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### *Analysis of IBM Third Quarter Business Results*

# A Slam Dunk Quarter

## *IBM Revenue and Profit Soar, Led by Software, Mainframe Resurgence and Japan Recovery*

SHANGHAI, China, Oct 18 (Oct 17 EDT) - Big Blue's third quarter was a slam dunk in basketball jargon. Led by a software and mainframe resurgence, IBM net profit surged by 47% since a year ago to \$2.2 billion, while revenues rose 5% to \$22.6 billion. Both exceeded Wall Street expectations.

This was also the first quarter in which the "real new IBM" is showing, without the PC/Lenovo comparisons. And what we are seeing is a company bursting at the seams now that it is free of the PC boat anchor. The mainframe revival is especially impressive, as is the software sales, especially that of Websphere and other key brands. Both mainframe and software are even more important to the bottom line than to top line contributions. And both are synergetic as a sale of one pulls the other.

No surprise there. A year and a half ago, we predicted an upcoming mainframe resurgence in a whitepaper titled "[Poughkeepsie Spring.](#)" The latest IBM results show that what you sow in springtime, you harvest in the fall, even it takes a year or longer for some fruit to ripen (pineapples, for example, have a two-year gestation period).

"We had a great quarter... our performance was very strong," IBM CFO, Mark Loughridge, said in a post-earnings call with Wall Street analysts, echoing IBM CEO Sam Palmisano's comments in a statement. Palmisano credited "excellent execution and the repositioning of IBM's business model" for the strong third quarter results.

## **Key Software Brands Soar**

The Websphere and Tivoli (software brands) performance was nothing short of spectacular, each soaring by 30% and 44% respectively in the quarter compared to the year ago revenues. The five key IBM brands grew by 20% in the aggregate, while software revenues as a whole were up 9% year-over-year to \$4.4 billion.

No wonder IBM CFO, Mark Loughridge, led off with software results this quarter, the first time this has happened in the history of IBM quarterly calls. "Software was our largest profit contributor," Loughridge said. "We've been investing heavily in our software business for some time. Our performance in 2006 underscores that this strategy is working."

Actually, software has been IBM's largest profit contributor for some time now. But the fact that Big Blue chose to underscore that in its third quarter report card is worthy of note.

As we file this report from Shanghai, China, we can also add that Websphere, Tivoli and Lotus are becoming a defacto standard in web-based applications design, based on our discussions with IT customers and independent software vendors in Japan and China. That includes many of the small and medium size companies, and not just the major enterprises that have been the IBM mainstay for decades.

The reawakening of demand Europe is also encouraging after several quarters of relative hibernation, as is the recovery in Japan, IBM's biggest Asia/Pacific market that accounts for about half of this region's revenues. European revenues were up 6% (up 2% in local currency), while Asia/Pacific business grew 4% (up 6% in local currency).

## **Stock Sets New High in After-Hours Trading**



It took several Big Blue salvos fired over the Wall Street bow to finally get the investors' attention. We've been saying for over six months now that the IBM stock is grossly undervalued. And it looks like Wall Street is finally getting it. Big Blue shares soared more than 5.5 points in after hours trading this evening (East Coast time) to \$92, a new 52-week high. Chances are that, when the stock market opens for regular trading tomorrow, [Big Blue's latest results might just be the spark that pushes the Dow past the 12,000-point mark.](#)

## Business Segment Analysis

**Hardware.** Besides the mainframe and software resurgence, which stole the limelight in this quarter, IBM hardware as a whole also turned in a strong performance. Systems and Technology Group's revenues were up 10% to \$5.5 billion (up 8% in constant currency). System p (Unix), storage and Microelectronics revenues each grew in double digits (10%, 12% and 29% respectively), as did the sales of retail (Point of Sale) solutions (up 18%). IBM System x blade performance was also impressive, rising 24% in the quarter.

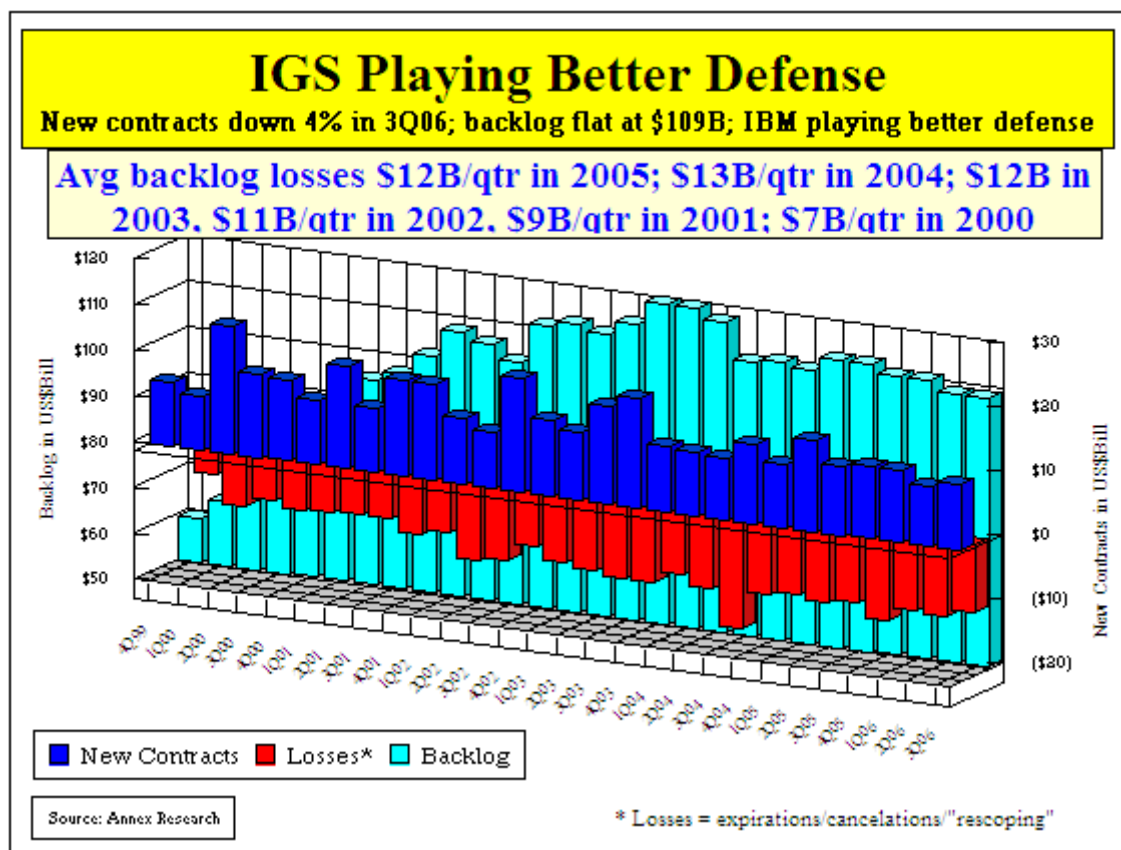
"IBM is now the number one Unix vendor in the world," IBM CFO Loughridge boasted during the conference call.

But the System i and Engineering & Technical Services (E&TS) business declined 22% and 23% respectively. The reason in each case is what IBM calls "a difficult compare." Both product lines had outstanding results in the third quarter of last year. The System i 3Q05 revenues were up 25%, for example, bolstered by several big orders, such as the Russian Pension Fund, for example. Since such deals are hard to come by very often, one year's gain becomes next year's bane.

**Services.** IBM Global Services (IGS), the company's biggest unit, was a relative disappointment, though even here there were signs of improvement. Revenues were up only 3% (up 2% in constant currency), but that's a turnaround relative to the declines this unit has experienced in several recent quarters. More importantly for the IBM bottom line, the profit margins improved by more than a point (from 27.8% to 29%).

"We made a lot of progress on the profitability of IGS... and are working on the top line," Loughridge told the analysts. But he admitted that the long-term signings fell "short of expectations," as IGS continues to have trouble closing big deals and growing its new contract sales.

"We fully expected to grow our signings more. We just didn't get the deals closed," he added, noting that the current quarter's signings should benefit from the delay.



In the latest period, new signings were \$10.5 billion, down 4% from \$11 billion a year ago. That's the bad news. The good news is that the company is playing better defense. Cancellations, expirations and 'rescoping' are down, helping keep the backlog stable at \$109 billion.

There has been "a very modest level of (backlog) erosion," Loughridge said during the post-earnings Q&A with analysts.

Since IGS now reports its results in two segments - Global Technical Services (GTS) and Global Business Services (GBS) - it is worthy to note that its outsourcing arm had a slightly better quarter than the consulting operation. GTS revenues were up by 3% to \$8.1 billion, while GBS business grew by 1% to \$4 billion.

Within GTS, strategic outsourcing grew by 6% while systems integration work declined by 2%. The GBS profit margins jumped by 2.6 points while those at GTS declined by a little less than point.

**Geographies.** As noted earlier, both Europe and Japan improved their performances in the latest quarter. All major European countries reported revenue growth with exception of Germany. And the IBM emerging countries continue to grow in double digits (up 19% in the quarter).

India again posted the strongest growth, up 37%; China grew 27%, and Brazil grew 13%. Russia declined 7%, again mostly due to the "difficult compare" (a strong quarter a year ago).

**Cash Flow.** When a company boosts its profits by as much as IBM has, a natural consequence is improved cash flow. Big Blue's year-to-date net cash from Operations, excluding the year-to-year change in Global Financing receivables, was \$7.3 billion, an increase of \$2 billion from last year.

Excluding the pension funding activity in the U.S. and U.K. from both years, IBM generated over \$1.3 billion more cash from operations year-to-year. Such a strong cash flow performance is another proof point that this "new IBM" is putting quality over quantity in its business strategy and execution.

## Summary

As a result of the better-than-expected third quarter results, IBM raised its outlook for the full year earnings by 10 cents per share. IBM's Loughridge said the company was confident it will be able to deliver double-digit earnings growth over the long-term. And Wall Street seems to be finally paying attention.

It was about time... better late than never.

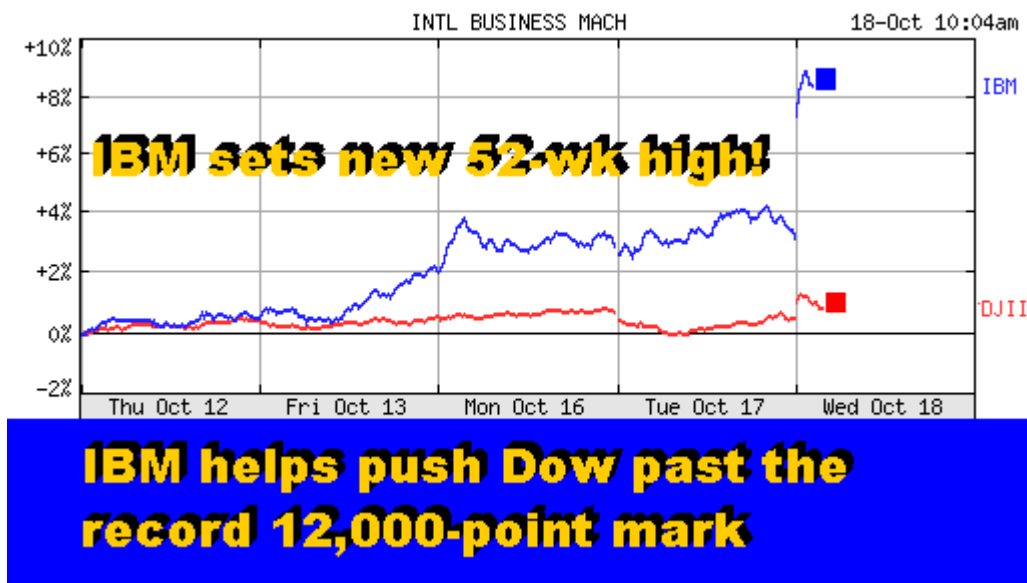
*Happy bargain hunting!*

*Bob Djurdjevic*

## IBM Helps Dow Surpass 12,000

### History in the Making

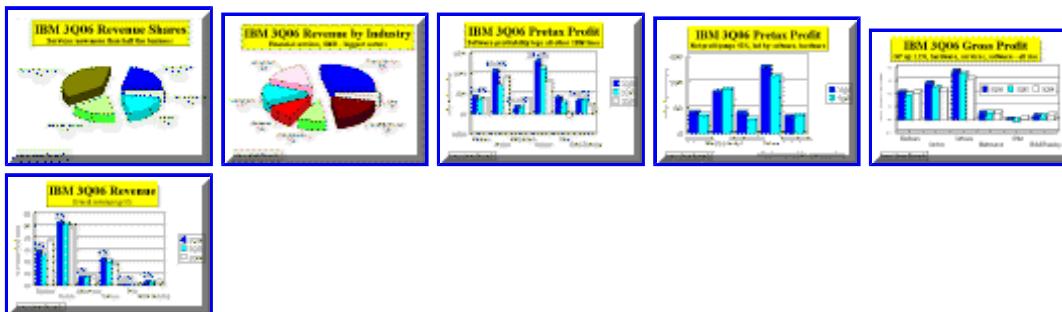
SHANGHAI, China, Oct 19 - As predicted last night (New York time, Oct 17), IBM's stellar third quarter results helped push the Dow Jones industrials past the 12,000-mark for the first time in history (12,049.51 in early morning trading on Oct 18).



"The Dow's quick move past 12,000 Wednesday came after a Labor Department report indicated consumer price pressures are leveling off, and third-quarter earnings reports from companies including IBM bolstered investors' confidence," the [Associated Press reported today](#).

## IBM 3Q06 Detailed Charts & Tables

SCOTTSDALE, Nov 12 - Here are the detailed IBM 3Q06 revenue and profit charts and tables...




For detailed tables, click on [IBM 3Q06 P&L](#) and [3Q06 Pretax](#)

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