



SAMUEL J. PALMISANO
Chairman, President and Chief Executive Officer

Dear IBM Investor,

Last year, I told you that we were repositioning IBM for leadership, in all the ways that a business can lead. I described how IBM defines leadership, along with our plans to achieve it. And I said that I believed the results of this repositioning would roll out in meaningful ways in the years and decades to come.

TWELVE MONTHS LATER, it's clear that the future we envisioned is arriving, and more rapidly than we expected. This is in part because of the hopeful signs we're seeing of economic recovery, with the promise of renewed business investment in information technology. It's partly because of the rapid adoption of our on demand strategy by clients, partners and the overall IT industry. But it's also something more—something specific to this company and its people, and something longer lasting than a particular economic cycle.

IBM today is a very different enterprise than it was just a few years ago. Our business model has been quietly but substantially reshaped to capitalize on the most promising growth and profit opportunities in the market. Even more important for the long term, our operations and culture are being transformed as well. We are now focused with an intensity and unity I haven't seen since the heyday of the mainframe. As a result, we are poised to take IBM to the next level, and to redraw and extend the boundaries of the IT industry.

A very good year, for a very different company

IBM's 2003 is the kind of year on which it's gratifying to look back—both for our overall achievements and for the strong momentum with which we ended the year.

Our revenue from continuing operations, at \$89.1 billion (a company record), increased by 10 percent. Earnings from continuing operations were \$7.6 billion compared to \$5.3 billion in 2002, which included \$1.6 billion of after-tax charges for second and fourth quarter 2002 actions. We continued to gain market share across all our core businesses. IBM today is the market leader in servers, middleware, business transformation services and strategic outsourcing.

Highlights for the year included revenue growth in every server segment, a WebSphere middleware platform that grew 12 percent and gained market share, and 14 percent growth in strategic outsourcing. Our success with clients was evident in faster-than-market growth for five of IBM's six industry sectors. For example, in the public sector, which includes our relationships with governments and health care providers, we grew by 15 percent; in communications by 8 percent; in industrial by 14 percent; and in financial services by 13 percent.

We again generated excellent cash flows. After investing \$5.1 billion in R&D, we had \$12.7 billion in cash available for investment and distribution to shareholders. We invested \$3.9 billion of that in net capital expenditures and \$1.8 billion in acquisitions to

strengthen our portfolio. And we were able to return \$5.4 billion to investors—\$4.3 billion through share repurchase and \$1.1 billion through dividends—ending the year in a strong cash position, with \$7.6 billion, including marketable securities.

Overall, despite facing serious challenges, the IBM team executed with discipline. And indications for the year ahead are encouraging, including a strong demand pipeline (enlarged by more than \$17 billion of services signings in the fourth quarter) and a growing number of alliances with business partners and software companies committed to leading with IBM's open, standards-based platforms.

All in all, a very good performance. But is it sustainable? Can we, in fact, improve upon it and keep growing for the foreseeable future? I believe so, and let me tell you why.

Recommitting to high value

For the past couple of decades, if you were to look at IBM's performance in any given year or over several years, what would you see? You'd see a very large global company in which some businesses are growing rapidly, some are flat and some are declining. Add it up, and it would average out to steady profitability—but perhaps uninspiring growth. For people with comparatively short memories, this might be the only IBM they'd ever known. And it would be legitimate to ask if the company is capable of more.

The answer is: We certainly are. In fact, over most of our nearly 100-year history, IBM was consistently a company that outperformed others in our markets and generated superior returns. And that was because we were singularly focused on leading, and most often creating and defining, the high-value spaces in our industry.

Of course, with a company of IBM's breadth and global presence, there are always ups and downs that result from economic cycles, product and technology transitions, and sometimes issues of execution. But it's also apparent that, somewhere along the line, we became more focused on defending our existing leadership position than on creating the next one. We weren't particularly bold or imaginative in getting into new markets or developing new businesses, products and services, even when our strategic analyses indicated that something new was coming. And, just as important, we hesitated to reinvent or get out of businesses that no longer represented high value for either

clients or shareholders. In a word, we lost sight of IBM's mission, of what had always set us apart.

Well, we've regained our focus now. IBM is an innovator—in every dimension of that word. We know that IBM and IBMers are at their best when they create value that our clients cannot get from anyone else. That means we will provide leading-edge technology, services, expertise and intellectual capital, and will integrate these capabilities for each client to provide them with competitive advantage.

We commit to that. We commit to innovating to deliver client success. And that is something for which clients are willing to pay a premium.

This may seem like a truism, but it actually commits us to a very focused strategy, based on a choice between the two primary sources of growth and profit in IT today: the high-volume, undifferentiated product play; and the high-value, innovation and integration play, focused on the enterprise. It is this high-value space we have chosen to lead.

We believe this is the right choice for IBM and our investors. By focusing on this space, we believe we can, on a sustainable, long-term basis, generate superior returns compared to the overall IT industry, command leading share position in our selected businesses, outperform the average of the S&P 500 on return on invested capital, and produce strong cash flows.

In recent years, we've taken many steps to seize this position. Before I talk about those steps, I want to spend a minute on what constitutes "high value" for clients today, and what will do so for the foreseeable future. It's embodied in what we call the on demand enterprise. And that, in turn, is all about a new kind of integration.

The next wave of integration

After two decades of disaggregation, the IT industry is re-integrating. This is being driven simultaneously by a major shift in client demand, and a major shift in technology.

Companies have come to realize that if they're going to respond rapidly and effectively to today's volatile marketplace, they need to do more than Web-enable discrete systems, processes or business units. They need to pull together all of the systems they've already got and integrate them securely with their core business activities—horizontally, across not just their whole company but their entire value chain, from customers to suppliers. This is an on demand enterprise.

Focus on High Value

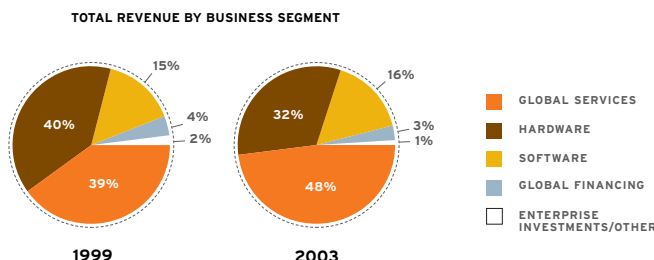
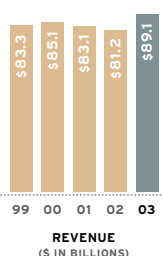
IBM Global Services generated \$55 billion in services signings in 2003, including seven contracts over \$1 billion and an additional 56 contracts in excess of \$100 million each.

IBM Systems Group revenue increased 11 percent to \$14 billion in 2003. It outpaced competitors with double-digit growth in strategic UNIX, blade and Intel-based servers, and storage systems products.

In 2003, IBM earned 3,415 U.S. patents, breaking the record for patents received in a single year and eclipsing the nearest company by more than 1,400 patents. During the past eleven years, the U.S. Patent Office has issued IBM more than 25,000 patents—nearly triple the total of any U.S. IT competitor during this time.

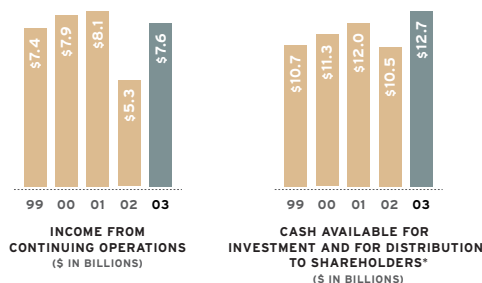
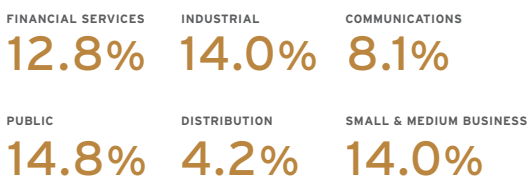
IBM Global Financing pre-tax income was \$1.2 billion for 2003, representing a 24 percent year-to-year increase.

In 2003, revenue from IBM middleware increased 11 percent to \$11 billion, primarily driven by continued strength in demand for WebSphere (12 percent growth), DB2 database (13 percent growth) and Tivoli (12 percent growth) middleware products.



INDUSTRY SECTOR GROWTH YEAR TO YEAR (2002-2003)

REVENUES IN ALL SIX OF IBM'S INDUSTRY SECTORS GREW FOR THE FULL YEAR, WITH THE FINANCIAL SERVICES SECTOR, INDUSTRIAL SECTOR AND PUBLIC SECTOR AMONG THE STRONGEST, AND WITH CONTINUED GOOD RESULTS IN THE SMALL AND MEDIUM BUSINESS SECTOR.



* This represents management's view of cash available for investment and for distribution to shareholders. See the company's Management Discussion section on pages 64 and 65 for a reconciliation of these amounts to GAAP net cash from operating activities and basis for its presentation.

INCUBATED NEW BUSINESSES

- In just three years, Life Sciences has become a \$1 billion business, more than doubling its revenue each year. It has grown from two employees in 2001 to more than 1,000 employees in 2003.
- IBM's Digital Media business grew 60 percent to \$1.7 billion in revenue in 2003.
- Application Management Services grew 30 percent and contributed more than \$1 billion in new revenue since the line of business was created two years ago.
- In 2003, Linux revenue grew over 50 percent to more than \$2 billion, as the rate of related software and services combined nearly doubled year to year.
- IBM's Pervasive Computing business generated more than \$2.4 billion in revenue in 2003, 36 percent growth mainly from services and software installations.

EMERGING GROWTH AREAS

- In China, India, Russia and Brazil, IBM generated revenue of \$3 billion in 2003 and saw double-digit growth.
- IBM Business Consulting Services' Business Transformation Outsourcing (BTO) unit generated fourth-quarter 2003 signings of nearly \$3 billion. Major contracts are in place with clients including BP, Procter & Gamble, Sprint, Raytheon Aircraft, Dresdner Bank of Germany, and United Technologies Corporation.
- With more than 2,000 clients, e-business Hosting Services revenue increased by more than 20 percent each of the past three years, topping \$1 billion in revenue in 2003.
- IBM clients have more than \$10 billion in dormant computing capacity installed, which can be turned on and paid for on demand. More than \$500 million in capacity was turned on in 2003.

- In its first year, IBM's Engineering & Technology Services business designed products for Medtronic, New York Stock Exchange, Raytheon, Mayo Clinic and others, generating more than \$160 million in revenue in 2003.

SUPPLY CHAIN IMPROVEMENTS

- By the end of 2003, the work of transforming and integrating the supply chain resulted in the lowest inventory levels for IBM in more than 20 years.
- IBM's supply chain transformation efforts have reduced the amount of time the sales force spends on activities like checking on order status, proposal generation and contracts by 20 percent.
- By speeding inventory turns and improving client collections and supplier payment terms, IBM's supply chain efforts generated more than \$700 million in cash in 2003.

Financial Highlights

INTERNATIONAL BUSINESS MACHINES CORPORATION AND SUBSIDIARY COMPANIES

(\$ in millions except per share amounts)

FOR THE YEAR	2003	2002
Revenue	\$89,131	\$81,186
Income from continuing operations	7,613	5,334
Loss from discontinued operations	(30)	(1,755)
Net income	7,583	3,579
Earnings/(loss) per share of common stock:		
Assuming dilution:		
Continuing operations	4.34	3.07
Discontinued operations	(0.02)	(1.01)
Total	4.32	2.06
Basic:		
Continuing operations	4.42	3.13
Discontinued operations	(0.02)	(1.03)
Total	4.40	2.10
Net cash provided by operating activities from continuing operations	14,569	13,788
Investment in plant, rental machines and other property	4,393	4,753
Cash dividends paid on common stock	1,085	1,005
Per share of common stock	0.63	0.59

AT YEAR END

Cash, cash equivalents and marketable securities	7,647	5,975
Total assets	104,457	96,484
Working capital	7,098	7,502*
Total debt	23,632	26,017
Stockholders' equity	27,864	22,782
Common shares outstanding (in millions)	1,695	1,722
Market capitalization	157,047	133,483
Stock price per common share	92.68	77.50
Number of employees in IBM/wholly owned subsidiaries	319,273	315,889

* Reclassified to conform with 2003 presentation.

Becoming one is dauntingly hard to pull off. It requires both the end-to-end integration of the technology—which niche product vendors simply cannot do—and the integration of technology with business processes. This in turn requires deep business knowledge and industry expertise that few traditional technology companies have, and significant technical knowledge and research strengths that few consulting firms possess.

Integration is also an emerging force in core technology and computing architectures. To cite one example, advances in semiconductor devices have been largely propelled by increasing the clock speed of the microprocessor chip; this is like revving up the RPM of a car engine. But while advances in raw speed are continuing apace, they are no longer enough to increase chip and overall system performance. For one thing, chips have become so densely packed with transistors that they produce more heat than can be cost-effectively dissipated.

The solution is integration—putting multiple, often less-than-top-speed processors on the same chip, along with additional functions like fast memory and high-performance input/output. This is the approach IBM engineers have taken in developing our Blue Gene supercomputer. Integration of this sophistication is beyond the reach of most chip and systems companies. It requires expertise not just in semiconductors but in advanced systems architecture, custom logic design, operating systems and software tools. This is the kind of expertise that IBM has built up over decades, and it is not easily replicated. And that's why technology leaders like Sony, Cisco, Apple and QUALCOMM have partnered with IBM for advanced technology—and why last year Microsoft licensed IBM's microprocessor technology for use in its next-generation Xbox game console.

Bulking up in on demand

Many IT companies will struggle with this world that is dawning—with the need to choose between open and proprietary, between serving consumers and enterprises, between redistributing other people's intellectual capital and innovating. This is not about making pronouncements or promises. A company cannot be all things to every client, every partner and every investor.

For our part, we've decided. The two parallel trajectories of integration—in client demand and in what the technology requires—play directly to IBM's historic strengths. However, even with everything IBM brought to this table, we needed more. That's why we've made acquisitions such as PricewaterhouseCoopers Consulting (PwCC), Rational software and 19 other companies in the past two years. And it's why we reset our priorities in R&D to develop more technologies and services specifically for client needs in the on demand era.

On demand integration is also why we've placed a huge bet on standards, from the Internet protocols and Linux to grid computing and Web services. Without open technical interfaces and agreed-upon standards, even integration within a single enterprise would remain a gargantuan task. And forget about integration with the other companies, business processes, applications, pervasive computing devices, laws, regulations, customs and cultures that make up the ever-more-global marketplace of the 21st century. An IT company's position on open standards—not just its rhetoric, but its actions—is a clear indicator of whether it faces forward or backward, is serving the needs of clients or protecting its market position.

In addition to the opportunities I've described, our move into on demand has opened up some very large businesses beyond the frontiers of the traditional IT industry—opportunities that remain out of reach for most of our competitors.

One promising example is Business Transformation Outsourcing (BTO), which was not even part of the industry lexicon 18 months ago. In BTO engagements, IBM becomes responsible for transforming—and actually providing—a client's business process in areas such as human resources, procurement, customer care, and finance and administration. Thanks to the acquisition of PwCC and the formation of IBM Business Consulting Services, we generated nearly \$3 billion in BTO signings during the fourth quarter of 2003 alone. To give a rough idea of the potential here, the current size of businesses' outsourced spending on sales, marketing, logistics, finance, HR and all other administrative processes is about \$1 trillion a year. Of that, there is an opportunity in excess of \$100 billion in the BTO areas we are pursuing. We are committed to extend our leadership position in BTO in 2004.

Remaking IBM

To some people, it may seem bold to have made all these moves during the worst market ever seen in the IT industry. But I don't believe it was particularly risky, because it was driven by client demand and the realities of the technology. What's really important for you to understand is that our commitment to leadership in the high-value spaces and in innovation isn't a mission statement. It's a business model. And it commits us to continual reinvention of IBM itself.

Over the past several years, we've taken aggressive steps to remix our business so that we are positioned for long-term leadership and new opportunities in the high-value enterprise space, however that changes.

We have, since 1997:

- exited or reduced our presence in such areas as application software, hard-disk drives, networking hardware, low-end printers and retail PCs—which we estimate have declined from 31 percent to 25 percent of IT industry revenue;
- entered or increased our presence in distributed middleware, non-hardware maintenance services, Intel-based servers and mobile PCs—which have grown from 40 percent of industry revenue to 46 percent, and are expected to continue outperforming the overall IT market;
- increased our revenue in business and technology consulting services, infrastructure services and infrastructure software—which generate superior long-term revenue growth, profit, cash and return on invested capital—from 48 percent to 64 percent of our total, with expectations of increasing that going forward;
- grown aggressively in emerging markets; in China, India, Russia and Brazil we generated revenue of \$3 billion last year and saw double-digit growth;
- upped our rate of new account growth, giving us a total of 730,000 large, medium and small enterprise clients—with IBM's small-and-medium business segment alone growing 14 percent to outperform the market in 2003, adding \$2.4 billion in revenue; and
- incubated successful new high-growth businesses such as life sciences, digital media, application management services, e-business hosting services, Linux and pervasive computing—each of which has already

become a \$1 billion-plus revenue stream. In the areas we're targeting within life sciences and digital media alone, third-party analysts see more than \$60 billion of market opportunity by 2006.

While we do all this, we're continuing relentlessly to improve execution. By becoming an on demand business ourselves, we've made big strides in product cycle time, new product introduction, sales productivity and simplification of our processes. Our inventories are at their lowest level in more than 20 years, and our continuing progress in integrating our supply chain took \$7 billion of cost out of the business in 2003, surpassing what we achieved in 2002.

Business value, and a company's values

As I mentioned last year, we've been spending a great deal of time thinking, debating and determining the fundamentals of this company. It has been important to do so. When IBMers have been crystal clear and united about our strategies and purpose, it's amazing what we've been able to create and accomplish. When we've been uncertain, conflicted or hesitant, we've squandered opportunities and even made blunders that would have sunk smaller companies.

It may not surprise you, then, that last year we examined IBM's core values for the first time since the company's founding. In this time of great change, we needed to affirm IBM's reason for being, what sets the company apart and what should drive our actions as individual IBMers.

Importantly, we needed to find a way to engage everyone in the company and get them to speak up on these important issues. Given the realities of a smart, global, independent-minded, 21st-century workforce like ours, I don't believe something as vital and personal as values could be dictated from the top.

So, for 72 hours last summer, we invited all 319,000 IBMers around the world to engage in an open "values jam" on our global intranet. IBMers by the tens of thousands weighed in. They were thoughtful and passionate about the company they want to be a part of. They were also brutally honest. Some of what they wrote was painful to read, because they pointed out all the bureaucratic and dysfunctional things that get in the way of serving clients, working as a team or implementing new ideas. But we were resolute in keeping the dialog free-flowing and candid. And I don't

think what resulted—broad, enthusiastic, grass-roots consensus—could have been obtained in any other way.

In the end, IBMers determined that our actions will be driven by these values:

- Dedication to every client's success
- Innovation that matters, for our company and for the world
- Trust and personal responsibility in all relationships

I must tell you, this process has been very meaningful to me. We are getting back in touch with what IBM has always been about—and always will be about—in a very concrete way. And I feel that I've been handed something every CEO craves: a mandate, for exactly the right kinds of transformation, from an entire workforce.

Where will this lead? It is a work in progress, and many of the implications remain to be discovered. What I can tell you is that we are rolling up our sleeves to bring IBM's values to life in our policies, procedures and daily operations.

I've already touched on a number of things relating to clients and innovation, but our values of trust and personal responsibility are being managed just as seriously—from changes in how we measure and reward performance, to how we equip and support IBMers' community volunteerism.

Our values underpin our relationships with investors, as well. In late February, the board of directors approved sweeping changes in executive compensation. They include innovative programs that ensure investors first receive meaningful returns—a 10 percent increase in the stock price—before IBM's top 300 executives can realize a penny of profit from their stock option grants. Putting that into perspective, IBM's market value would have to increase by \$17 billion before executives saw any benefit from this year's option awards. In addition, these executives will be able to acquire market-priced stock options only if they first invest their own money in IBM stock. We believe these programs are unprecedented, certainly in our industry and perhaps in business.

Clearly, leading by values is very different from some kinds of leadership demonstrated in the past by business. It is empowering, and I think that's much healthier. Rather than burden our people with excessive controls, we are trusting them to make decisions and to act based on values—values they themselves shaped.

To me, it's also just common sense. In today's world, where everyone is so interconnected and interdependent, it is simply essential that we work for each other's success. If we're going to solve the biggest, thorniest and most widespread problems in business and society, we have to innovate in ways that truly matter. And we have to do all this by taking personal responsibility for all of our relationships—with clients, colleagues, partners, investors and the public at large. This is IBM's mission as an enterprise, and a goal toward which we hope to work with many others, in our industry and beyond.

Playing offense

Put it all together—a more focused business model, an industry shift that plays to our strengths, bets that are paying off in the near term, and a workforce that is united and impatient to become the great company we all aspire to be—and I feel good about IBM and our prospects.

Without the prod of fear or of a “burning platform,” we've begun a substantial transformation of our company. For the first time in a very long time—probably since my early days with IBM 30 years ago—I'm seeing a company ready to focus more on opportunities than on threats, more intent on setting the agenda than on reacting to the moves of others. Our deep-seated optimism—a fundamental belief that IBMers have always possessed in progress, science and the improvability of the human condition—is reasserting itself. IBMers are ready to reclaim a position of leadership—in our industry and in the larger world of business.

Which is a very exciting place to be. For me and my colleagues, it's just terrific to be part of an energized IBM company that is once again ready to play some offense.



SAMUEL J. PALMISANO

*Chairman, President and
Chief Executive Officer*