

The Chairman's Letter to Stockholders
from the 2009 IBM Annual Report



Dear IBM Investor:

When I wrote to you a year ago, the global economy was experiencing profound disruption. The financial system was freezing up. Many companies and entire industries were pulling in their horns, hoping simply to ride out the storm. IBM's own industry was no different.

Nonetheless, I said that we felt confident heading into 2009. We were entering the year strong, and we expected to exit it stronger.

A year later, despite an environment that remains very challenging, I am happy to report that your company has continued to outperform our industry and the market at large. We delivered strong results in 2009, once again achieving record pre-tax earnings, record earnings per share and record free cash flow—despite reduced 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 economy begins to recover.



Samuel J. Palmisano
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

The explanation for this performance—and for our optimism about both the near-term and the longer-term future—is threefold. It rests, first, on the ongoing transformation of our company; second, on our focused strategy to capture the large opportunity of a globally integrating world; and third, on a business model that reliably generates strong profits and cash, giving us the financial flexibility to invest for future growth.

I will talk about each of these factors in detail in this letter. It is important for you to understand the ways in which IBM today is a very different company than it was just a few years ago. This repositioning explains why we have demonstrated such stability and strong results during this downturn and why we believe we will benefit as the economy recovers and growth returns.

A Strong Year Capping a Strong Decade

Two thousand nine was a tough year by any measure, but IBM's performance was indicative both of our high-value market position and of the discipline we apply to our strategy and operations. Since the dot-com crash in 2002, we have added \$12 billion to IBM's pre-tax profit base, increased our pre-tax margin 2.5 times, quadrupled our earnings per share and more than doubled our free cash flow. Cumulatively, we have generated about \$80 billion of free cash flow.

Our strong 2009 continued this record of superior performance:

MARGINS: IBM's gross profit margin rose for the sixth consecutive year—to 45.7 percent, up 9.2 points since 2003. Our pre-tax income margin rose to 18.9 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 2009 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 \$10.01, up 13 percent. This marked seven straight years in which we have grown EPS by double digits.

CASH FLOW: IBM has consistently generated strong cash flow, a key indicator of real business performance. In 2009 our free cash flow, excluding the year-to-year change in Global Financing receivables, was \$15.1 billion, an increase of \$800 million from 2008. IBM ended 2009 with \$14 billion of cash and marketable securities.

REVENUE AND INCOME: Our revenue was \$95.8 billion, down 5 percent at constant currency. Nonetheless, in 2009 we grew pre-tax income from continuing operations by 9 percent, to \$18.1 billion, our highest ever.

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 2009 cash investment was \$1.2 billion for six acquisitions—five of them in key areas of software. And after investing \$5.8 billion in R&D and \$3.7 billion in net capital expenditures, we were able to return more than \$10 billion to you—\$7.4 billion through share repurchase and \$2.9 billion through dividends. Last year's dividend increase was 10 percent, marking the 14th year in a row in which we have raised our dividend.

In sum, with our excellent financial position, strong balance sheet, solid recurring revenue, strong profit streams and unmatched global reach, we are confident about the year ahead, and beyond. Indeed, we achieved our 2010 objective of \$10 to \$11 in earnings per share one year early. We believe that we will again grow EPS by double digits this year, reaching at least \$11.

The information on pages 10 through 15 — “A Decade of Generating Higher Value at IBM”—summarizes the story of our transformation, and describes the opportunities it has opened up for growth in the coming era.

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Leading Our Industry and the Market

As we enter a new decade, it's interesting to reflect upon how the last one began. The conventional wisdom back then was that the robust IT growth of the go-go '90s would continue—and even after the dot-com bust, most believed it would resume. It was thought that buyers of IT would continue to self-integrate—which would mean that our industry would remain highly disaggregated—and that client/server computing would become the predominant enterprise model.

It wasn't unreasonable to hold these views. However, as we looked out, we saw a different picture—an undercurrent of fundamental change. As we worked to understand the deeper meaning of events, to separate the cyclical from the secular and to apply lessons from our own past, we came to believe that major shifts were underway that would reshape our industry and, indeed, the global economy:

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 business models 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 this was being connected through the Internet. And we now had the computing power, advanced analytics and new models (now known as “clouds”) 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: Compelled by the new opportunities and competitive demands of these first two shifts, enterprises and institutions were no longer content with cost savings from off-the-shelf technologies and solutions. 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 integrate advanced technology far deeper into their operations.

Because we believed that these shifts would change our industry, creating winners and losers, we made some important decisions and got to work. We transformed IBM’s mix of products, services, skills and technologies—exiting commoditizing businesses like PCs and hard disk drives, and making 108 strategic acquisitions over the course of the decade. We amassed substantial industry expertise, and also re-invented 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 emerging markets around the world, and we accelerated the global integration of IBM’s operations.

At the same time, we transformed our vast services delivery capability, applying automation, standardization and advanced engineering and management principles of the sort that prior generations had applied to manufacturing. We also rebalanced our internal R&D. Today, IBM’s portfolio is built around networked, modularized and embedded technologies, such as service-oriented architecture (SOA), business intelligence and analytics. Of the more than 4,900 U.S. patents IBM received in 2009 (our 17th straight year of patent leadership, and a record for any company), more than 70 percent were for software and services.

That’s how the last decade played out—for our industry and for your company.

The Landscape for Growth

Today, many of our competitors are emulating our moves. For instance, several have gone on an acquisition binge to get into new spaces. However, there is a vast difference between what your company has done—amassing truly differentiating technology and skills, and focusing on the needs of enterprise clients—and what others are doing, largely to compensate for rapidly commoditizing business models.

As the new decade begins, some in our industry still seem to believe that history will repeat itself—for example, that clients will invest in IT simply because of product upgrade cycles. Once again, we have a different view. We believe that clients will only invest in what delivers compelling, quantifiable business value. We believe that the fundamental shifts I described earlier will continue to play out, and that they create a unique opportunity for IBM. And because of the way we have managed the company during the economic downturn, we have the flexibility to take advantage of this opportunity, and to invest for growth.

Our investments in 2010 are focused on four high-potential opportunities.

1. Growth Markets

IBM has among the broadest global footprints of any corporation or institution. We serve clients in more than 170 countries around the world, and we have been deeply established within myriad local economies and cultures for decades.

Our Growth Markets unit, established in 2008, is helping to capture the highest-growth opportunities of the world's emerging economies. Since 2005, these markets have expanded their contribution to IBM's geographic revenue by a point a year, growing at least 8 points faster than major markets over the last three years.

Going forward, both mature and emerging markets are building out and integrating their physical and digital infrastructures, and infusing the resulting systems with intelligence. More than \$2 trillion in fiscal stimulus has already been

earmarked by governments around the world. We are uniquely positioned to benefit from these large business and technology opportunities, and we are pursuing them aggressively in 2010.

2. Analytics

Data is being captured today as never before—both from the so-called Internet of Things (heading toward trillions of connected objects) and from hundreds of millions of individuals using social media. In just three years, IP traffic is expected to total more than half a zettabyte. (That's a trillion gigabytes—or 1 followed by 21 zeroes.) And this data no longer consists merely of text and numbers. It includes rich media of all kinds, from video and audio, to images, avatars, simulations and applications. Thirty percent of the data in the world today consists of medical images alone.

All this information—the knowledge of the world, the flow of markets, the pulse of societies—can now be turned into insight through sophisticated mathematical models, also known as analytics. Where once we inferred, now we know. Where once we interpolated and extrapolated, now we can determine. The historical is giving way to the real-time, and even the predictive.

IBM is moving quickly to capitalize on this promise. We have built the industry's premier analytics practice, with 4,000 consultants, mathematicians and researchers, as well as leading-edge software capabilities—bolstered by key acquisitions such as Cognos and SPSS. Our new Business Analytics and Optimization service line targets the highest-growth opportunities by delivering integrated analytics solutions based on the needs of specific industries.

3. Cloud and Next-Generation Data Center

As our planet becomes instrumented, interconnected and intelligent, the computing model is evolving to support it. Think of it as the industrialization of IT. Over the past generation, our digital infrastructures have become very complex and inefficient, so now we're optimizing them through automation, creating systems that are highly tuned to the specific workloads they run and to new consumption and delivery models, such as clouds.

Thus, the data center is shifting from being a single physical place to something more like the Internet, a diverse set of services fueled by IT. This provides far more choice and flexibility, of particular interest to the many businesses and governments that want simply to consume some services they once built, maintained and provided themselves. It also makes possible things that were not previously so, such as modeling systemic risk or creating integrated healthcare records.

However, with these new possibilities come new challenges, in areas such as security. As a result, our clients are seeking help in architecting and building a new kind of highly efficient infrastructure that is reliable and secure, even as it integrates services from a variety of external sources.

We have invested billions of dollars in R&D and acquisitions to build leadership in two key dimensions of this new IT model: service management

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software and optimized systems. We have also established a portfolio of cloud services that clients can access externally from IBM or offer internally to users on their own premises. And because of IBM's track record of integrating new technology paradigms like open source and the Internet into the enterprise, we have earned the trust of clients and the industry to bring reliability and security to what is new.

4. Smarter Planet

All of these growth strategies come together in the opportunity we call "smarter planet." This is not a metaphor. It describes the infusion of intelligence into the way the world actually works, the way that almost anything—any person, any object, any process or any service, for any organization, large or small—can now become digitally aware, networked and intelligent. This means that industries, infrastructures, processes, cities and entire societies can be more productive, efficient and responsive.

We developed this agenda and strategic initiative in the summer of 2008, and we launched it that autumn—at the peak of the economic crisis. We did so because we believed it represented a pragmatic way to address the very problems that were transfixing the world.

After just a year, it is clear that our belief was correct. The idea of “smarter systems” is resonating with decision-makers in both the private and public sectors. We are seeing these systems being implemented in every major industry and across every region of both the developed and developing worlds. And they are creating measurable economic and societal value.

- In a study of 439 cities, those that employ smarter transportation solutions—including ramp metering, signal coordination and incident management—reduced travel delays on average by more than 700,000 hours annually.
- Eight hospitals and 470 primary care clinics in Spain implemented smarter healthcare systems across their facilities—and improved clinical results and operational efficiency by up to 10 percent.
- Banks and other financial services organizations around the world are achieving new levels of risk control, efficiency and customer service. For instance, payment processing costs at the Bank of Russia have been reduced by 95 percent. And CLS Bank now handles most of the world’s currency exchange transactions, securely eliminating the risk from trades worth \$3.5 trillion per day, and growing.

- Four leading retailers have reduced supply chain costs by up to 30 percent, reduced inventory levels by up to 25 percent, and increased sales up to 10 percent. They’ve done so by analyzing customer buying behaviors, aligning merchandising assortments with demand and building end-to-end visibility across their entire supply chain.

This list could go on. We are quantifying the outcomes of hundreds and hundreds of smarter systems, and this measurable value gives leaders everywhere the confidence to try something new.

So the questions we are hearing are no longer about whether a smarter planet is a real possibility. Now, there is an enormous hunger to learn *how*. CEOs, CIOs, governors and mayors are asking questions like: How do I infuse intelligence into a system for which no one enterprise or agency is responsible? How do I bring all the necessary

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constituents together? How do I make the case for budget? How do I coalesce support with citizens? Where should I start?

In 2010, we are focusing our efforts on helping clients answer those questions in nine high-growth industries: healthcare; oil and gas; energy and utilities; transportation; telecommunications; retail; banking; government; and electronics.

At the same time, we are continuing to push the scientific frontiers at the core of smarter technologies. Today, more than 25 percent of IBM Research's work is on smarter planet projects, and we are in the process of doubling that to more than 50 percent, in areas such as mobile Web, nanotechnology, stream computing, analytics and cloud.

Seizing the Opportunity Before Us

The opportunity to make our planet smarter is both real and inspiring. It has excited forward-thinking leaders in industry, government and across civil society in both mature and growth markets. Encouragingly, but not surprisingly, it has also energized IBMers. Over nearly a century, IBM's greatest achievements have arisen from our distinctive culture and values.

This is why, despite the current economic climate, I am optimistic about IBM's prospects to lead the era we are now entering. Underneath the surface turmoil, this moment presents a rich

and transformational opportunity. Everywhere around the world, people are eager for change. And every day, more and more forward-thinking leaders are creating tangible outcomes and benefits, making their parts of our planet smarter. Like IBMers, they recognize that we cannot wait, cannot let this moment pass. They know the time to act is now. And the way to act is together.

Let me close by expressing my pride in the 400,000 women and men of the global IBM team who have brought us to this point. And let me express 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 role we can play in what promises to be a new epoch for our industry, for business and for our planet.



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