IBM Plunges as CEO Abandons 2015 Earnings Forecast

By Alex Barinka - Oct 20, 2014

*International Business Machines Corp. (IBM)* plunged the most in more than four years after abandoning an earnings forecast for 2015, as the company struggles to transform fast enough to handle the shift to cloud computing.

IBM said it will provide an update on its projections in January, ditching a five-year plan to boost profit. The shares *tumbled* as much as 8.4 percent, dragging down the Dow Jones Industrial Average. *Warren Buffett*, IBM’s biggest shareholder, had as much as $1 billion of his investment wiped out.

While Chief Executive Officer Ginni Rometty had been banking on a strong second half of the year, IBM instead faced weaker-than-expected software sales and lower productivity in services in the third quarter. With technology customers moving from owning hardware to storing data in the cloud, IBM is now cutting more jobs, reducing its forecast for free cash flow and offloading an unprofitable chip unit to Globalfoundries Inc.

“Obviously we were disappointed in this quarter,” Rometty said on a conference call today, adding that the company is facing “unprecedented change” in the industry. “We have more to do and we need to do it faster.”

IBM is backing away from a pledge -- instituted by former CEO *Sam Palmisano* and sustained by Rometty when she succeeded him in 2012 -- to reach adjusted profit of $20 a share by 2015.

“IBM needs to find success and growth in the cloud through organic and acquisitive means,” said *Daniel Ives*, an analyst at FBR Capital Markets. “Otherwise there could be some darker days ahead for the tech giant and its investors.”

**Globalfoundries Deal**

The Armonk, New York-based company now expects 2014 operating earnings per share to fall 2 percent to 4 percent from $16.64 in 2013. That reflects changes for the chipmaking unit, which is now classified as a discontinued operation. IBM is taking a third-quarter pretax charge of $4.7 billion for the business. The company had been projecting 2014 adjusted earnings of at least $18 a share.
Earlier today, the company announced an agreement to pay Globalfoundries $1.5 billion to take over the chip-manufacturing division, confirming what people familiar with that matter told Bloomberg yesterday. The deal removes a drag on profit, part of Rometty’s efforts to jettison lower-margin businesses and prioritize earnings growth over expanding revenue.

“These divestitures do give us an opportunity to go ahead and simplify the business and remove layers,” Rometty said on a conference call today. “Make no mistake, that is important because the strategy is correct and now it is our speed of execution that needs to continue to improve.”

Cloud Unit

IBM’s technology customers increasingly seek to store data and software on cloud-computing networks, rather than on site. That has limited clients’ need for IBM’s servers and mainframes, making it more difficult to reach profit targets.

To help drive that shift, IBM is creating a separate business unit for its cloud-computing operations. To remake its cloud business, Rometty bought provider SoftLayer Technologies Inc. in 2013 for $2 billion and this year committed an additional $1.2 billion to bolster its data centers and offerings.

Cloud offerings delivered as a service are now at an annual run rate of $3.1 billion, compared with $2.8 billion as of the second quarter. That’s still a fraction of IBM’s total $100 billion in revenue last year.

IBM reduced its forecast for free cash flow to $12 billion to $13 billion this year, down from a projection for $16 billion a quarter ago. The company also plans to cut more jobs, resulting in a fourth-quarter charge of as much as $600 million.

Third Quarter

Third-quarter adjusted earnings from continuing operations were $3.68 a share, down from $4.08 a year earlier. Including the loss from discontinued operations, the company had profit of 2 cents a share. Revenue fell 4 percent to $22.4 billion, the 10th straight quarterly drop, weighed down by declines in its hardware division and in emerging markets.

Analysts at Stifel Nicolaus & Co. and BMO Capital Markets, among others, had been calling for IBM to abandon its five-year financial roadmap.

David Grossman, an analyst at Stifel, wrote in a note last week that while he thought it was possible for IBM to reach the target, he was skeptical about its utility.

“We do question whether the roadmap remains relevant in the current environment and wonder whether it would be in the company’s longer term interests to abandon it and modify the way they provide guidance,” Grossman wrote.
Stock Buybacks

As it reshapes itself, IBM still has to rely on its older global business services and software units, which together make up about three-quarters of sales. To boost earnings in the meantime, Rometty has raised debt to fund share buybacks, laid off workers and reduced the company’s tax rate.

IBM has about $1.4 billion remaining in its current share repurchase authorization and said it will request additional funds for buybacks at its October board meeting.

Rometty has made a concerted effort to offload less profitable businesses -- like the low-end server unit that Lenovo Group Ltd. agreed to buy for $2.1 billion. After clearing regulatory hurdles, that deal closed on Oct. 1.

IBM fell 7 percent to $169.27 at 10:30 a.m. New York time, the lowest intraday price in three years. The drop of as much as 8.4 percent earlier was on track for the biggest dip since 2002 on a closing basis.

The stock had fallen 2.9 percent this year through last week, compared with a 1.2 percent dip in the Dow Jones Industrial Average.

Buffett spent $10.9 billion amassing a stake in IBM in 2011 for about $170 a share and has since added more. The investment was a departure for the billionaire, who has long said that he avoided buying technology stocks for Berkshire Hathaway Inc. because it was hard for him to understand their business plans and forecast their prospects.

Buffett Stake

In April, he told CNBC that he stood by his pick and wasn’t surprised by IBM’s revenue decline in the first quarter. He didn’t respond to a message left with an assistant today seeking comment on IBM’s latest results.

At the current 7 percent drop, IBM’s decline wiped almost $900 million off Berkshire’s investment, assuming Buffett’s company still has the 70.2 million shares it reported holding at the end of June.

IBM’s sales to Brazil, Russia, India and China fell 7 percent, compared with 2 percent last quarter and an 11 percent drop in the first three months this year.

The majority of IBM’s sales, about 55 percent last year, comes from its services business. IBM’s backlog for services -- an indicator of expected future revenue -- fell 7 percent from a year earlier to $128 billion.

“The global services business will likely continue to see pressures given overall industry dynamics,” Maynard Um, an analyst at Wells Fargo Securities LLC, said in a note before the results.

“Customers are making their projects smaller thereby creating pricing pressure. Competition
remains intense.”

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