

ANNEX BULLETIN

Annex Bulletin 2007-28

July 18, 2007

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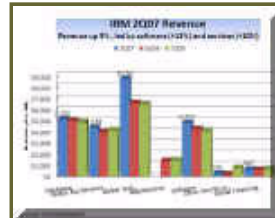
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MUMBAI, India, July 19 (July 18 PDT) - Sam Palmisano has finally gotten the growth monkey off his back. The second quarter 2007 revenues showed the best growth in IBM CEO's five-year tenure at the helm. After years of trying to rev up its top line, Big Blue has finally done it. It removed the bane of slow growth from its critics' agenda. Revenues were up 9% to \$23.8 billion, with IBM's biggest and most profitable business segments growing in double digits. Earnings per share grew even faster, rising 15% from a year ago.



IBM's CFO, Mark Loughridge, sounded like a football coach who won the Super Bowl and then showed up for a post-game press conference.



"This was really a great quarter," said Loughridge in conclusion of an hour-long teleconference with analysts. "Every CFO waits for a quarter like this."

More jubilant than boastful, Loughridge sounded proud of his team achievements, even congratulating the Big Blue U.S. team as the "most improved" part of the company at one point of the teleconference.

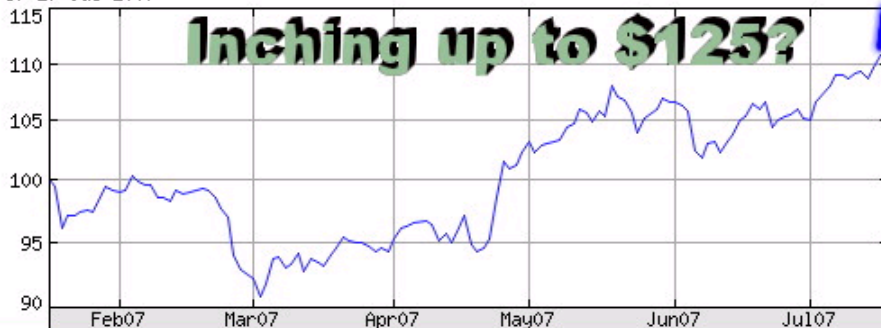
Sure, there were some minor weaknesses in the latest quarterly, but they pale in comparison to the strength that IBM's major engines of showed. One would have to look hard and be really nitpicky to find them. Which we will do in a moment. But first,

the big picture...

Gathering Momentum

It takes a long time to turn a huge ship around and gather up speed. Now that IBM has done it and has the growth momentum, it is likely to carry it forward for some time to come. And that has got to bode well for its stock as well. After-hour traders recognized that, as they pushed Big Blue shares up four points to about \$115.

INTL BUSINESS MACHINES
as of 17-Jul-2007



Strong 2Q lifts IBM stock after-hours to new multi-year highs (\$115)

Ever since a year ago, when the IBM shares were trading at about \$74 per share, we have been saying that the IBM stock was grossly undervalued (see "[Grossly Undervalued](#)," July 2006). We have restated that last fall (see "[A \\$125 Stock](#)," Nov 2006), and again this past April (see "[IBM Stock Still Grossly Undervalued](#)," Apr 2007). Well, it appears that the market is finally getting the message. The IBM shares have climbed a long way from \$74 toward that \$125-mark, at which we think the company may be fairly valued relative to its competitors' shares.

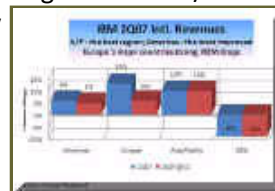
Shareholders may be also encouraged seeing that the earnings' growth was actually faster than the revenue increase (net was up 15%), and that the free cash flow surged by \$1.7 billion since a year ago.

As a result, IBM lifted its year-end 2007 revenue forecast by a point to 14% to 15%.

Strong Overseas Performance

Geographies. Strength in overseas market topped the slower U.S. growth. Asia/Pacific again had the best performance with 10 percent growth, led by India, Southeast Asia and a steady recovery in Japan.

Still, at a 6% revenue increase, the largest IBM geographic region (Americas at \$10.1 billion) now also has a bounce to its walk.



IBM revenue in Europe rose 13% to \$8.2 billion, while sales in the Asia/Pacific region rose 10% to \$4.6 billion. Most major countries performed well, including Spain, the UK,

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and Italy.

Emerging Markets. The company's overall growth was underpinned by soaring sales in emerging markets (up 32%; up 25% at constant currency). Among the four BRIC countries (Brazil, Russia, India, China, Russia), Russia took the pole position in this quarter with a 52% revenue jump. India and China were also strong, rising 34% and 45% respectively. Brazil was up 21%.



These countries now represent five of IBM's revenue and contribute one point of growth to IBM's total. IBM CFO Loughridge said the company's objective is to double the revenue growth from these countries over the next four years.



Rapid growth and seemingly unbounded optimism were also evident in this writer's discussions with local customers and IT companies here in India. IT is the bursting at the seams in this land of a billion people and has become the talk of the town. Which means that the country that was once blamed for taking away American jobs, such as during the 2004 presidential campaign, for example, is now being celebrated as one of the global growth pillars for U.S.-based multinationals. (The photo shows the financial district in Mumbai, India).

As if to underscore this point, Loughridge said, "we are beating the local (Indian) competition on their own turf." IBM is now the largest IT services provider in India, he added, citing an independent research source.

Business Segment Analysis

As we have also pointed out before, it was just a matter of time before the stock market gave IBM credit for its improved fundamentals, and for Palmisano's stressing quality over quantity in his business strategy (see "[Quality over Quantity](#)", Mar 2005 and "[IBM 5-Yr Forecast: Steady As She Goes](#)", Apr 2006). Nowhere is that more apparent than in Big Blue's software business.

Software. IBM's most profitable part of the business - software - generated double digit growth (up 13%) in the quarter. With three of its major brands growing in the 20%-plus range, the company is cleaning up at the top of its middleware portfolio. Websphere revenue was up 28%, Tivoli was up 33%, Information Management up 21%. Lotus and Rational also grew in low double digits.



In the aggregate, all five major brands surged by 23%. As these five key brands now represent more than half (53%) of IBM's software business, they have become the driving force behind the company's growth in profits and revenues.

Services. Finally, there is something to cheer about in IBM's biggest business segment - IBM Global Services (IGS). Investors will also be buoyed by the fact that even this relative growth laggard in recent years also grew in double digits (up 10%) in the latest quarter. Both Global Technology Services (GTS) and Global Business Services (GBS) contributed to that growth, making it a balanced performance.



results) [[Annex clients click here](#)]

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[EDS: On Sunny Side of Street](#) (Analysis of EDS' fourth quarter business results)

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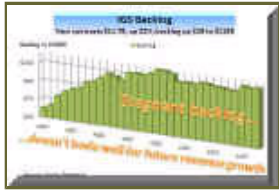
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The future also looks bright, as the company closed \$11.7 billion in new contract signings in the second quarter, up 22% from a year ago. But this is also an area in which we saw one of the few blemishes in the company's latest quarterly results.

IBM CFO boasted that, "the best customer is the one you've already got," proudly pointing out the fact that most of the new business has come from existing customers. But we find that a little troubling, especially considering IGS' relatively stagnant backlog (left chart). Most successful businesses grow from the bottom. That means winning new customers in addition to expanding the existing relationships. The fact that IGS has been going back to the same old large company trough from which it has been feeding for years suggests that the small and medium (SMB) portion of its business isn't doing so well.



Industries. This concern seems to be also supported by the tepid growth that the IBM SMB segment showed overall. It was only fourth in terms of growth out of the six vertical segments that IBM reports (see the chart).



If the company is sustain its growth momentum over a longer time frame, it will have to start winning new logos, both in the services business and overall. And that's where SMB comes in, one of the Big Blue seedlings we talked about last fall (see "[IBM: From Little Acorns Mighty Oaks Grow](#)," Nov 2006).

Hardware. Hardware was the only relatively weak part of the second quarter results. Its total revenues of \$5.1 billion were up 2% from a year ago (flat, adjusting for currency). The weakness was mostly due to a decline in its chip business and gaming consoles. But hardware profit grew 77%, adding 2.6 points to the gross margin.

The System p (UNIX) server revenues rose 7%, while the System x servers jumped 16%. Revenues from System z server products increased 4%, while the System i servers declined 15%. Overall, IBM systems business was up 7%.

Mainframe strength continued for the fifth consecutive quarter. Revenues were up for the fifth consecutive quarter, while the System z MIPS shipments were up 45%, for the eighth consecutive quarter.

"If you look at the MIPS on specialty engines they grew over 130%, reflecting the mainframe's ability to virtualize and consolidate different workloads," Loughridge said. "Linux MIPS grew over 80 percent, Java and Database MIPS each grew over 100 percent."

Storage revenues rose 6%, while Microelectronics business, which includes the gaming consoles, decreased 9%. But as IBM pointed out, this business accounts for only 1% of its gross profit.

Humongous Stock Buybacks

IBM's stock buybacks went from huge to humongous in the second quarter. At \$14.6 billion, they dwarfed all other quarters in the 12-year history of this dubious squandering



[IBM: A \\$125-Stock? \(An update to "From Small Acorns Mighty Oaks Grow"\)](#)

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[Capgemini: By Leaps and Bounds \(Analysis of Capgemini's preliminary third quarter business results\)](#)

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[IBM: A Slam Dunk Quarter \(Analysis of IBM third quarter business results\)](#)

[Accenture's Emphatic Year-end Accents \(Analysis of Accenture's fourth quarter results\) \[Annex clients click here\]](#)

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[Stock Buybacks: A Fading Fad \(Dell, erstwhile "King of Fluff," suspends its stock buybacks\)](#)

[Capgemini: Growth Continues \(Revenues, net](#)

of capital, including the highest previous quarter (1Q07) - by more than three-fold (left chart). In the aggregate, IBM has now spent about \$94 billion on share repurchases.

Since the latest round of stock buybacks included \$12.5 billion executed through share repurchase agreements in May that involved taking out loans to finance them, IBM's debt has now jumped by 53%, from \$22.7 billion to \$34.7 billion (right chart).

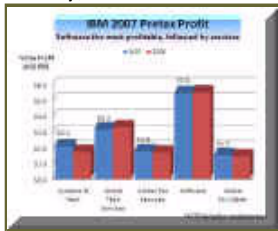


At the same time, its shareholders' equity slumped by 41%, from \$28.5 billion at the end of 2006, to \$16.8 billion as of June 30. Add to it that what IBM did was sort of shady or clever, take your pick (the IRS closed the tax loophole IBM used to pull off this scheme in early June - see the Wall Street Journal story "[IBM's Under-the-Wire Tax Break](#)", June 7, available by subscription), and you'll see that it's not a pretty picture.

In the complex deal, that the Journal first reported on May 30, IBM created a Netherlands unit to finance the stock repurchase with overseas earnings and avoid having to repatriate funds, which would make them subject to higher U.S. taxes.

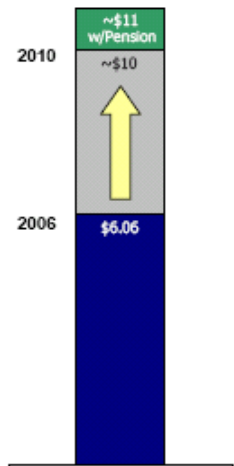
Outlook

As the IBM CFO pointed out, his company seems to be firing on nearly all cylinders. Back in May, he and the IBM CEO Palmisano showed the Wall Street



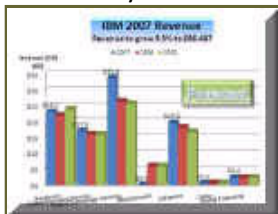
analysts a "roadmap" to an ambitious 2010 earnings per share of \$11, up from \$6.06 last year (see "[BRIC by BRIC... to Top Line Growth](#)," May 2007). Now it appears that the first part of that journey - the 2007 fiscal year - is likely to produce faster than anticipated growth.

IBM EPS



Source: IBM/Loughridge (7/18/07)

IBM said it earned \$2.26 billion, or \$1.55 a share in the second quarter, on revenues of \$23.8 billion. The results topped Wall Street analyst estimates, who forecast IBM to earn \$1.47 a share on \$23.1 billion in revenue.



So the better-than-expected second quarter revenue and profit was Big Blue's first step toward achieving its lofty 2010 EPS goal (see the chart).

"We've made our first installment toward our \$11 per share goal for 2010," said Loughridge in conclusion of his prepared remarks during the teleconference with analysts.

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Happy bargain hunting!

Bob Djurdjevic

profit up in double digits, margins also improve)

[HP Firing on All Cylinders](#)
(Stock sets new multi-year record following excellent third fiscal quarter results)
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[Power of Manpower](#)
(While others move to India, Russia... AMD invests in New York, hailing "phenomenal" quality of its labor force)

[Ebb Tide Lowers Most Boats](#) *(Analysis of EDS' and CSC's latest quarterly results)*

[IBM Stock Grossly Undervalued?](#) *(Analysis of stock market valuations of IBM and its major competitors)* [\[adds latest Fujitsu, Capgemini results\]](#)

[IBM vs. HP: A Tale of Two Blues](#) *(Both companies are doing well in business, but only HP is favored by Wall Street; Big Blue trying to change that now with its new "India Opus")* [\[Annex clients click here\]](#)

[Go East, Young Man!](#) *(A speech delivered in St. Petersburg, Russia, May 25, 2006; click here for slides)*

[IBM 5-Yr Forecast: Steady As She Goes](#) *(Emphasis on quality continued)* [\[Annex clients click here\]](#)

[Octathlon 2006: Accenture Again Wins "Gold!"](#) *(HP gets "Silver," IBM "bronze")* [\[Annex clients click here\]](#)



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