

ANNEX BULLETIN

Annex Bulletin 2009-04

January 20, 2009

A partially OPEN edition

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IBM FINANCIAL

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Analysis of IBM's Fourth Quarter Business Results

Two Thumbs Up for Big Blue

On Inaugural Day, When Markets Turned Thumbs-Down on New President Obama, IBM Provides Badly Needed Boost

SCOTTSDALE, Jan 20 – The stock market gave America’s new president a resounding “thumbs down” signal today, with Dow dropping 332 points on Barack Obama’s inaugural day. But what the American president failed to do, Big Blue’s outstanding fourth quarter results are probably going to rectify when the markets reopen tomorrow morning. Just like IBM did back in July, it should pick up the skittish stock market by its bootstraps, and give it a badly needed kick upstairs (see [IBM Delivers Explosive Growth](#), July 2008). So make that two thumbs up for Big Blue.



It didn't take long for investors to get the message. Only a few minutes after IBM released its fourth quarter results, the stock was up 3 points in after-hours trading to \$85 per share, after dropping by almost as much in the regular day's session.

As we suspected when IBM made those two expansion announcements last week (in Iowa and Michigan – see [Big Blue: All Heart](#) (*IBM investing in America's Heartland while others in Corporate America are downsizing there*)), the Big Blue engine was firing on all cylinders in the fourth quarter, as it had been through most of 2008. The company results set all-time new records in revenues, pretax profit, EPS and free cash flow, exceeding Wall Street's and this writer's expectations by a wide margin.



What recession? Not in Armonk, evidently.

Furthermore, IBM buoyed investors by raising the earnings outlook for the full year 2009 to \$9.20 per share, saying its business model would continue to deliver results in bad economy as it did in good times.

How's that possible? By focusing on quality not quantity of business. And this journey didn't start "yesterday." It started a long time ago, when the IBM chairman, Sam Palmisano, told the investors and analysts in a historic-first Bangalore, India, meeting in June 2006, that the company would exit any business that's a commodity business (see [Palmisano on Quality over Quantity](#) left chart).



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Like now, the IBM stock was in its doldrums back then (under \$80 per share). Yet by June of 2008, it had surpassed \$130 per share, before dropping back to the low \$80s in recent days. Which makes the Big Blue shares a buying opportunity again today, as we said they were three years ago.

Look at IBM margins, for example. Even though its fourth quarter revenues were actually down 6% from a year ago, in part due to a negative impact of the foreign currency translations, its pretax profit margins surged by 2.5 points, led by Global Services and Software improvements (up 4.1 and 3.6 points for GTS and GBS units in Services, and up by 4.2 points in Software). IBM gross margins rose even more, up 3.0 points to 47.9% (right chart).

	Q4 08	Q4 07	Q4 08	Q4 07
Global Technology Services	34.9%	4.8 pts	24.1%	4.2 pts
Global Business Services	29.9%	5.6 pts	24.3%	5.8 pts
Systems & Technology	29.9%	(5.8 pts)	35.7%	(5.7 pts)
Software	57.7%	3.6 pts	54.1%	4.2 pts
Global Financing	40.8%	4.9 pts	35.9%	5.9 pts
Total Segments	47.9%	3.0 pts	44.9%	3.0 pts
Total IBM	47.9%	3.0 pts	44.9%	3.0 pts

As a result, the fourth quarter net earnings jumped 17% to \$3.28 per share, exceeding Wall Street's expectations of \$3.03 per share by a wide margin. For the full year 2008, IBM earnings surged 24% to \$8.93 per share, also beating expectations.

And all that is mostly because services, software and financing now account for 90% of the company's profits. So even though its hardware revenues were down 16%, in line with the general malaise in the U.S. industrial sector, the foresighted strategy IBM adopted in the 1990s - to transition from being a product to a services & software company - is now paying dividends in spades.

Add to it the company's excellent cash flow, and you can see why Big Blue is firing on all cylinders at this time.

Business Segment Analysis

Services. IBM services took the pole position among the company's business segments' performance in the fourth quarter. Not only is that part of the company the world's largest IT services operation by far, with annual revenues in excess of \$58 billion, it is also now the most profitable, having surpassed Accenture, industry's perennial leader in that category.



As you saw from the above chart, the Global Technology Services' (GTS, outsourcing) gross margins area now about 35%, up 4.8 points, while the Global Business Services (GBS, consulting) are about 29%, up 5.6 points. That makes IBM's aggregate services gross margins about 33%. By comparison, Accenture's gross margins are around 32%. So we'll be likely sending another "gold" medal up to Armonk when update our annual [Global IT Services Octathlon](#) results.

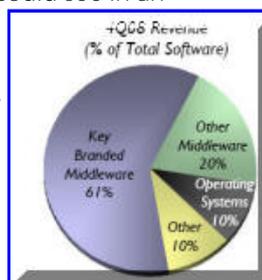


Furthermore, the two IBM services continued to close new business as if these were times of bloom, rather than economic gloom. New bookings surged to \$17.2 billion in the fourth quarter, up 11% over the year earlier total, lifting the backlog by \$3 billion to \$117 billion. That narrowed the gap between the backlog outflows and inflows. But IBM services backlog is still down for the year (meaning that average outflows exceeded the average inflows by \$14.1 billion to \$13.9 billion per quarter - see above charts).

When asked by an analyst during the post-earnings release teleconference if there was an increase in "rescoping" (services contract renegotiations) due to a difficult economic conditions, the IBM CFO, Mark Loughridge, said that the rescoping was "fairly typical."

Well, we don't know what yardsticks the IBM CFO considers "typical," but the outflows from the IBM backlog have definitely increased in the last three years. In 2006, they averaged \$11 billion per quarter, in 2007, \$12 billion, and last year they were \$14 billion. And since "rescoping" is a part of that outflow, the tougher economic environment must have had a derogatory effect on it.

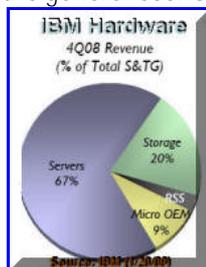
Software. While the backlog erosion was the only blemish we could see in an otherwise spotless IBM services business record, there were no flaws in IBM's most profitable unit - Software. Even in this tough economic situation this IBM unit managed to increase its gross profit to an incredible 87.7%, up 0.7 points from a year ago. Not even the desktop monopolist Microsoft is making that much money (MS' gross margins are around 81%).



IBM software's full year profit has doubled in the last five years, said Loughridge, IBM CFO. This was fueled by double digit growth in IBM Middleware and its five major brands.

And even in this tough environment, IBM managed to grow its software revenues by 3% (up by 9% in constant currency).

Hardware. IBM hardware revenues, on the other hand, were sharply down in the fourth quarter (down 20%; down 16% in constant currency). This was partly because of the general economic conditions, partly because of product line transitions.



Particularly hard hit among the IBM servers were the System i and System x businesses, down 92% and 32% respectively, as well as the company's chip business, which declined by 34%.

On the other hand, the System p revenues were up 8% (up 14% when adjusted for currency). The System z (mainframe) business was also up 1% in constant currency, though it was down 6% as reported.

IBM hardware gross margins also dropped from 45.7% a year ago, to 39.9% in the latest quarter.

Industries. IBM industry sales were all down as reported, though the public and communication sectors did grow by 5% and 3% respectively. That the financial and industrial business was down was certainly something one could have expected, in the current economic environment.

IBM Industries

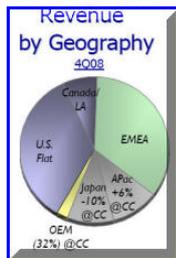


The biggest surprise, however, was that the business segment that the IBM chairman touted in 2007 as being the company's greatest growth opportunity - SMB (see [IBM: Lowering Center of Gravity Partnerworld May 2007](#)), was the largest decliner. Yet IBM SMB revenues were down 9% in the fourth quarter as reported, or 3% in constant currency.

Stand by for a more detailed report on IBM SMB, along with our analysis of the possible reasons why this unit is not meeting our and its CEO's expectations.

Geographies. IBM's focus on emerging markets was the second most important

reason for the company's excellent results despite the deepest recession in the U.S. market since the Great Depression. This became very evident in the fourth quarter results. While revenues in major (developed) countries shrank 5%, the business in the BRIC markets (Brazil, Russia, India and China) grew by 2% (up 13% in constant currency).

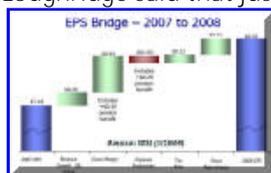


Russia was the only exception there, as IBM's business in that country contracted 22%, due to both the credit crunch and the slump in energy prices. But the revenues in India, Brazil, Egypt and Chile, among some developing countries, soared. And China also bounced back with a 14% revenue surge (up 9% in constant currency), after a third quarter slowdown due to the Beijing Olympics.

Summary & Outlook

Having summed up his presentation by saying that the fourth quarter "wrapped up an exceptional year for us," IBM CFO went on to explain why he was confident IBM would make at least \$9.20 per share this year, the new and higher guidance the company has just issued.

Loughridge said that just as most of the earnings growth in 2008 came from the margin improvement (see the "EPS Bridge" chart - left), he expected the same trend to continue in 2009.



"Given what we are seeing in the economy, we're not counting on constant currency revenue growth to achieve this," he said. "It'll come more from margin improvement, just as it did in 2008."



IBM CFO added that, "with this strong 2008 performance, we are clearly ahead of pace on our roadmap to \$10-\$11 of earnings per share" (right chart).

Annex Clients: [CLICK HERE](#) for detailed IBM 4Q08 P&L tables & charts

Happy bargain hunting!

Bob Djurdjevic

MARKET UPDATE

As Expected, IBM Lifts Dow; Stock Soars by Over Seven Points

SCOTTSDALE, Jan 21 – As expected, IBM picked up the Dow by its bootstraps, and kicked it upstairs. Both the IBM stock and the major stock market index are up sharply "the morning after."



As expected, IBM lifts reluctant Dow, both up sharply "the morning after"

As we write this, IBM was up by over seven points or 9%, trading at about \$89, while the Dow was up over 130 points.

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Volume XXIII, Annex Bulletin 2009-04
January 20, 2009

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