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Wag the dog

International Business Machines Corp. didn't upstage the Red Sox, but its Sunday bid to acquire operating-system provider Red Hat, Inc. for $190 a share, 63% above the Friday close, for $34 billion in cash, could make history. If consummated (corporate nuptials are slated for late next year), it would be the largest-ever cash-only M&A transaction in high tech.

It would likewise constitute a milestone in the credit cycle and in the long-term decline of the once-triple-A-rated centenarian from Armonk, N.Y. Ginni Rometty, IBM's chairman, president and CEO, pledged that the deal will lead to accelerating revenue growth and to expanding gross margins and free cash flow to "support a solid and growing dividend." A growing dividend and falling share price combine to deliver a dividend yield of 5.35%.

The press release skirted the balance sheet. If IBM borrowed the entire purchase price rather than spending some of its ample $11.7 billion cash hoard, debt to adjusted earnings before interest, tax, depreciation and amortization would jump to 3.2 from 1.5 times at the end of the third quarter. At that, the calculation excludes $30 billion of debt at IBM Credit LLC, the captive financing unit as well as the hypothetical extra debt that IBM could wind up incurring if the Red Hat purchase price goes up. Bondholders blinked at the news, and we urge them to blink again.

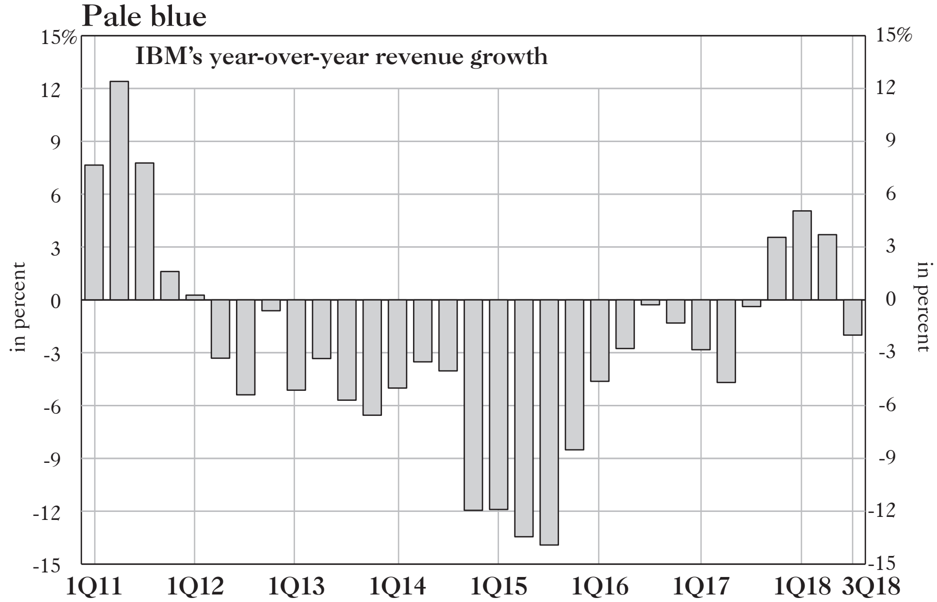
"A June 15 analysis in these pages advised the stockholders to sell," relates colleague Fabiano Santin. "Although the shares of IBM have since fallen by 16.4% thanks to poor operating results, bondholders have continued to perceive Big Blue as a relatively good credit thanks to the company's long-dated bonds, which have offered a roughly 100 basis-point premium to Treasurys (granted, that's not much more than what the long-duration bonds from higher-rated tech leaders Amazon.com, Inc. and Apple, Inc. yield). Perhaps this week will mark a salutary change in perception."

Sunday's news prompted S&P to cut IBM's rating by one notch, to single-A with a negative outlook. Moody's placed the A1 rating (a single-A-plus equivalent) under surveillance for downgrade. Is IBM therefore poised to swell the hosts of the triple-Bs (*Grant's*, Oct. 20, 2017)? For now, Big Blue vows to maintain a "strong" investment-grade credit rating on its soon-to-be $80 billion debt pile, aiming for a leverage profile "consistent [with a] mid to high single-A credit rating," the release said. Share buybacks will be suspended in 2020 and 2021, although nothing was said about 2018 and 2019. That is, until Tuesday morning, when the directors authorized another $4 billion of repurchases.

Buying back shares is one way to neutralize underwhelming business performance. In a related strategem, IBM has been issuing short-dated notes, which typically carry a lower interest cost than long-dated bonds. Barring a decision to divert cash flows to pay down maturing debt, the company must continuously tap the debt markets, possibly at rising rates: An average of nearly $6 billion comes due between 2019 and 2021.

Third-quarter operating results, with an attendant earnings miss (ex-

Pale blue

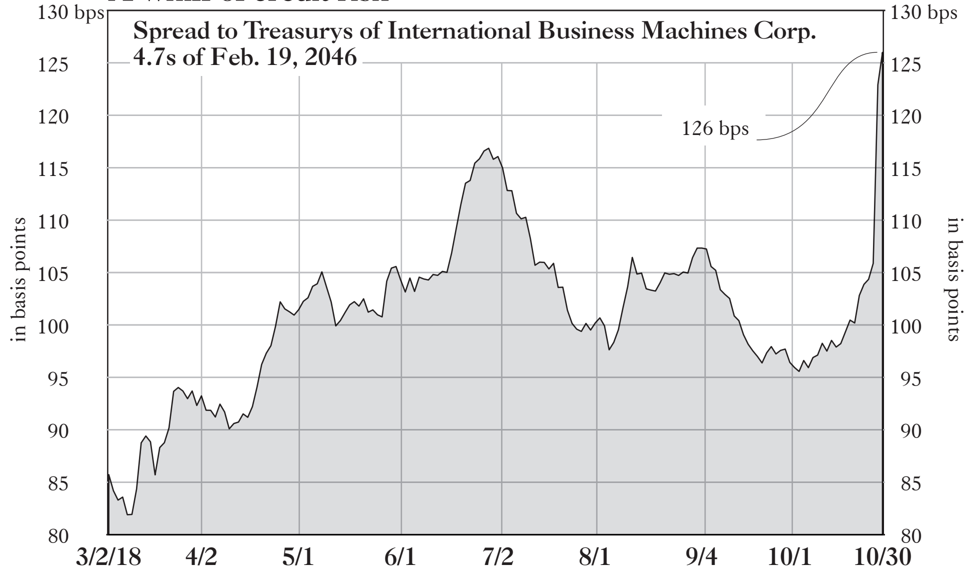


source: The Bloomberg

cluding an extraordinary tax benefit), have laid a heavy weight on the IBM share price. The company disappointed on weaker-than-expected software revenue growth, which fell by 3% on a constant currency basis, and on service signings, which dropped by 23% after growing by 6% in the June quarter. IBM's oft-praised free cash flow runs at a $12 billion annual rate, but may or may not prove sustainable, Toni Sacconaghi, the Bernstein Research analyst who rates IBM "market-perform," commented on Oct. 17: "[W]e increasingly worry about the quality of IBM's free cash flow, which includes benefits from receivables factoring, Treasury securities contributions to its pension/retirement plans, elevated [non-recurring] IP income and tax."

Red Hat may, indeed, turn out to be a "terrific" acquisition, to quote Lisa Ellis, partner and senior equity analyst at MoffettNathanson LLC, though it will make no great contribution to IBM's results, even under "generous revenue synergy" assumptions. Yes, Red Hat's sales spurted by 20% in the past 12 months, but IBM is a huge business. The smaller business's contribution to the larger one promises to boost growth in operating profit by 4.2% rather than by the 3.3% that Ellis was expecting before the acquisition news.

A whiff of credit risk



source: The Bloomberg

"On Monday," Santin relates, "the spread to Treasurys on the 4.7s of 2046 widened by 15 basis points to 126 basis points; the bonds fell to 101¾ from 104 last week and now yield 4.6%. If the bonds were to drop into triple-B territory, and if triple-B spreads widened to 200 basis points (a not-uncommon occurrence) from 147 basis points currently, bondholders would stand to lose 10.5%, or 2.2 years of coupon income."

A cogent analysis by David Novosel of Gimme Credit on Tuesday bore the concise, unimprovable headline, "IBM Bonds: Sell."

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