

ANNEX BULLETIN

Annex Bulletin 2007-35

October 12, 2007

A CONFIDENTIAL client edition

IBM CORPORATE

Updated 10/12/07, 4:00PM PDT

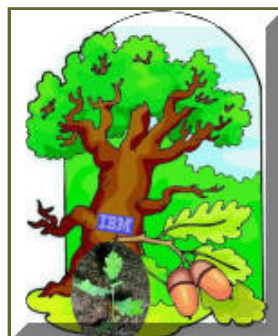
Update to Our 2007 "State of the IBM Union" Analysis

Seedlings Sprouting Stronger Limbs

Innovation Drives Growth; Server Brand Convergence Leads to New Sales & Marketing Model

Big "Green" Initiative Played Right into Our 2006 Garden Analogy

SCOTTSDALE, Oct 12 - Nearly one year ago, we first noted that "[From Little Acorns Mighty Oaks Grow](#)" (see right image). The report was a part of our fall 2006 analysis of the "State of the IBM Union" and Big Blue's growth prospects. And we concluded back then that, "as more Wall Street investors turn their eyes from feeds and speeds to weeds and seeds, more will recognize the growth potential of the new seedlings in the Big Blue garden. As they do, the IBM stock will break out of its multi-year slump and surpass that two-year record."



Well, the IBM stock has certainly done that. It closed yesterday (Oct 10) at \$118.32, up 41% from a year ago, but still a little short of our \$125-target price, that we also set last fall. In the process, the Big Blue shares have also outperformed the Dow, of which they are a part, by more than double the rate of growth (see left chart).

Since that time, IBM's "green" initiative (see "[The Greening of Big Blue](#)", May 2007 and

Recent...

HEADLINE

[Seedlings Sprouting Stronger Limbs - Update to "IBM State of the Union" \[Annex clients click here\]](#)

[An Apple a day keeps bear away \(Analysis of Top 20 IT companies' market, business performances\)](#)

Home

Also check out...

[Index 1993-2007](#)

[Profitable Growth Continues - Analysis of HP's 3Q business result: \[Annex clients click here\]](#)

[zAAP-ed by IBM! \(Analysis: Mainframe demand benefiting from specialty engines, Java\)](#)

[Profitable Growth Continues - Analysis of HP's 3Q business result: \[Annex clients click here\]](#)

[Sun's Solaris to Shine on IBM's Polaris \(IBM to offer Sun's OS on its hardware\)](#)

[The Greening of Big Blue Part 2 \(IBM to save \\$250M in mainframe consolidation\)](#)

[IBM Beats the Street \(Analysis of IBM 2007 business results\)](#)

[Adios, Microsoft Vista! \(How I Failed Twice in Trying to Scale Mt. Vista\)](#)

[Burning the Track - Firing on all cylinders, Accenture raises forecast \[Annex clients click here\]](#)

[New Broom Sweeps](#)

"[The Greening of Big Blue, Part 2](#)," Aug 2007) has played right into our garden analogy from last fall. All we needed to do is change the color of the IBM logo from blue to green. Here's an excerpt:

It used to be a business of speeds and feeds. Now it's more about weeds and seeds. Running a successful IT business these days is not unlike caring for a beautiful garden. It takes a lot of TLC (tender loving care) and creativity. And back-breaking work... planting the seeds for future growth; nurturing them to seedlings; weeding and pruning the excess, thus shaping the design into a "[constant gardener's](#)" vision of beauty.



Sometimes, it can be years before results become discernible. Which takes patience and perseverance. Both are in short supply on Wall Street. But "from little acorns mighty oaks grow." Small seeds sprout into pretty seedlings. As Sam Palmisano's new Big Blue garden is starting to take shape, Wall Street is (finally) taking notice of some seedlings that have grown from seeds planted years ago.

(An excerpt from [Annex Bulletin 2006-41](#), Nov 2007)

So how are the "Big Green" seedlings doing a year later? Are there any new ones that have sprouted since that time? Here's our update to last year's fall "State of the Union" analysis...

IBM "State of the Union" Update

With IBM expected to report its third quarter results next week, we can only use the first half results as the latest indicators. And they were good... very good, in fact. Second quarter 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.

Wall Street also liked it, pushing the IBM shares to about \$115 (see "[IBM Beats the Street](#)," July 2007). That was only three points below the current near-record level, but quite a bit above the August chasm caused by the turbulence in financial credit markets. The crisis dragged down most IT stocks, including IBM's, but did not keep them down, as the subsequent rally lifted the Big Blue shares to nearly a six-year high (\$120, set on Oct 2).



We had a chance to look more closely into the Big Green garden last week at an IBM Systems and Technology Group (STG) conference in Stamford, CT. And what we saw was some last year's seedlings getting stronger and sprouting new limbs, and some new ones also jutting out of the mighty oak (right chart).



New "Go-to-Market" Approach. One of them was a new "go-to-market" approach, "a change from a brand-centric to a customer-centric format," according to Bill Zeitler (right), who heads up the STG, the \$22 billion IBM unit that encompasses all of its hardware businesses.

"It's the most significant change in 15 years," echoed Bob Samson, the head of IBM's worldwide hardware sales



[Clean](#) - Analysis of CSC's 4Q07 business results [[Annex clients click here](#)]

[The Last of the \(PC\) Mohicans](#) - Analysis of Dell's strategy changes. Linux, Wal-Mart

[BRIC by BRIC... to Top Line Growth](#) - Echoes from IBM meeting for analysts [[Annex clients click here](#)]

[Per Ardua Ad Astra](#) - Analysis of HP's 2Q07 business results [[Annex clients click here](#)]

[The Greening of Big Blue](#) (IBM to spend \$1 billion on "going green")

[Are We in "Buyback Bubble?"](#) - Analysis of corporate stock buyback trends

[IBM: Lowering Center of Gravity](#) (Highlights of Partnerworld 2007, with [Detailed Reports for Clients](#))

[Growth Accelerating](#) - Analysis of Capgemini's 1Q07 business results [[Annex clients click here](#)]

[To Buy \(back shares\) or Not to Buy?](#) - Analysis of stock buybacks in corporate America

[No Surprises in Good Opening Quarter](#) - Analysis of IBM 1Q business results [[Annex clients click here](#)]

[IBM Stock Still Grossly Undervalued](#) (A preview of IBM first quarter business results)

[Accenture Beats Forecasts, Again](#) (Analysis of Accenture's 2QFY07 results)

[HPS, Capgemini Tie for](#)

whose job it was and is to implement the new marketing approach (below left).

He said the company first tested its new sales model in China, and the results were "significantly better" than before.

That's not surprising. It's hard to image how you can lose if you put your customer first. Perhaps the only question is what took IBM so long?



We can recall, for example, the former IBM CEO (twice removed), John Akers, declaring 1987 to be "the year of the customer." Which in turn gave DEC, then the main IBM challenger, a chance to mock Big Blue's sales tactics by running ads saying, "at DEC, every year is the year of the customer" (see Annex Bulletin 87-31, May 1987, and "[Akers: The Last Emperor](#)," June 1991).

Samson seemed to anticipate such skepticism by asking the rhetorical question himself. He answered it by saying that, as the growth emphasis shifted this year to the SMB and market-specific solutions markets, and a brand consolidation got underway, it became necessary to change the IBM sales model to reflect the new market realities.



And so the preceding is our graphical presentation of the latest IBM seedling, its new three-pronged sales model. Underpinning all three channels is innovation, some through collaboration with customers, IBM executives said.

"You've got to be a foundry of innovation to help change the world a little," said Samson.

His boss, Zeitler, said at the start of the two-day conference that he had never seen more important technology innovations coming down the chute as what IBM has in the pipeline for the next six months.

Server Brand Convergence. Furthermore, IBM can be expected to converge of its various server brands (x, i, p and z) into a unified "form factor" (box). This process has already begun in the midmarket, with the merger of the high-end of the System i and p server lines announced in late July. Over time, other brands will follow suit, including the high end of the the "p" and "z," though you should not expect that in the near future.



The ultimate "form factor" in which IBM will deliver its "Big Blue in a Box" solution to SMB and other customers is BladeCenter S (right). Initially, it has the "i" and the "x" server blades. But eventually it will include many others, including the new game blades (Cell processors), for example, and even competitors' blades (Dell, HP, etc.),



according to Marc Dupaquier (left), the former software executive who took over the new IBM SMB unit within STG in January of this year (see "[IBM Lowers Center of Gravity](#)," Jan 2007).

["Gold" - Results of Octathlon 2007](#) [[Annex clients click here](#)]

[The Value of pi \(p\)](#) - Analysis of IBM System and System i market and product strategies

[IBM Profit to Grow Fast Than Revenue](#) - Update to 5-yr IBM forecast [[Annex clients click here](#)]

[The \(T\)ides of March Stir Markets Again](#) - Analysis of global economic & investment trends

[IGS: Growth Slows, Prof Surges](#) - Analysis of IGS 2006 business results [[Annex clients click here](#)]

[HP: Toward New Highs](#) (Excerpts from analysis HP's 1Q07 business results) [[Annex clients click here](#)]

[Capgemini Caps Great Year, Saves Best for Last](#) (Analysis of Capgemini's fourth quarter business results)

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

[CSC: Where Less Seems More](#) (Analysis of CSC's third quarter fiscal 2007 business results)

[Fujitsu: Sales Up, Profit Down](#) (Analysis of Fujitsu's third quarter fiscal 2007 business results)

[IBM Shatters Records](#) (Analysis of IBM's fourth quarter business results)

[IBM Stock Passes Century Mark](#) (Analysis of Big Blue's Stock Performance)

[Happy Days Are Here Again](#) (Analysis of Top 2

And IBM will wrap its software and services around the BladeCenter S, as well as the software of its select partners, and have the package sold at the low end by existing partners as well as through some new channels, such as telcos, for example. Dupaquier said IBM has already signed 194 of 348 most popular ISVs (Independent Software Vendors) whose software the "Big Blue in a Box" will offer (right chart).

So with the server technological convergence, the old IBM brand-based sales and marketing organization is becoming redundant and is being replaced with a new three-pronged model, as Samson pointed out. So that's the ultimate IBM answer to the "why now?"-question.



Large Enterprises. At the high end, for example, where IBM has a 31% overall market share (41% in servers and 24% in storage), according to Zeitler, IBM's challenged it so keep the growth going through new initiatives, such as virtualization and IT optimization, and, of course, the "greening of IBM" and of the customer data centers.

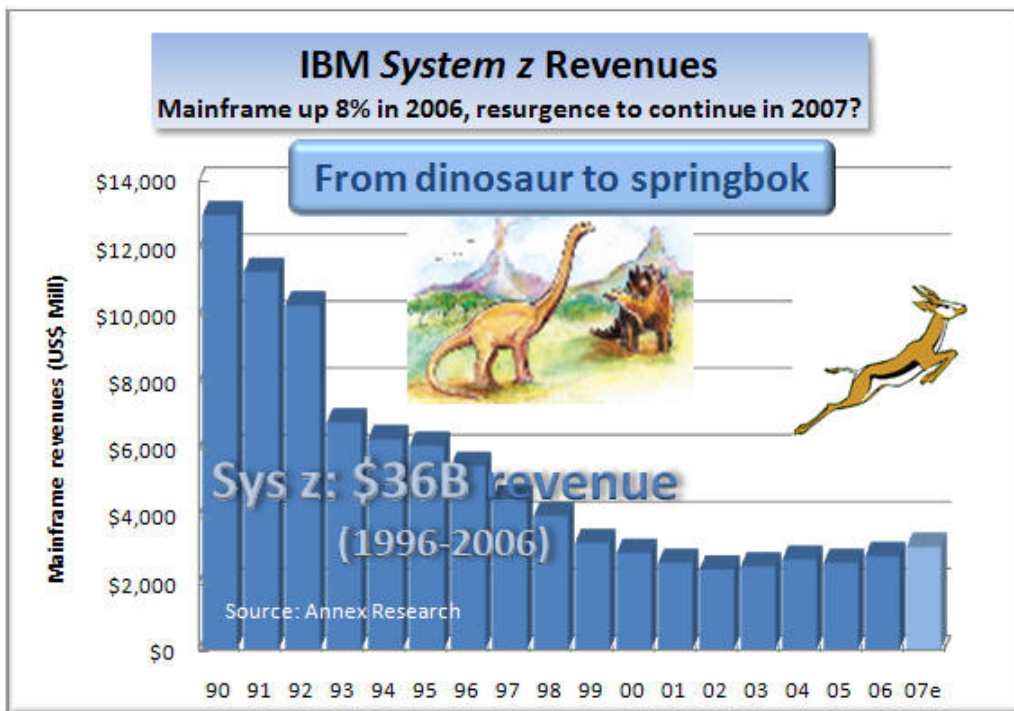


Globalization is another driving force behind the resurging mainframe demand, noted Jim Stallings (right), the head of the largest IBM server product line. He cited several customer examples, including



Citigroup, for example, which bought 124 companies over the last several years.

All that global churning and consolidation is good for IBM mainframe business. The System z revenues were up for the fifth consecutive quarter, while the overall MIPS shipments were up 45%, the eighth consecutive quarter of growth, Stallings pointed out (also see "[IBM Beats the Street](#)," July 18).



IBM sees the overall systems market as a \$95 billion per year opportunity, about 60% of it in servers, and the rest in storage (left chart).



This is a market where power and cooling costs represent a significant

IT leaders' latest stock market and business performances)

["Excellence" Excels Again](#) (Analysis of Accenture's first quarter fiscal 2007 business results) [[Annex clients click here](#)]

[Hedging the Bets](#) (Analysis of latest institutional shareholdings of leading IT companies: IBM, HP, Accenture, EDS, CSC, BearingPoint, ACS, Perc [[Annex clients click here](#)])

[Globalization Accelerates](#) (Analysis of United Nation's annual survey global investments)

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

[Capgemini: Longest Sustained Stock Price R](#) (An update to "By Leap and Bounds")

[HP: New King of the Hill](#) (Analysis of HP's fourth quarter business results)

[IBM: From Little Acorns Mighty Oaks Grow](#) (Analysis of IBM's "Stat of the Union")

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

[Fujitsu: Good Performance Gets Better More Global](#) (Analysis of Fujitsu's first half FY2006 business results)

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

[Accenture's Emphatic Year-end Accents](#) (Analysis of Accenture's

opportunity for savings. And IBM is leading the way by example. As you can see from the right chart as well as in "[The Greening of Big Blue, Part 2](#)," (Aug 2007), IBM is going through a massive consolidation of its IT resources that will result in annual savings of \$1.5 billion, according to Steve Sams, an IBM GTS (Global Technology Services) executive who is spearheading the effort.

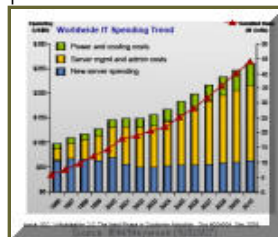
IBM spends about \$500 million annually on energy, and its energy bill is growing at 18% per year, Sams added.

"In most customer sites, we should be able to increase the energy efficiency by 40% to 50%," he said. Yet "many clients are not (yet) focuses on energy consumption issues," which is, of course, an opportunity for a vendor like IBM that thinks it can help customers with such problems.

IBM Metrics	1997	Today
CIOs	128	1
Host data centers	155	7
Web hosting centers	80	5
Network	31	1
Applications	15,000	4,700



IBM's chief hardware technology officer, Dr. Bernie Meyerson, said the power and cooling expenses are growing 800% faster than the customers' spending on servers (right



and left charts). So the opportunity for developers and customers to save goes well beyond the traditional ways of scaling and compressing chips, a process that actually increases the heat output.



Custom Solutions. In what IBM calls the "custom and embedded solutions" market, one of the new seedlings we analyzed last year, a relatively new opportunity for IBM, customers are spending about \$92 billion per year on various engineering services, customized systems and chips, according to IBM (right chart). But since most of the customers consider their own

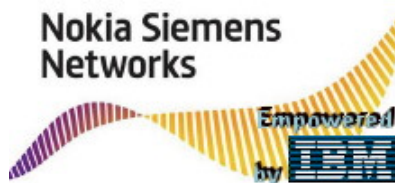


R&D as one of their "crown jewels," it has been tough for IBM to demonstrate why Big Blue innovators can do better or more.

We said last year that in many respects what Adalio Sanchez (left), the head of IBM Global Engineering Services (GES), renamed earlier this year from TCS (Technology Collaboration Services) and his team are trying to do is reminiscent of the early days of IBM Global Services efforts to promote outsourcing. Just like now with the R&D prospects, there were a lot of skeptics among the customer CIOs of the late 1980s and early 1990s that turning over their data centers to the likes of IBM or EDS or Accenture was a smart thing to do. It took a few high-profile wins, like Eastman Kodak or McDonnell Douglas to legitimize the new concept.



Well, the GES team just got their first big milestone win - the Nokia Siemens Network (NSN). And the key was the customer's perception that IBM would *empower* and enhance its own R&D rather than displace it.



"In order to ensure our world-leading technology capabilities and optimum synergies across the Business Lines, we have decided to strengthen our R&D activities by creating a cost efficient R&D structure." said Jürgen Walter, head of Service Core and Applications at NSN, in a release. "This move provides Nokia Siemens Networks with the flexibility it needs to successfully compete in the market,"

[fourth quarter results](#)
[\[Annex clients click here\]](#)

[IBM: Services in a Box](#)
 (Analysis of IBM Global Services' Ground-shifting Announcements)

[Strong Comeback by IT Stocks in Third Quarter](#)
 (Analysis of top 20 IT companies' market and business trends)

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

[Capgemini: Growth Continues](#) (Revenues, n profit up in double digit margins also improve)

[HP Firing on All Cylinders](#) (Stock sets new multi-year record following excellent third fiscal quarter results) [\[Annex clients click here\]](#)

[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 quarter results)

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

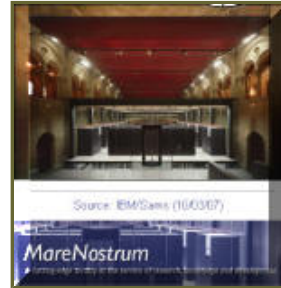
[IBM vs. HP: A Tale of Two Blues](#) (Both companies are doing well in business, but only HP is favored by Wall Street; Big Blue trying to change that now with its new "India Opus") [\[Annex clients click here\]](#)

[Go East, Young Man!](#) (A speech delivered in St.

The deal was a part of the \$2 billion cost-cutting directive that the Siemens CEO Peter Loescher wants to take out of the NSN cost structure. About 235 NSN engineers from labs in Munich and Berlin will transfer to IBM under the agreement, Sanchez said.

Refusion of Arts & Sciences (revisited). Another IBM deal in Europe underscored an old industry trend that we first identified in 1994 - a refusion of arts and sciences that the silicon is facilitating. When the sponsors of the Mare Nostrum data center, the #1 supercomputing site in Europe, based in Barcelona, Spain, gave IBM the specs as to how they wanted it built, they insisted it had to be "beautiful" as well as energy efficient. And that's what they got eventually (right).

"It's the most beautiful site we've ever built," said IBM's Sams. He should know a thing or two about that. Sams and his GTS team have built about 60 new data centers so far, spending an average of only six to eight weeks on each.



[Petersburg, Russia, May 25, 2006; click here for slides](#)

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

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



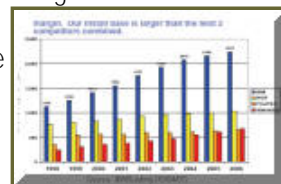
Retail Store Solutions. IBM's Retail Store Solutions is perhaps one of the best kept secrets inside the Big Blue. It's what was left over from the PC sale to Lenovo in 2005. Yet it's one of the fastest growing businesses in IBM, and the only one in which Big Blue actually touches consumer markets directly.



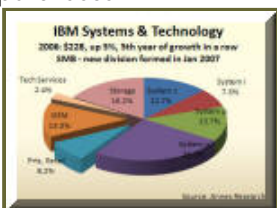
Last year, for example, IBM's retail business grew by 21%, with its kiosk revenues up over 70%, according to Steve Ladwig (left), who heads up this unit. We estimate that this business will bring contribute \$900 million to IBM revenues this year. And IBM has its point-of-sale (POS) and other servers installed in 65 of the top 100 retailers, Ladwig said.



So Retail Store Solutions is another of Big Blue's seedlings whose growth has been surprisingly strong.



But the real stunner for us was Ladwig's chart (right) that showed that IBM is the largest POS provider in the business, with more than double the installed base of the next two vendors combined (NCR and Fujitsu). And that 94% of retail revenues still comes from the stores, not the web purchases.



"There has been an unprecedented fragmentation of the consumer markets," he said. So now it takes targeting many more smaller segments for a marketing campaign to work.

Ladwig said that about 40% of the IBM retail business comes from SMB, where his unit now sells through about 2,000 partners now. And once again, IBM's retail SMB delivery is based on the BladeCenter S.

"SMB is a big play for us," he added. "It's growing much faster than the enterprise market."

SMB. Speaking of SMB, that was one of the promising seedlings identified in our [last year's "State of the IBM Union" report](#). And its importance seem to rise this year when the IBM chairman and CEO said at the Partnerworld conference in St. Louis in early may that this is the company's most important growth opportunity (see "[IBM:](#)



Competitiveness	High Volume		Cash flow
(2006 IDC)	High Vol	Blades	High End
Opportunity	\$17,608	\$2,655	\$5,376
YTY Growth	4%	29%	4%
Profit	=	+	++

Source: IBM/Hume (10/03/07)

We also learned that the low end of the System x product line accounts for about half of its revenues, yet has margins that are considerably lower than those at the high-end of the same product line. Now, that sure smacked of a commodity-type business to us. So we asked Hume (right) to explain this apparent inconsistency with IBM chairman's statement of strategy.

He replied that, "you need the leverage of scale to be able to sustain the high-end business." "Without the high volume (low end) servers, the costs of high-end servers would be much higher."



The last time we checked, this type of an explanation would qualify as cross-subsidization of products. Or "rationalization for synergy," as Palmisano put it in Bangalore when he said that IBM would NOT engage in such practices anymore.

"Customers demand that we deliver top-to-bottom servers," Hume summed it up. And he said that there will be new "specialty form factors" in 2008-2009 in the low end that would help IBM differentiate itself more (presumably leading to higher margins).

But when we asked him if that differentiation might also include some "beautiful servers" at the low end, just like HP or Dell are now doing in consumer markets, or the Mare Nostrum data center exemplified a refusion of arts and sciences (see above), Hume deferred the question to one of his staffers who seemed clueless about what we were talking about.

Summary: Innovation, Innovation...

Innovation, innovation... and then more innovation. That was basically the theme of Rod Adkins', STG's chief technology officer's (right) summary of IBM's hardware strategy, as were the earlier presentations by Dr. Meyerson and Zeitler. The three top IBM hardware executives marshaled out numerous examples of where IBM's inventions, either in-house or in collaboration with clients, helped change the world and the shape of the IT industry.



Meyerson, for example, talked about IBM's "holistic" approach to innovation that encompasses everything "from atoms to software." Innovation at Big Blue these days is about "simultaneous optimization of materials, devices, circuits, cores, chips, system architecture, system assets and system software," and, of course, the new big "p" for power. And it is the latter that is turning the IBM's famous blue into green.



Within that holistic approach, there are still pockets of excellence that are carried out at the old "speeds and feeds" levels. Zeitler, for example, showed the tremendous

expansion of processing power by the Blue Gene processors at the Argonne National Labs, soon to be dwarfed an order of magnitude more powerful PERCS processor, based on Power 7, at DARPA (Defense Advanced Project Research Agency - two above charts).

Adkins also pointed to "hybrid supercomputing" breakthroughs at Los Alamos Labs, where x86, Linux master cluster and a Cell processor cluster are targeting to deliver a 1.4 petaflop peak, 1.0 petaflop sustained performance in project dubbed "Roadrunner" (right).



And so, the beat goes on... faster, smaller, cheaper, cooler is winning the day again, but in a new way, for IBM and its customers. Adkins saw the current period as the "virtualized" era, coming on the heels of "distributed" and "centralized" periods during the first 50 years of the computer industry (left chart). And the STG general managers, whom Zeitler assembled on stage for discussion and a Q&A with analysts and consultants put their own individual spins on the IBM innovation theme.



Overall, IBM seems to be churning out inventions at a rate that even Big Green itself sometimes has trouble consuming, as evident from the IBM-Google announcement this week of "cloud" computing (see "[IBM-Google on Cloud Nine?](#)," Oct 2007). Enter the collaboration dimension of innovation. Everybody is welcome to participate. All stand a chance of benefiting from each other's creativity.

"You've got to be a foundry of innovation to help change the world a little," as you saw earlier IBM's Samson declare.

Foundry and an art workshop as well. For, a refusion of arts of sciences is indeed taking place and taking hold of the IT world 13 years after we first discerned it. Leonardo da Vinci would be pleased.

Happy bargain hunting!

Bob Djurdjevic

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



For additional Annex Research reports, check out... [Annex Bulletin Index 2007](#) (including all prior years' indexes)



Or just click on [SEARCH](#) and use "company or topic name" keywords.

Volume XXIII, Annex Bulletin 2007-35
October 12, 2007

Bob Djurdjevic, Editor
(c) Copyright 2007 by Annex Research, Inc. All rights reserved.
e-mail: annex@djurdjevic.com

8183 E Mountain Spring Rd, Scottsdale, Arizona 85255
Tel/Fax: +1-602-532-7789

The copyright-protected information contained in the ANNEX BULLETINS is part of the Comprehensive Market Service (CMS). It is intended for the exclusive use by those who have contracted for the entire CMS service.

[Home](#) | [Headlines](#) | [Annex Bulletins](#) | [Index 1993-2007](#) | [Special Reports](#) | [About Founder](#) | [Search](#)
| [Feedback](#) | [Clips](#) | [Activism](#) | [Client quotes](#) | [Speeches](#) | [Columns](#) | [Subscribe](#)