

# International Business Machines Corp. (IBM)

Updated October 27<sup>th</sup>, 2020 by Prakash Kolli

## Key Metrics

<b>Current Price:</b>	\$111	<b>5 Year CAGR Estimate:</b>	10.4%	<b>Market Cap:</b>	\$99.94B
<b>Fair Value Price:</b>	\$120	<b>5 Year Growth Estimate:</b>	4.0%	<b>Ex-Dividend Date:</b>	08/07/20
<b>% Fair Value:</b>	93%	<b>5 Year Valuation Multiple Estimate:</b>	1.5%	<b>Dividend Payment Date:</b>	09/10/20
<b>Dividend Yield:</b>	5.9%	<b>5 Year Price Target</b>	\$146	<b>Years Of Dividend Growth:</b>	25
<b>Dividend Risk Score:</b>	B	<b>Retirement Suitability Score:</b>	A	<b>Last Dividend Increase:</b>	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 Q3 2020 results on October 19<sup>th</sup>, 2020. For the quarter, companywide revenue decreased (2.6%) to \$17,560M from \$18,028M while diluted adjusted earnings per share declined (4%) to \$2.58 from \$2.68 on a year-over-year basis. Diluted GAAP earnings per share increased 1% to \$1.89 in the quarter from \$1.87 in the prior year. IBM's focus on hybrid cloud is increasing gross margins, which are up 160 bps from the prior year.

Revenue for Cloud & Cognitive Software increased 6% to \$5,553M from \$5,201M in comparable quarters due to growth in Cloud & Data but offset by Transaction Processing and flat Cognitive Applications. Growth is being driven by the Red Hat acquisition and hybrid cloud. Global Business Revenue declined (6%) \$3,965M from \$4,160M due to decreases in Consulting, Application Management, and Global Process Services. Revenue for Global Technology Services declined (4%) to \$6,462M from \$6,700M due to declines in Infrastructure & Cloud Services and Technology Support Services. Revenue for Systems fell (16%) to \$1,257M from \$1,481M due to lower Systems Hardware and Operating Systems Software. After several quarters of declines, services signing increased by 5% and the backlog ticked up to \$108B. The company provided no 2020 guidance due to the COVID-19 pandemic.

IBM is now led by a new, CEO Arvind Krishna, who is rapidly putting his stamp on IBM. IBM is splitting into two companies a new IBM with ~\$59B in revenue and a New Company with ~\$19B in revenue. The new IBM will be a Hybrid Cloud and AI company focused on software. The New Company will focus on Managed Infrastructure Services.

## Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
<b>EPS</b>	\$11.52	\$13.06	\$14.37	\$14.94	\$15.59	\$13.60	\$12.39	\$13.66	\$13.81	\$12.81	<b>\$10.89</b>	<b>\$13.25</b>
<b>DPS</b>	\$2.50	\$2.90	\$3.30	\$3.70	\$4.25	\$5.00	\$5.50	\$5.90	\$6.21	\$6.43	<b>\$6.52</b>	<b>\$7.93</b>
<b>Shares<sup>1</sup></b>	1228	1163	1117	1054	990	965	946	922	892	892	<b>889</b>	<b>820</b>

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 IBM's late entry to 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. We have lowered our earnings forecast for 2020 and dividend growth rate to 4% to account for COVID-19 headwinds. The impending spin off will affect future earnings and dividend growth estimates. 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.

<sup>1</sup> Share count in millions.

Disclosure: This analyst is long IBM

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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	10.2	11.0
Avg. Yld.	1.9%	1.7%	1.7%	1.9%	2.3%	3.2%	3.7%	3.7%	5.8%	4.5%	5.9%	5.4%

Due to the difficult operating environment for IBM resulting from COVID-19, we have lowered our earnings estimate to \$10.89 per share. This now gives a fair value estimate of \$120 using our fair value multiple for the long haul of 11.0. Our five-year price target is now \$146 share. The current yield is well above the market average.

## 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%	60%	60%

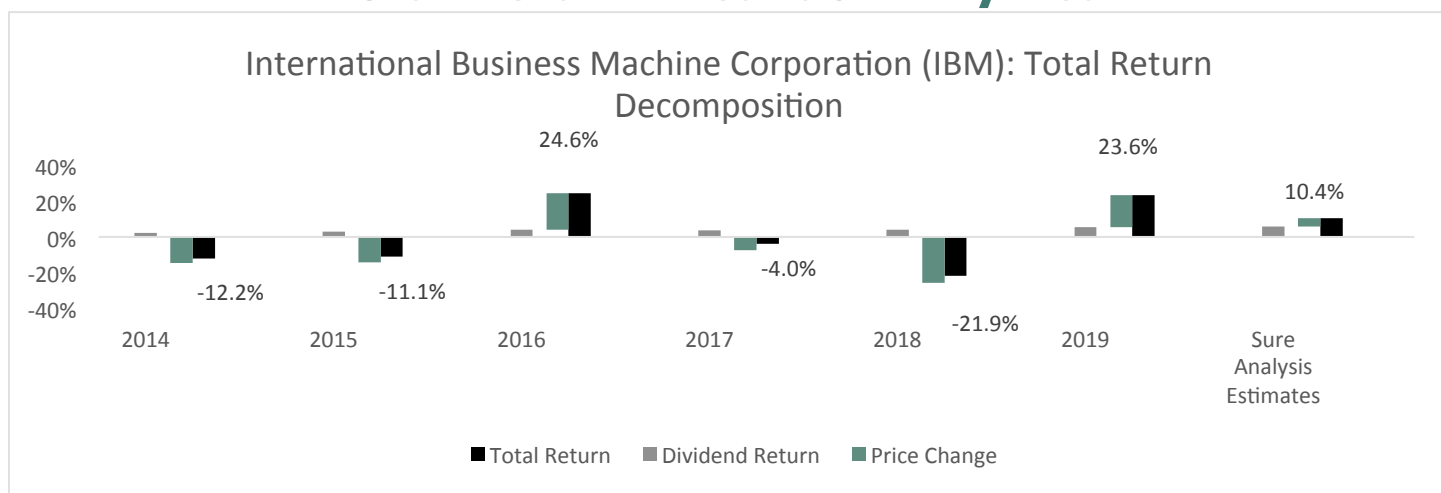
IBM's competitive strength is its brand, entrenched customer relations and extensive patent portfolio. IBM is also the market leader in mainframe computers where it has little competition. IBM is a surprisingly recession-resistant company since the company has long-term service and maintenance contracts 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 \$44.5B but is offset by \$15.8B in cash, equivalents, and securities. The latter is used by the Global Financing segment and is \$20.9B but it is decreasing due to winding down of OEM financing.

## Final Thoughts & Recommendation

At present we are forecasting a 10.4% annualized total return for the next five years. The new CEO is moving aggressively to change IBM's organizational structure. IBM's spin off should make it more focused on growth and software. The companies cloud segment and hybrid cloud efforts have momentum. The legacy businesses are slowly declining. The total dividend will at least be the same as the current one but split between the two companies. IBM is in transition and new investors may want to wait for more clarity. 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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