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INTELLECTUAL AMMUNITION

IBM's Defense Rests

Thursday, April 18, 2002
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IBM's first quarter 2002 earnings conference call yesterday sounded not so much like a business update as it did the closing argument in a criminal trial. Listening to carefully crafted defenses against the charges of accounting improprieties that have dogged IBM this quarter -- and against the critiques of the robustness of IBM's earnings-per-share growth during the **Lou Gerstner** years -- I wasn't sure whether I was hearing **CFO John Joyce** -- or **Johnny Cochrane**. I was almost surprised when Joyce didn't conclude by saying: "If our financials don't lie, you must buy."

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IBM's strategy in the conference call did, indeed, follow the pattern of **O. J. Simpson's** defense in his murder trial -- to focus attention away from the inconvenient realities of guilt or innocence, and instead get a basically sympathetic jury to believe that the defendant has been framed by overzealous police and prosecutors. It was a message that Afro-American jurors in Los Angeles could believe. And with IBM trading higher this morning, apparently it's a message that investors can believe, too. Or perhaps after the NASDAQ's sharp decline of the last several weeks, investors have simply had all the reality they can take for a while.

Joyce began his prepared remarks by addressing accusations of accounting and disclosure improprieties:

"We have been astounded over the things we have read about IBM in the last few months. We certainly have no interest in rehashing any of it. So let me just say once and again that we are proud of our accounting and disclosure practices. We hope that this issue is behind us, and we'd like to move on."

Reminiscent of **Claude Rains** exclaiming in *Casablanca* that he is "Shocked -- *shocked!* -- to find gambling going on here," this doesn't seem like much of a defense. And having said he wished to "move on," several minutes later Joyce raised the matter again:

"It is absurd to characterize our intellectual property and custom development income as non-operating, as has been done in a number of reports and articles."

Yes, as a general proposition that *is* absurd. But the real issue is anything but general: the most damning reports are the ones that quote IBM as defending its undisclosed inclusion of the proceeds of its optical transceiver unit sale to **JDS Uniphase** as an offset to sales, general and administrative expenses -- on the grounds that the divestiture represented a sale of intellectual property. Now *that's* absurd.

Joyce did no better in taking on the critics who have faulted IBM for pumping up otherwise lackluster earnings-per-share growth with share repurchases, tax rate reductions, and credits from an over-funded pension plan.

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"We don't view these as non-operating -- it's good management."

But having thus bragged about the very things for which the critics fault IBM, Joyce immediately turned around and stated that these factors actually "reduced profit growth in 2001."

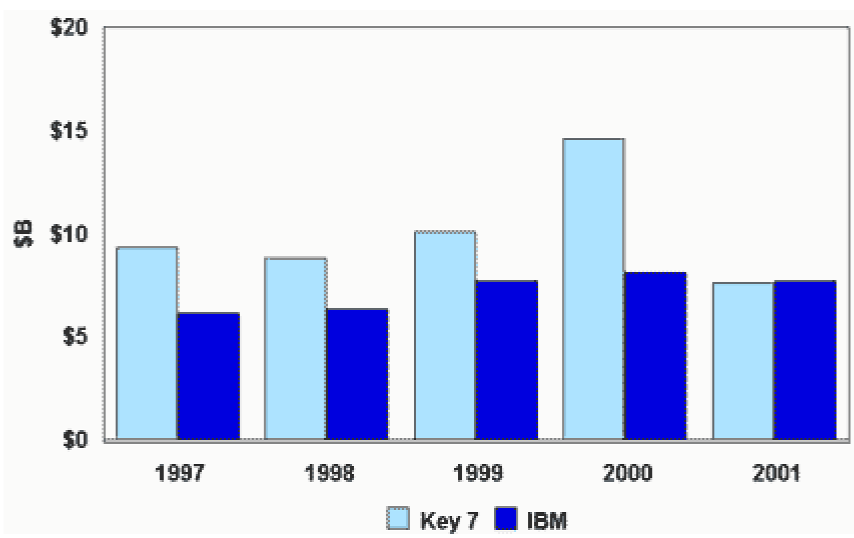
How's that again? For *any* factor to *reduce* profit growth, doesn't there have to *be* profit growth in the first place? Earnings *fell* in 2001 to $7.7 billion from $8.0 billion.

But even overlooking that whopper, how can Joyce say that share repurchases didn't help? It's a law of arithmetic that as long as earnings are positive, buybacks *always* help earnings-per-share. And how can he say that pension credits didn't help? In 2001 IBM claimed a credit of $1.02 billion, *higher* than the 2000 credit of $896 million. And with IBM's effective tax rate unchanged year-on-year because they just couldn't find any more tricks to drive it lower, the worst you can say is that it had no effect one way or the other.

Except for stating that these elements of "good management" had reduced (nonexistent) profit growth in 2001, Joyce didn't have a lot to say about growth. There were repeated references to stable "annuity revenue streams," businesses that are "stabilizing," and how IBM is "better positioned than the competition." But scarcely a word about growth.

Instead, Joyce displayed a chart showing that IBM's profits in 2001 just slightly exceeded the combined profits of seven "key competitors," having strongly lagged them for the previous four years. Joyce declares victory that IBM's "profit share" has now exceeded 50% -- but investor wealth isn't created by "profit share," it is created by *profit*. It does no good whatsoever for IBM shareholders to attain a superior *relative* position by virtue of a stumble by competitors that is worse than IBM's own stumble.

IBM Profit vs 7 Key Competitors



But for all the distracting defensiveness about accounting and disclosure, and all the happy-talk about "profit share," the reality is that IBM remains guilty of the earnings murder it had to announce last week. The best Joyce could say about that in his prepared remarks was to strongly assure that IBM could meet its sharply reduced earnings forecasts.

"We believe that the recent changes to the 2002 revenue and earnings estimates for IBM better reflect the reality of the marketplace. Based on where we stand today, we should be able to make those estimates... We see a continued slowdown in customer buying decisions until they see a sustained improvement in their own businesses. Discussions with our large client base give us confidence that IT remains key to their future business strategy, and that it will have an increasing role in their plans."

Fair enough -- and entirely in line with the way **Trend Macrolytics chief economist David Gitlitz** has contextualized IBM's woes against the backdrop of a largely inventory-driven recovery in which enterprises have no real incentive to invest in new productive capacity until they can see that they will make a return on it (see "Oil, the Middle East, and IBM" Thursday, April 11, 2002).

But toward the end of the Q-and-A session, Joyce gave a distinctly rosier rendition of the same information.

"The declines aren't getting any worse. We are stabilizing. Given what we're seeing in consumer spending, and as we talk to our customers, it could look like a pretty good second half."

After the drubbing IBM has taken over the last couple weeks, each weary investor desperate for any ray of hope is sure to seize on that last sentence -- imagining Joyce giving him a conspiratorial nudge-nudge-wink-wink, a secret hint meant for only him to understand, signaling that prosperity is just around the corner.

But after a couple days of those self-imposed delusions, it will become obvious that Joyce is really saying something else entirely: for IBM to meet its sharply reduced estimates, it's going to *need* a pretty good second half. TM