

SUPPLIER SCOUTING REPORT

Actionable Quarterly Insights on Key Software and Service Providers



UpperEdge projects high leverage for customers negotiating with IBM in Q3. More details inside this report.



THE TAKEAWAY

IBM's 2015 goal of \$20 EPS has been an increasing pressure point as 2015 nears. This aggressive performance goal has resulted in IBM altering its business focus, resource mix, and corporate activity to meet investor expectations. IBM just increased its 2013 EPS guidance to \$16.90, which is still a long way from \$20 with only ten quarters remaining. Plans to achieve this EPS goal include margin expansion, improving business segment mix to more profitable services and software, workforce rebalancing to higher margin lower cost offshore resources, and an aggressive share repurchase program.

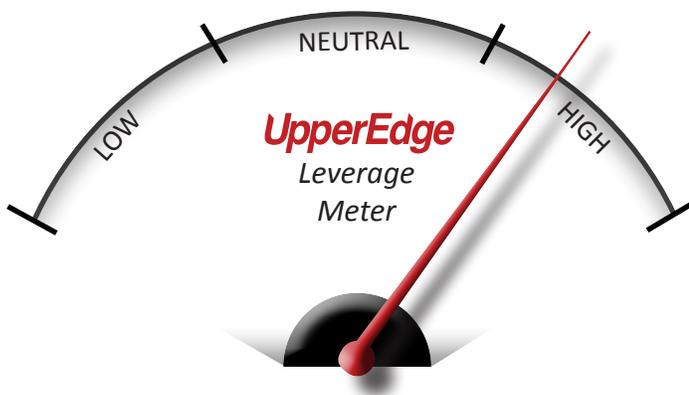
While IBM has been able to continue improving EPS with these levers and shift in strategic direction from hardware to software and services, top line revenue growth is a must if IBM is to achieve \$20 EPS by 2015. Therefore, we expect continued pressure on all IBM sales teams to drive revenue, with a particular focus in services, as IBM views their services teams as their entry point into selling more software, long-term services contracts, and hardware. Organizations that understand IBM's strategic goals and sales approach will have opportunities to leverage their long-term IT roadmaps to negotiate highly competitive deals and more comprehensive and holistic relationship structures and governance models.

IBM Q2 Numbers at a Glance

	Q2 FY 2013	YoY	QoQ	Leverage Contribution
Revenue & Net Income				
Total Revenue	\$24.92B	(3.3%)	6%	High
Net Income	\$3.23B	(16.9%)	6%	Medium
Revenue By Business Unit				
Global Technology Services (GTS Outsourcing, integrated technology services, maintenance)	\$9.54B	(4.6%)	(1%)	High
Global Business Services (GBS Outsourcing, consulting, and systems integration)	\$4.61B	(1.3%)	3%	High
Software (WebSphere family, Tivoli, Information Management, Lotus, Rational)	\$6.42B	4.1%	15%	High
Systems & Technology (System Z, power systems, storage, retail solutions, microelectronics)	\$3.76B	(11.8%)	21%	Medium
Global Financing	\$0.49B	(5.8%)	(2%)	Low
Other				
Services Backlog	\$141.00B	3%	0%	Medium
Cash	\$9.56B	(12%)	(10%)	Medium
Free Cash Flow	\$2.69B	(27%)	58%	Medium

UpperEdge Leverage Meter

What is Your Current Leverage With IBM?



1. Software and Services deals (and combinations of both) provide the greatest leverage with IBM as these represent strategic growth areas with recurring annuity streams.
2. Deals in IBM designated geographic growth markets provide added leverage as IBM has targeted these regions for market share capture and leadership.
3. Ability to provide shorter payment terms to improve IBM's DSO and more quickly generate cash have added significance and leverage in IBM's current climate.

Key Considerations & What They Mean For You:

What IBM Q2 Results Mean for Current and Future Oracle Customers

Poor Revenue Performance

While IBM achieved sequential quarterly growth, Q1 was a very poor quarter where IBM failed to close many deals targeted for Q1 closure. Therefore, we believe the Q2 year-over-year performance comparison is much more insightful. Year-over-year revenue performance declined across all business units except software which grew by 4%. But software only accounts for roughly 26% of total revenue. Services revenue, which includes Global Technology Services (GTS) and Global Business Service (GBS), accounts for roughly 57% of total revenue and decreased 4%, although services backlog grew by 3% to \$141B, representing the largest services backlog for IBM in 4 years. Systems and Technology, which includes IBM's hardware products and represents 14% of total revenue, declined by almost 12%.

While IBM is putting a positive spin on its software growth and improved services backlog, including 15 Q2 deals over \$100M and a multi-billion dollar outsourcing deal in Europe, top line revenue is down 3% and net income is down 17%. EPS goals are contingent upon revenue growth which will lead to increased pressure on sales and services teams to generate revenue wherever possible. However, IBM incentivizes its sales teams to pursue revenue growth in higher margin software and services and in its targeted growth initiatives. These areas include Cloud, Smarter Planet, Business Analytics, Mobility, Social, Security, and Big Data. Additionally, long-term services outsourcing deals are a high priority. These areas provide higher margins and recurring revenue streams which are the focal points of IBM's strategic direction. Deals in these areas will provide greater leverage in negotiations.

Decline in Regional Performance

Revenue in the Americas was down by 3% with declines in both the U.S. and Canada, although there was strong performance in Latin America. EMEA revenue declined by 1% and APAC revenue was flat. But key larger growth markets of China, Russia, and Australia, which represent 40% of IBM's geographic growth markets, saw declines in performance.

IBM growth areas provide added leverage in negotiations, and this includes geographic regional growth areas. Organizations looking to expand globally, as well as domestically, will have opportunities to utilize this leverage not only for new expansion deals, but also to renegotiate prior deals or renewals. The key is to make the new purchase contingent on the outcome of renegotiating the prior deals or renewals; just like how a bill passes through Congress with additional items being added in order to gain support from lawmakers. The bill goes to vote with everything included, there by requiring lawmakers to approve everything in order to get the provisions important to them passed. Approach your IBM negotiations in a similar fashion for success.

Workforce Rebalancing

As a result of IBM's poor Q1 performance, IBM's previously planned workforce rebalancing efforts were ramped up in Q2. These efforts are more commonly referred to as layoffs, but since IBM is also hiring or replacing some of these resources in lower cost offshore markets, IBM refers to this process as workforce rebalancing.

IBM took a \$1B charge in Q2 which did have a significant impact on year-to-year profit of about \$850M, as last year's rebalancing effort resulted in a \$150M charge. But the workforce rebalancing effort is expected to result in financial performance benefits for IBM as early as Q3 and continue over the next year. The challenge for IBM clients is to make sure assigned resources have the requisite experience and skills to deliver on expectations. We have picked up more chatter in the market expressing concerns on projects where clients felt IBM resources lacked the experience necessary to manage issues and provide real problem solving leadership on projects. Make sure your IBM team has the appropriate skills and experience.

Other Key Metrics

Here are some additional metrics to keep in mind. IBM's closure rate in software pipeline deals is typically just under 50%. Accounts Receivable days outstanding increased by 1.5 days in Q2 with an impact of roughly \$250M per day. IBM's 2015 goals also include reaching \$50B in share repurchases (currently at \$33B), \$20B in acquisitions (\$6B), and \$20B in dividends (\$9B).

These key metrics support the requirement for revenue growth to meet 2015 goals. While IBM's cash position of \$9.5B is strong, cash will be required to reach stated 2015 EPS, share repurchase, acquisition, and dividend goals. Organizations that have the flexibility to provide more aggressive payment terms can use this as leverage in negotiations for additional concessions on price and other terms. Additionally, maintaining competitive environments in software sourcing initiatives that include IBM will also result in added leverage. Expect IBM to be very aggressive in trying to win and close out software deals in Q3 to improve their closure rate, add lump sum top line revenue growth from license fees, and lock in maintenance and support annuity streams. Keep in mind that IBM will also be looking to package service offerings with software solutions, and vice versa. While IBM has historically been challenged to present one unified face to its customers, and often reverts to operating in business unit silos, cross-selling is a priority and will remain a big part of IBM's execution strategy.



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.

For more information on UpperEdge: www.upperedge.com

For strategic insights on IT sourcing: www.upperedge.com/blog

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.

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