

Dear IBM Investor:
Today your company is positioned to lead as we enter the era of hybrid cloud and AI. As I write to you, the world is still experiencing disruption as a result of the global pandemic.

What we have witnessed over the past year is an acceleration of digital transformation. Every company in every industry wants to build a much stronger digital foundation to fundamentally change the way its business works. There is no going back. In the next two to three years, we expect to see digital transformation at a rate that, before 2020, we thought would take 5 to 10 years.

Perhaps the most profound and exciting change our clients are experiencing is the adoption of new business models based on digital technologies that IBM is building. This is evident whether you look at the use of AI-powered assistants to offset the massive increase of requests flooding call centers, the meteoric rise of telemedicine, or the use of hybrid cloud to build rich, personalized and secure experiences in areas like digital banking.

As I will describe to you in this letter, we have made decisive moves to help our clients thrive by tapping into the immense power of hybrid cloud and AI. My confidence in our ability to exit this turbulent period stronger is grounded in the strength of our strategy, the progress of our transformation, and the talent and resilience of IBMers around the world.

2020 performance

For the year, we generated \$73.6 billion of revenue, a decline of 4 percent excluding the impact of currency and divestitures. Much of this reflects the broader uncertainty of the macro environment, which also affects our clients. The urgency for digital transformation continues to fuel momentum for our business. Our cloud-related revenue grew 20 percent to \$25.1 billion excluding the impact of currency and divestitures, and now represents over one-third of our total revenue.

Red Hat was a key driver with normalized revenue growth of 18 percent in 2020 and a backlog topping \$5 billion for the first time at year end. Red Hat, together with our modernized Cloud Pak solutions, delivered overall software revenue growth for the year. Global Business Services (GBS) cloud revenue grew at a double-digit rate as we focused on modernizing clients' applications and reimagining their workflows with AI. Global Technology Services helped clients navigate the unprecedented volatility in their own business volumes, ending the year with strong contract renewals and new client additions. With IBM Systems, as always, performance reflects product cycles. Even with a very successful new product introduction in the second half of 2019, IBM Z revenue grew in 2020, with the z15 now shipping the largest capacity in the platform's history.

The fundamentals across our business continue to be strong. Our operating gross profit margin expanded 130 basis points to over 49 percent, an indication of the value our clients derive from our offerings. Operating net income was \$7.8 billion, even after a significant charge for structural actions to improve our go-forward position.

In this environment we also took actions to enhance our balance sheet and liquidity, resulting in a stronger financial position. Free cash flow is the fuel for our growth, and for the year we generated a solid \$18.2 billion of net cash from operations and free cash flow of \$10.8 billion. We focused our captive financing business on our hybrid cloud and AI strategy, reducing our external financing needs. We continued to return capital to our shareholders in the form of \$5.8 billion in dividends. We raised the dividend for the 25th consecutive year in an uninterrupted 105 years of paying a dividend, while continuing to invest in technologies, skills, and ecosystems to expand our capabilities and accelerate future growth.

The right strategy for digital transformation

Hybrid cloud and AI are the two next great shifts in the technology landscape, and IBM is positioning itself to play a key role in this swift and massive transformation. We see the hybrid cloud opportunity at \$1 trillion. Most of it is still ahead of us, as less than 25 percent of workloads have moved to public clouds thus far. Meanwhile, the current enterprise deployment rate of AI is only in the single digits.

To seize the immense opportunity that this represents, our approach is platform-centric. Linux, Containers and Kubernetes are the foundation of our hybrid cloud platform with Red Hat OpenShift as our core product, delivering all of these attributes and more. We have a vast software portfolio modernized to run cloud-native anywhere. Our GBS expertise is a key factor in driving consumption and is currently helping hundreds of major clients on their hybrid cloud journeys. All of these capabilities are supported by our systems and cloud infrastructure, which allows us to build industry-specific clouds.

Based on this foundation, we are successfully leveraging Red Hat as a unique platform to address what our global, complex and highly regulated clients need: a hybrid cloud platform that is open, flexible and secure. Our hybrid cloud approach lets clients connect their back office to their front office, modernize mission-critical workloads, build cloud-native apps, and securely deploy and manage data and applications across various IT environments.

Everywhere you look today, businesses have an acute need for speed to market, flexibility and nimbleness, and continuous innovation. On these, hybrid cloud delivers. In fact, clients find that choosing a hybrid cloud approach is 2.5 times more valuable than relying on public cloud alone.

Gaining momentum

One of the best indicators of progress is to look at the pace of client consumption. On that front, we are making good headway. We now have more than 2,800 clients using our hybrid cloud platform, up 40 percent over the past year, as they leverage it to accelerate their own digital transformation journeys.

Energy industry services, software and equipment leader Schlumberger is expanding customer access to its AI-powered exploration and production solutions and making its data platform hybrid cloud-friendly, exclusively through OpenShift. This engagement is also driving business for Cloud Paks, IBM Cloud and GBS. Delta Air Lines is using OpenShift, Cloud Paks and GBS expertise to modernize its digital customer experience.

IBM has built two industry clouds designed to tackle the specific needs of mission-critical and highly regulated industries. Our Cloud for Financial Services added key partners in 2020, such as Adobe, Infosys Finacle, Persistent Systems and many others. Some of the world's largest banks signed on, including Bank of America, BNP Paribas and MUFG Bank.

In 2020, we launched our Cloud for Telecommunications. So far, more than 35 partners have joined. As a strategic partner, Samsung is working with IBM and Red Hat to develop next-generation 5G and mobile edge device solutions for private networks. Separately, we are helping companies like Vodafone Idea, Verizon and Bharti Airtel transform their IT and telecom network operations.

Clients are moving to deploy AI at scale. More than 40,000 clients have turned to IBM to unlock value from their data. IBM's AI platform is differentiated by automation, natural language processing and trust. It is the only AI platform that can run anywhere—on premise, private cloud and public cloud. Clients across industries are using it to infuse AI into their core business processes, such as hiring, supply chains and customer service.

Putting Watson Assistant, natural language processing and enterprise AI search capabilities to work as multilingual virtual agents, IBM helped Children's Healthcare of Atlanta create the "COVID-19 Pediatric Assessment Tool" for parents.



Arvind Krishna
Chairman and
Chief Executive Officer

Thank you to former Executive Chairman Ginni Rometty. Under her leadership we laid the foundation for the hybrid cloud and AI strategy that will drive the engine of our clients' success.

Using the OpenPages with Watson platform, we are helping clients to manage risk more effectively and efficiently across their global operations by consolidating audit, risk, and control processes and procedures.

Trust is table stakes for the expansion of data and AI in daily business processes. IBM clients' data is their data, and their insights are their insights. That commitment and our industry-leading encryption technology differentiate our AI in the marketplace.

Decisive moves for future growth

Over the past year, we have made a series of decisive moves to support our hybrid cloud and AI strategy.

We announced the separation of our managed infrastructure services business in October 2020. In a business where scale matters, "NewCo" will be the biggest in its field, with more than 4,600 clients at the start, including 75 percent of the Fortune 100. Our two companies will continue to share a strong bond as NewCo will remain IBM's preferred partner for infrastructure management.

In 2020, we closed seven strategic acquisitions. All are designed to strengthen our hybrid cloud and AI portfolio. They enhance our software, expand our GBS capabilities in implementation and consulting, augment our security offerings, and support our go-to-market to drive hybrid cloud consumption.

To accelerate consumption of our hybrid cloud platform, we have elevated the role of partners and also rapidly expanded our ecosystem by adding hundreds of new partnerships with global system integrators, independent software vendors and major third-party software partners. We are investing \$1 billion in our ecosystem so that our partners can play a much bigger role in fulfilling the many needs of our clients.

Partners are helping broaden the reach of our software portfolio. For example, we collaborated with Salesforce to build our Digital Health Pass, which incorporates data such as temperature checks, COVID-19 test results and vaccine status to help organizations safely reopen. The Digital Health Pass is combined with the power of Salesforce's customer relationship management solutions and IBM's technologies, such as hybrid cloud, AI and Blockchain. Together we are also building a new vaccine management platform for Ireland's Health Service Executive. Our partnership with ServiceNow on Watson AIOps supports our continued leadership in transformative AI by helping clients automate IT operations and reduce risk.

In addition, we are aligning our go-to-market model with our hybrid cloud and AI approach, implementing a simplified client segmentation, putting IBM Garage at the center of our experiential sales process and working more closely with ecosystem partners so they can deliver more value to clients.

Responsible stewardship

Being a responsible steward of technology is core to IBM culture and has never been more important than it was in 2020.

We saw how our commitment to Good Tech can make a difference during a global emergency. We organized the High-Performance Computing Consortium to put our fastest computers at the disposal of scientists around the world working to understand and combat COVID-19. IBM's Watson Assistant for Citizens helped dozens of governments at all levels disseminate information about COVID-19 testing and best practices.

As protesters took to the streets to condemn systemic racism, we sent a letter to Congress explaining our decision to abandon facial recognition software, prompting other tech companies to follow suit. Internally we launched several social justice initiatives including Emb(race), a program highlighting the experiences of Black IBMers, and a program increasing our partnerships with historically Black colleges and universities (HBCUs). We created the position of SVP of Transformation and Culture, strengthening our transparency around and commitment to fostering the culture of diversity and inclusion that is the foundation of IBM's success.

The climate crisis is one of the most urgent issues of our time. IBM has been a leader in corporate sustainability for half a century. Our first corporate environmental policy statement dates back to 1971. Since 1990, we have shared our progress in managing waste, conserving energy, using renewable electricity and reducing carbon dioxide emissions.

We are taking other steps to advance our environmental leadership. We are setting a new goal to reach net zero greenhouse gas emissions by 2030 to help address the climate crisis. As a founding member of the Climate Leadership Council, we also support a carbon tax that will reduce carbon emissions globally through market-based incentives.

Trust is our license to operate, and for more than a century IBM has earned the trust of our clients and society. We continue to earn it through projects such as our work with the Vatican to develop principles for ethical AI, and our leadership role in data privacy reinforced by the IBM Policy Lab.

Emerging stronger

I am proud of the work IBMers have done to bring us to this point, and I am grateful to you, our shareholders, for your support on our journey.

As I look back, for me as for so many other IBMers, 2020 has put the spotlight on IBM's essential role for our clients. IBM is the backbone of some of the most critical systems that keep the world running. Our technologies and services help banks process credit card transactions, businesses run supply chains, telcos connect customers, healthcare providers improve patient care, and companies and cities tackle cyber threats.

IBM's essential and transformative role in the world is a reminder that few companies have the trust, talent and ingenuity to help clients solve their greatest challenges the way that your company can. IBM is reshaping its future as a hybrid cloud and AI platform company. I am excited about our ability to emerge stronger as the world recovers from the effects of the global public health crisis, and the possibilities ahead as our clients accelerate their digital transformation journeys.

Arvind Krishna

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Chairman and Chief Executive Officer

In an effort to provide additional and useful information regarding the company's financial results and other financial information, as determined by generally accepted accounting principles (GAAP), these materials contain non-GAAP financial measures on a continuing operations basis, including revenue adjusted for divested businesses and constant currency, free cash flow, and other "operating" financial measures including operating gross profit margin, operating earnings, operating earnings per share and operating net income. The rationale for management's use of this non-GAAP information is included on pages 18, 19, and 57 of the company's 2020 Annual Report, which is Exhibit 13 to the Form 10-K submitted with the SEC on February 23, 2021. For reconciliation of these non-GAAP financial measures to GAAP and other information, please refer to pages 21, 45, and 58 of the company's 2020 Annual Report. These materials also contain year-to-year change in revenue for Red Hat, normalized for historical comparability. The rationale for management's use of this non-GAAP financial measure and its reconciliation to GAAP are respectively included as Exhibits 99.2 and 99.1 to the company's Form 8-K submitted with the SEC on January 21, 2021.