

International Business Machines Corp. (IBM)

Updated July 27th, 2020 by Prakash Kolli

Key Metrics

Current Price:	\$126	5 Year CAGR Estimate:	8.1%	Market Cap:	\$112,061M
Fair Value Price:	\$122	5 Year Growth Estimate:	4.0%	Ex-Dividend Date:	05/07/20
% Fair Value:	103%	5 Year Valuation Multiple Estimate:	-0.7%	Dividend Payment Date:	06/10/20
Dividend Yield:	5.2%	5 Year Price Target	\$148	Years Of Dividend Growth:	25
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 ~\$77B in 2019.

IBM reported better than expected Q2 2020 results on July 20th, 2020. For the quarter, companywide revenue decreased (5.4%) to \$18,123M from \$19,161M while diluted adjusted earnings per share declined (31%) to \$2.18 from \$3.17 on a year-over-year basis. Revenue was impacted by divestitures and currency exchange. Diluted GAAP earnings per share decreased (46%) to \$1.52 in the quarter from \$2.81 in the prior year. Revenue growth in the quarter was driven by 34% increase in cloud revenue due to organic growth and the Red Hat acquisition. Red Hat continues to act as a catalyst for growth with 18% revenue growth. Gross margins improved by 150 bps continuing a trend from last quarter. Revenue for Cloud & Cognitive Software increased 5% to \$5,748M from \$5,563M in comparable quarters due to growth in Cloud & Data but offset by Transaction Processing and Cognitive Applications. Global Business Revenue declined (6%) \$3,890M from \$4,197M due to decreases in Consulting, Application Management, and Global Process Services. Revenue for Global Technology Services declined (5%) to \$6,316M from \$6,837M due to declines in Infrastructure & Cloud Services and Technology Support Services. Revenue for Systems increased 6% to \$1,852M from \$1,753M due to z15 mainframe and storage gains but offset by Power and operating systems. Global Financing revenue was down (25%) to \$265M from \$351M reflecting wind-down of OEM commercial financing. IBM's backlog declined (1%) to \$107.1B.

The new CEO, Arvind Krishna, now leads IBM, who is focused on hybrid cloud and AI. The former Red Hat CEO, James Whitehurst is the new President of IBM. The company pulled 2020 guidance due to the COVID-19 pandemic.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$11.52	\$13.06	\$14.37	\$14.94	\$15.59	\$13.60	\$12.39	\$13.66	\$13.81	\$12.81	\$11.09	\$13.49
DPS	\$2.50	\$2.90	\$3.30	\$3.70	\$4.25	\$5.00	\$5.50	\$5.90	\$6.21	\$6.43	\$6.52	\$8.32
Shares¹	1228	1163	1117	1054	990	965	946	922	892	892	889	820

IBM's core operations are highly 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 lack of meaningful growth from initiatives such as Watson. 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. We are forecasting a decline in earnings per share in 2020 and then on average 4% gain annually out to 2025. We forecast on average 5% annual growth of the dividend out to 2025. Due to the Red Hat acquisition and impact of the coronavirus we are not expecting any share buybacks in 2020 and 2021 as the company pays down debt.

¹ Share count in millions.

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	11.4	13.1	13.7	13.0	11.7	11.4	12.1	11.6	10.4	11.2	11.4	11.0
Avg. Yld.	1.9%	1.7%	1.7%	1.9%	2.3%	3.2%	3.7%	3.7%	5.8%	4.5%	5.2%	5.6%

IBM withdrew its 2020 guidance due to the uncertainties with COVID-19. We have maintained our estimate for earnings at \$11.09 per share. This now gives a fair value estimate of \$122 using our fair value multiple for the long haul of 11.0. Our five-year price target is \$148 share.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	22%	22%	23%	25%	27%	37%	44%	43%	45%	50%	59%	6.2%

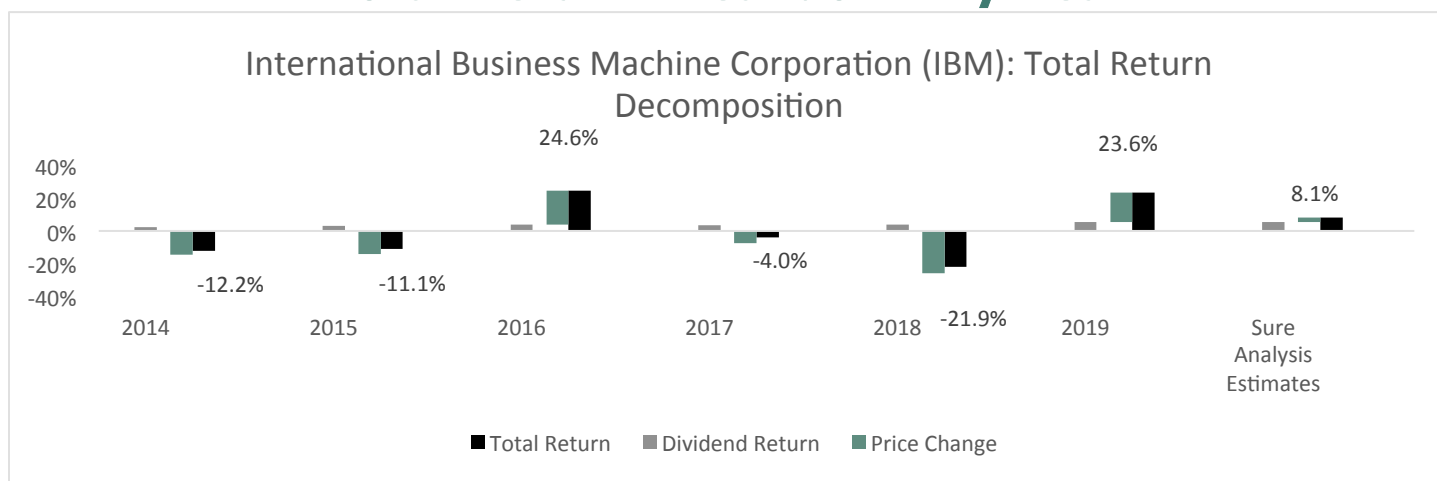
IBM's competitive strength is its brand, entrenched customer relations and extensive patent portfolio. IBM is also the market leader in mainframe computers where it has little competition. IBM is a surprisingly recession-resistant company since the company has long-term service and maintenance contracts 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 a head start in the cloud and are growing faster.

IBM's increased debt for the Red Hat acquisition and is now deleveraging. IBM divides its debt into core debt and financing debt. The former is \$42.8B but is offset by \$14.3B in cash, equivalents, and securities. The latter is used by the Global Financing segment and is \$21.9B but it is decreasing due to winding down of OEM financing.

Final Thoughts & Recommendation

At present we are forecasting an 8.1% annualized total return for the next five years. The new CEO is starting to place his stamp on IBM. Cloud continues to grow, Red hat is generating momentum, and the company is cutting costs. Granted, older businesses are facing slowly declining sales. But IBM generates a copious amount of cash flow and the balance sheet is stronger. That said, COVID-19 will continue to cause headwinds. IBM's dividend yield is much higher than the market average and covered by earnings and cash flow. At the current price, we rate this stock a hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue (\$B)	99.87	106.92	102.87	98.37	92.79	81.74	79.92	79.14	79.59	77.15
Gross Profit	46014	50138	50361	48684	46407	40684	38516	36943	36936	36488
Gross Margin	46.1%	46.9%	49.0%	49.5%	50.0%	49.8%	48.2%	46.7%	46.4%	47.3%
SG&A Exp.	21545	23217	23085	22924	22472	19894	20279	19128	18863	20604
D&A Exp.	4831	4815	4676	4678	4492	3855	4381	4541	4480	6059
Operating Profit	19304	21394	22156	20313	18532	15690	13552	13140	13218	10543
Op. Margin	19.3%	20.0%	21.5%	20.7%	20.0%	19.2%	17.0%	16.6%	16.6%	13.7%
Net Profit	14833	15855	16604	16483	12022	13190	11872	5753	8728	9431
Net Margin	14.9%	14.8%	16.1%	16.8%	13.0%	16.1%	14.9%	7.3%	11.0%	12.2%
Free Cash Flow	14795	15179	14869	13345	12685	13104	12934	12951	11283	12400
Income Tax	4890	5148	5541	3363	4234	2581	449	5642	2619	731

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets (\$B)	113.45	116.43	119.21	126.22	117.27	110.50	117.47	125.36	123.38	152.19
Cash & Equivalents	10661	11922	10412	10716	8476	7686	7826	11972	11379	8172
Acc. Receivable	11968	11179	10667	10465	9090	8333	9182	8928	7432	7870
Inventories	2450	2595	2287	2310	2103	1551	1553	1583	1682	1619
Goodwill & Int.	28624	29607	33034	35055	33659	35507	40888	40529	39353	73456
Total Liab. (\$B)	90.28	96.20	100.23	103.29	105.26	96.07	99.08	107.63	106.45	131.20
Accounts Payable	7804	8517	7952	7461	6864	6028	6209	6451	6558	4896
Long-Term Debt	28624	31322	33270	39719	40722	39889	42168	46823	45812	62899
Total Equity	23046	20138	18860	22792	11868	14262	18246	17594	16796	20841
D/E Ratio	1.24	1.56	1.76	1.74	3.43	2.80	2.31	2.66	2.73	3.02

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	13.3%	13.8%	14.1%	13.4%	9.9%	11.6%	10.4%	4.7%	7.0%	6.8%
Return on Equity	64.9%	73.4%	85.2%	79.1%	69.4%	101.1%	73.0%	32.1%	50.8%	50.1%
ROIC	29.5%	30.7%	32.0%	28.7%	20.8%	24.6%	20.7%	9.2%	13.7%	12.9%
Shares Out.	1228	1163	1117	1054	990	965	946	922	892	892
Revenue/Share	77.58	88.09	89.03	89.18	91.87	83.18	83.36	84.43	86.86	86.41
FCF/Share	11.49	12.51	12.87	12.10	12.56	13.33	13.49	13.82	12.31	13.89

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

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