

18 July 2014 | 15 pages

Computer Hardware
North America | United States

International Business Machines Corp (IBM)

2Q14 Results Review: Mixed Bag of Results

- **Event** — IBM reported Q2 EPS of \$4.32 which was slightly better than consensus at \$4.30 as revenues of \$24.36 bln were also marginally better than \$24.1 bln that consensus had modeled. The company reaffirmed its 2014/2015 EPS goals of at least \$18/\$20.
- **Key Positives:** 1) Revenue beat was driven by hardware as mainframe revenues rebounded in 2Q from a depressed 1Q'14. 2) Strategic partnership with AAPL to collaborate on applications that are optimized for iOS on IBM's cloud platform could bear fruit in the next twelve months. 3) Cloud service revenues doubled (in line with prior quarter while other strategic initiatives are all tracking up double digit y/y. 4) Growth markets revenue declines were more moderate this quarter (down 4% y/y at constant currency levels); 5) Maintained EPS target of \$18 and FCF target of a ~ + \$1 bln increase y/y.
- **Key Negatives:** 1) EPS beat was aided by non-operating items (gain on sale of business) which contributed ~\$0.10 to EPS; 2) GBS outsourcing remain pressured (-9% y/y) amidst pricing pressures and contract negotiations; 3) Service signings down -33% (albeit off a tough compare but down for a second quarter in a row, while backlog is also down 1% (in cc terms ex the divestiture); 4) Software revenues flat, trailing industry growth of mid-single digits; 5) Mainframe strength is unlikely to continue with management guiding mid-teens revenue declines y/y for FY 14.
- **Stock Call** – IBM shares remain rated Neutral with a \$200 target price (unchanged as estimate changes are nominal). While shareholder returns (including dividends and buybacks) at 9% are positives, key concerns are lower quality of earnings, deceleration in EPS growth characteristics (9-10% CAGR looking ahead to 2020) versus mid-teens in prior years, x86 server sale challenging other parts of IBM's business such as storage and continued pricing pressures & shift to cloud (very aggressive competitive pricing) that are likely to temper margin expansion.

■ Estimate Change

Neutral	2
Price (17 Jul 14)	US\$192.49
Target price	US\$200.00
Expected share price return	3.9%
Expected dividend yield	2.3%
Expected total return	6.2%
Market Cap	US\$194,835M

Price Performance (RIC: IBM.N, BB: IBM US)



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EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2013A	3.00A	3.91A	3.99A	6.13A	17.04A	16.28A
2014E	2.55A	4.32A	4.37E	6.77E	18.01E	17.87E
Previous	2.55A	4.39E	4.50E	6.63E	18.07E	na
2015E	3.73E	4.65E	4.78E	6.87E	20.03E	19.78E
Previous	3.91E	4.74E	4.81E	6.59E	20.04E	na
2016E	3.83E	4.85E	5.04E	7.38E	21.10E	21.56E
Previous	4.02E	4.92E	5.06E	7.12E	21.12E	na

Source: Company Reports and dataCentral, Citi Research. FC Cons: First Call Consensus.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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IBM.N: Fiscal year end 31-Dec						Price: US\$192.49; TP: US\$200.00; Market Cap: US\$194,835m; Recomm: Neutral					
Profit & Loss (US\$m)	2012	2013	2014E	2015E	2016E	Valuation ratios	2012	2013	2014E	2015E	2016E
Sales revenue	104,507	99,751	98,168	100,362	99,127	PE (x)	12.6	11.3	10.7	9.6	9.1
Cost of sales	-53,568	-50,225	-48,801	-49,280	-46,659	PB (x)	11.4	9.0	8.1	6.7	5.7
Gross profit	50,939	49,526	49,367	51,082	52,468	EV/EBITDA (x)	7.7	7.9	8.3	7.8	7.6
Gross Margin (%)	48.7	49.6	50.3	50.9	52.9	FCF yield (%)	6.8	6.5	8.0	9.8	9.6
EBITDA (Adj)	26,384	26,285	25,768	27,777	28,296	Dividend yield (%)	1.7	1.9	2.2	2.5	2.7
EBITDA Margin (Adj) (%)	25.2	26.4	26.2	27.7	28.5	Payout ratio (%)	21	22	24	24	25
Depreciation	-3,392	-3,327	-3,175	-3,025	-3,184	ROE (%)	84.7	78.7	74.6	73.3	65.1
Amortisation	-1,284	-1,351	-1,356	-1,356	-1,424	Cashflow (US\$m)					
EBIT (Adj)	21,708	21,607	22,046	24,208	24,500	EBITDA	26,384	26,285	26,578	28,589	29,108
EBIT Margin (Adj) (%)	20.8	21.7	22.5	24.1	24.7	Working capital	-2,449	-2,446	-2,959	-1,402	-2,790
Net interest	-460	-402	-532	-580	-564	Other	-4,464	-6,327	-4,597	-5,443	-5,822
Associates	0	0	0	0	0	Operating cashflow					
Non-op/Except	908	-1,074	236	-32	-21	Capex	-4,307	-3,768	-3,611	-3,784	-3,784
Pre-tax profit	22,156	20,131	21,750	23,596	23,914	Net acq/disposals	-4,090	-2,494	-1,364	-3,000	-1,000
Tax	-5,553	-3,646	-4,512	-5,366	-5,681	Other	-608	-1,063	-78	0	-386
Extraord./Min.Int./Pref.div.	0	0	0	0	0	Investing cashflow					
Reported net profit	16,603	16,484	17,238	18,230	18,233	Dividends paid	-9,005	-7,325	-5,053	-6,784	-5,170
Net Margin (%)	15.9	16.5	17.6	18.2	18.4	Financing cashflow					
Core NPAT	17,626	18,723	18,109	19,025	19,019	Net change in cash	-11,977	-9,882	-14,907	-15,505	-15,705
Per share data						Free cashflow to s/holders					
Reported EPS (\$)	14.41	15.00	17.14	19.19	20.23		15,164	13,744	15,410	17,959	16,711
Core EPS (\$)	15.30	17.04	18.01	20.03	21.10						
DPS (\$)	3.27	3.69	4.25	4.73	5.20						
CFPS (\$)	16.90	15.94	18.92	22.89	22.74						
FCFPS (\$)	13.16	12.51	15.33	18.90	18.54						
BVPS (\$)	16.95	21.35	23.63	28.56	33.88						
Wtd avg ord shares (m)	1,143	1,095	1,005	948	899						
Wtd avg diluted shares (m)	1,152	1,099	1,006	950	901						
Growth rates											
Sales revenue (%)	-2.3	-4.6	-1.6	2.2	-1.2						
EBIT (Adj) (%)	4.1	-0.5	2.0	9.8	1.2						
Core NPAT (%)	8.0	6.2	-3.3	5.1	0.0						
Core EPS (%)	13.4	11.4	5.7	11.2	5.4						
Balance Sheet (US\$m)											
Cash & cash equiv.	11,129	11,066	10,077	9,531	9,151						
Accounts receivables	10,667	10,465	10,328	10,592	10,387						
Inventory	2,287	2,310	2,365	2,381	2,239						
Net fixed & other tangibles	14,941	19,372	20,722	20,881	20,881						
Goodwill & intangibles	42,028	42,745	44,396	46,640	46,816						
Financial & other assets	38,162	40,265	41,376	43,256	46,045						
Total assets	119,214	126,223	129,263	133,281	135,518						
Accounts payable	9,181	7,461	6,936	6,986	6,568						
Short-term debt	7,952	6,862	12,462	12,462	12,462						
Long-term debt	24,088	32,856	31,508	31,508	31,508						
Provisions & other liab	59,008	56,115	55,087	55,835	55,679						
Total liabilities	100,229	103,294	105,993	106,791	106,216						
Shareholders' equity	18,985	22,929	23,270	26,490	29,514						
Minority interests	0	0	0	0	0						
Total equity	18,985	22,929	23,270	26,490	29,514						
Net debt (Adj)	20,911	28,652	33,893	34,439	34,819						
Net debt to equity (Adj) (%)	110.1	125.0	145.6	130.0	118.0						

For definitions of the items in this table, please click [here](#).

Figure 1. Results vs. Citi Estimates

Revenues (\$M)	Actual	Citi Est	Street Ests	Actual vs. Citi	Actual vs Street
Global Technology Services	\$9,414	\$9,499	\$9,370	-0.9%	0.5%
-y/y	-1.3%	-0.4%	-1.7%		
Pre-tax Margin	19.2%	18.5%		0.7%	
Global Business Services	\$4,534	\$4,528	\$4,646	0.1%	-2.4%
-y/y	-1.6%	-1.7%	2.5%		
Pre-tax Margin	17.8%	19.8%		-2.0%	
Total Service Signings	\$11,000	\$12,880			
Systems and Technology	\$3,331	\$2,661	\$2,945	25.2%	13.1%
-y/y	-11.4%	-29.2%	-21.6%		
Pre-tax Margin	0.7%	-9.1%		9.8%	
Software	\$6,488	\$6,622	\$6,530	-2.0%	-0.6%
-y/y	1.0%	3.1%	1.7%		
Pre-tax Margin	36.5%	37.4%		-0.9%	
Global Financing	\$504	\$486	\$503	3.6%	0.2%
-y/y	3.5%	-0.1%	3.3%		
Pre-tax Margin	49.8%	52.8%		-3.0%	
Total Revenues	\$24,364	\$23,904	\$24,141	1.9%	0.9%
-y/y	-2.2%	-4.1%	-3.1%		
Gross Margin	49.8%	50.1%	49.7%	-0.3%	0.1%
Operating Margin	21.2%	22.5%	23.0%	-1.3%	-1.7%
Non-GAAP EPS	\$4.32	\$4.39	\$4.30	-1.7%	0.5%
-y/y	34.2%	36.5%	33.5%		
Tax Rate	20%	20%	20%	0.0%	0.0%
Share count	1,005	999	1,020	0.6%	-1.5%

Source: Citi Research, Company Report, Factset

Below we show our estimate revisions which are a function of the slight beat in sales in 2Q but offset by lower operating margins.

Figure 2. IBM Estimate Revisions

	3Q14		FY14		FY15	
	New	Old	New	Old	New	Old
Total Revenues (\$B)	\$23.7	\$23.4	\$98.2	\$96.7	\$100.4	\$99.0
Gross Margin	50.1%	49.3%	50.3%	50.0%	50.9%	50.5%
Operating Margin	22.9%	23.3%	22.5%	22.7%	24.1%	24.0%
EPS (Non-GAAP)	\$4.37	\$4.50	\$18.01	\$18.07	\$20.03	\$20.04

Source: Citi Research

Commentary on IBM Services Segment

IBM's Services business seemed unappealing relative to even the beaten-down expectations that existed. Adjusted for the divestiture of the customer care BPO and currency, revenue for GTS was \$9.4 billion (up 2% in constant currency) while GBS

revenues of \$4.5 billion were down 2% in constant currency terms. These are not purely organic numbers, they do include the impact of M&A (although the impact of the customer care BPO divestiture has been excluded, otherwise GTS revenue growth would be negative as well). Within GTS, we note the following (a) GTS outsourcing was flat, adjusted for the customer care BPO divestiture; (b) ITS was up 5%; (c) Maintenance revenues declined and we expect this will continue given the long term trend in hardware. GBS performance was a negative surprise, as GBS outsourcing declined 9% and was only partly offset by modest growth of consulting / SI.

The reasons for GBS' performance include (a) Pricing pressure from competitors – considering that most other competitors are not complaining of pricing pressure, we have to believe that IBM's application management services may have been priced at a premium and do not seem to be differentiated enough to justify such a premium anymore; (b) Deals being broken up and IBM is unable to hang on to all of the functionality it used to previously provide (c) Weakness in traditional ERP work (d) Some offset from strength in digitization.

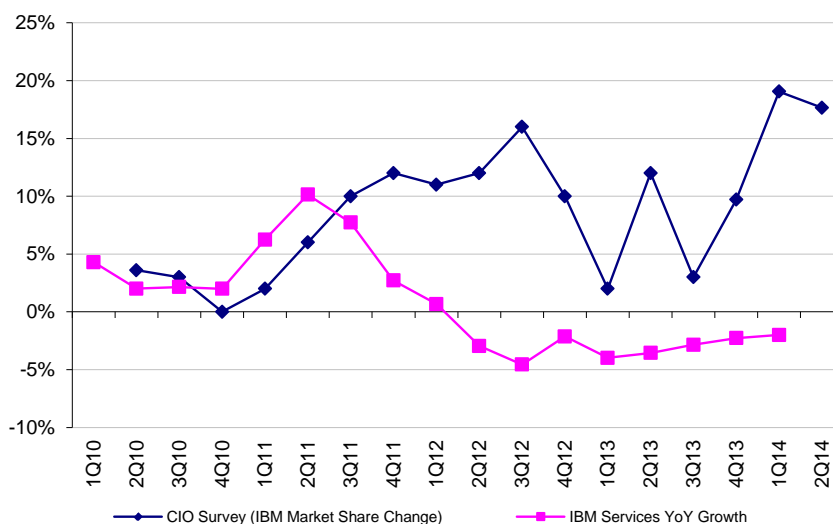
Gross margins were up for GTS while they were down for GBS. Given the above comments on the loss of mature (and hence higher-margin work) and pricing commentary, we believe that the productivity gains from workforce actions may not be fully realizable by IBM.

Quarterly signings were unexpectedly weak at \$11 billion (-33% year/year) and backlog down 3% to \$136 billion. This is the second consecutive weak quarter. IBM did point out that the presence of digitization (shorter projects) and cloud strength (pay-as-you-go, so full contract size is difficult to compute) did not help their case. However, our view is that this is not a situation that is likely to change. IBM did imply that there could be a higher level of signings in 3Q14 based on its pipeline.

A final point, with regards to IBM's agreement with Apple. Recall earlier this week, IBM and AAPL also announced an "exclusive partnership" whereby IBM will sell iPhones and iPads to business clients globally while the two companies will collaborate on a suite of apps that will be called IBM MobileFirst for iOS with the first offerings expected in the fall. Apple will start a new version of its AppleCare customer service specifically for the enterprise, with Apple handling calls from IT professionals while on-site service calls will be performed by IBM representatives.

This is a positive for IBM but likely a greater positive for Apple, in our view. IBM's global sales reach offers a direct sales team into global enterprises that Apple cannot get to on its own. For IBM, Apple also brings an enormous developer community that may now decide to develop applications for the enterprise on IBM's Cloud platform. This in turn should aid IBM in developing stronger analytics that in turn drive more successful adoption of its cloud applications. However, one question worth discussing further is that the relationship is not broadly exclusive, so that other services companies (especially those that do not represent hardware competition to Apple) could tie up with Apple as well and help Apple further its enterprise IT goals. In other words, these services companies are like a new channel for Apple. We use the term "not broadly exclusive" carefully because there is an element of exclusivity in terms of a portfolio of industry-focused apps that IBM and Apple are developing together. Also, IBM does get a head start in terms of Apple support. Having said this, future channel partnerships with other IT companies like Cognizant, Accenture and CSC are not necessarily ruled out, in our view.

Figure 3. IBM's win loss ratio for services – CIO Survey



Source: Citi Research

Figure 4. Sales Surprise History



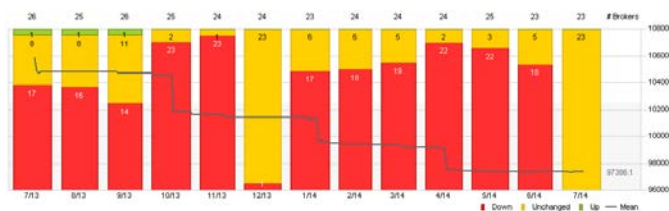
Source: FactSet

Figure 5. EPS Surprise History



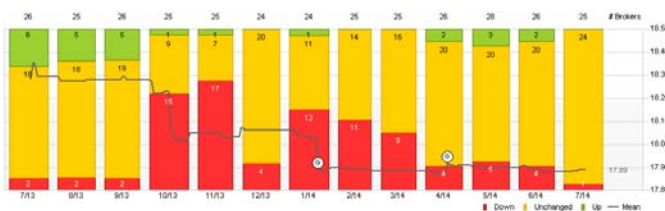
Source: FactSet

Figure 6. 2014E Sales Estimate History



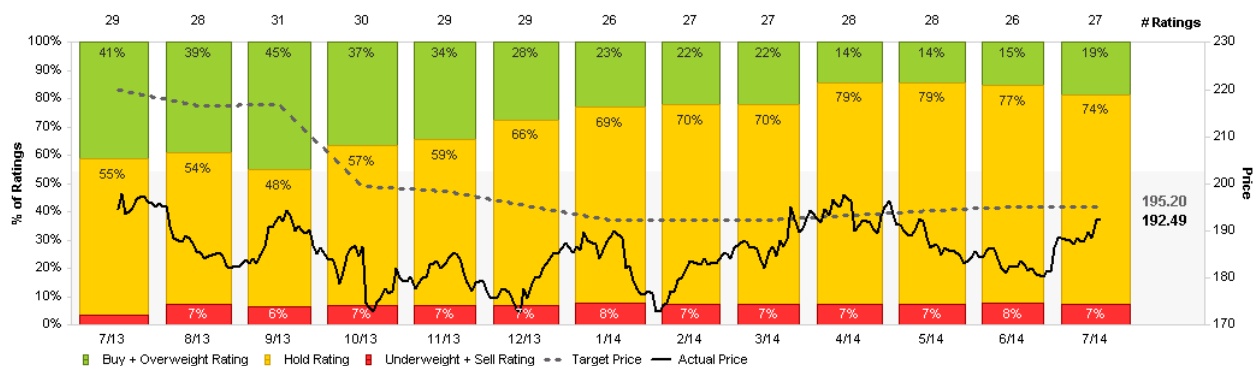
Source: FactSet

Figure 7. 2014E EPS Estimate History



Source: FactSet

Figure 8. Sell-Side Ratings Distribution



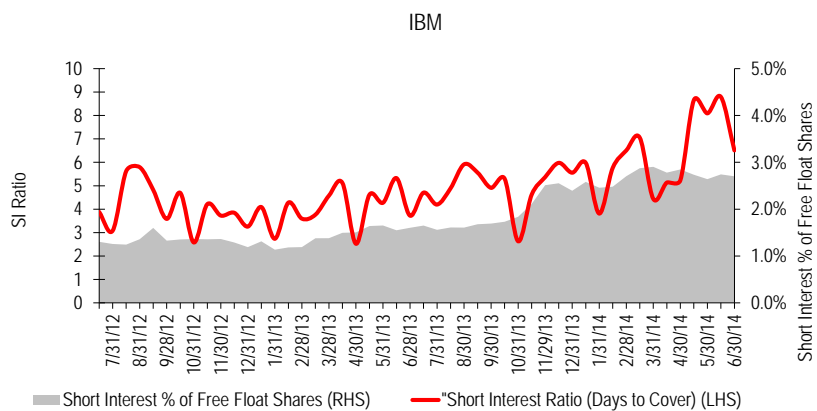
Source: FactSet

Figure 9. Valuations



Source: FactSet

Figure 10. Short Interest



Source: FactSet

Figure 11. Income Statement

Fiscal Year Ends December	FY10	FY11	FY12	FY13	1Q	2Q	3QE	4QE	FY14E	FY15E	FY16E
Dollars in Millions					Mar-14	Jun-14	Sep-14	Dec-14			
Total Services Revenue	\$58,535	\$62,202	\$60,687	\$58,725	\$14,195	\$14,335	\$14,333	\$15,123	\$57,986	\$58,783	\$59,948
% chg yr to yr	3%	7%	-2%	-3%	-2%	-1%	-2%	-1%	-1%	1%	2%
% chg qtr to qtr	-	-	-	-	-6%	1%	-1%	6%	-	-	-
Total Hardware Revenue	\$18,775	\$19,823	\$18,343	\$14,965	\$2,487	\$3,521	\$3,170	\$4,032	\$13,210	\$13,165	\$8,980
% chg yr to yr	11%	6%	-7%	-19%	-23%	-11%	-6%	-9%	-12%	0%	-32%
% chg qtr to qtr	-	-	-	-	-44%	39%	-8%	27%	-	-	-
Total Hardware Revenue	\$18,775	\$19,823	\$18,343	\$14,965	\$2,487	\$3,521	\$3,170	\$4,032	\$13,210	\$13,165	\$8,980
% chg yr to yr	11%	6%	-7%	-19%	-23%	-11%	-6%	-9%	-12%	0%	-32%
% chg qtr to qtr	-	-	-	-	-44%	39%	-8%	27%	-	-	-
Total Software Revenue	\$25,434	\$28,219	\$28,723	\$29,124	\$6,454	\$7,345	\$7,074	\$9,735	\$30,607	\$32,283	\$34,190
% chg yr to yr	5%	10.9%	2.0%	1.9%	2%	1%	7%	5%	3.7%	6.2%	5.9%
% chg qtr to qtr	-	-	-	-	-30%	15%	-4%	38%	-	-	-
Total Global Financing Revenue	\$4,079	\$4,196	\$4,073	\$4,304	\$1,129	\$1,189	\$1,189	\$1,284	\$4,791	\$4,874	\$4,838
% chg yr to yr	-3%	-6%	-4%	0%	3%	3%	0%	2%	2%	0%	-1%
% chg qtr to qtr	-	-	-	-	-4%	-5%	0%	8%	-	-	-
Total Revenue	\$99,870	\$106,917	\$104,507	\$99,751	\$22,484	\$24,364	\$23,677	\$27,642	\$98,168	\$100,362	\$99,127
% chg qtr to qtr	-	-	-	-	-19%	8%	-3%	17%	-	-	-
Cost of Goods Sold	\$53,801	\$56,437	\$53,568	\$50,225	\$11,785	\$12,238	\$11,809	\$12,969	\$48,801	\$49,280	\$46,659
Gross Profit	\$46,069	\$50,480	\$50,939	\$49,491	\$10,699	\$12,126	\$11,869	\$14,673	\$49,369	\$51,082	\$52,468
SG&A	\$21,628	\$23,273	\$22,909	\$21,750	\$6,105	\$5,478	\$4,984	\$4,754	\$21,321	\$20,841	\$21,953
R&D	\$6,152	\$6,345	\$6,322	\$6,169	\$1,518	\$1,477	\$1,453	\$1,551	\$6,000	\$6,033	\$6,015
Operating Expenses	\$27,780	\$29,618	\$29,231	\$27,919	\$7,623	\$6,955	\$6,437	\$6,305	\$27,321	\$26,874	\$27,968
Operating Income	\$18,289	\$20,862	\$21,708	\$21,607	\$3,076	\$5,171	\$5,432	\$8,368	\$22,046	\$24,208	\$24,500
Depr and amort	\$4,831	\$4,815	\$4,676	\$4,678	\$1,141	\$1,200	\$1,095	\$1,095	\$4,531	\$4,381	\$4,608
EBITDA	\$22,563	\$25,003	\$25,644	\$25,482	\$4,016	\$6,168	\$6,324	\$9,260	\$25,768	\$27,777	\$28,296
Other (income), expense	(\$793)	(\$46)	(\$857)	(\$342)	(\$126)	(\$201)	\$0	\$0	(\$327)	\$0	\$0
Intellectual property and custom dev (income)	(\$1,154)	(\$1,108)	(\$1,074)	(\$822)	(\$207)	(\$191)	(\$191)	(\$191)	(\$780)	(\$764)	(\$764)
Interest Expense	\$369	\$410	\$460	\$402	\$105	\$136	\$147	\$144	\$532	\$580	\$564
Pretax Income	\$19,867	\$21,606	\$23,179	\$22,369	\$3,304	\$5,427	\$5,475	\$8,415	\$22,621	\$24,391	\$24,700
Provision for Taxes	\$4,845	\$5,288	\$5,553	\$3,646	\$650	\$1,085	\$1,095	\$1,682	\$4,512	\$5,366	\$5,681
Effective Tax Rate	24.4%	24.5%	24.0%	16.3%	19.7%	20.0%	20.0%	20.0%	19.9%	22.0%	23.0%
Net Income	\$15,022	\$16,318	\$17,626	\$18,723	\$2,654	\$4,342	\$4,381	\$6,733	\$18,109	\$19,025	\$19,019
Non-GAAP Net Income to Common	\$15,022	\$16,318	\$17,626	\$18,723	\$2,654	\$4,342	\$4,381	\$6,733	\$18,109	\$19,025	\$19,019
GAAP Net Income	\$14,834	\$15,854	\$16,603	\$16,484	\$2,395	\$4,138	\$4,177	\$6,529	\$17,238	\$18,230	\$18,233
Basic EPS	\$11.84	\$13.63	\$15.43	\$17.11	\$2.56	\$4.34	\$4.40	\$6.81	\$18.02	\$20.08	\$21.15
Diluted EPS (non-GAAP)	\$11.72	\$13.49	\$15.30	\$17.04	\$2.55	\$4.32	\$4.37	\$6.77	\$18.01	\$20.03	\$21.10
Basic Shares Out (million)	1,269	1,197	1,143	1,095	1,035	1,000	997	989	1,005	948	899
Diluted Shares Out (million)	1,281	1,209	1,152	1,099	1,042	1,005	1,002	994	1,006	950	901
Percent of Revenue											
Gross Margin (incl. Options Expense)	46.1%	47.2%	48.7%	49.6%	47.6%	49.8%	50.1%	53.1%	50.3%	50.9%	52.9%
SG&A + Options Expense	21.7%	21.8%	21.9%	21.8%	27.2%	22.5%	21.0%	17.2%	21.7%	20.8%	22.1%
R&D + Options Expense	6.2%	5.9%	6.0%	6.2%	6.8%	6.1%	6.1%	5.6%	6.1%	6.0%	6.1%
Total Op Ex	27.8%	27.7%	28.0%	28.0%	33.9%	28.5%	27.2%	22.8%	27.8%	26.8%	28.2%
Operating Income	18.3%	19.5%	20.8%	21.7%	13.7%	21.2%	22.9%	30.3%	22.5%	24.1%	24.7%
Pre-tax Income	19.9%	20.2%	22.2%	22.4%	14.7%	22.3%	23.1%	30.4%	23.0%	24.3%	24.9%
Net Income	15.0%	15.3%	16.9%	18.8%	11.8%	17.8%	18.5%	24.4%	18.4%	19.0%	19.2%
% Change Year to Year											
Revenue	4.3%	7.1%	-2.3%	-4.6%	-3.9%	-2.2%	-0.2%	-0.2%	-1.6%	2.2%	-1.2%
Cost of Sales + Options Expense	3.4%	4.9%	-5.1%	-6.2%	-5.5%	-2.4%	-2.3%	-1.2%	-2.8%	1.0%	-5.3%
Gross Profit	5.4%	9.6%	0.9%	-2.8%	-2.2%	-2.0%	2.0%	0.7%	-0.2%	3.5%	2.7%
SG&A + Options Expense	4.1%	7.6%	-1.6%	-5.1%	13.5%	-0.7%	-1.4%	-18.0%	-2.0%	-2.3%	5.3%
R&D + Options Expense	3.5%	3.1%	-0.4%	-2.4%	-6.8%	-3.8%	0.0%	-0.1%	-2.7%	0.6%	-0.3%
Total Op Ex	3.9%	6.6%	-1.3%	-4.5%	8.8%	-1.4%	-1.1%	-14.2%	-2.1%	-1.6%	4.1%
Operating Income	7.6%	14.1%	4.1%	-0.5%	-21.7%	-2.9%	5.9%	15.8%	2.0%	9.8%	1.2%
Pretax Income	9.6%	8.8%	7.3%	-3.5%	-19.1%	-2.5%	3.6%	13.2%	1.1%	7.8%	1.3%
Net Income	11.7%	8.6%	8.0%	6.2%	-21.4%	0.0%	-0.2%	1.8%	-3.3%	5.1%	0.0%
Fully Diluted EPS before Extra	16.9%	15.1%	13.4%	11.4%	-15.2%	10.4%	9.5%	10.5%	5.7%	11.2%	5.4%

Source: Citi Research, Company Reports

Figure 12. Balance Sheet and Cash Flow Statement

Balance Sheet (IBM)											
Fiscal Year Ends December	FY10	FY11	FY12	FY13	1Q	2Q	3QE	4QE	FY14E	FY15E	FY16E
Dollars in Millions					Mar-14	Jun-14	Sep-14	Dec-14			
Cash and Cash Equivalents	\$10,661	\$11,922	\$10,412	\$10,716	\$9,409	\$9,715	\$11,095	\$10,072	\$10,072	\$9,526	\$9,145
Marketable Securities	\$990	\$0	\$717	\$350	\$295	\$5	\$5	\$5	\$5	\$5	\$5
Trade Receivables	\$10,834	\$11,179	\$10,667	\$10,465	\$9,682	\$9,902	\$9,780	\$10,328	\$10,328	\$10,592	\$10,387
Short-term Financing Receivables	\$16,257	\$16,901	\$18,038	\$19,787	\$18,329	\$18,620	\$19,304	\$20,183	\$20,183	\$22,201	\$22,645
Other Receivables	\$1,134	\$1,481	\$1,873	\$1,584	\$1,650	\$1,555	\$1,555	\$1,555	\$1,555	\$1,555	\$1,555
Total Inventories	\$2,450	\$2,596	\$2,287	\$2,310	\$2,456	\$2,338	\$2,342	\$2,365	\$2,365	\$2,381	\$2,239
Deferred Income Taxes	\$1,564	\$1,601	\$1,415	\$1,651	\$1,708	\$1,783	\$1,856	\$1,912	\$1,912	\$1,873	\$1,925
Prepaid Expenses and Other Current Assets	\$4,226	\$5,249	\$4,024	\$4,488	\$4,430	\$4,263	\$4,363	\$4,843	\$4,843	\$4,744	\$4,875
Total Current Assets	\$48,116	\$50,929	\$49,433	\$51,351	\$47,959	\$48,182	\$50,301	\$51,263	\$51,263	\$52,878	\$54,552
Property, Plant and Equipment, gross	\$40,289	\$40,124	\$40,501	\$40,475	\$40,478	\$40,936	\$41,732	\$42,528	\$42,528	\$45,712	\$48,896
Accumulated Depreciation	(\$26,193)	(\$26,241)	(\$26,505)	(\$26,654)	(\$26,795)	(\$27,188)	(\$27,944)	(\$28,700)	(\$28,700)	(\$31,725)	(\$34,909)
Property, Plant and Equipment, net	\$14,096	\$13,883	\$13,996	\$13,821	\$13,683	\$13,748	\$13,788	\$13,828	\$13,828	\$13,987	\$13,987
Long-term Financing Receivables	\$10,548	\$10,776	\$12,812	\$12,755	\$11,918	\$12,140	\$11,792	\$12,883	\$12,883	\$12,883	\$13,269
Intangible Assets & Other	\$12,486	\$11,790	\$12,781	\$11,561	\$11,762	\$11,782	\$11,555	\$11,328	\$11,328	\$10,572	\$9,748
Goodwill	\$25,136	\$26,213	\$29,247	\$31,184	\$31,214	\$31,568	\$32,318	\$33,068	\$33,068	\$36,068	\$37,068
Prepaid Pension Assets	\$3,068	\$2,843	\$945	\$5,551	\$6,110	\$6,894	\$6,894	\$6,894	\$6,894	\$6,894	\$6,894
Total Intangible and Other Assets	\$40,690	\$40,846	\$42,973	\$48,296	\$49,086	\$50,244	\$50,767	\$51,290	\$51,290	\$53,534	\$53,710
Total Assets	\$113,450	\$116,434	\$119,214	\$126,223	\$122,646	\$124,314	\$126,648	\$129,263	\$129,263	\$133,281	\$135,518
Taxes	\$4,216	\$3,313	\$4,948	\$4,633	\$2,245	\$2,335	\$3,746	\$4,633	\$4,633	\$4,633	\$4,633
Accounts Payable	\$7,804	\$8,517	\$9,181	\$7,461	\$6,865	\$6,271	\$6,693	\$6,936	\$6,936	\$6,986	\$6,568
Compensation and benefits	\$5,028	\$5,099	\$4,745	\$3,893	\$3,664	\$4,037	\$4,210	\$3,893	\$3,893	\$3,893	\$4,210
Short-term Debt	\$6,778	\$8,463	\$7,952	\$6,862	\$9,312	\$12,462	\$12,462	\$12,462	\$12,462	\$12,462	\$12,462
Deferred Income	\$11,580	\$12,197	\$11,952	\$12,557	\$13,681	\$12,591	\$12,591	\$12,591	\$12,591	\$12,591	\$12,591
Other current	\$5,156	\$4,535	\$4,847	\$4,748	\$5,292	\$4,737	\$4,643	\$4,748	\$4,748	\$4,748	\$4,643
Total Current Liabilities	\$40,562	\$42,124	\$43,625	\$40,154	\$41,060	\$42,433	\$44,345	\$45,263	\$45,263	\$45,313	\$45,107
Long Term Debt	\$21,846	\$22,857	\$24,088	\$32,856	\$34,668	\$34,008	\$34,008	\$31,508	\$31,508	\$31,508	\$31,508
Other Liabilities	\$27,871	\$31,217	\$32,516	\$30,284	\$30,179	\$30,360	\$29,084	\$29,222	\$29,222	\$29,970	\$29,602
Total Liabilities	\$90,279	\$96,198	\$100,229	\$103,294	\$105,907	\$106,801	\$107,437	\$105,993	\$105,993	\$106,791	\$106,004
Common Stock	\$45,418	\$48,129	\$50,110	\$51,594	\$51,943	\$52,163	\$52,163	\$52,163	\$52,163	\$52,163	\$52,163
Retained Earnings	\$92,532	\$104,857	\$117,641	\$130,042	\$131,431	\$134,483	\$137,557	\$142,992	\$142,992	\$156,716	\$170,244
Treasury Stock	(\$96,161)	(\$110,963)	(\$123,131)	(\$137,242)	(\$145,612)	(\$148,900)	(\$150,276)	(\$151,652)	(\$151,652)	(\$162,156)	(\$172,660)
Accumulated Gain (Loss) not affecting R.E.	(\$18,743)	(\$21,885)	(\$25,759)	(\$21,602)	(\$21,156)	(\$20,369)	(\$20,369)	(\$20,369)	(\$20,369)	(\$20,369)	(\$20,369)
Noncontrolling Interest and Others	\$125	\$98	\$124	\$137	\$133	\$136	\$136	\$136	\$136	\$136	\$136
Shareholders' Equity	\$23,171	\$20,236	\$18,985	\$22,929	\$16,739	\$17,513	\$19,211	\$23,270	\$23,270	\$26,490	\$29,514
Total Liabilities and Equity	\$113,450	\$116,434	\$119,214	\$126,223	\$122,646	\$124,314	\$126,648	\$129,263	\$129,263	\$133,281	\$135,518
Cash Flow Statement (IBM)											
Fiscal Year Ends December	FY10	FY11	FY12	FY13	1Q	2Q	3QE	4QE	FY14E	FY15E	FY16E
Dollars in Millions					Mar-14	Jun-14	Sep-14	Dec-14			
Net Income	\$14,833	\$15,855	\$16,604	\$16,484	\$2,395	\$4,138	\$4,177	\$6,529	\$17,238	\$18,230	\$18,233
Depreciation	\$3,657	\$3,589	\$3,392	\$3,327	\$802	\$861	\$756	\$756	\$3,175	\$3,025	\$3,184
Amortization of Intangibles	\$1,174	\$1,226	\$1,284	\$1,351	\$339	\$339	\$339	\$339	\$1,356	\$1,356	\$1,424
Stock-based compensation	\$629	\$697	\$688	\$614	\$124	\$124	\$124	\$124	\$496	\$496	\$496
Gain on Sale of Assets	(\$801)	(\$342)	(\$729)	(\$236)	(\$161)	\$0	\$0	\$0	(\$161)	\$0	\$0
Balance Sheet Items:											
Accounts receivable	(\$489)	(\$1,279)	(\$2,230)	(\$1,407)	\$0	\$0	\$122	(\$548)	(\$426)	(\$264)	\$205
Inventories	\$92	(\$163)	\$280	(\$57)	\$0	\$0	(\$4)	(\$22)	(\$27)	(\$17)	\$143
Deferred Income Taxes	\$1,294	\$1,212	\$797	(\$1,610)	\$0	\$0	(\$73)	(\$56)	(\$129)	\$39	(\$52)
Pension Assets	(\$1,963)	(\$1,371)	(\$1,008)	\$294	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Other Assets	\$949	(\$28)	\$733	(\$747)	\$0	\$0	(\$784)	(\$1,359)	(\$2,143)	(\$1,919)	(\$2,351)
Accounts payable	\$174	\$451	(\$224)	(\$529)	\$0	\$0	\$422	\$665	\$665	\$50	(\$418)
Other liabilities	\$0	\$0	\$0	\$0	\$0	\$0	\$214	\$813	\$1,027	\$748	(\$369)
Cash Flows from Operations	\$19,549	\$19,847	\$19,587	\$17,484	\$3,326	\$3,579	\$5,292	\$6,819	\$19,016	\$21,743	\$20,495
Net Investment in PP&E	(\$3,415)	(\$3,500)	(\$3,672)	(\$3,251)	(\$775)	(\$796)	(\$796)	(\$796)	(\$3,163)	(\$3,184)	(\$3,184)
Investments in Software	(\$569)	(\$559)	(\$635)	(\$517)	(\$112)	(\$112)	(\$112)	(\$112)	(\$448)	(\$600)	(\$600)
Purchase of ST Investments	(\$6,129)	(\$1,594)	(\$4,109)	(\$4,608)	\$0	\$200	\$0	\$0	\$200	\$0	\$0
Proceeds from ST Investments	\$7,877	\$3,345	\$3,142	\$4,873	\$131	\$0	\$0	\$0	\$131	\$0	\$0
Acquisitions	(\$5,922)	(\$1,811)	(\$3,722)	(\$3,056)	(\$264)	(\$339)	(\$750)	(\$750)	(\$2,103)	(\$3,000)	(\$3,000)
Divestitures	\$55	\$14	\$599	\$297	\$391	\$17	\$0	\$0	\$408	\$0	\$2,000
Other Investing Liabilities	(\$404)	(\$291)	(\$608)	(\$1,063)	\$665	\$0	\$348	(\$1,091)	(\$78)	\$0	(\$386)
Cash Flows from Investing	(\$8,507)	(\$4,396)	(\$9,005)	(\$7,325)	\$36	(\$1,030)	(\$1,310)	(\$2,749)	(\$5,053)	(\$6,784)	(\$5,170)
Proceeds from New Debt	\$8,055	\$9,996	\$12,242	\$16,353	\$4,875	\$2,490	\$0	(\$2,500)	\$4,865	\$0	\$0
Short-term repayments/borrowings	\$817	\$1,321	(\$441)	\$621	\$845	\$0	\$0	\$0	\$845	\$0	\$0
Payments to Settle Debt	(\$6,522)	(\$8,947)	(\$9,549)	(\$10,013)	(\$1,507)	\$0	\$0	\$0	(\$1,507)	\$0	\$0
Common Stock Repurchases - net	(\$15,375)	(\$15,046)	(\$11,995)	(\$13,859)	(\$8,166)	(\$3,662)	(\$1,500)	(\$1,500)	(\$14,828)	(\$11,000)	(\$11,000)
Common Stock Transactions, other	\$3,774	\$2,453	\$1,540	\$1,074	\$270	\$0	\$0	\$0	\$0	\$0	\$0
Cash Dividends Paid	(\$3,178)	(\$3,473)	(\$3,773)	(\$4,058)	(\$990)	(\$1,096)	(\$1,102)	(\$1,094)	(\$4,282)	(\$4,505)	(\$4,705)
Cash Flows from Financing	(\$12,429)	(\$13,696)	(\$11,977)	(\$9,882)	(\$4,673)	(\$2,268)	(\$2,602)	(\$5,094)	(\$14,907)	(\$15,505)	(\$15,705)

Source: Citi Research, Company Reports

International Business Machines Corp

Company description

IBM is the world's largest enterprise IT company and is a significant player in virtually every major segment of the enterprise market, including services, servers, storage, software, and semiconductors. The company generated almost \$100B revenue in 2013 and has led the world in the number of US patents granted for more than a decade. Revenue categories include Global Services, Hardware, Software, and Global Financing, which were 53%, 15%, 29%, and 3% of 2013 total revenue, respectively.

Investment strategy

We assign IBM a Neutral rating. IBM shares have significantly outperformed the market since mid-December as money has flown out of high-growth, high-multiple tech stocks into large-cap value tech names which were trading at a sharp discount to S&P500. We believe the shares reflect long-term deceleration in EPS growth (10% to 2020E versus mid-teens in prior years) while adequately reflecting the risks of the mainly tepid IT spending environment, macro uncertainty in emerging markets which could continue to hamper revenue growth, currency pressures, pricing pressures, and shift to cloud in services likely to temper margin expansion.

Valuation

Our target price of \$200 is based on 10x forward 12-month EPS estimates. During the past 10 years, IBM shares have traded at an average of 11-12x but we believe a discount is warranted as the company is undergoing a significant transition which will require significant investment and potentially workforce rebalancing/restructuring in the coming years. We forecast a deceleration of EPS growth to 10% through 2020 compared to prior years of mid-teens growth thus we believe a lower target multiple of 10x is justified.

Risks

Risks to the stock deviating from our valuation target include: 1) Any meaningful increase/slowdown in infrastructure rollout in emerging markets given that it has been a key driver of IBM's revenue growth (and mainframe adoption; we note recently China state owned enterprises have been told to sever ties with US consulting firms and commercial banks are being asked to replace IBM servers with local brands), 2) Material increase/drop in long-term Services signings as it has an eventual impact to Services revenues, 3) Potential share gains/loss in the key branded Middleware segment, which could limit the expectation of positive mix shift, and 4) Productivity improvements from recent restructurings; 5) SEC investigation into IBM's reporting of cloud revenues, claiming it misrepresented revenues as cloud-based when it is traditional hardware and software.

More than half of the company's pretax income is derived from annuity-like sources such as IT outsourcing, maintenance, software, and financing, contributing to a high degree of EPS predictability. Market cap, liquidity, and a solid balance sheet also pose somewhat limited risk. That said, roughly half of Services revenues is transactional and short-term oriented in nature, and can be vulnerable during period of macro weakness. Within software, a significant portion is tied to the mainframe which has seen more and more competition from x86 platforms.

Appendix A-1

Analyst Certification

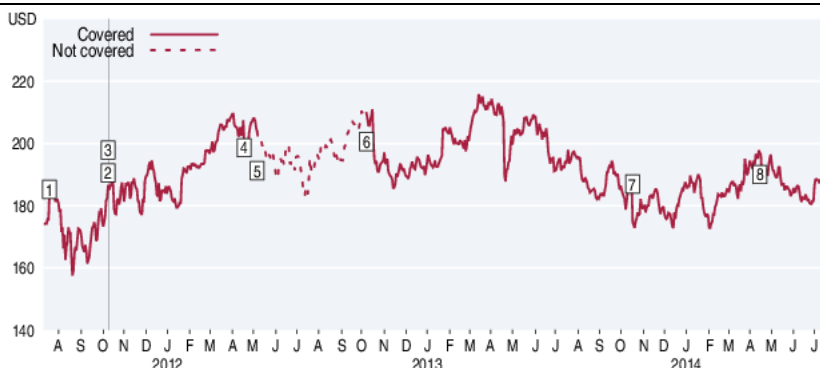
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IMPORTANT DISCLOSURES

International Business Machines Corp (IBM)

Ratings and Target Price History Fundamental Research

Analyst: Jim Suva, CPA
Covered since October 8 2012



	Date	Rating	Target Price	Closing Price
1	19-Jul-11	1M	*205.00	185.21
2	8-Oct-11	Stock rating system changed		
3	8-Oct-11	*1	205.00	182.39

* Indicates change

	Date	Rating	Target Price	Closing Price
4	18-Apr-12	1	*235.00	200.13
5	7-May-12	Coverage terminated		
6	8-Oct-12	1	*250.00	209.82

	Date	Rating	Target Price	Closing Price
7	17-Oct-13	1	*235.00	174.83
8	15-Apr-14	*2	*200.00	197.02

Rating/target price changes above reflect Eastern Standard Time

International Business Machines Corp (IBM)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Jim Suva, CPA
Covered since October 8 2012



	Date	Rating	Target Price	Closing Price
1	24-Aug-11	*ADD MP	-	166.76

* Indicates change

	Date	Rating	Target Price	Closing Price
2	7-May-12	*REM MP	-	203.75

Rating/target price changes above reflect Eastern Standard Time

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Citi Research Equity Ratings Distribution

<i>Data current as of 30 Jun 2014</i>	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Research Global Fundamental Coverage	49%	40%	12%	0%	100%	0%
% of companies in each rating category that are investment banking clients	55%	53%	46%	0%	54%	0%

Guide to Citi Research Fundamental Research Investment Ratings:

Citi Research stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.

Risk rating takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

Investment Ratings: Citi Research investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of Citi Research management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

Prior to May 1, 2014 Citi Research may have also assigned a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may have highlighted a specific near-term catalyst or event impacting the company or the market that was anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) may have indicated the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may have been different from and did not affect a stock's fundamental equity rating, which reflected a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls corresponded to a buy recommendation and least preferred calls corresponded to a sell recommendation. Any stock not assigned to a most preferred or least preferred call was considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we corresponded NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we did not consider NRR to be a recommendation.

Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings**, which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of the Citi Research expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings were: Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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Citigroup Global Markets Inc

Jim Suva, CPA; Ashwin Shirvaikar, CFA; Asiya Merchant, CFA

OTHER DISCLOSURES

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