

ANNEX BULLETIN

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Updated 1/21/07, 11:30AM PDT; adds [New SMB Division](#)

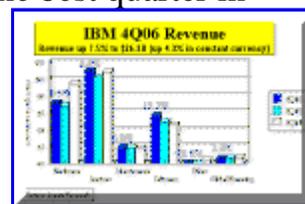
Analysis of IBM's Fourth Quarter Business Results

IBM Shatters Records

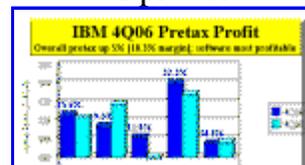
Latest Quarter Sets New High Water Marks; Yet Stock Drops

IBM Lowers Its Center of Gravity, Forms New SMB Division

SCOTTSDALE, Jan 18 - The fourth quarter of 2006 was the best quarter in IBM's 81-year history. Everybody said it would be a tough compare this year. And it was. So how did Big Blue do in the latest quarter? It smashed its old records. The fourth quarter of 2006 is now its new high water mark. The company exceeded its own and Wall Street's expectations.



Software, IBM's most profitable unit (accounting for about 40% of pretax profit), grew 15% in the quarter, the best growth rate in five years. That's due in part to its acquisition strategy (11 of 14 IBM acquisitions in 2006 were software companies; the 14 acquisitions totaled \$3.8 billion, up



from \$2.3 billion year-to-year). Big Blue's five middleware brands - Websphere, IM, Tivoli and Lotus - all grew even faster than the total software segment (up 22%, 28%, 25% and 30% respectively), and up 25% in the brand aggregate.

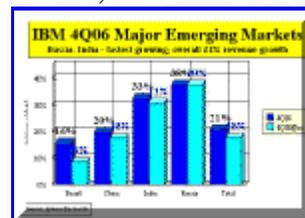
The five brands are becoming defacto standards in independent software vendors (ISV) application portfolios, as we reported earlier from this writer's trips to Japan, China, Russia and Ukraine (see "[IBM: A Slam Dunk Quarter](#)," Oct 2006). They now represent 56% of IBM software revenues.

The IBM Global Services (IGS), a growth laggard in the last several years, had a gangbuster quarter. Revenues were up a respectable 6.4% to \$12.8 billion, and its profitability jumped half a point to a 27.9% gross margin. But the most impressive statistics was its 55% jump in new contract signings to \$17.8 billion - the best quarter since 4Q02 when IGS closed \$18.1 in new business. As a result, the backlog was also up \$5 billion since a year ago to \$116 billion.

IBM hardware lines also had a tough compare, yet most of them managed to grow in single digits. The System z (mainframe) had its best quarter on record in terms of MIPS shipments (mainframe capacity). And the company's overall gross profit rose to 44.6% after IBM jettisoned its PC business in 2005.



The emerging countries, led by a 38% surge in Russia's business, were the real growth engine for Big Blue. They led all IBM geographic segments with a 21% revenue spurt (18% in constant currency), both for the fourth quarter and for the full year (for details - click on thumbnail image to enlarge).



"These four countries (Brazil, China, India and Russia) contributed \$4.5 billion of revenue," said Mark Loughridge, IBM CFO, during the post-earnings teleconference with analysts. "We continue to invest to build capabilities in these countries, to address the fast-growing domestic market opportunities," he added.

At the bottom line, IBM net profit was up 11% to \$3.5 billion, or \$2.26 a share, beating the estimates of Wall Street analysts who expected earnings of \$2.19 a share.

Net cash provided from operations, excluding the year-to-year change in Global Financing receivables, was \$15.3 billion - an increase of \$2.2 billion from last year. IBM returned a record \$9.8 billion to shareholders this year, an increase of almost \$800 million year-to-year.

No wonder IBM chairman and CEO, Sam Palmisano, gloated in his statement that accompanied the earnings release. He said IBM had "a terrific quarter and a good year with record cash performance, profit and EPS, as well as record payouts to shareholders."

Wall Street Shrugs Off Stellar Results



Despite such stellar results, and the fact that they exceeded Wall Street expectations at both the top and bottom lines, the IBM stock sagged nearly five points in after-hours trading following the release of its fourth quarter results.

Guess Big Blue could take some small measure of comfort from Apple Inc., which also reported solid business results last night, but was killed by Wall Street traders today. Unlike IBM, however, Apple did miss some forecast numbers, even though its Mac shipments increased 28% to 1.61 million machines last quarter, and iPod shipments grew 50% this quarter to a record 22.1 million units. Apple's profit in the period surged 78% to \$1 billion, or \$1.14 a share, exceeding the 78 cents analysts' forecast. Apple's sales topped \$7 billion for the first time, rising 24% to \$7.12 billion in the period ended Dec. 30. And so on...

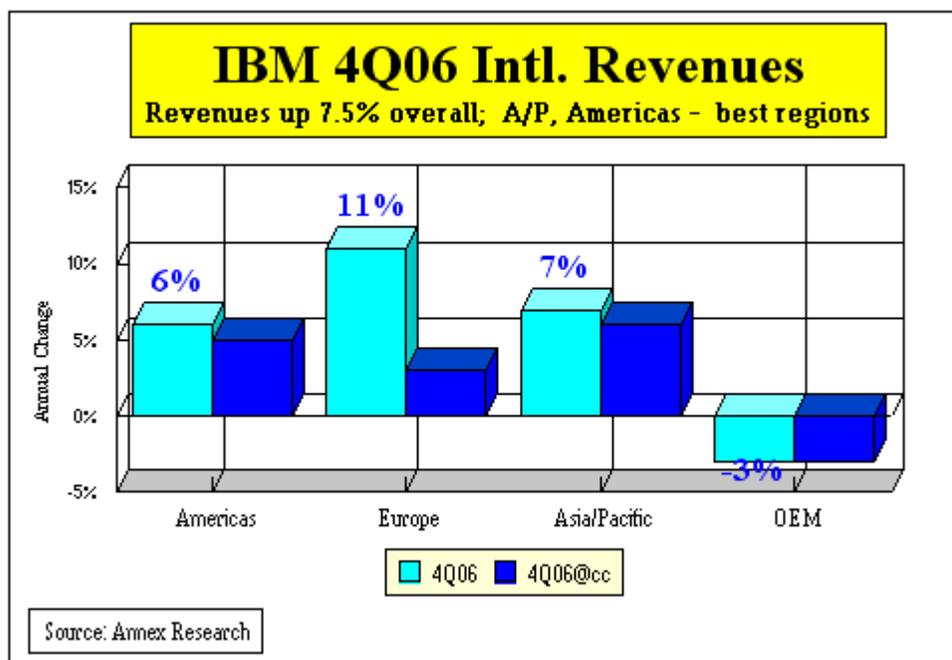
Yet the Apple stock dropped over 5% today after all was said and done. Ditto re. Big Blue shares this evening. Sometimes, you just can't win on Wall Street, can you?



No amount of good news seemed enough to offset the bearish mood about tech stocks set off by Intel's disappointing earnings report two days ago. Just as a rising tide lifts most boats on Wall Street, so does the ebb tide drop them. So January 18 may be the first day of the traditional first quarter blues (see the chart). Before common sense and logic return, and quality stocks like IBM start to win back investors who value such companies.

Business Segment Analysis

Geographies. The Americas and Asia/Pacific were the best performing geographic regions for IBM in the fourth quarter. Each grew by 5% in constant currency, although the A/P outgrew the Americas by 7%-to-6% as reported.



Europe, on the other hand, whose currencies have strengthened the most against the U.S. dollar, was up 11% as reported, but only 3% in constant currency. The OEM revenues were down 3 percent compared with the 2005 fourth quarter.

For the full year, the Americas region grew by 4%, Europe and A/P were up 2% - adjusting for currency and PCs in all cases. The OEM revenues were up 18% last year compared to 2005.

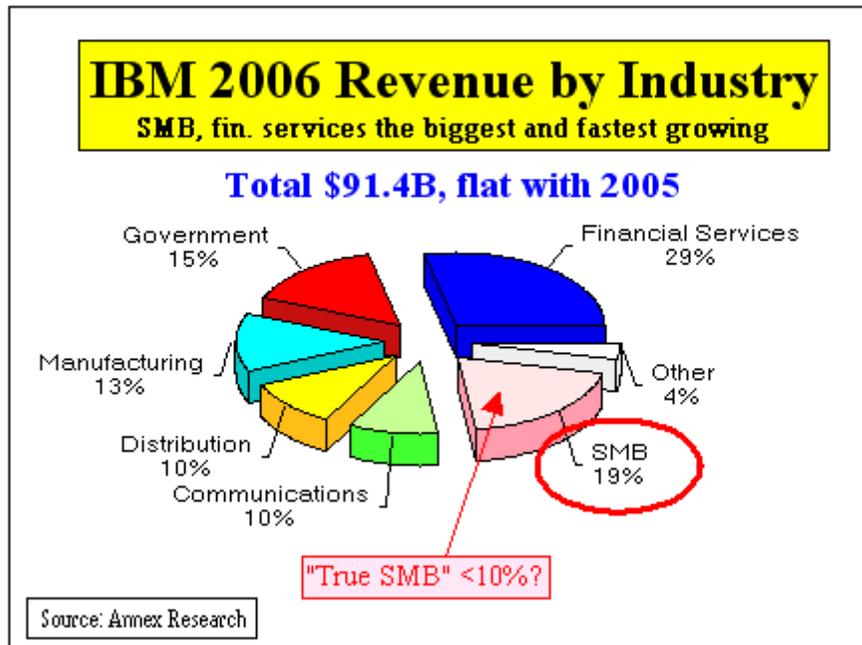
Industries. Small and medium business (SMB) and distribution were IBM's best industry segments in the fourth quarter. Each rose by 11%.



The financial sector, by far the company's largest (\$7.5 billion - see the chart), also grew in double digits (up 10%). But the \$3.8 billion government business was flat (down 3% in constant currency), while manufacturing and communications grew in single digits.



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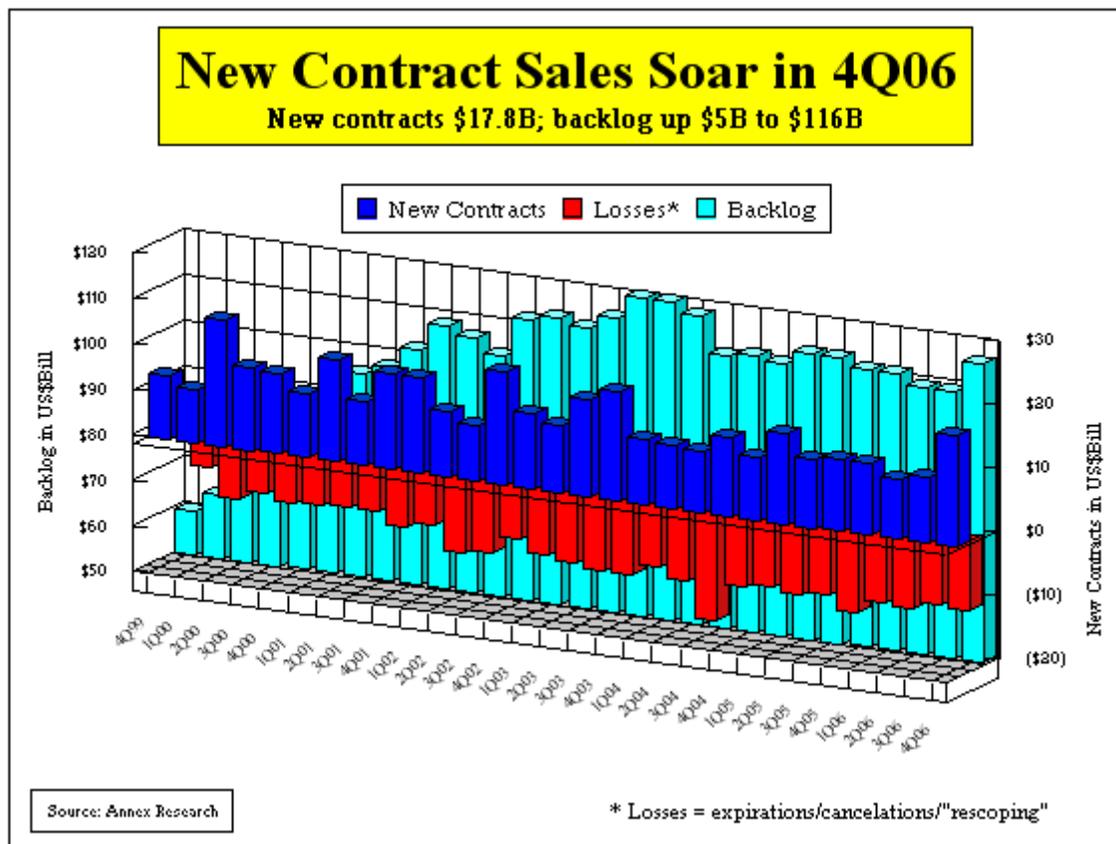
The SMB 4Q06 growth rate of 11%, and its total full year revenues (\$17 billion), are both better than most IBM businesses. But they are not nearly as good as they can be, if IBM were to exploit the full SMB opportunities, especially in emerging markets. That's another conclusion to which we arrived following our meetings with customers and ISVs in China and Russia, for example, among some developing countries.

Local companies are growing by leaps and bounds (30% to 50% annually) in those markets, and are looking for an IT vendor that's going to provide them the

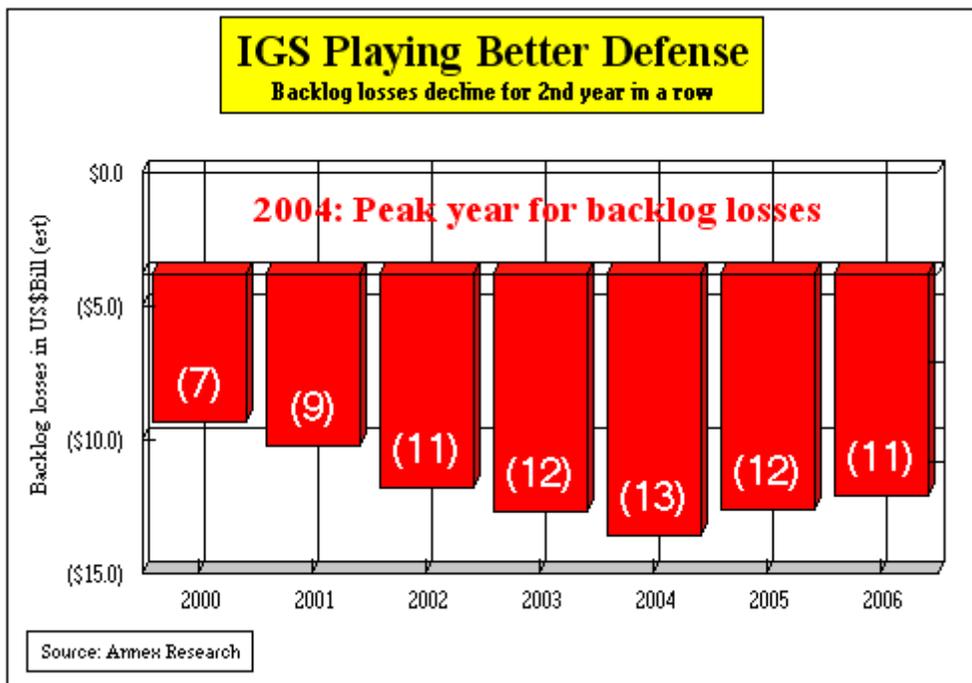
scalability they need for such growth. And scalability, along with IBM's three-tier architecture, happens to be Big Blue's sweet spot.

So if IBM continues to "invest to build capabilities in these countries" in the future, as IBM CFO has said about the past, and if the company does so by focusing on the SMB market segment, nothing but goodness will follow - both up and down its financial statements.

Services. As previously noted, at a first glance, the most impressive part of IBM Global Services' fourth quarter results was the 55% surge in new business contracts to \$17.8 billion. Why "at a first glance?" Because a large portion of that number of comprised of "megadeals" (deals bigger than \$100 million). IGS had 14 such deals in the fourth quarter. And as we've noted many times before, and as EDS shareholders, for example, are painfully aware, such deals have a way of turning the signing day euphoria into a rainy day nightmare.



Time will tell, of course, but experience teaches us that many megadeals could be a reason to fret, not to rejoice. To us, the more impressive number was the 1.5 point increase in IGS gross profit margins (to 27.5%). Alas, that was before the latest surge in megadeals. Unless IGS has some "miracle cures" for megadeals up its sleeve, that will be probably the IBM services profitability peak for some time to come.



Another impressive (implied) figure that emerges from the IGS numbers is its improved defense. For a second year in a row, the IBM services arm has lost less business from its backlog than the year before (\$11 billion per quarter in 2006). Which means that the company gets to keep more business it closes than before. No wonder the backlog surged by \$5 billion in 2006 to \$116 billion, the highest it has been since 4Q04.

For all of 2006, IGS closed \$49.3 billion in new business, up 5% from 2005, but down 11% from 2003, its best year for new business wins (\$55.4 billion).

Also for the full year, revenues from the Global Technology Services (GTS - outsourcing) segment totaled \$32.3 billion, an increase of 3% (up 2% in constant currency). The Global Business Services (GBS - consulting) business was \$16.0 billion, flat with 4Q05 (up 1% in constant currency).

Hardware. Besides the System z's impressive surge in mainframe computing power that we mentioned earlier, its revenues increased by 5% in the quarter. Revenues from the System p (UNIX) server products increased 4% in the quarter, while the System x (Intel-based) servers grew by 7%. The storage revenues increased 9%, ending up at the pole of the STG product lineup.

On the downside, revenues from the System i (a.k.a. iSeries; AS/400) servers decreased 10% in the quarter, and Microelectronics' business shrank 6%.

For the full year, STG revenues were \$22.0 billion, an increase of 5% (4% adjusting for currency).

Software. Apart from the quarterly software highlights that we've already cited at the top of this story, what may be worthy of note is that for the full year, software revenues were \$18.2 billion, an increase of 8% (7% in constant currency). And that, despite all the acquisitions, its enviable gross margins improved a little from a year ago (to 85.2% from 84.9%).

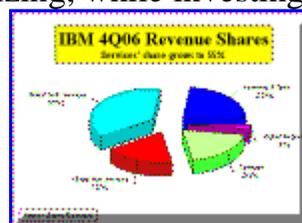
"We have been investing heavily in our software business for some time, both internally and through our targeted acquisitions," IBM's Loughridge noted. "This quarter's strong results reflect those investments."

Indeed, the fourth quarter gross margins were higher than the full year's (86.5% vs. 85.2%).

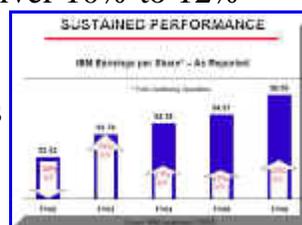
Summary

Nearly five years ago, Sam Palmisano was named IBM CEO. His first full year of independent leadership was 2003. Since that time, he has been steadily transforming Big Blue on the basis of emphasizing quality over quantity (see ["Steady As She Goes,"](#) Apr 2006).

IBM has been "divesting of businesses that are commoditizing, while investing in targeted acquisitions to build capabilities in higher value areas," Loughridge told the analysts this afternoon (also see a ["Tale of Two Blues,"](#) June 2006). "This has lead to a more balanced mix of businesses, and a stronger, more competitive and sustainable global business."



As a result, Wall Street can expect IBM to continue to deliver 10% to 12% earnings per share growth over the long term, he said. Which is a conservative forecast (i.e., it is less than what the company has been doing anyway during the five years of Palmisano's leadership - see the chart).



Notwithstanding the sell-off of the IBM shares this afternoon and evening, it is just a matter of time before Wall Street investors realize that there are not many companies around that offer the predictability of growth and the stability of earnings as IBM has done and should do again this year and beyond. Those who understand the importance of "quality over quantity" will find it in the Big Blue stock.

[Click here](#) for detailed 4Q06 P&L and Pretax statements (for Annex clients only)

Happy bargain hunting!

Bob Djurdjevic

IBM Lowers Its Center of Gravity

New SMB Division Formed within Hardware Group

SCOTTSDALE, Jan 21 – Big Blue has just lowered its center of gravity. A new SMB division was formed Friday (Jan 19) within IBM’s hardware unit (STG). It will have the sole mission of developing and growing the small and medium size business (SMB) market.

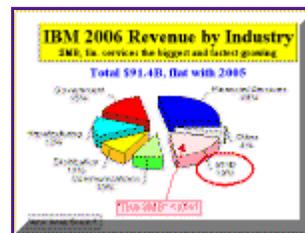
“Its mandate is *integration* and *simplicity*,” said Bill Zeitler, IBM’s hardware boss who named Marc Dupaquier, former vice president of marketing in IBM Software Group, to head up the new division. And since integration and simplicity are key virtues of the IBM System i (a.k.a. iSeries; a.k.a. AS/400), that product line will anchor the new SMB operation (also see [“An iSeries Revival”](#) 2005).



Although treated as a fairly low-key event, IBM's Friday announcement is an important strategic move for Big Blue. For, it means that IBM is putting its money where its mouth was (when its executives talked about the importance of SMB). And it's sort of a trip back to the future...

The company last restructured itself along customer sizes over 30 years ago (in 1975). That's when IBM formed GBG (General Business Group), which consisted of GSD – General Systems Division, and OPD – Office Products Division. Both GSD and OPD had their own product lines that catered to small and medium size businesses. The S/3 successors – S/38 at the high end, and S/32 and S/34 at the low end – were at the core of the GSD product line. The AS/400, announced in 1988, extended IBM’s journey through the SMB market.

Big Blue’s SMB odyssey started in 1969 with the introduction of the S/3. The fact that 38 years later SMB still accounts for only a tiny fraction of IBM’s business (19% - see the chart; or less than 10% depending on the definition of SMB), is a likely reason for the company’s decision to focus more on it by forming a new dedicated SMB unit (also see [IBM Seedlings: SMB](#), Nov 2006).



Over time, Zeitler expects the new division to develop its own suite of SMB products. Other IBM units, such as software, for example, are will contribute their own resources and SMB-related solutions to it, according to Mike Borman, the head of IBM worldwide software sales.

As we said back in November, "[From Little Acorns Mighty Oaks Grow.](#)" And SMB, one of the promising seedlings, has just been promoted to a tree in the Big Blue garden.

Also see...

[Analysis of IBM's iSeries product enhancements \(Jan 31, 2006\)](#)

[Annex Research analysis of IBM hardware businesses \(Nov 15, 2005\)](#)

[Annex Research analysis of IBM midrange servers \(Mar 30, 2005\)](#)

[An iSeries Revival \(iWhitepaper \(Feb 2005\)](#)

[Annex Research analysis of IBM servers \(Nov 22, 2004\)](#)

[Annex Bulletin - 96-32 \("Renaissance II" - Eastern Europe, 1996\)](#)

[Annex Bulletin - 96-19 - Break Up IBM! \(Mar. 20, 1996\)](#)

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Bob Djurdjevic, Editor
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