exp. | 23217 | 23085 | 22924 | 22472 | 19894 | 20279 | 19128 | 18863 | 20604 | 23082 |
| D&A Exp. | 4815 | 4676 | 4678 | 4492 | 3855 | 4381 | 4541 | 4480 | 6059 | 6695 |
| Operating Profit | 21394 | 22156 | 20313 | 18532 | 15690 | 13552 | 13140 | 13218 | 10543 | 6786 |
| Op. Margin | 20.0% | 21.5% | 20.7% | 20.0% | 19.2% | 17.0% | 16.6% | 16.6% | 13.7% | 9.2% |
| Net Profit | 15855 | 16604 | 16483 | 12022 | 13190 | 11872 | 5753 | 8728 | 9431 | 5590 |
| Net Margin | 14.8% | 16.1% | 16.8% | 13.0% | 16.1% | 14.9% | 7.3% | 11.0% | 12.2% | 7.6% |
| Free Cash Flow | 15179 | 14869 | 13345 | 12685 | 13104 | 12934 | 12951 | 11283 | 12400 | 15155 |
| Income Tax | 5148 | 5541 | 3363 | 4234 | 2581 | 449 | 5642 | 2619 | 731 | -864 |

Balance Sheet Metrics

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|--------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Total Assets (\$B) | 116.43 | 119.21 | 126.22 | 117.27 | 110.50 | 117.47 | 125.36 | 123.38 | 152.19 | 15.60 |
| Cash & Equivalents | 11922 | 10412 | 10716 | 8476 | 7686 | 7826 | 11972 | 11379 | 8172 | 13212 |
| Acc. Receivable | 11179 | 10667 | 10465 | 9090 | 8333 | 9182 | 8928 | 7432 | 7870 | 7132 |
| Inventories | 2595 | 2287 | 2310 | 2103 | 1551 | 1553 | 1583 | 1682 | 1619 | 1839 |
| Goodwill & Int. | 29607 | 33034 | 35055 | 33659 | 35507 | 40888 | 40529 | 39353 | 73456 | 73413 |
| Total Liab. (\$B) | 96.20 | 100.23 | 103.29 | 105.26 | 96.07 | 99.08 | 107.63 | 106.45 | 131.20 | 135.24 |
| Accounts Payable | 8517 | 7952 | 7461 | 6864 | 6028 | 6209 | 6451 | 6558 | 4896 | 4908 |
| Long-Term Debt | 31322 | 33270 | 39719 | 40722 | 39889 | 42168 | 46823 | 45812 | 62899 | 61538 |
| Total Equity | 20138 | 18860 | 22792 | 11868 | 14262 | 18246 | 17594 | 16796 | 20841 | 20597 |
| D/E Ratio | 1.56 | 1.76 | 1.74 | 3.43 | 2.80 | 2.31 | 2.66 | 2.73 | 3.02 | 2.99 |

Profitability & Per Share Metrics

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|------------------|-------|-------|-------|-------|--------|-------|-------|-------|-------|-------|
| Return on Assets | 13.8% | 14.1% | 13.4% | 9.9% | 11.6% | 10.4% | 4.7% | 7.0% | 6.8% | 3.6% |
| Return on Equity | 73.4% | 85.2% | 79.1% | 69.4% | 101.1% | 73.0% | 32.1% | 50.8% | 50.1% | 27.0% |
| ROIC | 30.7% | 32.0% | 28.7% | 20.8% | 24.6% | 20.7% | 9.2% | 13.7% | 12.9% | 6.7% |
| Shares Out. | 1163 | 1117 | 1054 | 990 | 965 | 946 | 922 | 892 | 892 | 889 |
| Revenue/Share | 88.09 | 89.03 | 89.18 | 91.87 | 83.18 | 83.36 | 84.43 | 86.86 | 86.41 | 82.11 |
| FCF/Share | 12.51 | 12.87 | 12.10 | 12.56 | 13.33 | 13.49 | 13.82 | 12.31 | 13.89 | 16.90 |

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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