



Holland Views – IBM (Price: \$157, MCap: \$153bn)

Value, staring us in the face

At Holland, we think about and categorise companies in terms of business models. We find that the best businesses across the world – regardless of their industry – all have many subtle commonalities (think: Ryanair + Colruyt, Next + Direct TV). We say subtle, because in many cases, Mr Market overlooks many of these companies' highly attractive business attributes such as the generation and allocation of owner earnings.

Today, we present a \$150bn market cap US business that, despite growing earnings at 15% over the last decade with an average RoNTA of 68%, is today generally believed to be going ex-growth and is by most accounts, deemed to be gaming the system (via buybacks) to meet EPS targets. It trades on a lowly 10x P/E multiple and is dismissed as a dinosaur by many investors.

We took an open mind and decided to see for ourselves. We found a business of huge scale (and commensurate ability to invest) that has a very long track record of reinvention, high returns and formidable cash generation. Buffett has said he can think of “*no major company that has had better financial management*” and after much reading, we are inclined to agree. The business is a technology services business, so please don't expect an in-depth discussion of the vagaries of cloud computing here – that said, we think we know an attractive investment when we see one. The stock is IBM.

IBM – what's to like:

- Low starting P/E of 10x.
- A complex monopoly of sorts with c.60-70% of services and software enjoying recurring revenues from deeply entrenched customers.
- Huge scale: With c\$100bn in revenues, IBM invests c\$6bn in R&D per year (Accenture, a competitor, invests c\$800m; SAP around \$2.5bn) or 30% of Net Income.
- An Asset-Light business means very high RoNTA and structurally excess cash.
- Long track record of very disciplined capital allocation (both in terms of acquisitions and more importantly share buybacks etc.).
- Quality of earnings (i.e. cash generation relative to earnings) looks very good.
- Has successfully continually reinvented itself and its cash flow generation affords c.\$3-4bn in acquisitions every year (before buybacks) giving optionality on growth.
- Management culture is very aligned with shareholders (in terms of the distribution of excess cash and also the drastic reduction in employee options payments).
- Even if the market's gloomy outlook on growth transpires (excluding acquisition optionality) and profits are flat, cancelling of shares alone still affords c4% EPS growth.
- Over 6,800 US patents awarded last year (the highest for the 21st consecutive year) suggests it is far from 'game over' for this business.
- We are in good company – Buffett and Prem Watsa own stakes.

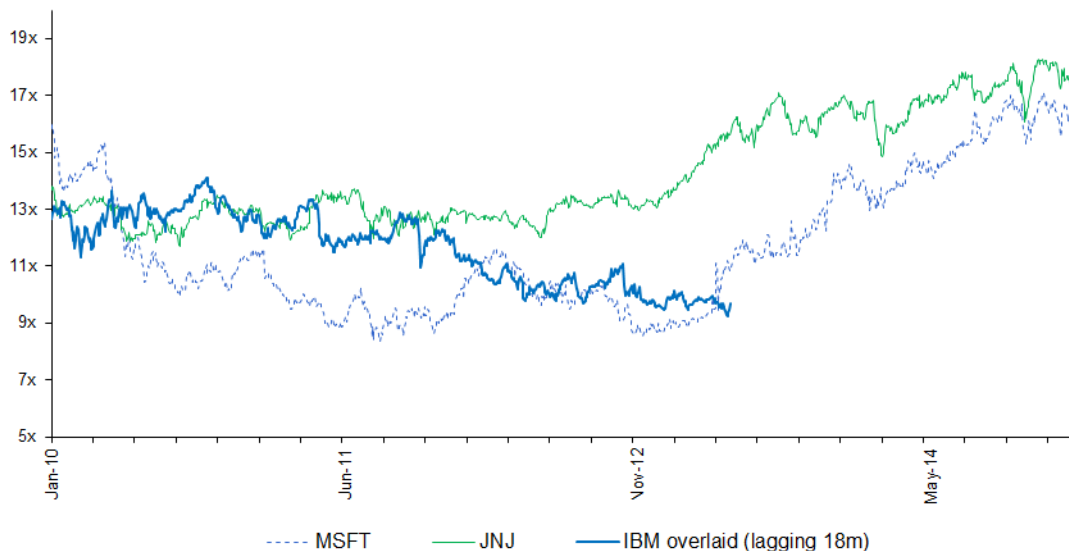
Knowing what you are looking for (and the advantage of being a global investor)

In describing our investment process, we talk a lot about the importance of really knowing what you are looking for. The big advantage is that once you figure it out new ideas can become easier to identify. For us, this meant that having recognised Next plc's amazing capital allocation prowess in the UK, we quickly noticed the same features across the water with DirectTV (where those same features were underappreciated). Similarly our work on Colruyt, JD Wetherspoon and Ryanair all showed significant overlaps in terms of business model strengths (that being an aggressive low-cost mentality targeting high volumes).

In the case of IBM, two other US behemoths come to mind: Microsoft and Johnson & Johnson – not necessarily because of business model overlaps but rather in how they were treated by Mr Market. As shown in Fig.1 below, both of those mega-cap stocks went through periods in which they were written-off as has-beens by the market only to see a subsequent revival of interest. Arguably, what these companies all share is huge scale in their industry along with an immense ability to reinvest in their moats. Of course, scale alone does not compensate for bad management or weak market positioning. However in all three of the above, we suggest the ingredients were there. It was their 'supertanker' status that gave them money and time to invest, survive and ultimately recover.

In IBM, just like Next plc, we also see a company has enjoys structural excess cash and deploys it impeccably via a combination of reinvestment, acquisitions, dividends, and buybacks.

Fig.1: Stocks can go out (and also back into) favour



Source: Capital IQ

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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