

## IBM Business Model – Annuity Content Provides Solid Base of Business

November 15, 2007

In IBM's third quarter earnings report, we mentioned a few characteristics of our business model, including geographic diversity, a broad mix of businesses, and high annuity content.

Annuity businesses have several benefits. They:

- provide a solid base of business – in good times, and in uncertain times,
- reflect deep customer relationships, and
- are a good source of profit and cash.

The simplest definition of IBM's annuity business is based on category of revenue:

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What's in Annuity?

Outsourcing – SO and BTO

Maintenance

AMS for custom applications

Middleware “stream”

System z operating system

Financing

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What's in Transaction?

Integrated Technology Services

Consulting

AMS for packaged applications

Middleware “transactions”

Other platform operating systems

Hardware – new and used

This definition is imperfect, since there is some activity in the annuity category that is “sold and delivered” in the quarter. And some of the activity in the transaction category is recognized over time. But overall, it is a good indication of the split.

Based on this definition, over the last few years approximately half of IBM's revenue has been annuity, and half transactional. The precise ratio varies by quarter, with typically more transactional content in the seasonally strong fourth quarter.

The annuity content is primarily in software and services.

- Software: over 2/3 of software revenue has been annuity.  
Most of the mainframe software is billed via monthly license charge, and software sold in a distributed environment includes subscription and support charges which are also recognized ratably.
- Services: approximately 60% of services revenue has been annuity.  
The backlog provides a solid base as we enter each year. For example, in 2006 and 2007 approximately 80% of the Strategic Outsourcing revenue was under contract as we entered the new year. Global Business Services has less revenue coming from long term categories, though annuity is becoming larger percent of the total.

Because we have a different mix of business by customer, the annuity vs. transaction content will vary by sector. For example, Financial Services Sector has had a higher share of outsourcing revenue, and more mainframe associated revenue, such as monthly license charge software and financing income. As a result, FSS has had a higher portion of revenue coming from the annuity businesses than for IBM overall. Since the beginning of 2006, FSS' annuity content was 8 to 10 points higher than the IBM average.

While transactional businesses are more subject to economic conditions and the competitive environment in the short term – with a higher annuity content, geographic breadth, and broad mix of businesses, we believe IBM’s fundamental business model has more stability than most other technology companies. This has allowed IBM to provide sustainable profit and cash flow growth over the long term, and supports the 2010 earnings per share roadmap.