

ANNEX BULLETIN

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Analysis of IBM's 4Q07 Business Results

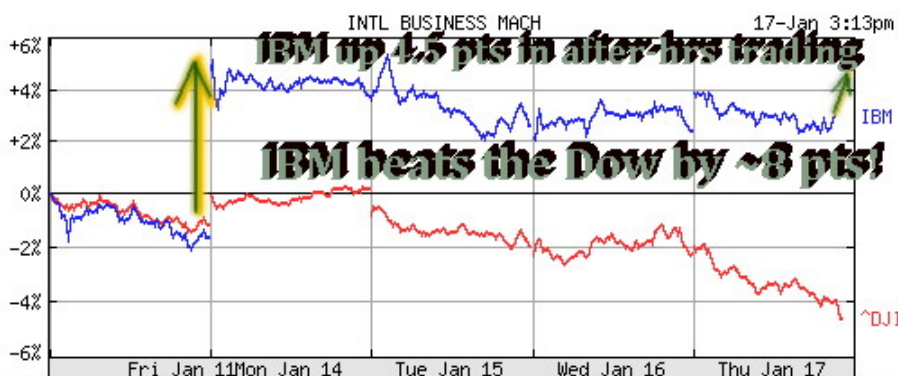
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Services, Emerging Markets Boost IBM

Improved Profitability across Business Segments Also Strengthens Big Blue's Bottom Line; CFO Bullish on 2008

SCOTTSDALE, Jan 17 – Have you ever read a book by checking out the last chapter first? Well, that's what IBM did with its double-dipping fourth quarter release. As you saw three days ago, IBM first released its preliminary top and bottom line results. Wall Street loved it (see "[Big Blue Shines in Fourth Quarter](#)," Jan 14). And this afternoon, after the markets closed, the company filled out the mid-sections of its financial statements. Wall Street loved it even more. Big Blue shares were up 4.85 points in after-hours trading to \$106, and are still rising as we write this.



IBM's double-dip 4Q announcement lifts stock despite 300-pt Dow tumble

"This turned out to be a great quarter, in fact, the strongest revenue and profit performance in almost a decade," IBM CFO Mark Loughridge told the analysts in a post-earnings teleconference.

The biggest upside surprise in IBM's 4Q results came from the two services segments -

Global Technology Services (GTS) and Global Business Services (GBS), whose revenues shot up 16% and 17% respectively. This was due to both a significant currency boost (between six and seven points), and the humongous fourth quarter signings a year ago, when IBM Global Services closed \$17.8B in new business.



But the \$2B jump in IBM backlog since 3Q despite a 13% decline in new signings suggests that IBM services has been playing tougher defense in the services area. Still the outflow of business ("rescoping"/cancellations/expiration) from the backlog in the fourth quarter amounted to \$13.4 billion, the second highest figure since the fourth quarter of 2005.

As a result, the services profitability has gone up even faster than revenues (up 26% vs. 16% in the GTS unit).

The second most important boost to IBM's results has come from emerging markets and the SMB sector. By focusing on those, IBM has been able to execute an "end around" play - avoiding the trouble spots in the U.S. banking sector, and finding ways to grow from the midsize and overseas markets.

Nor is this just the growth from the BRIC countries (Brazil, Russia, India and China). More than one-fifth (22%) of IBM's revenue now comes from emerging markets that are growing at 20% or higher rates (see the chart). And in all those countries, IBM is helping the local economies build their infrastructures for the 21st century. IBM CFO Loughridge analogized this to the building of railroad lines during the American gold rush in the late 19th century.



IBM software performance was also strong, especially in terms of profitability (pretax income up 21%).

Hardware revenue performance was also solid (flat revenues), in light of the strong 4Q06 results, and the product transitions, especially in the mainframe line. Even the System i has grown for the first time in several quarters. But the most important improvement in IBM's hardware business has been in the profit margins that jumped from 42% to 46%.

"This quarter, the real story of the STG is profit," said Loughridge during the teleconference with analysts.

Just to put things in perspective, back in 2004, while IBM still had PCs in its hardware portfolio, the hardware gross margins were 29.5%. So the hardware sector's margins have improved by more than 16 points in just three years.

Summary & Outlook

Overall, the IBM CFO sounded pretty bullish about the company's prospects in 2008 and beyond, the current uncertainty about the U.S. economy and the stock market pessimism notwithstanding.



"Going into 2008, we have a lot of tail winds," Loughridge said answering an analyst question. He cited the pension fund benefits; a good tax plan; share repurchase benefits; but importantly "a strong services momentum and a strong annuity base." The IBM CFO also cited strong profitability due to cost reductions and a stream of new technology slated to come online this year, led by the next generation mainframes, due to premier in late February.

Can Big Blue Lift Bearish Markets?

The big question when the markets open tomorrow will be if Big Blue and its tail wind still has enough market power left to overcome the negative sentiments that are pervading the overall markets.

A growing conviction that the U.S. is in a recession sent stocks plunging in their worst three-day decline since 2002. The Dow decreased 306.95 today, or 2.5%. The Nasdaq slid 47.69, or 2%. The S&P 500 lost 39.95, or 2.9%, to 1,333.25, and is down 9.2% this year after tumbling 5.9% the past three days.

Merrill Lynch contributed to the bearish sentiment today with its biggest stock decline since September 2001. Merrill's fourth-quarter net loss of \$9.83 billion led to \$5.64 or 10% drop in its stock to \$49.45. The huge fourth quarter loss resulted in Merrill's first full-year loss since 1989.

Concern that the economy has entered a recession was spurred after the Fed said manufacturing in the Philadelphia region contracted more than forecast in January, adding to evidence factories are cutting production as the economy slows. The Philadelphia Fed's general economic index declined to minus 20.9, the lowest reading since October 2001, from minus 1.6 in December.

Finally, the Fed Chairman Ben Bernanke told Congress today that the outlook for economic growth has worsened. Still, he said the central bank is not forecasting a recession for this year. Bernanke said a "temporary" fiscal stimulus would help the central bank to buttress economic growth, while warning against worsening the longer-term outlook for budget deficits.

Now, amid all this economic and market gloom and doom, here we have IBM delivering a



stellar fourth quarter report card that stands out not only in the context of the global economy, but even within the financial sector. IBM revenues from the financial sector grew in the double digits in the fourth quarter (up 11%), in line with the overall growth of



the business. And the major reason for that is that more than three-quarters of it comes from overseas markets (right chart).

So once again, IBM's emphasis on global expansion seems to be paying dividends and protecting the company from being afflicted by the domestic banking sector malaise. Now the question that will be answered tomorrow morning is - can Big Blue take the U.S. financial sector on its shoulders and lift the markets again tomorrow, as it did on Monday with its preliminary fourth quarter release? (see "[Big Blue Shines in Fourth Quarter](#)," Jan 14). If it does, maybe Wall Street should start treating IBM once again as a bellwether stock.

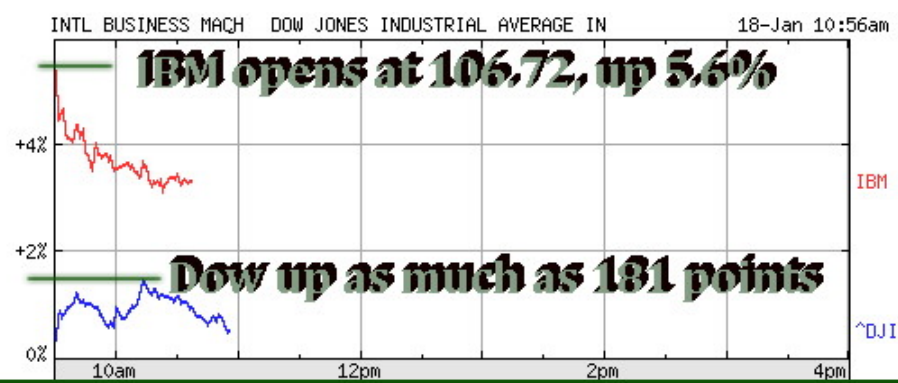
Annex Clients: [CLICK HERE](#) for detailed IBM 4Q07 P&L tables & charts

Happy bargain hunting!

Bob Djurdjevic

Market Update

SCOTTSDALE, Jan 18 - Well, now we know the answer to the question we posed last night. Yes, IBM still matters. And yes, Big Blue can still move markets. They say, "proof's in the pudding." Take a look...



IBM still packs enough of a punch to move markets against powerful negative forces

As you can see from today's upward market surge, IBM still packs enough of a punch to move markets, even against such powerful forces as those that had driven them down in the last three days. And Big Blue did it for a second time this week, leaving no doubt about it.

On Monday, IBM grabbed the Dow by its bootstraps and pulled it up over 100 points (see "[Big Blue Shines in Fourth Quarter](#)," Jan 14). This morning, it did it by over 180 points. Of course, in each case, there were some other factors at work as well. A strong GE earnings release and a positive consumer confidence survey also contributed to the upward market surge this morning.

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