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Seeking the cure for IBM's Big Blahs

Sales growth and cost cutting haven't helped the stock. Here's what to watch for in Big Blue's first-quarter report.

By [Amanda Cantrell](#), CNNMoney.com staff writer

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NEW YORK (CNNMoney.com) - The Nasdaq is sailing along in 2006 but the currents sweeping the index to a five-year high haven't helped shares of IBM.

Despite the fact that investors seem pleased with [IBM](#) (down \$0.34 to \$81.64, [Research](#)) chief executive Sam Palmisano's cost-cutting moves and efforts to restructure the company from a stodgy computer maker to a software and services shop, IBM's shares are flat for the year.

But IBM bulls also point out that with the stock trading at 14 times 2006 earnings estimates, it's also pretty cheap.

So why the Big Blues when it comes to the company's stock price?

Some say it's just the law of large numbers, which is plaguing other tech companies including [Microsoft](#) (down \$0.23 to \$26.84, [Research](#)) and [Hewlett-Packard](#) (down \$0.59 to \$32.03, [Research](#)). In other words, it's difficult to achieve double-digit sales growth when you already have \$91 billion in revenues, as IBM did last year.


Big Blah?

Wall Street will undoubtedly pay close attention to IBM's first-quarter results, which are due after the closing bell on Tuesday. Industry analysts are expecting \$20.7 billion in sales, which would be down 10 percent from a year earlier, due mostly to the sale of IBM's personal computer business to Lenovo last year. Minus the PC division, year-over-year revenue growth is expected to be roughly 1 percent.

Analysts expect earnings of \$1.05 a share, a 23 percent increase from the year-ago quarter.

For IBM, services and software account for the lion's share of operating profits. While hardware ranks ahead of software as a percentage of total revenues, the software business boasts much higher profit margins.

One of the most closely watched measures of how Big Blue is doing is the dollar amount of service contracts the company signed in the just ended quarter. IBM's Global Services division, which performs outsourcing and other




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high-tech services, accounted for roughly 52 percent of its overall revenue last year. Wall Street analysts expect services bookings this quarter to be in the \$11 billion to \$12 billion range - a strong showing for the first quarter.

Moors & Cabot analyst Cindy Shaw thinks IBM's services bookings will grow 17 percent year over year to \$12.8 billion, thanks to a particularly strong quarter for outsourcing contracts. During the quarter, IBM signed a \$1.1 billion deal with Gap and a \$500 million contract with General Motors, as well as contracts with Colgate-Palmolive and Nissan North America.

But the company faces increased competition in this area from HP as well as from offshore players, Lehman Brothers analyst Harry Blount wrote in a note to clients.

As for IBM's software group - its third-largest division, accounting for about 17 percent of total revenues - Blount thinks sales will be flat versus a year ago, despite solid corporate spending on software.

Blount suspects the company offered more aggressive discounts on its software than usual during the first quarter, possibly because of incentives Microsoft offered to get IBM customers to switch to its products.

Blount thinks IBM's hardware business, which provides servers, storage devices and mainframes to corporate customers and accounted for about 26 percent of total revenue last year, should record sales of \$4.6 billion for this quarter, which is the third full quarter that IBM has operated without its PC business.

Moors & Cabot's Shaw expects hardware revenue, excluding PCs, to grow about 7 percent to \$4.1 billion, thanks to strength in its storage products, Cell microprocessors and its new zSeries mainframe, the z9-109, which was introduced in September.

Cost cuts helping, but growth still an issue

Shaw, who has a 12-month price target of \$101 – nearly 25 percent higher than where IBM was trading Monday afternoon – thinks the company will continue to improve its operating margins thanks to cost-cutting moves that Palmisano began last year, including cutting some 13,000 jobs and moving some of its operations to lower-cost geographic regions.

Kim Caughey, an analyst at Fort Pitt Capital Group who owns shares of IBM in the funds she manages, said she likes how the company has scaled back or exited lower-margin businesses like PCs and is refocusing on more profitable software and services. She adds that the stock is a "great buy" at current prices.

But Roger Kay, president of technology research and consulting firm Endpoint Technologies, noted that growing competitive challenges remain for IBM.

He acknowledged Palmisano is steering IBM in the right direction but said that rivals including Microsoft, HP and even [Sun](#) (down \$0.15 to \$4.84, [Research](#)) are stepping up their focus on areas that have been strongholds for Big Blue.

Blount does not own shares of IBM, but Lehman Brothers has investment banking ties to the company. Moors & Cabot's Shaw does not own shares of IBM, but the firm has banking ties to the company. Endpoint's Kay does not own shares of any of the companies he discussed, and his firm does not do investment banking business.

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