



International Business Machines (IBM)

Updated May 2nd, 2018 by Bob Ciura

Key Metrics

Current Price: \$144	5 Year CAGR Estimate: 13.0%	Quality Percentile: N/A
Fair Value Price: \$171	5 Year Growth Estimate: 5.0%	Momentum Percentile: N/A
% Fair Value: 84%	5 Year Valuation Multiple Estimate: 3.6%	Total Return Percentile: N/A
Dividend Yield: 4.4%	5 Year Price Target: \$217	Valuation Percentile: N/A

Overview & Current Events

IBM is an information technology company, which provides integrated solutions that leverage information technology and knowledge of business processes. The company was founded in 1911. Today, it has a market capitalization of \$131 billion.

On 4/17/18, IBM reported first-quarter earnings results. IBM had earnings-per-share of \$2.45 on revenue of \$19.08 billion. IBM's revenue increased 5.1% year-over-year, making two quarters in a row of revenue growth. For most companies, this might not be a huge achievement, but IBM was coming off a streak of 20+ consecutive quarters of declining revenue. Adjusted earnings-per-share increased 4% from the same quarter a year ago.

Among IBM's various segments, the Global Business Services segment was the notable decliner, with revenue down 1%. This segment includes consulting, global process services, and application management. The Technology Services and Cloud Platform was also down 1% for the quarter. Helping to offset this was a 2% revenue increase for Cognitive Solutions, while Systems revenue increased 4%.

Per-Share Growth

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	\$8.93	\$10.01	\$11.52	\$13.06	\$14.37	\$14.94	\$15.59	\$13.60	\$12.39	\$12.04	\$13.80	\$17.61
DPS	\$1.90	\$2.15	\$2.50	\$2.90	\$3.30	\$3.70	\$4.25	\$5.00	\$5.50	\$5.90	\$6.60	\$8.42

As shown in the above table, IBM enjoyed rapid earnings growth coming out of the Great Recession of 2008-2009. However, earnings growth reversed course starting in 2014, and declined each year since. IBM expects to finally return to earnings growth in 2018 and beyond. The key areas of growth for IBM are data, mobile, security, and analytics. Collectively, IBM refers to its group of growth initiatives as the "strategic imperatives", which continue to perform well. Strategic imperative and cloud revenue rose 10% last quarter, and is up to \$37.7 billion in the trailing 12 months. Total cloud revenue increased 20%, as did the annual run-rate for as-a-service revenue. As the strategic imperatives become a larger part of the company, growth can finally offset declines in the legacy systems and hardware businesses. Last quarter, the strategic imperatives represented 47% of IBM's total revenue. We expect IBM to return to modest growth over the next five years, due to the slow progress of the company's turnaround thus far. Over the next five years, earnings growth and dividend growth are expected at 5% per year.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	12.3	10.9	11.4	13.1	13.7	13.0	11.7	11.4	12.1	13.1	10.3	12.3
Avg. Yld.	1.7%	2.0%	1.9%	1.7%	1.7%	1.9%	2.3%	3.2%	3.7%	3.7%	4.4%	3.9%

IBM expects to generate earnings-per-share of \$13.80 in 2018. Based on this, stock trades for a price-to-earnings ratio of 10.3. This is below the historical valuation of the stock. Over the past 10 years, IBM traded for an average price-to-earnings ratio of 12.3, which is a reasonable estimate of fair value. IBM is going through a difficult turnaround, but it is a highly profitable company with a strong brand. Assuming a price-to-earnings ratio of 12.3 and earnings-per-share of \$13.80, the fair value price for IBM stock is approximately \$171. With a current share price of \$144, we believe IBM is

undervalued, by approximately 19%. A rising valuation could add significantly to IBM's total returns moving forward. With projected earnings growth of 5.0% each year and a 4.4% current dividend yield, total returns are expected to reach 13% over the next five years, including the impact of a rising price-to-earnings ratio.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	41.7%	40.2%	40.5%	43.1%	42.2%	38.6%	39.6%	36.8%	32.6%	28.9%	28.9%	28.9%
Int. Cov.	52.7	60.2	72.8	77.9	65.7	62.9	51.9	45.6	24.8	25.5	25.5	25.5
Payout	21.3%	21.5%	21.7%	22.2%	23.0%	24.8%	27.3%	36.8%	44.4%	49.0%	47.8%	47.8%
Std. Dev.	32.0%	20.7%	12.6%	18.5%	15.3%	15.9%	18.1%	15.6%	21.1%	16.6%	16.6%	16.6%
Debt/A	87.6%	79.1%	79.6%	82.6%	84.1%	81.8%	89.7%	86.9%	84.3%	85.9%	85.9%	85.9%

While IBM has struggled to return to earnings growth in recent years, it scores well across many safety metrics. The company has very high interest coverage, meaning its debt levels are of little concern right now. The company also has a modest dividend payout ratio below 50%, which indicates sufficient dividend coverage.

IBM's strong financial position is the result of its competitive advantages. For all the negative sentiment created by IBM's lack of growth, the company still has a wide economic moat. IBM has a massive patent portfolio. IBM states in its most recent annual report, that it has led the world in U.S. patents earned for 25 years in a row. Last year it set a new record with over 9,000 patents, nearly half of which are in strategic areas such as artificial intelligence, the cloud, blockchain, and other emerging technologies. IBM is a surprisingly recession-resistant company. Despite operating in a cyclical industry, IBM grew earnings-per-share in 2008 and 2009, during the worst years of the Great Recession.

Final Thoughts & Recommendation

IBM has been a disappointing stock for several years, as the company struggled through a prolonged and difficult turnaround. Now that IBM has returned to revenue growth, it is likely to generate positive earnings growth over the next 5 years. Combined with a low valuation and high dividend yield, IBM is an attractive stock. We believe IBM can generate total annual returns of 13% over the next five years. IBM is a buy at current prices.

Total Return Breakdown by Year

