

ANNEX BULLETIN

Annex Bulletin 2006-28

July 18, 2006

A **CONFIDENTIAL** Client Edition

 [Click here for PDF \(print\) version](#)

[Revenue Forecasting Paper](#)

CFOs discuss key challenges, forecasting tools & best practices.

Ads by Google

[New york stock exchange](#)

Stocks and New york stock exchange Get Connected to the Stock Market.

Advertise on this site

IBM FINANCIAL

Updated 7/18/06, 8:00PM PDT

Analysis of IBM's Second Quarter Results

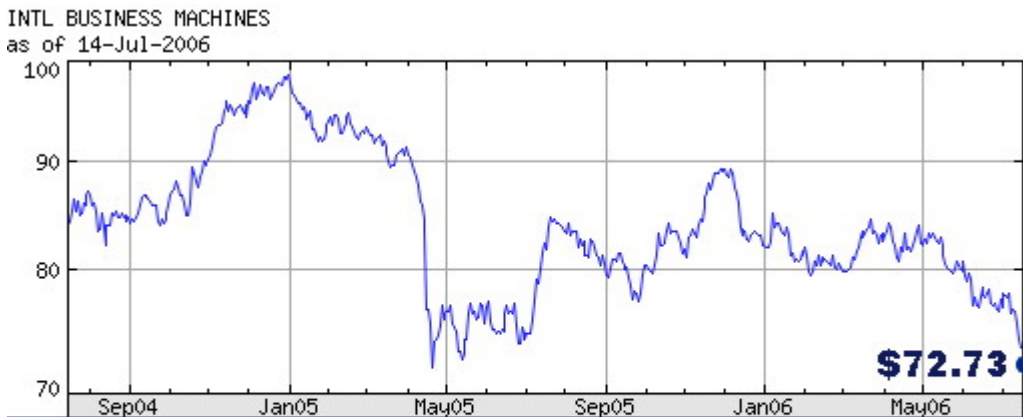
No Bad News Is Good News

Market Breathes Sigh of Relief after IBM Release

SCOTTSDALE, July 18 - Market breathed a sigh of relief after IBM's second quarter financial release, lifting the stock more than two points in today's after-hours trading. Absence of major bad news was welcomed good news by the battle-weary investors, buffeted by a myriad of scary global and economic developments in the last week or so.

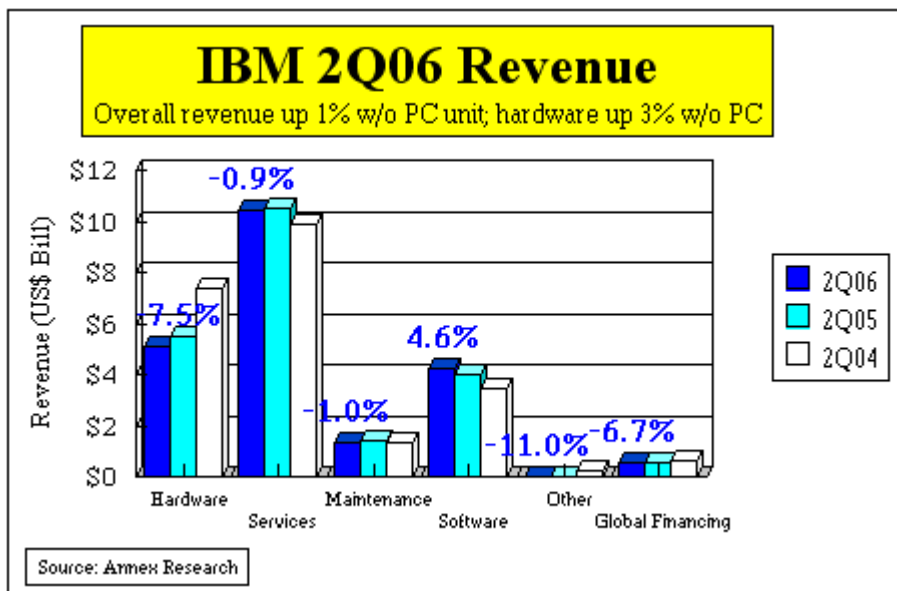


IBM stock continued to rise in after hours trading, up 2.3% and climbing



But stock still down 25%+ since Jan 2005, setting near 52-week low

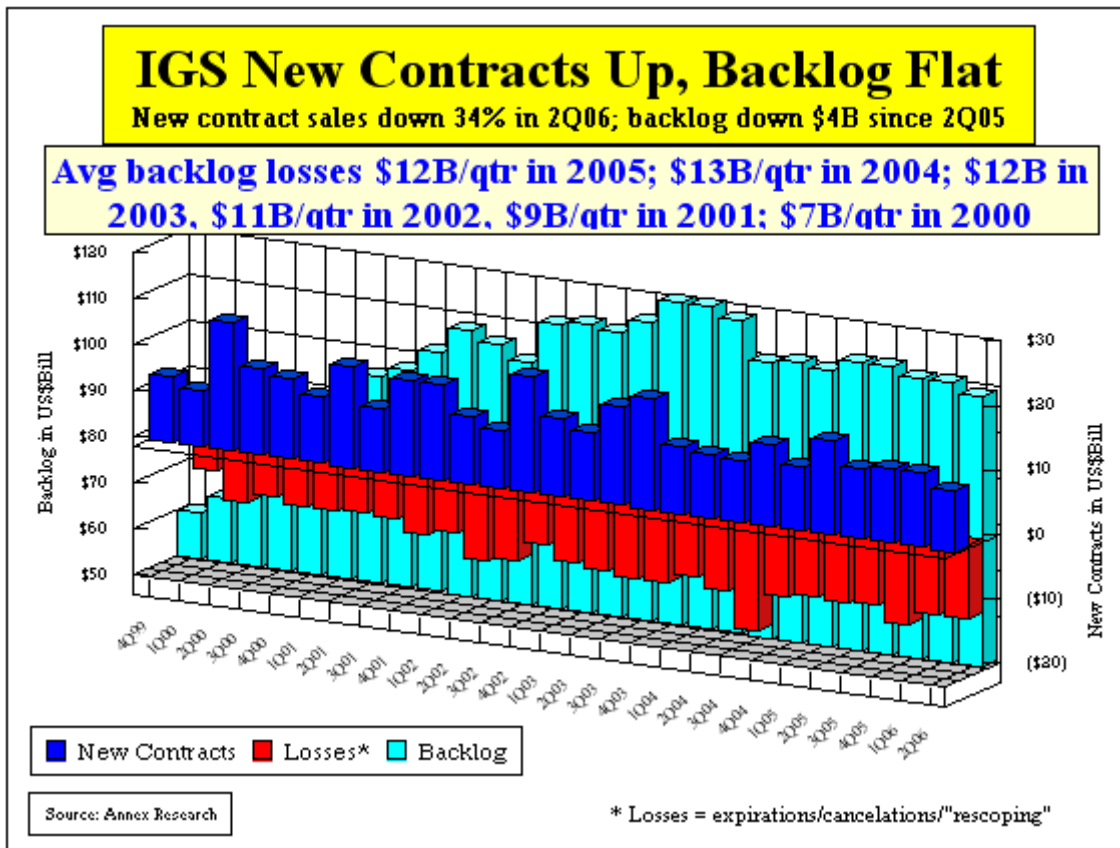
The Big Blue shares had set a new 52-week low earlier in the day of \$72.73. They are still down 11% since a year ago, and more than 25% bellow the January 2005 level. In fact, with so much pent-up pessimism in the marketplace, "the only way to go after the IBM release was - UP," we [had told the major business media](#) before Big Blue announced its earnings.



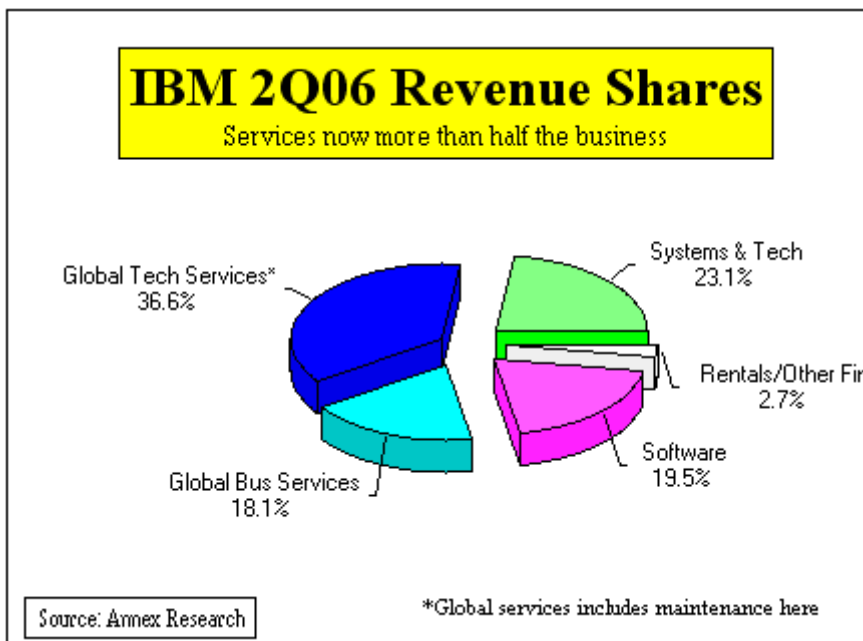
The absence of major disappointments, however, did not mean that IBM had a great quarter. On the contrary. Big Blue's results were at best mixed. But top and bottom lines did hit the Wall Street expectations on the button. Revenues were \$21.9 billion, down 2% as reported (up 1% adjusted for currency fluctuations and sales of the PC unit). Earnings were \$2 billion, up 9% from a year ago (up 11% from continuing operations).

Business Segment Analysis

Global Services. IBM's largest business segment was also the biggest disappointment in the quarter. IBM Global Services (IGS) revenues declined again by 1% to \$11.9 billion. More worrisome, however, was a precipitous 34% drop in new contract signings to \$9.6 billion, and the corresponding \$2 billion sequential decline in the backlog. Since a year ago, however, the IGS backlog is down \$4 billion. It is \$9 billion lower than in the second quarter of 2004.



All this spells trouble for future growth. Within the two IGS operating units, the new contract signings at Global Technical Services are down 46% since a year ago, while those at Global Business Services are 19% lower. In each case, long-term contracts are down much more sharply than the short-term ones.



Clearly, IGS' anemic results indicate long-term problems that the reorganization from one year ago has failed to fix.

And what are its problems? In a word, it is its size. The unit is simply too big for its own good. Nothing new there, of course, for Annex clients and readers. We have been saying since 1996 that Big Blue should consider splitting it up. Well, now that's even more evident than ever.

And how should IGS be broken up? The most logical way to us would be to create a number of semi-autonomous industry units. This should speed up decision making, and make gigantic operation more nimble, and thus more competitive.

But while IGS is having a hard time growing, there are a number of other things this IBM unit is doing right. It is increasing the share of smaller and more profitable deals in its portfolio. And it is lowering its costs by its Indian offshoring strategy.

As a result, the IGS gross margin jumped from 26.1% a year ago to 27.7% in the latest period. We see this as another piece of evidence that IBM is now putting quality ahead of quantity (also see "[IBM vs. HP: A Tale of Two Blues](#)," June 2006).

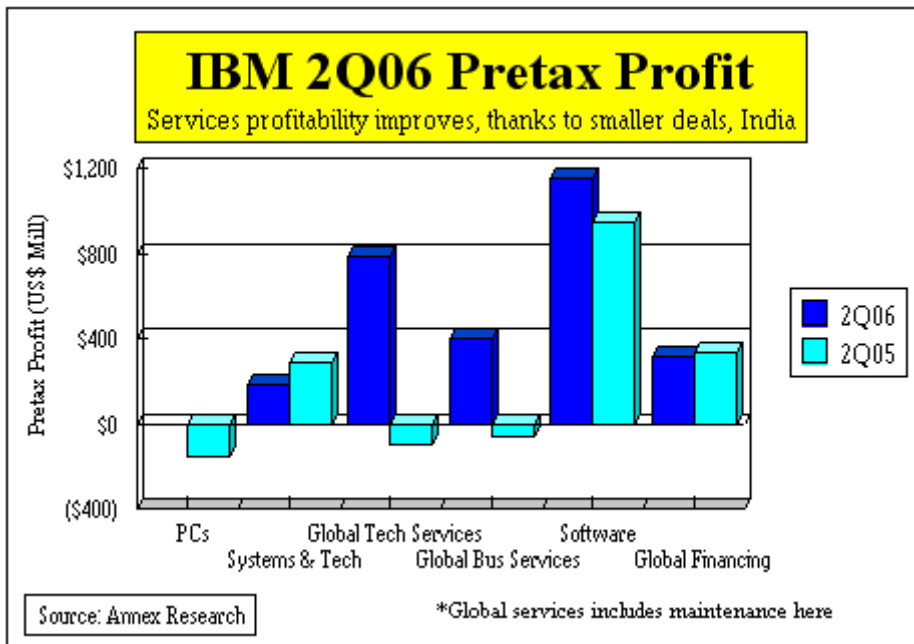
Hardware. IBM second quarter hardware results were mixed. A seven percent jump in mainframe revenues was a positive surprise. So was a 45% surge in Microelectronics business. But revenue shortfalls caused by operational problems in *System i* and *System x* server product lines were unexpected disappointments.

"Our unusually high level of unfilled orders were due to end-to-end supply chain complexities which were primarily driven by parts and product transitions to support the RoHS (Removal of Hazardous Materials) requirement in Europe," explained Mark Loughridge, the CFO, in a post-earnings teleconference with analysts.

This meant that a number of *System i* and *System x* orders were not fulfilled. Without this problem, the *System i* revenue would have been flat, and *System x* revenue would have risen by about six percent.

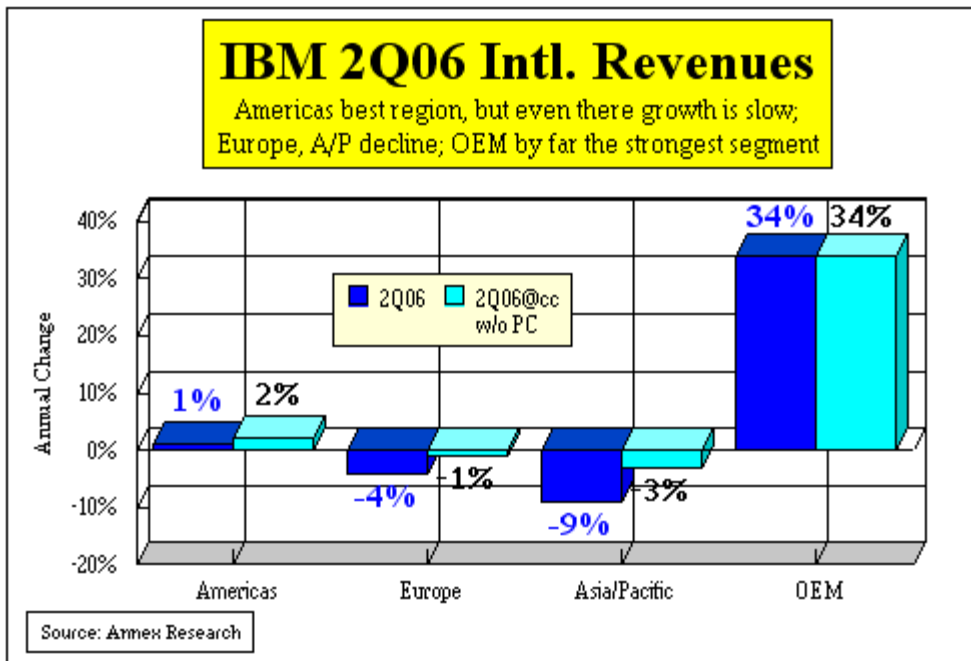
The 10% drop in *System p* revenues, brought about by technology transition, was less surprising, especially as it compares to one of its best quarters ever (last year's 2Q).

Despite these problems, IBM hardware revenues grew by 3% to \$5 billion, thus continuing to be a bulwark of the company's recovery.



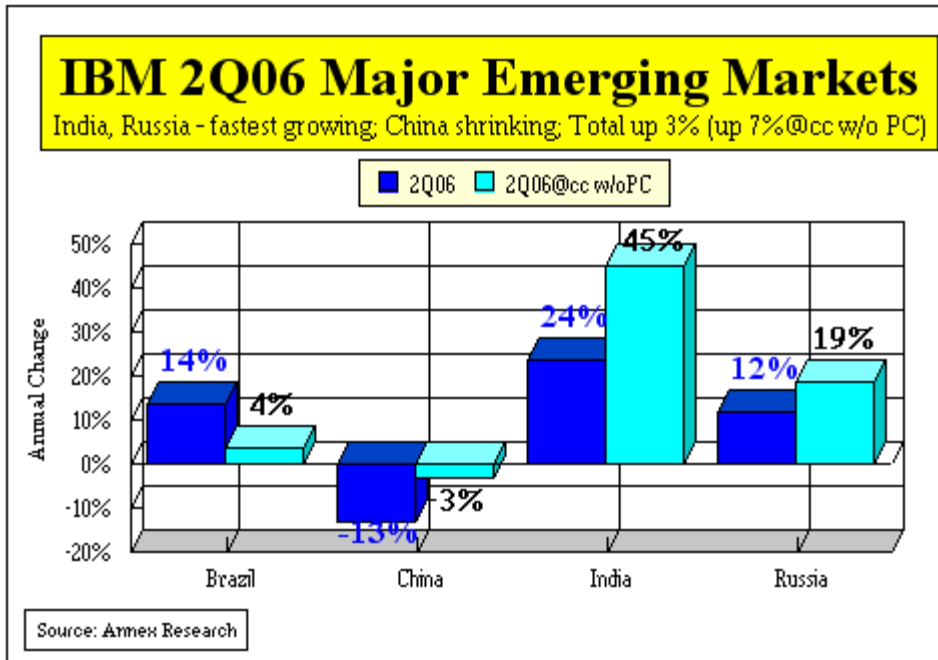
Software. IBM software continues to be the company's most profitable operation, contributing almost \$1.2 billion to Big Blue's pretax profit. IBM also grew its second quarter software revenues by 5% to \$4.2 billion. WebSphere and Tivoli had double-digit growth, while IBM's "key branded middleware" enjoyed a 9% jump since a year ago.

"We had constant currency growth in all major geographies," Loughridge said, "with particular strength in the Americas."

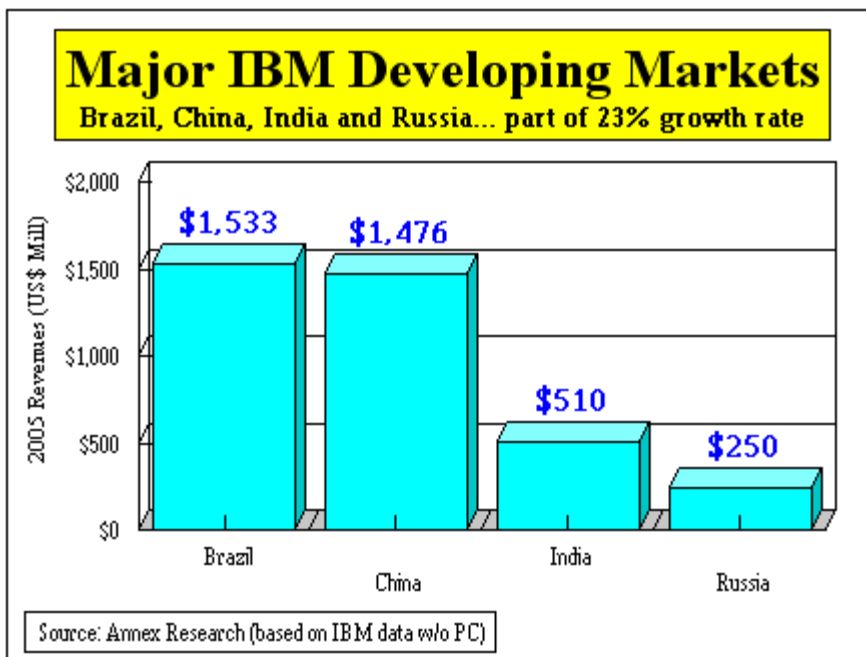


Geographies. That was evidently no small feat as IBM's overall geographic results were pretty anemic. The America's region grew by 1%

since a year ago, but Europe and Asia/Pacific were both down (4% and 9% respectively). It was the OEM sector that produced the best results, rising 34% in the period.

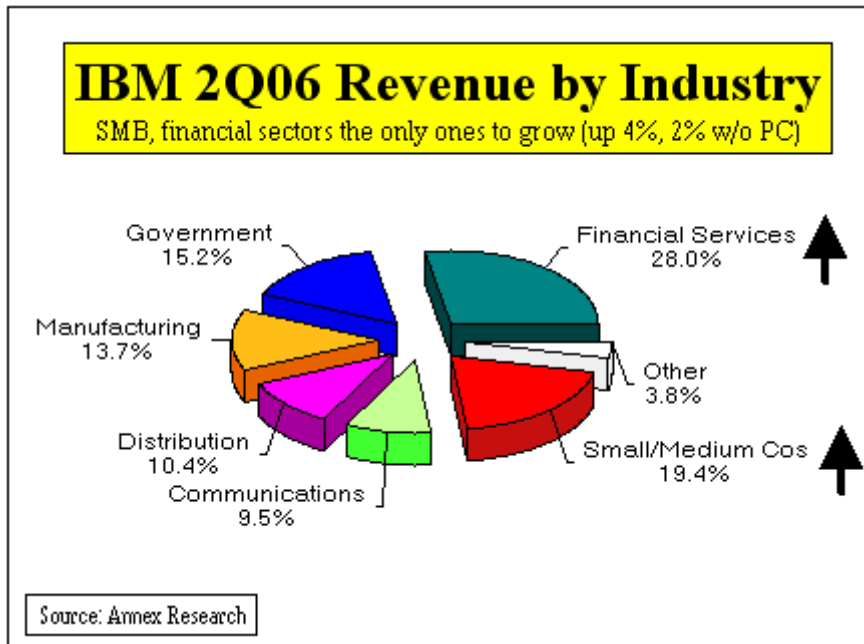


Major emerging markets continue to be sources of strength in IBM financial results. Three of the four reported double-digit growth, with India and Russia leading the way. The only decline was in China, but that's compared to a quarter a year ago in which IBM closed some major banking deals in that country.



Meanwhile, Brazil, the largest of the four IBM operations, had a 14% jump in the quarter as reported, or 4% when adjusted for currency.

Industries. Small and medium business (SMB) and financial services were the best IBM industry sectors in the second quarter. Their revenues rose 4% and 2% respectively. The rest of the sectors declined.



Outlook

Loughridge acknowledged disappointment in services contract signings. But he was encouraged about the future demand.

"Clearly there's enough opportunity," he said of the services' sales outlook. "We just need to get it signed."

The IBM CFO admitted that the services and hardware divisions "didn't perform to our expectation" in the quarter. But he hailed the software results as a good example of IBM's multi-dimensional portfolio. When one side of the business underperforms, another is there to pick up the slack.

"The strength and breadth of the IBM model comes from being able to leverage across these two dimensions," he said.

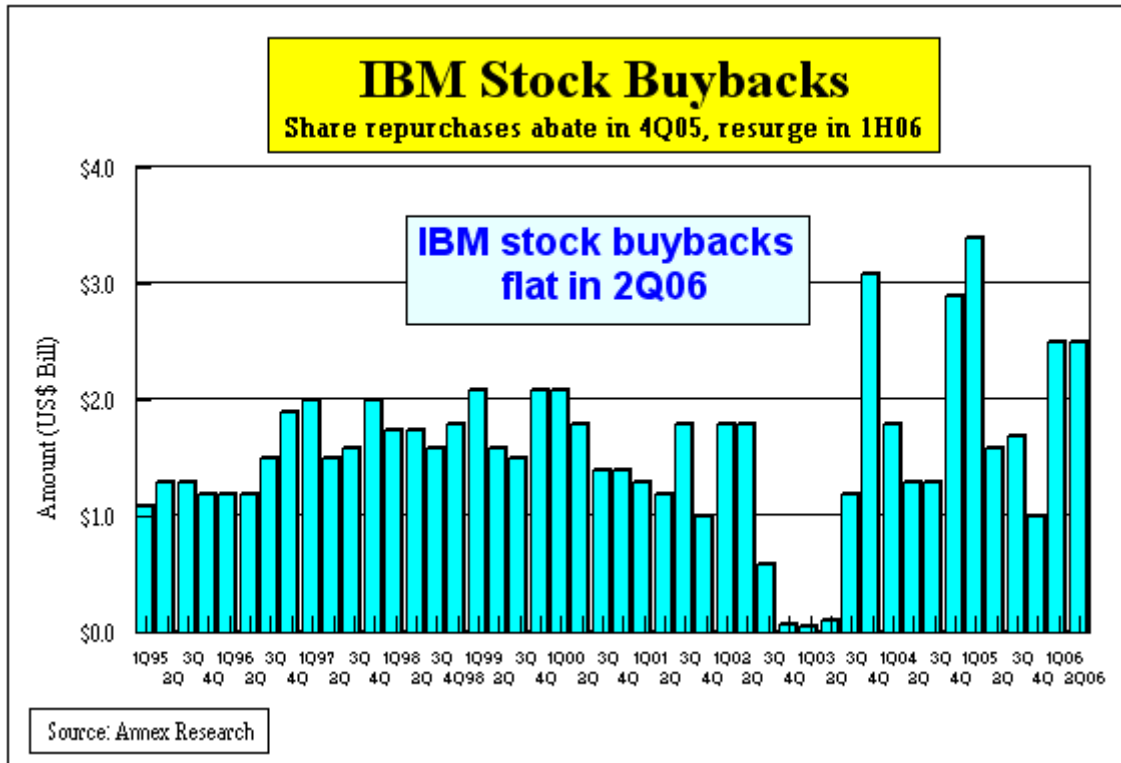
It is for that reason that Loughridge confirmed his and IBM's belief that the company would be able to deliver the 2006 results in line with Wall Street's expectations. Which means revenues of about \$90 billion, and EPS of about \$6.

So stand by for additional stock price hikes tomorrow, as broader markets digest and act upon this news.

For detailed tables, click on [IBM 2Q06 P&L](#) and [2Q06 Pretax](#)

Happy bargain hunting

Bob Djurdjevic




[Click here for PDF \(print\) version](#)



For additional Annex Research reports, check out... [Annex Bulletin Index 2006](#) (including all prior years' indexes)



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

Volume XXII, Annex Bulletin 2006-28
July 18, 2006