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Fountain of youth

International Business Machines Corp. has paid a dividend for 102 consecutive years. It has earned more U.S. patents than any other company, worldwide, for 25 consecutive years. Just the other day, the Armonk, N.Y.-headquartered centenarian disclosed that it's built the world's fastest supercomputer. To what does Big Blue owe these feats of productive longevity? In assigning the causes (for there must be many), we do not underestimate the life-extending force of ultra-low interest rates.

IBM is the subject at hand, and *Grant's* is—has long been—bearish on it. Every now and then, we return to the story to test old premises against new facts. Our latest revisit complete, we judge the stock and the bonds alike to be overpriced and the business prospects dim. Optically, IBM is a technology business. Substantively, it is more and more becoming a financial business. (For the origins of this transformation, see the [issue dated March 30, 2001](#).)

IBM came into the world in 1911, three years before the Federal Reserve opened its doors. Few could have predicted how the paths of the two spanking-new institutions would eventually cross.

Now it's plain enough. To compensate for weak business results, IBM deploys leveraged financial stratagems. The company that Thomas J. Watson built issued no public debt until, in 1979, it presented itself to the bond market. Its 9³/₈s of 2004 were priced right on top of the Treasury curve. Rated triple-A, Big Blue was a byword for corporate solidity and its bonds were museum pieces.

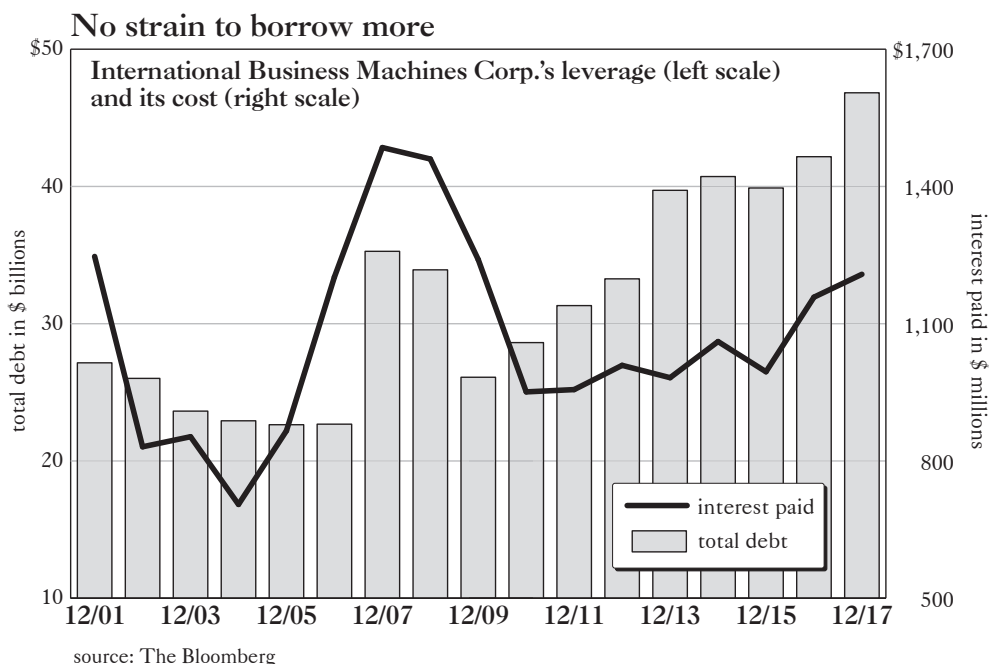
Thirty-nine years and a succession of downgrades later, IBM has accumulated

\$46.4 billion of borrowings, excluding pension liabilities. On these A1/single-A-plus-rated debts the company pays an average interest cost of 2.9%. Notice, in the graph on the following page, how much faster debt has risen than the cost of debt service. Holders of the 4s of 2042 (of which \$1.1 billion is outstanding), offered at 99 cents on the dollar, earn 4.07% to maturity, or 98 basis points over Treasuries. IBM's common shares yield 4.3%, whatever that might say about the market's confidence in the sustainability of the earnings from which that hefty yield derives.

No more is IBM paper prized for its scarcity. Still, it retains something of the glamour of the era in which white shirts and dark suits were the corporate

uniform. The glamour comes at a price to the investor. "Comparable spreads," observes colleague Fabiano Santin, "can be obtained by higher-quality, lower-levered companies such as triple-A-rated Microsoft (the 3¹/₂s of 2042 that pay 82 basis points over Treasuries), double-A-plus-rated Apple, Inc., (the 3.85s of 2043 that pay 96 basis points over) or double-A-minus-rated Amazon.com, Inc. (the 4.95s of 2044 that deliver a spread of 102 basis points over). The first two hold more cash than debt on the balance sheet.

"If," Santin continues, "the IBM 4s of 2042 were to widen in yield by 100 basis points, bondholders would suffer a 14% drawdown, equivalent to 3¹/₂ years of coupon income. It reminds you



of the little perturbation in 2013, when the 30-year Treasury yield climbed to almost 4% from 2.5% and the long IBMs were offered at 86. Buy-and-hold investors may or may not deign to notice such interim flutters, but are they being fairly compensated for 24 years of waiting? At least the time frame is shorter for holders of the euro-denominated 1½s of 2029 (of which €1 billion are outstanding) that trade at par for a 1.5% yield to maturity, 90 basis points over bunds."

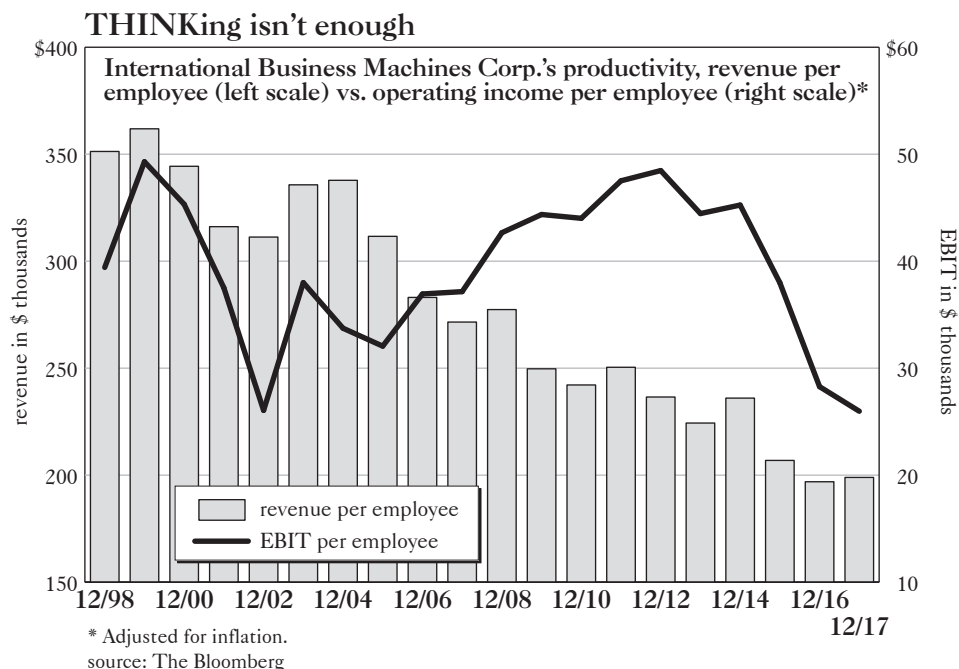
IBM's business is divided into five parts: Cognitive Solutions (\$18 billion in 2017 revenues), Global Business Services (\$16 billion), Technology Services & Cloud Platforms (\$34 billion), Systems (\$8 billion) and Global Financing (\$1.7 billion). Cognitive and Cloud, the segments with the highest margins, earned \$6.8 billion and \$4.3 billion, respectively, in pre-tax operating income in 2017, or 75% of \$15 billion total, before research and development expenses. Global Financing houses IBM Credit LLC, the parent's financial beating heart.

The essential bullish case on IBM is that its lucrative mainframe business will keep generating the funds with which to finance dividends and buybacks while the front office seeks the next big thing, say, in artificial intelligence or the blockchain. The bearish case is, obviously, that it won't.

IBM's loss of mainframe market share is not exactly front-page news—the 10-times forward price/earnings multiple on IBM common attests to the familiarity of the problem. Still, the lowest short interest on those shares in the past five years suggests that the bears may have walked away too soon. Unexceptional technology and rising leverage point to a lower share price and wider credit spreads.

The late Alex Porter, longtime hedge-fund investor, was wont to reflect that it was easy to sell IBM short. "But then, one day, you wake up thinking, 'Man, I'm short IBM.'" It used to be an uncomfortable feeling. The lasting legacy of corporate dominance still sustains the mainframe business. Loyal clients hesitate to expose bank accounts, commercial flight bookings and telecommunications infrastructure to untried, non-IBM hardware. It's an attitude that translates into "relatively stable" annuities, to quote the 2017 IBM 10-K.

"THINK," CEO Watson commanded his IBM charges, and the record 2017



patent haul—there were 9,043—suggests that the message stuck. Still, ingenuity is different from revenue. It's true that, after sliding for 22 consecutive quarters, IBM revenues did grow by \$773 million to \$22,543 million in the final three months of 2017, though the year-over-year gain, on a currency-neutral basis, amounted to just 0.9%. In the full year, sales fell to \$79.1 billion from \$79.9 billion in 2016 and from \$81.7 billion in 2015. Operating income and net income likewise declined, the strong economy and some \$9 billion of acquisitions over the past three years notwithstanding. In the past two recessions, IBM's top line fell by more than 10%. You wonder what will happen in the next cyclical downturn.

Not that the business cycle presents the most serious risk to IBM's long-term viability. Mainframe and UNIX-based servers are at once cash cow and Achilles' heel. While they produce no more than 5% of IBM's revenue, the knowledgeable Toni Sacconaghi, analyst at Bernstein Research, observes, they are indirectly responsible for as much as 50% to 55% of pretax income. Such hardware sales, contends Sacconaghi, lead to add-on business in software, maintenance contracts, outsourcing of services and financing.

So it's a worrying trend that IBM's mainframe sales fell to \$2 billion in 2017 from \$3.7 billion in 2008, and that UNIX-related revenue dropped to \$3.6 billion in 2017 from \$20.8 billion all

the way back in 1996, according to Sacconaghi's estimates and other sources. The cash cow is running dry.

"The IBM computer system called Watson gained fame after winning the TV show *Jeopardy!* in 2011," Santin relates. "The feat sparked a wave of marketing by the company. Old-economy, non-tech-savvy firms like H&R Block, Inc. and Kraft Heinz Co. duly signed up. But it's unclear what Watson brings to the table compared with AI systems from other tech giants and numerous startups. It's also unclear how much revenue or profit comes from Watson because it's not disclosed by IBM."

In March 2017, the MD Anderson Cancer Center of the University of Texas, an early adopter of Watson, announced that it was placing its Watson project "on hold." The investment had cost the hospital \$39.2 million in fees to IBM and \$21.2 million in billings to PricewaterhouseCoopers, according to the University of Texas System Audit Office. An Anderson spokesperson said the institution was returning to the marketplace for competitive bids "to see where the industry [had] progressed."

Reports of heavy layoffs at the Watson Health subsidiary have elicited a partial front-office denial. "We're not discussing specific numbers of employees affected," said IBM spokesman Doug Shelton, responding to a reporter at the *The Triangle Business Journal*, of Raleigh, N.C. "But it's a small percentage of our global Watson Health workforce, as we

move to more technology-intensive offerings, simplified processes and automation to drive speed.”

No spokesman responded directly to a question we raised (it was prompted by Jeff Matthews, founder and portfolio manager of the hedge fund Ram Partners, L.P.), to wit: Will earnings per share in the second quarter be plumper than they would otherwise have been on account of the exclusion of costs associated with the laid-off Watson Health employees?

If Watson is not going to be the passport to IBM's future, what might that helpful instrument be? Probably not the blockchain, even if IBM's marketing message suggests otherwise.

“If you search for ‘IBM blockchain supply-chain solutions’ on their website or on Google,” says Kai Stinchcombe, author of a pair of must-read essays on the blockchain and the speaker at the [Spring 2018 Grant's Conference](#) who characterized the digital ledger as that “crappy and useless” technology, “it will say that you can use blockchain for your supply chain. If you search for ‘IBM supply chain,’ [IBM] will say that ‘we have lots of stuff about supply chain,’ but it is not actually [related to] blockchain.” In other words, IBM is happy to offer blockchain to deal with supply-chain issues if one asks for it but doesn't think that the technology is the best way to deal with supply-chain issues—or else Big Blue would be offering it as soon as a customer asked for supply-chain solutions. (Links to Stinchcombe's blockchain writings are available on the *Grant's* website.)

Betting on new technology is well and good—indeed, necessary—but, at IBM, it comes with the cost of rising leverage. IBM's aforementioned total debt of \$46.4 billion is up from \$26.1 billion at the end of 2009. Add about \$12.9 billion in pension liabilities, and the figure rises to \$59.3 billion, or 3.4 times the past 12 months' adjusted earnings before interest, taxes, depreciation and amortization of \$17.6 billion. Adjust for \$29 billion in financing receivables, most of which stand at the wholly financing unit, and the ratio is half as large, 1.7:1.

IBM Credit LLC, wholly owned by the parent, banks most of the receiv-

ables. In 2017 the credit sub started issuing its own debt driven by a 2016 internal restructuring that led parent and sub to separate their assets and liabilities. The parent provides support such that IBM Credit's tangible net worth is at least \$50 million and its leverage is no higher than 11:1. The parent also has agreed to retain at least a 51% interest in the unit. The sub is an indispensable sales facilitator in a highly competitive market.

At the end of the first quarter, leverage at IBM Credit stood at 9.4:1—up from 7.3:1 at the end of 2016. Of the \$29 billion in financing receivables, \$7 billion comes from financing leases and \$12 billion from client loans, which are usually unsecured installment plans for software and services. The balance of \$10 billion stemmed from commercial financing, which consists of 30- to 90-day working capital loans to suppliers, distributors and resellers of IBM and OEM (Original Equipment Manufacturer) IT products and services. Vendors availing themselves of IBM accommodation have included electronic-components distributors Arrow Electronics, Inc. (triple-B-minus), Avnet, Inc. (triple-B-minus with a negative outlook) and Ingram Micro, Inc. (Ba1/NR), a subsidiary of the levered Chinese conglomerate HNA Group Co. Ltd.

Historically, IBM's financing unit has stood on the solid ground of necessity—its clients have depended on Big Blue mainframes and servers to operate their businesses. Even in the fraught years of 2008–09 credit losses were manageable. Without significant concentration in any one name, overall credit quality is now deteriorating. At the end of 2009, the then-\$25 billion financing portfolio was 59% exposed to investment-grade names. At year-end 2017, the now-\$30.7 billion portfolio was 53% exposed to investment-grade.

Missing in the latest earnings presentation was the customary disclosure of the distribution of credit ratings in the consolidated financing portfolio. The March 10-Q did reveal details of a portion of that portfolio—one which excluded working-capital loans—and that the overall portfolio remains 53% exposed to investment-grade,

unchanged from year-end. The data showed marked long-term deterioration in credit quality. Thus, at the end of 2010, that management-curated portfolio was 70% exposed to investment-grade counterparties. By March 31 of this year, its investment-grade exposure had dropped to 57%.

Brisk growth in these commercial-financing receivables (to the aforementioned \$10 billion from \$5.6 billion at the end of 2009), notwithstanding IBM's vital signs, from the top line to the bottom, have continued to dwindle. Credit origination in commercial financing topped \$63 billion in 2017, up from \$54 billion in 2016 and \$27 billion in 2009. Such lending grew to \$17.7 billion during the first quarter of 2018, up by 28% from \$13.8 billion in the first quarter of 2017.

“IBM's capital structure is heavily represented in ETFs and in the portfolios of yield-starved insurance and pension plans,” Santin observes, “but active investors seem to shy away. It's clear enough that the business is in secular decline. Arguably, too, earnings per share have benefited by an unsustainably low tax rate (as low as 3.6% in 2016, down from 26.2% in 2008), enormous stock buybacks that reduced the share count by 31% in the past decade and plunging interest rates. Looking through the gauge of enterprise value (market cap plus total debt minus cash) to trailing free cash flow (cash from operations minus capex) and adjusting for discrete cash benefits that totaled \$3.2 billion, according to Sacconaghi's estimates, Big Blue trades at a hefty 16 times multiple; higher than 15 times for Apple, 14 for Oracle Corp. and 10 times for HP, Inc.”

In the past 12 months, insiders sold \$2.7 million worth of IBM, driven by a \$2 million February sale in the market by Eric Clementi, senior vice president of Global Integrated Accounts and chairman of IBM Europe, and a \$780,000 sale by Diane Gherson, senior vice president of human resources. A bullish director bought \$100,000 worth of shares in January. Sell-side sentiment is slightly bullish. We are stoutly bearish.

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