

ANNEX BULLETIN

Annex Bulletin 2011-01

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*A partially OPEN edition***Recent...****HEADLINES**

[IBM Hardware: Rise and Shine Again](#) (Analysis of IBM STG business results and outlook)

[BARRON's: IBM Shareholders Will Like New Year](#) (Analysis of Barron's article on IBM stock)

IBM CORPORATE

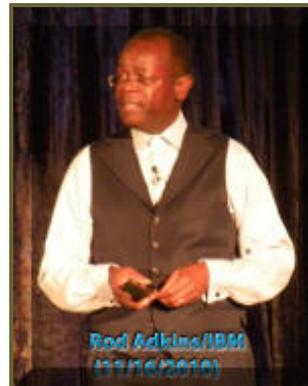
Updated 1/03/11, 11:30AM HST

*Analysis of IBM's Hardware Business - Systems Technology Group***IBM Hardware: Rise and Shine Again***Erstwhile Laggard Now Enjoying Fruits of Turnaround; Big Blue Is Once Again Bellwether Stock*

HAIKU, Maui, Jan 3 – A year ago, IBM's hardware business seemed in shambles. Revenues were down in most of its product lines. And the business had lost its head (see [NOTE](#) below). But all was not lost, we said. Sam Palmisano, IBM CEO, did the right thing when it picked a seasoned STG insider to succeed the disgraced Bob Moffat. Rod Adkins' (right) quiet, unassuming, collegial, yet efficient, leadership style was perfect for the turnaround role IBM hardware needed.

Consequently, a year ago, when both IBM stock and its hardware business were in the doldrums, this is what we said about its outlook:

IBM is once again poised for growth. A 98-year old company, written off as a dinosaur in the 1990s, is once again acting as spry as a springbok, and setting the leadership agenda for the IT industry to follow. We see blue skies are ahead for Big Blue. "Post nubilla, phoebus" ("After the clouds, sunshine" [Latin]).



[HP's "Stealth CEO" Sounds Bullish in First Public Appearance](#) (Analysis of HP's fourth quarter business results)

[Silicon Valley Rodeo](#) (Editorial on shenanigans and costly trivial pursuits)

[IBM Business Up, Stock Down](#) (Analysis of Big Blue's third quarter business results)

(An excerpt from [Big Blue Poised for Growth Again](#), Jan 2010)

And this is what happened in 2010 (see the charts).



The IBM stock closed out 2010 on a high note, up 11% for the year, and up 19% in the fourth quarter alone. Big Blue outperformed last year most of its major competitors, including HP and Microsoft, whose shares declined (-20% and -10% respectively). Oracle topped them all, however, with a 26% surge in the last 12 months. But Big Blue is once again the IT industry's bellwether stock. It's 2010 chart mirrored that of the Dow Jones Industrials, of which IBM is a part (above right).

Yet, we feel that the IBM stock is still undervalued. For reasons why, check out the note we sent to clients on Christmas Eve, the day the influential BARRON's magazine also published a lead story on IBM (see [BARRON's: IBM Shareholders Should Enjoy New Year](#), Dec 24). But since "high tide lifts all boats," the market will first need to warm up more to the IT sector before Big Blue shares take their rightful place in the industry pecking order (we figure that's around \$176 per share).

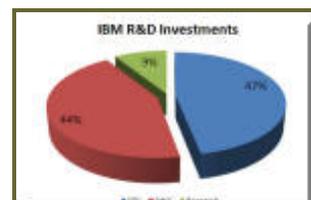
IBM Hardware: Rise and Shine

...and merge with software



Meanwhile, back to IBM hardware, IBM did something else during 2010 that makes us still feel bullish about STG going into 2011. For the first time in several decades, IBM merged its hardware and software businesses under a single leader. Steve Mills (left), longtime head of IBM software, the company's most profitable business segment, enshrined the role he had been performing informally for several years now. He assumed responsibility last year for overseeing STG as well.

The reason we thought this was a net plus for IBM is that in today's highly integrated corporate marketplace, it is necessary for both hardware and software people to play from the same sheet of music. As you can see from the R&D investments chart (right), the



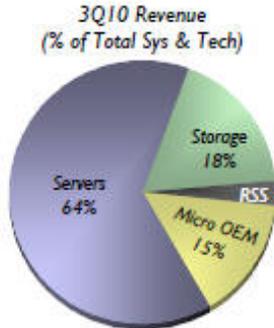
spending on hardware and software innovation is now fairly balanced at IBM (47% vs. 44%, with pure research accounting for the remaining balance of 9%). So coordination and integration of products on the vendor side is as important as it is in customers' IT shops.



And there is much to coordinate and integrate. The IBM STG development team numbers about 15,000 engineers in 37 labs in 17 countries (left chart). There are about 35,000 IBM software programmers. So sharing the information and working together as a team is challenging even now. But at least they are all now under the same roof, so to speak.

And the results are already showing up. Here's what we said about STG's last report card, issued in October:

Hardware. Finally, IBM hardware segment, the star of the third quarter,

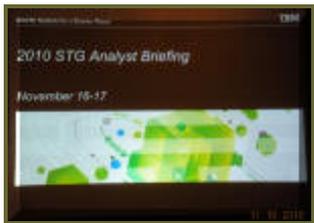


soared by 10%, powered by a 15% resurgence in mainframe revenues. And as we said earlier, this is only a start. The new mainframe is only now (fourth quarter) starting to ship in full volume.

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.

(An excerpt from [IBM Business Up, Stock Down](#), Oct 2010)

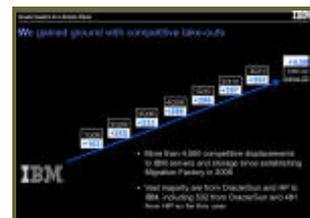


Speaking at an IBM conference for industry analysts in New York in November (left), Adkins said the third quarter (of 2010) was STG's "best in six years!"

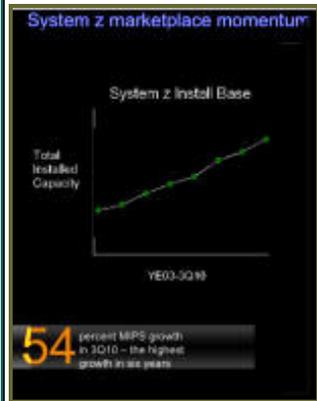
In part, that's because the company seems to be beating the pants of the competition.

"We've gained ground with competitive takeouts," Adkins said.

There have been more than 4,500 of them in the last four years, including 532 from Oracle/Sun and 481 from HP in the first three quarters of 2010 (see right chart). This includes 800 migrations to its Power (Unix) systems in 2010, 200 more than in 2009, Adkins said.

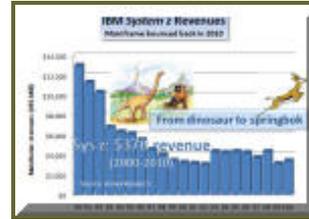


IBM also gained 37 net new mainframe clients in the first nine months of 2010, something that hasn't happened in a long time. In part, that's due to Big Blue's success in opening up new emerging markets to its old but rejuvenated technology. Growth markets now constitute 29% of IBM's hardware revenues.



Also, the most expensive computer system is actually now delivering the most economical solutions. The mainframe offers up to 56% lower acquisition costs, and up to 55% lower cost of ownership, according to Mills.

As a result, the demand for mainframe is soaring. In the third quarter, for example, the MIPS growth was 54%, the highest in six years, according to Tom Rosamilia (left chart). Once again, an erstwhile dinosaur has a new bounce to its step - like a young springbok (right chart).



Beating Up on Oracle

Now that Oracle is also in the hardware game, following its Sun acquisition, Oracle has also become fair game for IBM. Adkins' new boss, Mills, led the assault. In fact, we have never heard the generally even-tempered Mills sounding as combative as he was at the IBM November conference.

"SPARC is dead," Mills declared. "Larry (Ellison, Oracle's CEO - right) is pretty much moving the company to Intel."

SPARC are the Fujitsu-made chips used in Sun Microsystems computers, which Oracle acquired in 2009.



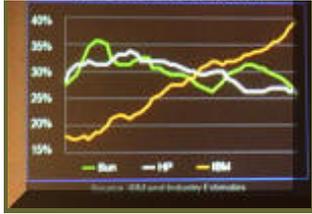
Mills said that it was only IBM and Intel that are capable of manufacturing the highly integrated circuits, such as the 5.4 GHz chips.

"He (Ellison) does things for his own financial benefit, not because he is enamored of some technology," Mills added.

But the IBM executive conceded that since "there are still some one million SPARC boxes around, their death is not imminent."



Which makes for good pickings by competitors, such as IBM, was the implication (left chart).



"There is a lot of testosterone flowing out of that company," Mills continued, referring to Oracle. "We always win; we never lose,' the Oracle people say."

But Mills saved his best anti-competitive barbs for the Q&A. When one of the consultants asked the IBM executive what advice he would give Larry Ellison, Oracle's boss, Mills replied, "you don't tell God what to do. He is not interested in my advice."

For what it's worth, Mills said, he thought Ellison should "just keep doing what he is doing. Larry is a good creator of (his) customers' distress. So he generates a lot of opportunities for us."

"Larry is a multi-billionaire who lives on a huge field of distorted reality," Mills concluded. "By the way, I understand that Larry Ellison finds me annoying," Mills added.

Wonder why?

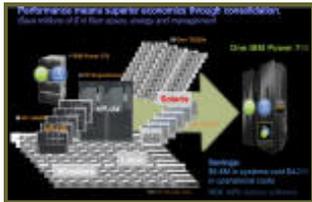
There is evidently no love lost between IBM and Oracle, just as there isn't between HP and Oracle (see [Silicon Valley Rodeo](#), Nov 2010). Looks like Ellison has managed to alienate most of his major competitors. Which is good news for customers.

Powering Up Power Systems

As a result, IBM's Power (Unix) systems have been winning the market share war against both Sun (Oracle) and HP. Tom Rosamilia (right), who heads up both IBM mainframe and Power systems, said that there have been more than 3,000 successful Power migrations to-date. And the pace is accelerating.



After winning more than 500 competitive engagements in 2009, IBM System p (Power) claimed nearly 800 competitive scalps in the

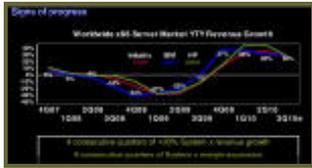


first nine months of 2010. Over 90% of them came from HP and Sun customers, with the balance attributable to x86 consolidations.

The chart on the left illustrates why IBM's Power has been so successful. Take a look at the kluge of competitive gear on the left that a single System p Model 795 replaced - at savings of \$6.8 million in acquisition costs, and \$4.2 million in operating expenses.

System x: IBM's Biggest and Fastest Growing Server

The honor of being the fastest growing IBM system in the last four quarters goes to the x96-based System x server. Which also happens to be the largest IBM server in terms of revenues.

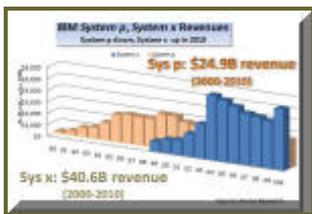


As you can see from the chart on the left, the System x has been growing its revenues at 30% or higher in the last 12 months. And it has been improving its margins for six consecutive quarters. The sine-shaped blue line on the chart tells the tale of this extraordinary turnaround.

Asked to explain the reasons for it, Adalio Sanchez, the top System x executive who is credited with turning things around replied, "in a word, it was the execution."



Sanchez dismissed the theory that it was the Windows 7 pull that created the new demand for his server line. He argued that there had been pent-up demand in the marketplace from the buying hiatus in 2008 and early 2009. And he feels that the demand is still not back to where it was before the downturn in customer spending two years ago.

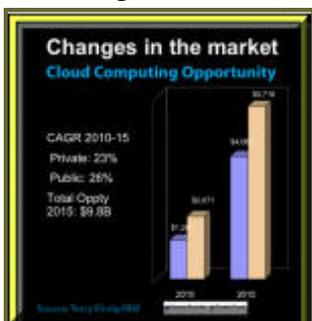


Furthermore, even though 51% of the new System x workloads are virtualized, the utilization of the installed base is still only 15% today. By contrast, the System p utilization is 65% to 70%, Sanchez said. Which leaves a huge opportunity for System x upgrades in the next several years.

That is why when one looks ahead, one can see continued strong demand for System x, and sustained market share gains for System p in a declining market.

When Clouding Issues Means Goodness

Cloud computing is one of the four major new growth opportunities for IBM. Terry Virnig, (right) the IBM executive in charge of the Cloud technologies at STG, said she saw it as nearly a \$10

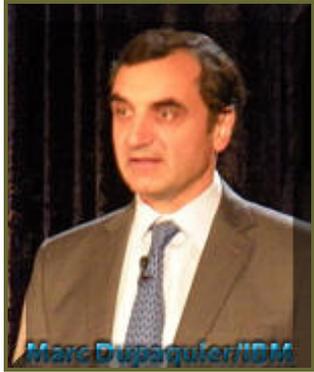


billion opportunity by 2015. Of that total, "private" clouds, which currently account for about 70% of the customer focus, are



expected to grow at 23% per year. "Public" clouds, on the other hand, should expand even faster - at 26% per year (left chart).

Marc Dupaquier (below left), the head of marketing at STG, pointed out that "growth markets" represent 26% of STG's opportunity today, and are growing five times faster than the major markets. That's another \$10 billion of potential revenue for IT vendors, according to his figuring (right chart).

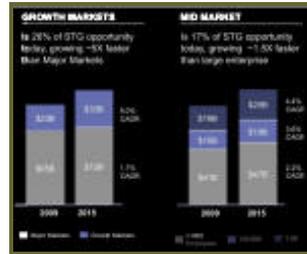


Meanwhile, the midmarket (SMB - small and medium size businesses), which represents 17% of STG opportunity today, is growing 1.5 times faster than the large corporate market. And midmarket has already been the best segment in IBM for the last six quarters, Dupaquier said.

But to tap into these new markets and cash in on the opportunities, the vendor will have to market in a new way. That's because 70% of the buying decisions are being made not by the customers themselves, but by the various influencers, Dupaquier said.

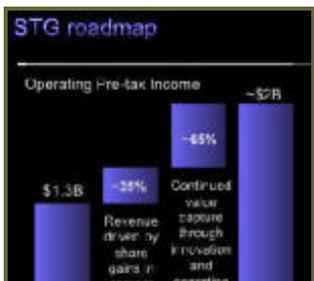
So Dupaquier is cranking up and pointing the IBM STG marketing machine to shift and align it with the new market realities. Which means traditional marketing focus will drop from 75% to 63%, competitive marketing will increase from 15% to 25%, while Cloud computing marketing will rise from 5% to 12% of the total.

That will also bring STG in alignment with IBM's overall corporate sales and marketing strategies. Speaking on the second day of the conference, Ginni Rometty, IBM's top worldwide sales and marketing executive (right), said that Smarter Planet, Analytics, Cloud and Growth Markets were the four key components of IBM's growth strategy between now and 2015.



"To grow, companies must either take share or make (new) markets," Rometty said. And those four tenets of IBM's growth strategy are the means to that end.

Summary and Outlook

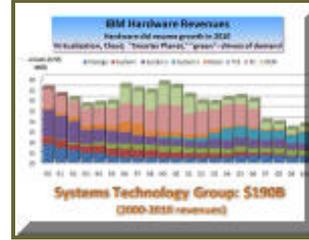


Looking ahead, Adkins said STG is committed to an operating pretax income growth of 6% to 8% per year. This means that five years from now, we can expect STG to generate about \$2 billion in pretax income, up from \$1.3 billion in 2009.

Adkins said that about 35% of that increase would come from



revenue-driven market share gains in servers and storage. The balance of 65% would be attributable to "innovation and operating leverage" (see the left chart).



So putting it all together, you can see what our STG revenue chart looks like for the last two decades. After ebbing in 2008-2009, the IBM hardware is once again growing (right chart). Rise and shine again in 2010 and beyond.

Happy bargain hunting

Bob Djurdjevic

NOTE: Bob Moffat was arrested in October 2009 on insider trading charges (and has been subsequently convicted and sentenced to jail). His fall from grace was a disgrace not just for the IBM System Technology Group (STG) but for the whole company. For, Moffat had been considered a front-runner as heir to the throne of Big Blue (see [Triple Trouble Hits Armonk](#), Oct 2009).

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