

International Business Machines

Better Than Feared 3Q Results, Motioning to Bottom of Full Year Revenue Guidance, Reiterating FCF Guide

Revenue and margins in-line, FCF beat. IBM delivered revenue and PTI margins relatively in-line with consensus estimates with FCF ahead of expectations. We expect investors may pick at lighter Red Hat performance and reliance on Infrastructure growth to offset softness in other areas of the business. However, we view results as better than feared considering investor concern over risk to Consulting growth heading into the earnings call based on reads from recent peer results. Healthy signings contributed to a TTM book to bill ratio of 1.16. While Red Hat growth was disappointing, we think Software backlog strength could support a return to double digit Red Hat growth. Automation revenue was better than expected (even after backing out estimated Apttio contribution), and we appreciate the stronger Infrastructure performance. Generative AI traction remains in early stages but progress is encouraging with tangible use cases and thousands of hands-on interactions with clients cited. Management commentary pointed investors to the bottom of the full year constant currency revenue growth range as the company reiterated FCF guidance of \$10.5bn for the year. We are encouraged by the stability of performance in the quarter and remain Neutral rated as we see risk-reward balanced at current levels.

What we liked

- **Consulting better than feared, Infrastructure stronger than expected.** IBM reported total revenue of \$14.75bn, relatively in-line with consensus. Consulting revenue was \$4.96bn (2.8% below consensus) with Infrastructure revenue of \$3.27bn (3.8% above consensus). Still, we think the Consulting results were a positive surprise in the wake of weaker recent performance from Consulting peers, including Accenture last month. Software revenue totaled \$6.27bn, in-line with expectations, as Red Hat softness was offset by Automation, and Data & AI. Operating PTI margins were also in-line with margin expansion of 170 bps y/y as all three major segment realized better gross margins. Diluted operating EPS of \$2.20 beat consensus estimates of \$2.14.
- **Full year FCF guidance reiterated.** IBM generated \$1.7bn of free cash flow in the quarter (adjusted for financing receivables) to reach \$5.1bn YTD while reiterating full year guidance of \$10.5bn. FCF growth in the first three quarters of the year has been driven largely through operating profit, with the company tracking ahead of expectations towards its guidance as we move into a seasonally strong Q4.
- **Seeing traction with Watsonx.** Data and AI revenue grew 6% y/y on a constant currency basis (CC). The company added additional capabilities for its core AI platform in the quarter, including Granite, a foundation model, and Watsonx Code Assistant for Z for mainframe code and app modernization. Early feedback on the platform has pointed to solid traction in three enterprise

Neutral

IBM, IBM US

Price (25 Oct 23):\$137.08

Price Target (Dec-24):\$145.00

Software - Large Cap / Mid & Small Cap

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J.P. Morgan Securities LLC

Key Changes (FYE Dec)

	Prev	Cur
Free Cash Flow (to firm) growth - 24E	10.5%	7.2%

Quarterly Forecasts (FYE Dec)

Free Cash Flow (to firm) growth

	2022A	2023E	2024E
Q1	(18.5%)	8.1%A	(23.2%)
Q2	101.3%	0.4%A	36.4%
Q3	24.3%	123.7%A	10.0%
Q4	55.8%	3.7%	2.5%
FY	42.8%	13.3%	7.2%

Style Exposure

Quant Factors	Current	Hist %Rank (1=Top)			
	%Rank	6M	1Y	3Y	5Y
Value	41	33	39	19	21
Growth	70	81	84	79	80
Momentum	47	61	29	87	80
Quality	53	43	10	17	13
Low Vol	1	1	1	6	6
ESGQ	46	23	47	32	17

Sources for: Style Exposure – J.P. Morgan Quantitative and Derivatives Strategy; all other tables are company data and J.P. Morgan estimates.

See page 6 for analyst certification and important disclosures.

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Price Performance



	YTD	1m	3m	12m
Abs	-2.7%	-6.4%	-2.3%	3.1%
Rel	-11.7%	-2.9%	6.0%	-5.4%

Company Data

Shares O/S (mn)	924
52-week range (\$)	153.21-120.55
Market cap (\$ mn)	126,620.80
Exchange rate	1.00
Free float(%)	99.9%
3M - Avg daily vol (mn)	3.91
3M - Avg daily val (\$ mn)	562.3
Volatility (90 Day)	15
Index	S&P 500
BBG BUY HOLD SELL	6 12 3

Key Metrics (FYE Dec)

\$ in millions	FY22A	FY23E	FY24E	FY25E
Financial Estimates				
Revenue	60,532	61,753	64,450	68,383
Adj. EBIT	9,937	10,954	11,542	12,203
Adj. EBITDA	12,344	13,057	13,654	14,315
Adj. net income	8,325	8,769	9,257	9,818
Adj. EPS	9.13	9.51	9.96	10.47
BBG EPS	9.06	9.49	10.03	10.50
Cashflow from operations	10,437	13,302	12,285	14,039
FCFF	9,293	10,526	11,285	12,039
Margins and Growth				
Revenue growth	5.6%	2.0%	4.4%	6.1%
EBIT margin	16.4%	17.7%	17.9%	17.8%
EBIT growth	13.6%	10.2%	5.4%	5.7%
EBITDA margin	20.4%	21.1%	21.2%	20.9%
EBITDA growth	(2.3%)	5.8%	4.6%	4.8%
Net margin	13.8%	14.2%	14.4%	14.4%
Adj. EPS growth	15.0%	4.2%	4.7%	5.1%
Ratios				
Adj. tax rate	6.4%	12.3%	11.3%	11.5%
Interest cover	10.2	8.0	8.0	8.4
Net debt/Equity	2.0	1.9	1.6	1.3
Net debt/EBITDA	3.5	3.6	3.3	2.8
ROE	40.8%	37.3%	34.5%	32.2%
Valuation				
FCFF yield	7.4%	8.3%	8.9%	9.4%
Dividend yield	4.8%	4.8%	4.9%	4.9%
EV/Revenue	2.8	2.8	2.7	2.5
EV/EBITDA	13.5	13.1	12.5	11.7
Adj. P/E	15.0	14.4	13.8	13.1

Summary Investment Thesis and Valuation

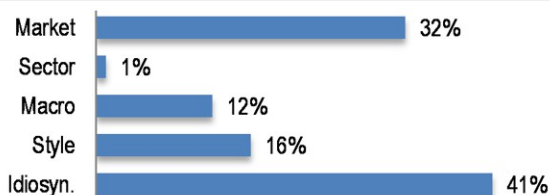
Investment Thesis

We view IBM's Software and Consulting businesses well positioned for Hybrid Cloud and Digital Transformation growth ahead. However, we think the setup for the stock is challenging as investors weigh the potential for a global macroeconomic trough ahead and the company manages its way through the tail end of its most recent mainframe cycle.

Valuation

Our CY24 price target of \$145 is derived from a 14.5x P/E multiple on our CY24 EPS estimate of \$9.96. Our price target implies a PEG of 2.8, an approximate 1.2x premium to the blended PEG for the company's Software, Consulting, Infrastructure peer group. Our price target also implies an EV/CY24E FCF of approximately 15.5x, compared with a blended peer median of approximately 21x.

Performance Drivers



Factors	6M Corr	1Y Corr
Market: MSCI US	0.61	0.62
Sect: Technology	0.05	-0.16
Ind: Software & Serv	-0.12	-0.28
Macro:		
Credit Spread	-0.30	-0.22
US 10yr yield	0.13	0.17
US Dollar	0.13	0.10
Quant Styles:		
Growth	0.14	-0.37
LowVol	-0.02	0.35
Value	0.52	0.34

Source: J.P. Morgan Quantitative and Derivatives Strategy for Performance Drivers; company data, Bloomberg Finance L.P. and J.P. Morgan estimates for all other tables. Note: Price history may not be complete or exact.

use cases: code modernization, customer support, and digital labor, with clear ROI for adopters of the Gen AI features.

What we are watching

- **Red Hat weakness.** Red Hat growth was a disappointing 8% y/y on a constant currency basis, driven in part by weakness in the consumption-based part of the business. Consumption software revenue accounts for ~20% of the business and fell to low single digit growth in the quarter. However, core subscription software for Red Hat, OpenShift, and Ansible grew 19% with a solid 110%+ net retention rate, giving us greater confidence in IBM's ability to reaccelerate this segment.
- **Infrastructure product cycle durability.** Infrastructure revenue declined -3% y/y CC but still came in ahead of consensus as zSystems is tracking well ahead of expectations. In addition to better underlying Infrastructure product cycle durability, offsetting some concern of pull forward, we think WatsonX has potential to extend mainframe adoption through AI code modernization using Code Assistant for Z. AI code modernization enables conversion of COBOL to Java, which is still heavily used in certain industries and could expand exposure to a larger population of programmers.
- **Positive impact from Apptio.** The company's Apptio acquisition closed in mid-August, earlier than the initial Q4 expectation. The earlier timing of this deal could result in closer to 70 bps of revenue contribution to the software segment on the whole year, above the previous expectation of half a point of contribution to this segment.

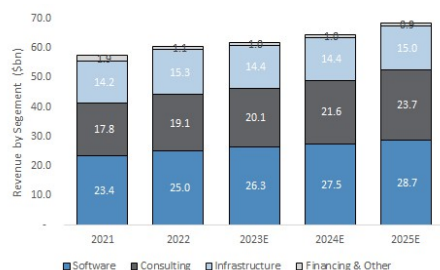
Guidance

Full year FY23 updated guidance

- **Total revenue growth** of 3% - 5% y/y on a constant currency basis.
- **Currency translation** of a one point headwind to revenue growth on the year.
- **Operating pre-tax margin** expansion of ~50 bps y/y.
- **Tax rate** in the mid teens.
- **Free cash flow** of \$10.5bn.

Figure 1: Revenue by segment

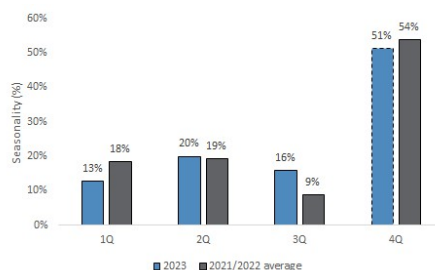
\$bn



Source: Company reports, J.P. Morgan estimates

Figure 2: 4Q is a seasonally strong quarter for FCF

Seasonality



Source: Company reports, J.P. Morgan estimates

Investment Thesis, Valuation and Risks

International Business Machines *(Neutral; Price Target: \$145.00)*

Investment Thesis

We view IBM's Software and Consulting businesses well positioned for Hybrid Cloud and Digital Transformation growth ahead. However, we think the setup for the stock is challenging as investors weigh the potential for a global macroeconomic trough ahead and the company manages its way through the tail end of its most recent mainframe cycle.

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Risks to Rating and Price Target

(+) Kyndryl spinout tailwind, Digital Transformation projects, movement to a hybrid environment

(-) Macro slowdown pressures customer budgets, inability to innovate, talent supply

International Business Machines: Summary of Financials

Income Statement - Annual						Income Statement - Quarterly					
	FY21A	FY22A	FY23E	FY24E	FY25E		1Q23A	2Q23A	3Q23A	4Q23E	
Revenue	57,348	60,532	61,753	64,450	68,383	Revenue	14,252A	15,475A	14,753A	17,273	
COGS	(25,863)	(27,845)	(27,764)	(28,599)	(30,325)	COGS	(6,743)A	(6,974)A	(6,730)A	(7,317)	
Gross profit	-	-	-	-	-	Gross profit	-	-	-	-	
SG&A	(18,746)	(18,608)	(18,866)	(19,348)	(20,413)	SG&A	(4,853)A	(4,900)A	(4,458)A	(4,655)	
Adj. EBITDA	12,638	12,344	13,057	13,654	14,315	Adj. EBITDA	2,102A	3,077A	3,037A	4,841	
D&A	-	-	-	-	-	D&A	-	-	-	-	
Adj. EBIT	8,750	9,937	10,954	11,542	12,203	Adj. EBIT	1,575A	2,557A	2,509A	4,313	
Net Interest	(1,154)	(1,216)	(1,628)	(1,700)	(1,700)	Net Interest	(368)A	(423)A	(412)A	(425)	
Adj. PBT	7,881	9,821	10,294	10,890	11,551	Adj. PBT	1,449A	2,396A	2,299A	4,150	
Tax	(124)	626	(1,266)	(1,234)	(1,333)	Tax	(124)A	(419)A	(159)A	(564)	
Minority Interest	-	-	-	-	-	Minority Interest	-	-	-	-	
Adj. Net Income	7,177	8,325	8,769	9,257	9,818	Adj. Net Income	1,249A	2,003A	2,031A	3,486	
Reported EPS	6.35	1.80	8.10	9.10	9.61	Reported EPS	1.01A	1.72A	1.84A	3.49	
Adj. EPS	7.93	9.13	9.51	9.96	10.47	Adj. EPS	1.36A	2.18A	2.20A	3.76	
DPS	6.55	6.59	6.63	6.67	6.71	DPS	1.65A	1.66A	1.66A	1.66	
Payout ratio	103.2%	366.6%	81.9%	73.3%	69.8%	Payout ratio	163.4%A	96.4%A	90.0%A	47.5%	
Shares outstanding	905	912	922	929	938	Shares outstanding	918A	920A	924A	927	
Balance Sheet & Cash Flow Statement						Ratio Analysis					
	FY21A	FY22A	FY23E	FY24E	FY25E		FY21A	FY22A	FY23E	FY24E	FY25E
Cash and cash equivalents	6,957	7,989	8,081	8,184	9,951	Gross margin	-	-	-	-	-
Accounts receivable	6,754	6,541	7,193	8,751	9,138	EBITDA margin	22.0%	20.4%	21.1%	21.2%	20.9%
Inventories	1,649	1,552	1,604	1,722	1,897	EBIT margin	15.3%	16.4%	17.7%	17.9%	17.8%
Other current assets	22,289	20,381	20,565	22,850	24,094	Net profit margin	12.5%	13.8%	14.2%	14.4%	14.4%
Current assets	29,846	29,222	32,367	34,755	37,766	ROE	75.9%	40.8%	37.3%	34.5%	32.2%
PP&E	5,694	5,334	5,351	5,279	5,207	ROA	10.9%	6.4%	6.7%	6.7%	7.0%
LT investments	1,823	1,617	1,582	1,582	1,582	ROCE	24.4%	13.0%	12.6%	12.7%	13.1%
Other non current assets	28,307	25,556	27,158	28,626	28,701	SG&A/Sales	32.7%	30.7%	30.6%	30.0%	29.9%
Total assets	132,001	127,243	135,684	139,207	141,962	Net debt/equity	2.4	2.0	1.9	1.6	1.3
Short term borrowings	6,787	4,760	6,414	6,414	6,414	P/E (x)	17.3	15.0	14.4	13.8	13.1
Payables	3,955	4,051	3,849	4,047	4,516	P/BV (x)	6.6	5.7	5.0	4.5	4.0
Other short term liabilities	22,877	22,694	20,849	20,849	20,849	EV/EBITDA (x)	13.3	13.5	13.1	12.5	11.7
Current liabilities	33,619	31,505	31,112	31,310	31,779	Dividend Yield	4.8%	4.8%	4.8%	4.9%	4.9%
Long-term debt	44,917	46,189	48,328	46,328	44,328	Sales/Assets (x)	0.9	0.5	0.5	0.5	0.5
Other long term liabilities	64,951	64,121	68,358	68,130	66,306	Interest cover (x)	11.0	10.2	8.0	8.0	8.4
Total liabilities	113,005	105,222	110,525	110,581	109,397	Operating leverage	-	244.3%	507.4%	122.9%	93.8%
Shareholders' equity	18,901	21,944	25,085	28,551	32,489	Revenue y/y Growth	-	5.6%	2.0%	4.4%	6.1%
Minority interests	95	77	75	75	75	EBITDA y/y Growth	-	(2.3%)	5.8%	4.6%	4.8%
Total liabilities & equity	132,001	127,243	135,684	139,207	141,962	Tax rate	1.6%	6.4%	12.3%	11.3%	11.5%
BVPS	20.89	24.05	27.21	30.73	34.63	Adj. Net Income y/y Growth	-	16.0%	5.3%	5.6%	6.1%
y/y Growth	-	15.1%	13.1%	12.9%	12.7%	EPS y/y Growth	-	15.0%	4.2%	4.7%	5.1%
Net debt/(cash)	44,747	42,960	46,661	44,558	40,791	DPS y/y Growth	-	0.6%	0.6%	0.6%	0.6%
Cash flow from operating activities	12,796	10,437	13,302	12,285	14,039						
o/w Depreciation & amortization	6,417	4,802	4,336	4,372	4,372						
o/w Changes in working capital	(346)	(2,886)	(705)	(1,696)	(503)						
Cash flow from investing activities	(5,974)	(4,202)	(10,916)	(4,040)	(4,040)						
o/w Capital expenditure	(2,381)	(1,861)	(1,736)	(2,040)	(2,040)						
as % of sales	4.2%	3.1%	2.8%	3.2%	3.0%						
Cash flow from financing activities	(13,355)	(4,959)	(2,174)	(8,142)	(8,232)						
o/w Dividends paid	(5,869)	(5,948)	(6,042)	(6,142)	(6,232)						
o/w Net debt issued/(repaid)	(8,115)	1,221	4,119	(2,000)	(2,000)						
Net change in cash	(6,718)	1,032	92	103	1,767						
Adj. Free cash flow to firm	6,508	9,293	10,526	11,285	12,039						
y/y Growth	-	42.8%	13.3%	7.2%	6.7%						

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec. o/w - out of which

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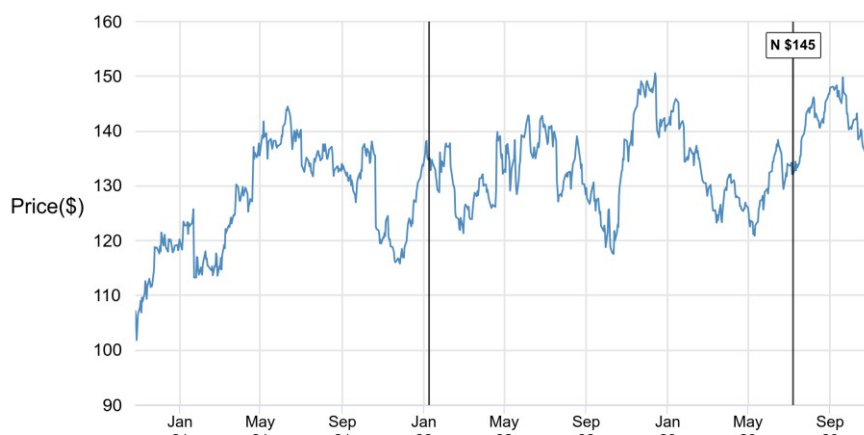
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International Business Machines (IBM, IBM US) Price Chart



Date	Rating	Price (\$)	Price Target (\$)
07-Jul-23	N	132.16	145

Source: Bloomberg Finance L.P. and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage May 01, 1999. All share prices are as of market close on the previous business day.
Break in coverage Jan 08, 2022 - Jul 07, 2023.

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