

ANNEX BULLETIN

Annex Bulletin 2010-15

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A partially *OPEN* edition

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IBM FINANCIAL

Updated 10/19/10, 10:30PM HIT

Analysis of IBM's Third Quarter Business Results

Business Up, Stock Down

IBM Delivers Strong Results, Yet Stock Punished for Bogus Reasons

LONDON, England, Oct 19 – As expected, IBM delivered strong third quarter business results. Yet, its stock was punished mostly for bogus reasons. No surprise there. Sometimes, even Wall Street's irrationality is predictable. This was one of those times...

Last week, one of our clients asked me what I figured would happen when IBM announces its third quarter earnings. I said I expected IBM to report strong results. It did. In fact, Big Blue's third quarter release exceeded Wall Street's expectations. And it was the 31st consecutive quarter of EPS increases. Not many companies can claim that kind of a record. In fact, none among the Dow Jones 30 Industrials.

So "steady as she goes," the title of a past report on IBM which included a five-year forecast, would be an appropriate headline again ([see Steady As She Goes](#), Apr 2010).



But I also told this client that I expected the Big Blue shares to decline after the third quarter announcement. Why? Not only because "buy on rumor, sell on facts"-rule would apply here again. Which it does. The IBM stock had appreciated already since the end of the third quarter in anticipation of strong results. And so did

Apple's share, another company which is being punished today for self-inflated Wall Street expectations (see left chart).

But also because the IT industry stock market rally seems to be running out of steam ([see Mover over Microsoft, Apple Takes the Pole](#) - analysis of top IT companies' market

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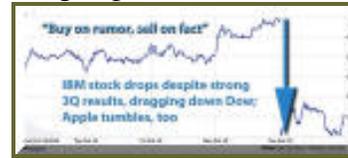
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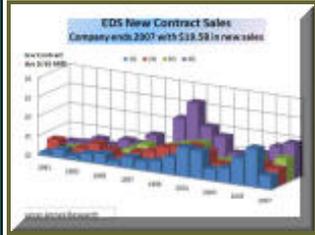
[Steady, As She Goes](#) - Update to 5-yr forecast for IBM

[HP, Capgemini Send](#)

and business performances). And when that happens, facts don't matter. Strong performances are ignored. In a world ruled by emotions, Wall Street grasps for crumbs of bad news and blows them up into mountains with menacing avalanches (see right chart).



That's what is now happening in reaction to IBM's third quarter earnings report. The investors and analysts scraped the bottom of the barrel of the IBM release, and dredged up the allegedly weak services new contract signings as an excuse for a sell off.



Never mind that IBM did sign a megadeal in early October with ABN Amro which would have turned the third quarter signings into a 14% year-over-year increase. Never mind that NO services company can ever predict accurately when it new deals come in.

Unlike revenue lines which are smooth and predictable, the new bookings charts tend to look like jagged Alpine peaks (see an old EDS chart, for example - left). Never mind that IBM is the ONLY

Dow Jones 30 index company that has reported 31 consecutive quarters of earnings increases.

And so on... there was an abundance of "good news" about Big Blue's latest release that the battle-scarred investors chose to ignore today. Here are some highlights:

- **EPS** --- Up 17% on top of year-ago 3Q09 EPS increase of 18%. Not an easy year-over-year compare, in other words, as last year's third quarter was also strong.
- **Revenue** -- \$24.3 billion, ahead of Wall Street consensus (\$24.1 billion). Up 3% as reported; up 4% at constant currency. This is the third straight quarter of sequentially improving revenue growth at constant currency.
- **Growth Markets** -- In our emerging market countries, revenue up 16 percent, up 13 percent at constant currency. BRIC countries up 29 percent, up 26 percent at constant currency.
- **Mainframe is clearly staging a comeback.** Revenue up 15%; MIPS up 54% -- **highest MIPS growth in 6 years!** Yet 4Q will be first full quarter of availability. In other words, this is only a start of the mainframe turnaround.
- **IBM hardware** is growing again. And in double digits at that. Systems and Technology Group's (STG) revenues totaled \$4.3 billion for the quarter, up 10% (11% in constant currency) from the third quarter of 2009. The mainframe resurgence has helped push the IBM STG hardware pretax profit up 46% since a year ago.

And so on...

But as we said earlier, in a world ruled by emotion, fact and reason don't matter. IBM shares are down because the Wall Street expectations for the entire IT sector had gotten ahead of themselves and the investors *felt* a correction was necessary. Just like high tide lifts all boats, low tide drags everyone down, including companies that report stellar results, such as IBM did today.

[Mixed Signals](#) - Analysis of latest quarterly business results

[IBM Delivers...](#) - Analysis of IBM's fourth quarter business results

[Big Blue Poised for Growth Again](#) - "State of the Union"-type analysis of IBM performance

[Rally of Hope over Fact Continues](#) - Analysis of Top IT Cos 2009 performances

[Broken Windows, Broken Promises](#) - "State of the Union"-type analysis of current PC/Windows quality

[A Shrinking Giant](#) - Analysis of HP's fourth fiscal quarter business results

[IBM Stock Takes a Beating](#) (Analysis of IBM's third quarter business results)

[Obama's "Don Quixote" Swings and Misses](#) (Analysis of DoJ's latest antitrust investigation of IBM)

[Triple Trouble Hits Armonk](#) (Analysis of insider trading charges against a senior IBM executive)

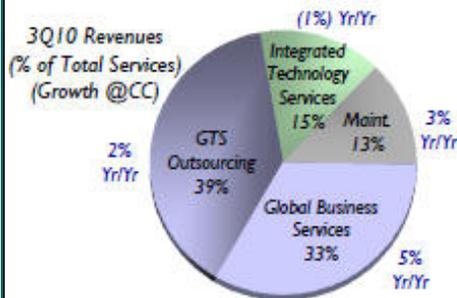
[A Rally of Hope over Fact](#) - Analysis of Top 18 IT companies' performances

[Tempest in a Tea Pot](#) (Analysis of latest IT services industry M&A's)

[Less Than Meets the Eye](#) - Analysis of HP's 3QFY09

Business Segment Analysis

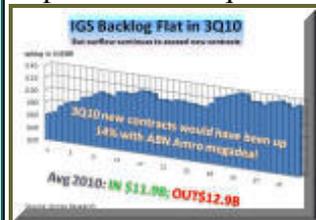
Now, Big Blue's third quarter score card was not entirely without blemishes. But Wall Street seemed blissfully unaware of them as it focused on a bogus reason for a sell-off.



Services. IBM Global Technology Services (GTS) unit, for example, grew only 1% in the third quarter. Given that, at \$9.5 billion in revenues, that's the company's largest segment, sluggish GTS growth is the main reason that dragged down the overall revenue performance.

And the reason for the sluggish IBM services growth is not just a third quarter new

contract signings lull, but that the company has been consistently losing more business this year out of its backlog than it has been signing. The average shortfall after the first nine months of the year was \$1 billion (see the right chart). Which is actually an improvement sequentially over the second quarter results. So even if IBM services has not impressed with its



offence (new contract signings), it was playing better defense in the third quarter, reducing the outflow from the backlog.

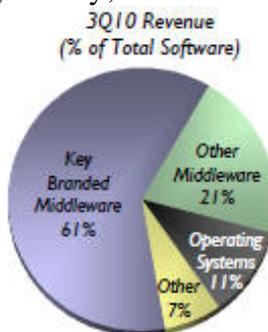


IBM's smaller services unit - Global Business Services (GBS), its consulting arm - has done better than GTS in the third quarter. Its revenues were up 5% to \$4.6 billion. And its new contract signings were also up 4% year-over-year.

Software. IBM software, for example, the company's most profitable business segment, grew only one percent in the quarter despite the many acquisitions the company has made. Year to date, for example, IBM had closed 11 acquisitions for total investment of \$3 billion. So one might have expected faster revenue growth even organically, let alone when you add acquisitions to it.

Flat year-over-year Lotus and Rational revenues were also partly responsible for it. On the plus side, the highly profitable Websphere continues to grow in double digits (up 14% in the quarter). And Tivoli's and IM's 9% and 5% respective growth was also respectable. So what IBM calls the "key branded software" portion of its portfolio was up 7%, more than double Big Blue's total revenue growth rate.

Finally, if one were to exclude the divestiture of PLM, the overall IBM software third quarter growth was 4%. Better, but still not very impressive at a time when mainframe is staging such a strong resurgence. So maybe the fourth quarter will bring a mainframe software resurgence, too.



results

[Big Blue Blows Lid Off Forecasts](#) - Analysis of IBM's 2Q09 results

[Apple, Google Lead Comeback](#) - Analysis of Top IT Cos' stock & business performances

[Revenues, Earnings Drop](#) - Analysis of Accenture's 3QFY09 business results

[IBM Wins the "Gold"](#) - Analysis of IT Services Octathlon 2009 results

[Suddenly, All Lines Point South](#) - Analysis of HP's 2Q09 business results

[Back on Growth Track](#) - Analysis of IBM Global Services 2008 results

[Sometimes Less Is More and Down Is Up](#) - Analysis of IBM's 1Q business results

[IBM's Holistic Approach](#) - Treating businesses like living organisms - secret of success

[IBM Tries to Pull Down, HP Up](#) - Big Blue stock up sharply after CFO remarks at investor conf

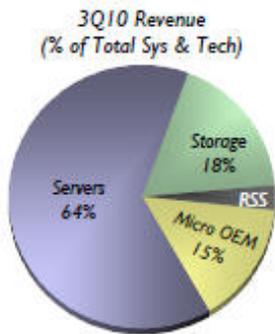
[Hurd's First Stumble](#) - HP's 1Q09 revenues, earnings disappoint Wall Street

[Two Thumbs Up for Big Blue](#) - Analysis of IBM 4Q08 business results

[Big Blue: All Heart](#) - IBM creating new jobs in American Heartland

[When You Catch a Tiger](#)

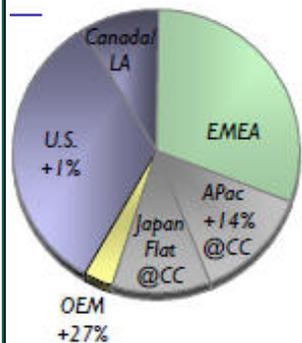
Hardware. Finally, IBM hardware segment, the star of the third quarter, soared by 10%, powered by a 15% resurgence in mainframe revenues. And as we said earlier, this is only a start. The new mainframe is only now (fourth quarter) starting to ship in full volume.



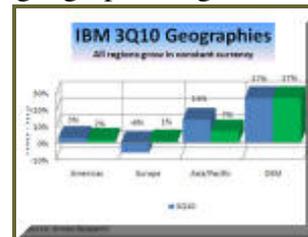
Sales of x86-based System x servers were also strong. They were up 30% in the quarter, continuing to lead all IBM servers, as they had in the first two quarters of 2010.

Storage revenues also increased 7%, while retail solutions business was flat, and System p servers' revenues dropped 13% in the quarter. Sales of IBM's OEM products were also very strong, up 28% in the quarter.

Geographies. What a difference a year can make. Last year, most geographic segments' revenue lines pointed southward. This year, they are all up in constant currency (green bars - right chart). Europe was the only market that declined as reported. But that's mostly because of the rise in the value of the U.S. dollar since a year ago.



But IBM's growth strategy isn't based on developed countries. It is focused on emerging markets. That's where the company recorded a 16% growth in the third quarter. The resurgence was accented by BRIC countries (Brazil, Russia, India, China), the largest members of the developing world. IBM's business there jumped 29%.



The business in Russia and China, for example, soared by 57% and 37% respectively, while Brazil's and India's growth was "only" 20%.

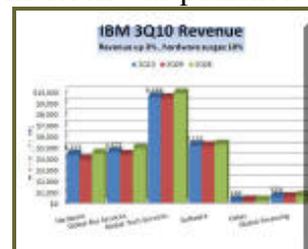
Industries. Consistent with IBM's strong performance in emerging markets, the company's "General Business" (SMB - small and medium size businesses) was the best performer among Big Blue's vertical units. GB revenues in the third quarter were \$4.7 billion, up 7% over the year ago period. Financial services and distribution also reported solid growth, up 5% year-over-year. The government business rose 2%, while the industrial (manufacturing) sector's revenues declined 3%.



Summary and Outlook

As expected, IBM had a strong third quarter. Again, as it expected, its stock was punished despite the good results. No surprise there. Eventually, we do anticipate that Wall Street will correct its correction and that the shareholders of IT industry's leaders and top performers, such as Apple and IBM, for example, will continue to benefit from their companies market share and profit gains.

As IBM's CFO Mark Loughridge pointed out during the third



[by the Tail...](#) - An editorial about greed & success

[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

quarter teleconference with analysts, "based on this (strong) performance, and our view of the fourth quarter, we are increasing our expectation for the full year of 2010 to at least \$11.40 of earnings per share."

That's up 15 cents from IBM's previous guidance of at least \$11.25 in July, and represents a 14% year-to-year increase over 2009.

IBM's optimism about the future is founded on resurgences in several of its business segments. The mainframe, System x and OEM are fueling the hardware growth, while emerging markets are adding additional business impetus across the entire IBM portfolio of products and services.

So Big Blue is once again a colossus on the move. Wall Street can only ignore this fact for so long before factoring it into its investment strategy.

Happy bargain hunting!

Bob Djurdjevic

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