ANNEX BULLETIN

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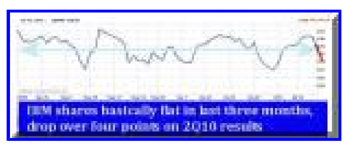
Analysis of IBM's Second Quarter Business Results

A Mixed Bag of Goodies

Investors Focus on the Bad, Ignore the Good, Stock Drops as Result

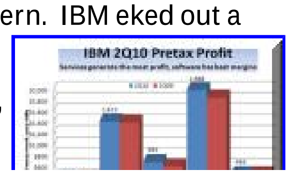
HAIKU, Maui, July 20 – When IBM released its second quarter results after the markets closed last night, Wall Street ignored the good and focused on the bad, sending the Big Blue shares down over four points in after-hours trading. The second quarter brought a mixed bag of goodies in which IBM exceeded the earnings expectations, but came up short on revenues and new services contract signings.



Why would investors choose the bad over the good? Because they can. Because as hard as IBM brass try to appeal to Wall Street with logic and reason, quarter after quarter, year after year, they end up hitting their heads against the wall of emotion. On Wall Street, emotion is king. And marketing to investors is an art, not an MBA class. One has to appeal to their right brain senses, not to the left brain rationality.

After an exuberant reception which greeted Intel's results on Wall Street on Friday, it was time for cooler heads to prevail. The Street looked for an excuse to cool off, to calm its ebullience. IBM and Texas Instruments, which also reported last night, were convenient scapegoats. Or was Big Blue a scapegoat?

The Wall Street reaction was not completely irrational. Investors had some valid causes for concern. IBM eked out a meager 2% revenue growth (left chart), while increasing net earnings 9% (right), partly due to aggressive share buybacks



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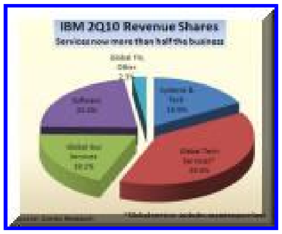
(which accounted for about two points). The slow revenue growth in this quarter suggests that a recovery may be stalling. Lest we forget, IBM revenues were DOWN 13% a year ago. Which means that they are now still below the 2008 business volumes. In fact, they are a tad lower than even the second quarter 2007 numbers.

So renewed concerns about the rate of business spending on IT raises legitimate questions.

Services New Contract Signings, Backlog Down

Just as importantly for IBM, which now generates more than 56% of its business from



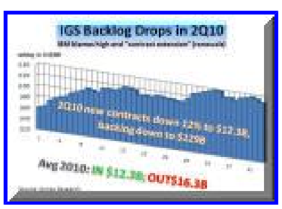
services (left chart), new contract signings in that business segment were down 12% from the year ago quarter. The outsourcing signings were down 19%.

Furthermore, the IBM services backlog also declined by $3 billion since a year ago (although IBM now claims it is down by only $2 billion in the press release, while the IBM CFO told the analysts last evening that the "backlog remains steady at $129 billion, up $1 billion adjusted for currency").

Best not to go there, either. For, currencies are like the wind. Sometimes they are at your back, at other times in your face. So unless business executives want the market to start discounting their results whenever they get a tailwind from foreign currency translations, it's better not to use them as an excuse when they diminish the results, as was the case with IBM in this quarter.

The $129 billion backlog as of June 30 was also down by a whopping $5 billion since March 31, when IBM said in a first quarter release that it stood at $134 billion. The company said at the time in a release that the backlog was up $8 billion from $126 billion in 1Q09 at *actual* exchange rates (it was up only $1 billion adjusting for currency... see what we mean with "best not to go there?").

Why does backlog matter?



Because backlog is a sum total of all pluses and minuses in a services business. As such, it is a gauge of future revenues and earnings. New contracts and renewals are the pluses. Expiration, cancelations and "rescoping" (downward contract renegotiations) are the minuses. In IBM's case, the minuses outweighed the pluses by $4 billion in the the first half of 2010 ($16.3 billion vs. $12.3 billion - left chart). Which raises a legitimate concern that no analyst focused on during the Q&A session. Instead, they dwelled only on the less important new contract signings shortfall.

IBM's third quarter business results)

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IBM's Holistic Approach

The IBM CFO tried to explain the disappointing signings by saying that not all new contract signings are equal; that this quarter's total would produce more short-term revenue that a bigger number a year ago.

"We will actually get more revenue over the next 12 months from this quarter's outsourcing signings of $6.5 billion than we did from last year's second quarter signings of $8 billion," IBM CFO Mark Loughridge told the analysts during the teleconference.

Maybe so. But such finer points were lost on an already downcast audience. It was like trying to justify a baseball team's meager current results with promises of a better season next year. Best not to go there, either. It brings back unwelcome memories of the John Joyce and Lou Gerstner era at IBM (see "Slam Dunk of Bunk", Jan 2000). It's best to let the chips fall where they may.

Wall Street has a way of overreacting and then overcorrecting the overreaction. Ultimately, investors tend to end up where they were supposed to be if they used logic and reason in the first place. Which is probably why some of them had second thoughts today, when the IBM shares dropped precipitously at first, and then started to rise. They ended down only $3.24 at $126.55.

Some Bright Spots

Meanwhile, a sharp selloff of Big Blue shares did create a buying opportunity. For, there is indeed much to cheer about in IBM's second quarter results.

Bottom Lines. Let's start with the bottom lines...

- Net income of $3.4 billion, up 9%
- Pretax income of $4.6 billion, up 7%
- Pretax margin of 19.3%, up 1 point

The foregoing results conclude 30 consecutive quarters of EPS growth, 12 of last 14 at double digits. We don't know of any other major company that can boast that kind of bottom line stability. "**Steady As She Goes**" - we also noted in our five-year forecast for IBM in 2009.

Software. Investors could also get a lift if they looked at the IBM software. They would see not only a faster rate of growth (up 6% from last year on an apples-to-apples basis), but also an amazing 87.1% gross profit and a 33.3% pretax margin. Again, we are not aware of many businesses Wall Street trades that can generate that kind of gross profit. Microsoft, the software juggernaut and a monopolist in the PC market, for example, had a pretax margins of 34% in its last full fiscal year. And Big Blue is far from being a monopolist in its software business.

- Treating businesses like living organisms - secret of success

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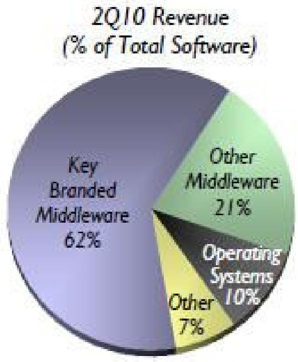
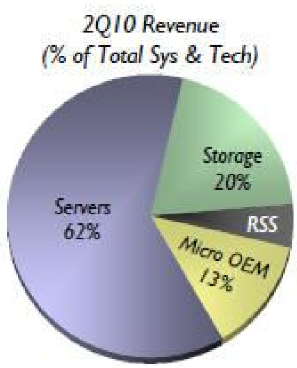


Revenues from the WebSphere, for example, which delivers capabilities that enable clients to integrate and manage business processes across an enterprise, increased 17% year over year. Tivoli software, which helps clients manage technology and business assets by providing visibility, control and automation across the organization, increased 18%, while revenues from Information Management software rose 7%. Even the operating systems business increased 3%. A year ago, operating systems revenues were down 11%.

Hardware. If investors wanted to find for a real IBM turnaround story, they should look at Big Blue's hardware sector. A year ago, Systems and Technology Group's revenues were down 26%, with all of its product lines declining in double digits. Mainframes were down 39%, for example, while Retail Store Solutions led the precipitous drops with a 41% decline.



What a difference a year can make. In the latest quarter, IBM's hardware revenues were up 3% (4%, adjusting for currency). S ystems revenues increased 1% (2%, adjusting for currency), while Storage business rose 5%, and revenues from Retail Store Solutions and Microelectronics OEM surged by 31% and 23% respectively.

Furthermore, revenues from the System x (x86-Wintel servers) increased 30%. A year ago, they were down 22%. That's a 52% swing in performance.

Revenues from System z declined 24% from a year ago, but that is the last double-digit decline the market is likely to see in IBM's mainframe business for a while. Later on this week, Big Blue is expected to unveil its "latest and greatest" mainframe solution whose capabilities will reach far beyond the scope of traditional mainframe applications. Think of it as sort of a new "IT Czar." It will run and control practically everything that an enterprise-class customer considers information technology. And it will do that for a fraction of the cost of traditional computing.

So we should consider the second quarter System z results as the last lull before the spurt which will occur on the fourth quarter, the first full three-month period of the new IBM "system of systems" shipments. No surprise there (see **Big Blue Poised for Growth Again**, Jan 2010).

"I expect this (STG) growth rate to improve in the third and the fourth quarters, and to deliver double-digit pre-tax income growth for the second half of the year," IBM's

Loughridge told the analysts.

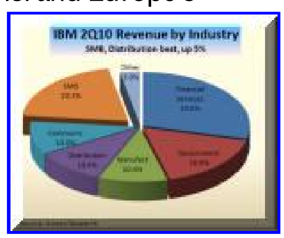
Growth Markets. Another IBM success story in the second quarter was what the company now calls "growth markets" (we used to refer to this global sector as "emerging markets"). Check out these highlights...

- Growth markets revenue was up 14%;
- Frst-half revenue as large as total Euro zone revenue (i.e., the "Old Europe")
- BRIC countries revenue up 22%;

BRIC, of course, stands for Brazil, Russia, India and China - the world's largest "emerging" economies. And double-digit growth occurred in each of the four countries. But IBM's strong performance extended beyond the BRIC countries.

"In fact we had double-digit growth in over 35 countries this quarter, up from 30 in the first quarter," said Loughridge, the IBM CFO, during the teleconference with analysts.

So the growth momentum is clearly there, though not visible as much in the places where Wall Street usually looks first - in the U.S. and Europe's majors. In fact, IBM's growth markets outpaced the majors by nine points in this quarter.



The pick up in the growth of IBM's SMB business (small and medium size businesses which IBM now calls "General Business) is also a reflection of the increased importance of the company's overseas operations in smaller markets (right chart).

Summary

IBM delivered a mix bag of goodies in the second quarter. Declines in services backlog and new contract signings are a worry. High profitability and good growth of software and a big turnaround in Big Blue's hardware business are major pluses. Double-digit growth in emerging markets, a steady new growth engine for IBM for several years now, continued to boost the overall corporate performance.

So on balance, it looks like there is more upside than downside for IBM as we look ahead to the second half of this year. Maybe that's why the company also raised its outlook yesterday for the full year EPS (earnings per share) to \$11.25. If Big Blue were to achieve it, it would reach the first step of the steep trail to \$20 (operating) EPS goal in 2015.

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

Happy bargain hunting!

Bob Djurdjevic

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- Full-year 2010 EPS expectations raised to at least $11.25;
- Revenue of $23.7 billion, up 2%, as reported and adjusting for currency;

ARMONK, N.Y., July 19, 2010 . . . IBM (NYSE: IBM) today announced second-quarter 2010 diluted earnings of $2.61 per share compared with diluted earnings of $2.32 per share in the second quarter of 2009, an increase of 13%.

Second-quarter net income was $3.4 billion compared with $3.1 billion in the second quarter of 2009, an increase of 9%. Total revenues for the second quarter of 2010 of $23.7 billion increased 2% (2%, adjusting for currency) from the second quarter of 2009. The impact of changes in currency rates since IBM’s first-quarter earnings report in April reduced revenue by approximately $500 million in the second quarter.

The estimated services backlog at March 31 was $134 billion at actual rates compared with $126 billion in the first-quarter 2009.

"In the second quarter we again delivered double-digit earnings-per-share growth, increased margins, as well as improving constant-currency revenue performance in our ongoing software, services and hardware businesses, and in all geographies," said Samuel J. Palmisano, IBM chairman, president and chief executive officer.

"With the benefit of our strategic growth investments, our mix of higher-value business and the introduction of new System z and Power Systems, we are confident of our ability in the second half of the year to continue our strong business performance, grow profit and drive shareholder returns. As a result, we expect full-year 2010 diluted earnings per share of at least $11.25."

From a geographic perspective, the Americas’ second-quarter revenues were $10.2 billion, an increase of 3% (2%, adjusting for currency) from the 2009 period. Revenues from Europe/Middle East/Africa were $7.4 billion, down 6% (1%, adjusting for currency). Asia-Pacific revenues increased 9% (3%, adjusting for currency) to $5.4 billion. OEM revenues were $677 million, up 26% compared with the 2009 second quarter. Revenues from the company’s growth markets organization increased 14% (9%, adjusting for currency) and represented 20% of IBM’s total geographic revenue in the quarter. In the first half, revenue for the growth markets organization was as large as the total revenue of the Euro zone countries for the first time.

Total Global Services revenues increased 2% (1%, adjusting for currency). Global Technology Services segment revenues increased 1% (flat, adjusting for currency) to $9.2 billion. Global Business Services segment revenues were up 3% (3%, adjusting for currency) at $4.5 billion.

IBM signed services contracts totaling $12.3 billion, at actual rates, a decrease of 12% (12%, adjusting for currency). In the quarter, 15 services contracts greater than $100 million were signed compared with 13 contracts last quarter.

Total Outsourcing services (GTS Outsourcing and Application Management Outsourcing) signings decreased 19% (19%, adjusting for currency) to $6.5 billion. Signings of larger new-business outsourcing services contracts, which result in more immediate revenue than contract extensions, had strong growth.

Signings in Transactional services (Consulting, Integrated Technology Services and Application Management Systems Integration) were $5.8 billion, a decrease of 3% (3%, adjusting for currency).

The estimated services backlog at June 30 was $129 billion at actual rates, down $2 billion year over year (up $1 billion, adjusting for currency).

Revenues from the Software segment were $5.3 billion, an increase of 2% (2%, adjusting for currency), or 6% excluding the first-quarter divestiture of the Product Lifecycle Management operations (PLM), compared with the second quarter of 2009. Revenues from IBM's key middleware products, which include WebSphere, Information Management, Tivoli, Lotus and Rational products, were $3.3 billion, an increase of 9% (10%, adjusting for currency) versus the second quarter of 2009. Operating systems revenues of $544 million increased 3% (2%, adjusting for currency) compared with the prior-year quarter.

Revenues from the WebSphere family of software products, which delivers capabilities that enable clients to integrate and manage business processes across the organization, increased 17% year over year. Revenues from Information Management software, which enables clients to integrate, manage and use information to gain business value, increased 7%. Revenues from Tivoli software, which helps clients manage technology and business assets by providing visibility, control and automation across the organization, increased 18%, and revenues from Lotus software, which connects people and processes for more effective communication and increased productivity through collaboration, messaging and social networking software, decreased 6%. Revenues from Rational software, which supports software development for both IT and embedded system solutions, increased 1%.

Revenues from the company's Business Analytics operations within Global Business Services and Software increased 14%.

Global Financing segment revenues decreased 4% (5%, adjusting for currency) in the second quarter to $544 million.

The company's total gross profit margin was 45.6% in the 2010 second quarter compared with 45.5% in the 2009 second-quarter period, led by improving margins in Software and Global Business Services.

Total expense and other income decreased 1% to $6.2 billion compared with the prior-year period. SG&A expense of $5.1 billion decreased 1% year over year compared with prior-year expense. RD&E expense of $1.5 billion increased 3% compared with the year-ago period. Intellectual property and custom development income decreased to $297 million compared with $302 million a year ago. Other (income) and expense was income of $95 million compared with prior-year income of $28 million. Interest expense decreased to $90 million compared with $101 million in the prior year.

IBM's tax rate in the second-quarter 2010 was 26.0% compared with 27.2% in the second quarter of 2009.

The weighted-average number of diluted common shares outstanding in the second-quarter 2010 was 1.30 billion compared with 1.34 billion shares in the same period of 2009. As of June 30, 2010, there were 1.26 billion basic common shares outstanding.

Debt, including Global Financing, totaled $26.7 billion, compared with $26.1 billion at year-end 2009. From a management segment view, Global Financing debt totaled $21.2 billion versus $22.4 billion at year-end 2009, resulting in a debt-to-equity ratio of 7.1 to 1. Non-global financing debt totaled $5.5 billion, an increase of $1.7 billion since year-end 2009, resulting in a debt-to-capitalization ratio of 23.1% from 16.0%.

Mike Daniels has been named Senior Vice President and Group Executive, Services. Reporting to Mike will be Frank Kern, Senior Vice President, Global Business Services.

Mark Loughridge has been named Senior Vice President, Finance and Enterprise Transformation. Reporting to Mark will be Linda Sanford, Senior Vice President, Enterprise Transformation, and Bob Zapfel, Senior Vice President, IBM Global Financing.

Steve Mills has been named Senior Vice President and Group Executive, Systems and Software. Reporting to Steve will be Rod Adkins, Senior Vice President, Systems and Technology Group.

Ginni Rometty has been named Senior Vice President and Group Executive, Sales, Marketing and Strategy. Reporting to Ginni will be Erich Clementi, Vice President, Strategy and General Manager, Enterprise Initiatives, and Jon Iwata, Senior Vice President, Marketing and Communications.

All other executives who currently report to Daniels, Loughridge, Mills and Rometty will continue to do so.

Commenting on these changes, Samuel J. Palmisano, IBM Chairman, President and Chief Executive Officer, said: "Over the past several years we have seen great value in working collaboratively, starting with the example set by the senior management team. Today's changes have that in common — they will further strengthen teaming in support of our strategies and initiatives.

"For example, we know that IT infrastructure performance is greatly enhanced when every element — from microprocessors and storage through operating systems and middleware — is designed and brought to market as tightly integrated, optimized systems. There are logical synergies across our services units, including the increasing value of leveraging our intellectual property in business process management and transformation projects for our clients. In this way we can help them achieve quantifiable value sooner. And we know that in order to achieve the productivity goals of our 2015 EPS Roadmap we need to drive both efficiency and process transformation throughout the company.

"Today's announcement is not about organization. Rather, it is about how we work together — making our culture even more collaborative, in support of our integrated business model and grounded in client value as we strive to build a Smarter Planet."

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

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