BEHIND THE NUMBERS
Quality of Earnings Analysis

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

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International Business Machines Corp (IBM)
Earnings Quality Update

We are maintaining our earnings quality rating of IBM at 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

IBM's adjusted EPS of $2.31 beat forecasts by 2 cents. As is always the case, IBM slow-rolls its SEC filings so we will need to write a second IBM update after the 10-Q shows up. Given the number of gimmicks and earnings levers that IBM routinely pulls, we're not impressed with a 2-cent beat:

- Depreciation/Amortization fell by $435 million y/y. Much of that is having Kyndryl in 2Q21 but not 2Q22. Adjusted earnings add back amortization. Looking at KD's depreciation from 1Q22, we estimate that IBM's depreciation fell by about $72 million. That likely is what happened in 2Q22 too and added about 7 cents to EPS. We will tighten that up when we can see the 10-Q reports.

- The tax rate of 16.4% looks below the low range of guidance for mid-high teens. 60bp of lower tax rate would add 1.7 cents to EPS – there's the whole beat.

- It is interesting that R&D was essentially flat on higher sales. It declined 77 bps as a percentage of sales, which would have added as much as 11 cents to EPS. That likely overstates the issue a bit – every 10bp is about 1.5 cents and we could see that IBM picked up 3 cents here. What is worth pointing out here is while flat R&D helped margins – IBM saw gross margin decline at every operating unit. There is clearly some cost pressure here, just not in R&D?

- Other (income) expense is where IBM records some pension expenses, gains/losses on investments and hedges, and gains/losses on retiring debt early. It backs out the pension items and the mark-downs of its Kyndryl investment for adjusted earnings. The y/y change here was $418 million of income vs. $16 million of income. We cannot see fully what this is yet, but this was worth 37 cents of adjusted EPS or more than half the total EPS gain. If IBM picked up a couple of pennies of low-quality EPS in this area - it would not surprise us.

- Adjusted SG&A only rose by $21 million y/y so it was also basically flat. We know this is where the recurring workforce rebalancing charges are located. IBM had its last easy comp as 2Q21 was a $95 million expense. We expect to find that IBM generated about 2-6 cents from having this decline y/y. For 3Q21 the charge was $0 and for 4Q21 it was a $60 million credit so the comps get much tougher. IBM has also been cutting advertising to help EPS and we will check that when the 10-Q is available.

- IBM cut its forecast for Free Cash Flow to $10 billion for the year. The market hated that. We would add that IBM continues to make acquisitions to help its growth and R&D and it does not consider that in Free Cash Flow. We would note that the $3.3 billion of free cash flow through 6 months, excludes acquisitions that would make it $2.4 billion. IBM has also seen a sizeable drop in financing receivables in 2Q that added $1.3 billion.

- Kyndryl is forecasting negative sales growth – but IBM continues to see considerable sales coming from that area:

    - Software sales up 6%, 11.6% without FX hits, but 7% was from KD. This is the largest division at 41% of sales, with the highest margin – generating 59% of gross profit. It sure looks like KD is the bulk of the growth here. Within Software, transaction processing was up 12%, 19% without FX hits, but 22% was from KD.

    - Infrastructure looks better with sales up 19%, 25.4% without FX, with only 7% from KD. But, the roll-out of the new Z-cycle within infrastructure's zSystems drove that unit up 69%, up 77% with no currency and no mention of KD. That really helped juice the full unit's sales and IBM had a VERY easy comp on zSystem sales which were down 13% in 2Q21. IBM should have a VERY easy comp for zSystem in 3Q22 as 3Q21 saw zSystems down 33% and 3Q20 down 16%. IBM toned down expectations a bit for 3Q22 zSystem sales growth though.

    - KD isn't mentioned in the zSystem area, but that strong growth is diluting down the KD impact. If we look at Infrastructure support, IBM said growth was -2% or up 5%

without FX but KD was 8% of the gain. We think this along with the software sales shows that KD is having an outsized impact on growth here.

- We also want to point out that IBM's guidance for 3Q22 is for 60% of the annual profit hit in 3Q and 4Q. It expects to see a 200bp increase in pretax margin y/y for 3Q. We still see IBM having headwinds after boosting its forecast to a -8% hit from FX, from tough comps to overcome on workforce rebalancing and advertising in SG&A, and that its gross margin is down almost 200bp so far this year. Other (income)/expense may become a big factor again in 3Q results.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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