

International Business Machines (IBM)

International Business Machines Corporation (IBM) is an information technology company that provides integrated solutions that leverage information technology and knowledge of business processes. It operates through five business segments: Cloud & Cognitive Software, Global Business Services, Global Technology Services, Systems, and Global Financing. Cloud and Cognitive Software brings together IBM's software platforms and solutions, enabling it to deliver integrated and secure cloud, data and AI solutions to its clients. This segment includes all software except operating systems software reported in Systems. Global Business Services (GBS) provides clients with consulting, business process and application management services. These professional services deliver solutions which leverage industry, technology and business strategy and process expertise. GBS helps clients to build business platform strategies and experiences, transform processes to intelligent workflows using AI and other technologies and build hybrid, open cloud infrastructures. Global Technology Services (GTS) provides comprehensive IT infrastructures and platform services that create business value for clients. These include access to the IBM Cloud and a comprehensive set of hybrid cloud services and solutions as well as comprehensive support services for both IBM products and other technology platforms. Systems includes IBM's servers and storage systems as well as the IBM Z and other operating system software. Global Financing is made up of IBM Credit which finances IBM clients' acquisition of the company's technology systems, software and services, and the remanufacturing and remarketing of used equipment.

Thesis

We owned IBM in the recent past and sold it when the firm acquired Red Hat. While it was an interesting acquisition, we thought it muddied the firm's strategy that had emphasized Watson (AI). We also were unsure how well Red Hat would be integrated into the larger firm as well as IBM's rather high expectations for the new acquisition's immediate contribution to its growth prospects. A little less than one and a half years later we think that it makes sense to revisit the stock.

The company is under new leadership. Arvind Krishna was IBM's Sr. VP for Cloud and Cognitive Software before his promotion to CEO in April 2020. He has been with the company since 1990. His stated objective is to grow the value of the company primarily by better aligning its portfolio around hybrid cloud and AI to meet the evolving needs of their clients. He also has taken a more proactive approach to communicating with the investment community and expects to regularly attend quarterly conference calls.

Hybrid cloud will become the Fourth platform at IBM (we do not consider Global Financing a platform). Hybrid cloud is a platform for applications and infrastructure built on two or more components from public cloud, private cloud, and on-premises IT. The company believes that the combination of IBM and Red Hat has the opportunity to "win the architectural battle for the cloud". This is a result of IBM's leadership in open source and security and its ability to build mission-critical applications that can be run anywhere. The firm believes that it is establishing Linux, containers and Kubernetes as the new standard architecture for the cloud. IBM appears to be well-positioned to help its current clients, many of them large companies, and others to migrate to the cloud using its hybrid strategy. The company believes its ability to build and manage a hybrid cloud platform opens a nearly \$600 Billion business opportunity.

We expect that IBM's revenues, earnings, cash flow, and stock price (like most companies) will remain under pressure as the economic and business impacts from the ongoing Covid-19 pandemic unfold. We also expect that IBM should be able to weather the storm with its dividend intact. While patience will be required, we believe that the combination of new leadership and a focus on corporate transitions to hybrid clouds supplemented by Watson (AI) should be positive long-term catalysts for the company.

One potential shorter-term catalyst is the possibility of an accelerated transition to hybrid cloud by large corporations due to the Covid-19 pandemic. Companies discovered that employees could work effectively offsite. If larger companies determine that a decentralization of the workforce can help with employee efficiency, recruitment and retention, it could encourage a more acceptance of a hybrid cloud-based IT structure.

Positives

Red Hat integration appears to be going well. Red Hat provides IBM with a strong set of software products that can be used to create private, hybrid or multi-cloud infrastructure using its Open Shift platform. IBM has begun to leverage its long-term relationships with its clients to grow Red Hat revenues.

Jim Whitehurst, Red Hat's former President and CEO, was recently appointed President of IBM. He is responsible for the IBM Cloud and Cognitive Software organization as well as Corporate Strategy. This should be a positive for the ongoing integration and growth of Red Hat. An interesting note is there has not been a President of IBM for several years. Whitehurst's promotion could put him in line to eventually succeed Mr. Krishna.

Approximately 60% of IBM's revenue is recurring services and the firm is focused on increasing this proportion. The ability to grow recurring revenue faster than the deterioration of the transaction-oriented business will be key to the company's future growth.

The new CEO is committed to maintaining and growing IBM's dividend. The company raised its dividend by one cent on April 28th. While the increase was not significant, it did send a positive signal about the company's approach to its dividend.

The company generates significant cashflow. Even if the global response to the Covid-19 pandemic results in a meaningful reduction in revenues, the company should be able to cover both its dividend and capex programs. The critical nature of IBM's technology and a client list studded with Fortune 500 companies should help it navigate through the current downturn. Cash flow after dividends and capex is expected to be used to pay down debt in order to maintain its mid-to-high A credit rating.

IBM has a robust Research and Development operation. As of the end of 2019, IBM was awarded more US patents than any other company for the 27th consecutive year. It was awarded 9,262 patents, including more than 4,500 relate to artificial intelligence, cloud, cyber security and quantum computing.

Quantum computing is an interesting wildcard. IBM is one of the leaders in Quantum computing development and is focused on both developing faster computers and making them economically viable. This is an interesting long-term project.

Risks

IBM significantly increased its debt load with the acquisition of Red Hat in 2019. This adds additional risk to the company as well as additional demands on the company's cash flow. While the debt appears to be manageable, a weaker economic environment with its accompanying pressure on sales will make it more difficult for the company to continue to reduce it.

Covid-19 has had a negative impact on transactional revenues with companies putting off purchase decisions until they can determine the virus's impact. While IBM's ability to help its clients to quickly configure their IT to support a

significantly larger stay-at-home workforce is a positive, the delay of longer-term decisions will pressure revenues as Covid-19's ongoing impact on the economy evolves.

IBM has been unable to consistently generate top line growth for several years. If the company is unable to grow recurring revenue faster than its mature transactional revenue deteriorates, it will continue to experience uneven revenue, earnings and cash flow growth. Legacy software remained under pressure during Q1 2020, with Cloud & Cognitive software declining about 8% ex Red Hat and Global Technology Services revenues declining about 4% despite easing comps. This weakness probably will continue as companies slow, defer, or cancel projects to conserve cash.

IBM's financing arm currently owns over \$19 billion in loans and leases used to purchase or lease IBM products. Approximately 67% of the clients have an investment grade credit rating when credit risk transfer transactions are included. A long period of poor economic performance could result in a higher default rate that would negatively impact IBM's profitability.

Uncertainty surrounding Covid-19, the economy and the consumer continues to encourage business managements to conserve cash and delay purchases. This could negatively impact IBM's ability to grow/stabilize transactional businesses such as consulting, outsourcing, systems sales, and software installations.

Valuation

Standard valuation metrics are difficult to use in the current environment. Sales and earnings estimates for most companies are guesses that generally reflect a terrible Q2 2020 and some recovery in the latter half of the year. In IBM's case, consensus estimates show a year-over-year sales decline of -5.6% and a year-over-year earnings decline of -13.6%. If these materialize, shares of IBM are attractively valued versus its five-year averages on a last-twelve-month P/E (11.8) and P/S (1.4) basis at their current level. Since the accuracy of consensus estimates is much more suspect than those produced during more "normal" periods, these metrics have limited value. However, using more stable valuation metrics such as dividend yield and Price/Book also imply that the stock is trading at an attractive price.

Conclusion

IBM has been a stock that has underdelivered for investors over the past decade. We believe that a confluence of events could change this lackluster record. A new CEO focused on AI and the hybrid cloud, the acquisition of Red Hat and a hybrid cloud strategy that seems an ideal fit for IBM's client base particularly as businesses evaluate a more decentralized work environment in the era of Covid-19 finally could return the company to consistent growth. While the current economic environment probably will slow major technology investments, IBM's dividend yield in excess of 5% supported by solid cash flows provides a relevant reward for investors as they wait for the eventual economic recovery. We think it makes sense to initiate a position in the portfolio at this time.

Note:

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