.COM

We’re not changing our name. Just everything else.
And we’re not the only ones.

Millions of enterprises aren’t waiting for a revolution.
And they aren’t just watching one either.
The revolution has arrived.

With stunning speed, it has swept all of us into a new kind of economy and a new kind of society.
A world of new mindsets and new ambitions, to be sure.
But also a world where time-honored assets – customer relationships, smart people, deft strategy – still matter.
This is the world of e-business.

It is a world where everyone looks both new and familiar.
Where any company and every company is a dot-com.
e-business is here. We’re never going back.

Louis V. Gerstner, Jr. — Chairman and Chief Executive Officer

Dear fellow investor,

At this point last year, the only thing we knew for certain was that the coming year would be unlike any other. We faced some big unknowns – economic crises in Asia and Latin America, the Euro conversion and, of course, Y2K. Underlying it all, making the uncertainties even more uncertain, was the tectonic plate shift of e-business.

As it played out, 1999 was, indeed, a roller coaster for IBM. The first half saw remarkable growth for our company, but in the second half, Y2K hit us hard. Many of our biggest customers locked down their systems and their spending, and because IBM's customer base contains so many of the world's leading businesses, government agencies and financial institutions – the very enterprises most at risk from Y2K – our sales suffered accordingly.

Even so, when you average out the highs and lows, 1999 was a good year for IBM. For the fifth straight year, we reported record revenue – $87.5 billion, up 7 percent over 1998. Our earnings rose to $7.7 billion, a 22-percent increase, resulting in another new record in earnings per diluted common share. Customer satisfaction achieved its highest level in a decade.

After making substantial investments – $5.8 billion on research and development, $6 billion on capital expenditures and $1.5 billion on acquisitions that strengthened our business portfolio – we had enough cash to buy back $7.3 billion of common shares and to increase our dividend to shareholders. Our market value, probably the most important measure of progress to investors, grew $24 billion in 1999, and has increased by nearly $170 billion in the past seven years.

Those are all good numbers, but not good enough. After building some real momentum over the previous two years, IBMers found the last two quarters of 1999 frustrating in the extreme. Some outside the company say it was a wake-up call. I say it was a starting gun, because now, the real race begins.

The dot-coms, it seems, are taking over. You can't chart future strategy, execute a transaction, invest money, even read a paper or magazine or watch TV without, somewhere in the process, bumping into dot-coms and, behind them, the whole world of e-business.

Some find all this energizing, some annoying, but everyone's paying attention. It's the first question I get from any IBM customer in almost any part of the world: "What must I do to survive and win in this new world?" In fact, at the moment, it's just about the *only* question I get.

The fact is, 1999 was the year e-business and the global Internet economy came of age. It was a tidal wave, sweeping everything before it, driving new levels of megamerger activity, carrying thousands of entirely new businesses to unprecedented levels of wealth (much of it probably unsustainable), submerging almost as many others, and rearranging the landscape of commerce.

One conservative estimate is that the e-business opportunity will approach $600 billion by 2003, and it could well be even larger than that. While the overall information technology (I/T) industry grows at around 11 percent, the e-business portion is growing much faster – at around 22 percent.

All that adds up to a tremendous opportunity for IBM. I'm not talking here about the pent-up demand that will be released as Y2K lockdowns are unlocked. I'm talking about the fact that customers are investing heavily in new e-business applications and solutions. We expect 2000 to be a good year for our company. However, we aren't taking anything for granted. We know how open the field is and how huge the stakes are. It's tough to be fast, focused and surefooted in a period of explosive change. But that's what we have to do.

As the race begins, these are our top three goals:

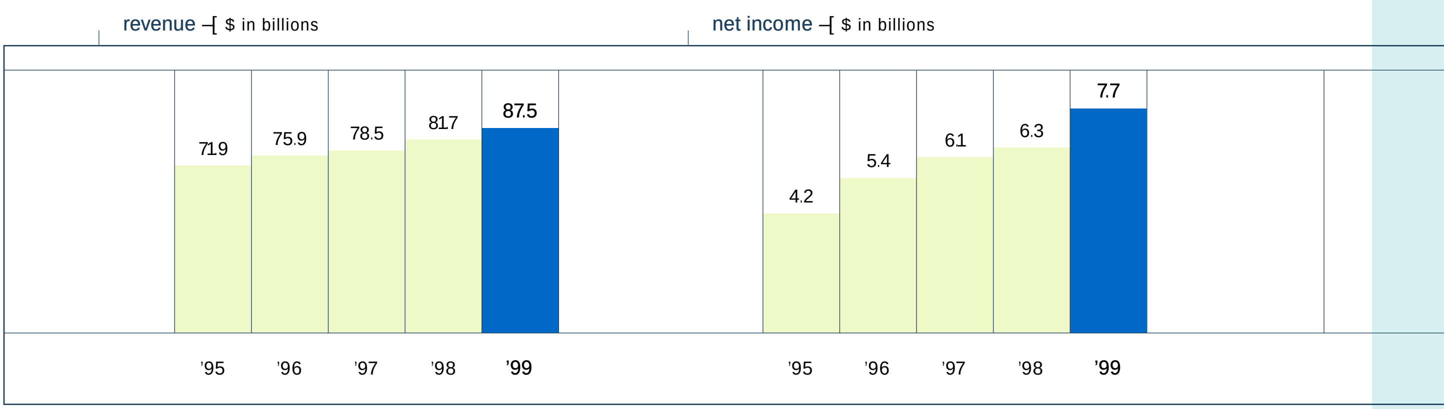
[1] Accelerate our growth. A hyperdynamic marketplace such as we see today values *trajectory* – that is, the potential for growth – more than current market position. That's good for IBM, because we're entering a period of explosive demand for everything we have – hardware, software, services, component technology, expertise – the whole portfolio. There's no question the opportunity is there, but thus far we haven't captured our rightful share across all segments.

However, when we set our targets high – to grow not with the market, but faster – we've proved that we can deliver. In 1999, for example, our revenue for database products on UNIX and Windows NT was up 56 percent, more than three times the industry growth rate; our custom-logic chip business growth exceeded 70 percent year over year, as we focused on the communications industry; and shipments of our Netfinity line of Intel-based servers increased more than 30 percent. Shark, our new enterprise storage subsystem, was ordered by half of the Fortune Global 100 within the first 100 days of its introduction. In the first three months of the RS/6000 S80 e-business server, we sold as many as Sun shipped of its competitive offering in its first one and a half years. And e-business services, the most exciting growth opportunity since we started our services business, reached more than $3 billion in 1999 revenue, a 60 percent increase.

We will continue to shift our portfolio toward the highest-growth e-business opportunities. In this regard, we passed an important milestone last year. Our three major growth engines – services, software and component (OEM) technology – now provide more than half (in fact, nearly 60 percent) of IBM's revenue. Conversely, we are exiting businesses where we can't achieve our growth objectives, or where partnership is the preferred strategy. That's why we formed a networking solutions alliance with Cisco Systems last year. And it's why we scaled back our enterprise application software efforts in 1999, instead partnering with leading software developers like Siebel Systems, i2 Technologies, SAP and Telcordia Technologies.

We are stepping up our work with the NetGen and dot-com companies and aggressively pursuing opportunities in online trading hubs, application service providers and the whole area of pervasive computing. One standout opportunity is in wireless devices, particularly in Europe and Asia, where the number of data-enabled cell phones is expected to surpass the number of PCs in just a few years. We recently signed a deal with Vodafone AirTouch to design, build and manage an Internet portal that will allow businesses and individuals to access content and services over the Internet using a variety of wireless devices.

We're targeting the emerging "white spaces" of the networked world, such as storage, which is being transformed through the emergence of Net-driven storage area networks (SANs); and the



game-changing open-source operating system Linux, which we're moving aggressively to support across our entire product line. And we will continue to build on IBM's e-commerce lead, increasing sales and distribution through ibm.com. In 1998, e-commerce generated $3.3 billion in sales; in 1999, that rose to $14.8 billion. We expect to double that this year.

Finally, as the Net shifts computing workload, applications and data from PCs to large server systems, more and more computing solutions will be delivered as a service, over the Web. We've already got a significant Web hosting business, from complex sites for customers like Macy's and the Olympics, to small businesses. And our acquisition of Whistle Communications last June strengthened our ability to offer network computing services to smaller customers.

[2] In all things, innovate. By innovation I don't just mean technology – though of course I mean that, too. With our seventh straight year of patent leadership and another record total (2,756 U.S. patents in 1999), IBM's position as the world's premier commercial center of technology innovation is unchallenged. We will continue to invest in that. We will also continue to speed those innovations – such as copper chips and record-setting hard disk drives – into products (our own, and those of our customers). And we'll continue taking on "grand challenges" that bring technology breakthroughs to bear on previously intractable problems. For example, in December 1999, IBM Research announced a $100 million push to build a supercomputer named "Blue Gene" – 500 times more powerful than today's fastest computers – that initially will be used to model the mysterious folding of human proteins.

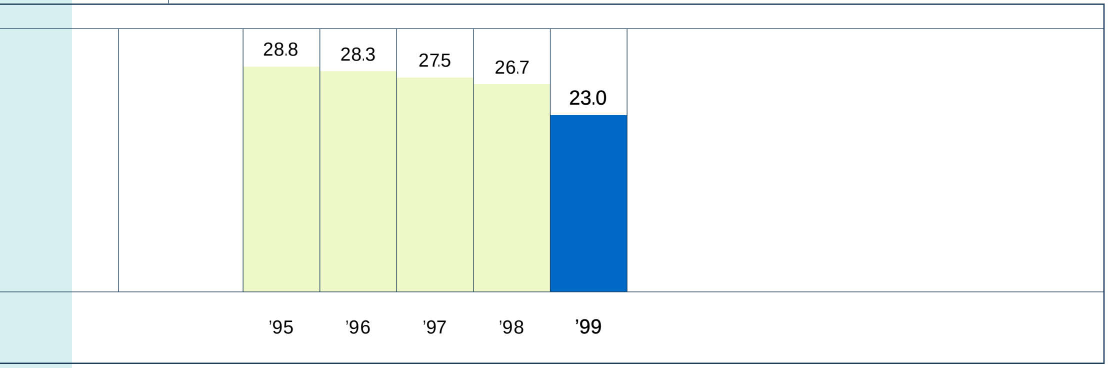
But innovation at IBM has never been about technology alone, or for its own sake. Especially now, when the competitive environment demands that we create radically new ways in which we go to market, attract new employees and structure relationships with customers and partners.

For instance, we have stepped up our efforts to reach out to Internet startups – through novel incubator programs and more than $700 million in planned startup financing and venture capital investments. We form relationships with dot-coms while they're still in the incubator, so we can help them make technology decisions before they launch. Just as important, we get to see beyond the current technology horizon, understand the trends and deploy that learning directly in IBM. (And, by the way, we've already seen a tidy return on our investments.)

We're also innovating in how we build relationships with such important communities as software developers (via our developerWorks Web site, a resource for the Web's 10 million-plus developers worldwide) and future employees (witness last summer's "Extreme Blue" internship program, which gave some of the world's brightest computer science students a chance to work on real, cutting-edge IBM projects).

Finally, we continue to drive innovation in

total expenses as a percentage of revenue



transforming IBM into a leading e-business – and not just in e-commerce sales, which I mentioned earlier. In providing e-care for customers, we handled 42 million self-service transactions in 1999, avoiding some $750 million in support costs. We delivered 25 percent of our internal training via distributed learning, which has not only saved us more than $200 million, but made it far easier and faster for our people to educate themselves. Through e-procurement, we bought about $13 billion in goods and services over the Web, saving at least $270 million. And our intranet, which we believe is the largest and most heavily trafficked in the world, has emerged as a vital business platform and knowledge-sharing medium for IBMers. It is quickly becoming IBM's digital nervous system.

[3] Shape the new face of IBM. What will "IBM" mean to customers, potential customers and employees, and the public at large in the years ahead? Our brand used to be touched and our company experienced primarily through our products. But going forward, a smaller percentage of our customers will buy an item with "IBM" stamped on it. Instead, when they experience the benefits of our innovative technology, much of it will be inside other companies' branded products, or at work behind the scenes in the computing infrastructure of the Net.

Even more important, they'll experience IBM in the person of another human being. Sometime within the next five years, more than half of our revenues and workforce will come from services. This will mean that, very soon, revered IBM brand attributes like quality, reliability and innovation will primarily be descriptors of IBM people – their knowledge, ideas and behavior – just as today they describe IBM ThinkPads, servers and software.

We are very proud of what we accomplished through the 1990s in reanimating the IBM brand. Going forward, as the nature of our business changes, we will create new ways to make "IBM" relevant, compelling and exciting to people. And since so much of the IBM experience will be shaped by our people, I believe one of the most important tasks will be building the training, development, reward and knowledge management systems that support the IBM workforce. In other words, the strategic connection between our culture and our brand will be even more important – and more visible.

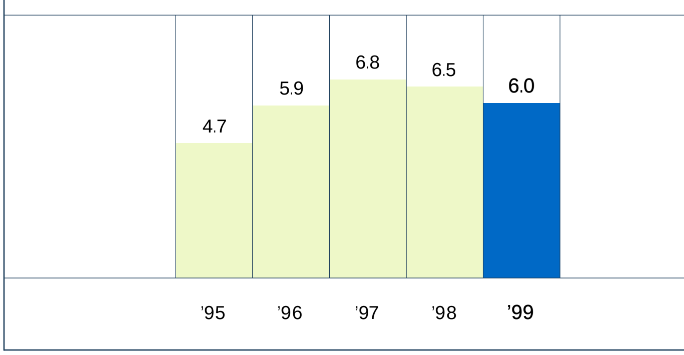
What's Next? Last year I told you about three trends that were shaping the immediate future of information technology:

> the Internet was creating not just new businesses, but new business models;
> competitive advantage in the I/T industry was moving from creating technology to helping customers use it; and
> with the rise of the networked world, the PC era was over.

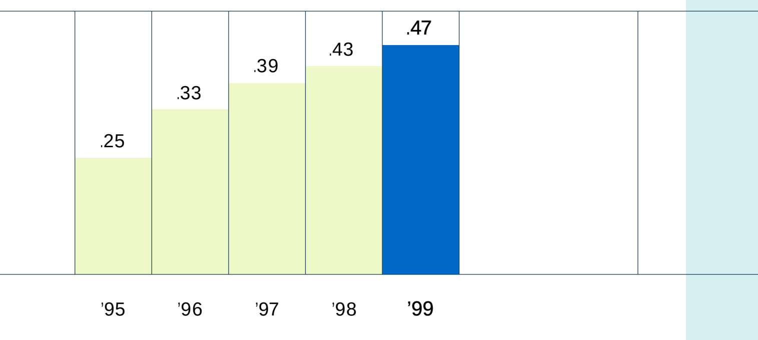
There was some clucking about my PC era statement by the usual suspects, but amid the ups and downs of 1999, all three trends were confirmed and underscored in the marketplace.

ADJUSTED TO REFLECT A TWO-FOR-ONE SPLIT
OF THE COMMON STOCK EFFECTIVE MAY 10, 1999

capital investments –[$ in billions



dividends –[$ per share



financial highlights

International Business Machines Corporation
and Subsidiary Companies

(Dollars in millions except per share amounts)	1999	1998
FOR THE YEAR:		
Revenue	$ 87,548	$ 81,667
Income before income taxes	$ 11,757	$ 9,040
Income taxes	$ 4,045	$ 2,712
Net income	$ 7,712	$ 6,328
Earnings per share of common stock—assuming dilution	$ 4.12	$ 3.29*
Earnings per share of common stock—basic	$ 4.25	$ 3.38*
Cash dividends paid on common stock	$ 859	$ 814
Per share of common stock	$ .47	$ .43*
Investment in plant, rental machines and other property	$ 5,959	$ 6,520
Average number of common shares outstanding (in millions)		
Assuming dilution	1,871	1,920*
Basic	1,809	1,869*
AT YEAR END:		
Total assets	$ 87,495	$ 86,100
Net investment in plant, rental machines and other property	$ 17,590	$ 19,631
Working capital	$ 3,577	$ 5,533
Total debt	$ 28,354	$ 29,413
Stockholders' equity	$ 20,511	$ 19,433
Number of employees in IBM / wholly owned subsidiaries	307,401	291,067
Number of common stock holders	646,702	616,800

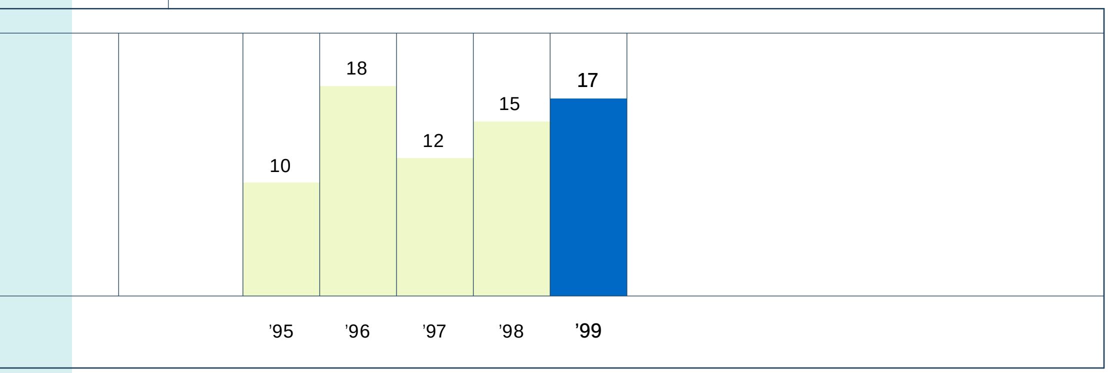
*Adjusted to reflect a two-for-one split of the common stock effective May 10, 1999

This year I'd like to mention three other important developments (actually, they are more like new realities) that are now taking hold:

> Up to now, the primary impact of e-business has been on individual companies. Now the Internet is reinventing entire markets – you might say, the very *idea* of a market. A few years ago, search engines took off because people needed help finding information on the Web. Then, as e-commerce exploded, search engines morphed into portals, which helped people find not just information but also products and services.

Last year we began seeing entirely new business life-forms – companies that function not like traditional companies, because they don't make or sell anything themselves, but very much like markets. They help buyers find and qualify sellers. We call these "e-marketplaces" and "e-exchanges," and we already see them facilitating business-to-business

number of acquisitions



transactions in chemicals, steel, pharmaceuticals, industrial goods of all kinds, capital, even labor.

As they grow, e-marketplaces hold the potential fundamentally to change the dynamics of every industry, as they venture out into the global, borderless marketplace of the Internet, with millions of buyers looking for millions of sellers, and vice versa. IBM is already working with pioneers in this area, like SciQuest.com, e-Chemicals and PartMiner.

> Market control is no longer a sensible or an achievable business goal. I don't think this is fully understood by Wall Street. In the world we're now leaving – defined by the era of proprietary technology and computing architectures – customers were dependent on the providers of key pieces of technology. New iterations, new features came out when the provider decided they would.

The Internet changes all that. Customers, not technology providers, are in the driver's seat. No longer is it possible to operate a successful information technology company from the lab out; an e-business economy requires that we organize ourselves from the customer in. (And this applies not just to labs, but to garages. If what you want to do is get some cool new technology into the marketplace and then cash out, that's one thing. But if you want to build an enterprise that lasts, you've got to address some real customer need.)

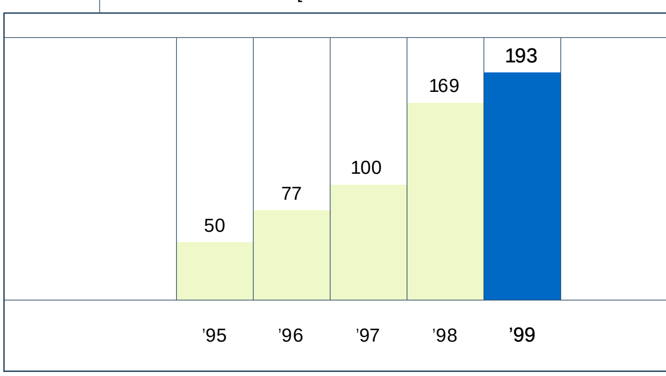
Breakthrough technology is just as crucial as it ever was – but it doesn't confer control. For our industry, that changes everything. No technology company can any longer dream of coming up with the magic bullet that will establish it as "the next IBM" or "the next Microsoft" – that is, sole owner of a key platform. I believe the wild market valuations of many dot-coms reflect the persistence of "Next Big Thing" thinking – the idea that one or more of these companies will lock up some controlling position. We're not managing IBM – or investing its resources – in the expectation of or hope for that kind of control. Instead, we're building an enterprise that will thrive in a more complex, interdependent and open world.

> The intersection of societal issues and the Internet will force our industry to grow up – fast – and assume a new level of public responsibility. It is disturbing to see many of the new members of our industry – and even some of the "old" ones – act as if the rest of society had no call on them. Yet modern history shows that when a new technology really matters, when it changes society in fundamental ways, the industry that pioneered it – be it telecommunications, energy, transportation or broadcasting – has always been called upon to take responsibility for those changes, for their impact on people and on the planet. If the industry doesn't, people do something about it – as they should – often through government intervention.

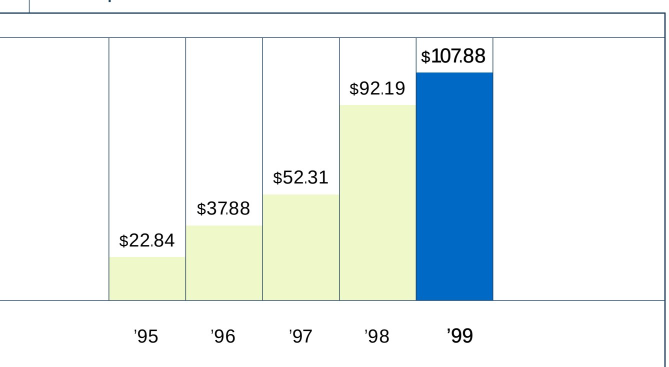
We are now at one of those inflection points. The Internet is driving everything our industry creates into every factory, store and office – and also into every home, classroom and voting booth. Crucial issues such as privacy, equal access, data security, national security, protection of children and

YEAR-END CLOSING PRICES ADJUSTED TO REFLECT A TWO-FOR-ONE SPLIT OF THE COMMON STOCK EFFECTIVE MAY 10, 1999

IBM market value – $ in billions



stock performance



education are all profoundly affected by this onrush. In most cases, our technology is at once a threat and an important part of the solution.

The implications are clear. Our industry has a very limited opportunity to step up to these imperatives and demonstrate responsible leadership. Just as we are entitled to ask our public institutions to adjust to a world that runs at Web speed, so the information industries themselves must learn to define their ambitions with the broadest constituency – and longest time frame – in mind. The business of e-business is not the IPO; it's the future. At IBM, that's how we're shaping our business decisions and our actions in the ever-more-essential arena of Internet-driven public policy.

* * *

There has never been a headier time to run a business – or a more challenging one. For all its fluctuations, though, I find myself more optimistic than I have been in my seven years at IBM – and that optimism has been deepened by three lessons of 1999.

First, the global economy has proven a lot more resilient than many of the doomsayers predicted. A networked world, it turns out, cushions rather than amplifies local downturns.

Second, technology and technology professionals came through the challenge of Y2K with flying colors (including tens of thousands of IBMers who exemplified our company at its very best in the way they helped our customers and our own company through this challenge). A year ago, a severe backlash against technology in the wake of Y2K seemed likely. Going forward, people will probably feel confident in I/T's ability to survive even the severest of threats.

But the biggest reason for my feeling of optimism about IBM's prospects is the change in IBM itself. In identifying and defining e-business, we have created a huge, entirely new kind of market for our goods, services and expertise – and we are stepping up to an entirely new set of challenges. We are reshaping our own company into a fundamentally different enterprise, what *Business Week* magazine recently called "The Biggest Dot.Com of Them All."

I don't make predictions. Even with 1999's uncertainties largely behind us, our industry, our economy, the developments in technology and the shape of the emerging global culture remain far too dynamic to predict outcomes. But I am certain of one thing that 2000 holds in store for IBM. This year we will attack our remarkable opportunities with a new level of aggressiveness.

Watch this space.

Louis V. Gerstner, Jr.
Chairman and Chief Executive Officer

e-business is here.