ANNEX BULLETIN

Annex Bulletin 2006-29 July 26, 2006

An OPEN client edition

Click here for PDF (print) version

INDUSTRY TRENDS

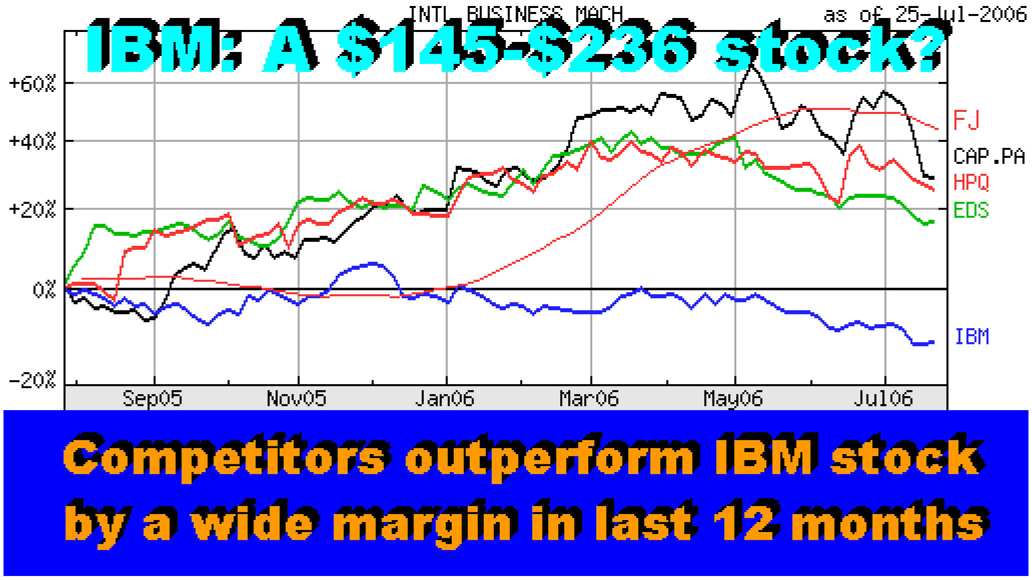
Updated 7/27/06, 11:00AM PDT, adds Stock chart, Capgemini, Fujitsu...

Stock Market Echoes of IBM's Second Quarter Results

Grossly Undervalued?

Big Blue Stock Should Be Between $145 and $236 Based on Some of Its Competitors' Valuations

SCOTTSDALE, July 26 - After IBM released its second quarter results last week, Big Blue's solid results helped lift some of its competitors' shares more than its own (see Market Reaction, July 19). As weird as such market reaction may seem, it was par for the course. Wall Street has largely ignored the good in the IBM results during the last 12 months while exaggerating the bad.

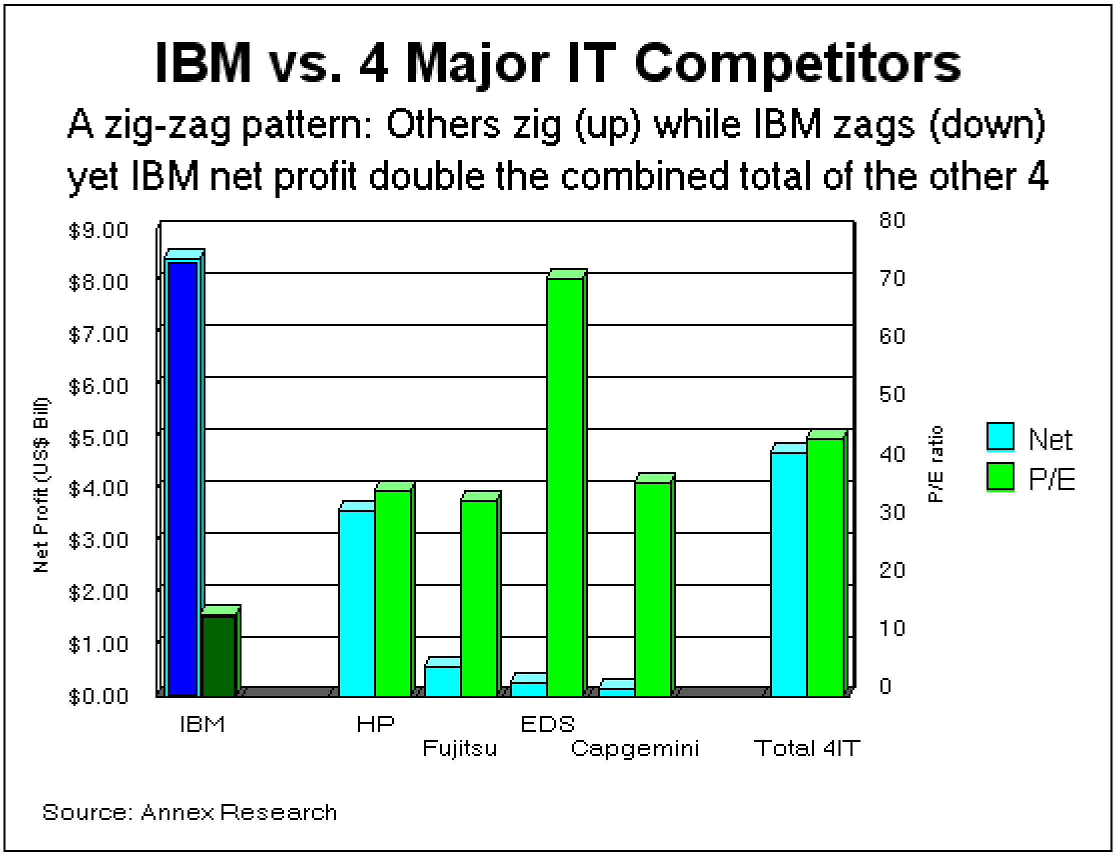


As a result, while four major competitors' (Fujitsu, HP, EDS, Capgemini - see the rationale below) shares surged between about 20% and 40% in the last year, IBM's declined about 10% during the same period. And yes, even the lowly EDS has done much better than IBM (see the chart, and "A $160 Billion Loss," June 2006, and "IBM vs. HP: A Tale of Two Blues," June 2006).

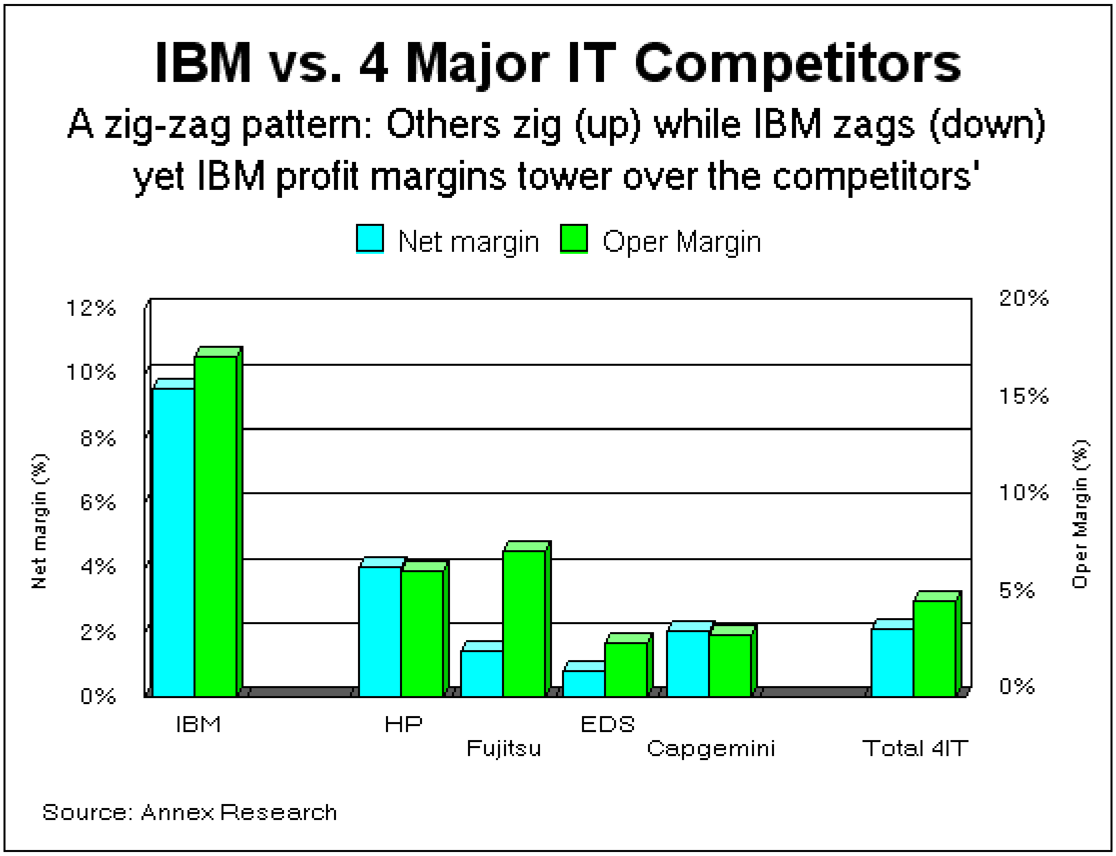
Yet, our analysis of the five IT leaders' fundamentals shows that if Big Blue stock were valued by the same yardstick (P/E ratios) as that used for its for competitors' shares, IBM should be trading between $145 and $236 per share.

Another indication as to how much the IBM stock may be undervalued can be seen from the above chart. Big Blue shares have been trading well below their 50 and 200-day moving averages in the last three months. The last time such a situation existed was in September-October of last year (see the trough on the chart), which sparked a modest year-end rally.

Fundamental Differences



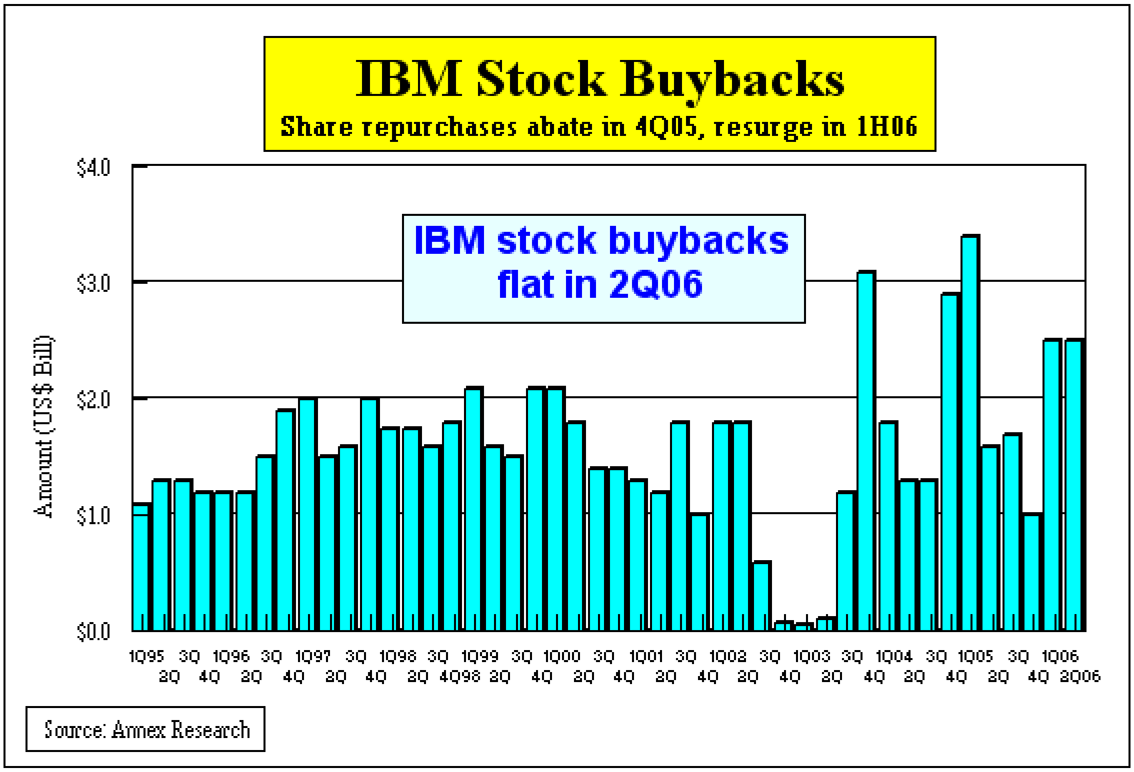
Take IBM's net profit, for example. It is nearly double the combined total of the four competitors' earnings in the last 12 months (see above chart). Yet its price/earnings ratio is two to four times lower.



IBM's advantage in business fundamentals is even greater if one compares profit margins. Big Blue's net margin is nearly five times higher than the four major competitors' average. Its operating margin is nearly four times better.

IBM is also paying a higher dividend yield. Yet its stock is in the doldrums. Why? Because the company has failed to generate enough positive excitement about its *growth* prospects.

Sadly, Big Blue been there before. In the 1990s. Ten years ago, we also noted that the company's shares were grossly undervalued. We recommended a break up that would force Wall Street investors to evaluate each piece of the company separately, generating a greater sum of the parts for the IBM shareholders (see "Break Up IBM," Mar 1996).



Instead, IBM opted for massive stock buybacks. The strategy worked great for several years. But no longer. Even after spending a record $18 billion on share repurchases in the last two years (for a total of over $72 billion since 1995 - see the chart), the company has failed to push its shares upward.

Time for a different tack this time? Now, about that break-up idea...

Happy bargain hunting!

Bob Djurdjevic

P.S. By the way, the reason we picked HP, Fujitsu, EDS and Capgemini as the four major IT leaders to compare IBM to was first, that the first two are conglomerates, like IBM. Second, Fujitsu and EDS are also No. 2 and No. 3 services vendors in the world. And third, Capgemini is the only leading European-based IT services company.

As you have seen from our earlier analyses and recommendations (see "No Bad News Is Good News", July 2006), we think that IBM Global Services (IGS) has become too big for its own good, and that IGS is the unit that IBM needs to break up (operationally) this time around. Which is why we compared IBM to four leading competitive entities in the global services business.

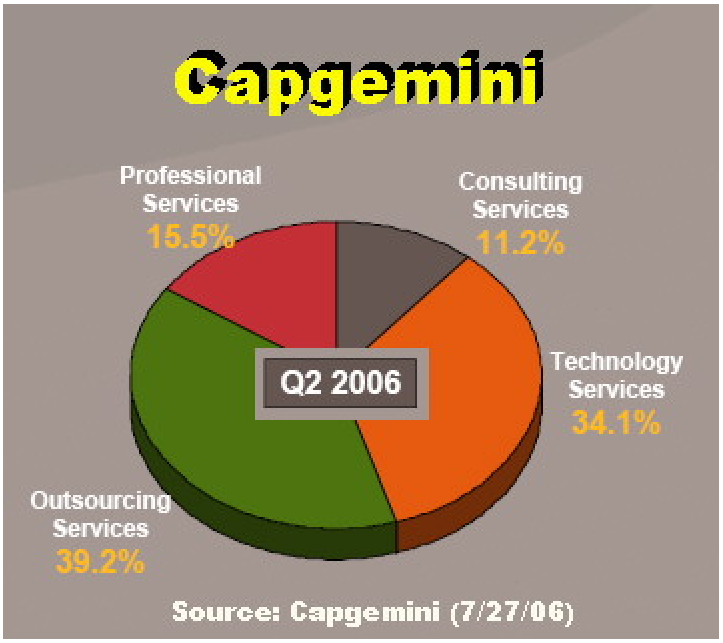
Fujitsu, Capgemini Boost Business Outlook

SCOTTSDALE, July 27 - Fujitsu and Capgemini both boosted their business outlooks for the year as they released their latest quarterly results earlier today. And the stock market investors applauded the news. Fujitsu shares jumped more than 3% while Capgemini's stock soared by over six points.

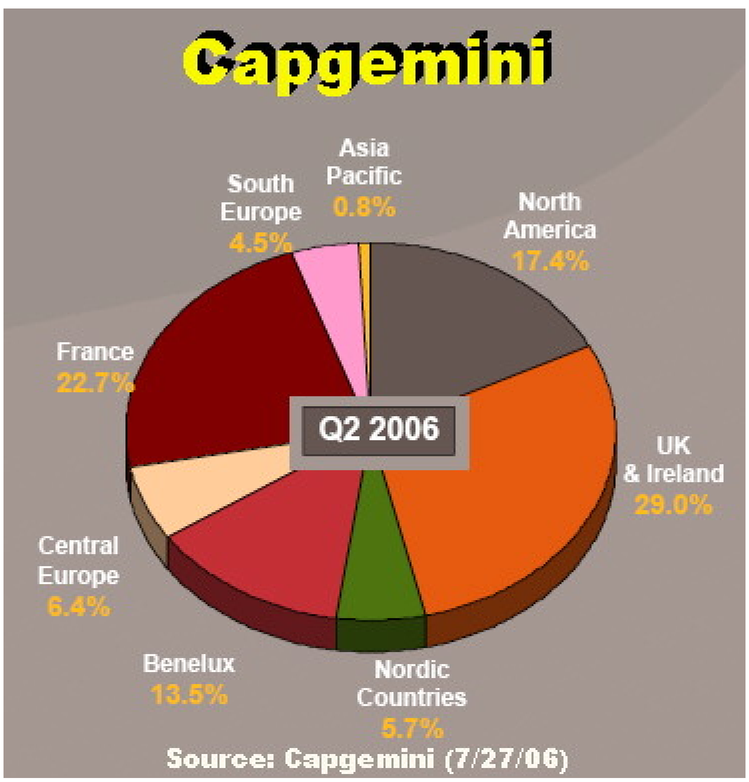
The latter company's shares (Capgemini) have now moved up almost 14 points this week alone (see the charts). Its shares have risen about 20% since the start of 2006, outperforming a 6% gain in France's benchmark CAC 40 index.

Capgemini: Central Europe, North America Lead

Capgemini's second quarter revenues rose about 11% to 1.915 billion euros (about $2.4 billion), exceeding the average sales forecast of 1.877 billion euros by the ten analysts polled by Reuters.



- Lines of business: Technology Services (+10.9%), Local Professional Services (+5.6%), Consulting Services (+4.5%), and Outsourcing Services (+15.3%).



- Geographies: Europe (+12.5%), led by the United Kingdom & Ireland region (+29.4%). In North America, formerly a troubled region, evidence of a complete turnaround continues to mount. Revenues grew by 3.9% (up 6.3% sequentially), led by

Consulting and Technology Services (+12.1%).

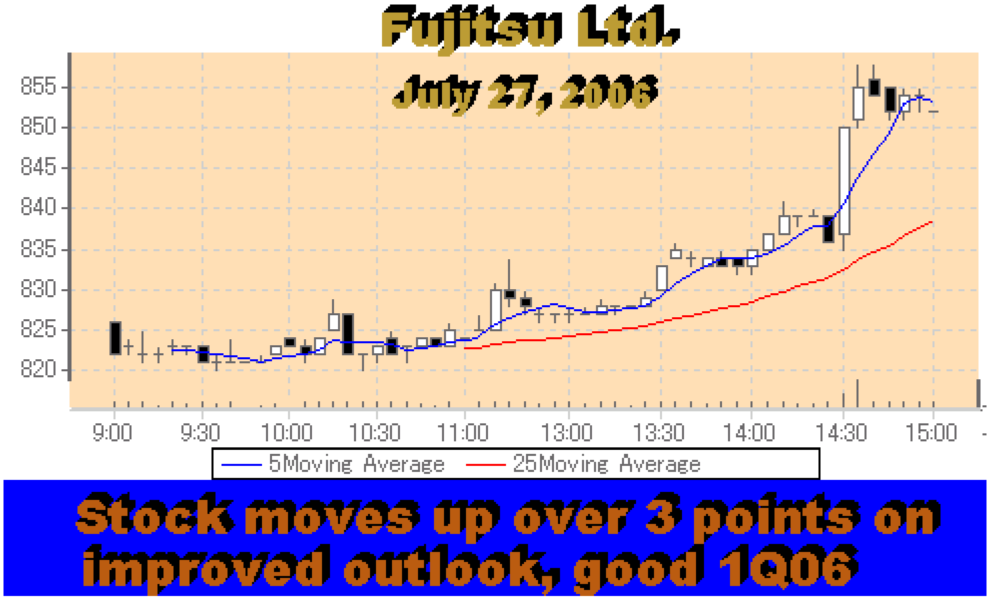
New contract bookings for the second quarter 2006 were €1.7 billion. They were strong for Technology Services, Local Professional Services and Consulting Services, which were up by 23.3% in North America and 10.2% in Europe. But the outsourcing signings declined, making the second quarter bookings slightly below those a year ago.

During the first half of 2006, Capgemini grew its headcount in developing countries (India, China and Poland) to over 6,000, up more than 75% compared to the June 30, 2005 employment.

"Following these results, the group is upwardly revising its revenue growth target which, at constant rates and perimeter (on a like-for-like basis), should approach 10% for the whole of 2006," Capgemini said in a statement.

Fujitsu: Strong Overseas Markets

Meanwhile, over in Tokyo, Fujitsu raised its first-half FY 2007 forecast, pushing its shares up 3.3% to 852 yen, outperforming the Tokyo stock market's electrical machinery index which rose 1.7%.



Fujitsu's stock price jump came despite a 2% drop in quarterly profit in the first quarter of the current fiscal year. Japan's largest computer maker, whose servers are used by the Tokyo Stock Exchange, posted an operating profit of 14.57 billion yen ($125.2 million) in April-June, down from a 14.8 billion yen a year earlier. But the latest result was better than a consensus forecast of a 11 billion yen from four analysts polled by Reuters. Which is in part why the stock moved up.

Fujitsu also raised its operating profit forecast for the fiscal first half to 35 billion yen from 20 billion, but kept its full year forecasts unchanged at 190 billion yen.

First quarter (FY07) revenues grew by 7.5% to of 1,102.8 billion yen (approximately $9,674 million). Overseas sales soared by more than 20%, while business in Japan was flat. All three business segments recorded revenue gains outside of Japan.

The Technology Solutions segment, which includes the System Platforms and Services sub-segments, increased 5.9% over the same period in fiscal 2005, to 649.6 billion yen ($5,698 million). Operating income for the Technology Solutions segment was 5.0 billion yen ($44 million), a decrease of 2.3 billion yen in comparison with the first quarter of fiscal 2006. The company blamed tough price competition for the drop.

The System Platforms sub-segment, however, recorded an operating loss for the quarter of 5.2 billion yen ($46 million). This was offset by operating income of 10.2 billion yen ($90 million) for the Services sub-segment. The U.K. and the U.S. markets reported "particularly favorable results," the company said in a statement.

Fujitsu's outsourcing and other services businesses are performing well, both in Japan and in overseas markets. The demand is also "firm" for logic LSI devices for digital consumer electronics and other applications, the company said. Coupled with strong overseas results, these three business segments were the backbone behind the company's bolstered business outlook for the first half of its current fiscal year.

Click here for PDF (print) version

Market Reaction

SCOTTSDALE, July 19 - IBM's second quarter results helped lift the shares of some of its competitors more than its own stock. A weird market reaction? But true, nonetheless. Take a look at the chart as of mid-afternoon Eastern time...

We said last night that you should " stand by for additional stock price hikes tomorrow, as broader markets digest and act upon this news." And indeed, that's what happened this morning, when the IBM stocked moved up more than three points even before the Fed chief Ben Bernanke ignited the market with his comments at today's Senate hearing. But then, that's all she wrote. From then on, Big Blue shares have been on a slightly declining curve.

The reason? Wall Street research evidently cast a downcast spell over the upbeat Big Blue numbers, helping jade the investors' opinions, too (see the AP story, "IBM Up Despite Bearish Analysts," July 19). Analysts' negative comments halted the Big Blue advance and pushed up the shares of its competitors (like Dell, HP, Accenture, Perot Systems... etc.).

So what's IBM to do? Apply the full court marketing press on Wall Street investors, especially the buy-side of the Street and the hedge funds. Breaking up IGS to foster growth would get their and everybody's else attention (for details, check out our above comments about the IBM services results).

For additional Annex Research reports, check out... Annex Bulletin Index 2006 (including all prior years' indexes)

Or just click on Search and use "company or topic name" keywords.

Volume XXII, Annex Newsflash 2006-29
July 26, 2006

Bob Djurdjevic, Editor

e-mail: annex@djurdjevic.com

8183 E Mountain Spring Rd, Scottsdale, Arizona 85255
Tel/Fax: +1-602-532-7789