

Managing Finance During Change: IBM

Prof Amit B Chakrabarti
Associate Professor
IIM Visakhapatnam

1

1

Mechanisms used to distribute cash

- **Dividends:** Firms pay cash to all shareholders on a per-share basis.
 - These cash payments can be done on a recurring basis (**Regular Dividends**)
 - The cash payments can be done on a one-time basis (**Special Dividend**)
- Dividends are taxed as ordinary income.
- All shareholders benefit
- Does not change ownership structure

2

2

Mechanisms used to distribute cash

- **Share Repurchase:** The firm uses cash to buy back shares. These shares can then be retired or classified as "treasury stock" (available for reissuance)
- Share repurchase is taxed at short or long-term capital gains rates depending on the holding period.
- Benefits select shareholders
- Ownership structure changes

3

3

Mechanisms used to distribute cash

- Firm can buy shares at the market price (**open market repurchase**)
- Firm can make a tender offer with a fixed price, often at a premium to market prices, and a fixed date (**tender offer repurchase**)
- Firm can ask for bids. Shareholders submit quantity and price at which they would sell. Firm chooses lowest bid. (**Dutch Auction**)

\$110 \$112

A 10K @ \$111 each

B 5K @ \$100 each

C 5K @ \$99 each

4

4

Mechanisms used to distribute cash

10%

- Firm buys shares from a single or small number of investors (**targeted or negotiated repurchase or greenmail**)
- Firm buys desired quantity of shares from an investment bank, which obtains them through a short sell. The bank later buys the shares in the open market to cover its position. This fast repurchase improves EPS quickly (**Accelerated Share Repurchase**)
- Firm gives shareholders the option (right but not obligation) to sell share to the firm at a set price by a given date (**Put Right**)

5

5

IBM set to transform itself in 2014

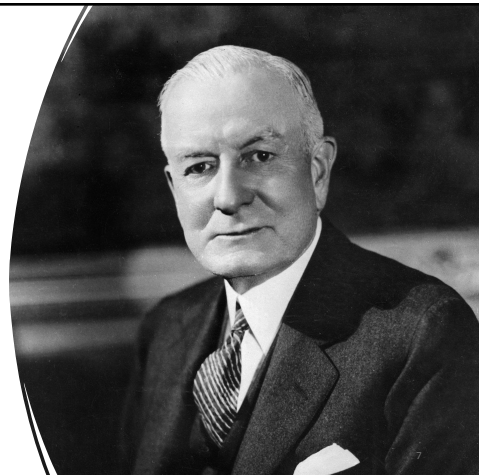
- Virginia Rometty became CEO in 2012
- Martin Schroeter, CFO announced target of achieving EPS of at least \$20 up from \$16.28 in 2013
- Since 2007, IBM issued 5-year EPS forecasts to help employees and investors understand the firm and its transformation strategy
- After 10 years of strong financial performance, IBM reported weak results in 2014
 - From 2004 to 2013 IBM distributed \$140 Bn of cash to shareholders through dividends and share repurchases
 - Its Leverage ratio (D/E) rose from 43% to 63% - "slow motion LBO"

6

IBM: A history of transformations

- Incorporated in 1911 & led by Thomas J Watson Sr. till 1952
- Revenues of \$412 Mn; 41,000 employees focusing on large-scale tabulation devices for large corporations & Govt.

B2B



7

IBM: A history of transformations

- Led by Thomas J Watson Jr till 1970s
- Revenues of \$22.8 Bn; 337,000 employees by end of 1970 focusing on electronic computers, trying to keep up with advances in data processing technology.
- Shifted from "one size fits all" mainframe computer to customised mainframes through the "\$5 Bn gamble"


B2B
B2G



8

IBM: A history of transformations


- In the 1980s shifted focus to personal computers
 - Period of stagnation *B2C*
- Outsider, Louis V Gerstner Jr became CEO from 1993-2002
 - Restructured product lines, reduced headcount, trimmed costs
 - Revenues of \$83 Bn focusing on network computing, "e-business", shift to software & services *Services*



9

IBM: A history of transformations

- Samuel J Palmisano became CEO from 2002-2011
 - Transformed strategy, product mix and structure of IBM
 - Revenues of \$107Bn by divestment of PC, disk-drive, D-Ram businesses and focusing on services & software. *Services PwC*



10

The 2010 EPS Roadmap

- In 2007 EPS target of \$11 in 2010 from baseline EPS of \$6.11 in 2006
 - ✓ \$0.75 from revenue growth
 - ✓ \$1.2 from future acquisitions and growth initiatives
 - ✓ \$1 from margin expansion
 - ✓ \$1.1 from share repurchase
 - \$0.9 from reduction in post-retirement costs

$$\begin{array}{r}
 11.00 \\
 - 6.11 \\
 \hline
 \$3.89 \\
 \text{3 years}
 \end{array}$$

11

The 2010 EPS Roadmap

- From 2002 to 2007 the share price of IBM had stagnated at \$100
- In May 2007, IBM borrowed \$11.5 Bn to buy 119 Mn shares (8% of all Outstanding)
- By 2009 revenues were up by 5% to \$95.8 Bn and net income was up by 41% to \$13.4 Bn
 - Internal* — *external*
- Started as a communication tool to highlight strategy, but used for internal goal-setting

12

The 2015 EPS Roadmap

- In 2010 EPS target of \$20 for 2015 from EPS of \$11.67 in 2007
 - \$1.45 from revenue growth
 - \$0.7 from revenue mix (shift to high-growth business)
 - \$0.9 from future acquisitions
 - \$0.75 from margin mix (shift to high-margin business)
 - \$2.8 from share repurchase
 - \$1.75 from enterprise productivity

$$\begin{array}{r} \$20.00 \\ \text{\$ } 11.67 \\ \hline \text{\$ } 8.33 \end{array}$$

13

13

Leadership & Shareholder Changes

- Virginia Rometty became CEO in 2012 and Martin Schroeter became CFO
 - Priority for Capex allocation:
 - 1) Internal capex investments;
 - 2) Acquisitions;
 - 3) Dividend
- Warren Buffet bought \$10 Bn worth of IBM stock (5.5% of the firm)
 - Initially reluctant to buy tech stock



14

14

Financial Performance 2010-14

- From 2010 to 2013 revenues were flat, net income was up by 11% to \$16.5Bn and operating profit was up by 20% to \$18 Bn
 - The effective tax rate had reduced to 15.6% due to favourable geographic location
 - EPS rose from \$11.67 in 2010 to \$16.28 in 2013 – 40% in 3 years

$$\begin{array}{r} 2015 \quad 20.00 \\ 2010 \quad 11.67 \\ \hline \text{\$ } 8.33 \end{array}$$

$$\begin{array}{r} 2013 \quad 16.28 \\ 2010 \quad 11.67 \\ \hline \text{\$ } 4.61 \\ \text{2 years.} \end{array}$$

15

15

Financial Performance 2010-14

- 1st quarter 2014, were declared in April 2014
- 1st quarter 2014 results were dismal
 - Net income down by 21%, revenues down by 4%
 - EPS target of \$18 by year end

$$\begin{array}{r} 2014 \quad 18.00 \\ 2013 \quad 16.28 \\ \hline \text{\$ } 1.72 \end{array}$$

 1 year. $\text{\$ } 2$

16

16

Investor Briefing - May 2014

- IBM was trading at \$190 prior to the briefing
- IBM reiterated goal of \$20 EPS target by 2015 from \$1.28 in 2013
 - ✓ • \$2 from share repurchase
 - ✓ • \$3.25 from revenue & efficiency gains
 - -\$1.5 from "tax headwinds" (increase in effective tax rate)

17

17

Earnings Guidance & Shareholder Communication

- If you are an investor, would you buy, sell or ~~hold~~?

BUY.

- Leaders are confident.
- Repurchasing shares.
 - ↳ I will make money.
- Debt will reduce tax
- Transformed in 100 years.
- Short-term problem
- Warren Buffet

SELL

- Growth is stunted.
- Reduced expenses already.
- R&D, product Dev are taking a back seat.
- Financial being uneasy.

18

18

Earnings Guidance & Shareholder Communication

- Given the ambiguous performance, should Rometty affirm, adjust or abandon the 2015 roadmap?

Affirm stick to \$20

- Past history - 100 years.
 - stretch targets.
- Brand image
 - Buffet has just invested.
- Avoid losing credibility with shareholder
 - take another year.

Abandon \$20.

- Avoid destroying value
 - unsustainable
 - bite the bullet, now
 - Problem may get worse.
- Focus on restructuring
 - long-term shareholder wealth
 - organic growth is not possible
 - ↳ Acquisition / R&D / Product
- EPS is not the right target.
 - ↳ benchmark with other firms.
 - ↳ Problem because of Paterson's.

19

Investor Briefing - October 2014

- Revenues down by 4% - no longer expect to deliver \$20 EPS target
 - Divestiture of micro-electronic business
- IBM's stock price fell by 8.5% and finished the day at \$169

20

20

Earnings Guidance & Shareholder Communication

- Why did Palmisano create the 2010 roadmap?
 1. Increase the stock price.
 2. R&D - Strategic transformation → optimization.
↳ Commodity → high margin
 3. Undervalued. → growth, profits, paycom.
 4. Control → Slow motion LBO 'strategy'
 5. Transparency
 6. Communication.

21

21

Earnings Guidance & Shareholder Communication

- Why did IBM decide to issue a second roadmap in 2010?
 1. Successful - Stretch target previously.
 2. Confident to stick around.
↳ Road map confident.
 3. Build Investor confidence.
 4. External Business Conditions.
 5. Complete the Strategic Transformation.

22

22

Thank You

All the Best!

23

23