Bird's Eye View of IBM

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Dave

0:00

All right, folks, welcome to Investing for Beginners podcast. Tonight, Andrew and I are going to do a bird's eye view of IBM International Business Machines; we're going to talk about the company a little bit, maybe some things you can look for, talk a little bit about a hurdle rate for me, that would prevent me from looking further into a company like this possibly. For those of you new to the podcast, we might discuss some things that are a little above beginner today. If you are not familiar with these terms, please check out our episodes 43 through 47.

These are a great foundation to give you a base for learning what stocks are and all the great stuff. And that'll help give you a better understanding of what we're going to discuss tonight. So without giving it away yet, I thought we could talk a little bit about that. So Andrew, what are your, I guess, initial thoughts on IBM?

Andrew

0:50

So similar to what we discussed in the first bird's eye view, which was Walmart, I want to look at the company's top-line revenue, and I want to see growth and growth that's tracking pretty well. And so when I say pretty well, I mean, it's at least getting close to GDP or somewhere around there. And that's in most of the cases. So when I look at IBM, that's definitely not the case; there seems to be this very long-term trend; if I pull up on quick, fast on that from 2012, all the way down to 2021, revenues went in half. And that line has looked pretty consistently lower. I mean, there are a few ups in there.

But it's not a good trend, at least over the last ten years. So for me, that's something that I don't consider further when I look at a company like this. But what stood out to you when you first pulled up IBM?

Dave

1:45

Well, that obviously was one of the first things that I noticed right away because when you look at the income statement of a company, that's obviously the top line is the first thing you're going to notice. And I'm looking at a smaller snapshot here. So I only had like five years to look at. And it was down a fair amount in the five years. So that wasn't encouraging. But it may not be a deal killer quite yet. But as I look farther down the income statement, so as we kind of go down the income statement, and you talk about the revenues, the cost of goods sold, which are what it costs for the business to, you know, generate those sales in materials, typically, or things of that nature. And then, we look at the operating expenses. Such things as r&d, or SGMA, which stands for selling general administration or marketing. So any of those kinds of things, those are generally what you look at to kind of determine the operating income of the businesses, so you take the cost of goods sold and the operating expenses. And that's how much it takes for IBM to generate revenues.

And that's the profit that they have left over after they pay for those expenses. Because every company, as great as they are, including Apple, has to pay for those expenses to generate the revenues that they do. And so it's also a bit of a proxy, if you will, for free cash flow. And we can talk about that a little bit later. But when you're looking at a company, one of the things that I always try to want to look at is see if the company is profitable on an operating income level, and then I also want to see if that's going to generate if that's going to translate into free cash flow. I don't; I personally don't look at earnings a whole lot because there could be some gobbly gook in between the operating expenses and the net income that can sometimes make it a little questionable. And I'm not saying that there's out-and-out fraud, but there's just that sometimes things can be manipulated a little bit.

So anyway, when I'm looking at a company like IBM, the first thing that jumps out at me when I look at the operating income is I see their margins. And their operating margins have dropped from 17.7% in 2016 to the latest 12 months at 11%. That's not a good sign. And so it kind of matches that the revenues are going down. But here's an interesting thing. If you look at the percentage of the year-over-year change, it doesn't match the drop in revenues, which tells me that they're not controlling their expenses very well. So, in other words, when revenues drop, they're not adjusting for that in the other expenses that cost them to run the business. And sometimes things like r&d will fluctuate a little bit or may even be going up if the company is really trying to ramp up a product or a project or something. I get that when you see those numbers consistently going up versus the revenues coming down.

That means that the operating income that the company generates is going to be on a steady decline. And that's not something you want to see. So for me, if I was, you know, screening for companies, and I saw something that like I do with IBM that would be from yard pass. I'm like, Oh, we're done here. I know. Need to dig any further because that's not what I want to see.

Andrew

5:03

It makes sense. You know, I'm not like a growth stock expert. But I've kind of noticed just from afar; it seems like you want them; you generally want to see the opposite. So gross stock investors don't really care if the margin is small, just as long as it's getting better over time. Well, you're describing it as the opposite

case where the margin is getting worse over time. At the top of my head, I can't think of a situation where that's something investors want to see.

No, because even if, if you're sacrificing margin, so they say you should see revenue, going up to basically say, Hey, we're spending that we're at least growing sales because of it

Dave

5:43

Yeah, exactly. And I'm not a growth investor, either. I certainly read about the stuff, and I understand the concepts to a certain extent. And it's not something I generally adhere to, but one of the things that I do know is you kind of want to start to see some form of operating leverage, where you see that the company is able to leverage those costs, those expenses to generate more revenue. And ideally, people can't see my hands here but like to see the revenue go up. And the operating expenses either stay flat or go down.

That indicates that the company has operating leverage, which means that they're able to more efficiently use the expenses and costs that they have to generate higher margins, which gives them more money to do other things, whether it's reinvested in the company, whether it's buyback shares, pay a dividend, depending on where the company is in their lifecycle, the world is their oyster, if they have, you know, bigger margins. And that's what makes a company like Visa, for example, so ridiculous is that you know, they have 80, or 90%, gross 85 90%, gross margins, and 60% plus operating margins, which means they have lots and lots of money to play with to figure out how to do things. And a company like IBM is kind of on the opposite spectrum of that, right now, where you see the margins contracting, which means that they have less available money to go out and do the things that they need to do to grow.

And that's what makes it hard when you see those kinds of things. And, you know, IBM is a legacy company. I know; they've been trying really hard to work towards becoming a bigger player in the cloud. But Amazon and Microsoft, and Google have already kind of beaten them to the punch. And they're kind of Johnny to come later and that but doesn't mean it's they don't make good products. But you know, you can see it in the numbers. Sometimes my buddy as well, Dumbledore and likes to say that the numbers tell us a story. It's our job as an analyst, depending on what level of analysts we are, to interpret those numbers and figure out what that story is they're trying to tell us. And I think when you look at a company like IBM, the story is telling me that things are probably going in the wrong direction. I'm not predicting any sort of bankruptcy or anything like that.

But it just looks like the company is not trending in the right direction. And that they're either living on their past, or there are the products and services that they're offering people just started enticing to people and are having trouble selling them to people to make it relevant.

Andrew

8:14

I think it's a great example because one of the reasons a company could have revenues that fall is because they could be splitting off parts of their business. We touched on that with the AT and T episode, where we talked about the spin-off for TNT. So sometimes you'll see businesses do that where they're breaking pieces off, and they're getting smaller, but they could still be executed well if the margins are going in the right direction. So you know, seeing that not happening, at least now as we look at it today, makes for another good way to screen out for companies that maybe aren't going to give you the growth that you're hoping for.

I like the example with Visa having a really high operating margin. So we talked about the trend and operating margin. And then we also talked about kind of higher low levels. In your opinion, which of those is more important? Is it the trend and operating margin? Or is it the operating margin level itself? Or does it depend on our favorite two words?

Dave

9:10

It depends; it really comes down, I think it really comes down to the business that they're in. And let's take opposite ends of the spectrum. If you look at VSA, because of the nature of their business, it's a very asset-light, very capital-light type of business; most of the foundation that they run off of was established a long, long time ago. And so, at this point, they aren't really in a position where they really have to innovate a lot. They do to keep their edge, but they're not really out there, really pushing to really, I guess, create something new. So they are investing a ton comparatively, and their margins are huge.

Likewise, on the flip side of that is a company like Costco, which has really, really well Oh margins; because of the nature of their business, they're a retail business that basically sells everything for was it 14% Above cost or something crazy like that, I think they have like a set margin that they offer to do really, really well. And so and that includes, that doesn't include it compensating for employees, insurance power, the building's an all the stuff that goes into that 14%. So I don't know, off the top of my head, what Costco's margins there are, but I want to say four or 5%, somewhere in that range. And maybe a little higher than that. But they're low, and especially low compared to a company like Visa. But if you look at a company like Costco, you want to see those margins stay even or even creep up a little bit depending on whether they some of that for Costco is going to depend on their subscription model if they raise those prices, that could help them increase that operating margin, it's a very well run company, they're very cost efficient.

And they're very focused on that because they understand that there isn't a lot of room for error for them because of the nature of their business. And we looked at Walmart a little while ago; they're kind of the same kind of idea where they, they're a low-cost provider. So, they offer things for a very, very small margin, and Amazon, their retail side, is kind of the same idea. It's just a very, very small margin. So there isn't a lot of room to play with. So I guess it really kind of you have to; for me, I was trying to look at it through the lens of what kind of business they operate in; if it's a payments company, it's going to be a lot higher than if it's a bank.

And if it's a retail, it's going to be lower than, let's say, some sort of technology company and like an apple, or something or Microsoft just because of the nature of what they're looking at. But if you look at Microsoft versus, I don't know, CrowdStrike, CloudFlare, aka snowflake, any of those companies, then you get a better sense of maybe how they're doing margin-wise. So that's, I guess that's kind of what I look at.

Andrew

12:05

What about you? Yeah, that's a great answer. I mean, I would, I would basically say the same thing, you got to take the margin in context with the other competitors and its industry. And also as IT trends between itself is it getting better, stay in the same getting worse. Those are all really important things. The only thing I'll add is this was a pretty big epiphany for me when I realized it because Costco is a good example of, you know, their margins are so small that we're talking about hundreds of billions of dollars in revenues every

year. Now, when your operating margins like 3% on that, let's say that's on 200 billion, I'll use a 2% to make it easy. That's 4 billion, right? So if you improve that just by 1%.

And what I mean by that is you get from 2% to 3%. You've just added another, basically 50% growth. I don't know if those numbers make sense just hearing them, but basically, you go from 4 million to help me here, and you go from 4 billion to 6 billion. Thank you, yeah, 4 billion, the 6 billion are adding the 2 billion, which is a 50% increase, correct Visa where to go from 68% to 69%. It's the same 1%. But because it's startling that 68% It's not making a difference to profit. So that it doesn't move the needle, so that's why with lower margin businesses, you'll tend to see more of an emphasis on that kind of stuff. And then higher margin businesses like Netflix or Facebook, everybody's focused on the top line, because I don't really care about the costs, because the margins are so high that the difference in costs generally is not going to be that much.

Dave

13:44

Yeah, exactly. That's a good insight. How do you think a pricing power would impact an operating margin? Or would it?

Andrew

13:52

Yeah, it would, it should, depending on the environment, right? If you have high inflation, as we've seen lately, you just need pricing power to just kind of keep up with inflation; then the operating margin stays the same. If you have an environment where inflation isn't that bad, you still have pricing power. Now you get that operating leverage that you were talking about earlier, where we couldn't see your hands, but the revenue was opening up while the expenses stayed down, and you're getting this nice shark by mouth opening up and really unlocking. That's where you can get the multiplication of our needs.

And I know Coca-Cola in the 80s was late 80s. Through the 90s. Warren Buffett had serious growth from the operating leverage.

Dave

14:37

It's when you find a company that has that that those are some of the things that you really want to focus on. And it can help you find great investments that compound your returns over long periods of time because the market will reward companies like that. And when you see that kind of thing, and that's something you really want to pay attention to, the pricing power directly affects the gross margin and also flows to the operating margin as well. And the more that Apple can charge for an iPhone, the more it's going to help their operating margins and their gross margins along the way. And that's, that can help the company really improve their earnings as well as our returns. And that's really what we want. And that's why finding these strong companies that have that pricing power, as much as we hate paying an extra dollar for our Domino's Pizza, we love it when we see that on the income statement of the company because that means it's translating to more money for the company, which means they can, if it's good management, then it translates to better returns for the company, which in turn, translates to better returns for us.

That's why a lot of the stuff that we talk about is kind of so interconnected. You know, finding companies that have strong finance, finding companies that have strong products and pricing power, that they can improve their prices without affecting how many people buy their units, you know, Netflix, when they raise their prices? Does that really we don't know? Does it affect how many subscribers I have? It's kind of hard to tell right now. But that could be something that's going on right now is that they have raised the prices over the last year or so. And they're also losing subscribers. So maybe Netflix doesn't have pricing power, maybe it's not essential that we all thought it was, we don't know.

But these are all questions that you need to ask yourself when you're looking at a company, whether it's IBM, or whether it's Texas Roadhouse, or whether it's Texas Instruments, or whether it's Costco, a, just the kind of have to, those are all questions you have to kind of try to factor in when you're looking at it. But it also goes back to the management as well. Because if you got this great company that's doing awesome things, and generating all this income, from, you know, a great product, a great design, a great service, whatever it is that they offer, but then management kind of mishandles, that money, then you know that great product over a period of time is not going to be so great because they're going to have to keep reinvesting keep it where it is or to keep it better growing and make it relevant for people otherwise, that's going to be money squandered. And that's why understanding and having a little bit of knowledge about management and whatnot can help you a lot

Andrew

17:12

to kind of take that idea a little bit further to try to unpack, like, what about IBM? Why are their margins declining? I'm not an expert on IBM; I've looked at the company I'm aware of generally what they do. Something that stood out to me, though, is if you look at their cash flow statement, they spent $31 billion on acquisitions and 2019. That was Red Hat. And people generally look favorably on that because they basically injected new life into an old tech stodgy company. And they finally brought something into the business that actually grows basic basically, well, if you look at 2021, they made another pretty splashy acquisition. I don't know if it was one; I think it was several acquisitions. But basically, in the cash flow statement, it's saying $3.1 billion towards acquisitions.

And so you start to wonder, you're talking about how management's using money, and obviously, management's going to do things to try to turn things around. But you start to wonder if you're making acquisitions, and the margins not going up, it's going down after the acquisition, if you don't have revenue growth on that, that's really strong and compelling. Are they potentially even squandering? What little is left? I don't know the answer for IBM, but just in general, that could be another thing to think about

Dave

18:25

That's a great insight. And for those of you that aren't quite following what we're talking about, when you kind of look at the three big financial statements, the income statement, the balance sheet, and the cash flow statement, the income statement flows into the cash flow statement, which flows into the balance sheet. And so the net income that's at the bottom of the income statement goes directly to the top of the cash flow statement. And if you follow along with us on your favorite website, whatever that might be, you'll see that the net income matches exactly what the net income was on the income statement. And at the bottom of that is a line item called cash from operations. And that basically tells us how much money or how much cash IBM has generated from that added income from the income statement. And think of the cash flow

statement; I guess an easy way to think of it. I've always thought of it is its kind of like a checkbook of the business. It's the money going in and the money going out. And the money left over is money we get to use to spend on other things.

And so one of the things that a lot of companies will do is they will use that cash from operations, which is kind of a quickie way of seeing what kind of cash flow the company can produce. And if we want to look at cash flow, just in general, you're looking at cash from operations, fewer capital expenditures. And if you look at those two line items, that'll tell you what kind of free cash flow the company is generating. And generally, once they have that number, they have choices to make. With all that stuff now, Andrew is just pointing out acquisitions. So if you notice on the cash flow statement, it's trended downwards over the last five or six years by a lot. And that's not good. That's never good because the free cash flow is what the company really can reinvest back into the business.

And like Andrew was saying, it looks like they're choosing to buy other companies in an effort to try to stimulate growth. And one of the things about companies that make acquisitions, there's the good, and there's not so good. And there's not a whole lot in between. And so a lot of serial acquirers companies like constellation software, or Roper technologies, or Danaher, or Thermo Fisher, these are all companies that buy a lot of companies, they have teams that work for them that their whole job is to integrate these businesses with their business. And they have systems; they have processes, they have people that have been doing it for years, decades. So they have lots of experience, they're very good at it. And they're also very good at finding companies that will be a good match for their company, as well as being able to integrate well with the current culture. And so it's not just about, you know, hey, let's go out and buy this because this will be a great addition for our business if the culture is completely opposite. And the systems are completely the opposite. It's going to take lots of money and lots of time to integrate that; meanwhile, you're paying for all of the costs of buying that business like they bought Red Hat for 32 billion or so and had to take on a lot of debt, to do that, as well as using some of the cash flow that they generate. So it became a very expensive proposition. And if they don't see, like Andrew said, if they don't see revenue growth from that in a relatively decent amount of time, then that's not a good thing. And that's what sets some of these companies that acquire companies and integrate them really well, apart from the ones that do not.

And I think McKinsey did a study, and I think it's what 6070, maybe 80% of all acquisitions don't achieve the goals that the CEO state that they're going to state, most of them are either revenue synergies, which means they're going to be able to integrate the business and, and see a lot of revenue growth from it. Or it's cost efficiencies, like eliminating doubled-up sectors and that kind of thing. But most acquisitions don't achieve either one of those targets; it ends up being a costly mistake for shareholders. And that's why companies like Berkshire Hathaway, with Warren Buffett, or Google and Microsoft, and all the other ones I mentioned, those are really good companies that make great acquisitions that do a good job of integrating, for the most part, the acquisitions, and they end up performing well for the parent company. And so I think that's one of the things about IBM is I think the jury is still out on this Red Hat acquisition and whether it's going to pay off for the company, and the CEO, in essence, save their bacon over the next few years or not. And I think that's what people are kind of maybe treading water on the company waiting for to see. I don't know; it's an interesting observation.

Andrew

23:12

Yeah, that's a very good one, and a lot, a lot of like wisdom unpacked there. I hope people use that to look at margins, take margins seriously, and also take acquisitions seriously because they can be great ways to grow. And they can also be great ways to kill value. Absolutely. So what's your verdict on this one?

Dave

23:36

And he, it's obviously a hard path, this is gonna be a no. And it's kind of interesting that we chose us because I've been kind of starting to go down the rabbit hole of cloud providers and some of that. And so I've been reading about some of these companies. And this is totally anecdotal. So take it for what it's worth. But I read somewhere not too long ago that people that can't get real jobs like Google and Microsoft and stuff go to work at IBM. So I don't mean to offend anybody that works at IBM. And please, I don't have any proof of any of this. But that's just. I read somewhere that some analysts said that about IBM. So I guess you take that for what it's worth.

A

Andrew

24:11

After that type of investing, I do. I mean, I'm sure there's going to be investors out there who can know when IBM is cheap, buy it quickly, when it's cheap, sell it quickly when it gets expensive. That's not really my thing. I like to buy and hold for the long term. So for me, it doesn't pass for all those great reasons that Dave said.

D

Dave

24:28

Alright, folks, well, with that, we will go ahead and wrap up our bird's eye view of IBM. And I hope you guys enjoyed our discussion on the company as well as the ideas behind operating margins, operating leverage, cost of goods sold, free cash flow, acquisitions, and all kinds of the fun stuff we talked about. If you are new to the podcast, we have beginner episodes that you could go back and listen to. I would highly recommend you do that just to kind of give you a good base for all the things that you're going to learn as you listen to our show, their episodes 43 Read through 47. You can find them on any of your podcast players.

And I would strongly encourage you to listen to them. If you're like, I have no idea what you guys were talking about tonight, that will help give you a good basis to kind of start learning about the stock market and everything that we are trying to teach. Also, we have a website, einvesting for beginners.com, that has this huge search bar at the top that you can not miss that has; you can find almost everything that we talked about today on our website, operating margins, operating leverage acquisitions, we have articles about all that stuff to help you learn a little deeper about some of the things that we talked about.

You can add those to your toolkit of analysis. So I hope that helps you guys. And without any further ado, I'll go ahead and sign us off; you guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week. We'll talk to you all next week.

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A

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