ANNEX BULLETIN

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IT SERVICES

Updated 4/14/06, 5:00PM PDT; updates Outlook

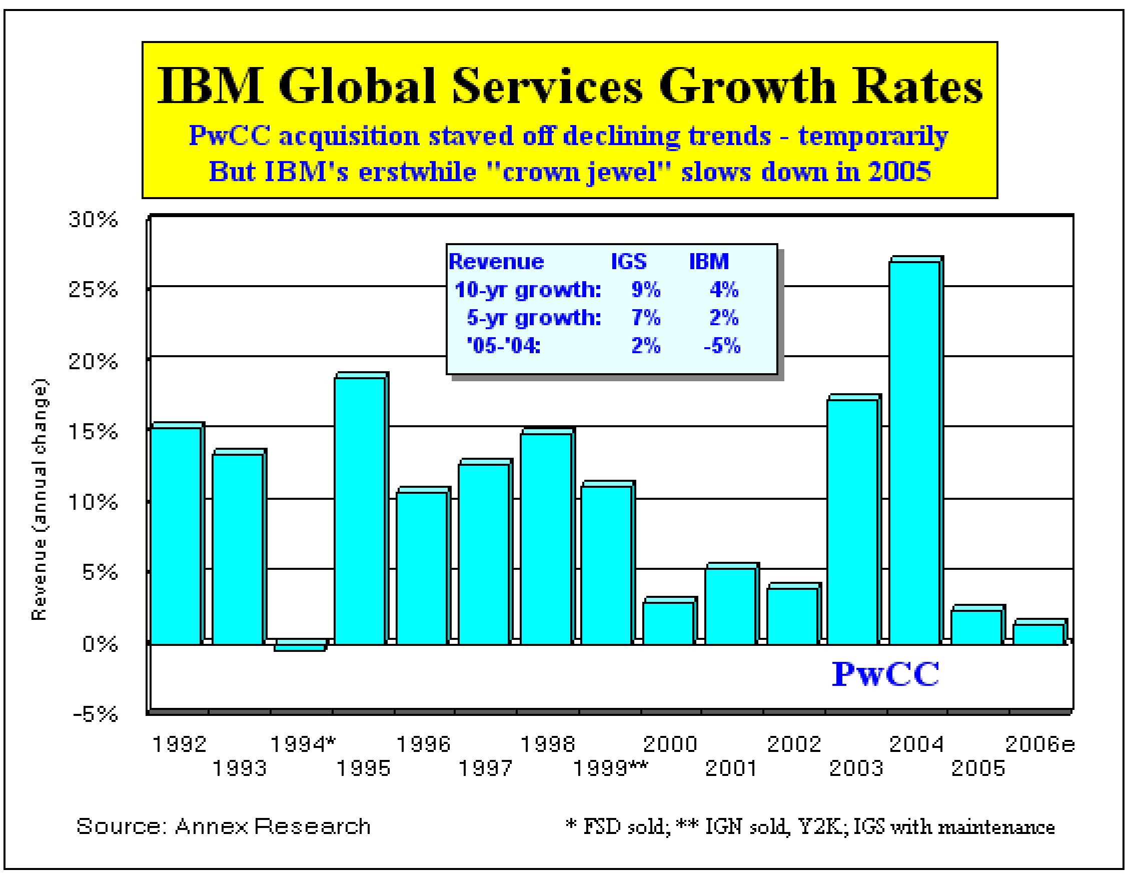
Analysis of IBM Global Services' 2005 Business Results

Jewel Develops Patina

Profit Drops Sharply on Small Revenue Increase

SCOTTSDALE, Apr 14 - Big Blue's brightest crown jewel of the 1990s has developed a patina in the 2000s. The 2002 PwCC acquisition temporarily masked the IBM Global Services (IGS) weaknesses by boosting its revenue growth into double digits. But in 2005, the world's largest IT services firm returned to its old slow or no growth ways.

For the full year, IGS revenues rose 2.5% to $47.4 billion, or 52% of IBM's total. But pretax profits dropped 16% to $3.4 billion, for a 7% pretax margin. We estimate that last year's net earnings plunged even more steeply thanks to higher tax rates - down 22% to $2.2 billion, for a 4.7% net margin.



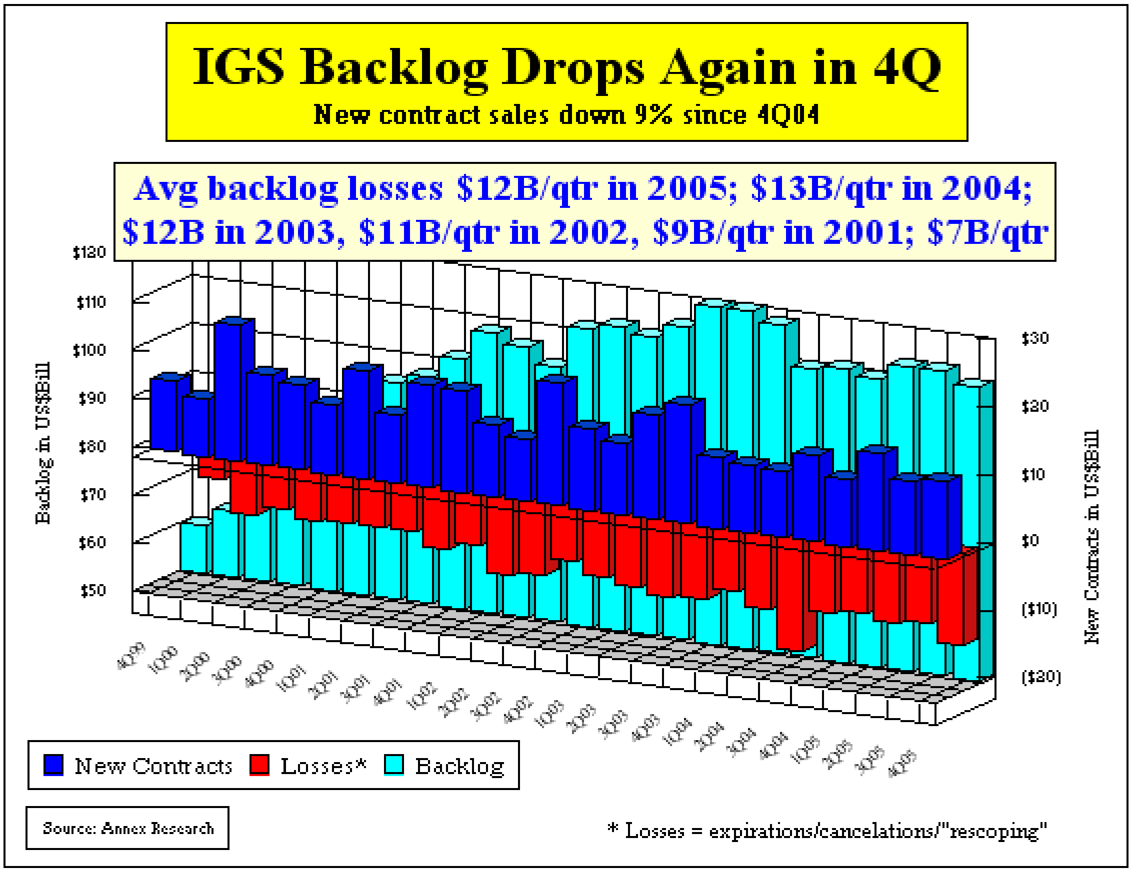
Long-term trends also point downward. After the heady years in the 1990s, when revenues grew in double digits year after year, the IGS slowdown in the 2000s resulted in its first ever single digit 10-year compound annual growth results (9% between 1995 and 2005). The five-year growth was even slower (7%) even though both figures include the temporary boost of the PwCC acquisition.

The IGS' growth is still outpacing that of IBM as a whole, but not by much anymore. In 2005, Big Blue revenues declined 5%, but that was because of the sale of its PC business to Lenovo. Without it, however, the IBM business from continuing operations grew by more than 3%. And the corresponding pretax income jumped by 15%, reflecting the company's new emphasis on quality rather than quantity.

Sales Slowdown, "Rescoping" and Backlog Issues

Meanwhile, back to IGS, as we've said many times since the start of this decade, IBM's services unit will have a hard time sustaining its growth without some major acquisitions. That's in part because IGS is losing business from the bottom end of its backlog. Here's what we said about its latest quarterly results (4Q05):

> The most worrisome figure to us was a $2 billion drop in IBM Global Services' backlog in the fourth quarter (since the third). Coupled with a 9% decline in new contract signings, these two figures mean that the biggest IBM unit is losing more business from its backlog than it is signing.



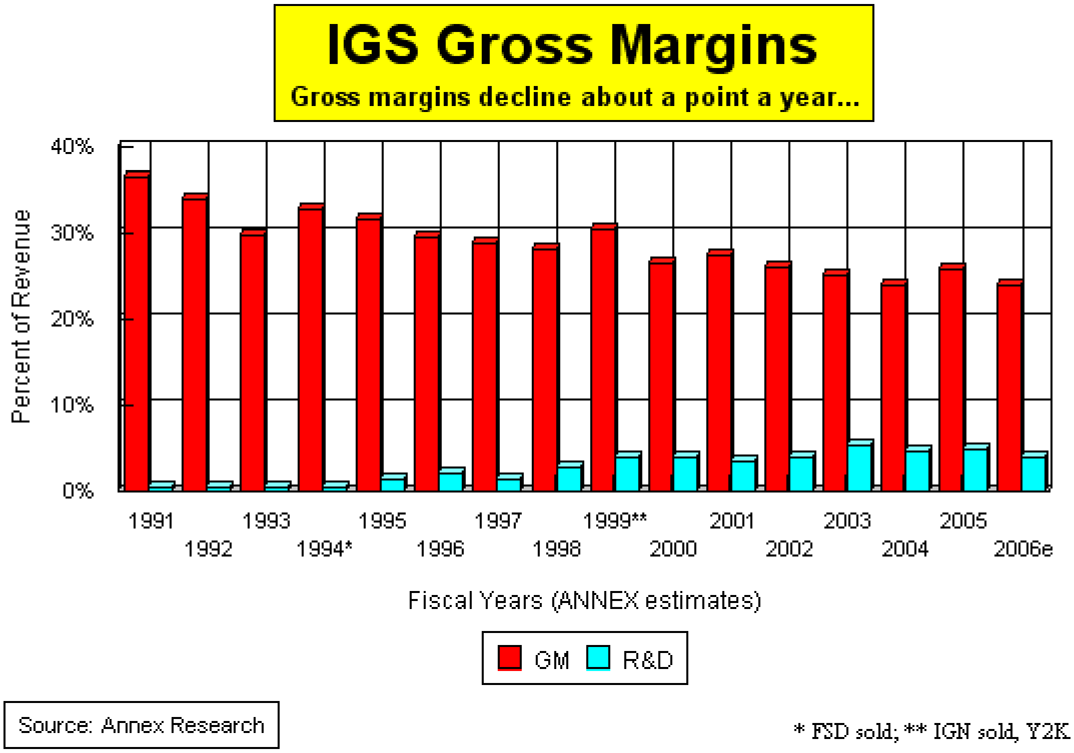
Unfortunately, that's nothing new. Ever since the first quarter of 2004, when IGS backlog peaked at $120 billion, the inflow of new business has fallen short of the outflow (expirations, cancellations, rescoping). In 2005, the outflow averaged $12 billion per quarter, an improvement from 2004, but still a huge hole that new contract sales have to fill every three months.

No wonder IGS revenues dropped 5% (it was down 1% in constant currency) despite a single-digit increase in maintenance revenues, a component of it.

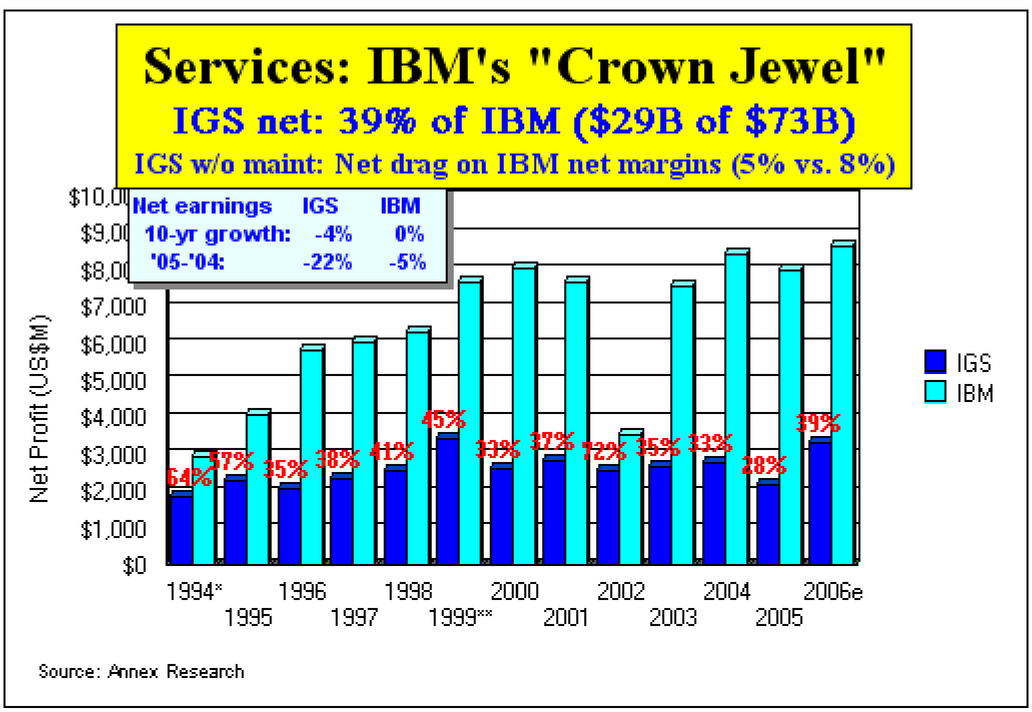
(An excerpt from "Slammed and Dunked," Apr 2005)

Declining Profitability

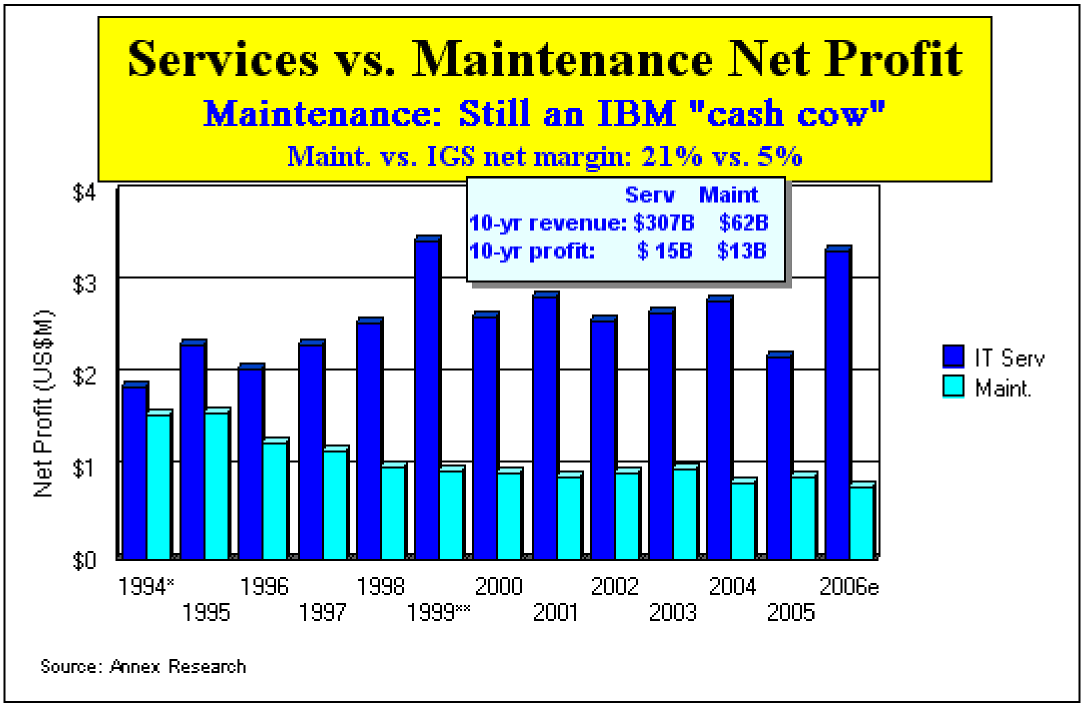
So new contract sales shortfall and backlog shrinkage are two additional negative long-term factors that are slowing down IGS's growth. But they do not directly affect another troubling development, peculiar only to 2005 so far. Which is IGS' declining profitability. Nothing new there...



Take a look at IGS' declining gross margins... (above).



...and then consider what we have been also saying for years - that IBM's biggest unit has been a net drag on the company's net margins (5% vs. 8% net margin). And now they also declined sharply last year (above).



Take away the maintenance component, and the IGS profit picture gets even worse. We figure that the maintenance net margins were about four times higher than those of the rest of the IGS services (above).

While the preceding may be old news to our clients and readers, most people first became acutely aware of the IGS profitability issue exactly one year ago to the day (Apr 14, 2005), when IBM released its disappointing first quarter results several days ahead of schedule. Its stock, as well as the shares of most of its competitors, tumbled in shocked response to the news (see "Slammed and Dunked," Apr 2005):

> IBM announced this afternoon after the markets closed a new round of major layoffs that are intended to address its major problem area during the first quarter - Europe. The company will cut between 10,000 and 13,000 jobs, and will take a charge between $1.3 billion and $1.7 billion.
>
> IBM said it plans to improve the efficiency of its *services* operations by consolidating much of the service delivery workload into fewer locations by using standard job roles, processes and tools.
>
> (An excerpt from "Slammed and Dunked," Apr 2005)

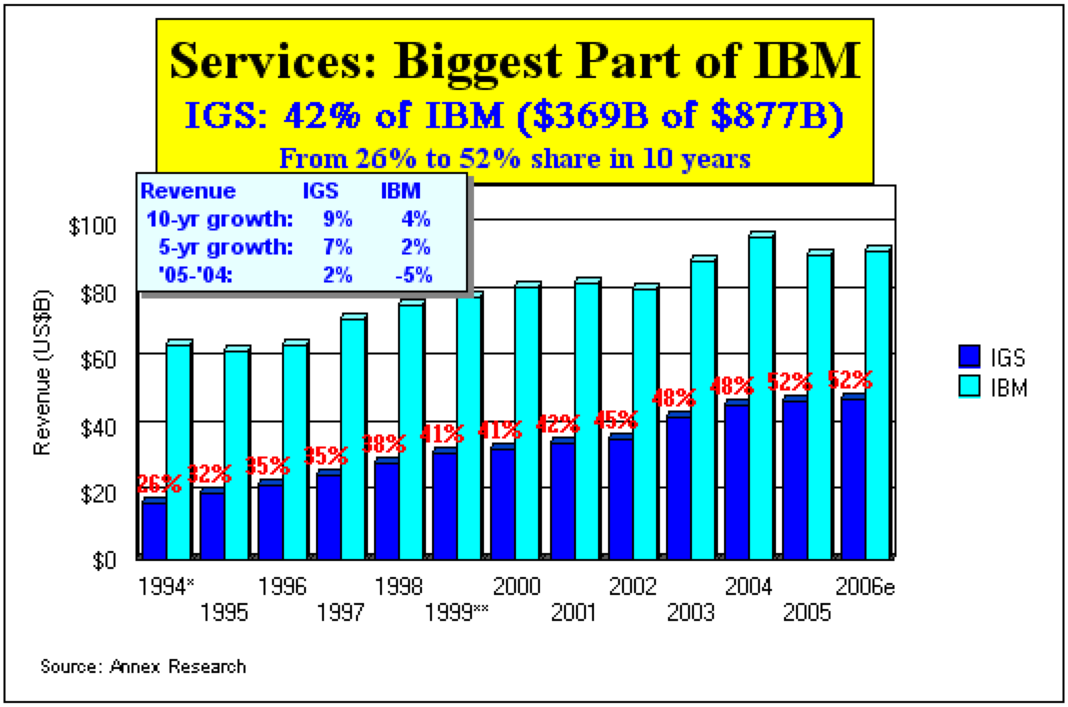
A part of IBM's quick second quarter 2005 bounce-back was due to an IGS organizational break-up into several pieces. Here's what we said about it in July of last year:

> Sam Palmisano, IBM's CEO, wasted no time in using Joyce's departure (former IBM services boss) to reorganize IGS. Using what we called the

> "amoeba syndrome" (splitting up in order to continue growing - see below), Palmisano did not replace Joyce, but effectively broke up Big Blue's biggest business unit in two (or three parts, depending on how one looks at it).
>
> Ginni Rometty, who successfully spearheaded the PwCC acquisition in 2002, was promoted to senior vice president, and made the head of Enterprise Business Services (EBS), a new entity that comprises of consulting, business process outsourcing, systems integration, etc. Mike Daniels, was also promoted to senior vice president and given the helm of Information Technology Services (ITS), that includes strategic outsourcing, eBusiness, maintenance etc. Daniels has made his claim to fame as the head of IBM Americas unit.
>
> IBM also promoted Bob Moffat to senior vice president and head of Integrated Operations. Moffat, who ran IBM's supply-chain operations, will continued to do that. But now he will be senior vice president of integrated operations, with a focus on services operations. All three executives report to the IBM CEO.
>
> As you can see, Palmisano split up IGS in a true BPO (Business Process Outsourcing) spirit - by function, rather than by replicating processes in each unit. The way we see it, Rometty's EBS unit is the IBM services *"front office"* that is in charge of present and future customer value creation. Daniels' ITS operation, on the other hand, handles legacy systems and operations, and is in charge of *delivery* of the IGS solutions. Moffat's Integrated Operations function runs IBM and customer infrastructures and supply chain processes. It includes not just IGS but also other IBM operations.
>
> We find this a clever and thoughtful way to break up a company. If it succeeds, it may become a new "amoeba model" model for IBM customers and competitors who may also copy it in years to come.
>
> (An excerpt from "IBM Bounces Back," July 2005)

Well, nine months later, the jury is still out if the new organizational model will produce better results. So far, things don't look very good. But a $47 billion-operation doesn't turn on a dime. It takes time to get all its ducks into a new order. The next nine months will show if the IGS new structure was indeed an improvement.

Business Outlook



So what does the future hold for IGS? Well, we figure that 2006 will represent a modest improvement over 2005. IGS revenues can be expected to grow in low single digits, but its net profitability is likely to improve and bounce back above the $3 billion-mark. This would put it at about a 7% net margin, as compared to less than 5% last year.

Any additional growth spurts are unlikely without major acquisitions. And we cannot think of any that would truly enhance the quality of the IGS business and not just the quantity. So if Palmisano's emphasis on quality remains at the top of his strategic agenda, smaller will be probably better in IGS' case, too.

But this may be a hard concept to sell on Wall Street. The fact that the IBM stock is still lower today than it was a year ago, despite a significantly better quality of its business mix, is proof of it. Still, if IGS 2006 profitability were to improve as outline above, it would bolster Palmisano's case and IBM's stature on the Street.

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Happy bargain hunting!

Bob Djurdjevic