

Dear IBM Investor: Last year, I told you that IBM was in the process of becoming a very different company. I said that we had achieved a new degree of clarity about our business model—innovation for the enterprise—and that this was driving change in every aspect of the corporation. And I described the deeper level of this reexamination—our collective work to redefine IBM's core values.

Now it's a year later, and I want to tell you about the progress we have made. IBM today is stronger and more focused than it has been in years. The path we set for ourselves several years ago is yielding results—in terms of an improved competitive position, an enhanced capacity to innovate, and a greater ability to deliver results to our clients and to you, our owners.

Our task now comes down to execution. At a recent meeting with IBM's senior leaders, I said that 2005 is the year of "small s and big E": less focus on strategic development, maximum push on execution. This is the appropriate emphasis for our company today, because most of the major strategic pieces are now in place for IBM to become the leader of a rapidly changing information technology industry.

A good year

I want to explain to you what we did last year to turn strategy and vision into results. Your company turned in another good year in 2004. We continued to execute our business plan effectively, producing share gains in key markets, increasing revenue and growing both earnings and earnings per share.

Our results from continuing operations saw record revenue of \$96.3 billion, an increase of 8 percent; earnings of \$8.4 billion, an increase of 11 percent; and diluted earnings per share of \$4.94, an increase of 14 percent.

One of the strengths of our business model, from a financial point of view, is the amount of cash we generate. After committing \$5.7 billion to R&D in 2004, we had

\$12.9 billion in cash available for investment and distribution to shareholders. Of that, \$3.7 billion went for net capital expenditures and \$1.7 billion for acquisitions that strengthened our capabilities.

We were able to return a record \$8.3 billion to investors—\$7.1 billion through share repurchase and \$1.2 billion through dividends. We ended the year in a strong cash position, with \$10.6 billion, including marketable securities. In 2004, our return on invested capital increased to 29 percent, excluding our Global Financing business and a one-time pension settlement charge.*



Samuel J. Palmisano
CHAIRMAN, PRESIDENT AND
CHIEF EXECUTIVE OFFICER

We were able to achieve these results because of our performance in the marketplace.

- IBM Global Services is the leading IT services company in the world, with more than twice the revenue of our nearest rival. We are ranked number one in IT outsourcing, application management and e-business hosting. In 2004, Global Services revenue grew 8 percent to \$46.2 billion, driven by continued growth in Strategic Outsourcing, as well as revenue increases in Integrated Technology Services and Business Consulting Services (led by strong growth in Business Transformation Outsourcing). Although signings and backlog declined in 2004, Global Services improved its rate of revenue growth in every quarter, excluding the benefit of currency, due to the improving yield of our backlog and current signings.
- Our software revenue totaled \$15.1 billion, an increase of 5 percent. We gained share in key segments and held our leading share position in middleware overall. WebSphere grew 14 percent, Rational 15 percent and Tivoli 15 percent.
- We continue as number one in the world in servers, with zSeries, pSeries and xSeries each increasing its share position in 2004. IBM is the market leader in the super-hot category of blade servers, with revenue growing more than 150 percent for the year. Industry analyst IDC estimates that by 2008 one of every four servers will be a blade. We had challenging product transitions in storage systems and iSeries, which hurt us. Personal computer revenue growth was strong for the year. Technology OEM growth was good, and we continue to see yield improvements in our semiconductor operation. Overall, our hardware revenue was \$31.2 billion, an increase of 10 percent.
- Revenue in all of IBM's industry sectors—which is the way we serve our largest clients globally—grew for the full year, led by the financial services, communications and distribution sectors. We continued our strong growth in sales to small and medium-size businesses, which grew by 8 percent.

- We grew and expanded our business in the world's hyper-growth markets. We have learned over many years that the best way to pursue opportunities in emerging markets is to make investments and build relationships for the long haul, to become part of the local economy and to help advance the society's broader goals. We are doing that in China, India, Brazil and Russia—and it's yielding good results. IBM's business in these four key emerging markets grew more than 25 percent in 2004, to more than \$4 billion.

The year had its share of challenges, and some parts of the business fell short. But overall, it was a solid year for the IBM company. The results confirm that we are in the right businesses and the right segments of the industry.

A transaction and a transformation

Of course, just as significant as the segments we are in are those we are not. The industry's contraction in recent years has forced IT companies to choose between being high-value innovation players or high-volume distributors of other people's intellectual capital. Companies that are caught in the middle run the risk of being hammered from both below and above.

As I described to you last year, we've made our choice: IBM is an innovation company. Of course, declaring something like that is easy. It has taken a great deal of discipline to execute.

For instance, over the past several years, while we increased our presence in software, consulting and infrastructure services, we exited or reduced our presence in commoditizing businesses like hard disk drives, memory chips and networking hardware. And most notably, this past December we announced our agreement for Lenovo, China's computer leader, to acquire IBM's Personal Computing Division.

These kinds of decisions are hard for many companies—indeed, some won't make them—because it means parting with business models and technologies that were once their crown jewels. In our own case, IBM invented the hard disk drive and DRAM chip, and we set the standard in PCs back in 1981.

We take enormous pride in these achievements. But if you intend to *remain* the innovation leader, you commit yourself to continuous reinvention. You've got to do the hard work, every day, to discover and develop new capabilities—and new ways of working—that will keep you moving forward.

The new Lenovo will be the world's third-largest PC business. It will have greater global reach and greater economies of scale, and we will continue to work together to deliver world-class PC solutions in the marketplace. There's no doubt in my mind that this was the best path forward for our personal computer business.

For IBM, our PC transaction—perhaps the most widely commented-upon event of the year for us—was certainly a milestone. But not, I would argue, for the reasons many believe. We could simply have sold our PC business. Instead, what we did was to reposition both that business and IBM itself in ways that help each and that align with the future trajectory of the IT market. This deal crystallizes, as well as any single event could, the nature of our business model, strategy and marketplace position today:

IBM is an enterprise-focused company. It is not our strength or intention to participate directly in consumer markets.

We are all about innovation. We are best at creating and delivering differentiating value to our clients.

We are a global business. Much more than marketing products and services around the world, this means establishing deep roots locally and leveraging our multinational presence for operational advantage.

To explain our perspective on both the IT industry and IBM's transformation lies beyond the scope of an annual report. However, I do believe it is vital for anyone with an interest in IBM to understand this long-term view and what lies behind it—not a mere cyclical change, but a major structural shift in our industry. That is why we created the document

"Understanding Our Company: An IBM Prospectus," which accompanies this year's annual report. I encourage you to take a look at it. I think it will help explain how we see the world, and how that is driving our actions.

The meaning of 2004

Several major shifts—in business models, in technology and in how they together are reshaping our industry—have driven everything we've done at IBM over the past four years. They continued to do so in 2004.

1. Because clients now demand that information technology be intimately integrated with their business operations, we have reshaped IBM's business skills, assets and delivery capability.

This has involved everything from our acquisition of PricewaterhouseCoopers Consulting in 2002, to the launch of multiple industry- and process-specific practices and lines of business. Some people may see this simply as IBM bulking up in services. It is true that we needed to add a lot of deep business expertise—and we will continue to strengthen our hand here. But clients want more than the consultant's strategic advice, the systems integrator's skills or the IT outsourcer's scale. They want new business designs, enabled by technology, that give them some quantifiable competitive advantage. They want new options and alternatives, not only in how they manage IT, but in how they conceptualize and manage their companies.

This is what we mean by On Demand Business. CEOs might not use that exact term (yet), but a more responsive, virtually integrated company is increasingly what they are asking us to help them build. Companies like eBay, Bank of America and METRO Group, and institutions like Miami-Dade County and the new Museum of Modern Art are, to one degree or another, on demand enterprises.

I want to highlight one aspect of On Demand Business, because it represents a very large new market opportunity for us. We call it Business Performance Transformation Services

(BPTS), and industry analyst IDC sizes it at about \$1.4 trillion – as large as the existing global IT industry. We peg the part of BPTS that IBM is addressing at about \$500 billion.

As its name suggests, BPTS involves helping clients optimize their operations through new business designs and processes, and, in some cases, turning over those operations to expert partners to manage. As you can imagine, this is a very different type of services business – one that is increasingly “asset-based.” It requires deep knowledge of business processes like logistics, supply chain and human resource management, and relies heavily on automated processes and intellectual capital, not mere labor arbitrage.

In 2004, we extended our capabilities in BPTS, making substantial investments in four areas – Business Transformation Outsourcing, Engineering and Technology Services, Strategy and Change Consulting, and Business Performance Management Software. We generated more than \$3 billion in revenue in these four areas – up about 45 percent over the previous year. And our software and services groups are working together to build out an infrastructure that fuses business transformation with information technology – what is called services-oriented architecture – to support our evolution to an asset-based services business.

2. Because we saw that computing was undergoing a fundamental shift, we developed the architecture and technologies for the On Demand Operating Environment, based on open standards.

The new computing architecture is based on a truly networked world and the emergence of open standards – for the first time in our industry’s history – as well as some exciting new technologies and new ways of accessing and managing IT. It builds on our strengths in enterprise computing, core technology and software.

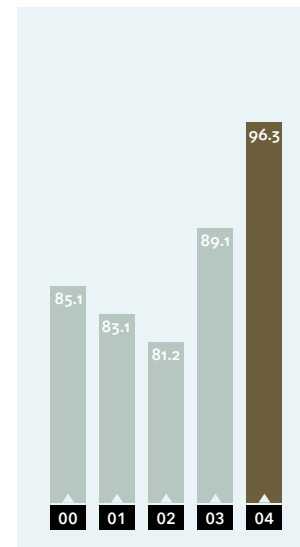
One of our most important core technologies is our Power microprocessor family. What’s significant about Power is not just that it’s fast and packs a lot of punch (plenty of microprocessors do). Power is highly customizable.

Consider: 32,768 Power processors are at the heart of our Blue Gene supercomputer, which last year set a new record – more than 70 trillion calculations per second. Yet variations of Power chips are also the foundation for our pSeries and iSeries, and are used in our blade servers, our storage systems and an expanding array of devices – network routers, mobile devices, game consoles – designed by our OEM partners. Built on a Power core, the Cell processor – a “supercomputer on a chip” – was developed along with Sony and Toshiba for broadband, high-definition uses.

Increasing the uses of the Power family is important for IBM, because it gives us the advantages of a high-performance processor and high-volume economics. This is one reason we’ve opened Power’s technical specifications through our

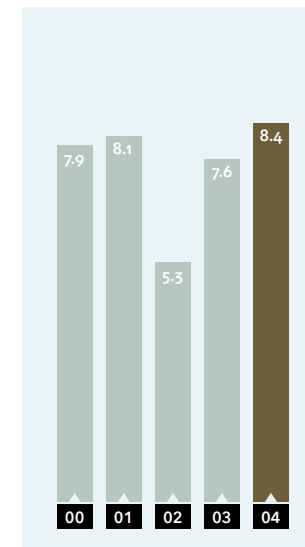
REVENUE FROM CONTINUING OPERATIONS

(IN BILLIONS OF DOLLARS)



INCOME FROM CONTINUING OPERATIONS

(IN BILLIONS OF DOLLARS)

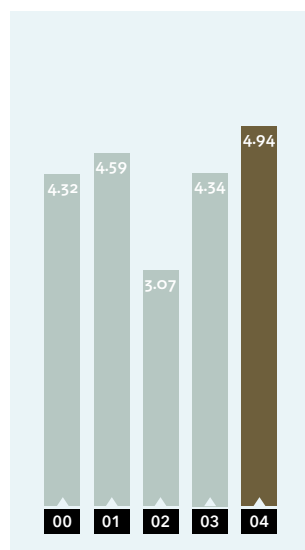


Power Everywhere and Power.org initiatives. We are building a broader ecosystem of innovation around Power, reflecting the fact that innovation today is an increasingly collaborative process—and not only in software.

And speaking of software, through steady internal development and select acquisitions over the past several years, IBM has become the leader in enterprise-class middleware, which helps companies integrate and manage their operations. An important differentiator for our software business is that it is entirely built on open standards, supporting a wide variety of hardware platforms and applications. This gives our clients flexibility and choice, and makes it easy for them to integrate their infrastructure and business operations.

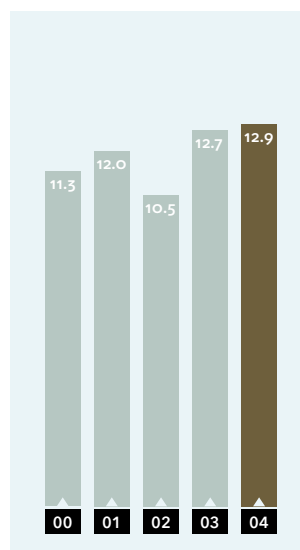
EARNINGS PER SHARE

(IN DOLLARS, ASSUMING DILUTION FROM CONTINUING OPERATIONS)



CASH AVAILABLE FOR INVESTMENT AND DISTRIBUTION TO SHAREHOLDERS

(IN BILLIONS OF DOLLARS)



3. These two elements of on demand—new business models and a new computing infrastructure—are now coming together in ways that will redefine the industry and play to IBM's strengths.

All of these changes—businesses we've exited, those we've entered, our increased investments, the technologies and practices we've invented—were undertaken not simply to assemble a portfolio, even a portfolio of high-value businesses, but to do something with them. Namely, we aim to give our clients capabilities they cannot get either from another company or even a collection of other companies.

This is why we've worked hard to forge connections between our services and software businesses, our semiconductor unit and our server and storage units, between IBM Research and every other part of the company, and between IBM and an increasing variety of business partners. IBM's strategy is less about going to market with a more complete array of capabilities than it is about leveraging those capabilities to create new intellectual capital for clients.

Priorities going forward

As we move ahead in 2005, we are guided by the same priorities that have shaped our progress thus far.

WE WILL MAKE ON DEMAND BUSINESS A FULLER REALITY FOR CLIENTS.

The concept is no longer in dispute. Enterprises are achieving tangible benefits from being on demand—and are increasingly embracing its long-term strategic promise for competitive advantage. We will work with a growing roster of clients who want to become on demand enterprises, and we will continue to build out the technologies and services for the On Demand Operating Environment.

WE WILL CONTINUE TO DEEPEN IBM'S CAPABILITIES AS A COMPANY BUILT ON INNOVATION. This is our business model and has been since the company's inception. It has shaped our transformation over the past several years, and it continues to shape the evolution of our workforce strategy, management systems, economics and client relationships.

FINANCIAL HIGHLIGHTS

International Business Machines Corporation and Subsidiary Companies

(Dollars in millions except per share amounts)

FOR THE YEAR	2004	2003	AT YEAR END	2004	2003
Revenue	\$ 96,293	\$ 89,131	Cash, cash equivalents and marketable securities	\$ 10,570	\$ 7,647
Income from continuing operations	8,448	7,613	Total assets	109,183	104,457
Loss from discontinued operations	18	30	Working capital	7,172	7,039**
Net income	8,430	7,583	Total debt	22,927	23,632
Earnings/(loss) per share of common stock:			Stockholders' equity	29,747	27,864
Assuming dilution:			Common shares outstanding (in millions)	1,646	1,695
Continuing operations	4.94	4.34	Market capitalization	162,223	157,047
Discontinued operations	(0.01)	(0.02)	Stock price per common share	98.58	92.68
Total	4.93	4.32	Number of employees in IBM/ wholly owned subsidiaries	329,001	319,273
Basic:					
Continuing operations	5.04	4.42			
Discontinued operations	(0.01)	(0.02)			
Total	5.03	4.40			
Net cash provided by operating activities from continuing operations	15,406	14,569			
Investment in plant, rental machines and other property	4,368	4,393			
Cash dividends paid on common stock	1,174	1,085			
Per share of common stock	0.70	0.63			

**Reclassified to conform with 2004 presentation.

WE WILL FOCUS IN 2005 ON EXECUTION. This is that “big E” message I gave to IBM’s leaders at the beginning of this year. All of our strategic work over the past four years has given us considerable capabilities to seize the growth and profit opportunities I’ve described. Now, we have to improve our ability to integrate all of this capability for our clients.

In other words, we need to become even more of an On Demand Business ourselves. And a big part of that is what I call “lowering the center of gravity” of our company. For us, this is neither conventional decentralization nor simple delegation. It means shifting resources closer to the point of contact with the client, creating enterprise-wide processes that are commonly shared, and establishing truly global operations that capitalize on the talent and scale now available in every part of the world.

Every time we have simplified the company and pushed authority and resources closer to where the day-to-day action is, we’ve seen great results—with clients (because we are easier to do business with), in our cost structure (because we eliminate unnecessary layers), in revenue growth (because we differentiate ourselves from the competition) and in how individual IBMers feel about their company.

Last year, I told you about the online “jam” in which IBMers collectively defined our values for the first time in nearly a century. I told you what an outpouring of passion, imagination and pride that was.

Well, even more impressive was the follow-up jam we held last fall. This time, we asked IBMers to contribute ideas to make our values a day-to-day reality in the company. Participation was extraordinary—more than 57,000 IBMers contributed more than 32,000 comments and ideas—and the ideas were concrete, practical and focused on execution.

The top-rated ideas range from back-office integration supporting the development and marketing of integrated solutions; to helping first-line managers by giving them more authority over budgets and freeing up their time to devote to their people; to clearing away the barriers that

inhibit us from collaborating, innovating and contributing to IBM’s growth.

These and dozens of other ideas are now in various stages of implementation, and I am confident that they will make a material difference to IBM. Our values are also being turned into actions every day in countless other ways: how we work with our clients and colleagues; the actions of IBM’s crisis response team after the Asian tsunami disaster; or the progress of the World Community Grid—harnessing vast, unused computational power to help cure disease and forecast natural disasters.

From the point of view of a CEO, perhaps the best aspect of this entire process has been the broad platform it creates to drive change. When your primary organizational challenge is one of execution, there is nothing more encouraging than the knowledge that your organization’s direction and sense of mission come not out of some threat or crisis, but from the aspirations of your own workforce. For 329,000 IBMers—and you can count me among them—what drives us every day is a determination to make IBM the great company we all want and expect it to be.



Samuel J. Palmisano
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

* IBM’s Form 8-K dated January 18, 2005 (Attachment III) contains information about return on invested capital.