YOU'RE **ONE PAGE** AWAY

from the **NO-HOLDS-BARRED** STORY

of ONE YEAR

in **THE LIFE OF A COMPANY.**

It's the story of

BIG BATTLES, STINGING DEFEATS

&

GRITTY COMEBACKS.

UNEXPECTED ALLIANCES, DARING FORAYS

&

GAME-CHANGING DISCOVERIES.

In many ways,
IT'S A STORY ABOUT THE FUTURE,
AS WELL AS THE RECENT PAST,
AND ABOUT ALL BUSINESS TODAY.
WHICH MEANS IT'S ABOUT E-BUSINESS.
AND ONE IN PARTICULAR.

IBM

ANNUAL REPORT 2000

THE STORY OF IBM is really many stories.

We're opening up new markets and extending our lead in others. We're fighting back in businesses we pioneered and changing ourselves in some fundamental ways. Last year, we absorbed our share of hits, too. But we won more than we lost. And closed the year on a high note.

All the while, we've kept working, inventing and partnering to write the next chapter of the story we started five years ago. The story of e-business.

So, while this year's report is not a simple narrative, it does yield one singular theme. It's ultimately the story of hundreds of thousands of people tackling scores of the toughest business and technological challenges over 12 intensely challenging months.

It's one story we're proud to tell.

REVENUE
($ in billions)

Year	Value
91	64.8
92	64.5
93	62.7
94	64.1
95	71.9
96	75.9
97	78.5
98	81.7
99	87.5
00	88.4

NET INCOME
($ in billions after adjustments)

Year	Value
91	2.3
92	1.4
93	.01
94	3.0
95	6.0
96	5.9
97	6.1
98	6.3
99	7.0
00	8.1

EARNINGS PER SHARE — DILUTED
($ after adjustments)

Year	Value
91	1.00
92	.62
93	-.02
94	1.24
95	2.55
96	2.71
97	3.00
98	3.29
99	3.72
00	4.44

TOTAL EXPENSE AS A PERCENTAGE OF REVENUE
(after adjustments)

Year	Value
91	44.5
92	41.6
93	38.3
94	31.4
95	28.8
96	28.3
97	27.5
98	26.7
99	25.3
00	23.6
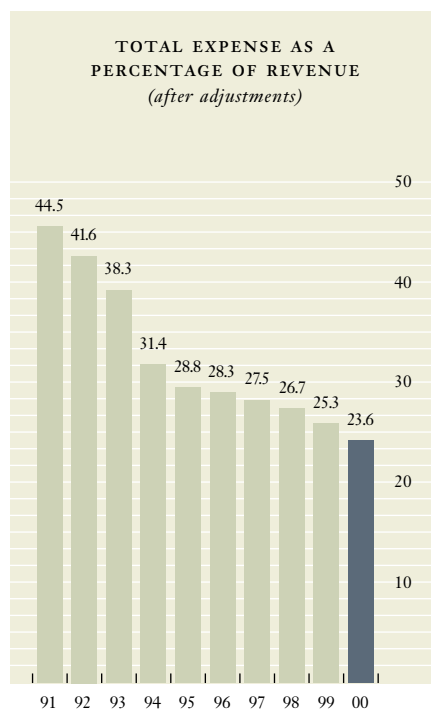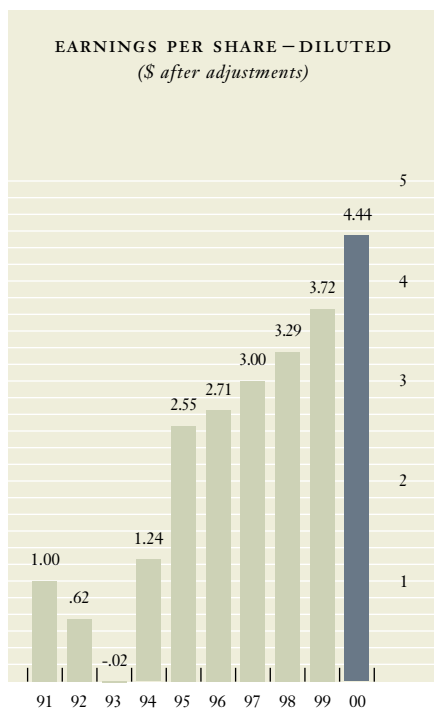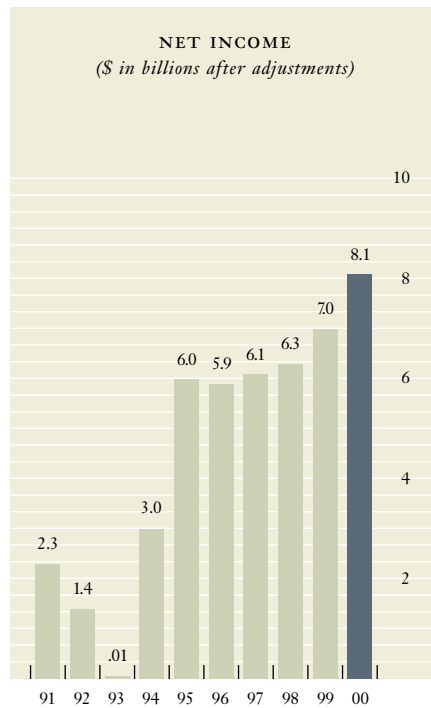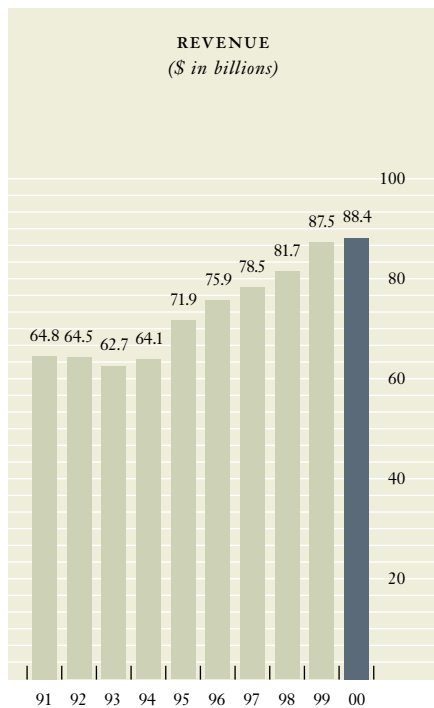
DEAR FELLOW INVESTOR,

Last year at this time, I said 2000 looked to be a year of great promise for IBM—as well as a year of great uncertainty. I said that, based on the way things were playing out in our

industry—and in business in general—and because IBM, more perhaps than any other company in information technology, was vulnerable to customer wariness over "Y2K problems."

It turned out that last year was, in a word, unique. As you may remember, our company entered the year facing a severe drop-off in customer demand because of Y2K. Many of our largest customers had frozen big-ticket technology purchases heading into the new millennium, and that persisted until almost the middle of 2000.

Then, in a flip-flop the likes of which I have never seen, demand went through the roof. Within a 30-day period last summer, orders for some of our products tripled. We couldn't build fast enough to fill orders and, to make matters worse, we had shortages of some key components. Thanks to the determined, round-the-clock work of literally hundreds of thousands of IBMers, we got supply and demand into better balance in the final quarter of the year, and we finished strong. But, I don't need to describe to you the frustration of not being able to satisfy customer demand, particularly in view of the drought we had endured. I am determined that's not going to happen again.

But, add it all up—the highs, lows and sideways moves of 2000—and IBM had a solid year. For the sixth straight year we reported record revenue—$88.4 billion. Our earnings rose to $8.1 billion, a 16 percent increase, resulting in another record in earnings per diluted common share. After making substantial investments—$5.6 billion in research and development, $5.6 billion in capital expenditures and more than $500 million in strategic acquisitions that strengthened our business portfolio—we had enough cash to increase our dividend to shareholders and to buy back $6.7 billion of common shares.

The most disappointing note was that our year-to-year stock price went down for the first time since I joined the company—to $85 from $108, a decline of 21 percent. Of course, just about all information technology stocks dropped, in what might be called a NASDAQ crash, and IBM fared better than most. Also, over the past eight years IBM's share price has increased nearly 800 percent. Even so, we can do better.

What about 2001? Can the recent trend continue? Whether or not there is a softening of the U.S. economy, IBM should be in reasonably good

SAMUEL J. PALMISANO
President and
Chief Operating Officer

LOUIS V. GERSTNER, JR.
Chairman of the Board and
Chief Executive Officer

JOHN M. THOMPSON
Vice Chairman of the Board

competitive shape. Of course, we all hope such a downturn doesn't occur. But if it does, the ebbing tide may not beach all boats. For one thing, services offerings like outsourcing and hosting are cost-saving propositions for our customers. Services, in this regard, is a countercyclical business. And in a tightening economic environment, customers are going to invest in projects that deliver rock-solid, tangible, near-term payoffs, not in speculative, exploratory schemes. As a result, this may be a prime opportunity for IBM to improve its market position.

THE DOT-COM CRASH: WHAT IT MEANS

That's not the way things seemed a year ago. Back then, it looked as though Internet start-ups were taking over and traditional bricks-and-mortar enterprises had better jump with both feet into "e-tailing" or get steamrolled.

Well, as we all know today, it didn't happen. The crash brought out the usual pundits and weathervanes—the same ones who a year earlier had declared that dot-coms were taking over the world. Only now they were saying, "This e-business was mostly hype anyway. E-nough!"

Since, in many ways, IBM gave birth to all things "e" five years ago, I'd like to offer a perspective.

The collapse of the dot-coms was not a failure of e-business. It was the failure of an overly narrow approach to e-business. For all the proclamations we have been hearing about a "new economy," the problem with most dot-coms was that their business model—win customers through lower prices—wasn't anything new, not to mention transformative.

IBM has always said that e-business involves more than transforming one part of a company, such as selling directly over the Net. We said the real action, the real work—and the ultimate payoff—involved the transformation and the integration of the *entire enterprise*, from the customer all the way through the supply chain. Things have played out pretty much that way—and that may have been a bucket of cold water for some. For IBM, it was a tough but ultimately heartening reaffirmation of the strategic direction we set in place several years ago.

So, if there is a lesson to be extracted from the dot-com crash, it may be this: There is no short-cut to e-business. And if 2000 comes to be seen as a watershed (and I think it will), that will be because this was the year the world's established enterprises awoke to the true possibilities of e-business. I believe a broad consensus has emerged that e-business is just…business, real business. And real business is serious work.
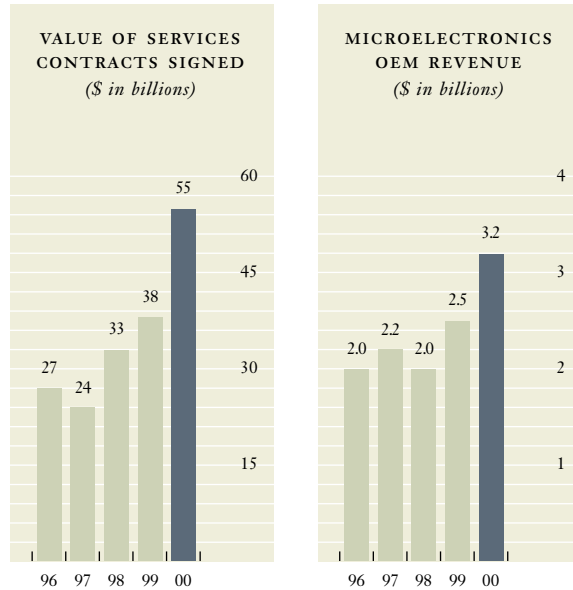
THE GAME TODAY

One word you heard a lot last year was "buzz." It's what the cooler members of our industry were supposed to create to get all their constituencies excited about what they were doing. Unfortunately for them, this isn't a very buzz-y period for our industry. In fact, it's downright boring, but oh so important for the future.

Customers tell us the battleground has shifted to computing infrastructure. Of course, IBM is no longer alone in saying that the PC era is over, nor in pointing to the explosion in personal access devices (as well as an even wider array of *things* with embedded intelligence, such as appliances and cars). Most of our competitors today are saying that enterprise servers, storage and software are key, and that they must be bulletproof, robust, scalable, never-go-down. But I'm not sure we all agree on what "infrastructure" actually means.

Businesses are coming to see that their computing infrastructure cannot be designed or built around any one product—or even any particular *type* of technology, whether databases, or servers, or storage. None of those tails can wag this entire dog. For one thing, the pieces all have to work with one another. For another, in order to function in the real world—where there is a hodgepodge of existing systems within any company and among its customers, suppliers and trading partners—they have to take a broad view of the full spectrum of infrastructure elements.

The point is, no company's systems are an island. They're part of a new, emerging, *global* infrastructure that is made possible by the emergence of the Internet, and that no one enterprise can—or wants to—own. It's *collectively* owned, accessed and relied upon by every business, government, school, hospital and neighborhood.

**VALUE OF SERVICES
CONTRACTS SIGNED**
($ in billions)

Year	Value
96	27
97	24
98	33
99	38
00	55

**MICROELECTRONICS
OEM REVENUE**
($ in billions)

Year	Value
96	2.0
97	2.2
98	2.0
99	2.5
00	3.2

In that respect, computing infrastructure is rapidly becoming like all the other kinds of infrastructure we take for granted in the world—the telephone system, the highways, the power grid.

This has been a long time coming. The main obstacle has been a lack of standards in our industry. Simply put, without standards, computing systems cannot work with each other. And if your computer can't work with all the other computers in the world, then you're limited in how you can buy and sell, trade stock, book a vacation, receive health care and cast a vote over the Net. And in the same way, your company is limited in how it can work with its trading partners, its suppliers, its customers—and you.

The Internet, of course, began to change all that by bringing common standards to network connectivity. Now, the astounding adoption of the Linux operating system—and the broader Open Source movement of which it is a part—are pushing standards over the top (which is why IBM has made such a huge commitment to Linux). Standards are a reality of our industry today. There's no going back.

This is wonderful for customers and users of computing. But for many technology companies, it is an earthquake. No longer will the battle be won or lost over computing technology controlled by one company. Success going forward will require open platforms, and tech companies that rely on closed, proprietary technologies will dry up. In fact, some of the players riding high today may never, without major strategic adjustments, see their current growth rates again.

Now, some people assert that standards-based computing will commoditize information
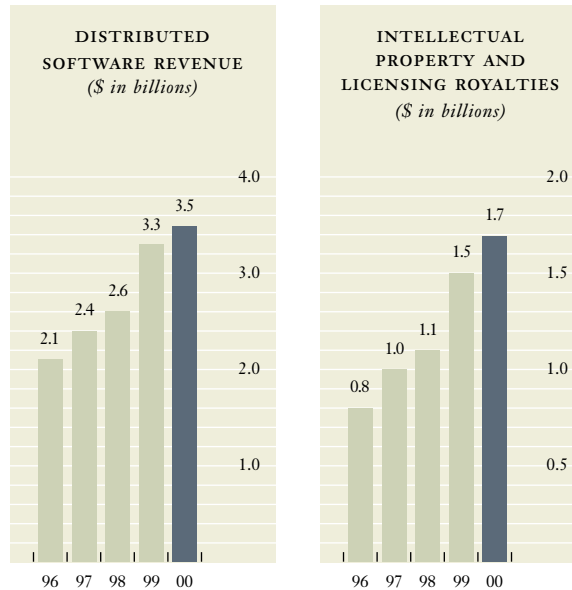
technology. And certainly, many are asking: Where will the value be? The profits? Who will set the agenda? What will matter most to customers?

We ask ourselves these questions all the time. I think we can now see clearly that competitive advantage in the future will rest essentially on three things: technological innovation, the ability to help customers integrate technology with their business, and the capability to make information technology easy to acquire and manage.

Each of these capacities takes a long time to build, and the barriers to entry are daunting. These are not things you can simply buy your way into. Step back from the array of all the things IBM is and does today, and what you'll see is a company strengthening its position in these three fundamental areas.

1. Technology Innovation. Make no mistake. A world of standard computing technology increases, not decreases, the value and competitive advantage of innovation. And that requires real science. Not just software developers, but also quantum physicists. Not just storage specialists, but computational biologists. Not just people who move data, but people who move atoms—one at a time. We have all of that.

This ability to invent is IBM's ace in the hole. The scope and impact of what our researchers have invented in just the past eight years—during which they have continually set record after record in patents—is remarkable. We are in the midst of a Golden Age at IBM Research. Equally important is how rapidly we've moved those innovations into the marketplace. From silicon germanium to copper chips, from silicon-on-insulator to WebSphere,

DISTRIBUTED SOFTWARE REVENUE ($ in billions)	INTELLECTUAL PROPERTY AND LICENSING ROYALTIES ($ in billions)

DISTRIBUTED SOFTWARE REVENUE ($ in billions)

4.0
3.5
3.3
3.0
2.6
2.4
2.1
2.0
1.0

96 97 98 99 00

INTELLECTUAL PROPERTY AND LICENSING ROYALTIES ($ in billions)

2.0
1.7
1.5
1.5
1.1
1.0
1.0
0.8
0.5

96 97 98 99 00

from self-managing servers to microdrives—IBM's technology business has become a multibillion-dollar juggernaut.

That's important. If the first age of e-business was an age of supply—a seemingly endless abundance of Web sites, new businesses, new business models and capital—then the second age of e-business will be an age of *demand*. Before long, we'll see Internet traffic grow a thousandfold, propelled by, among other things, an explosion in the number of client and embedded networked devices that will reach into the trillions. That's a lot of bits and bytes that businesses are going to have to capture, manage, store, access, analyze and use. And no matter how much more efficient we make our current computing infrastructure, no matter how many more bright young people go into computer science, it won't be enough. We're going to need whole new levels of scientific and technological discovery, much of it aimed at creating *self-managing* e-business infrastructure. Who would you bet on to create and patent the lion's share?

2. Business Innovation. So, new technology is essential. But let me tell you, when I was a customer, I never turned to IBM because of a piece of technology; I took that for granted. Instead, I turned to IBM because they helped me apply all their amazing technology to my business. I valued IBM's *applied* intelligence, its ability to understand my problems and help fix them.

This capability will be even more important as e-business moves into the realm of serious business transformation. All of the decisions that customers

need to make—technology decisions, product decisions and process decisions—derive from some much more basic, strategic choices. So the first thing a customer needs is a partner with a deep, experience-based understanding of their business, of business in general, of e-business in particular.

Of course, a "solution" isn't truly a solution unless your customer can implement it quickly and affordably. Business transformation doesn't mean much if you can't then enable applications and get the infrastructure in place. One of IBM's key competitive advantages is our experience in actually building and integrating e-business systems and e-business infrastructure for our customers (and for ourselves).

3. Managing Technology's Cost and Complexity. And then there's the question of how a company should acquire and manage information technology. This is not trivial, especially when you understand the vast, sophisticated computing infrastructure that will be required to support real e-business.

There's traditional purchase, of course. And outsourcing—where a partner like IBM Global Services takes on the operation of a customer's existing I/T systems and staff. IBM is already the world leader in strategic outsourcing, including more than 50 deals signed in 2000 that were valued at more than $100 million each. But now, we have bigger ideas about how to help our customers.

How about moving infrastructure out of the corporate data center, and onto the Net? Don't own it. Rent it as a service, on an as-needed, as-used basis. This is what we call "e-sourcing," and it will vastly increase companies' access to computing

power, expertise and innovation. IBM is already one of the world's largest hosting companies, with revenue that doubled in 2000. And we are working rapidly with telecom partners to build new IBM e-business hosting centers worldwide.

Finally, often overlooked in IBM's portfolio is a capability our customers and business partners value highly, because it makes e-business real and financially manageable. IBM Global Financing is the world's largest provider of I/T financing—a $4 billion business managing over $40 billion in assets.

UNDER THE HOOD

When you look at these industry trends, at our strategies and at what's happening "under the hood" within IBM, not only did our company have a good year in 2000, but prospects for 2001 are even better.

As I've reported here, not only is the marketplace ready for IBM, but we're ready for it. A whole lot of hard, disciplined work turning our strategic plans into reality is now coming to fruition. And in helping our customers build their computing infrastructure, we have the advantage of having a strong position in all its major parts—middleware, enterprise servers, component technology and enterprise storage. In every one of those fields, we've made major gains.

• In software, value continues to shift from the operating system to middleware, which links all kinds of servers and all the applications with every kind of client device. A few years ago, IBM set out to build a software business focused on middleware. It wasn't glamorous. We just quietly invested billions of dollars to create a set of open products that work with every industry-leading platform. And what's happening? Explosive growth. Our DB2 database revenue was up more than 70 percent on UNIX and Windows NT platforms in 2000. MQ Series messaging software was up more than 60 percent. And WebSphere, our e-commerce middleware, tripled year over year. Industry analysts estimate that the middleware market—already $77 billion today—is growing at a 14 percent annual clip.

• In servers, after years of investment and invention, we transformed our products from the inside out, integrating our offerings with common technologies, common chip architecture, a common development platform in Linux, interoperability with dozens of leading applications—and took them to market as the IBM eServer family. Customer reaction has been swift and enthusiastic.

• After deciding a couple of years ago to exit the enterprise application software business, we have put into place a powerful set of partnerships. In 2000, we established strategic alliances with 50 leading independent software companies, most of whom had previously been going to market mainly with some of our top competitors.

• In component technology, we are getting our innovations to market not just inside our own products, but inside the products of other high-tech companies. At the same time, we made a key shift from increasingly commoditized, general-purpose DRAM chips to high-end microprocessors for servers, chips for pervasive computing devices and chips for networking equipment. It's taken us time to build up our technology portfolio, but now we have it, and demand is white-hot. In the market for pervasive device chips alone, our revenue increased 80 percent last year. Revenue from networking infrastructure chips grew 137 percent.

• The list goes on. We reanimated our enterprise storage business with a product we call Shark; restructured our PC unit and returned it to profitability in the second half of the year; drove the growth of Linux inside and outside IBM; and staked out new ground in emerging markets, such as life sciences.

• Finally, there's services, which in many ways is our trump card. We provide consulting, implementation services, outsourcing and now e-sourcing, aimed at the heart of the hosting and service provider opportunity. After years of hard work, we've got the most capable services business in the world. In fact, IBM is now the largest business and technology consultancy. We have 50,000 consultants who billed more than $10 billion in revenue in 2000. We have

FINANCIAL HIGHLIGHTS—*International Business Machines Corporation and Subsidiary Companies*

ONE-YEAR PERFORMANCE

(dollars in millions except per share amounts)	*2000*	*1999*	*Percent Increase*	*Percent Increase Normalized*
FOR THE YEAR				
Revenue	$ 88,396	$ 87,548	1%	1%
Net income	$ 8,093	$ 7,712*	5%*	16%
Per share of common stock:				
Assuming dilution	$ 4.44	$ 4.12*	8%*	19%
Basic	$ 4.58	$ 4.25*	8%*	19%
Cash dividends paid on common stock	$ 909	$ 859	6%	6%
Per share of common stock	$ 0.51	$ 0.47	9%	9%
AT YEAR END				
Total assets	$ 88,349	$ 87,495	1%	1%
Total debt	$ 28,576	$ 28,354	1%	1%
Stockholders' equity	$ 20,624	$ 20,511	1%	1%

*Includes a net benefit from the 1999 sale of the IBM Global Network and other 1999 actions.

SIX-YEAR PERFORMANCE

(dollars in millions except per share amounts)	*2000*	*1994*	*6-Year CAGR** *
FOR THE YEAR			
Revenue	$ 88,396	$ 64,052	6%
Net income	$ 8,093	$ 3,021	18%
Per share of common stock:			
Assuming dilution	$ 4.44	$ 1.24	24%
Basic	$ 4.58	$ 1.26	24%
Cash dividends paid on common stock	$ 909	$ 585	8%
Per share of common stock	$ 0.51	$ 0.25	13%
AT YEAR END			
Total assets	$ 88,349	$ 81,091	1%
Total debt	$ 28,576	$ 22,118	4%
Stockholders' equity	$ 20,624	$ 23,413	-2%

** Compound Annual Growth Rate

created a network of Business Innovation Centers, offering customers everything from front-end Web design to the heavy lifting at the back end. And just as important, we have built a field force that includes thousands of experienced industry specialists—many of them former professionals in their respective domains, from manufacturing to consumer products, from health care to government.

*   *   *

When I look back on the past five years, I think that, for a lot of people, the "e" in e-business came to mean "easy" or "escape"—e-business represented a kind of magical way of *avoiding* everything traditionally associated with "business." All the planning. All the process. All the relationship building. All the checks and cross-checks and safeguards. Boring stuff like accounting. Gut-wrenching stuff like accountability and responsible public policy. The magic "e" seemed to offer the prospect of leapfrogging right over all that, achieving wealth overnight—in a sprint, rather than a marathon.

Some of us, though, actually enjoy business. We enjoy the competition. Our adrenaline kicks in at the prospect of a long-distance race. We accept—we relish—the pragmatic, tactical, roll-up-your-sleeves-and-dive-in aspects of planning, and process creation, and management systems. It doesn't feel boring. It feels like building something important and significant.

The soaring fantasies of the era we're now leaving were, perhaps, inevitable—and, in their own way, inspiring. Big shifts in history usually begin with a romantic revolution. Whenever people set out for the unknown, they do so in a spirit of adventure. But, when they arrive there, they put down roots. They build something that lasts.

So arguably, the most striking thing about this moment in e-business's short, eventful life is the people who are now at the front of the march. The era we're now entering calls for a new breed of adventurer. The veterans have joined the crusade—with vigor. Indeed, we've never felt so energized. In the pages that follow, we hope to communicate our excitement about what we are doing.

For me personally, I experience this time with a mixture of satisfaction, confidence and hope. Satisfaction at IBM having stuck to its guns—and gotten things pretty much right. Confidence in our ability going forward to deliver on our promise, and to deliver on our customers' needs. And hope about the genuinely transformative future that is opening up before all of us—businesses, schools, governments, entire societies.

And there's something else, too. This is fun. I find myself relishing this work as never before. There's simply nothing like working as hard as you can with an extraordinary group of people to hit your targets, to prove yourself against tough odds, to build something entirely new, even to change the world. For me, it's the most satisfying feeling there is.

We'd better not blink. These next couple of years are going to go by in a flash.

*   *   *

I want to introduce two people to you who are very important to the future of IBM.

• Sam Palmisano was named president, chief operating officer and a director of IBM in September. He has a stellar record of achievement in the 27 years he has worked at IBM, including stints as head of our services, PC and server businesses. His primary responsibility is making sure that we execute well and that all our business units work as one team. Our fourth quarter results are, in part, evidence of Sam's expertise.

• John Thompson, elected vice chairman and a director in September, is responsible for research, new business opportunities, new technology, new directions. While everyone's focused on the ball, John is focused on the fences.

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