

Annex Newsflash

Annex Newsflash 2006-04

January 17, 2006

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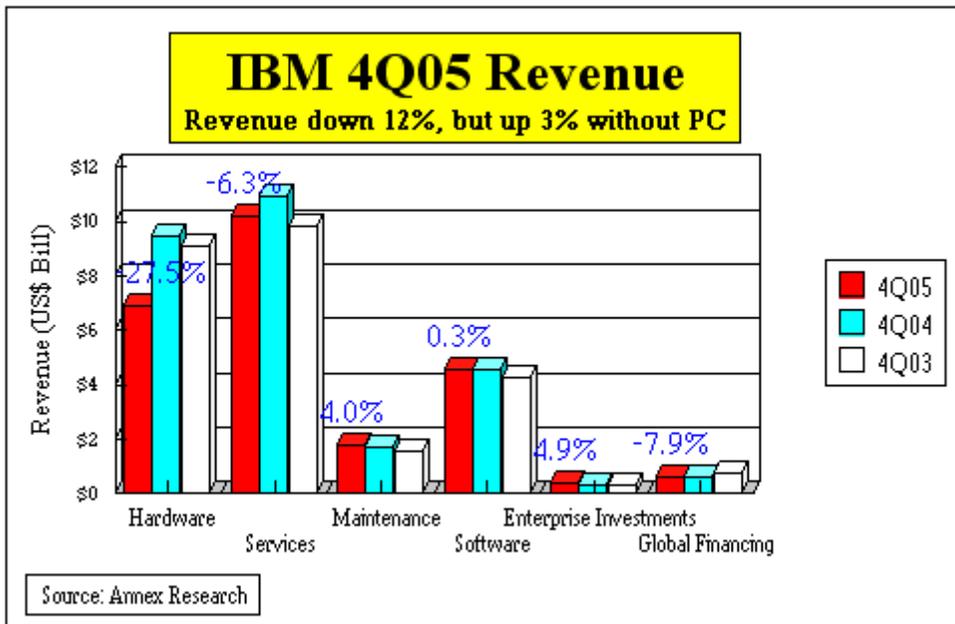
Updated 1/18/06, 8:20AM MST, adds [IBM Zigs As Market Zags](#)

Analysis of IBM's Fourth Quarter Business Results

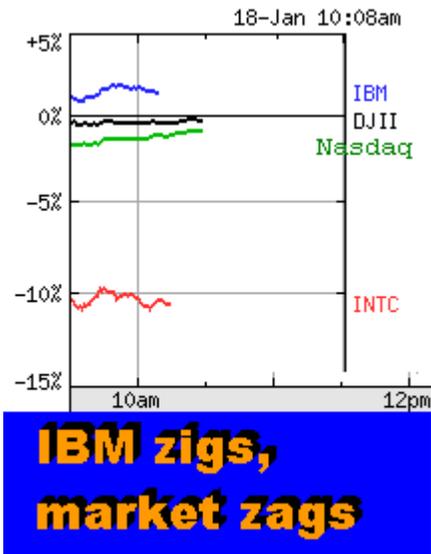
Smaller IBM Is Better

But Wall Street Doesn't Get It: IBM Beats Earnings Estimates by a Whopper, Yet Stock Drops

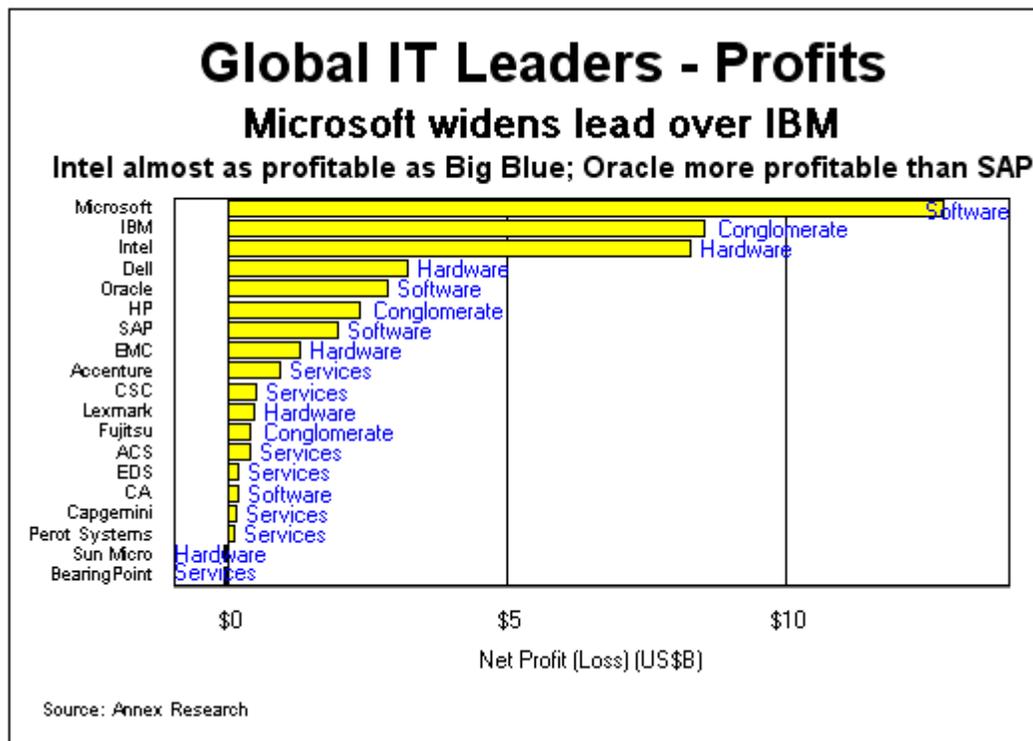
SCOTTSDALE, Jan 17 - It is one of those days again on Wall Street that leaves anyone who depends on logic and reason for analysis shaking his/her head. IBM came out with a strong fourth quarter performance in most of its businesses, beating the almighty average earnings estimates by a whopper (17 cents - \$2.11 vs. \$1.94 per share). Yet investors shrugged off the good news and focused on the negative, sending Big Blue stock into the red in after-hours trading. IBM was also down \$0.17, closing at \$83 in regular session today.



The ostensible reason for the investor pessimism was that the revenues were down 12% compared to the fourth quarter of last year. But that's actually good news. For, it proved what we have been saying since a decade ago - that a smaller IBM would be a better IBM. The fact that gross margin surged by more than five points to 44%, the highest in 14 years (!); and that the net margin is now 13%, the highest since 1985 (!); and that both multi-year highs were set on a double digit decline in revenues, shows just how much more efficient the company has become.



No surprise there for our clients and regular readers. That's what we said last March that would happen in our five-year forecast for IBM (see above chart and "[IBM 5-yr Forecast: Quality over Quantity](#)").

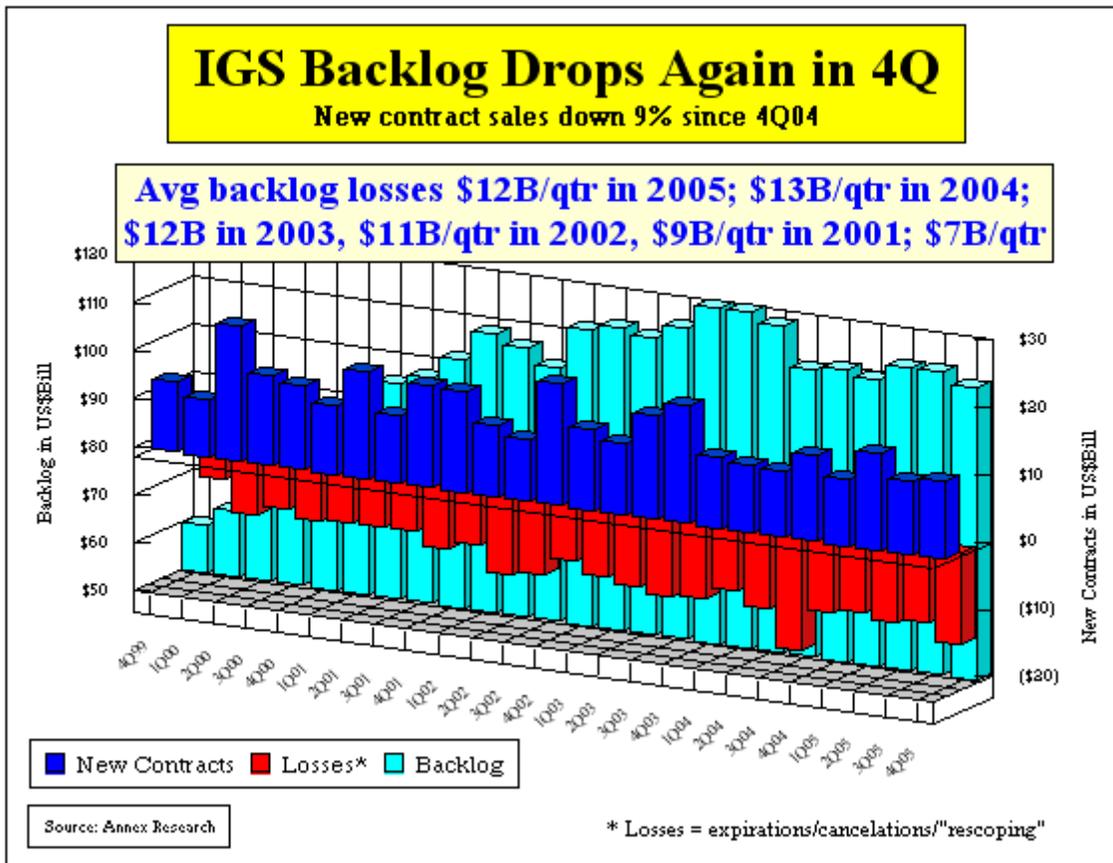


By the way, at nearly \$8 billion in actual net profit, even this smaller IBM is nothing to sneeze at. That's more than most of its competitors derive in revenues. Only two other IT companies exceed it in absolute net profit (Microsoft and Intel, though the Intel stock got killed this evening, down 9%, because it missed the earnings expectations).

In short, now that IBM got rid of a dud (PC), the profitability of rest of IBM hardware can now shine. Hardware revenues without the PC business increased 6% (up 9% in constant currency). And the quality of both revenues and earnings has improved.

Some Disappointments: IBM Global Services

But not everything came up smelling like roses in IBM's fourth quarter. The most worrisome figure to us was a \$2 billion drop in IBM Global Services' backlog in the fourth quarter (since the third). Coupled with a 9% decline in new contract signings, these two figures mean that the biggest IBM unit is losing more business from its backlog than it is signing.



Unfortunately, that's nothing new. Ever since the first quarter of 2004, when IGS backlog peaked at \$120 billion, the inflow of new business has fallen short of the outflow (expirations, cancellations, rescoping). In 2005, the outflow averaged \$12 billion per quarter, an improvement from 2004, but still a huge hole that new contract sales have to fill every three months.

No wonder IGS revenues dropped 5% (it was down 1% in constant currency) despite a single-digit increase in maintenance revenues, a component of it.

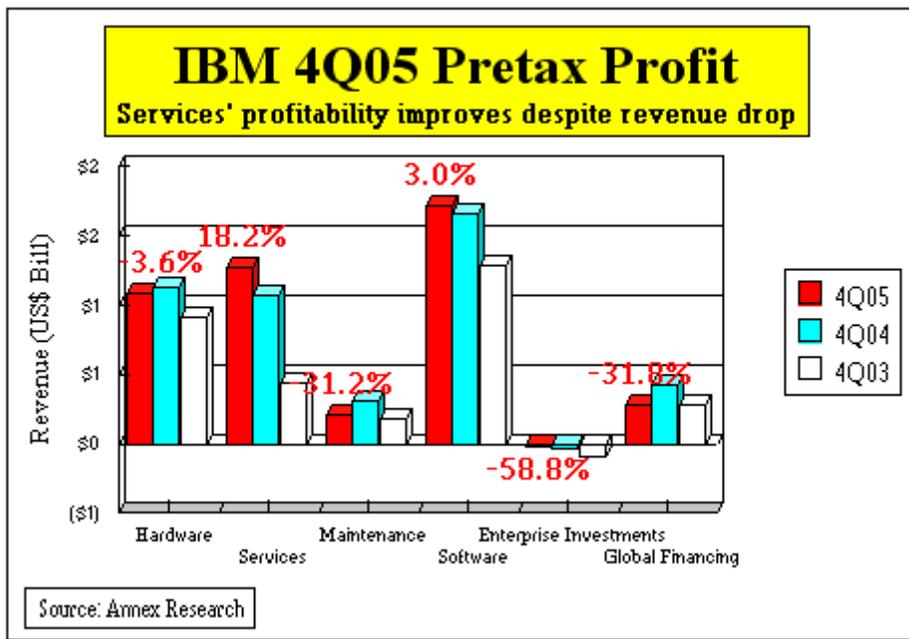
Mark Loughridge, IBM CFO, acknowledged during the post-earnings teleconference with analysts that IGS fell short of IBM's full-year revenue expectations. But he said the business benefited from "productivity initiatives" that helped boost gross margins by over three points. IBM also signed a 10-year, \$1.1 billion technology outsourcing pact last week with Gap Inc. The news was announced earlier today, probably intended as a PR boost in advance of disappointing actual fourth quarter results.

Loughridge also said he was confident IGS would bounce back in 2006, and work itself back up to "mid-single digit growth in the second half" of the year.

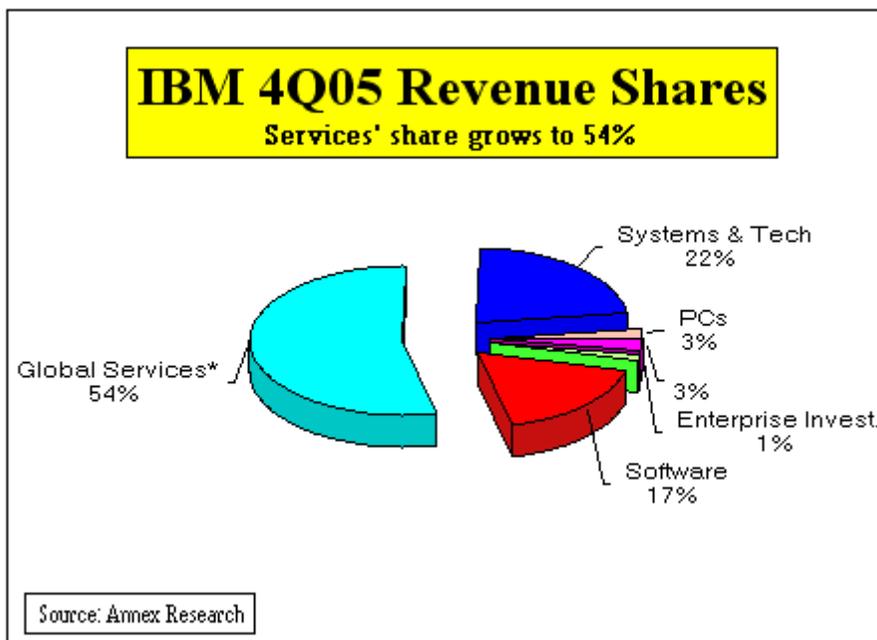
"Our pipeline for the first quarter is up year-to-year, with particular strength

in our long-term businesses," he said. "We expect improvement in our short-term businesses," he added. "Actions we are taking in Integrated Technology Services and Consulting and Systems Integration should yield benefits over the course of the year."

We'll see...



Meanwhile, the services profitability did improve even in the latest quarter by about three points.



Business Segment Analysis

Hardware. By contrast to the sputtering IGS growth, IBM hardware continues to shine. As noted earlier, hardware revenues were up 6% (9% in constant currency), led by a burst of the zSeries (mainframe) business. The MIPS shipments surged by 28%, the biggest increase in eight years. The zSeries revenues also increased in double digits (up 10%) in constant currency in the quarter.

No surprise there, either (see "[IBM: Polaris Eclipses T-Rex](#)," July 2005), and "[IBM Hardware Revival](#)," Nov 2005, and "[Poughkeepsie Spring](#)," a whitepaper, May 2005).

The pSeries and xSeries revenues also rose in the fourth quarter - up 7% and up 3% respectively in constant currency. This puts the pSeries on top for the full year growth among all IBM servers (up 14%). Which means that 2005 will have been the fourth consecutive year of market share gains for the IBM Unix servers.

But the fastest growth, both in the fourth quarter, and for the year, was recorded by IBM's storage, microelectronics and Engineering & Technical Services (E&TS) units. They were up 29%, 48% and 15% in the quarter, and 15%, 16% and 41% for the year (all in constant currency).

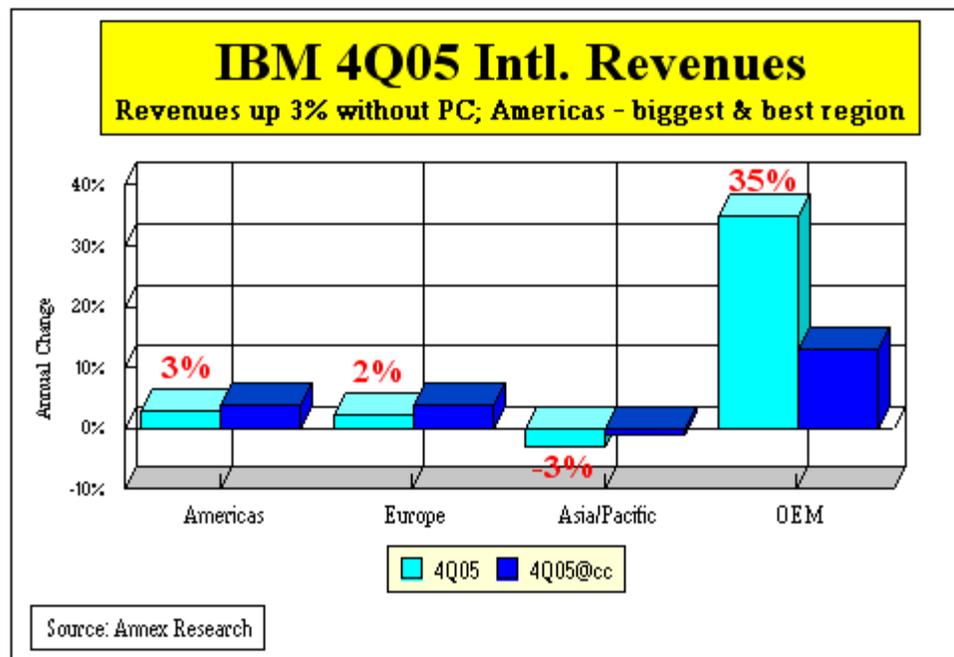
One hardware disappointment in the fourth quarter was a 14% decline (in constant currency) in the iSeries revenues. The best-performing server line just a quarter ago slowed down at the end of the year, as many customers deferred their buying decisions until the new Power5+ products are unveiled, Loughridge said. The new product announcements are expected at the end of January.

During 2005, however, the iSeries gained over 2,500 new customers. And that feat, more than the new technology, is an encouraging sign for its continued growth prospects this year.

Software. IBM fourth quarter software revenue was flat as reported, but up three percent at constant currency relative to the year-ago period. For the full year, software grew four percent, both as reported and at constant currency. Once again, mainframe-related software led the way (Websphere, Tivoli, Lotus...).

In fact, the IBM CFO said that one reason for IBM's bullishness about the mainframe prospects in the future is that 60% of the growth are new workloads (such as Linux and the above mentioned software). This compares to only 15% new workloads back in 1998, the previous high water mark for MIPS shipments.

Geographies. IBM's Americas region was once again the best among the three geographic units. Its performance "was broad-based, with growth across all key brands and all regions," Loughridge said.



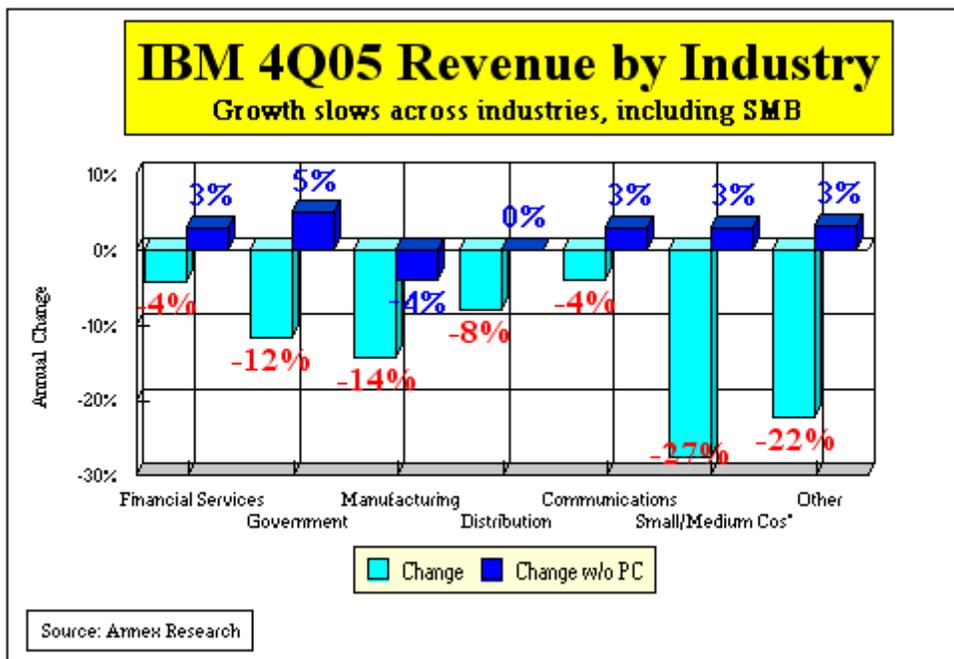
Europe, on the other hand, turned in a spotty report card. Revenues in Spain and the Nordics were up. The business in France also grew for the second consecutive quarter. But Germany and Italy revenues continue to decline.

The Asia Pacific revenue declined this quarter, both as reported and in constant currency. The main culprit is Japan, which accounts for about 60% of the A/P business. But IBM revenues in China rose, and the rest of Asia also posted good results, led by India.

The four biggest emerging countries, China, India, Brazil and Russia, delivered \$3.8 billion of revenue without PCs, and grew 14% at constant currency. India surged by 55%, followed by Russia (up 29%), while China and Brazil increased by 8% and 7% respectively.

"We'll continue to shift investments to these high growth markets," Loughridge said.

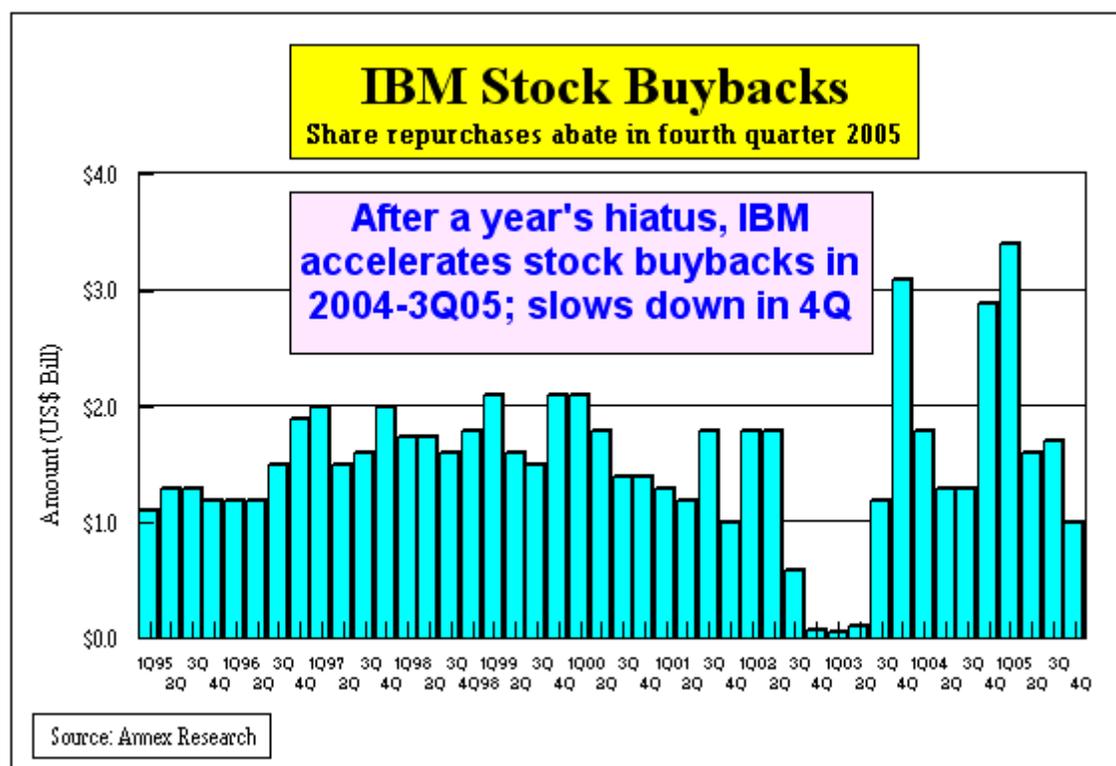
Finally, IBM's OEM growth was an impressive 35% in the fourth quarter, driven primarily by the E&TS business demand.



Industries. Growth slowed across all industry sectors in the fourth quarter, including the heretofore fast-growing SMB market. Even without the PC revenues, all segments reported low single digit revenue increased, while the distribution business was flat compared with the year-earlier quarter.

Stock Buybacks Abate

Another positive development in the fourth quarter has been an abatement in IBM's stock buybacks. They were down 66% from the fourth quarter of 2004.



Instead letting others spend its hard-earned money, IBM has been putting it to good business use lately. In 2005, the company completed 16 acquisitions in the software and services arena. Not all of them will pan out, of course. That's the nature of the venture capital business. But some that do, may pay off big. At least that's a definite possibility. With stock buybacks, on the other hand, there is one definite certainty - it's money down the drain, as far as business operations are concerned.

Outlook

Even though services now account for more than half of IBM revenues, about two-thirds of IBM's profit comes from hardware and software. And these have been the two business segments that have been delivering steady growth and earnings. IBM executives expect that to continue in 2006 and beyond.

"We remain committed to deliver double-digit earnings per share growth over the long term," said Loughridge.

In the subsequent Q&A session with analysts, the IBM CFO guided the Wall Street 2006 EPS estimates about 12 cents higher than the current average of \$5.66 per share. It remains to me seen if IBM executives' optimism translates into higher stock prices in tomorrow's trading.

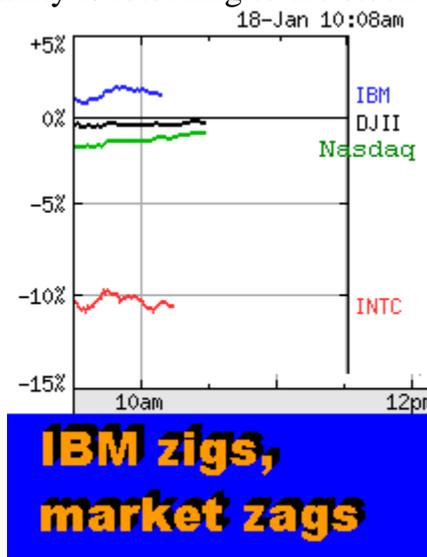
Happy bargain hunting!

Bob Djurdjevic

IBM Zigs As Market Zags

SCOTTSDALE, Jan 18 - Well, it looks like sanity is returning to the stock market. IBM ziggied this morning as the market zagged. Big Blue stock was *up* nearly two points in early trading, as its last night's report card would have warranted by logic and reason, at least by our logic and reason.

The IBM stock rise ran in the face of an overall bearish market, driven largely by disappointing news from Intel and Yahoo (both stocks were down more than 10 points). The Dow and Nasdaq were also down, though not by as much.



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