

Neutral

January 21, 2015

International Business Machines Corp (IBM)

4Q14 & FY14 Top-Line Misses Estimates

IBM reported falling revenues and income in FY14 with its profitability and earnings growth under threat over the last few quarters. The dollar appreciation by ~17% in last 6 months along with recent divestment of a few business segments has negatively impacted its topline growth. In addition, IBM has greatly accelerated buyback of its shares in an attempt to prop up its falling EPS, despite the fact that free cash flow has been falling steadily over the years (\$12.4 bn in FY14 from \$15.0 bn in FY13). Net Gearing ratio accelerated from 1.3 in FY13 to FY14, which is high by industry standards, adding to the Company's risk. We maintain a "Neutral" view as execution remain inconsistent for past few quarters and expect it to trade at a target price of \$160/share, based on ~9.3x our 2015 EPS estimate.

IBM US

Current Price: \$157

(20/01/15)

Target Price: \$160

MARKET DATA

Price (closing 20/01/15)	157.0
Diluted shares (in M)	989.7
Market cap (\$ in B)	155.3
Net Debt (\$ in B)	32.3
EV (\$ in B)	187.7
Exchange	NYSE
Industry	Technology Services
ISIN	US4592001014
Bloomberg	IBM:US
Reuters	IBM.N

\$ in B	2012	2013	2014	2015e
SALES	104.5	99.8	92.8	88.5
%growth	(2.3%)	(4.6%)	(7.0%)	(5.0%)
Adj. EBITDA	26.4	25.3	23.4	23.4
%margin	25.2%	25.4%	25.3%	26.4%
Adj. PAT	17.6	18.0	16.7	16.6
%margin	16.9%	18.0%	18.0%	18.7%

4Q14 & FY14 Highlights:

- Total revenues for 4Q14 down 12% y/y (down 2% y/y CC) to \$24.1 bn. For FY14, total revenue declined 7.0% y/y (declined 1% y/y CC) to \$92.8 bn;
- Non-GAAP net income from continuing operations in 4Q14 down 13% y/y to \$5.8 bn; Non-GAAP diluted earnings stood at \$5.87/sh (4Q13: \$6.27/sh);
- For FY14, net income from continuing operations decreased 7% y/y to \$15.8 bn. Non-GAAP net income declined 9% y/y to \$16.7 bn;
- For FY14, Non-GAAP diluted earnings stood at \$16.57/sh (FY13: \$16.3/sh);
- Strategic imperatives grew 16% y/y to \$25 bn, and now represent 27% of total revenue; Total Cloud revenue stood at \$7 bn, up 60% y/y;
- Revenues in the BRIC countries declined 8% y/y CC. Revenue from its major markets and growth markets declined 2% y/y CC;
- During FY14, it repurchased shares worth \$13.7 bn (FY13: \$13.9 bn).

MANAGEMENT

Chairman, President & CEO	Virginia M. Rometty
VP & Treasurer	Simon J. Beaumont

SHAREHOLDINGS

Top 10 Institutions	(%)
Berkshire Hathaway, Inc. (Invst Mgmt)	7.1
The Vanguard Group, Inc.	5.4
SSGA Funds Management, Inc.	5.4
BlackRock Fund Advisors	3.5
State Farm Invst Mgmt Corp.	1.7
Northern Trust Invst, Inc.	1.4
Fidelity Mgmt & Research Co.	1.3
Norges Bank Invst Mgmt	0.8
Massachusetts Financial Services Co.	0.7
Geode Capital Mgmt LLC	0.7
Total	28.0

Source: markets.ft.com

4Q14 & FY14 Earnings Snapshot

PARTICULARS (\$ in M)	1Q14	2Q14	3Q14	4Q14	FY13	FY14
Total Revenue	22,484.0	24,364.0	22,397.0	24,113.0	99,751.0	92,793.0
Y-o-Y growth %	-3.9%	-2.2%	-4.0%	-12.9%	-4.6%	-7.0%
Gross Profit	10,543.0	11,975.0	10,874.0	12,862.0	48,505.0	46,407.0
Margin %	46.9%	49.2%	48.6%	53.3%	48.6%	50.0%
EBITDA	3,894.0	6,081.0	5,378.0	6,508.0	24,994.0	22,290.0
Margin %	17.3%	25.0%	24.0%	27.0%	25.1%	24.0%
Operating Income	2,753.0	4,915.0	4,239.0	5,508.0	18,777.0	17,790.0
Margin %	12.2%	20.2%	18.9%	22.8%	18.8%	19.2%
Earnings from Cont. Ops.	2,384.0	4,137.0	3,455.0	5,160.0	16,483.0	15,751.0
Margin %	10.6%	17.0%	15.4%	22.9%	16.5%	17.0%
Diluted EPS Excl. Extra Items	2.3	4.1	3.5	5.5	14.9	15.6
Y-o-Y growth %	-15.2%	41.6%	-8.2%	-9.5%	4.0%	4.4%

Source: Company reports

BULLS

- IBM growth initiatives, including its Big Data & business analytics, cloud computing, mobile and social business are expected to drive growth.
- Divestments may lead to better operating leverage.
- In 2014, IBM patented more than 7,534 innovations that will position the company to lead in strategic areas such as cloud computing, analytics, mobile, social and securities.

Disappointing Year Ahead (Historical Stock Price and Estimates)



BEARS

- *Cloud computing sales and persistent softness in traditional software.*
- *SaaS transition less disruptive than expected.*
- *FX losses may be high due to double digit rise in dollar currency value in 6 months time.*
- *Free cash flow and operating income are falling but company is targeting larger buybacks much above the FCF levels.*
- *Management Investing heavily in the cloud with high priced acquisition but the cloud business is just the 5% of the total IBM's business portfolio. Its effort is minimal on the larger business.*

VALUATIONS & RISKS

Our fair value for IBM is \$160 based on 9.3x our non-GAAP FY15 EPS estimate. Our P/E multiple is at the low end of the 9x to 15x forward earnings multiple range and in line with the company's 5-year 12-month forward P/E average. Risk in attaining the target price includes possibility of weakened demand for IT services, enterprise software, and enterprise hardware

COMPANY DESCRIPTION

IBM is the largest Information Technology (IT) and consulting services company in the world. IBM's business can be divided into four major business segments: IBM Global Services (59% of revenue), Software (22%), Systems and Technology (17%), and Global Financing (2%). IBM Global Services is divided into two divisions, Global Business Services (GBS) and Global Technology Services (GTS). IBM services six verticals: Financial Services (28% of revenue), General Business (19%), Public (16%), Industrial (11%), Communications (10%), and Distribution (10%). Across geographies, the Americas is the largest region (43% of revenue), followed by EMEA (32%) and Asia Pacific (24%). IBM has approximately 400,000 employees worldwide; 190,000 of which are within Global Services located in over 160 countries.

Income Statement

PARTICULARS (\$ in M)	FY11	FY12	FY13	FY14	FY15e
TOTAL REVENUES	106,916.0	104,507.0	99,751.0	92,793.0	88,560.7
<i>y/y growth</i>		(2.3%)	(4.6%)	(7.0%)	(5.0%)
COST OF REVENUE	56,778.0	54,209.0	51,246.0	46,386.0	43,653.7
Adj. Gross Profit	50,481.0	50,938.0	49,528.0	46,996.0	44,907.0
Reported Gross Profit	50,138.0	50,298.0	48,505.0	46,407.0	44,907.0
Operating Expenses					
Selling, General & Administrative Expenses	23,272.0	22,910.0	22,732.0	22,538.0	20,293.4
Research & Development Expenses, Net	6,346.0	6,322.0	5,169.0	5,514.0	5,330.2
Total Operating Expense	29,618.0	29,232.0	28,901.0	28,052.0	25,623.5
Adj. Operating Income	20,863.0	21,706.0	20,627.0	18,944.0	19,283.5
<i>As a % of Sales</i>	<i>19.5%</i>	<i>20.8%</i>	<i>20.7%</i>	<i>20.4%</i>	<i>21.8%</i>
<i>y/y growth</i>		4.0%	(5.4%)	(12.3%)	(1.5%)
Reported Operating Income	20,416.0	20,443.0	19,777.0	17,790.0	19,283.5
D&A	4,815.0	4,676.0	4,678.0	4,590.0	4,120.2
Adj. EBITDA	25,678.0	26,382.0	25,305.0	23,444.0	23,403.7
<i>As a % of Sales</i>	<i>24.0%</i>	<i>25.2%</i>	<i>25.4%</i>	<i>25.3%</i>	<i>26.4%</i>
<i>y/y growth</i>		2.7%	(4.1%)	(7.4%)	(2.3%)
Reported EBITDA	25,131.0	24,992.0	24,994.0	22,290.0	23,403.7
Intellectual Property & Custom Development Income	1,108.0	1,074.0	822.0	742.0	805.6
Interest (Income)/Expense, Net	411.0	459.0	402.0	384.0	415.6
Other Income/(Loss)	45.0	856.0	343.0	3,939.0	422.5
Adj. PBT	21,605.0	23,177.0	21,990.0	21,141.0	20,096.0
<i>As a % of Sales</i>	<i>20.2%</i>	<i>22.2%</i>	<i>21.9%</i>	<i>22.8%</i>	<i>22.7%</i>
<i>y/y growth</i>		7.3%	(7.7%)	(9.2%)	(1.4%)
Reported PBT	21,033.0	21,901.0	19,324.0	19,986.0	20,096.0
Income Tax Exp (benefit)	5,287.0	5,552.0	3,431.0	4,440.0	3,543.1
Adj. Net Profit from Continuing Operations	16,318.0	17,625.0	17,959.0	16,701.0	16,552.8
<i>As a % of Sales</i>	<i>15.3%</i>	<i>16.9%</i>	<i>18.0%</i>	<i>18.0%</i>	<i>18.7%</i>
<i>y/y growth</i>		8.0%	1.9%	(7.0%)	(0.2%)
Reported Net Income from Continuing Operations	15,855.0	16,603.0	16,483.0	15,751.0	16,552.8

Source: Company Reports and IFS Research

Balance Sheet

PARTICULARS (\$ in M)	FY11	FY12	FY13	FY14
Assets				
Current assets:				
Cash & Cash Equivalents	11,922.0	10,412.0	10,716.0	8,476.0
Marketable Securities		717.0	350.0	0.0
Accounts Receivables, Net	11,179.0	10,667.0	10,465.0	9,090.0
Short-Term Financing Receivable	16,901.0	18,038.0	19,787.0	19,835.0
Other Accounts Receivables	1,481.0	1,873.0	1,584.0	2,906.0
Inventories, Net	2,595.0	2,287.0	2,310.0	2,103.0
Prepaid Expenses & Other Current Assets	5,249.0	4,024.0	4,488.0	4,967.0
Deferred Tax Assets	1,601.0	1,415.0	1,651.0	2,044.0
Total Current Assets	50,928.0	49,433.0	51,351.0	49,421.0
Non-current Assets:				
Long-Term Financing Receivables	10,776.0	12,812.0	12,755.0	11,109.0
Prop. Equipment & Software, Net	13,883.0	13,996.0	13,821.0	10,771.0
Prepaid Pension Assets	2,843.0	945.0	5,551.0	2,160.0
Intangible Assets, Net	5,392.0	3,787.0	3,871.0	3,104.0
Goodwill	26,213.0	29,247.0	31,184.0	30,556.0
Deferred taxes	3,503.0	3,973.0	3,051.0	4,808.0
Investment & Sundry Assets	4,895.0	5,021.0	4,639.0	5,603.0
Total Non-Current Assets	65,505.0	69,781.0	74,872.0	68,111.0
Total Assets	116,433.0	119,214.0	126,223.0	117,532.0
Liabilities & Shareholders' Equity				
Current Liabilities				
Short-Term Debt	8,463.0	9,181.0	6,862.0	5,731.0
Accounts Payables	8,517.0	7,952.0	7,461.0	6,864.0
Compensation & Benefits	5,099.0	4,745.0	3,893.0	4,031.0
Accrued Expenses & Other Current Liabilities	4,535.0	4,847.0	4,748.0	6,013.0
Deferred Income	12,197.0	11,952.0	12,557.0	11,877.0
Taxes	3,313.0	4,948.0	4,633.0	5,084.0
Total Current Liabilities	42,124.0	43,625.0	40,154.0	39,600.0
Non-Current Liabilities				
Long-term Debt	22,857.0	24,088.0	32,856.0	35,073.0
Retirement & Non-Pension post-Retirement Benefits Obligations	18,374.0	20,418.0	16,242.0	18,261.0
Deferred Income	3,847.0	4,491.0	4,108.0	3,691.0
Other Liabilities	8,996.0	7,607.0	9,934.0	8,892.0
Total Non-Current Liabilities	54,074.0	56,604.0	63,140.0	65,917.0
Total Liabilities	96,198.0	100,229.0	103,294.0	105,517.0
Shareholders' Equity				
Common Stock, par \$0.01	48,129.0	50,110.0	51,594.0	52,666.0
Treasury Stock	(110,963)	(123,131)	(137,242)	(150,715.0)
Retained Earnings	104,857.0	117,641.0	130,042.0	137,793.0
Accumulated Other Comprehensive Income	(21,885.0)	(25,759.0)	(21,602.0)	(27,875.0)
Total Shareholders' Equity	20,138.0	18,861.0	22,792.0	11,869.0
Non Controlling Interest	97.0	124.0	137.0	146.0
Total Liabilities & Shareholders' Equity	116,433.0	119,214.0	126,223.0	117,532.0

Source: Company reports and IFS Research

Ratios

PARTICULARS	FY11	FY12	FY13	FY14
Diluted Earnings Per Share (\$)	15.44	16.25	16.28	16.54
Book Value Per Share (\$)	16.67	16.43	20.79	11.90
Dividend Per Share (\$)	2.90	3.30	3.71	4.25
Payout (%)	22.2%	23.0%	24.8%	25.7%
LIQUIDITY RATIOS				
Debt/Equity Ratio (x)	1.55	1.75	1.73	3.40
Current Ratio (x)	1.2	1.1	1.3	1.2
TURNOVER RATIOS				
Debtors Turnover Ratio (x)	72.2	62.3	57.7	41.3
Debtors Day	5	6	6	9
Net Fixed Assets Turnover Ratio (x)	7.7	7.5	7.2	7.5
PROFITABILITY RATIOS				
EBIT Margin	19.5%	20.8%	20.7%	20.4%
EBITDA Margin	24.0%	25.7%	25.4%	25.3%
Return on Capital Employed	28.1%	29.0%	23.6%	23.1%
Return on Networth (RONW)	81.0%	93.4%	86.2%	96.4%
VALUATION RATIOS				
P/E (x)	12.9	12.0	11.7	9.5
P/BV (x)	10.4	11.2	8.9	13.2
EV/Sales (x)	2.1	2.2	2.3	2.1
EV/Adj. EBITDA (x)	8.9	8.9	9.1	8.2
Dividend Yield	1.68%	1.80%	2.02%	2.70%
CAPEX / D&A	0.6	0.7	0.6	0.8
CAPEX / Sales	2.8%	3.2%	2.7%	4.1%
No. of Shares Outstanding =	1,213.8	1,155.4	1,103.0	1,010.0
Year-end Adj. Closing Share Price (in \$) =	173.2	183.5	183.1	157.1
Add: Debt =	31,320.0	33,269.0	39,718.0	40,804.0
Minority Interest (\$ in M) =	97.0	124.0	137.0	146.0
Preferred Shares (\$ in M) =	-	-	-	0.0
Less: Cash & Cash Equivalents (\$ in M) =	11,922.0	10,412.0	10,716.0	8,476.0
Enterprise Value (\$ in M) =	229,707.5	234,948.2	231,128.1	191,185.4
DEBT RATIO ANALYSIS				
PAT/PBT	75.5%	76.0%	84.0%	79.0%
PBT/EBIT	103.6%	106.8%	103.7%	111.6%
EBIT/Revenue	19.5%	20.8%	20.7%	20.4%
Revenue/Total Assets	0.92	0.88	0.79	0.79
Total Asset/Total Equity	5.78	6.32	5.54	9.90
Return on Equity (RoE)	81.9%	93.4%	78.8%	140.7%

Source: Company reports, and IFS Research

Technical Analysis

Closing Price - \$157.1 (16 Jan 2015)



Source: IFS Research

AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS AVISE ANALYTICS

MOVING AVERAGES				Summary
EMA(20)	EMA(50)	EMA(100)	EMA(200)	Summary
158.07	161.78	168.28	175.46	SELL

MOMENTUM OSCILLATORS & INDICATORS				Summary
RSI(14)	% K Stoch	William %R(7)	MACD(12,26,9)	Summary
58.77	51.52	-48.38	133.3	NEUTRAL

VOLATILITY		VOLUME ANALYSIS	
ATR(14)	0.02	Current	5,753,100
		7-days Average	4,528,550
		14-days Average	4,567,386

SHORT TERM (7 DAYS) PIVOTABLE				
Classic	S1	S2	Pivot Point	R1
	150.47	155.81	157.07	160.41
Fibonacci Levels	152.99	154.55	157.07	159.59
				163.67
				161.15

Source: IFS Research