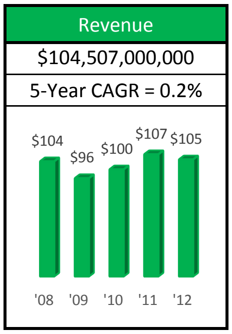
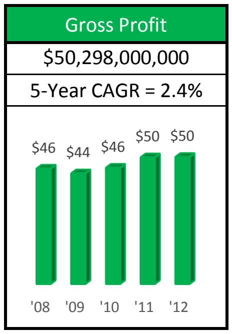
SELECTIVE
WEALTH MANAGEMENT

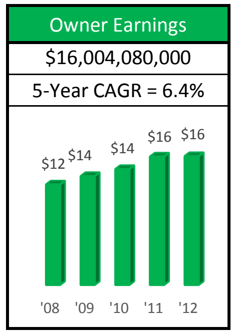
International Business Machines
August 27, 2013

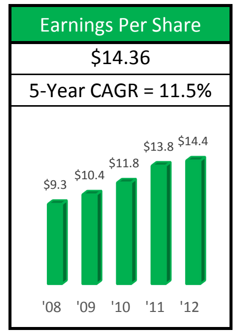
General Overview

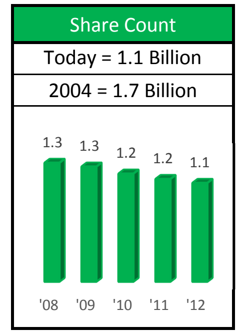
IBM was founded in 1911 in the State of New of York and has since grown to one of the most widely recognized technology firms in the world. The company creates value for clients by solving business problems through integrated solutions that utilize information technology. These solutions typically reduce costs for clients and introduce new avenues for revenue creation.











Purchase Logic

In the last 15 years IBM has been transformed through a series of very impressive business moves. The company use to sell hardware products and build out dedicated datacenters for clients all across the globe. This business model was lucrative when IBM held a monopolistic position in the marketplace, however, hardware has become commoditized and extremely price competitive. The company realized this change in industry conditions and transitioned to providing business process consulting for the development of IT solutions and enterprise software.

This transition has been long, difficult, but extremely profitable. As the company shed hardware related business segments the overall revenue of the business declined, but was replaced by much more lucrative software and business consulting revenue streams. For this reason IBM has had stagnant revenue, but increasing profits for nearly 10 years. This transformation is continuing today and we anticipate revenues to remain relatively flat as price competitive divisions are closed or sold and replaced with more lucrative services.

During this transition period IBM has allocated the majority of all earnings to share repurchases. During this time frame the income of the business has doubled and the outstanding shares was reduced by 50% - effectively quadrupling in EPS. While this shift to higher margin business has greatly increased the earning power for long-term shareholders Wall Street has been less than impressed. Analysts are frustrated with IBM's lack of revenue growth and fearful about the short-term prospects of the company. This frustration has created a buying opportunity for us – we purchased our stake in IBM at approximately 11x earnings or 66% of the average price for an S&P 500 constituent. Our intentions are to hold onto IBM while the share price remains depressed because of the increased effectiveness of the share repurchase program when the stock price is low.

Key Metrics

The key metrics for IBM are revenue, gross profits, owner earnings, earnings per share, and share count. A brief description of each metric is provided below.

<u>Revenue</u>

IBM has a diverse revenue mix with several divisions that contribute substantially to the overall business mix. Each business division is unique with very different profit profiles depending on the division. The major business segments include Global Technology Services, Global Business Services, Software, Systems and Technology, and Global Financing.

- *Global Technology Services.* Includes IT outsourcing services dedicated to transforming clients' existing infrastructures to improve quality, flexibility, risk management and financial value. This division is defined by very high margins and excellent prospects for growth.
- *Global Business Services.* Includes business consulting services for clients to automate processes in an attempt to reduce costs and open avenues for additional revenue generation. This division is also defined by high margins and excellent prospects for growth.
- *Software.* Consists primarily of middleware and operating systems software. This division has the highest margins and exceptionally high retention rates. The prospects for growth are not as robust as GTS and GBS due to the competitive nature of winning new contracts. Additionally, this division is closely related to hardware sales discussed below.
- *Systems and Technology.* Provides clients with hardware for traditional or hybrid datacenter capacity. This division was the majority of IBMs' revenue 20 years ago and has seen major shifts in the industry. This division is relatively price competitive and significantly less profitable than the other three operations divisions of IBM.
- *Global Financing.* Global financing provides lease and loan financing to clients on terms ranging from one to seven years. This financing allows clients to purchase more of IBM's services on favorable terms and IBM to earn adequate returns on the loans. This division accounts for the majority of IBM's debt.

Gross Profits

While revenue has been the primary focus for most Wall Street analysts we believe that gross profit is a much more important indicator of the overall health of the business. For example, the systems and technology division has several product lines that are multi-billion dollar contributors to revenue, but contribute little to gross profits. The gross profits and owner earnings has been the primary focus of management over the last two decades (not top line growth) which we believe is an appropriate focus.

Owner Earnings

Even more important than gross profits are owner earnings. This can be illustrated clearly using the same example, the systems and technology division, which has products that contribute billions to the top line but are actually money losing divisions and reduce overall owner earnings. Selling or disposing of these assets would increase owner earnings and the intrinsic value of the business – despite a short-term decline in revenues. We strongly agree with management's focus on owner earnings rather than revenue.

Earnings per Share

The most important metric, and managements primary focus, has been earnings per share. This metric is driven by the overall owner earnings of the business and the share count. Management has allocated substantial capital to share repurchases in the last 10 years which has greatly increased earnings per share for all long-term shareholders.

Share Count

The share count is the number of shares outstanding each year. As this number is reduced the overall profits for the remaining shareholders increases proportional to the number of shares that have been retired. We anticipate the share count to continue decreasing for the foreseeable future.

Historical Performance of Key Metrics

Year	'08	'09	'10	'11	'12
Total Revenue	$103,630,000,000	$95,759,000,000	$99,870,000,000	$106,916,000,000	$104,507,000,000
Gross Profit	$45,661,000,000	$43,785,000,000	$46,014,000,000	$50,138,000,000	$50,298,000,000
Owner Earnings	$12,477,680,000	$13,518,880,000	$14,392,120,000	$15,947,080,000	$16,004,080,000
Earnings Per Share	$9.30	$10.41	$11.80	$13.76	$14.36
Share Count	1,341,667,786	1,299,003,390	1,219,536,250	1,158,661,712	1,114,509,771
Cash	$17,965,000,000	$19,353,000,000	$17,429,000,000	$16,817,000,000	$16,150,000,000
Debt	$33,925,000,000	$26,100,000,000	$28,624,000,000	$31,320,000,000	$33,269,000,000

<u>Revenue</u>

Revenue has been relatively flat for nearly 10 years at IBM. In 2004 the company reported $96 billion dollars in revenue compared to $99 billion in 2013. The lack of growth in reported revenue is not the primary focus of the story that has been unfolding at IBM for nearly 20 years – a dramatic shift to more profitable business. The company has been selling off unprofitable divisions and focusing on 'strategic imperatives' that are much more lucrative. These strategic imperatives include cloud, analytics, mobile, social and security and have been growing at rates close to 20%. We anticipate revenue to remain flat for the next 3-5 years as IBM continues to shed less profitable divisions and replaces this revenue with much higher value services. We anticipate IBM posting revenue growth for the following 5 years in a range between 2-5%.

<u>Gross Profits</u>

The gross profits at IBM have been consistently climbing upward. The table below demonstrates the clear progress IBM is making shifting the company's business mix to higher value products and services.

Table 1
(Millions)

	Year	2004	2013	CAGR
Strategic Imperatives ++Owner Earnings	Global Technology Services	$8,004	$14,687	+7.0%
	Global Business Services	$3,179	$5,684	+6.4%
	Software	$13,161	$23,027	+6.4%
Price Competitive -Owner Earnings	Systems and Technology	$9,520	$5,116	-6.7%
	Global Financing	$1,577	$922	-5.8%
	Total	$35,442	$49,438	+3.8%

We anticipate gross profits to continue to climb upward at a rate fluctuating between 0% and 8% for the next 10 years.

<u>Owner Earnings</u>

The historical growth in owner earnings further highlights the success of IBMs' transformation plan. In the last 10 years IBM has more than doubled owner earnings with no revenue growth. We anticipate owner earnings to continue to steadily rise between 0% and 8% with an average of approximately 4% for the next 10 years.

Table 2
(Millions)

Year	2004	2013	CAGR
Owner Earnings	$7,479	$16,483	+6.8%

Earnings per Share & Share Count

In the last 10 years the overwhelming success of IBMs' business transformation is most notably seen in earnings per share. The company has allocated $108 billion dollars, or roughly 66% of earnings, to share repurchases since the year 2000. The share count has been reduced from 1.8 billion to 1.1 billion during this time frame. Long term shareholders of IBM have seen their stake in the company increase by 64% with no additional investment.

Table 3

Year	2004	2013	CAGR
Owner Earnings	$4.74	$13.23	+12.1%

Our purchase price in IBM was at a relatively low valuation for the company which has the effect of greatly increasing the efficacy of IBMs' share repurchase program. We anticipate IBM to allocate approximately 75% of all earnings to share repurchases. This will in turn reduce the share count and allow EPS to compound at a rate in excess of owner earnings. We anticipate EPS growth ranging from 0% to 15% in any year with a 10-year average of approximately 12%. This EPS growth is only possible if the price of IBM stock remains low.

Summary of Key Metrics

Metric	**Expectations**
Revenue	No growth for 3-5 years Growth ranging from 0% to 6% for the next 5 years
Gross Profit	Growth ranging from 0% to 8% per year Average of 3% over a 10-year period
Owner Earnings	Growth ranging from 0% to 8% per year Average of 4% over a 10-year period
Earnings Per Share	Growth ranging from 0% to 15% per year Average of 12% over a 10-year period
Share Count	A reduction of 5-10% of total shares per year

The Moat Around The Metrics

There are two primary contributing factors to IBMs' economic moat: High Switching Costs and a strong Brand Name.

High Switching Costs

While the quantitative results of the business transformation at IBM are readily apparent, such as a dramatic rise in EPS, it is the qualitative elements that are even more impressive. Prior to IBMs' transformation the business had highly unpredictable income based on the business cycle of the company's' clients. If clients were not going to upgrade mainframes or hardware IBMs' results suffered accordingly. However, the radical transformation from a hardware firm to a software and services firm has created extremely stable profits at IBM that are easy to predict and much easier to defend.

IBM benefits from extremely high switching cost for the services the company provides to clients. The high switching costs arise from the extreme integration that occurs when a business process partner, such as IBM, engages a client on a new project. It takes substantial time and energy for the client to communicate their business model, vision, and needs to IBM. This process often requires teams ranging from 10 to 1,000 communicating together across the two organizations. Once IBM is familiar with how a client operates and begins building custom solutions for that client the two operations begin to integrate. The longer the two companies work together the deeper this integration and the more expensive it is to switch to a competing firm. This gives IBM a considerable pricing advantage when bidding for additional projects with existing clients.

Brand Name

In addition to high switching costs IBM also benefits from an exceptional brand name. The company is world renown with clients in 170 countries and more than 40,000 customer relationships. For the last 50 years IBM has been the business partner of choice for the world's largest enterprises and governments. While this brand name may not be as illustrious as it was 50 years ago – IBM still wins a lot of business around the world. Exceptionally large contracts are extremely difficult to win and the history of IBM as a company allows them to bid competitively on any contract with any customer of any size.

Risks

We view IBM as a very low risk investment. The company earns exceedingly large profits and our purchase price was low relative to other investment possibilities. No growth is required for this investment to be successful due to the powerful share repurchase program. Additionally, IBMs' relationships are deeply ingrained and very diverse which helps mitigate potential declines in earnings from lost customers or changing technological trends. Below is a brief description of the primary risks we've assumed as owners of IBM.

Short-Term Risks

- Reduction in Client Spending. On occasion multiple clients elect to reduce or delay project costs associated with business process development. Historically these reductions or delays are temporary and spending resumes at higher levels once short-term budgeting concerns alleviate.
  - Low Risk
- Loss of major customer. As of December 31, 2013 the company provided services to more than 40,000 customers. No individual customer exceed 10% of consolidated revenues. The loss of multiple major customers simultaneously would impact short term results, but we believe IBM would be able to adjust and win back market share.
  - Low Risk
- Strengthening of the USD. The company derives substantial revenue from currencies other than the USD. When reporting these revenue streams are translated into USD and for that reason a strengthening dollar would have a negative impact on short-term results.
  - Moderate Risk

Long-Term Risks

- Cloud Computing. Historically IBM made substantial revenue by providing onsite datacenter services to clients. This onsite model is rapidly being replaced by a more price competitive cloud model. The shift to the cloud will definitely impact IBM over the long term, but we believe the economics of a cloud based IT service industry are still extremely attractive. In the event that cloud based solutions replace typically BPO relationships and continue to pressure IBM's business model it could adversely impact long-term results.
  - Moderate Risk
- Complacency. The biggest risk facing IBM is complacency. The company's dominant position for many years could potentially create a culture where IBM does not adapt and change quickly to customer

demands. In the event that IBM becomes complacent and continuously loses market share the decline would be very gradual due to the high switching costs of customer relationships. We believe there would be sufficient time to notice this decline trend and lack of innovation and sell our investment.

- Moderate Risk

Conclusion

IBM is an outstanding business that has been transitioning from highly competitive hardware products to more lucrative software and services for nearly 10 years. The shift in philosophy has created tremendous value for shareholders and created a wide economic moat around IBMs' earning power based on the high switching costs and strong brand name. We anticipate flat revenues for the next 3 to 5 years as additional business units are sold or closed down and replaced with more lucrative income streams. Once this transformation is complete we anticipate modest growth. We purchased our stake in IBM at roughly 11x earnings, or 66% of the average price of an S&P 500 constituent. The effectiveness of the share repurchase program increases as the price of the stock declines and for that reason we intend to hold onto IBM as long as the market capitalization remains below $220 billion.

Works Cited

1) *IBM Annual Report - SEC Filing 10-K.* EDGAR, 2013.

Disclaimer