



International Business Machines (IBM)

Updated July 18th, 2018 by Bob Ciura

Key Metrics

Current Price: \$145	5 Year CAGR Estimate: 12.6%	Volatility Percentile: 32.6%
Fair Value Price: \$171	5 Year Growth Estimate: 5.0%	Momentum Percentile: 26.1%
% Fair Value: 84%	5 Year Valuation Multiple Estimate: 3.2%	Valuation Percentile: 82.6%
Dividend Yield: 4.4%	5 Year Price Target \$217	Total Return Percentile: 80.3%

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 July 18th, IBM reported second-quarter earnings results. Earnings-per-share of \$3.08 beat analyst expectations by \$0.04 per share. Revenue of \$20 billion increased 3.7% year-over-year, and also beat expectations by \$120 million. The second quarter represented the third in a row of positive revenue growth for IBM, after a streak of 20+ consecutive quarters of declining revenue. Adjusted earnings-per-share increased 5% from the same quarter a year ago. Assessing IBM's results by segment, Global Business Services revenue was flat, while Cognitive Solutions declined 1% in constant currency. The Technology Services and Cloud Platform was also flat for the quarter. Fortunately, Systems revenue increased 23% to more than offset declines in the other three main segments.

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

We continue to expect a slow and gradual turnaround for IBM. As shown in the above table, the company grew earnings at a rapid pace after the end of the Great Recession. Growth began slowing down dramatically starting in 2014 and earnings have declined each year since. Now that IBM has returned to revenue growth, chances are good that the company can return to earnings growth this year as well. 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.

In the second quarter, revenue from analytics increased 5% to \$5.4 billion, while mobile and security revenue increased 3% and 79%, respectively. Collectively, IBM's strategic imperatives represented 48% of IBM's revenue in the second quarter. As the strategic imperatives become a larger part of the overall organization, IBM should return to earnings growth in the years ahead. 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	10.5	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 10.5. 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 still having difficulty turning itself around, but the company remains highly profitable and has a strong brand. Assuming a price-to-earnings ratio of 12.3 and earnings-
Disclosure: This analyst has no position in the security discussed in this article, and no plans to initiate one in the next 72 hours.

per-share of \$13.80, the fair value price for IBM stock is approximately \$171. A rising valuation could add 3.2% to IBM's annual shareholder returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

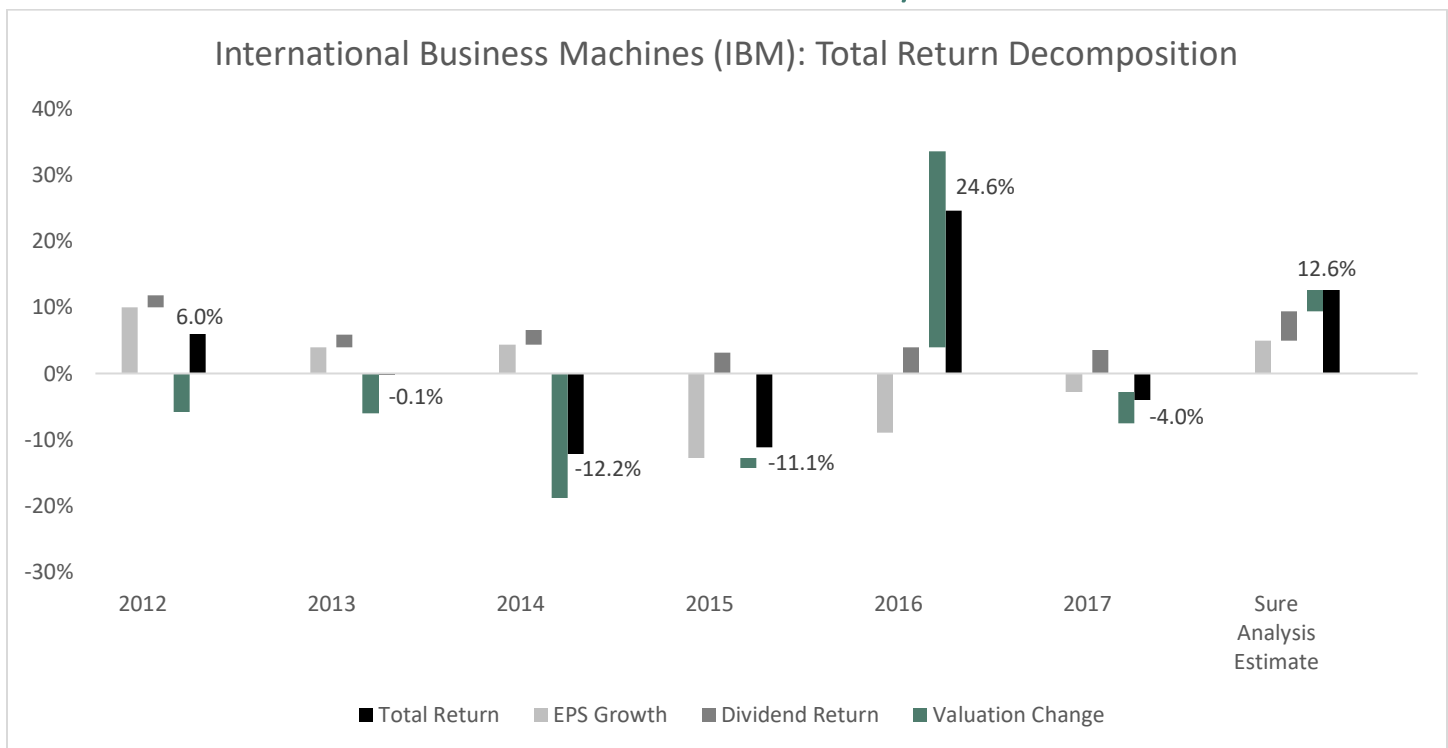
Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	41.7%	40.2%	40.5%	43.1%	42.2%	38.6%	39.6%	36.8%	32.6%	28.9%	28.9%	28.9%
Int. Cov.	52.7	60.2	72.8	77.9	65.7	62.9	51.9	45.6	24.8	25.5	25.5	25.5
Payout	21.3%	21.5%	21.7%	22.2%	23.0%	24.8%	27.3%	36.8%	44.4%	49.0%	47.8%	47.8%
Std. Dev.	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%

Despite IBM's prolonged difficulties, the company still scores highly when it comes to safety and quality. IBM has a strong balance sheet, with 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. IBM has a strong brand and an impressive patent portfolio. The company 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, cloud technology, 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

Investors have likely been disappointed with IBM's performance over the past few years. While the turnaround has taken longer than many investors would prefer, it is not easy to turn around a company as large as IBM. The good news is, growth has finally returned, meaning IBM stock could be a buying opportunity at its current valuation. The combination of valuation changes, earnings growth, and dividends are expected to result in annual returns of 12.6%.

Total Return Breakdown by Year



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