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<div data-bbox="461 609 872 644" data-label="Text"> <p>Updated 1/05/10, 9:00PM HIT</p> </div> <div data-bbox="381 674 951 714" data-label="Text"> <p><i>IBM 2010 "State of the Union" Analysis</i></p> </div> <div data-bbox="230 749 1110 816" data-label="Section-Header"> <h1>Big Blue Poised for Growth Again</h1> </div> <div data-bbox="167 846 1169 924" data-label="Text"> <p><i>Hardware to Return to Profitable Growth; Software & Services Are There Already</i></p> </div> <div data-bbox="149 957 1188 1026" data-label="Text"> <p><i>Integration of All Three Makes "Big Blue Battleship" Formidable Force in Future; "Smarter Planet:" Demand-generating "System of Systems"</i></p> </div> <div data-bbox="141 1060 1200 1356" data-label="Text"> <p>HAIKU, Maui, Jan 6 – With Big Blue's fourth quarter earnings release just over a week away, we thought we'd update our own IBM "State of the Union" analysis and outlook for 2010 and beyond. We will start with our fourth quarter expectations. The final 2009 period will help set the bar for IBM's subsequent performance. We will then also take stock of how IBM is positioned in the marketplace and analyze its strengths and weakness relative to competition as well as vis-à-vis global opportunities.</p> </div> <div data-bbox="141 1394 1192 1604" data-label="Text"> <p>Hopefully you will see then why we think that IBM is once again poised for growth. A 98-year old company, written off as a dinosaur in the 1990s, is once again acting as spry as a springbok, and setting the leadership agenda for the IT industry to follow. We see blue skies are ahead for Big Blue. "Post nubilla, phoebus" ("After the clouds, sunshine" [Latin]).</p> </div> <div data-bbox="652 1638 685 1671" data-label="Image"> </div> <div data-bbox="141 1701 1175 1908" data-label="Text"> <p>To say that 2009 was a challenging year for IBM and the industry is both to state the obvious, and to understate the gravity of the economic situation. Which is why we hear so many CEOs and CFOs parroting each other in using the same phrase - a "challenging year." For, describing last year by the proper attribute - a "terrible year" - would sound too depressing for both employees and investors.</p> </div>	<div data-bbox="1294 609 1364 640" data-label="Text"> <p>usual</p> </div>

As you saw in our year-end analysis of market and business performances of the Top 18 IT global leaders we follow, earnings plunged 17% while revenues declined 6.5% in the trailing 12 months. And while in 2008 most of these companies did pretty well, only to be clobbered in the stock market by the general pessimistic malaise, in 2009 the IT leaders' shares shares soared by 59% despite their obvious business woes.

But not all top IT companies are hurting. Big Blue was an exception. IBM, which enjoyed a stellar 2008, was one of only two major global IT leaders that also recorded an increase in earnings last year (the other being Apple). In the fourth quarter, we expect IBM earnings to grow in single digits and its revenue decline to slow to less than two percent. From then on, we see blue sky again for Big Blue, both in terms of revenues and profits.

There are many tactical reasons for it, including several demand-generating initiatives, such as "Smarter Planet," spiffy "clouds," and lush "green acres" rejuvenating the corporate data center wastelands. But the main strategic reason is that ever since about 2006, IBM has been putting quality over quantity as its global modus operandi.

When Sam Palmisano, IBM CEO, said at the Bangalore June 2006 conference for financial analysts that Big Blue "exit any business that is a commodity business," and that IBM



would "not rationalize for synergy" (as Lou Gerstner did by hanging on to the low margin PC business for so long), we applauded the new IBM strategy. We saw it as a statement of "quality over quantity" (left chart). And that's something that we

had been urging IBM to do, both from the business fundamentals, as well as stock market viewpoints.

Smarter Planet, cloud computing, greening of data centers... etc. are only the latest manifestations of that strategy which has now proven to be "recession proof." That's because in bad times, Big Blue helps its customers save money and recover quicker. In good times, IBM services and products are there to help them grow faster. In all circumstances, rain or shine, customers and partners alike can count on Big Blue to help lead them to light.

Blue Skies Seen Again at IBM Hardware Forum

The preceding conclusion became quite obvious at IBM Systems Technology Group's conference for global analysts and consultants, held at the Yorktown Heights, New York, research center in early December.

The meeting started on New York's first big snow storm of the year (right). The traffic was snarled everywhere. Radio stations reported tons of accidents. Schools were closed. Many people stayed home rather than brave treacherous roads. But not even such a weather

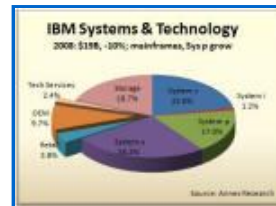


challenge straight from the heavens stopped Big Blue from holding the conference, nor from launching it on time.

Rod Adkins (below), the newly appointed head of IBM's \$16 billion hardware unit who hosted the conference, also promised blue skies ahead for the part of IBM that has been hit hard by the recession in the last 12 months. He said his unit's mission is to deliver "revenue and double digit pretax income growth."



Coming on the heels of steep double digit revenue declines in the first three quarters of this year, and a steady revenue erosion in the last two decades (see the revenue charts below), one could say that was a bold statement. Yet Adkins backed up his optimism with some encouraging facts that showed that IBM has been gaining momentum in the hardware marketplace, mostly at the expense of competition.



- The company has been an overall server revenue share leader for six consecutive quarters, with special strength of the Unix and x86 (Wintel) market.
- In the third quarter alone, Big Blue scored \$150 million in competitive wins against HP alone; \$400 million year-to-date. IBM also lured 100 of the Top 300 Sun accounts into its stable, as well as 100 DB customers.
- In 2008, there had been 1,500 competitive migrations to IBM. As of early December, there were already more than 2,000 competitive wins, 90% of them against HP or Sun, Adkins said.
- Nor is Big Blue cleaning up against the competition only in the hardware arena. The IBM Software unit had reportedly scored 180 wins with its Tivoli management products against HP's optimization software by early December. That's a 240% gain over 2008, according to a source who requested anonymity.

In short, the IBM "migration factory" seems to be running at full capacity. An extra shift coming in 2010? :-)



As if endorsing Adkins' blue sky forecast, the second day of the conference was blessed from on high by bright sunshine and beautifully clear blue skies (see above two photos, the right one taken



from roughly the same spot as that gloomy shot from the day before). So there... you don't have to take just my word for it. :-)

"Smarter Planet" - Smarter Demand Generation Idea

If you have never heard of IBM's "smarter planet" idea, you have probably been away at another planet. For, IBM has been running 30 different full page print media ads touting this concept (right) in the last 12 months, in addition to TV and other media advertising channels.



Jon Iwata, IBM's top communications and marketing executive



(left), spoke on the first day of the IBM STG conference about how Big Blue came up with the "smarter planet" idea in 2008, almost nixed it when the gloom and doom of the recession closed in on everybody, and then forged ahead anyway.

"We realized that 'smarter planet' was a leadership agenda, not just an IBM self-promotion," Iwata said. "We" was Iwata and Palmisano, the IBM boss. They decided to go through with the campaign despite the blackened economic backdrop in late 2008. And now, "smarter planet" has become a theme song and a rallying point for most of IBM groups. And not just IBM's...

IBM started with 20 "showcase solutions" which illustrated unorthodox ways of using technology, mostly by governments across the country and around the world. Why would an establishment company seek unorthodox ways of using technology? Because it is trying to expand its business universe.

"Smarter planet opens up 40% of new addressable space for the IT industry," Iwata said. "Which is amazing."

And IBM, of course, is working hard to get the biggest slice of that expanded IT pie. So enter a "smart sewer" idea in San Francisco, a "smart grid" and "smart traffic" in Stockholm and Singapore, a "smart crime fighting" approach in Chicago, LA and New York.



After having launched the "smarter planet" campaign in November of 2008, IBM got an early boost from a high level endorsement. You can see in the above CNBC picture the IBM CEO Palmisano speaking about it at the White House in late January, while the newly inaugurated U.S. president Obama approvingly smiles in the background.

So what is this "smarter planet" idea in a nutshell? From a buyer perspective, it is a way for governments to do something for their people by using IT technology and the

information it generates in a new and creative way. From a vendor perspective, it is a way to open new markets, especially in the public sector. After all, while the private industry has been retrenching, the government business is booming.

Has anyone ever added up the cost of all those huge bailouts? They are just one example of governments' increased role in the business world.



And the way toward a "smarter planet" is paved with smarter use of existing data and systems.

"It's about a system of systems," opined Ginni Rometty, the head of IBM global sales, who was in charge of IBM's Global Business

Solutions unit until about a year ago. Rometty is shown in the left photo along with Iwata. They were answering questions from the audience during a Q&A that followed Iwata's "smarter planet" presentation.

Holistic Approach to Business: "Smarter Solutions"

The same idea - using a "system of systems" to back up intelligent decisions - is what sets IBM apart from the competition. While most other companies try to fix and improve what's broken here and there within a given system, Big Blue uses what we called "a holistic approach" to problem solving (see [IBM's Holistic Approach](#), Feb 2009):

All you need to do is substitute IT techie-talk for medical terms above and you will get the essence of the IBM strategy. Its focus is on wellness and harmonization of the whole, not just individual parts.

Virtualization, dynamic infrastructure, reusable service products... have been some of the instruments of integration the Big Blue practitioners have brought to the treatment table.



And just as holistic medicine can help both healthy and sick people, IBM's strategy is healing both well-to-do and maligned companies. You don't have to be sick to benefit from yoga, jin-shin-jitsu, tai chi, reiki, chakra balancing or other shamanic energy healing treatments. The same works in business. A company is living organism, too.

(An excerpt from [IBM's Holistic Approach](#), Feb 2009)

Take virtualization trend, something that is giving a big boost to IBM's server businesses, especially the mainframes. We first identified it five years ago, and published our findings in a 2005 whitepaper "[Poughkeepsie Spring](#)." Yet this is still an evolving trend.

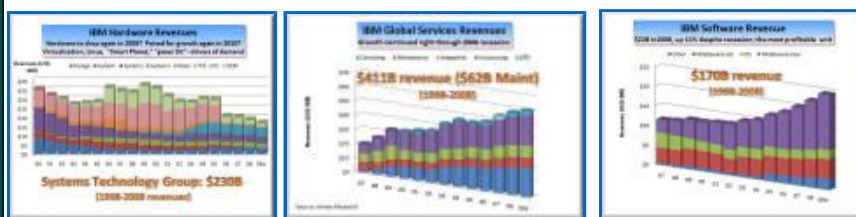


"As an industry, we are just starting the virtualization journey," said Helene Armitage, the head of the newly formed Systems

Software unit within STG (left). "And software is the key differentiator between IBM and its competitors."

As a result, Armitage also said that Systems Software "a key STG growth engine," as well as "the integrating force in the data center."

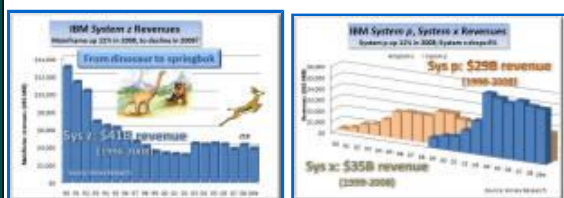
Creation of this new *software* unit with IBM's *hardware* division is an excellent example of how product lines are blurring; how integrated Big Blue itself is becoming. The same is true of integration between STG and IBM's Services and Software units. All three are now trying to work together on creating "smarter solutions" for IBM customers, as befits someone who uses a holistic approach to diagnosing and treating "patients" (customers) and live on a "smarter planet."



It is exactly such diversity in horizontal businesses and collaboration between them that has given the impression that IBM is "recession proof." While IBM hardware business has suffered setbacks due to customer spending cutbacks in a recessionary global economy (left chart), you can also see that the two other, bigger components of Big Blue's business - services and software - have continued growing merrily as if there were no recession.



Services now represents nearly 60% of IBM's business and 46% of pretax profit. The enormously profitable software brings it about as much in pretax income (45%) from only 22% of total revenue. The two account for over 90% of IBM earnings. But IBM hardware technology is the backbone that keeps Big Blue together in good times as well as bad, through rain and shine, through thick and thin. Without STG to back them up, neither IBM software nor services would be looking so "smart" these days.

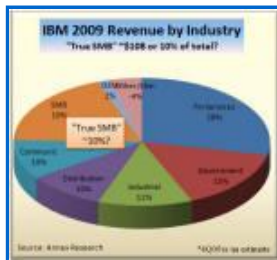


Not Everything IBM Touches Turns to Gold

Of course, not everything that IBM touches turns to gold. Does anyone still remember TCS or GES, for example? They were among the much touted Big Blue "seedlings" a few years ago that did not bear fruit and grow into mature trees (see [Seedlings Sprouting Stronger Limbs - update to "IBM State of the Union" \[Annex clients click here\]](#), Oct 2007).

Similarly, the growth of Retail Solutions business, which offered much promise two years ago, has fizzled in the last 12 months.

But to us, the biggest disappointment has been IBM's performance in the SMB market (small and medium size business). This was supposed to have been a key growth engine



for IBM. Speaking at an IBM partner conference in St. Louis in May 2007, IBM CEO Palmisano said that the SMB (small and medium size business) market is "the biggest IT growth opportunity in the world today" (see [IBM: Lowering Center of Gravity - highlights of Partnerworld 2007, with Detailed Reports for Clients](#)).

We agreed and we still think so. But IBM has not been able to capitalize on the opportunity its chairman was talking about two and a half years ago. Big Blue's SMB results since then don't leave much to cheer about.

In the last quarter (3Q09), for example, SMB (or GB as IBM now calls it) was down 9% - more than even IBM as a whole. In the second quarter, IBM's SMB revenues were down 14%, again more than the corporation's as a whole. That's some "growth engine," given that it sputters more so than the rest of the parts.



What is the reason for it? In short, Big Blue's unwillingness or inability to shed the "Big" from the way it plays in the SMB market. As we noted in our 2006 "State of the Union" review of IBM, SMB customers like to buy from SMB vendors, not big companies like IBM or HP. So the key is to make oneself appear small in the way you treat these clients.

That is why we suggested at the time that IBM create a new "Baby Blue" brand, and split this part of its business off from the rest so as to promote entrepreneurship in developing SMB solutions and "act small" (see [From Little Acorns Mighty Oaks Grow - Analysis IBM's "State of the Union"](#), Nov 2006).

Well, that evidently has not happened. And you can see the results: Big Blue is still acting big and producing small numbers in the biggest global growth opportunity.

Summary

"For an industry elder, IBM has the energy of a kid," noted Wall Street's influential weekly's year-end front page story ("[Smart Play](#)," Barron's, Dec 29). "The company's stock has surged 54%, profits have risen, margins are higher and its strategy looks strong. So why don't more investors feel the love?"

After this story came out, investors did seem to feel a little more love for Big Blue. The stock set a new multi-year high yesterday, the first trading day of the year (\$133, Jan 4). Whether or not this turns into a long-term love relationship will depend in part on IBM's fourth quarter results, which are due to be released later this month. As in any relationship, you have to stoke the fire to keep it going.

As you saw earlier, we expect Big Blue to report slightly lower revenue and modestly higher earnings than a year ago. More importantly, we think this may be the last declining revenue quarter in a series brought about by the global recession. If IBM STG's Rod Adkins starts to deliver on his bold promise (double digit revenue and pretax profit growth), Wall Street will have much to cheer about in its newfound old love relationship.

Alas, investors' loyalty is fickle. IBM will have to keep stoking those fires through 2010 by adding buzz and excitement the way Apple and Google do, for example, even with their trivial moves. "Acting in unorthodox ways with the energy of a kid" seems to be a "smarter play" for Big Blue in 2010.

But if IBM does it, we think that Big Blue stock has potential to reach at least \$154 valued relative to its peers (see [Rally of Hope over Fact Continues](#), Jan 3). Which is about a \$30 billion market cap climb from where it is today.

[Click here](#) for detailed IBM 4Q tables and charts (Annex clients only)

Happy bargain hunting!

Bob Djurdjevic

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Photo Album from IBM Yorktown Heights Conference (Dec 9-10, 2009)

(click on thumbnails to enlarge)



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

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