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REFINE YOUR SEARCH

Deconstructing the Books at Big Blue

By MARK VEVERKA

The mere whiff of mildly optimistic news from [Dell Computer](#) last week sent shares of rival [International Business Machines](#) flying. Showing that it takes very little to impress battle-scarred tech investors these days, Dell's shares soared 13.5% to close on Thursday at 25.19 after telling the Street: "Hey everybody, we aren't going to blow our quarter!"

The modestly upbeat disclosure that Dell would meet its consensus earnings estimate for the first quarter, triggered a sympathetic rise in **IBM** shares that same day. Big Blue vaulted 6.75% to close Thursday at 98.21, bouncing back from 52-week lows in December of 80.06 -- but still considerably off their high of 134.94.

Oddly enough, despite the sigh of relief in Austintown, Dell still confirmed the rather sobering fact that the boxmaker expects to post its first quarter-to-quarter revenue slide in 17 years. But techsters were willing to settle for table scraps after a steady diet of earnings warnings.

Relatively speaking, **IBM** is starting to look like a pillar of strength. Big Blue has yet to lower its earnings expectations and has been racking up consistent earnings.

But don't let the happy news and quarterly performance streak fool you, warns James Grant, founder of Grant's Interest Rate Observer. In tumultuous times like these, people want to believe that the mother of all tech companies is a safe haven. But the reality is that the health of IBM's core hardware and software businesses is difficult to detect because the company continues to play the Street like a fiddle by fiddling with its income statements.

"**IBM** is rightly known for the brilliance of its electronic engineering, and no less impressive is its brilliance in financial engineering," Grant told *Barron's* .

During the bull market, **IBM** posted earnings that were regular and predictable. But "the more we look at their reporting, the more we are struck with how these earnings have less to do with core operations. As far as we can tell, these results owe as much to the ingenuity of the front office as they do to the strength of sales," Grant says.

Creative financial reporting isn't new to **IBM** or its shareholders. Grant and others have been shining a light on the company's now patented practice of building better income statements through better engineering for some time.

"Like raising children, deconstructing **IBM** is a work neverending," Grant muses. But that doesn't make the lack of clear information on how much software, hardware and services the company actually peddles any less troublesome or relevant. In fact, as investors jumped back into Big Blue's shares with both feet last week, it is apparent that not everybody is paying attention.

What's more, Grant observes that with the publication of the company's latest 10-K, **IBM** may have surpassed even its own audacious standards of finding new ways to account for disappointing revenue growth without disappointing Wall Street.

For example, although net income rose in 2000, operating income declined. "How did the team assembled by hard-driving CEO Louis V. Gerstner Jr. choose to present this anomaly to the vast extended family of **IBM** stakeholders?" asks Grant in a recent issue of the Interest Rate Observer.

It chose understatement. The company reformatted its income statement by omitting the "operating income" line from the 10-K and the new annual report, writes Grant. Call it the Soprano School of Financial Reporting. If you don't like something -- "poof" -- just erase it.

On the surface, 2000 was a stellar year for **IBM**. Revenues were flat, but net income jumped by about 5%. Return on equity climbed to 53% in the fourth quarter compared with 41% in 1999, and margins were strong. But after peeling the proverbial onion a bit, IBM's financial performance looks less rosy, Grant says.

The trouble spots include the company's growing contribution of pension-plan gains to operating income, the increasing use of working capital to finance receivables, and the alarmingly high sums spent purely to manage share dilution.

Last year, pension income -- that is, cash transferred from the pension plan to the P&L -- totaled \$728 million. That's more than double the amount of pension income booked in 1999, which was \$288 million, and huge increases over \$89 million in 1998 and \$17 million in 1997.

Secondly, what happened to operating income? Where is the body buried? Net income is rising, but cash flow from operations is falling. In a company such as **IBM**, which has demonstrated a stable top line, the two are expected to track at the same trajectory, notes Robert Tracy, a financial analyst at GrantsInvestor.com.

How did **IBM** "find the blood of net income in the stone of declining operating income?" The company reduced its tax rate to 29.8% from 34.4%, lowered the allowance for doubtful accounts as a percentage of total receivables, and harvested gains by changing important assumptions on pension returns, Tracy points out. With those three strokes, the company added \$858 million, or 47 cents a share, to 2000 net income. Voilà!

Lastly, there is the nettlesome practice of buying back tens of millions of shares a year. While shareholders generally perceive buybacks as a good thing, Tracy argues that the practice is an expensive way to manage dilution of shares from options grants.

"The practice is sold to shareholders as a means to improve shareholder value, but it is actually a real cost," Tracy says.

Like most tech firms, **IBM** loads its executive-compensation packages with stock options. When these options are exercised, the total number of shares increases at a rapid rate. The buybacks are a way to keep the total share count from mushrooming.

But this doesn't come free. The cost of holding the share count somewhat flat was about \$1.96 billion in 2000, down from \$2.23 billion in 1999 but hefty nonetheless. In other words, **IBM** spent what is roughly equivalent to 25% of its average net income on managing its share count.

Says Tracy: "What if the company added \$2 billion to its SGA costs, what would that do to profitability?"

We seem to have struck a nerve. The systems integration and inventory management capabilities of Celestica, the contract manufacturer of technology hardware and components, is just fine, thank you. So says Andrew Gort, the Canadian company's executive vice president of global supply-chain management.

Gort took umbrage with an assertion by Roger McNamee, who runs Integral Capital in Menlo Park, California, in last week's column. McNamee contended that Celestica's systems integration was a mess. "Our situation is quite the contrary. [Systems integration] has been a primary focus of mine," Gort says. McNamee's criticism "was quite surprising to me. In fact, McNamee's statement that 'Celestica has more than two dozen facilities that run on two dozen or so different enterprise

resource planning systems' is completely false and inaccurate," he says.

After completing 23 acquisitions in just over three years, Celestica currently has two primary enterprise resource planning systems: BPCS and SAP. BPCS is a legacy system that Celestica is abandoning in favor of SAP in all of 36 of the company's facilities worldwide. The switch has been implemented in Asia, is coming on line in Europe and has just begun in the United States, where one of its several plants has already had the software installed, says Gort, a former **IBM** executive.

Thus, it's fair to say that all but one of Celestica's U.S. facilities still operate on the company's legacy system. But Gort says that has not hindered Celestica's ability to manage inventory: "Our supply-chain processes were part of the reason Celestica was able to grow by 84% from 1999 to 2000, while ending last year with the best inventory turnover in the electronics manufacturing services industry. [And] all of this was during a very constrained market for electronic components."

Because of its supply-chain management prowess, Gort contends that Celestica will be able to handle its inventory efficiently when the market bounces back. But for now, the Street is taking a pessimistic view. Last month, analysts slashed earnings projections for the entire contract manufacturing sector. Deutsche Banc Alex. Brown analyst Chris Whitmore, for one, lowered his 2001 earnings outlook for Celestica to \$1.90 a share from \$2.10 and to \$2.35 from \$2.70 in 2002. Celestica closed Friday at 24.91, down 71% off its 52-week high of 87.

In the funding-challenged world of wireless start-ups, the principals at Nokia Venture Partners are pretty popular these days. The fund, which has raised \$650 million since it was launched in 1998, focuses on investments in early-stage mobile Internet plays. In addition to its telecommunications parent, the fund's limited partners include Goldman Sachs and BMC Software. This week, the fund is expected to name Valley veteran John Zeisler -- who played key roles at such tech stalwarts as Apple Computer and Claris -- a general partner.

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