

The Chairman's Letter to Stockholders
from the 2010 IBM Annual Report



Dear IBM Investor:

I am pleased to report that IBM had another strong year in 2010. Your company continued to outperform our industry and the market at large. We once again achieved record pre-tax earnings, record earnings per share, record free cash flow and improved profit margins, with increased revenues. At the same time, we continued to deliver superior returns to you, our owners. Most importantly, we are well positioned to grow as the global economy recovers.

These results were made possible by decisions and actions that we undertook a decade ago, based on where we believed the world was shifting. But even more, they are a reflection of the mindset, ambitions and values that have guided IBM since its inception, 100 years ago. As such, our performance in 2010 marks a fitting conclusion to our first century as a corporation, and a promising start to our second.

In this letter, I will explain why the long-term thinking and management that IBM has practiced over the past decade have positioned your company advantageously for the next five years and beyond.

IBM today

IBM's performance in 2010 is indicative both of our high-value market position and of the discipline we apply to our strategy and operations. Since 2002, we have added \$14 billion to IBM's pre-tax profit base, increased our pre-tax income 3.4 times, our earnings per share 4.7 times and our free cash flow 2.8 times. Cumulatively, we have generated about \$96 billion of free cash flow.

Our strong 2010 continued this record of superior performance:

Revenue and income: Our revenue was \$99.9 billion, up 4 percent. In 2010 we grew pre-tax income by 9 percent, to \$19.7 billion, our highest ever.

Margins: IBM's gross profit margin rose for the seventh consecutive year—to 46.1 percent, up 9.4 points since 2002. Our pre-tax income margin rose to 19.7 percent. Both margins are at their highest in more than a decade. We achieved this by driving productivity and continuing to shift our business mix to more profitable segments. Once again, more than 90 percent of our segment profit in 2010 was from software, services and financing.

Earnings per share: We have continued to achieve strong EPS growth. Last year was another record, with diluted earnings per share of \$11.52, up 15 percent. This marked eight straight years of double-digit EPS growth.

Cash flow: IBM has consistently generated strong cash flow, a key indicator of real business performance. In 2010 our free cash flow, excluding the year-to-year change in Global Financing receivables, was \$16.3 billion, an increase of \$1.2 billion from 2009. IBM ended 2010 with \$11.7 billion of cash and marketable securities.

Investment and return to shareholders: Our superior cash flow has enabled us to invest in the business and to generate substantial returns to investors. Our 2010 cash investment was \$6 billion for 17 acquisitions—13 of them in key areas of software. After investing \$6 billion in R&D and \$4 billion in net capital expenditures, we were able to return more than \$18 billion to you—\$15.4 billion through share repurchases and \$3.2 billion through dividends. Last year's dividend increase was 18 percent, marking the 15th year in a row in which we have raised our dividend. Over the past decade, we have returned \$107 billion to you in the form of dividends and share repurchases, while investing \$70 billion in capital expenditures and acquisitions, and almost \$60 billion in R&D.

Leading our industry and the market

We have been able to achieve these results because of the transformation of our company that we began several years ago. At the time, we saw an undercurrent of fundamental change.



Samuel J. Palmisano
Chairman, President
and Chief Executive Officer

1. Changes in the world: The lowering of trade barriers, the rise of the developing world and the emergence of the World Wide Web were unleashing the flow of work on a global scale. We believed these changes were powerful and irreversible, and that they would lead to new high-growth market opportunities and a new form of the corporation itself—what we came to call the globally integrated enterprise.

2. Changes in technology: At the same time, a new model of computing was replacing the PC-based, client/server approach. Computational capability was being put into things no one would recognize as computers: phones, cameras, cars, appliances, roadways, power lines, clothes—and even natural systems, such as agriculture and rivers. All of these were being connected. And we had developed the computing power and advanced analytics to turn mountains of data into insight. As a result, the economic, societal and physical systems of the world were becoming instrumented, interconnected and intelligent. Our planet was becoming smarter.

3. Changes in client demand: Driven by the new opportunities and competitive demands of these first two shifts, enterprises and institutions were no longer content with off-the-shelf technology. They now sought to innovate—not just in their products and services, but also their business processes, management systems, policies and core business models. To accomplish that, they needed to focus on the business outcomes that resulted from technological innovation.

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Because we believed that these shifts would change our industry, creating winners and losers, we transformed IBM's mix of products, services, skills and technologies—exiting commoditizing businesses like PCs and hard disk drives, and making 116 strategic acquisitions over the course of the decade, largely in software and services. We amassed substantial cross-industry expertise, and reinvented the way we deploy it, shifting skills and decision making closer to the marketplace and the client. We invested significantly more in our teams and capabilities in the developing world, and we accelerated the global integration of IBM's operations.

We also worked to rebalance our internal R&D. Of the 5,896 U.S. patents IBM received in 2010 (once again a record for any company, and our 18th straight year of patent leadership), more than 70 percent were for software and services.

A road map to the future

IBM today is a fundamentally different company. In order to make that clear to our investors and to the financial markets, we decided four years ago to introduce our 2010 Road Map. We wanted to explain where we were going and to provide benchmarks for you to evaluate us along the way. We believed—and still believe—that this longer-term framework is the most helpful way to understand our company.

To some, it seemed foolhardy. To my knowledge no company in our industry had done this before. But we felt IBM should take a long-term view, in public as well as in private. And we felt confident about the future, because of the transformational steps we had taken to reposition the company.

Clearly, this worked. As you know, we surpassed our 2010 goal of \$10 to \$11 in earnings per share. And now that we have shown we can deliver results with consistency, we are doing it again through the introduction last year of our 2015 Road Map.

As before, our new road map isn't just a list of targets; it's a management model, organized around the major drivers of IBM's earnings per share performance. Those are: operating leverage, share repurchase and growth strategies.

Operating leverage will come from our continuing shift to higher-margin businesses and our improving enterprise productivity. We are aiming for \$8 billion

of productivity improvement over the next five years. Part of that will go to our bottom line, and part will go to investments that improve our competitiveness in the marketplace.

Secondly, we will continue returning value to you. Our road map calls for \$50 billion in anticipated share repurchases and \$20 billion in dividends.

When it comes to the third component of our road map, we will focus on four growth priorities:

1. Growth Markets.

A historic economic expansion is underway in the emerging markets of the world—as their populations join the middle class and their economies join the global marketplace. These markets are expected to achieve average GDP growth of 5 percent through 2015, more than double the projected growth rate of the developed world. In the largest of these emerging markets, such as China, India and Brazil, IBM is broadening its well-established base of skills and capabilities, nearly doubling our number of branch locations. In less developed markets, such as Africa, we are leveraging anchor clients in sectors like communications and banking. Our recent partnership with Bharti Airtel to provide 21st century wireless telecommunications across 16 countries of Sub-Saharan Africa is one example. Our Growth Markets Unit accounted for 21 percent of IBM's geographic revenue in 2010. We are aiming to approach 30 percent by 2015.

2. Business Analytics and Optimization.

The research firm IDC predicts that global data volumes will increase by 29 times over the next 10 years—to 35 zettabytes. (A zettabyte is a 1 followed by 21 zeros.) Enterprises need a way to manage and mine this deluge of potentially valuable information, and the key is advanced data analytics. IBM spotted this emerging need early, building the world's leading analytics practice, with 7,800 expert consultants, the world's premier nonacademic mathematics function, leading-edge software and offerings integrated by industry. We have received more than 500 analytics patents and have made acquisitions to deepen our capabilities. Under our 2015 Road Map, analytics is expected to grow to \$16 billion in revenue by 2015.

3. Cloud and Smarter Computing.

As the world becomes more instrumented and inter-connected, businesses and institutions need smarter IT infrastructures to handle dramatic increases in data volumes, and to improve data center efficiency. We are creating new ways to design computer systems—optimized for specific workloads—and new ways to deliver IT-infused services. IBM has helped thousands of clients adopt aspects of cloud delivery, where IT resources are virtualized, highly automated and accessed by self-service. We are assisting clients in areas as diverse as banking, healthcare and government to build their own clouds or to tap securely into IBM cloud-based business and infrastructure services. Our road map calls for \$7 billion in revenue from cloud by 2015.

4. Smarter Planet.

Put it all together, and you have what we mean by “building a smarter planet.” In 2008 and 2009, we articulated a point of view on ways the world can become smarter, and in 2010, we deployed significant resources to capture the opportunity in key, high-growth industries—such as healthcare, retail, banking and telecommunications—where our experience and solution delivery is strongest. We also expanded our Smarter Cities initiative. Our road map calls for Smarter Planet solutions to grow to \$10 billion in revenue by 2015.

By becoming a very different company from what we were just a few years ago, we have become much more like the company IBM has been for most of its history.

In sum, our superior strategic positioning, strong balance sheet, solid recurring revenue, robust profit streams and unmatched global reach give us confidence that we will be able to continue achieving the same kinds of results in the next five years that we have achieved during the past decade.

Over the last 10 years, we have nearly tripled our EPS, added \$109 billion in free cash flow, returned \$107 billion to you, tripled our software profits and increased the share of our revenue from growth markets from 11 to 21 percent, excluding divested PCs and printers. Over the next five years, we expect to grow our operating (non-GAAP) earnings to at least \$20 per share, to generate another \$100 billion in free cash flow, to return an additional \$70 billion to you, to grow our software profit to about half of total segment profit and to increase growth markets' contribution to our revenue to nearly 30 percent.

The information on pages 9 to 15—"Generating Higher Value at IBM"—summarizes our road maps, places them in the context of IBM's 100 years of growth, and describes our opportunities in the coming era.

A new century of progress

Let me close with a few words on reaching the extraordinary milestone of 100 years, which we will mark on June 16 of this year.

Throughout this time, spanning many eras of technology, markets, global economics, politics and culture—and across multiple managements, strategies, innovations, products and services within IBM itself—our company has consistently done three things:

First, we have foreseen the opportunities of our times, and made markets in them.

These have included the automation of modern retail, banking and air travel; the creation of population-

scale systems such as U.S. Social Security; and the farther reaches of scientific progress, from the exploration of space to the frontiers of genomics, bioinformatics and nanotechnology. Today, it encompasses the even broader range of work we describe as building a smarter planet—optimizing the enormously complex systems that enable services to be delivered; physical goods to be developed, manufactured, bought and sold; everything from people and money to oil, water and electrons to move; and billions of people to work and live.

Second, we have created the tools to do that ambitious work and to capture its economic opportunity.

In the early decades of IBM's life, this involved clocks, scales and punched card tabulators. It changed fundamentally with the dawn of the computer age, as IBM created many of its technological breakthroughs, from the relational database to the disk drive, DRAM, FORTRAN, the mainframe, the PC and much more. We built the world's most productive industrial laboratory—home to five Nobel Prize winners and generator of more U.S. patents than any other company in the world. And it continues today, with breakthroughs such as Watson, the computer that recently defeated the two all-time champions on the television quiz show, *Jeopardy!* Watson's vast analytic capacity represents a new stage in computing's ability to tackle the world's most pressing needs where and when they really emerge—in the natural language of healthcare, banking, government, retail and more.

Finally, we have consistently built an organization that can sustainably deliver that kind of value.

This is nontrivial. Over the past century, many enterprises, institutions and governments have come and gone. IBM's longevity rests on our founders' success in shaping a particular kind of organization. It was a company that mastered the creation of economic value from knowledge and information; that was truly global—whatever that meant for each era; and that pioneered a new kind of relationship with society. Most importantly, IBM's leaders believed that a great company could only survive decades of change through the intentional creation of a vibrant culture, one grounded in shared beliefs and values. And they and subsequent generations of IBMers actually built it.

That is the legacy of IBM's first century, and it continues to shape our company today. It is no accident that our growth strategies like Smarter Planet and Growth Markets are aimed at the most promising business and societal opportunities of our era. Nor is it surprising that we are pushing the frontiers of science and technology to achieve those ambitious goals—from analytics, to cloud, to new workload-specific computing models. It is also consistent with our DNA that we have paid equal attention to the continual reinvention of IBM itself—most importantly, reexamining and applying our core values to how we run the company.

In a fundamental sense, by becoming a very different company from what we were just a few years ago, we have become much more like the company IBM has been for most of its history. As we start our second century, that's a good place to be.

Let me close by expressing my pride in the worldwide IBM team for bringing us to this point, and my gratitude to you, our shareholders, for your unwavering support. I hope that you are pleased with how your company is performing and evolving. And I trust that you share our excitement about the future of an enterprise whose storied past is propelling us into an enormously promising future.



Samuel J. Palmisano
Chairman, President and Chief Executive Officer

