

International Business Machines Corp (IBM)

Modest 1Q Miss due to Deal Slippage, But Remain Constructive on Impressive Service Signings; Reiterate Buy

- Company Update
- Estimate Change

- **Quick Call** — IBM shares are up +9.5% YTD, outperforming the market (+8.5% for SP500). However, IBM's softer reported 1Q sales and EPS may limit any out-performance near term. That said, we remain constructive on the shares despite the softer results (similar to Accenture, Oracle, and others) given that IBM's service backlog is up 5% yoy and signings up +48% yoy (at cc) both of which favorably positions the company to achieve its earnings target. Mgt remains confident in its full-year EPS guidance of "at least \$16.70". We note that 1H headwinds such as the govt sequester and unfavorable fx may pressure the shares near-term, but believe any pull-back presents a buying opportunity. We reiterate our Buy rating and \$250 target price.
- **Event** — Reported 1Q revs of \$23.4B (-5% y/y; -3% y/y at constant currency) were modestly below consensus estimate of \$24.6B. Non-GAAP EPS of \$3.00 (+8% y/y) were also modestly below consensus expectation of \$3.05, primarily due to the top-line miss. We note that EPS benefited from a lower tax rate (17.3% vs 25% guide) via R&D credit, which helped EPS by a material \$0.27.
- **Positives** — 1) Despite a challenging IT services market, services signings were up a stellar +48% yoy, driven by particularly strong deals in developed markets, with almost half of them coming from new clients, 2) GM of 46.7% was slightly above consensus 46.5% driven by continued margin expansion in Services, and improving mix, 3) Growth initiatives performed well with healthy results in Smarter Planet (>25% y/y), Cloud (>70% y/y), and Business Analytics (>7% y/y), 4) Mgt reiterated its annual EPS target and plans to accelerate workforce rebalancing in 2Q to help achieve this goal.
- **Negatives** — 1) software and mainframe deals slipped into the June quarter, creating an approx. \$400M revs shortfall. The good news is that mgt feels confident that they will close the bulk of those deals in 2Q, 2) currency, especially the Yen, became a more pronounced headwind during the quarter, pressuring top-line by 2 points, 3) shorter-term add-on deals were weak in the quarter as evidenced by the 3% y/y decline in GBS revs, 4) Hardware sales declined by 17% y/y, not only due to the push-out of mainframe deals, but also weak x-86, POWER, and storage.
- **Estimate Revisions** — While we are revising down our revs estimates for FY13-14 by 2-3% due to currency and weak hardware sales, we are only adjusting down our EPS estimates by 1% to reflect the benefit of workforce rebalancing.

Buy	1
Price (18 Apr 13)	US\$207.15
Target price	US\$250.00
Expected share price return	20.7%
Expected dividend yield	1.5%
Expected total return	22.2%
Market Cap	US\$230,871M

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



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2012A	2.78A	3.51A	3.62A	5.39A	15.30A	15.25A
2013E	3.00A	3.82E	3.95E	5.94E	16.71E	16.77E
Previous	2.86E	4.06E	4.00E	5.94E	16.86E	na
2014E	3.61E	4.37E	4.42E	6.37E	18.77E	18.46E
Previous	3.54E	4.47E	4.44E	6.45E	18.90E	na
2015E	3.91E	4.72E	4.77E	6.82E	20.23E	20.30E
Previous	3.87E	4.86E	4.83E	6.97E	20.53E	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\$207.15; TP: US\$250.00; Market Cap: US\$230,871m; Recomm: Buy					
Profit & Loss (US\$m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	106,917	104,507	104,738	109,641	112,696	PE (x)	15.4	13.5	12.4	11.0	10.2
Cost of sales	-56,437	-53,568	-53,131	-54,980	-56,133	PB (x)	12.1	12.5	10.3	8.5	7.0
Gross profit	50,480	50,939	51,607	54,661	56,564	EV/EBITDA (x)	9.3	9.1	8.3	7.5	7.1
Gross Margin (%)	47.2	48.7	49.3	49.9	50.2	FCF yield (%)	6.1	6.4	8.6	9.0	9.8
EBITDA (Adj)	25,677	26,384	28,528	31,351	32,836	Dividend yield (%)	1.4	1.5	1.5	1.5	1.6
EBITDA Margin (Adj) (%)	24.0	25.2	27.2	28.6	29.1	Payout ratio (%)	21	20	19	17	16
Depreciation	-3,589	-3,392	-4,200	-4,200	-4,200	ROE (%)	73.0	84.7	83.0	77.6	69.1
Amortisation	-1,226	-1,284	-515	-515	-515	Cashflow (US\$m)					
EBIT (Adj)	20,862	21,708	23,813	26,636	28,121	EBITDA	25,677	26,384	28,528	31,351	32,836
EBIT Margin (Adj) (%)	19.5	20.8	22.7	24.3	25.0	Working capital	-2,390	-2,449	1,305	383	568
Net interest	-410	-460	-455	-482	-482	Other	-3,933	-4,464	-6,056	-7,061	-7,441
Associates	0	0	0	0	0	Operating cashflow					
Non-op/Except	690	908	-417	-431	-431	Capex	-4,059	-4,307	-4,000	-4,400	-4,400
Pre-tax profit	21,142	22,156	22,940	25,723	27,208	Net acq/disposals	-46	-4,090	-3,690	-3,000	-3,000
Tax	-5,288	-5,553	-5,776	-6,789	-7,160	Other	-291	-608	-342	-396	-408
Extraord./Min.Int./Pref.div.	0	0	0	0	0	Investing cashflow					
Reported net profit	15,854	16,603	17,164	18,935	20,049	Dividends paid	-3,473	-3,773	-4,100	-4,500	-4,500
Net Margin (%)	14.8	15.9	16.4	17.3	17.8	Financing cashflow					
Core NPAT	16,318	17,626	18,581	20,366	21,480	Net change in cash	-13,696	-11,976	-11,964	-15,584	-15,584
Per share data						Free cashflow to s/holders					
Reported EPS (\$)	13.11	14.41	15.43	17.45	18.88		15,295	15,164	19,777	20,273	21,563
Core EPS (\$)	13.49	15.30	16.71	18.77	20.23						
DPS (\$)	2.86	3.02	3.10	3.18	3.26						
CFPS (\$)	16.00	16.90	21.38	22.73	24.45						
FCFPS (\$)	12.65	13.16	17.78	18.68	20.31						
BVPS (\$)	17.17	16.61	20.15	24.37	29.75						
Wtd avg ord shares (m)	1,197	1,143	1,104	1,076	1,053						
Wtd avg diluted shares (m)	1,209	1,152	1,112	1,085	1,062						
Growth rates											
Sales revenue (%)	7.1	-2.3	0.2	4.7	2.8						
EBIT (Adj) (%)	14.1	4.1	9.7	11.9	5.6						
Core NPAT (%)	8.6	8.0	5.4	9.6	5.5						
Core EPS (%)	15.1	13.4	9.2	12.3	7.8						
Balance Sheet (US\$m)											
Cash & cash equiv.	11,922	11,129	15,601	16,894	19,465						
Accounts receivables	11,179	10,667	10,888	11,144	11,462						
Inventory	2,596	2,287	2,334	2,389	2,457						
Net fixed & other tangibles	16,726	14,941	14,313	14,513	14,713						
Goodwill & intangibles	38,003	42,028	43,728	46,213	48,698						
Financial & other assets	36,008	38,162	39,644	40,874	42,166						
Total assets	116,434	119,214	126,508	132,026	138,961						
Accounts payable	8,517	9,181	9,370	9,504	9,710						
Short-term debt	8,463	7,952	8,725	8,725	8,725						
Long-term debt	22,857	24,088	24,672	24,672	24,672						
Provisions & other liab	56,361	59,008	61,371	62,693	64,245						
Total liabilities	96,198	100,229	104,138	105,594	107,352						
Shareholders' equity	20,236	18,985	22,370	26,433	31,609						
Minority interests	0	0	0	0	0						
Total equity	20,236	18,985	22,370	26,433	31,609						
Net debt	19,398	20,911	17,796	16,503	13,932						
Net debt to equity (%)	95.9	110.1	79.6	62.4	44.1						

For further data queries on Citi's full coverage universe please contact Citi Research Data Services at CitiRsch.DataServices.Global@citigroup.com
For definitions of the items in this table, please click [here](#).

Figure 1. 1Q13 Results vs. Citi Estimates

Revenues (\$M)	Actual	Citi Ests	Consensus Ests	Actual vs. Citi
Global Technology Services	\$9,605	\$9,870	\$9,901	-2.7%
Pre-tax Margin	16.1%	14.9%		1.2%
Global Business Services	\$4,484	\$4,720	\$4,592	-5.0%
Pre-tax Margin	15.1%	14.0%		1.0%
Systems and Technology	\$3,106	\$3,217	\$3,724	-3.5%
Pre-tax Margin	-12.6%	-1.1%		-11.5%
Software	\$5,572	\$5,716	\$5,815	-2.5%
Pre-tax Margin	31.5%	31.4%		0.0%
Global Financing	\$499	\$476	\$485	4.8%
Pre-tax Margin	51.7%	49.0%		2.7%
Total Revenues	\$23,408	\$24,099	\$24,646	-2.9%
Gross Margin	46.7%	46.4%	46.5%	0.3%
Operating Margin	16.8%	17.0%	18.0%	-0.3%
Non-GAAP EPS	\$3.00	\$2.86	\$3.05	5.1%

Source: Citi Research, Company Report, Factset

Figure 2. IBM Estimate Revisions

	2FQ13		FY13		FY14	
	New	Old	New	Old	New	Old
Total Revenues (\$B)	\$25.6	\$26.7	\$104.7	\$108.1	\$109.6	\$111.9
Gross Margin	48.7%	49.0%	49.0%	49.2%	49.9%	49.5%
Operating Margin	21.7%	22.0%	22.7%	22.4%	24.3%	23.5%
EPS (Non-GAAP)	\$3.82	\$4.06	\$16.71	\$16.86	\$18.77	\$18.90

Source: Citi Research

Deeper Dive Into Services

Commentary by Ashwin Shirvaikar

IBM's Services business disappointed relative to our revenue estimates even on a currency-adjusted basis but the bookings number was better than we were looking for.

The strength in bookings, up 44% year/year to \$16.9 billion and very broad-based, may surprise many given weak enterprise spending and the inability to close deals within the software and hardware segments, not just for IBM but for many other enterprise providers. On the services side as well, one of the leading third-party consultants TPI/ISG had indicated that 1Q13 was quite weak. However, we also note that Accenture had solid bookings with a similar pattern of closing large and transformational deals that IBM exhibited. From that standpoint, we believe IBM bookings are actually partly a counter-cyclical response to macro pressures and partly what we have characterized for the past few quarters as a strong need at IT buyers to focus on business needs and make long-term strategic investments while cutting elsewhere.

The topic of "IT Spenders cutting elsewhere" is actually a good segue into what we saw on the revenue front within services.

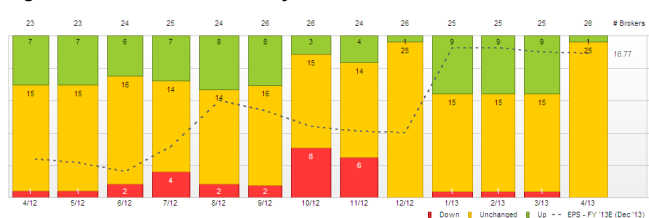
- GTS revenues were down 4% y/y (down 2% year/year constant currency) to \$9.6 billion while pretax profits were up 7% year/year. The revenue decline here is partly due to planned pruning of contracts (about half the constant currency decline) and the rest of it is due to macro weakness (translates to volume sensitivity in BPO and ITO contracts). Integrated Tech Services was the strongest

past of GTS, helped by growth markets and Japan geographically, and we also note that clients are increasingly inclined to buy strategic and focused solutions, especially where total cost of ownership (TCO) reduction can also be achieved. The pruning of lower-margin contracts is helping profitability.

- GBS revenues were down 3% year/year (and flat constant currency) to \$4.5 billion with pre-tax income up 17% year/year. Analytics, Cloud and apps outsourcing seemed to be the healthier part of GBS, which is consistent with the recent trend we have seen within other parts of our Services coverage. At the same time, short-cycle, "within the quarter" project activity is weak – our interpretation is that IT buyers are increasingly being highly focused and disciplined and buying solutions and services they planned for and nothing more (thereby depriving companies of a common historical source of upside). The main year/year profit drivers were continued benefit from enterprise productivity initiatives, lower workforce rebalancing charges (from prior year restructuring) and improved contract performance.

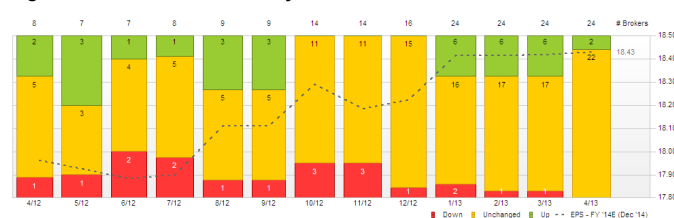
One point to note is that IBM has gained market share over the past year, at the expense of players such as HPQ, and this incremental revenue should start flowing through IBM's P&L over the next year or so. We do note that this share gain seemed to stabilize in the most recent quarter but the impact on revenues tends to be delayed, as we mentioned. Our wallet share survey has also picked up that IBM may be giving up some ground to smaller players - some of this is consistent with IBM's "contract pruning" commentary but we believe the trend bears watching in future quarters to see that it stabilizes.

Figure 3. EPS Estimate History FY13



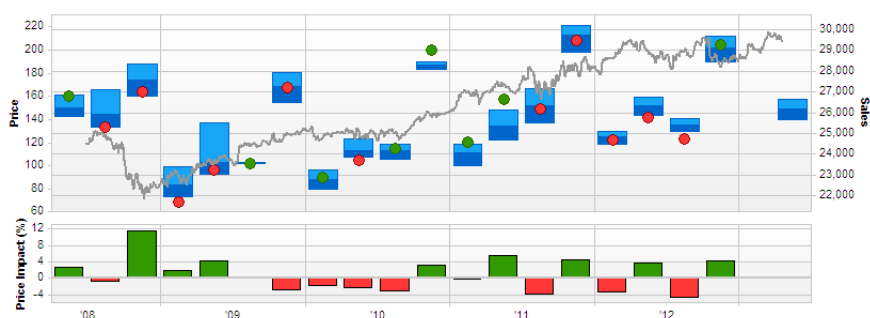
Source: FactSet

Figure 4. EPS Estimate History FY14



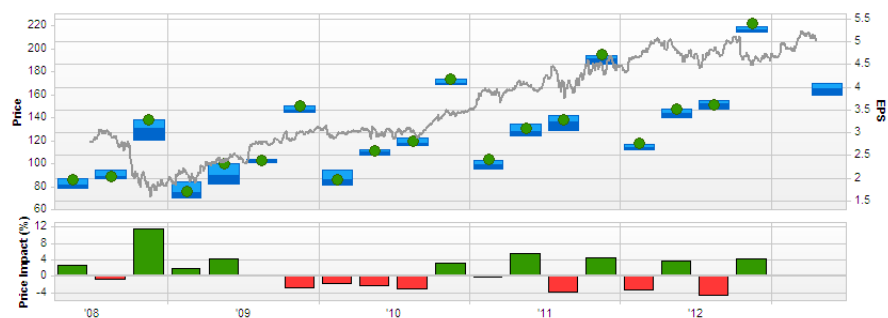
Source: FactSet

Figure 5. Sales Surprise History



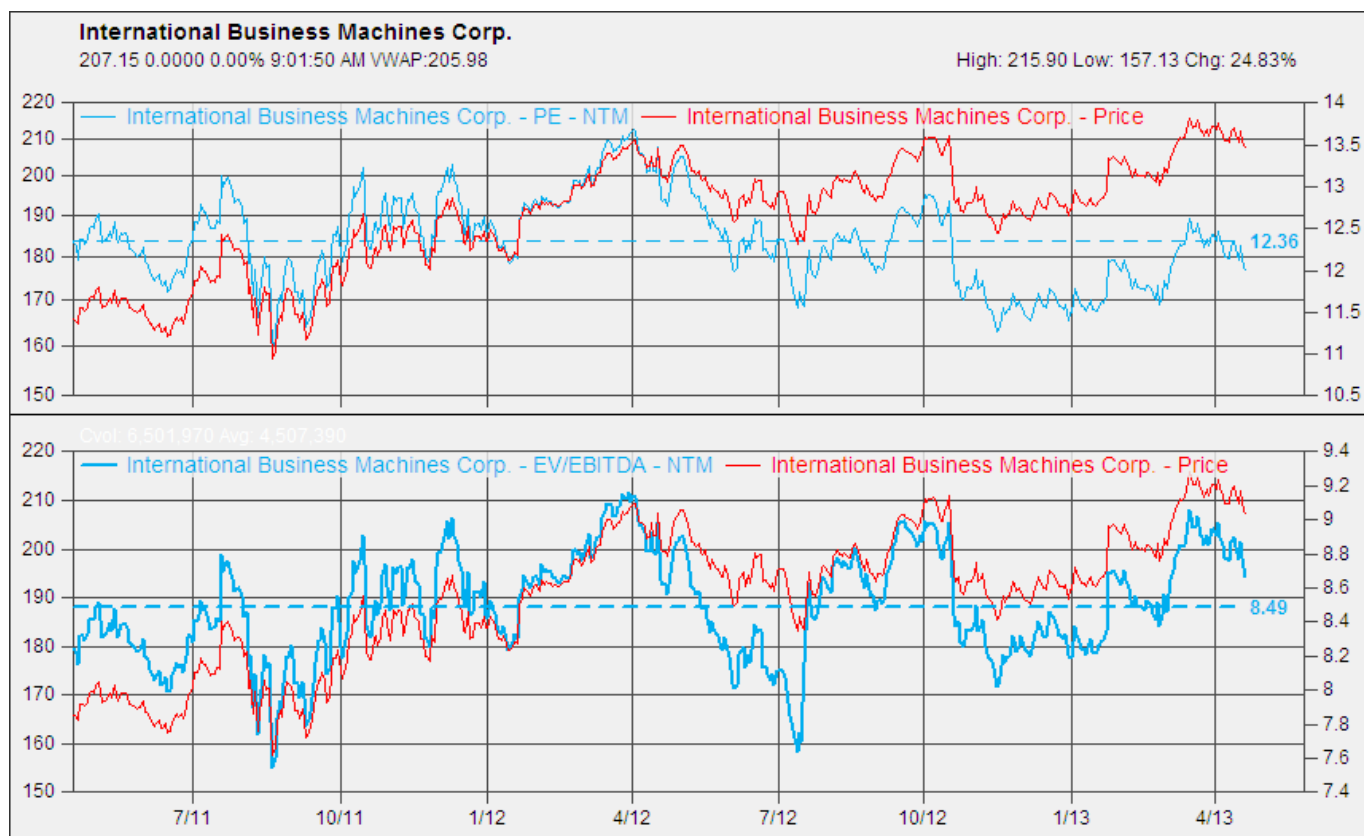
Source: FactSet

Figure 6. non GAAP EPS Surprise History



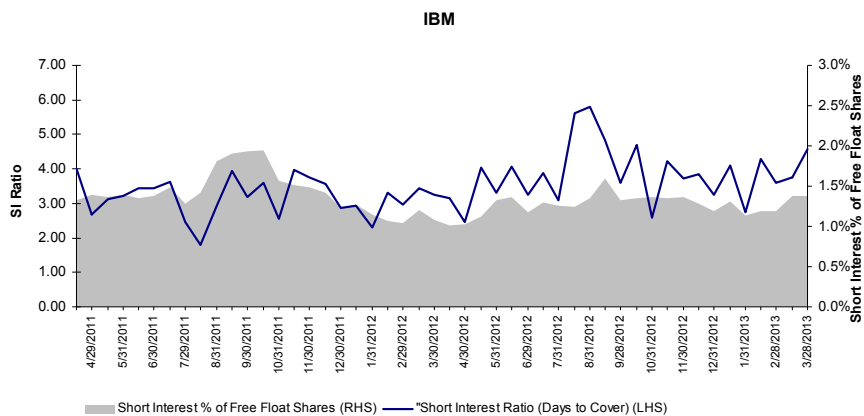
Source: FactSet

Figure 7. IBM Valuation Chart



Source: FactSet

Figure 8. IBM Short Interest



Source: Factset, Citi Research

Figure 9. Share Price Returns Across Our Coverage Universe

Sector / Stocks	2005	2006	2007	2008	2009	2010	2011	2012	2013
Tech Hardware									
IBM	-15.8%	19.8%	12.8%	-20.8%	58.6%	14.3%	27.4%	5.9%	8.6%
HPQ	38.3%	45.2%	23.4%	-27.6%	43.2%	-17.7%	-37.9%	-43.1%	42.7%
DELL	-28.9%	-16.2%	-2.3%	-58.2%	40.2%	-5.6%	8.0%	-29.6%	38.3%
EMC	-8.4%	-3.1%	40.4%	-43.5%	66.9%	31.1%	-5.9%	17.5%	-11.7%
NTAP	-18.7%	45.5%	-36.5%	-44.0%	146.0%	60.0%	-34.0%	-7.5%	0.7%
MSI	32.4%	-8.2%	-21.1%	-71.6%	75.2%	16.9%	25.9%	22.6%	10.3%
XRX	-13.9%	15.7%	-4.2%	-50.0%	8.9%	38.5%	-29.6%	-12.3%	27.4%
LXK	-47.3%	63.3%	-52.4%	-22.8%	-3.4%	34.0%	-4.3%	-26.6%	11.5%
EFII	52.8%	-0.1%	-15.4%	-57.5%	35.7%	10.3%	-0.4%	33.3%	26.9%
Handset									
AAPL	123.3%	18.0%	133.5%	-56.9%	146.9%	53.1%	25.6%	32.6%	-25.9%
MMI	32.4%	-8.2%	-21.1%	-71.6%	75.2%	16.9%	33.3%	-	-
NOK1V-HEL	36.6%	2.4%	75.3%	-57.0%	-16.6%	-9.1%	-47.9%	-15.9%	-17.4%
BBRY	-19.9%	93.6%	166.2%	-64.2%	66.4%	-13.9%	-75.1%	-18.1%	13.7%
CELL	112.9%	-12.7%	14.2%	-71.7%	69.0%	18.8%	23.3%	-	-
Optical/Glass									
GLW	67.0%	-4.8%	28.8%	-59.8%	105.6%	1.2%	-31.9%	-0.2%	4.2%
Electronic Manufacturing Services									
BHE	-1.4%	8.7%	-27.2%	-28.0%	48.1%	-4.0%	-25.8%	23.4%	-1.9%
CLS	-25.2%	-26.0%	-25.7%	-20.5%	104.8%	2.8%	-24.4%	11.2%	-5.3%
FLEX	-24.5%	10.0%	5.1%	-78.8%	185.5%	7.4%	-27.9%	9.7%	7.2%
JBL	45.0%	-33.3%	-37.0%	-54.7%	166.1%	18.0%	-0.7%	-0.4%	-12.7%
PLXS	74.8%	5.0%	10.0%	-35.5%	68.0%	8.6%	-11.5%	-5.8%	-1.5%
SANM	-49.7%	-19.0%	-47.2%	-74.2%	291.1%	4.1%	-18.9%	18.9%	-5.8%
Distributors									
ARW	31.8%	-1.5%	24.5%	-52.0%	57.2%	15.7%	9.2%	1.8%	-3.4%
AVT	31.3%	6.6%	37.0%	-47.9%	65.6%	9.5%	-5.9%	-1.5%	4.3%
IM	-4.2%	2.4%	-11.6%	-25.8%	30.3%	9.4%	-4.7%	-7.0%	3.1%
TECD	-12.8%	-4.4%	-0.4%	-52.7%	161.5%	-5.7%	12.2%	-7.9%	-4.5%
SNX	-37.2%	45.2%	-10.7%	-42.2%	170.6%	1.8%	-2.4%	12.9%	-4.6%
Connectors									
TEL				-55.5%	56.8%	47.5%	-11.1%	23.4%	5.9%
APH	20.8%	40.6%	49.6%	-48.2%	92.9%	14.4%	-13.9%	43.6%	11.8%
MOLX	-12.9%	22.9%	-12.5%	-45.5%	54.0%	8.6%	8.5%	18.4%	-0.6%
ST						66.0%	-12.7%	23.6%	-4.2%
Passive Components									
AVX	16.3%	3.1%	-8.4%	-39.9%	62.1%	23.3%	-15.9%	-13.1%	4.2%
VSH	-8.4%	-1.6%	-15.7%	-70.0%	144.2%	95.4%	-38.8%	18.2%	10.2%
MARKET INDEX									
COMP	1.4%	9.5%	9.8%	-40.5%	43.9%	16.9%	-1.8%	15.9%	4.9%
SP50	3.0%	13.6%	3.5%	-38.5%	23.5%	12.8%	0.0%	13.4%	8.1%
SECTOR AVERAGE									
Tech Hardware	-13.9%	15.7%	-4.2%	-44.0%	43.2%	16.9%	-4.3%	-7.5%	11.5%
Handsets	36.6%	2.4%	75.3%	-64.2%	69.0%	16.9%	23.3%	-15.9%	-17.4%
Glass	67.0%	-4.8%	28.8%	-59.8%	105.6%	1.2%	-31.9%	-0.2%	4.2%
EMS/Tech Supply Chain	-4.2%	3.1%	-10.7%	-48.1%	80.5%	9.4%	-11.5%	11.2%	-1.5%
Coverage Universe (Average)	12.9%	10.3%	9.0%	-50.0%	86.3%	17.9%	-9.6%	4.3%	4.4%
Coverage Universe (Median)	-2.8%	2.8%	-3.3%	-52.0%	66.9%	12.3%	-8.5%	3.9%	3.7%

Note: 1) MSI and MMI were previously MOT, 2) MMI was acquired by GOOG in May 2012, 3) CELL was acquired by IM in Oct 2012

Source: Citi Research, Factset

Figure 10. IBM Income Statement

Income Statement (IBM)													
Fiscal Year Ends December													
Dollars in Millions													
	FY10	FY11	1Q Mar-12	2Q Jun-12	3Q Sep-12	4Q Dec-12	FY12	1Q Mar-13	2Q Jun-13	3Q Sep-13	4Q Dec-13	FY13E	FY14E
Total Services Revenue	\$58,535	\$62,202	\$15,148	\$15,133	\$14,924	\$15,482	\$60,687	\$14,517	\$14,900	\$15,429	\$16,091	\$60,937	\$63,567
% chg yr to yr	3%	7%	1%	-3%	-5%	-2%	-2%	-4%	-2%	3%	3%	0%	4%
% chg qtr to qtr	-	-	-4%	0%	-1%	4%	-	-6%	2%	4%	4%	-	-
Total Hardware Revenue	\$18,775	\$19,823	\$3,900	\$4,418	\$4,076	\$5,949	\$18,343	\$3,226	\$4,237	\$4,131	\$5,318	\$16,912	\$17,479
% chg yr to yr	11%	6%	-7%	-9%	-13%	-1%	-7%	-17%	-5%	1%	-12%	-9%	3%
% chg qtr to qtr	-	-	-35%	14%	-9%	48%	-	-46%	30%	-2%	29%	-	-
Total Hardware Revenue	\$18,775	\$19,823	\$3,900	\$4,418	\$4,076	\$5,949	\$18,343	\$3,226	\$4,237	\$4,131	\$5,318	\$16,912	\$17,479
% chg yr to yr	11%	6%	-7%	-9%	-13%	-1%	-7%	-17%	-5%	1%	-12%	-9%	3%
% chg qtr to qtr	-	-	-35%	14%	-9%	48%	-	-46%	30%	-2%	29%	-	-
Total Software Revenue	\$25,434	\$28,219	\$6,440	\$6,947	\$6,606	\$8,730	\$28,723	\$6,403	\$7,455	\$7,280	\$9,867	\$31,005	\$33,262
% chg yr to yr	5%	11%	6%	0%	-1%	3%	2%	-1%	6%	11%	9%	7%	7%
% chg qtr to qtr	-	-	-27%	10%	-7%	37%	-	-30%	17%	-2%	36%	-	-
Total Global Financing Revenue	\$4,079	\$4,196	\$975	\$1,032	\$963	\$1,103	\$4,073	\$1,040	\$952	\$904	\$995	\$3,892	\$3,655
% chg yr to yr	-3%	-6%	-5%	0%	-9%	-2%	-4%	2%	2%	6%	3%	3%	-3%
% chg qtr to qtr	-	-	-11%	6%	-9%	13%	-	-7%	6%	-5%	10%	-	-
Revenue	\$99,870	\$106,917	\$24,673	\$25,783	\$24,747	\$29,304	\$104,507	\$23,408	\$25,594	\$25,824	\$29,912	\$104,738	\$109,641
% chg qtr to qtr	0%	0%	-16%	4%	-4%	18%	0%	-20%	9%	1%	16%	0%	0%
Cost of Goods Sold	\$53,801	\$56,437	\$13,395	\$13,343	\$12,853	\$13,977	\$53,568	\$12,471	\$13,131	\$13,265	\$14,264	\$53,131	\$54,980
Gross Profit	\$46,069	\$50,480	\$11,278	\$12,440	\$11,894	\$15,327	\$50,939	\$10,937	\$12,463	\$12,560	\$15,647	\$51,343	\$54,661
SG&A	\$21,628	\$23,273	\$5,766	\$5,717	\$5,625	\$5,801	\$22,909	\$5,381	\$5,310	\$5,291	\$5,444	\$21,427	\$21,580
R&D	\$6,152	\$6,345	\$1,605	\$1,592	\$1,539	\$1,586	\$6,322	\$1,628	\$1,589	\$1,556	\$1,594	\$6,367	\$6,445
Operating Expenses	\$27,780	\$29,618	\$7,371	\$7,309	\$7,164	\$7,387	\$29,231	\$7,009	\$6,899	\$6,847	\$7,038	\$27,794	\$28,025
Operating Income	\$18,289	\$20,862	\$3,907	\$5,131	\$4,730	\$7,940	\$21,708	\$3,928	\$5,563	\$5,713	\$8,609	\$23,813	\$26,636
Depr and amort	\$4,831	\$4,815	\$1,157	\$1,176	\$1,191	\$1,152	\$4,676	\$1,179	\$1,179	\$1,179	\$1,179	\$4,715	\$4,715
EBITDA	\$23,120	\$25,677	\$5,064	\$6,307	\$5,921	\$9,092	\$26,384	\$5,107	\$6,742	\$6,891	\$9,788	\$28,528	\$31,351
Other (income), expense	(\$793)	(\$46)	(\$59)	(\$133)	(\$611)	(\$54)	(\$857)	(\$67)	(\$67)	(\$67)	(\$67)	(\$268)	(\$268)
Intellectual property and custom dev (income)	(\$1,154)	(\$1,108)	(\$255)	(\$289)	(\$303)	(\$227)	(\$1,074)	(\$183)	(\$183)	(\$183)	(\$183)	(\$732)	(\$732)
Interest Expense	\$369	\$410	\$110	\$117	\$124	\$109	\$460	\$94	\$120	\$120	\$120	\$455	\$482
Pretax Income	\$19,867	\$21,606	\$4,111	\$5,436	\$5,520	\$8,112	\$23,179	\$4,084	\$5,693	\$5,842	\$8,738	\$24,358	\$27,154
Provision for Taxes	\$4,845	\$5,288	\$846	\$1,359	\$1,365	\$1,983	\$5,553	\$708	\$1,423	\$1,461	\$2,185	\$5,776	\$6,789
Effective Tax Rate	24.4%	24.5%	20.6%	25.0%	24.7%	24.4%	24.0%	17.3%	25.0%	25.0%	25.0%	23.7%	25.0%
Net Income	\$15,022	\$16,318	\$3,265	\$4,077	\$4,155	\$6,129	\$17,626	\$3,376	\$4,270	\$4,382	\$6,554	\$18,581	\$20,366
Non-GAAP Net Income to Common	\$15,022	\$16,318	\$3,265	\$4,077	\$4,155	\$6,129	\$17,626	\$3,376	\$4,270	\$4,382	\$6,554	\$18,581	\$20,366
GAAP Net Income	\$14,834	\$15,854	\$3,065	\$3,881	\$3,824	\$5,833	\$16,603	\$3,032	\$3,912	\$4,024	\$6,196	\$17,164	\$18,935
Basic EPS	\$11.84	\$13.63	\$2.82	\$3.55	\$3.65	\$5.45	\$15.43	\$3.03	\$3.85	\$3.98	\$6.00	\$16.83	\$18.92
Diluted EPS (non-GAAP)	\$11.72	\$13.49	\$2.78	\$3.51	\$3.62	\$5.39	\$15.30	\$3.00	\$3.82	\$3.95	\$5.94	\$16.71	\$18.77
Basic Shares Out (million)	1,269	1,197	1,159	1,149	1,137	1,125	1,143	1,114	1,108	1,100	1,093	1,104	1,076
Diluted Shares Out (million)	1,281	1,209	1,174	1,162	1,149	1,136	1,152	1,124	1,118	1,111	1,103	1,112	1,085
Percent of Revenue													
Gross Margin (incl. Options Expense)	46.1%	47.2%	45.7%	48.2%	48.1%	52.3%	48.7%	46.7%	48.7%	48.6%	52.3%	49.0%	49.9%
SG&A + Options Expense	21.7%	21.8%	23.4%	22.2%	22.7%	19.8%	21.9%	23.0%	20.7%	20.5%	18.2%	20.5%	19.7%
R&D + Options Expense	6.2%	5.9%	6.5%	6.2%	6.2%	5.4%	6.0%	7.0%	6.2%	6.0%	5.3%	6.1%	5.9%
Total Op Ex	27.8%	27.7%	29.9%	28.3%	28.9%	25.2%	28.0%	29.9%	27.0%	26.5%	23.5%	26.5%	25.6%
Operating Income	18.3%	19.5%	15.8%	19.9%	19.1%	27.1%	20.8%	16.8%	21.7%	22.1%	28.8%	22.7%	24.3%
Pre-tax Income	19.9%	20.2%	16.7%	21.1%	22.3%	27.7%	22.2%	17.4%	22.2%	22.6%	29.2%	23.3%	24.8%
Net Income	15.0%	15.3%	13.2%	15.8%	16.8%	20.9%	16.9%	14.4%	16.7%	17.0%	21.9%	17.7%	18.6%
% Change Year to Year													
Revenue	4.3%	7.1%	0.3%	-3.3%	-5.4%	-0.6%	-2.3%	-5.1%	-0.7%	4.4%	2.1%	0.2%	4.7%
Cost of Sales + Options Expense	3.4%	4.9%	-1.9%	-6.0%	-7.6%	-4.9%	-5.1%	-6.9%	-1.6%	3.2%	2.1%	-0.8%	3.5%
Gross Profit	5.4%	9.6%	2.9%	-0.3%	-2.9%	3.6%	0.9%	-3.0%	0.2%	5.6%	2.1%	0.8%	6.5%
SG&A + Options Expense	4.1%	7.6%	0.5%	-3.9%	0.7%	-3.3%	-1.6%	-6.7%	-7.1%	-5.9%	-6.2%	-6.5%	0.7%
R&D + Options Expense	3.5%	3.1%	-0.1%	-0.1%	-1.8%	0.5%	-0.4%	1.4%	-0.2%	1.1%	0.5%	0.7%	1.2%
Total Op Ex	3.9%	6.6%	0.3%	-3.1%	0.1%	-2.5%	-1.3%	-4.9%	-5.6%	-4.4%	-4.7%	-4.9%	0.8%
Operating Income	7.6%	14.1%	8.2%	4.0%	-7.2%	10.0%	4.1%	0.5%	8.4%	20.8%	8.4%	9.7%	11.9%
Pretax Income	9.6%	8.8%	3.1%	7.9%	6.6%	9.5%	7.3%	-0.7%	4.7%	5.8%	7.7%	5.1%	11.5%
Net Income	11.7%	8.6%	9.2%	7.9%	5.1%	9.5%	8.0%	3.4%	4.7%	5.5%	6.9%	5.4%	9.6%
Fully Diluted EPS before Extra	16.9%	15.1%	15.3%	13.5%	10.2%	14.5%	13.4%	8.0%	8.8%	9.1%	10.1%	9.2%	12.3%

Source: Citi Research, Company Reports

Figure 11. IBM Balance Sheet and Cash Flow Statement

Fiscal Year Ends December	FY10	FY11	1Q	2Q	3Q	4Q	FY12	1Q	2QE	3QE	4QE	FY13E	FY14E
Dollars in Millions			Mar-12	Jun-12	Sep-12	Dec-12		Mar-13	Jun-13	Sep-13	Dec-13		
Cash and Cash Equivalents	\$10,661	\$11,922	\$11,835	\$10,864	\$11,909	\$10,412	\$10,412	\$10,585	\$7,513	\$9,209	\$14,194	\$14,194	\$15,487
Marketable Securities	\$990	\$0	\$500	\$323	\$345	\$717	\$717	\$1,407	\$1,407	\$1,407	\$1,407	\$1,407	\$1,407
Trade Receivables	\$10,834	\$11,179	\$10,012	\$10,172	\$9,772	\$10,667	\$10,667	\$10,084	\$10,097	\$10,197	\$10,888	\$10,888	\$11,144
Short-term Financing Receivables	\$16,257	\$16,901	\$15,160	\$14,982	\$14,925	\$18,038	\$18,038	\$16,141	\$15,431	\$15,373	\$18,579	\$18,579	\$19,137
Other Receivables	\$1,134	\$1,481	\$1,669	\$1,703	\$2,066	\$1,873	\$1,873	\$1,971	\$1,971	\$1,971	\$1,971	\$1,971	\$1,971
Total Inventories	\$2,450	\$2,596	\$2,754	\$2,758	\$2,586	\$2,287	\$2,287	\$2,421	\$2,738	\$2,699	\$2,334	\$2,334	\$2,389
Deferred Income Taxes	\$1,564	\$1,601	\$1,617	\$1,478	\$1,522	\$1,415	\$1,415	\$1,592	\$1,603	\$1,838	\$1,534	\$1,534	\$1,606
Prepaid Expenses and Other Current Assets	\$4,226	\$5,249	\$5,299	\$5,113	\$5,016	\$4,024	\$4,024	\$4,747	\$5,544	\$6,058	\$4,363	\$4,363	\$4,568
Total Current Assets	\$48,116	\$50,929	\$48,846	\$47,393	\$48,141	\$49,433	\$49,433	\$48,948	\$46,304	\$48,752	\$55,271	\$55,271	\$57,708
Property, Plant and Equipment, gross	\$40,289	\$40,124	\$40,441	\$41,559	\$42,448	\$40,501	\$40,501	\$40,056	\$41,056	\$42,056	\$43,056	\$43,056	\$47,456
Accumulated Depreciation	(\$26,193)	(\$26,241)	(\$26,496)	(\$27,355)	(\$28,221)	(\$26,505)	(\$26,505)	(\$26,496)	(\$27,546)	(\$28,596)	(\$29,646)	(\$29,646)	(\$33,846)
Property, Plant and Equipment, net	\$14,096	\$13,883	\$13,946	\$14,203	\$14,227	\$13,996	\$13,996	\$13,560	\$13,510	\$13,460	\$13,410	\$13,410	\$13,610
Long-term Financing Receivables	\$10,548	\$10,776	\$10,549	\$10,795	\$10,791	\$12,812	\$12,812	\$11,946	\$11,119	\$11,115	\$13,196	\$13,196	\$13,592
Intangible Assets & Other	\$12,486	\$11,790	\$11,563	\$11,182	\$11,126	\$12,781	\$12,781	\$12,839	\$12,710	\$12,582	\$12,453	\$12,453	\$11,938
Goodwill	\$25,136	\$26,213	\$27,468	\$27,735	\$28,270	\$29,247	\$29,247	\$29,025	\$29,775	\$30,525	\$31,275	\$31,275	\$34,275
Prepaid Pension Assets	\$3,068	\$2,843	\$2,974	\$2,862	\$3,424	\$945	\$945	\$903	\$903	\$903	\$903	\$903	\$903
Total Intangible and Other Assets	\$40,690	\$40,846	\$42,005	\$41,779	\$42,820	\$42,973	\$42,973	\$42,767	\$43,388	\$44,010	\$44,631	\$44,631	\$47,116
Total Assets	\$113,450	\$116,434	\$115,346	\$113,832	\$115,779	\$119,214	\$119,214	\$117,258	\$114,321	\$117,336	\$126,508	\$126,508	\$132,026
Income Taxes Payable	\$4,216	\$3,313	\$2,184	\$2,183	\$2,147	\$4,948	\$4,948	\$4,678	\$2,286	\$2,272	\$5,330	\$5,330	\$5,577
Accounts Payable	\$7,804	\$8,517	\$7,416	\$7,482	\$7,085	\$9,181	\$9,181	\$7,203	\$7,363	\$7,312	\$9,370	\$9,370	\$9,504
Compensation and benefits	\$5,028	\$5,099	\$4,370	\$4,656	\$4,730	\$4,745	\$4,745	\$3,964	\$4,796	\$4,872	\$4,887	\$4,887	\$5,034
Short-term Debt	\$6,778	\$8,463	\$6,293	\$7,669	\$9,334	\$7,952	\$7,952	\$8,725	\$8,725	\$8,725	\$8,725	\$8,725	\$8,725
Deferred Income	\$11,580	\$12,197	\$13,269	\$12,311	\$11,230	\$11,952	\$11,952	\$12,971	\$12,971	\$12,971	\$12,971	\$12,971	\$12,971
Other current	\$5,156	\$4,535	\$4,677	\$4,602	\$4,973	\$4,847	\$4,847	\$4,583	\$4,740	\$5,122	\$4,992	\$4,992	\$5,142
Total Current Liabilities	\$40,562	\$42,124	\$38,209	\$38,903	\$39,499	\$43,625	\$43,625	\$42,124	\$40,881	\$41,274	\$46,276	\$46,276	\$46,952
Long Term Debt	\$21,846	\$22,857	\$25,760	\$24,766	\$24,333	\$24,088	\$24,088	\$24,672	\$24,672	\$24,672	\$24,672	\$24,672	\$24,672
Other Liabilities	\$27,871	\$31,217	\$30,595	\$29,599	\$30,280	\$32,516	\$32,516	\$31,249	\$29,382	\$31,598	\$33,190	\$33,190	\$33,970
Total Liabilities	\$90,279	\$96,198	\$94,564	\$93,268	\$94,112	\$100,229	\$100,229	\$98,045	\$94,935	\$97,545	\$104,138	\$104,138	\$105,594
Common Stock	\$45,418	\$48,129	\$48,800	\$49,157	\$49,603	\$50,110	\$50,110	\$50,522	\$50,522	\$50,522	\$50,522	\$50,522	\$50,522
Retained Earnings	\$92,532	\$104,857	\$107,036	\$109,928	\$112,773	\$117,641	\$117,641	\$119,713	\$122,600	\$125,599	\$130,770	\$130,770	\$145,205
Treasury Stock	(\$96,161)	(\$110,963)	(\$114,020)	(\$117,116)	(\$120,115)	(\$123,131)	(\$123,131)	(\$125,677)	(\$128,270)	(\$130,863)	(\$133,456)	(\$133,456)	(\$143,828)
Accumulated Gain (Loss) not affecting R.E.	(\$18,743)	(\$21,885)	(\$21,115)	(\$21,498)	(\$20,720)	(\$25,759)	(\$25,759)	(\$25,466)	(\$25,466)	(\$25,466)	(\$25,466)	(\$25,466)	(\$25,466)
Noncontrolling Interest and Others	\$125	\$98	\$81	\$93	\$126	\$124	\$124	\$121	\$0	\$0	\$0	\$0	\$0
Shareholders' Equity	\$23,171	\$20,236	\$20,782	\$20,564	\$21,667	\$18,985	\$18,985	\$19,213	\$19,386	\$19,792	\$22,370	\$22,370	\$26,433
Total Liabilities and Equity	\$113,450	\$116,434	\$115,346	\$113,832	\$115,779	\$119,214	\$119,214	\$117,258	\$114,321	\$117,336	\$126,508	\$126,508	\$132,026

Cash Flow Statement (IBM)	FY10	FY11	1Q	2Q	3Q	4Q	FY12	1Q	2QE	3QE	4QE	FY13E	FY14E
Dollars in Millions			Mar-12	Jun-12	Sep-12	Dec-12		Mar-13	Jun-13	Sep-13	Dec-13		
Net Income	\$14,833	\$15,855	\$3,066	\$3,882	\$3,823	\$5,833	\$16,604	\$3,032	\$3,912	\$4,024	\$6,196	\$17,164	\$18,935
Depreciation	\$3,657	\$3,589	\$847	\$859	\$866	\$820	\$3,392	\$1,050	\$1,050	\$1,050	\$1,050	\$4,200	\$4,200
Amortization of Intangibles	\$1,174	\$1,226	\$310	\$317	\$325	\$332	\$1,284	\$129	\$129	\$129	\$129	\$515	\$515
Stock-based compensation	\$629	\$697	\$168	\$160	\$182	\$178	\$688	\$178	\$178	\$178	\$178	\$712	\$712
Gain on Sale of Assets	(\$801)	(\$342)	(\$143)	\$25	(\$579)	(\$32)	(\$729)	\$0	\$0	\$0	\$0	\$0	\$0
Balance Sheet Items:													
Accounts receivable	(\$489)	(\$1,279)	\$0	\$0	\$0	\$0	(\$2,230)	\$583	(\$13)	(\$100)	(\$691)	(\$221)	(\$256)
Inventories	\$92	(\$163)	\$0	\$0	\$0	\$0	\$280	(\$134)	(\$317)	\$39	\$364	(\$47)	(\$55)
Deferred Income Taxes	\$1,294	\$1,212	\$0	\$0	\$0	\$0	\$797	(\$177)	(\$11)	(\$236)	\$304	(\$119)	(\$72)
Pension Assets	(\$1,963)	(\$1,371)	\$0	\$0	\$0	\$0	(\$1,008)	\$0	\$0	\$0	\$0	\$0	\$0
Other Assets	\$949	(\$28)	\$0	\$0	\$0	\$0	\$733	\$1,076	(\$87)	(\$455)	(\$1,511)	(\$978)	(\$762)
Accounts payable	\$174	\$451	\$0	\$0	\$0	\$0	(\$224)	(\$1,978)	\$160	(\$51)	\$2,058	\$189	\$134
Other liabilities	\$0	\$0	\$0	\$0	\$0	\$0	\$0	(\$1,563)	(\$3,270)	\$2,661	\$4,535	\$2,363	\$1,322
Cash Flows from Operations	\$19,549	\$19,847	\$4,291	\$4,436	\$4,513	\$6,347	\$19,587	\$2,196	\$1,731	\$7,238	\$12,612	\$23,777	\$24,673
Net Investment in PP&E	(\$3,415)	(\$3,500)	(\$842)	(\$1,118)	(\$889)	(\$823)	(\$3,672)	(\$1,000)	(\$1,000)	(\$1,000)	(\$1,000)	(\$4,000)	(\$4,400)
Investments in Software	(\$569)	(\$559)	(\$160)	(\$160)	(\$156)	(\$159)	(\$635)	\$0	\$0	\$0	\$0	\$0	\$0
Purchase of ST Investments	(\$6,129)	(\$1,594)	(\$1,227)	(\$428)	(\$941)	(\$1,513)	(\$4,109)	(\$690)	\$0	\$0	\$0	(\$690)	\$0
Proceeds from ST Investments	\$7,877	\$3,345	\$681	\$566	\$724	\$1,171	\$3,142	\$0	\$0	\$0	\$0	\$0	\$0
Acquisitions	(\$5,922)	(\$1,811)	(\$1,319)	(\$606)	(\$341)	(\$1,456)	(\$3,722)	(\$750)	(\$750)	(\$750)	(\$750)	(\$3,000)	(\$3,000)
Divestitures	\$55	\$14	\$0	\$0	\$0	\$599	\$599	\$0	\$0	\$0	\$0	\$0	\$0
Other Investing Liabilities	(\$404)	(\$291)	\$636	\$63	\$605	(\$1,912)	(\$608)	\$908	\$827	\$4	(\$2,082)	(\$342)	(\$396)
Cash Flows from Investing	(\$8,507)	(\$4,396)	(\$2,231)	(\$1,683)	(\$998)	(\$4,093)	(\$9,005)	(\$1,532)	(\$923)	(\$1,746)	(\$3,832)	(\$8,032)	(\$7,796)
Proceeds from New Debt	\$8,055	\$9,996	\$3,906	\$3,653	\$2,030	\$2,653	\$12,242	\$1,357	\$0	\$0	\$0	\$1,357	\$0
Short-term repayments/borrowings	\$817	\$1,321	(\$2,107)	(\$129)	\$59	\$1,736	(\$441)	\$0	\$0	\$0	\$0	\$0	\$0
Payments to Settle Debt	(\$6,522)	(\$8,947)	(\$848)	(\$3,221)	(\$922)	(\$4,558)	(\$9,549)	\$0	\$0	\$0	\$0	\$0	\$0
Common Stock Repurchases - net	(\$15,375)	(\$15,046)	(\$3,015)	(\$2,987)	(\$2,986)	(\$3,007)	\$11,995	(\$2,593)	(\$2,593)	(\$2,593)	(\$2,593)	(\$10,372)	(\$10,372)
Common Stock Transactions, other	\$3,774	\$2,453	\$619	\$299	\$280	\$342	\$1,540	\$0	\$0	\$0	\$0	\$0	\$0
Cash Dividends Paid	(\$3,178)	(\$3,473)	(\$870)	(\$978)	(\$968)	(\$957)	(\$3,773)	(\$1,025)	(\$1,025)	(\$1,025)	(\$1,025)	(\$4,100)	(\$4,500)
Cash Flows from Financing	\$12,429	\$13,696	(\$2,315)	(\$3,363)	(\$2,507)	(\$3,791)	\$11,976	(\$492)	(\$3,880)	(\$3,796)	(\$3,796)	(\$11,964)	(\$15,584)
Effect of FX Rate Changes on Cash	(\$135)	(\$493)	\$167	(\$360)	\$37	\$40	(\$116)	\$0	\$0	\$0	\$0	\$0	\$0
Net Change in Cash	(\$1,522)	\$1,262	(\$88)	(\$970)	\$1,045	(\$1,497)	(\$1,510)	\$172	(\$3,072)	\$1,696	\$4,985	\$3,781	\$1,293

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 \$107B revenue in 2011 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 56%, 18%, 23%, and 2% of 2011 total revenue, respectively. The same categories showed 33%, 40%, 89%, and 50% gross margins, respectively, with an aggregate gross margin of 47%. IBM operates labs around the world and its R&D expense in 2011 was \$6.3 billion as the company continues to innovate and evolve for future enterprise needs.

Investment strategy

We rate IBM with a Buy rating and a 12-month target of \$250, as we believe it is one of the most compelling long-term investments within Technology Hardware. IBM is uniquely positioned within the major IT vendors given its arguably best-in-class portfolio of products and services and to embrace BYOD. On hardware, IBM essentially has a monopoly within mainframes which remain superior to x-86 servers in terms of reliability, utilization, security and throughput which will see an upgrade in 2013. IBM's software portfolio, highlighted by its middleware, allows the company to provide superior integration and manageability of the customer's datacenter. IBM's services platform (consulting, BPO, IT outsourcing) allows IBM to offer a turnkey solutions to customer & also a channel to sell its products. The combination of these assets makes IBM arguably the most compelling end-to-end solutions provider in areas such as infrastructure roll-out, system integration, IT outsourcing & BYOD. From a financial perspective, the company is the only company within our universe that sets a 5-year EPS target, which is a testament to its earnings visibility (60-70% of revenues are recurring), as well as the ability to generate earnings growth via a combination of several levers which include organic growth, acquisitions, share repurchases, margin expansion, and productivity gain. Our estimates may prove to be conservative if the following occurs: 1) a meaningful pick-up in short-term consulting deals, which generally occurs with a macro recovery, 2) a potential refresh of the z-Series & IBM shares have generally performed well during the initial stages of the mainframe cycle given the earnings pick up (Roughly 30-35% of IBM's revenues are related to the mainframe business), 3) faster-than-expected share repurchases.

Valuation

Our target price of \$250 is based on 13x forward 12 month EPS estimates 12 months from now. During the past 20 years, we find that IBM shares have traded at a mean multiple of 19X F12 EPS, but this includes periods of significantly higher sales growth which were double digit growth as well as some periods of significant financial distress for IBM in the late 1980s and early 1990s. Since 1997, the shares have traded in a core range of 16-20X F12 EPS, excluding unusual periods during the Internet bubble and subsequent economic downturn. Given medium to long-term potential for single-digit revenue and double-digit EPS growth, good earnings visibility, tempered by the reality that share repurchase and acquisitions drive a substantial amount of IBM's EPS growth, we believe that IBM shares should trade more in line with the current market multiple at 13x compared to the >60% premium during the two decades. We also believe this lower than historical multiple reflects a

deceleration in sales growth stemming from various macro headwinds and general multiple compression across the tech universe. Consequently, we are using a 13x multiple (in line with the S&P). Applying 13x to our F12 month EPS 12 months from now of \$19.07 suggests a 12-month target price of \$250.

Risks

1) Any meaningful slowdown in infrastructure roll-out in emerging markets given that it has been a key driver of IBM's revenue growth (and mainframe adoption), 2) material drop in long-term Services signings as it has an eventual impact to Services revenues, 3) muted adoption of the pending new zSeries mainframes, 4) potential share loss (or slower growth) in the key branded Middleware segment, which could limit the expectation of positive mix shift.

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 the Systems and Technology segment, the company derives close to 28% of its revenues from the highly competitive x-86 market, and another 15-20% comes from Microelectronics and Tape, which generally lacks growth. Within software, a significant portion is tied to the mainframe which has seen more and more competition from x86 platforms.

If the negative impact on the company from any of these factors proves to be greater than we anticipate, the stock will likely have difficulty achieving our target price.

Appendix A-1

Analyst Certification

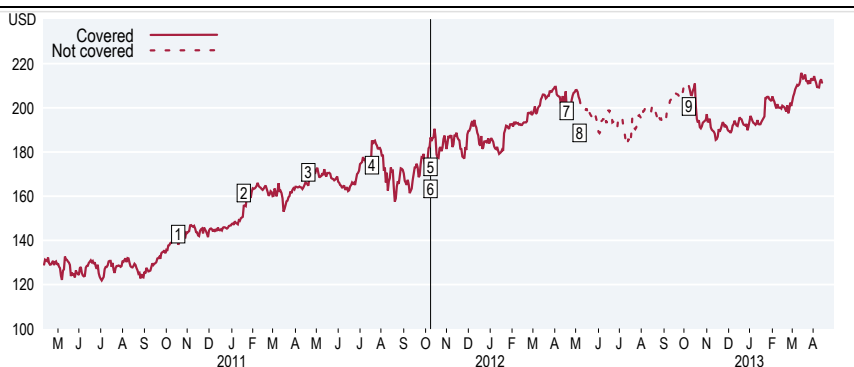
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International Business Machines Corp (IBM)

Ratings and Target Price History Fundamental Research

Analyst: Jim Suva, CPA
Covered since October 8 2012



	Date	Rating	Target Price	Closing Price
1	19-Oct-10	1M	*160.00	138.03
2	19-Jan-11	1M	*175.00	155.69
3	20-Apr-11	1M	*190.00	164.75

	Date	Rating	Target Price	Closing Price
4	19-Jul-11	1M	*205.00	185.21
5	8-Oct-11	Stock rating system changed		
6	8-Oct-11	*1	205.00	182.39

	Date	Rating	Target Price	Closing Price
7	18-Apr-12	1	*235.00	200.13
8	7-May-12	Coverage terminated		
9	8-Oct-12	1	*250.00	209.82

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

International Business Machines Corp (IBM)

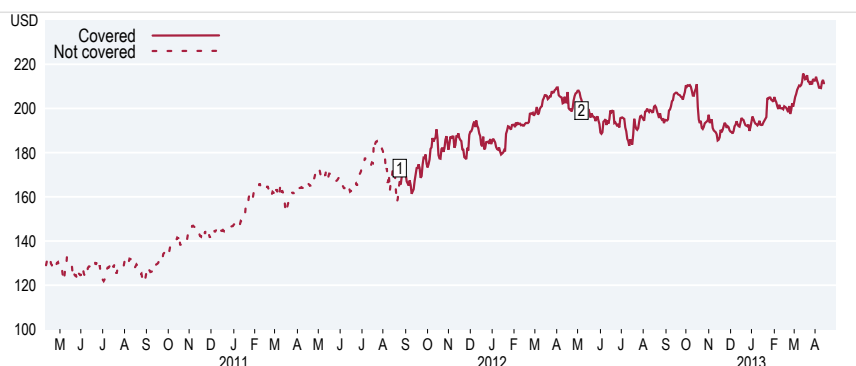
Ratings and Target Price History

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

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

* Indicates change

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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53%	49%	43%	65%	49%	51%

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