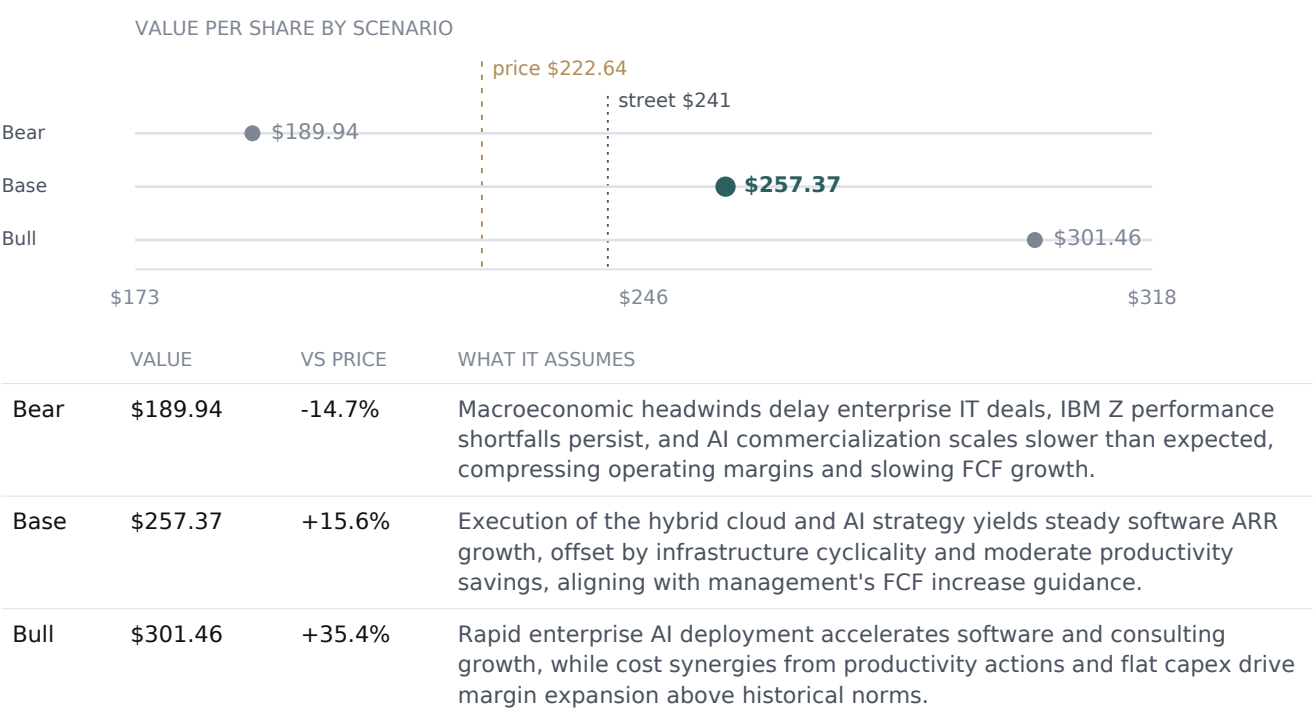


EQUITY RESEARCH / IBM

International Business Machines

LONG CANDIDATE · historical study through 2026-10-02 · horizon 365 days · DCF + P/E

PRICE	BASE CASE	UPSIDE	PROB-WEIGHTED	MARKET CAP	TRAILING P/E
\$222.64	\$257.37	+15.6%	\$245.96	\$209.76B	19.7x



STREET CHECK

Street target **\$241** (+8.1% vs price) · 12 buy / 10 hold / 2 sell · forward P/E 17.4x · EPS estimates \$12.31 this year, \$13.15 next

Our base case is **1.07x** the Street target: within the Street's range.

Consensus is shown for calibration only. The model never receives it.

Thesis

IBM is trading at a 19.72x trailing P/E with a base-case DCF value of \$257.37 and earnings multiple value of \$266.73, implying ~15-20% upside. The investment argument centers on IBM's transition to a software and AI-led hybrid cloud business with a high-recurring revenue base, supported by management's guidance for 4-5% constant-currency revenue growth and ~\$1B free cash flow expansion in 2026. Ongoing productivity initiatives and the commercialization of AI should drive sustained margin expansion, particularly in the software and consulting segments, while the enterprise license agreement (ELA) model locks in long-term client commitments. The market is currently discounting this trajectory due to near-term infrastructure cyclicality and macroeconomic headwinds impacting large deal closures, but the structural shift toward AI and cloud platforms provides a durable earnings growth runway.

What the market may be missing

The market appears to price a persistent drag from macroeconomic uncertainty and infrastructure margin volatility, while potentially underweighting the structural margin expansion from AI commercialization and productivity initiatives. The valuation assumes execution of the announced 4-5% constant-currency revenue growth and ~\$1B FCF increase guidance.

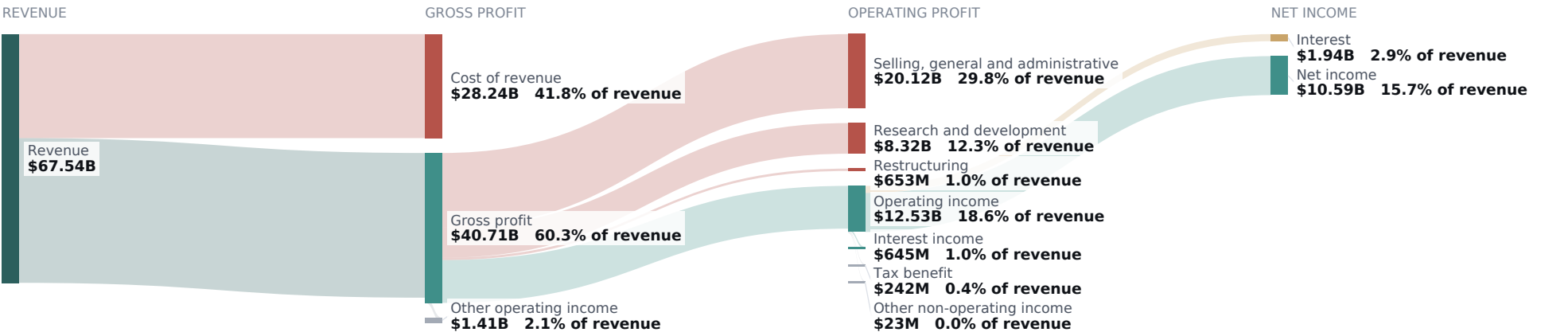
Why the opportunity exists

A transient setback. The market is pricing IBM as a legacy infrastructure company burdened by cyclical hardware downturns and macro uncertainty, rather than recognizing its structural transition to a high-margin, recurring-revenue software and AI platform business. Evidence: Current trailing P/E of 19.72x sits at the lower end of the company's own 5-year historical P/E range (20.09x to 78.27x, median 26.52x), alongside the reported 80% recurring software revenue base and \$15,313.9M TTM FCFF.

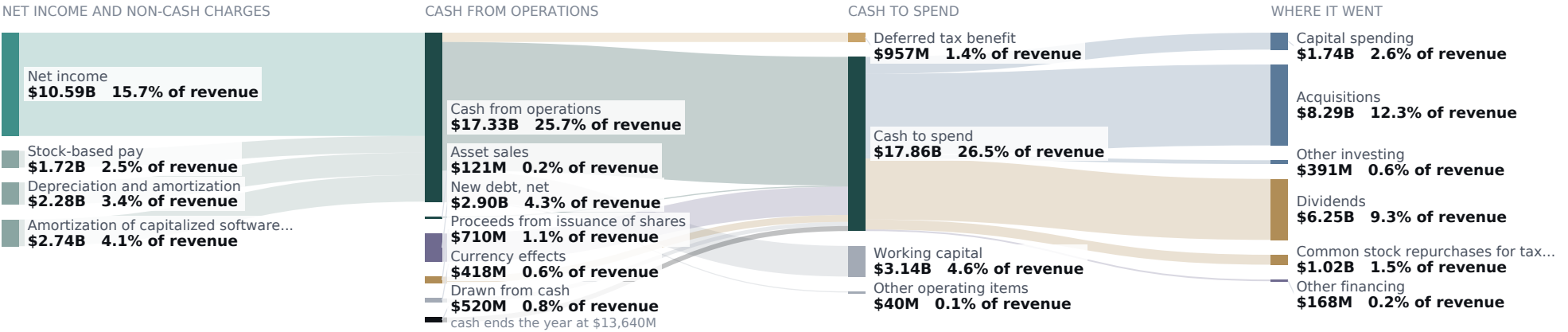
Follow the money: fiscal 2025

Of every \$100 of revenue, \$42 went to cost of revenue, \$41 to operating costs and \$2.9 to interest and tax, and \$16 became net income. Operations turned that into \$20 of cash; \$1.6 went to capital spending and \$9.3 back to shareholders.

1 WHERE EVERY DOLLAR OF REVENUE WENT



2 HOW PROFIT BECAME CASH, AND WHERE THE CASH WENT SHOWN 2.6 TIMES LARGER THAN PANEL 1



From the 10-K for the fiscal year ended 2025-12-31, XBRL accession 0000051143-26-000010. Every band ties to a reported figure; where the tagged lines do not add up, the difference appears as an explicit other or working-capital band. Lines outside the standard set are placed by the filing's own calculation links, under the company's labels; borrowing and investment flows are netted by instrument.

The business

IBM is a globally integrated enterprise that leverages hybrid cloud and artificial intelligence technology across software, consulting, and mission-critical infrastructure to drive client digital transformations, application modernization, and operational efficiencies.

What it sells

The company provides hybrid cloud platforms and artificial intelligence (AI) technology that support digital transformations, workflow reimagination, and application modernization. Offerings span software, consulting services designed to deliver business outcomes, and deep incumbency in mission-critical infrastructure including on-premises and cloud-based server and storage solutions. IBM also supplies life-cycle services for hybrid cloud infrastructure deployment and offers client and commercial financing to facilitate customers' acquisition of hardware, software, and services. Software (Hybrid Cloud/Red Hat, Automation, Data, Transaction Processing with enterprise license agreements), Consulting (Strategy and Technology, Intelligent Operations), Infrastructure (Hybrid Infrastructure including IBM Z mainframes, Distributed Infrastructure including Power and Storage, Infrastructure Support), and Financing (equipment and customer financing).

Customers and channels

Sells to enterprise clients across industries, including commercial customers in regulated sectors, with approximately sixty percent of revenues derived from sales outside the United States. Distribution occurs through direct sales and a broad ecosystem of strategic partners including hyperscalers, global system integrators, and software and hardware vendors who collaborate on end-to-end solutions. Global enterprise and government clients across Americas, EMEA, and Asia Pacific. IBM is expanding commercial coverage across thousands of additional clients and hiring Forward Deployed Engineers to support AI deployment. Enterprise license agreements (ELAs) drive long-term strategic client commitments and cross-sell multipliers.

Unit economics and costs

Competitive methods include price, quality, performance, and technology innovation. Costs are influenced by significant R&D investments, open-source and third-party software dependencies licensed with limited or no warranties, semiconductor supplier concentration for server processors, and intense competition for skilled technical talent. Financial results are subject to sales cycle length and strong seasonal purchasing patterns, particularly in the fourth quarter. Consolidated gross margin of 57.7% (down 1.0 pts) and operating (non-GAAP) gross margin of 59.4% (down 0.7 pts) driven by revenue shortfall, mix, and innovation investments, partially offset by productivity actions. Software segment profit margin expanded 1.1 pts to 32.2%. Consulting margin rose 1.4 pts to 28.9%. Infrastructure margin fell 3.1 pts to 58.4% due to IBM Z miss. R&D expense increased ~10% on AI/hybrid cloud/quantum investments. SG&A benefited from productivity actions (-7 pts) offset by acquired business costs (+4 pts) and intangible amortization (+2 pts).

Segments

- **Software** - Hybrid cloud and AI platforms that enable clients to realize digital and AI transformations across applications, data, and operating environments.
- **Consulting** - Integrates strategy, experience design, technology, and operations expertise to deliver transformation, systems integration, application development, and business process outsourcing services.
- **Infrastructure** - Provides on-premises and cloud-based server and storage solutions tailored for mission-critical and AI workloads, alongside life-cycle services for hybrid cloud deployment.
- **Financing** - Facilitates client and commercial financing for the acquisition of IBM hardware, software, and services, managing credit and residual value risk.

Revenue drivers

- Hybrid cloud and AI platform adoption and scaling
- Software subscriptions and platform licensing
- Consulting engagements for digital transformation and workflow modernization
- Mission-critical infrastructure sales (servers and storage)
- Client and commercial financing contract volume
- R&D commercialization and developer ecosystem growth
- Enterprise application modernization and data management
- ~80% recurring software revenue base delivering healthy growth

Competitive position

The company is the leader or among the leaders in each business segment. It differentiates through enterprise incumbency, deep technology and industry expertise, a broad global go-to-market reach, an extensive partner ecosystem, and a sustained focus on innovation. The financing segment further gains advantage by managing credit and residual value risk. Positioned as a software-led Hybrid Cloud and AI platform company with leadership in quantum computing. Differentiated AI-enabled storage and resiliency-focused Power systems. Strong open-source trust and scale via Red Hat. Scaling commercialization of AI at speed through specialized talent and expanded go-to-market coverage.

Industry direction

High growth and intense competition in hybrid cloud and AI workloads are driving demand for secure, scalable mission-critical infrastructure. The market is rapidly evolving with new competitors, disruptive technologies, and emerging business models. Quantum computing and AI represent adjacent growth frontiers, while regulatory and trade policies increasingly impact global technology supply chains and data localization requirements. AI adoption is moving from experimentation to enterprise-scale deployment, driving demand for data transformation and AI-ready infrastructure. Near-term client buying dynamics favor securing supply-constrained infrastructure ahead of expected price increases. Macroeconomic uncertainty is causing transactional software spending delays and impacting large deal closure timelines.

Recent developments

- Q2 revenue fell below expectations due to IBM Z performance shortfall and late-June client spending reallocation toward distributed infrastructure
- Confluent acquisition closed in Q1 2026, contributing significantly to Data line growth
- Management accelerating productivity initiatives and go-to-market model changes across thousands of new clients
- Announced investment of more than \$10 billion in quantum over five years to build the Anderton wafer foundry
- Declared regular quarterly cash dividend of \$1.69 per common share, maintaining consecutive payments since 1916
- Issued updated full-year 2026 guidance citing currency neutrality and margin expansion expectations
- Expanded strategic partnerships with hyperscalers and major technology vendors including AWS, Microsoft, Adobe, Oracle, SAP, and Palo Alto Networks.
- Continuous capital allocation and R&D investment focused on commercializing AI and hybrid cloud innovations.

Management outlook

Management now expects full-year 2026 constant-currency revenue growth in the range of four-to-five percent, with foreign exchange expected to be neutral to growth. Free cash flow is expected to increase by about \$1 billion year-over-year. The company anticipates improved pre-tax income margin expansion for the full year, driven by ongoing productivity initiatives, AI commercialization investments, and operational focus on high-growth software areas and distributed infrastructure. Management aims to drive accelerated growth by executing a hybrid cloud and AI strategy while leveraging the company's research organization and developer ecosystem. The company seeks to improve agility, productivity, and cost savings through automation, AI, and agile processes, scaling resources and investments across emerging and established markets while preparing for next-generation opportunities such as quantum computing.

Accounting flags

- Operating (non-GAAP) earnings exclude acquisition-related charges, intangible asset amortization, retirement-related non-operating costs, and U.S. Tax Cuts and Jobs Act impacts
- Expected credit loss provision decreased from \$14M to \$7M in Q2 due to lower specific reserve requirements
- Non-operating retirement-related costs increased significantly due to actuarial loss recognition and interest cost changes
- Goodwill and intangible assets increased following Confluent acquisition; amortization of acquired intangibles rose 27% year-over-year
- Lease accounting reflects reductions in revenue for estimated residual value less related unearned income on sales-type leases
- Constant currency adjustments exclude operational impacts of foreign exchange fluctuations

Key figures

KEY FIGURES	TTM TO 2026-06-30	FY2025	
Revenue	\$69.09B	\$67.53B	+7.6% y/y
Gross margin	58.1%		
Net income	\$10.72B	\$10.59B	
Diluted EPS	\$11.29	\$11.17	19.7x trailing P/E
Operating cash flow	\$14.89B	\$13.19B	-1.9% y/y
Capital spending	\$1.10B	\$1.09B	1.6% of revenue
Unlevered FCFF	\$15.31B		7.3% yield
Cash and short-term investments	\$7.17B	\$13.59B	
Net debt	\$54.81B		
Market capitalisation	\$209.76B		

Figures from the filings' XBRL; definitions in the method section. Depreciation and amortisation were reported separately and are summed. Flows are trailing twelve months to 2026-06-30 (fiscal year 2025 plus year to date less the same period a year earlier, from the 10-Q filed 2026-07-23). Balance-sheet items are as of 2026-06-30 from the quarterly report. Interest tax shield uses the 21.0% statutory rate from the filing's rate reconciliation. Current debt of \$5,775.0M (Short-term debt) falls due within twelve months of 2026-06-30; the price date is 94 days later, so check in the filing whether any of it matured or was refinanced before 2026-10-02. WACC ancho

The counter-case

The current 19.72x P/E and EV/revenue of 3.83x already reflect significant macro pessimism and infrastructure cyclicity, placing valuation at the lower end of IBM's 5-year historical P/E range (20.09x to 78.27x, median 26.52x). The bear case DCF value of \$189.94 requires negative FCFF growth, but the company's guidance and 80% recurring revenue base make a prolonged drawdown unlikely, while productivity initiatives and AI commercialization provide a clear path to the base-case 5% EPS growth and margin expansion. IBM Z shortfall and infrastructure margin contraction (down 3.1 pts to 58.4%) reveal execution risks in supply-constrained hardware. Macroeconomic uncertainty is already delaying transactional software spending and large deal closures. High debt levels (\$54,815.0M net debt) and near-term maturities (\$5,775.0M short-term debt) create refinancing risk in a higher-for-longer rate environment, while heavy M&A integration (Confluent) and AI R&D spending could compress FCF margins.

Valuation

IBM generates positive, predictable trailing-twelve-months FCFF of \$15,313.9M and sustainable TTM EPS of \$11.29. Its hybrid cloud and AI software business provides a high recurring-revenue base, supporting both a discounted cash flow model and an earnings multiple valuation.

SCENARIO	ASSUMPTIONS	VALUE	VS PRICE
Bear	FCFF growth -5%, -2%, +0%, +1%, +2%; WACC 8.2%; terminal growth 2.5%	\$189.94	-14.7%
Base	FCFF growth +4%, +5%, +5%, +5%, +3%; WACC 8.2%; terminal growth 2.5%	\$257.37	+15.6%
Bull	FCFF growth +8%, +9%, +8%, +7%, +5%; WACC 8.2%; terminal growth 2.5%	\$301.46	+35.4%
Bear (P/E)	18.0x forward EPS \$11.85 (reported diluted, growth +5.0%)	\$213.38	-4.2%
Base (P/E)	22.5x forward EPS \$11.85 (reported diluted, growth +5.0%)	\$266.73	+19.8%
Bull (P/E)	26.0x forward EPS \$11.85 (reported diluted, growth +5.0%)	\$308.22	+38.4%

- Discount rate: the model used 8.2% against an anchor of 8.2% (risk-free 5.24%, beta 0.83, equity risk premium 5.0%, cost of equity 9.4%, after-tax cost of debt 4.1%, debt 23% of capital).
- The price implies constant five-year FCFF growth of +1.8% at the base-case WACC and terminal growth.
- Anchors from the company's own history: base-case growth band -6.2% to +7.6% a year; worst revenue decline -41% (2014-2020); own trailing P/E 20.09-78.27x (median 26.52x) over the last five fiscal year ends.
- Sensitivity to discount rate: 6.2% gives \$427, 7.2% gives \$324, 8.2% gives \$257, 9.2% gives \$210, 10.2% gives \$175.
- Sensitivity to terminal growth: 1.5% gives \$219, 2.0% gives \$237, 2.5% gives \$257, 3.0% gives \$282, 3.5% gives \$311.
- Per-share values use 942,134,390 shares as of 2026-06-30; the fiscal-year diluted average differs by +0.7%.
- Probability-weighted value \$245.96 (+10.5% vs price) at 30%/50%/20% weights.

Bear case assumes macro headwinds delay enterprise IT deals, IBM Z shortfalls persist, and AI commercialization scales slower than expected, compressing margins and driving 5-year FCFF growth to -5%, -2%, 0%, 1%, 2%, resulting in a \$189.94/share value. Base case assumes steady execution of the hybrid cloud and AI strategy, yielding 4%, 5%, 5%, 5%, 3% FCFF growth aligned with management's FCF increase guidance, valuing the stock at \$257.37. Bull case assumes rapid enterprise AI deployment accelerates software and consulting growth, while cost synergies and flat capex drive margin expansion, producing 8%, 9%, 8%, 7%, 5% FCFF growth and a \$301.46/share value.

What breaks the case

SHOCK TO THE BASE CASE	VALUE	VS PRICE
Base case as planned	\$257.37	+15.6%
WACC 100bp higher	\$210.21	-5.6%
Pre-tax cost of debt 200bp higher	\$238.60	+7.2%
Every year's FCFF growth 5 points lower	\$194.99	-12.4%
Every year's FCFF growth 5 points higher	\$332.16	+49.2%
Starting FCFF 10% lower	\$225.81	+1.4%
Starting FCFF 10% higher	\$288.92	+29.8%

The base case equals the price at a 8.9% WACC or if every annual FCFF growth rate were -2.7% points different. These are thresholds, not forecasts.

No listed peer was judged comparable. The software's peer tree is unavailable for this quarter (anchors.peers.status: unavailable). Consequently, a formal comparable multiples or financials comparison cannot be constructed. The valuation relies on IBM's own historical five-year P/E range (20.09x to 78.27x, median 26.52x) and internal growth anchors. The current trailing P/E of 19.72x sits at the lower end of the historical range, reflecting macro sensitivity and infrastructure margin volatility rather than a structural multiple contraction.

What would change the view

Key debates

- AI commercialization speed: Decides whether software margins expand or contract as R&D and go-to-market costs scale. (Management expects improved pre-tax income margin expansion driven by AI commercialization investments.)
- Enterprise IT spending cycles: Macro uncertainty delays large software and consulting deals, impacting short-term revenue and FCFF. (Macroeconomic uncertainty is causing transactional software spending delays and impacting large deal closure timelines.)
- Infrastructure margin volatility: IBM Z shortfall and supply constraints affect overall profitability and FCF generation. (Infrastructure margin fell 3.1 pts to 58.4% due to IBM Z miss. Client demand shifting to secure supply-constrained infrastructure ahead of price increases.)

Catalysts

- Q3 2026 earnings confirming 4-5% constant-currency revenue growth and ~\$1B FCF expansion guidance
- Sustained growth in Software segment ARR and expansion of the ~80% recurring revenue base
- Successful integration of Confluent contributing to Data line growth and AI commercialization
- Continued margin expansion in Software (32.2%) and Consulting (28.9%) offsetting Infrastructure cyclicality
- Reduction in leverage or refinancing of short-term debt (\$5,775.0M) at favorable rates

Invalidation

- Macroeconomic downturn causes prolonged contraction in enterprise IT spending, delaying large software and consulting deals

- Infrastructure margin falls below 50% due to persistent IBM Z supply chain issues or pricing pressure
- AI commercialization fails to scale, causing R&D and go-to-market costs to outpace revenue growth and compress margins
- Free cash flow fails to grow as guided, with FCFF margin collapsing below 15% due to integration costs or credit losses
- Refinancing risk materializes with sharply higher interest expenses eroding net income and EPS

Risks

- Macroeconomic uncertainty causing transactional software spending delays and impacting large deal closure timelines
- Infrastructure margin volatility and IBM Z performance shortfalls affecting overall profitability
- High leverage (\$54,815.0M net debt) and near-term maturities requiring refinancing in a potentially higher-rate environment
- Execution risk on AI commercialization and hybrid cloud strategy against hundreds of competitive rivals
- Integration challenges, liability assumptions, and higher debt levels from acquisitions like Confluent
- Supply chain disruptions and reliance on single or limited suppliers for critical semiconductors

Short side

Not applicable; this is a long-thesis evaluation. IBM's high dividend yield, institutional ownership, and relatively stable cash flows present significant borrow and squeeze risks, while the fundamental upside profile outweighs short mechanics.

Open questions

Will the Confluent acquisition drive sustainable data-line revenue growth and margin accretion, or will integration costs and assumed liabilities dilute FCF? (forecast uncertainty)

Monitored via quarterly revenue contribution and GAAP vs non-GAAP margin reconciliation. Watch: Two consecutive quarters of Confluent revenue decline or gross margin contraction.

Can IBM successfully refinance the \$5,775.0M short-term debt maturing near 2026-06-30, and at what interest cost given current rates? (missing fact)

Assumed refinancing at current observable debt costs (5.24% pretax); sensitivity tested at +200bps to cost of debt. Watch: Credit rating downgrade or announced refinancing at rates significantly above the 5.24% anchor.

Limitations

The DCF model relies heavily on terminal value (76.8% of EV in the base case), making it sensitive to the 2.5% terminal growth and 8.24% WACC assumptions. The starting FCF margin of 22.16% is within historical bounds but assumes sustained execution of productivity initiatives. The bear case cumulative FCF change (-4%) is milder than the worst historical revenue drawdown (-40.5%, 2014-2020), which may understate downside risk if macro headwinds persist. Peer comparison data is unavailable for this quarter, limiting relative valuation cross-checks. Terminal value is 78% of enterprise value in at least one scenario, so the result is dominated by the terminal assumptions. Software checks raised during valuation: the bear case's cumulative FCF change over the forecast (-4%) is milder than the company's worst historical revenue decline (-41%, 2014-2020); a bear case should at least revisit history or say why this time differs. This memo is an initial research product from a frozen historical filing and price; it is not investment qualification.

Software flags: bear shallower than history; core line items missing:operating income; exposure quote unverified:customer concentration; exposure quote unverified:refinancing; exposure quote unverified:regulation.

Sources

10-K for the fiscal year ended 2025-12-31, filed 2026-02-24 (accession 0000051143-26-000010).

10-Q for the quarter ended 2026-06-30, filed 2026-07-23 (accession 0000051143-26-000078).

8-K for the earnings release dated 2026-07-22, filed 2026-07-22 (accession 0000051143-26-000077).

- Price: historical close of \$222.64 on 2026-10-02.
- 8 cited claims and 16 recorded calculations; every figure in the key-figures table is bound to a tagged XBRL fact, and every calculation reproduces independently.
- Street consensus from the market-data vendor on the same date, shown for calibration only.

Model: Qwen3.6-35B-A3B-NVFP4 · run discovery-20260911 · job 464 · memo SHA-256 b92a25ff05923257... · full memo and audit attached as JSON.

This note was written by a model from a single annual filing and a closing price. It is a starting point for human research, not a recommendation; nothing here has been investment-qualified.