Introduction

Thank you. This is Patricia Murphy, Vice President of Investor Relations for IBM. I'm here with Mark Loughridge, IBM's Senior Vice President and CFO, Finance and Enterprise Transformation. Thank you for joining our first quarter earnings presentation.

The prepared remarks will be available in roughly an hour, and a replay of this webcast will be posted to our Investor Relations website by this time tomorrow.

Our presentation includes certain non-GAAP financial measures, in an effort to provide additional information to investors. All non-GAAP measures have been reconciled to their related GAAP measures in accordance with SEC rules. You will find reconciliation charts at the end, and in the Form 8-K submitted to the SEC.

Let me remind you that certain comments made in this presentation may be characterized as forward looking under the Private Securities Litigation Reform Act of 1995. Those statements involve a number of factors that could cause actual results to differ materially. Additional information concerning these factors is contained in the company's filings with the SEC. Copies are available from the SEC, from the IBM web site, or from us in Investor Relations.

Now, I'll turn the call over to Mark Loughridge.

1Q13 Summary

Thank you for joining us today.

In the first quarter, we reported $23.4 billion in revenue, expanded gross, pre-tax, and net operating margins, and delivered operating earnings per share of $3.00, which is up 8 percent year to year.

But this quarter certainly didn't close the way it started. We had solid profit performance in January, but as the quarter ended, hundreds of millions of dollars of very profitable software and System z mainframe deals fell short of the goal line. This impacted the first quarter close, but the rollover of these deals positions us for a strong start in our software and mainframe businesses in the second quarter.

Taking full consideration of our first quarter performance, and a number of actions to improve this performance, we continue to expect operating EPS of at least $16.70 for the year.

Now let me make four points about what we saw in our business this quarter.

First, our total Services business performed as expected, with year-to-year constant currency revenue growth in line with last quarter, and pre-tax profit up 10 percent. Our backlog was up 1 percent year to year, or 5 percent at constant currency, driven by a lot of new business in the quarter.

Second, we had a shortfall in sales execution in our software and mainframe businesses. But with a good list of rollover transactions coupled with improved execution we've got a strong hand going into the second quarter in these businesses.

Third, in our growth initiatives, Smarter Planet was up over 25 percent and cloud over 70 percent. Business analytics was up 7 percent, led by double-digit growth in GBS. But our growth markets revenue was up 1 percent at constant currency, clearly not what we expected or what we needed. Across IBM, we delivered strong growth in several of our offerings to address market trends, like SaaS and mobile where we grew over 50 percent, leveraging our organic and acquisitive investments. As these become a larger part of our business they'll contribute more to our growth.

Finally, there are parts of our business that are in transition or have been underperforming, like elements of our Power, System x and storage product lines that showed disappointing performance in the first quarter. Here we are going to take substantial actions.

Now let me describe how this impacts the year.

With the improved execution in our software and mainframe businesses, we would expect the operating EPS growth in the second quarter to be similar to that of the first. However, given our first quarter performance, we now expect to take the bulk of our workforce rebalancing actions for the year in the second quarter, as opposed to last year, when it was distributed across the quarters. Though we certainly don't have a specific approved action, this will result in a charge that will additionally impact the operating EPS we report.

Like all years, we have a number of actions planned to improve the business for the long term, acquiring and divesting businesses,` and rebalancing our resources. This will result in charges in the second quarter, and gains in the second half, which we expect will roughly offset for the year.

By the end of 2013, taking into account our operational performance, benefits from the workforce rebalancing activity, and gains and charges, we are confident we can achieve at least $16.70 of operating EPS for the year.

Key Financial Metrics

Let me now walk you through the financial metrics for the first quarter.

In total, IBM's revenue growth at constant currency was down 3 percent. We entered the quarter with a modest currency headwind, but it became more pronounced due to currency movements over the last 90 days, especially in the Yen. When you look at the reported revenue for the quarter, currency impacted our revenue growth by 2 points.

Turning to the profit metrics, our ongoing focus on productivity and our shift to higher value contributed to our margin performance. We expanded operating gross margin by a point, led by services and an improving mix. And we expanded operating pre-tax margin by 8 tenths.

Our tax rate for the quarter was 17.3 percent, down approximately 3 points year to year. The lower tax rate is primarily due to benefits recorded to reflect changes in tax law enacted during the quarter, including the reinstatement of the R&D tax credit for 2012. We expect our ongoing operating tax rate for the next 3 quarters to be in the range of 25 percent.

Our operating net income grew 3 percent, and our margin was up over a point. With nearly $12 billion in gross share repurchase over the last 12 months we reduced our share count by 4 percent.

When you bring all of this together, we delivered operating EPS of $3.00, which is up 8 percent. Turning to cash, we generated $1.7 billion of free cash flow in the quarter and ended the quarter with a cash balance of $12 billion.

Now I'll get into the results, starting with revenue and gross margin by segment.

Revenue and Gross Profit Margin by Segment

Year-to-year constant currency revenue performance in our combined services businesses was consistent with the fourth quarter. At constant currency, Global Business Services' performance improved a couple of points, while Global Technology Services' revenue growth slowed due to continued pressure on sales into existing accounts, and actions taken to restructure the low margin outsourcing contracts. In Software, we had good performance in several key areas such as smarter commerce, social business, security, and storage management, but our growth rate was impacted by the inability to close some large transactions at the end of the quarter. In Systems and Technology, while we're delivering good performance in System z mainframe despite the slipped deals, and in our PureSystems offerings, weakness in Power, System x and storage resulted in overall declines.

Looking at our gross profit, our operating gross margin improved one point, driven by a combination of good margin expansion in both services segments, and an improving segment mix.

Revenue by Geography

Looking at revenue by geography on a constant currency basis, Americas' revenue was down 3 percent, with declines in both the US and Canada, mitigated by double-digit growth in Latin America, led by Brazil and Mexico. Our EMEA revenue was down 4 percent year to year, about half a point lower than last quarter. Most of the major countries declined, though Spain returned to modest growth. In Asia Pacific, revenue was down 1 percent. Within that, Japan revenue was up 3 percent. This was the second consecutive quarter of revenue growth in Japan, reflecting the stabilization of our business in the country. The balance of AP, which is part of our growth markets, declined.

Across all geographies, our growth markets revenue was up a disappointing 1 percent, though 5 points faster than the major markets. BRICs were up 3 percent, led by Brazil, but China and Russia posted modest declines. China's performance was impacted by weakness in large deals, and a slowdown in our low-end and midrange products.

Now let's take a look at our expense profile.

Expense Summary

Our Total Operating Expense and Other Income was down 4 percent. Acquisitions over the last 12 months drove 2 points of expense growth. Currency contributed a point of expense decline, driven almost entirely by translation. Consequently, our base expense, excluding currency and acquisitions, was better by 5 points.

I'll comment on a couple of expense items that had larger year-to-year impacts to our profit. First, workforce rebalancing was better by about $200 million year to year, driven by a charge in last year's results. Second, our IP income was down over $70M year to year.

Typically we talk about the impact of our hedging programs as a driver of expense. In first quarter the hedge activity was neutral year to year, with very modest gains in both periods. In the quarter, we were impacted by the significant depreciation of the Yen. As our business in Japan is more heavily skewed to local Services, the ability to hedge cross-border cash flows is low compared to most other countries. This had a profit impact in the quarter, which would continue at current spot rates.

So now let me go into the segments.

Services Segments

This quarter the two Services segments generated $14 billion in revenue, grew pre-tax profit 10 percent, and expanded pre-tax margin by 2 points. Total backlog was $141 billion, up 1 percent at spot rates but up 5 percent at constant currency. Backlog grew in both the transactional and outsourcing businesses. In fact, we had 22 deals greater than $100 million. We closed large transformational deals in every geography, but we had particularly good performance in our major markets where the vast majority of these 22 deals were done, and nearly half of those were new services contracts. These deals contributed to our major markets backlog which was up 3 percent at constant currency, and grew for the first time since the end of 2010.

Turning to the two segments, Global Technology Services revenue was $9.6 billion, down 4 percent as reported and down 2 percent at constant currency. There were two major categories affecting revenue growth. The first was a continuation of the decline in revenue from sales into existing base accounts. This activity tends to be more transactional in nature and economically sensitive. And, as expected, GTS revenue continued to be impacted by the work we've done to improve profitability of the restructured low margin outsourcing contracts. That initiative has helped improve our margin performance again this quarter, but does reduce the top-line. We estimate that impact to be about a point of revenue growth to GTS, and to Services in total. These two items were reflected primarily in GTS Outsourcing revenue, which was down 3 percent at constant currency. In Integrated Technology Services, revenue was up 2 percent at constant currency, led by continued strength in the growth markets and the third consecutive quarter of growth in Japan.

GTS delivered 7 percent pre-tax profit growth in the quarter and expanded pre-tax margin by about two points. This quarter, margin expansion was driven by continued efficiency improvements primarily through our enterprise productivity initiatives, and lower workforce rebalancing charges.

Turning to Global Business Services, revenue was $4.5 billion, down 3 percent as reported and flat at constant currency. This represents an improvement of 2 points quarter to quarter at constant currency.

From a geographic perspective, the growth markets and Japan drove the strongest performance, while North America slowed its rate of decline versus last quarter. Looking at the GBS business by offering, we had good results in our solutions that address the Digital Front Office. We delivered double-digit growth across the initiatives – Business Analytics, Smarter Planet, and Cloud. As these become a larger part of GBS they'll contribute more to the top-line performance. And as we address the Globally Integrated Enterprise, our traditional back office solutions, we're continuing to focus on improving our performance in implementation services that support the traditional packaged applications.

Turning to profit, GBS pre-tax income improved 17 percent year to year, and pre-tax margin expanded 3 points. The main year-to-year profit drivers were continued benefit from our enterprise productivity initiatives, lower workforce rebalancing charges, and improved contract performance.

So to wrap up Services, we grew backlog 5 percent at constant currency, with the major markets up for the first time since the end of 2010. Growth initiatives continued to perform well. We're continuing to improve in transition areas like traditional packaged application implementations, and we expanded profit margins and delivered 10 percent growth in our pre-tax income.

Software Segment

Software revenue of $5.6 billion was flat year to year or up 1 percent at constant currency. Pre-tax income was up 4 percent year to year, and pre-tax margin is up 1.2 points to 31.5 percent. As I stated up front, software growth was impacted by a number of large transactions that rolled into the second quarter. Key Branded Middleware grew 1 percent or 2 percent at constant currency.

Now, let me give you some insight into our branded middleware performance. WebSphere grew 7 percent at constant currency. For the twelfth consecutive year, Gartner designated IBM the worldwide market share leader in the application infrastructure and middleware segment. In the quarter, we had strong double-digit growth in Smarter Commerce and Smarter Cities, leveraging our organic and acquisitive investments. Our SaaS offerings contributed to this strong performance. To address the emerging opportunity around enterprise mobile computing, in the first quarter we introduced MobileFirst, which combines deep mobile expertise with cloud-based services.

Information Management was down 1 percent at constant currency, the brand most impacted by the large rollover transactions. However, we did hold share.

Tivoli was up 3 percent at constant currency driven by Security and Storage. Security was up 15 percent at constant currency driven by our Security Intelligence, and Identity and Access Management product segments. Security Intelligence, which more than doubled this quarter, provides solutions to help clients identify threats more quickly, prioritize risks more effectively, and automate compliance activities. Identity and Access Management was up double digits, allowing organizations to mitigate risks by controlling and monitoring users' access, which is even more critical as IT infrastructures become more interconnected. Tivoli Storage, which enables customers to manage their rapidly growing data, grew 11 percent at constant currency.

Social Workforce Solutions, which includes our recently acquired Kenexa business, grew 9 percent at constant currency. We began building a Social Business platform several years ago and we've been ranked as the #1 enterprise social software vendor for three consecutive years by IDC.

Across the software brands, as we close the transactions that rolled over, we should deliver double-digit growth in key branded middleware in the second quarter.

Systems & Technology Segment

Systems and Technology revenue of $3.1 billion was down 17 percent year to year, or 13 percent at constant currency adjusting for the divestiture of Retail Store Solutions.

System z grew 8 percent at constant currency. MIPS were up 27 percent and more than half of the MIPS were from specialty engines, which were up more than 65 percent. Within that Java was up 70 percent, Database 24 percent and Linux nearly doubled. Like software, as we close the large transactions that rolled over from the first quarter, we should be able to deliver double-digit revenue growth in our System z business in the second quarter.

We are also continuing to see traction in PureSystems, our expert integrated systems. We completed our first 12 months of operations for PureSystems, and have sold over 4,000 systems in over 90 countries.

Power revenue was down 31 percent at constant currency. Our declines were driven by both the High Performance Computing segment, where we had a strong performance last year, and the impact of the transition to Power 7+. Let me step back and provide a broader perspective. We are by far the market leader in UNIX. We are expanding our Power platform to go after the Linux opportunity. This opportunity is of similar size to UNIX, but growing faster. We have already had some key successes, with wins this quarter in China and in Europe. And in fact, Watson is based on Power Linux. Though this will take time to mature it provides a real opportunity for future growth.

System x was down 8 percent at constant currency, and our Storage revenue was down 10 percent at constant currency. We had strong growth in our new midrange products. Storage gross profit was up as our organic Storwize products grew over 50 percent and replaced older OEM products. The value in storage continues to shift to software. Our storage software, which is reported in Tivoli, grew 11 percent at constant currency.

For Systems and Technology, this is not the quarter we expected. Our performance was impacted by product transitions and our own execution. We expect to improve our revenue performance in the second quarter and return to profitability excluding the second quarter workforce rebalancing activity.

Cash Flow Analysis

Moving on to cash flow in the quarter, we generated $1.7 billion of free cash flow, down almost $200 million year to year.

The year-to-year performance was driven by a decline in our accounts receivable clearance rate and an increase in cash tax payments. These were mitigated by a year-to-year benefit associated with the timing change of funding our 401K, and a lower level of capital expense.

Looking at the uses of our cash, we closed two smaller acquisitions this quarter, Stored IQ and Star Analytics. We returned $3.5 billion to shareholders, including almost $950 million in dividends, and $2.6 billion in gross share repurchases. We bought back 12.3 million shares in the quarter, and at the end of the March, we had $6.2 billion remaining in our buyback authorization

Balance Sheet

Turning to the balance sheet, we ended the quarter with a cash balance of $12 billion, up $900 million from year end.

Total debt was $33.4 billion, of which over $25 billion was in support of our financing business, which is leveraged at 7.2 to one. Our non-financing debt was $8.2 billion, down $600 million from year end. At these debt levels, non-financing debt-to-cap was 34 percent, down 2 points from year end.

We continue to have a high degree of financial flexibility and our balance sheet remains strong to support the business over the long term.

Operating EPS Bridge – 1Q12 to 1Q13

So now let me start to wrap up with a summary of the drivers of our operating earnings per share performance this quarter.

Our revenue decline impacted our earnings growth by 14 cents. The contribution from margin was 23 cents, with gross, pre-tax, and net margins all up year to year, driven by our mix to higher value, margin expansion in services, and a lower tax rate resulting from changes in tax law during the quarter. A lower share count resulting from our ongoing share repurchase program contributed an additional 13 cents.

1Q 2013 Summary

For the quarter we delivered 8 percent operating earnings per share growth.

As I said at the beginning of the call, the quarter didn't end the way it started, so we're going to roll up our sleeves to get this back on track. First, by improving our sales execution, to close the rollover deals in software and mainframe and recover our position in the growth markets. Next, by taking the bulk of our workforce rebalancing actions in the second quarter, we'll start to get the benefits from those actions earlier in the second half. Finally, by taking actions to improve our underperforming businesses, including expanding our Power platform to address the Linux opportunity, and leveraging our investments in flash and mid-range storage solutions. Some of these actions will yield benefits quickly, while others will play out over time.

And of course we're going to continue to deliver on the core elements of our business model, as we continue to shift to higher value, leverage our key growth initiatives, drive productivity across the enterprise, invest in innovation and return value to shareholders.

Now we've got a lot of work to do, but we know how to get it done. By the end of 2013, taking into account our operational performance, benefits from the workforce rebalancing activity, and gains and charges, we expect to deliver at least $16.70 of operating EPS for the year. All of this is consistent with our objective to achieve at least $20 of operating EPS in 2015.

Now Patricia and I will take your questions.

Closing

Thank you, Mark. Before we begin the Q&A I'd like to remind you of a couple of items. First, we have supplemental charts at the end of the deck that complement our prepared remarks. Second, I'd ask you to refrain from multi-part questions.

When we conclude the Q&A, I'll turn the call back to Mark for final comments.

Operator, please open it up for questions.