



Ong Kai Kiat

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IBM Faces Serious Cloud and IT Services Challenges

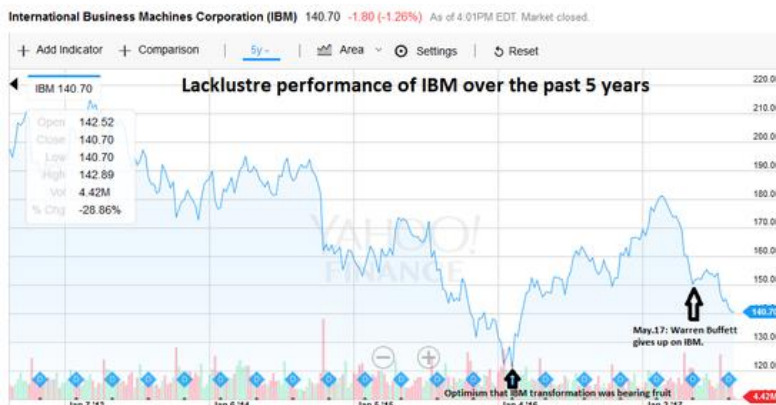
GF Chat

The company has experienced 21 consecutive quarters of revenue decline

August 24, 2017 | About: [IBM +0%](#) [FB +0%](#) [MSFT +0%](#) [AMZN +0%](#) [GOOG +0%](#) [GOOGL +0%](#) [BABA +0%](#) [COF +0%](#) [CMCSA +0%](#) [WMT +0%](#)

Facebook Inc. (NASDAQ:FB) exemplified the allure of the tech industry when it skyrocketed 507% in five years, from \$28 in 2012 to around \$170 today. While tech has great disruption potential and can create vast potential for revenue growth, not all areas of tech provide the same level of promise.

International Business Machines Corp. (NYSE:IBM) is one such example of choosing the wrong area of tech and, as a result, is being punished by investors. The cloud business is commoditized and IBM made a major mistake by choosing to focus on it instead of creating a unique product with a steady moat. The question today is whether IBM can transform itself as it did previously.



Source: Yahoo Finance

GuruFocus has detected 3 Warning Signs with International Business Machines Corp \$IBM.

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In 2011, [Warren Buffett](#) ([Trades](#), [Portfolio](#)) made a high-profile purchase of IBM at an average price of \$159 and owned 6% of IBM's shares, making it his second-largest holding

after [Wells Fargo](#) (WFC). He based his conviction on the company consistently hitting its own internal targets (Road Maps) early.

Under the leadership of CEO [Samuel J. Palmisano](#) (March 2002 to January 2012), IBM hit its 2010 earnings targets in 2007 and by 2011, it was set to hit the 2015 targets. Of course, Buffett was not the only investor to notice the company's performance. Its share price soared 157% from \$81 in November 2008 to peak at \$208 in March 2012.

What went wrong?

When IBM came under the leadership of CEO [Ginni Rometty](#) in January 2012, IBM began its multiyear decline in revenue. The situation was so bad that Buffett, who cheered for IBM in 2011, decided to reduce his exposure by selling 30% of his IBM stake in May.

Business segment	Revenue for Q2/2017	Year-on-Year Growth
Cognitive Solutions	\$4.6 billion	(2.5%)
Global business services	\$4.1 billion	(3.7%)
Technology Services & Cloud Platforms	\$8.4 billion	(5.1%)
Systems	\$1.7 billion	(10.4%)
Global Financing	\$415 million	(2.2%)

Source: [IBM Second-Quarter Results](#)

Of course, there were [some analysts who were bullish](#) about IBM's transformation in 2016, which resulted in a small boost from \$130 to \$180 over a one-year period. IBM posted its [21st consecutive quarter](#) of revenue decline in July, when revenue came in at \$19.29 billion, below expectations of \$19.46 billion. All five of the company's divisions recorded revenue decline. As a consolation, its earnings exceeded expectations of \$2.74 per share by 23 cents.

Tough to gain cloud traction amid strong competition

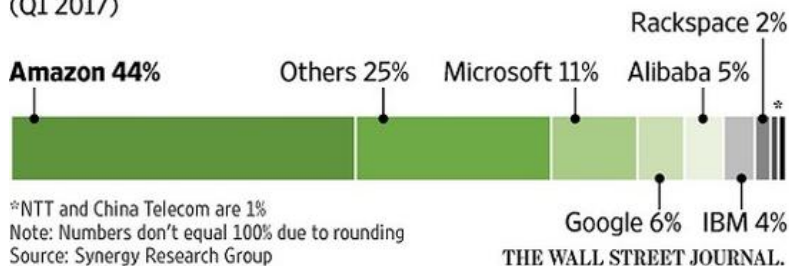
IBM's cloud division contributed the lion's share of its revenue at \$8.4 billion, which declined 5.1% in the most recent quarter. Despite the cloud's significance to IBM, the cloud product offering is not globally competitive relative to [Amazon](#) ([NASDAQ:AMZN](#)), [Microsoft](#) ([NASDAQ:MSFT](#)) or [Alphabet's Google](#) ([NASDAQ:GOOG](#))([NASDAQ:GOOGL](#)). [Alibaba](#) ([NYSE:BABA](#)) has a strong cloud presence in China.

IBM's 4% Cloud Share Is Way Behind Strong Rivals Amazon and Microsoft. Behind Challengers Google and Alibaba.

Cloud Competition

Amazon dominates the business of providing cloud-computing infrastructure, though Microsoft may gain some ground with the retailer's rivals.

World-wide cloud-computing infrastructure market share (Q1 2017)



Source: [A Better Way To Retire](#)

Amazon dominates the cloud business because it gained the first mover advantage in 2006, which allows it to cost-effectively scale up rapidly. Instead of spending millions on data centers, [Amazon](#) tapped into the budget constraints of small app developers who rely on its cloud offering and started

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primary alternative to Amazon and uses its Office 360 software to attract clients into the cloud environment. Retailers like **Wal-Mart (NYSE:WMT)** prefer to stay far away from Amazon, storing sensitive information on Microsoft Azure's servers.

For developers who prefer open-source cloud solutions, they would go to Google. As Google earns the bulk of its income from advertising, they are willing to provide open-source solutions while building an ecosystem around it.

These three players have effectively covered all major markets in the world except China. In China, Alibaba's Aliyun cloud solution leads the way. Even though IBM announced it will open a data center in China, it remains to be seen if it will add to its cloud revenue.

Today, both small businesses and large corporations use cloud computing for their operations. For instance, [3E Accounting](#) uses cloud services with [Quickbook Online](#) to create a streamlined and effective accounting solution for its clients. Even clients without accounting backgrounds can easily prepare receipts and ensure better cash flow management.

Commoditized IT services pressure margins

IBM's margin problem stems from consumers not seeing differentiated IT services. Currently in the IT services sector, IBM Global Services has to compete against Accenture, Tech Mahindra and HP Enterprise Consulting. IT services start to act like utilities, where consumers gain the upper hand and demand lower prices.

Its Global Services business reported \$4.1 billion of revenue, which represents a 4.1% drop from the prior year. IBM responded to the commoditization of its services by outsourcing work to India in 2007, where the average IT consultant cost [\\$17,000 compared to \\$100,000](#) in the U.S. Labor accounts for [80% of costs](#) for IT services, but they ran into serious competition with local Indian outsourcing giant Tata Consultancy Services, which cut into its margins. As IBM employs fewer workers in the U.S., it [sold property](#) from its [2 million square foot Rochester campus](#) last year to further cut costs.

Good management pay despite languishing business

The ugly truth in the commoditized IT services business is only the top management can retain their competitive salary packages, while the rank and file absorb the effects of the price war. IBM CEO Ginni Rometty will earn between [\\$33 million and \\$65 million](#) this year.

On the other hand, even low-cost Indian workers are being fired to cut costs further, with just a month of pay. Shareholders might flinch at approving such astronomical salaries next year if Rometty cannot deliver improved revenue.

Disclosure: No positions in the stocks mentioned.

About the author:

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I am a freelance writer from Singapore who specialize in writing about finance and technology.

Rating: **0.0/5** (0 votes)

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