ANNEX BULLETIN

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Analysis of IBM's First Quarter Business Results

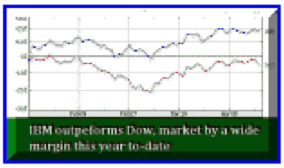
Sometimes Less Is more and Down Is Up

Smaller Is Better: Lower IBM Revenues Yield Higher Profit Margins

Also, Oracle-Sun Deal Could End Up More of a Duel than Marriage; Odd Timing for Oracle's Entry into Hardware Business

HAIKU, Maui, Apr 20 – All IBM revenue lines pointed downward at the end of the first quarter, yet its bottom line earnings were up 4%. It was another example of "down being up," a victory of quality over quantity. Big Blue used the global economic storm through which multinational companies have had to navigate in the last couple of years to cast off some ballast (i.e., shed costs and expenses), improve the profit margins and strengthen its balance sheet.

As a result, IBM is an improved company qualitatively while shrinking quantitatively. And that's a strange concept for the stone-agers on Wall Street who still seem to think that bigger is better. The fact that they sold off the IBM shares in after-hours trading following the first quarter call is proof of it (IBM was down 1.8% after closing at $100.43 in regular trading today).



Meanwhile, IBM has still outperformed the Dow this year to-date by a wide margin. And for a good reason. For, Big Blue has shifted to higher value areas at a time when the markets have been taking values out of commoditized businesses, especially hardware. Where IBM still has remnants of it, such as with the Intel-based System X servers, revenue decline has been especially precipitous (down 27% as reported; down 22% in constant currency).

Foreign currency translations (read a rising dollar) accounted for about eight points of IBM's 11% revenue drop since a year ago. One should keep in mind that the first quarter of 2008 was a

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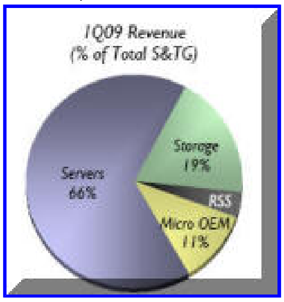
Business Segment Analysis

Hardware. In fact, IBM's overall hardware revenues were down in double digits (-23% overall; down 12% in constant currency). OEM and Retail Store businesses led the declines with 36% and 38% drops respectively. Mainframe business was also down, but mostly because of deep discounting. MIPS shipments were up 18%, suggesting there is still strong demand for the System z servers. IBM CFO, Mark Loughridge, said that was particularly true in emerging markets, where the mainframe is also experiencing strong revenue growth.



But the best performing IBM hardware line has been the System p (Unix) servers. Its revenue actually went up 5% in constant currency, though it was also down 2% as reported. The System p gained four points of market share against HP and Sun, according to IBM.

Oracle-Sun Deal. Which makes the timing of Oracle's entry into the hardware business at this stage [via its planned Sun acquisition] rather peculiar. It's one thing to be sliding deeper into an abyss because you're on a slippery slope anyway (like Sun). It's an entirely different kettle of fish when you do it deliberately. Maybe "Daredevil Larry" [Ellison; Oracle's CEO] has some secret potion that can reverse the force of gravity? The rest of us, who are not as fortunate, might prefer to navigate away from slippery slopes.

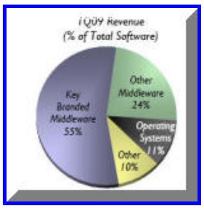
Of course, hardware companies have been among Oracle's biggest customers and partners. But it is one thing to know how to sail a boat, and quite another to be skilled at making it. At least in the Unix business, now Oracle will have to learn a new skill - crafting and selling of hardware. Which is very different from developing software. So its success in that part of the market is far from assured.

As a result, the Oracle-Sun deal will make an interesting spectator sport over the next several months. The upcoming merger may go down in history as a "clash of the titans." Or of "titanic egos." Or just "Larry vs. Scott: A Silicon Valley Duel."

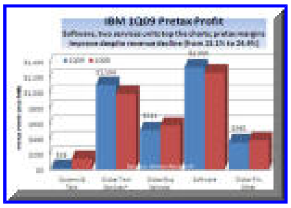
The only way this writer sees a merger like this one going smoothly would be if the two leaders holster their egos. Alas, neither has been known to do that in the past. So we'll see if the Sun will finally set at its Oracle this summer, or spotlight another gunfight at the old OK Coral in Silicon Valley.

And after the Sun sets and the dust settles, the new competitor will still have to face IBM and HP, the two largest and the most successful IT companies. And that can be a daunting challenge even for entrepreneurs with Larry's and Scott's bravado.

Software. Software was another bright spot in IBM's lineup. Its revenues grew by 2% in constant currency, although they were down 6% as reported. But the best part about Big Blue's software business is its large profit contribution. Even though IBM Software accounts for only 20% of Big Blue's revenues, it represents 40% of its profit.



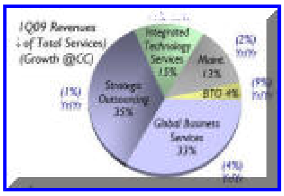
And its share of IBM earnings is growing. Software profit margins improved both at gross and pretax levels. The latter was up nearly three points to 25.9%.



Even software revenues were up in constant currency for most of its products. Websphere showed the fastest growth (up 14%); while Lotus was the only decliner (down 3%). Key branded middleware products as a group were up 5% in constant currency (down 4% as reported).

As a result, nearly all of IBM's first quarter pretax profit came from software, services and financing. Hardware was just a smidge above break-even point (see above left chart).

Services. IBM Global Services (IGS) now accounts for more than 60% of IBM's business. So it would be fair to say, "as goes IGS, so goes IBM." Well, IGS revenues decreased 10% (down 2% in constant currency). Global Technology Services (GTS), the outsourcing and infrastructure services provider, shrank to $8.8 billion in revenues. Global Business Services (GBS) declined to $4.4 billion.

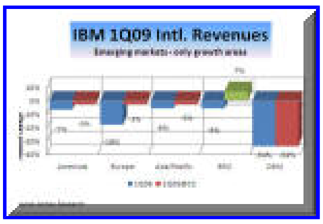


IBM signed new services contracts totaling $12.5 billion in the first quarter, a drop of 1%. IBM said 16 contracts greater than $100 million were included in this total. But backlog was down by more than $4 billion to $126 billion, compared with $130 billion at year-end 2008. And that spells trouble.

For, when the outflow of business from the backlog exceeds the inflow of new deals, what follows is a drop in revenues. So the revenue declines IGS is now experiencing are a consequence of a negative trend that started in 2008, and has evidently now extended into 2009 (see above charts).

The only remedy to this problem is for IGS to sell more and lose less. And that's easier said than done, especially in current economic conditions.

Geographies & Industries. Thanks to IBM's multi-year focus on emerging markets, revenues from overseas countries continue to grow about eight points higher than the rest. Major markets were down 4% in constant currency, while emerging countries were up 4%. India grew 12%, for example, while China was up 11%.



As a result, the BRIC countries (Brazil, Russia, India, China) and the emerging markets in general were the only bright spots on the above chart of Big Blue's international revenues.

IBM's industry results weren't a pretty picture, either. All six segments reported declining revenues. Government sector was the best, dropping only by 3% since a year ago. Interestingly, financial services, a part of the global economy that has been dragging everybody else down, declined "only" by 10% in IBM's case, less than the industrial segment (-20%), or distribution (-14%) or SMB (-12%).

To us, the latter (SMB) sector was the biggest disappointment among the six. Less than two years ago, IBM touted it as its best global growth opportunity (see IBM: Lowering Center of Gravity, May 2007). And here it is now shrinking in double digits.

Summary & Outlook

IBM CFO reaffirmed the company's 2009 guidance during the teleconference with analysts. He also said that IBM is "well ahead of pace on our roadmap to 2010" ($11 per share net earnings - see BRIC by BRIC... to Top Line Growth, May 2007).

One reason for it is that IBM's has been cutting costs at the same time as focusing on higher margin industry segments. It was a part of a strategy that the IBM CEO Sam Palmisano launched at an investor conference in Bangalore, India in June 2006. Here is our summary of it...

> **Palmisano on Quality over Quantity**
> (answering a question on commoditization at the IBM conference in Bangalore on June 7, 2006)
>
> "We'll get out of any business that doesn't make financial sense. We're not wedded to anything. We don't measure ourselves by trying to be the biggest… we'd like to be the best earnings and cash generation entity in our industry… not necessarily *the biggest* – (but) with spaces of no income. We will exit any business that is a commodity business. We will not rationalize cases for synergy." (such as the PCs and developing markets).

Ever since, IBM has been focusing on quality rather than quantity of business. That is why such high margin units as software and services are thriving, while its competitors' hardware or commodity-based businesses are suffering.

Such a strategy had paid dividends for IBM shareholders in good times, as the record stock price of last summer showed. The same strategy is now helping protect the company from the economic storms that are raging around it. And that is why Big Blue has once again become a market leader, notwithstanding HP's bigger size, or Oracle's and Sun's saber-rattling, or Microsoft's overtures to Yahoo or other web-based competitors.

In short, sometimes less is more, and down is up. IBM's first quarter results are a case in point.

Happy bargain hunting!

Bob Djurdjevic

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