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INDUSTRY TRENDS

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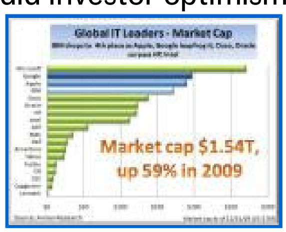
Analysis of Top Global IT Companies' Market & Business Performances

Rally of Hope over Fact Continues...

Top IT Companies' Market Cap Surges by 59% Even As Their Earnings Drop 17%, Revenues Shrink 6.5%, But P/E Ratios Up 143%!

Microsoft Still Market Cap King; Google, Apple Leapfrog over IBM; Big Blue Stock Still Undervalued, Now Aiming at $154 as Target Price?

HAIKU, Maui, Jan 3 – A stock market rally of hope over fact continued in the fourth quarter. The surge began late in the first quarter. It rolled through the second, gained momentum in the third trimester, and then peaked in the fourth period of 2009 . Just as a high tide lifts all boats, even the leaky ones, so did investor optimism boost the market cap of the top 18 global IT companies



we follow. Their aggregate valuations soared by 59% to $1.54 trillion in 2009, even though their their earnings tumbled 17%, and their revenues were down 6.5%.

As we noted three months ago (also see A Rally of Hope over Fact, Oct 2009), this has been a rally of hope over fact; of wishful thinking over actual profits; of rosy expectations over grim reality. It has been a rally of Price/earnings (P/E) ratios. They are the only market indicator that has grown solidly across the board for most of the top IT leaders.

The trailing 12-month P/E ratios are up 143% since a year ago! Even the forward 12-month P/E ratios are up 6%, suggesting Wall Street has been upping its forecasts even as earnings declined for most IT leaders.

But not all. Apple and IBM, for example, saw their earnings increase 27% and 15% respectively in the last 12 months. But

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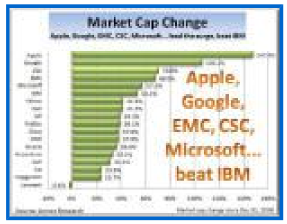
Revenues, Earnings Drop

while Apple's stock surged by 147%, Big Blue's rose by "only" 53% during the same time frame. Furthermore, the shares of EMC and Microsoft also outperformed IBM's, even though the earnings of these two companies declined 34% and 51% in 2009, while their revenues dropped 13% and 10% respectively.



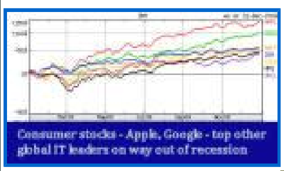
Among smaller IT competitors, CSC and CA saw their earnings rise in 2009 by 32% and 15% respectively. But while CSC's stock mirrored its strong business performance, rising by 71% - the third best performance in the industry, after Apple and Google - CA's shares rose by "only 24% last year.

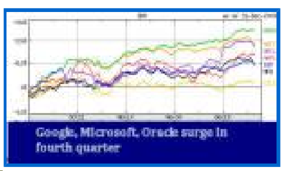
As a group, the Top 18 IT leaders have gained $555 billion in market value in 2009 even if their earnings slipped 17% since the start of the year.

MARKET Rankings of Annex Top IT Companies: *IBM at $154?*

Why Not, If Apple Is at $210; Google at $620?

Google, Microsoft, Oracle and Apple, in that order, have been the strongest stock market performers in the fourth quarter. For the year, however, Apple topped all major IT leaders, followed by Google, Microsoft, and IBM (see the charts below).





We've already recognized Apple's solid business performance in 2009 and an even stronger market surge. So at a first blush, its market valuation appears well deserved. But when one considers that it also implies the 34 trailing 12 months and 22 forward P/E ratios, one has to wonder if more of even Apple's market cap comes from rosy expectations than business fundamentals.

Nevertheless, it is what it is. Market makes its own rules about companies it trades, even if they "don't make sense," such as rewarding companies with declining earnings (Microsoft, Google) with high valuations. One can only question the market's reasoning at one's financial peril. But we thought we'd be brave and try to use some logic, while being mindful all the while of Thomas Gray's warning: "Where ignorance is bliss, 'tis folly to be wise."

And what we have concluded is that, if you take the current market's logic and apply it to IBM, for example, you would have to realize that Big Blue's share should be trading between $154 and $266. IBM has just closed out the year at $130.87, up from $117 three months ago, when we said the stock should be worth at least $137 (see A Rally of Hope

- Analysis of Accenture's 3QFY09 business results

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Squeezing the Consumer Dry *(Greed fueled both bankers & oilmen's try to squeeze blood out of stone - consumer)*

The Year of Living Dangerously - Analysis of global investment trends over Fact, Oct 2009).

Of course, one could say that the reason IBM is so grossly undervalued is that its competitors' shares are so grossly overvalued. It's the only glass half full or half empty story. Nevertheless, if logic had any place on Wall Street, that's what we would have to conclude... that IBM at $154 or higher would be a fair valuation for the Big Blue stock relative to its peers. Check out the following table...

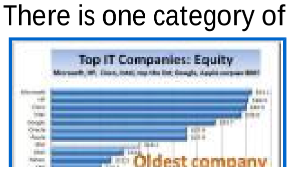
IBM vs. Peers	**Market Cap**	**Trail P/E**	**Fwd P/E**	
Microsoft	$270.64	19.81	14.58	
Google	$196.70	40.00	23.47	
Apple	$189.80	33.51	22.37	
IBM	$171.95	13.44	12.01	
Cisco	$137.72	24.40	14.78	
Oracle	$122.90	21.37	14.26	
HP	$121.78	16.39	10.80	
Intel	$112.65	49.51	13.69	
Avg Top 8 IT	**$148.83**	**27.30**	**15.75**	
				EPS 2009
IBM	$171.95	13.44	12.01	$9.76
IBM @ Top8 P/E		**$266.48**	**$153.67**	
IBM Current		**$130.87**		

If you take the Top 8 IT companies' market cap and corresponding P/E ratios, you get an average 27.3 trailing and 15.75 forward average P/E ratios. IBM current ratios are 13.44 and 12.01 respectively. Our estimate for the 2009 earnings is $9.76 per share (vs. $9.89 per share Wall Street average).

The rest is simple math. You apply the average peer P/E ratios to IBM earnings per share, and voila... $154 or higher.

Of course, this implies logical market behavior. Which is a tall order. And we have to be mindful of Mr. Gray's warning. But the stock has already moved up from $117 to close to $137, our previous target price. So you never know. Maybe as investors realize that they may have overvalued the shares of some of IBM's peers, additional investment capitals may flow into the Big Blue bucket.

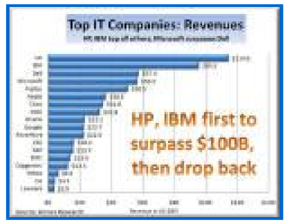
There is one category of market ranking, however, in which IBM is already No. 1. It is the market cap/equity ratio (right). After a decade



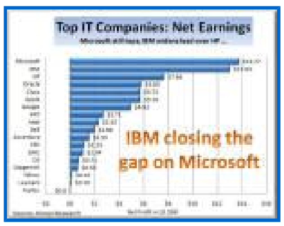
and a half of big stock buybacks, IBM has depleted its own equity so much that the 98-year old company now ranks only No. 8 in this category (left). Even the relative IT industry upstarts, like Google or Apple, have now surpassed Big Blue's equity. By contrast, Accenture, which is also a relative upstart, having gone public in 2001, is dead last on this chart.

BUSINESS Rankings of Annex Top IT Companies

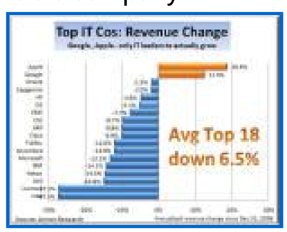
As for the Top 18 business charts, the pecking order at the top of the IT industry is still pretty much the same, except that most companies have shrunk since the last time we did this type of an update (see "Apple, Google Lead Comeback", July 2009). HP and IBM were the first IT companies to surpass the century revenue mark. And then drop back from there... (right chart).



Dell and Microsoft are now neck-and-neck in No. 3 and No. 4 positions in the industry, well back of HP and IBM. Fujitsu is No. 5, Apple No. 6. And so on...



As for net earnings, IBM is closing the gap on Microsoft ($13 billion vs. $13.8 billion - left chart). If the current trends continue, and Microsoft earnings continue to shrink while IBM's expand, Big Blue may once again regain the most coveted No. 1 position in the industry, as IT's most profitable company.



HP is a distant third with $7.7. net profit, down 12% from the year before. Oracle, Cisco, Apple and Google follow, in that order.

As for the revenue change in the last 12 months, Apple and Google were the only companies among the Top 18 to actually grow.

So much for the theory that the current recession affected the consumer markets the most. Evidently that is NOT necessarily the case. Not when companies have something to offer that consumers want and need.

Click here for detailed tables and charts (Annex clients only)

Happy bargain hunting!

Bob Djurdjevic

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Bob Djurdjevic, Editor
e-mail: annex@djurdjevic.com
Tel/Fax: +1-602-532-7789

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