

**Dear IBM Investor:** As I write to you, the global economy is experiencing profound disruption. There is a great deal of understandable and appropriate anxiety about where we are headed in the near and medium term. Many approaches are being offered to stimulate economic recovery and growth. And it is clear that IBM's industry, as well as many others, will look very different a few years from now.

You need to know, in this time of turmoil, that your company is well positioned to continue delivering strong results, as we have been doing and did again in 2008—achieving record revenue, record pre-tax earnings, record earnings per share and record free cash flow. Even more importantly, we are also positioned to lead in the new era that lies on the other side of the present crisis.

In this letter, I will explain why. I will describe how this moment of historic change presents an opportunity for IBM, not only to assert leadership in our industry, but to play a central role in changing how the world literally works. Our confidence is grounded in the strategic transformation of IBM over the past several years and the focused execution of nearly 400,000 dedicated and innovative women and men around the world.

IBM is now a very different company than it was just a few years ago. As a result, we entered this turbulent period strong, and we expect to exit it stronger.

## A New Era—and a New IBM

What explains our strong performance, when so many of our competitors and other companies across business are struggling during a deep economic slowdown? The answer lies at the beginning of this decade, when the IT industry and businesses everywhere were confronted by three fundamental shifts in the world:

### 1. THE REALITY OF GLOBAL INTEGRATION.

I don't mean simply the widely shared recognition that the world was becoming "flat," but the way in which that was happening, and what it meant for the goals and the very forms of organizations. The lowering of trade barriers, the rise of the developing world and the emergence of the World Wide Web combined to unleash the flow of work on a truly global scale. Therefore, the key questions facing leaders of all kinds became: How will we get that work to flow to us? How will we differentiate ourselves in a global economy? And how will we capture the new growth opportunities that are emerging around the world? Increasingly, new business models—in fact, a new model of the corporation itself—began to take shape. At IBM, we called it the Globally Integrated Enterprise.

**2. THE EMERGENCE OF A NEW COMPUTING MODEL.** This new model, which was replacing the PC-based, client/server approach, was networked, modular and open. Just as important, it was no longer confined to IT

systems alone. Increasingly, the digital infrastructure of the world was merging with the physical infrastructure of the world. And that was creating a new platform for the global economy and society. We are now living in a world that is:

- **INSTRUMENTED:** Computational power is being put into things no one would recognize as computers: phones, cameras, cars, appliances, roadways, power lines, clothes—and even natural systems, such as livestock and rivers.
- **INTERCONNECTED:** All of this is being connected through the Internet, which has come of age.
- **INTELLIGENT:** We now have the computing power, advanced analytics and new computing models (such as "cloud") to make sense of the world's digital knowledge and pulse, and to turn mountains of data into intelligence.

**3. INNOVATION AND INTEGRATION.** Because of this new global arena and new technology model, business leaders expanded their horizons—driven both by competitive pressures and the remarkable array of new capabilities. No longer content with cost savings from off-the-shelf technologies and solutions, they were seeking to innovate—and not just in their products and services, but also their business processes, management systems, policies and core business models. To accomplish that, they sought to integrate advanced technology far deeper into their operations.



Samuel J. Palmisano

CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

At IBM, we saw that these shifts would reshape the economic, technological and competitive landscape, and open up enormous business opportunity. So we made some important decisions, and we got to work.

**GLOBAL INTEGRATION:** We made major investments in our teams and capabilities in emerging markets around the world. This is helping us achieve superior growth in emerging markets—not only in the so-called BRIC countries of Brazil, Russia, India and China, but in dozens of countries across the developing world. At the same time, we accelerated the global integration of IBM's operations. As a result, our supply chain, research labs, software development and service delivery today are truly global in scope. We have made substantial progress toward remaking IBM into a Globally Integrated Enterprise, with more still to do.

**TECHNOLOGY:** We transformed IBM's mix of products, services, skills and technologies—exiting commoditizing businesses like PCs and hard disk drives, and making more than 100 strategic acquisitions this decade. We also shifted our internal R&D. Of the more than 4,000 U.S. patents IBM received in 2008 (our 16<sup>th</sup> straight year of patent leadership), more than 70 percent were for software and services. IBM's portfolio today is built around networked, modularized and embedded technologies, such as service-oriented architecture (SOA), virtualization, business intelligence and

analytics. As a result, we are well positioned to build the kinds of IT infrastructures and solutions that will be of the highest value to our clients.

**BUSINESS:** The kind of value our clients sought required a partner with intimate knowledge of their industry, and with the ability to turn that knowledge into company-specific operational and management systems. You can't do that on a global scale from corporate headquarters. So we not only amassed considerable industry expertise, but also made major changes in how we deploy it. We shifted skills and decision-making closer to the marketplace and the client. At the same time, we transformed our vast services delivery capability. We applied automation, standardization and the kinds of engineering and management principles that were long ago adopted in manufacturing and supply chains. The results are showing up in our margins and in our best-in-class levels of service delivery client satisfaction.

## **We Enter this Period Strong**

Put it all together, IBM today is a very different company, which is evident in our results. Since the dot-com crash in 2002, we have more than doubled our pre-tax income and free cash flow, and more than tripled our earnings per share. Our standout 2008 continued this record of superior performance.

**REVENUE AND INCOME:** Our revenue was a record \$103.6 billion, up 5 percent. In 2008 we grew pre-tax income from continuing operations by 15 percent, to \$16.7 billion, the highest ever.

**MARGINS:** IBM's gross profit margin rose for the fifth consecutive year—to 44.1 percent, up 7.6 points since 2003. Our pre-tax income margin rose to 16.1 percent. Both margins are at their highest in more than a decade. We achieved this by driving productivity and

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continuing to shift our business mix to more profitable segments. More than 90 percent of our segment profit in 2008 was from software, services and financing.

**EARNINGS PER SHARE:** We have continued to achieve strong EPS growth. Last year was another record, with diluted earnings per share from continuing operations of \$8.93, up 24 percent. This marked six straight years of double-digit EPS growth.

**CASH FLOW:** IBM has consistently generated strong cash flow. In 2008 our free cash flow, excluding the year-to-year change in

Global Financing receivables, was \$14.3 billion, an increase of \$1.9 billion from 2007. Our business model has allowed us to generate more than \$84 billion in free cash flow over the past nine years. IBM ended 2008 with \$12.9 billion of cash and marketable securities.

**INVESTMENT AND RETURN TO SHAREHOLDERS:** Our superior cash flow has enabled us to invest in the business and to generate substantial returns to investors. Our 2008 cash investment was \$6.3 billion for 15 acquisitions—10 of them in key areas of software. And after investing \$6.3 billion in R&D and \$4.5 billion in net capital expenditures, we were able to return more than \$13 billion to you—\$10.6 billion through share repurchase and \$2.6 billion through dividends. Last year's dividend increase was 25 percent, marking the 13<sup>th</sup> year in a row in which we have raised our dividend.

In this environment, clients' immediate needs are very clear: to save money, preserve capital and reduce costs. We help them do that, and our ability to deliver that kind of value is why they are continuing to choose IBM. It's why our services business achieved its highest margin in the past five years. It's why our software business continues to grow so robustly—with pre-tax profit doubling over the past five years, to \$7 billion in 2008. And it's why we continue to enjoy strength in high-utilization, high-performance infrastructure.

In sum, with our excellent financial position, strong balance sheet, solid recurring revenue, strong profit streams and unmatched global reach, we are confident about 2009 and are ahead of pace to achieve our 2010 objective of \$10 to \$11 in earnings per share. The information on pages 10-15—“Generating Higher Value at IBM”—will help explain why.

## A Smarter Planet

The coming era will not be kind to enterprises or institutions that have failed to step up to unresolved issues in their core models, strategies or operations. In our view, this is not simply a cyclical downturn, but a major shift in the global economy and society—one that is simple to state, but profound in its implications.

In the last two decades, we have seen our planet become smaller and “flatter.” In the next two, we will see it become smarter.

This isn’t a metaphor, and I’m not talking about the Knowledge Economy—or even the fact that hundreds of millions of people from developing nations are gaining the education and skills to enter the global workforce. I mean the infusion of intelligence into the way the world actually works: the systems and processes that enable physical goods to be developed, manufactured, bought and sold; services to be delivered; everything from people and money to oil, water and electrons to move; and billions of people to work and live.

Through pervasive instrumentation and interconnection, almost anything—any person, any object, any process or any service, for any organization, large or small—can become digitally aware, networked and intelligent. This means that industries, infrastructures, processes and entire societies can be more productive, efficient and responsive. And problems that have heretofore been insoluble can now be tackled.

Problems like wasting too much energy. Like spending too much time in traffic. Like producing food too expensively, and wasting too much of what we produce. Like missing too many sales opportunities and disappointing too many customers because of inefficient supply chains. Like making too many medical errors, and spending too much to deliver healthcare to too few. And most obviously of late, like failing to manage financial risk.

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These and other systems by which the world works are increasingly unsustainable. They may be networked, but it turns out that being connected isn’t enough. It doesn’t make them smart. But the good news is, they can be.

We know this because IBM is building these systems today, in collaboration with forward-thinking clients around the world. In them, we can see a foreshadowing of how banking will work, how telecommunications will work, how energy, healthcare, transportation and retail will work. We can see a world that is becoming smarter before our eyes.

**SMARTER TRAFFIC:** Stockholm's intelligent traffic system, created by IBM, has resulted in 20 percent less gridlock, a 12-percent drop in emissions and a reported 40,000 additional daily users of public transport. IBM is building smart traffic systems in cities from London to Brisbane to Singapore—with many more being planned.

**SMARTER POWER GRIDS:** IBM today is leading seven of the world's top ten automated meter management projects. Our intelligent utility network with CenterPoint Energy enables remote sensing and operation of the electric grid, connection and disconnection of service, fewer and shorter outages, improved customer service and the integration of new, environmentally friendly power sources such as wind and solar—as well as the charging of plug-in electric vehicles. In Malta, we will build the world's first national smart grid, which will also instrument and monitor the country's water systems.

**SMARTER HEALTHCARE:** The cost of therapy is being lowered by as much as 90 percent. For example, IBM technology is being used to monitor the proper delivery of injections and vaccines to more than 2 million patients in

38 states. And, partnering with Google and the Continua Health Alliance, we have introduced software that will enable data from personal medical devices to feed a patient's electronic health record.

**SMARTER FOOD SYSTEMS:** IBM built a system for Norway's largest food supplier that uses RFID technology to trace meat and poultry from the farm, through the supply chain, all the way to supermarket shelves.

**SMARTER MONEY:** Foreign currency exchange is the world's largest single market. Thanks to a smart financial system IBM developed, intraday settlement risk for more than \$2 trillion in daily volume—more than 60 percent of the world's foreign exchange transactions—has been effectively eliminated. And through technology-enabled microfinance, organizations like Grameen Foundation and Financial Information Network and Operations Ltd. (FINO) are providing poor people around the world with collateral-free loans and financial services to support income-generating businesses.

**SMARTER TELECOMMUNICATIONS:** IBM is helping traditional telecom service providers, mobile and broadband operators and broadcasters transform their networks and services. IBM's solutions are being used in India to deliver new services dynamically to support 185 million mobile phone subscribers—more than half of the total Indian market for mobile services.

**SMARTER WATER:** We can even use computer modeling to simulate, monitor—and potentially manage—the behavior of river basins around the world, as Water for Tomorrow, a collaboration between IBM and The Nature Conservancy, is now doing in Brazil, China and the U.S.

In every one of these examples—and there are many more—we see improved productivity, efficiency, responsiveness, profitability and societal benefit.

With so much technology and networking abundantly available at such low cost, what service wouldn't you provide a customer, citizen, student or patient? What wouldn't you connect? What information wouldn't you mine for insight? The answer is, you—or your competitor—will do all of that. You will do it because you can, because the technology is both available and affordable.

And governments and societies around the world will do it because they must. As I talk to leaders everywhere from business, government and across civil society, I am hearing the same urgency for action, the same need for significant investment, and the same focus on not simply repairing what's broken, but preparing for a new economy in a new century. In particular, there is widespread and growing recognition of the importance of smart infrastructure. Our conversations around the world are giving us confidence that IBM is well positioned to address society's and businesses' most urgent needs.

We will be aggressive in our pursuit of this opportunity. Indeed, you will be hearing and seeing much more about our smarter planet vision in the weeks and months ahead, as we establish our point of view, build the right relationships and offer smart solutions in the marketplace.

## We Will Emerge Stronger

In closing, I think it's worthwhile to step back and consider this moment, and our response to it, in a broader context. Many companies are reacting to the current global downturn by drastically curtailing spending and investment, even in areas that are important to their future. We are taking a different approach.

Of course, we must continue to improve our competitiveness. But while we maintain discipline and prudence in the near term, we also maintain the discipline to plan for the future. We're not looking back, we're looking ahead. We're continuing to invest in R&D, in strategic acquisitions, in growth initiatives—and most importantly, during these difficult times, in our people.

In other words, we will not simply ride out the storm. Rather, we will take a long-term view, and go on offense. Throughout our history, during periods of disruption and global change, this is what IBM has done. Again and again, we have played a leadership role. We have imagined what the world might be, and actually built it.



We find ourselves at such a moment now. This is an inflection point—both in the course of modern technology and economic history, and in the nearly 100-year journey of IBM. As someone who has been here for more than a third of that journey, I can tell you that it presents the best opportunity I have seen in my IBM career to align those two trajectories in very powerful ways.

From cabinet rooms, to board rooms, to kitchen tables around the world, people are eager for change. Such a mandate doesn't come around very often—perhaps once in a generation, or once in a century. It's not something to squander. I and my fellow IBMers have no intention of doing so.

Let me close by expressing my pride in the worldwide IBM team for bringing us to this point, and my gratitude to you, our shareholders,

for your unwavering support. I hope that you are pleased with how your company is performing and evolving. And I trust that you share our excitement about the role we can play in what promises to be a new era for our industry, for business and for our planet.



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Samuel J. Palmisano

CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

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The selected references in this letter to the company's financial results (i) excluding Enterprise Investments and stock-based compensation, (ii) at local (constant) currency, and (iii) excluding Global Financing receivables are, in each case, non-GAAP financial measures. These references are made to facilitate a comparative view of the company's ongoing operational performance. Information about references to the company's financial results excluding Enterprise Investments, stock-based compensation and Global Financing receivables is provided in the company's Form 8-K submitted to the SEC on January 20, 2009 (Attachment II—Non-GAAP Supplementary Materials). Information about references to local currency is provided in the company's 2008 Annual Report to Stockholders (Management Discussion—Year in Review) and in the company's Form 10-K for 2008 (Part II, Item 7).