About UpperEdge Supplier Scouting Reports

UpperEdge Supplier Scouting Reports are released quarterly and developed based upon analysis of quarterly results, market research, and UpperEdge IT sourcing and negotiation engagement data. The objective of these reports is to provide IT executives, as well as sourcing and procurement leaders, with digestible insights and actionable advice so they can make more informed and confident sourcing decisions and negotiate more effectively.
Once again IBM has delivered impressive quarterly financial results with growth in all areas. More importantly, IBM is either on track or ahead of its longer-term 2015 forecasts and selling more strategic business solutions which provide a foundation for downstream sales in its higher margin software and outsourcing services businesses. The software and outsourcing services businesses are very sticky long-term, allowing for incremental increases in fees in the outer years of contracts and feeding opportunities back into IBM’s more strategic consulting services and project-oriented IT services. In summary, IBM is achieving strong results and growth today and establishing a beachhead for recurring annual revenue from its next-generation solutions in cloud and business analytics, and from emerging growth markets.

Current customers can expect to see a bold IBM, highly confident in the value of its offerings and taking an aggressive approach to expanding its share of IT budgets. New customers can expect an assertive IBM to capture market share, especially where it can displace competitors. IBM’s success and market validation of its strategy will allow it to maintain discipline in pricing and discounting practices.

IBM will push back significantly in commercial negotiations with two key points:

1. The tremendous business case for justifying its fees;
2. The opportunity for greater discounting and commercial protections if customers are willing to spend more today or contractually commit to future spend volumes, especially in strategic growth and higher margin areas.

Highly competitive deals will be obtainable, but only for customers who have leverage, a well-defined long-term IT roadmap, comprehensive market intelligence, and a well-conceived sourcing strategy and communications approach. Organizations who approach IBM on a transaction-by-transaction basis and/or ignore downstream risks will pay substantial premiums and are likely to look back at uncompetitive commercial agreements and sub-optimized relationships in a few years, with little leverage for improvement outside of expanding the organization’s IBM footprint.

IBM Q2 Numbers at a Glance

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<th>Revenue → $26.7 billion</th>
<th>Net Income → $3.7 billion</th>
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<td>• 5% increase YOY</td>
<td>• 8% increase YOY</td>
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Revenue by Business Unit:

- Global Technology Services (GTS outsourcing, integrated technology services, maintenance) → $10.2 billion
- Global Business Services (GBS outsourcing, consulting, and systems integration) → $4.9 billion
- Software (WebSphere family, Tivoli, Information Management, Lotus, Rational) → $6.2 billion
- Systems & Technology (System z, power systems, storage, retail solutions, microelectronics) → $4.7 billion
- Global Financing → $500 million

Quarterly Revenue Trends:

- Q3 2010: +4%
- Q4 2010: +7%
- Q1 2011: +5%
- Q2 2011: +5%

Services Backlog: $144 billion (up $15 billion YOY)
Cash: $11.8 billion
Free Cash Flow: $3.4 billion
IBM Q2

IMPACT & ACTIONS:
What IBM’s Q2 Results Mean for Potential & Existing Customers

High-Priority Growth Areas – Exceeding Expectations

IBM had another outstanding quarter growing its higher margin software and outsourcing services businesses. These two components not only provide the highest profit margins, but also recurring renewal revenue that can grow through annual price increases, as customers face daunting costs and impacts to their business if they decide to migrate away from IBM. The prospect of paying incremental costs to maintain the status quo will far outweigh the costs and business disruption of displacement. The building blocks of this strategy are the investments IBM has made over the last few years in software acquisitions and the development of large service centers in India and China. IBM’s sales strategy is to remain disciplined in “seeding” customers and penetrating accounts with its higher-value and more strategic business consulting services (GBS business unit) and then sell “stickier” and higher margin software and technology services solutions.

Recommended Actions: First, be wary of the wolf in sheep’s clothing. Much value can be derived from IBM’s services, but it is important to understand its longer-term goals before allowing access to your organization. Clearly define project scopes, goals, and outcomes before commencing with services. Second, understand that the service teams will be trying to gather information for downstream selling opportunities while your team’s guard is down and focused on collaborating with IBM on project performance and service delivery. Coach teams accordingly and have in place a vendor management office that is disciplined in not allowing IBM to shift its attention away from performing as contracted.

Strategic Evolution & Solution Integration

As we stated last quarter, IBM has done a very good job in its transformation to a solutions-oriented company, realizing the synergies from acquisitions and developing a more integrated go-to-market strategy. But IBM has maintained its siloed business unit approach in commercial and financial negotiations. IBM has consistently articulated its direction and growth strategy and is highly incentivized to validate this strategy through market achievements.

Recommended Actions: To achieve greater concessions and value from IBM, we recommend customers elevate their relationships and negotiations above business-unit leaders to senior or industry-focused executives. These executives are more long-term focused, have greater flexibility, and are incentivized to offer greater concessions in order to achieve longer-term goals.
IBM has done a tremendous job developing an effective sales strategy by positioning attractive value-add services solutions that naturally tie into its long-term, high-margin businesses. Smarter Planet revenue grew by more than 50% in the first half of 2011, while business analytics was up 20%. GBS consulting is the key driver for Smarter Planet, Business Analytics, Cloud, and all the downstream software and IT services that attach to these solutions. If these were the early days of ERP, where new software sales were an indicator of ongoing support revenue, GBS would be the indicator of high-margin downstream software and implementation services revenue, which in turn would be the driver for high-margin support and outsourcing services revenue. Further, this value stack penetration makes an organization highly dependent on IBM, with very limited migration options. It gives IBM a firm foundation for continuing revenue and incremental increases in the outer years of contracts, and implementation of next-generation products and services in the far outer years. The bottom line is that IBM is delivering on a prediction made in the New York Times in May 2010, which described IBM’s future outlook as “the same, only more so.”

**Recommended Actions:** Building off previous recommendations, understand IBM’s strategic goals and approach to your organization, and develop a Plan B. We are not saying to avoid IBM – quite the contrary; IBM has provided tremendous value to customers and will continue to do so. But to avoid being trapped in the outer years of contracts with annual increases necessary to maintain the status quo, mitigate these risks up-front. Ensure commercial structures are clearly defined with full transparency and pricing protections before making incremental transactions. Develop back-up plans for potential migration away from IBM should the relationship sour. Build an ecosystem of partners with overlapping capabilities to maintain flexibility and leverage with IBM (and all suppliers). This approach will incentivize suppliers to proactively provide value and not become complacent or take your business for granted. Additionally, we recommend creating bonus programs to reward suppliers who exceed expectations. This approach will strengthen relationships and offset suppliers’ concerns about your organization maintaining the use of competitors.

IBM still faces intense competition from Oracle, CA, and BMC in software; HP, Dell, EMC, and NetAPP in hardware/storage; and Accenture, HP, and Deloitte in services. IBM remains most attracted to deals where it can gain market share from these top-tier competitors. For example, IBM made a point to mention in its earnings release how it is taking away market share from both Oracle and HP. IBM quoted figures of 250 competitive displacements this quarter, accounting for over $300 million – 60% coming from Oracle and 30% from HP. In total, IBM counts nearly 2,300 displacements valued at $2.3 billion since 2009. While IBM predominantly focuses on its own value proposition and results and mostly avoids public discussion of its competition, the company is highly incentivized to capture market share.

**Recommended Actions:** Buyers should leverage services and software competitors wherever possible, as IBM will offer aggressive terms when it is up against top providers. In most cases, IBM will continue to offer competitive replacement/migration packages to minimize the impact of switching. IBM is currently offering 12 months of interest-free financing on software as a means of establishing a foothold with customers. Understand that IBM is reluctant to change its commercial practices and will only offer the bare minimum to win business. Therefore, it is imperative to maintain a competitive environment and continually challenge IBM at the executive level to offer more flexible, transparent, and competitive commercial structures.
THE DRILLDOWN:
Detailed Insights on IBM’s Q2 2011 Results

REVENUES: Solid & Steady Growth

- Services revenue grew 2%, with a total backlog of $144B (up $15B)
  - GTS Outsourcing accounts for 40% of Services revenue
- Systems & Technology revenue grew 12%, with System z up 61% and MIPS up 86%
  - Servers account for 65% of total Systems & Technology revenue
  - Storage accounts for 19% of total Systems & Technology revenue
- Software revenue grew 10%
  - Branded Middleware accounts for 64% of Software revenue
  - WebSphere family grew 47%
  - Information Management grew 11%
- Geographic Revenue
  - Americas grew 8% to $11.2B, with the U.S. up 6%
  - EMEA grew 3% to $8.6B
  - PAC grew 3% to $6.2B, even with a 5% decrease in Japan

Some noteworthy areas:

- 68 new System z mainframe customers, which IBM called out as important new “flags” it has planted to expand software and services downstream.
- WebSphere growth of 47% is impressive, but note that many of IBM’s software acquisitions are folded under the WebSphere family.
- Growth in Information Management provides the foundation for business analytics and optimization, so the 11% growth here is another “force multiplier” downstream.
- U.S. growth of 6% on such a large base is quite impressive and demonstrates IBM’s success with its long-standing install base, through both hardware upgrades and new software and services investments.
- Outsourcing services was up 3% and reached $7.1B in total revenue.

In summary, IBM’s strategy of leveraging its business consulting services and its hardware install base to expand its footprint and grow its higher margin software and outsourcing services businesses is delivering impressive results today as well as establishing a strong foundation for downstream growth at higher margins.

Expect to see a bold IBM, highly confident in the value of its offerings.
STRATEGIC DIRECTION: Ongoing Evolution to Software and Services

IBM is continuing with its business transformation away from low-margin hardware and shifting towards higher margin and higher value software and services. For example, in 2000, IBM’s hardware and financing business represented 35% of its operating profit, with software only accounting for 27%. In 2010, hardware and financing represented 16%, while software grew to 45%. It is also worth noting that services remained stable at 38%. IBM has long been aware that services drive closer customer relationships that can be leveraged in solution development and selling products. The difference is that instead of selling low-margin hardware products, IBM now sells software products with much higher margins. The complete divestiture of the laptop business demonstrates that IBM plans to continue focusing on software and hardware that has a high attach rate for add-on support, services, and software.

Since the software market is rapidly maturing, IBM has taken an acquisition approach to gain market share. IBM invested $32 billion in acquisitions from 2000 to 2010, and has given guidance that they intend to invest $20 billion in acquisitions during the next five years. IBM tripled its software profit from 2000 to 2010, and has given guidance that it intends to double its software profit over the next five years. IBM reiterated that it is on target to achieve these goals.

Additionally, as part of IBM’s strategic direction and guidance through 2015, the company will focus on the following strategic areas:

- **Growth Markets**: IBM saw a 13% revenue increase in high-growth geographies, with a 21% increase in the BRIC (Brazil, Russia, India, China) countries. This was the fourth consecutive quarter of double-digit growth. Growth markets accounted for 22% of IBM’s total geographic revenue in Q2. IBM is targeting 30% coming from growth markets by 2015.

- **Smarter Planet**: In the first half of 2011, Smarter Planet revenue grew by 50%, and is helped by IBM’s new Smarter Commerce initiative. IBM’s vision and value proposition are to help organizations do more with less through smarter systems using data analytics and connectivity. The ROI reaches beyond cost reductions, operational efficiency, and increased productivity into areas such as energy savings, brand reputation, and strategic positioning, and improving an organization’s overall societal impact.

- **Business Analytics**: In the first half of 2011 revenue grew by more than 20%. Similar to the Smarter Planet initiative, IBM’s vision here is not just capturing and processing data, but in delivering applications that can analyze and convert data into actionable intelligence that enables businesses to run smarter and more effectively.

- **Cloud**: IBM has more than 200 wins in 2011, and its private cloud average transaction size has tripled from a year ago. Like most technology providers, IBM is focused on the next generation of data centers and cloud environments. Further, it sees the cloud as an avenue to catch up to the leading software providers, as organizations evolve from large installed enterprise systems to more efficient, flexible, and collaborative cloud computing models. IBM’s services team will continue to push cloud offerings.

SOLUTION INTEGRATION: Potential Value, Challenges around Silos

During IBM’s transformation, the company has struggled to successfully integrate and package its offerings as holistic solutions. Today, IBM’s business units often function as silos. While the company has improved in selling integrated solutions, financial and commercial terms and legal agreements frequently reflect IBM’s siloed approach and separate business units. While the company’s senior leadership recognizes this challenge, it remains troublesome for customers. The past quarter has not seen any meaningful evolution or improvements in this area.
**LEADERSHIP: Questions over Succession**

Recently CEO Sam Palmisano reshuffled the reporting structure of his executive team, reducing the number of direct reports to four. Of that group, Ginny Rometty, Senior Vice President of Global Sales and Distribution, is rumored to be the most likely candidate to succeed Palmisano as CEO. Rometty, who led the integration of PwC and is largely credited for her vision in building IBM’s services business, would be the first female CEO in IBM’s history.

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**Supplier Scouting Report References**

Information contained in this report was sourced from IBM’s earnings releases, investor and analyst presentations, earnings/analyst transcripts, SEC filings, and relevant UpperEdge IT sourcing and negotiation engagements. This report contains the opinions and perspectives of UpperEdge.

**About UpperEdge**

UpperEdge provides forward-looking organizations relevant market and supplier intelligence, tailored sourcing and negotiation strategies, and precise execution methodologies to generate more value from IT investments, assets, and relationships. Augmenting and complementing IT organizations and business-driven teams, UpperEdge clarifies the IT sourcing process, empowering clients to negotiate with confidence and optimize strategic IT relationships. The benefits include greater value from IT investments, increased strategic alignment, and reduced risk.

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