With Spin-off, IBM Finally Embraces a Cloud and AI-first Future

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IBM's efforts to accelerate its pivot to cloud and AI got a shot in the arm on October 8, 2020, when it announced plans to spin off the managed infrastructure services business of its Global Technology Services (GTS) division, a US$20B division that has been facing headwinds and business declines. The move, IBM's most significant shift in its 109-year history, follows from new CEO Arvind Krishna's strategy to secure Big Blue's future relevance. It enables IBM to focus on cloud and AI business – supported by its acquisition of Red Hat and hybrid-cloud projects – where it believes opportunity is abundant.

In this viewpoint, we explore developments in both the market and within IBM that led to this move and discuss potential impacts for IBM clients.

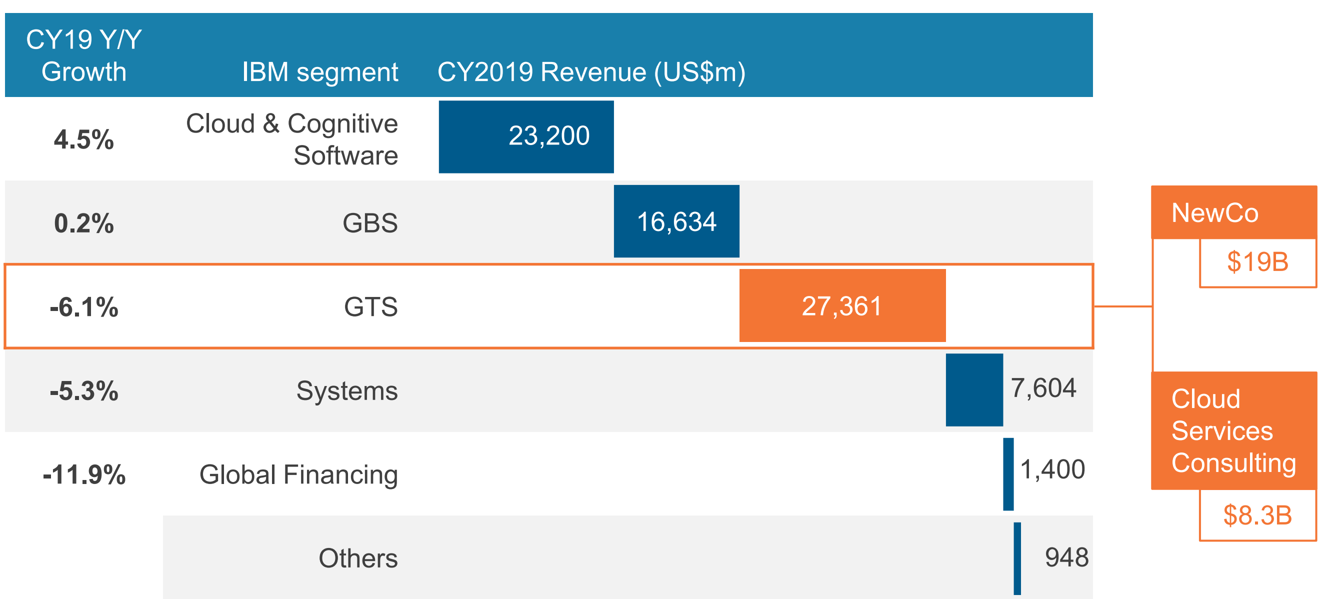
IBM's performance (or the lack of)

Pervasive digital transformation efforts among global organizations have driven accelerated cloud adoption, in turn leading to datacenter exits and shifts to colocation models. For the better part of the last decade, this trend has put downward pressure on revenues from IBM's infrastructure services business (part of its GTS division) as well as other IBM divisions. Further, GTS sales fell 6.1% in the last year alone as the business was forced to play second fiddle to hyperscalers, which are dominating the global cloud market. As Exhibit 1 illustrates, while several IBM divisions are underperforming, GTS is the largest of the underperformers, and therefore the target of this split.

EXHIBIT 1

IBM division performance - how IBM's CY2019 revenue US$77.1 billion splits by segment

Source: Everest Group (2020)



While Red Hat continues its stellar (about 20%) growth, that performance has not been reflected in IBM's stock performance or market cap because of declining bookings from the IT infrastructure services division, which is largely limited to helping legacy clients move their applications to public/private cloud.

IBM's goal to create the highway for the next phase of its growth

We believe the split enables IBM to achieve the following:

- **Laser-sharp focus on the hybrid cloud and AI market opportunity:** Arvind and the team plan to grow IBM on the promise of the hybrid-cloud market, which it claims is valued at about US$1 trillion. It has been trying to capitalize on this potential since acquiring Red Hat in 2018. The split makes Red Hat its crown jewel with immense focus on high-value cloud software and solutions such as IBM Cloud Paks for data and applications, OpenShift platform services, and others. IBM can now position itself as partner of choice with complete focus on helping enterprises succeed in a post-digital transformation era through its hybrid cloud and AI pivot
- **Positioning as a cloud-agnostic partner:** The spin-off is a huge step to becoming truly cloud-agnostic. IBM can now tightly integrate its offerings with hyperscalers and deliver on the promise of innovation enabled by technology from any source. This move enables IBM to focus more on scaling the Red Hat channel – offering better programs and support for Red Hat offerings with a potentially improved margin
- **Improvement in cash position if it finds a suitable acquirer for NewCo:** This part is possible but would be tricky as we believe there are few suitors for this asset, which operates in a challenging market. Pieces of NewCo could be valuable to investors, but acquisition is unlikely to happen in the current operating environment. We believe IBM's preference would have been to sell the business before announcing the move but finding buyers has been difficult.

Implications for IBM clients

The COVID-19 crisis has forced enterprises to integrate infrastructure resiliency as a critical element in their overall IT services strategy. Moreover, the financial implications of the pandemic have compelled many organizations to pursue cost savings and new approaches to staffing. This move unshackles the managed infrastructure services business from IBM assets such as Red Hat and the systems and software business. However, **unbundling is a contrarian move**. Clients will have to take a cautious approach to existing IBM relationships given that NewCo will lack application capabilities, which will be challenging for procurement personnel on the enterprise side who are used to procuring integrated applications and infrastructure services. We expect IBM eventually to unbundle multi-service contracts ,which will need to be sorted carefully for clients of NewCo and IBM.

Overall, we applaud IBM's move, given that it enables higher value business for IBM and a more focused market strategy. We believe this is a continuation of its ongoing strategic transformation (divesting its PC business to Lenovo in 2005 and its chip business in 2014). While there could be some challenges – with more for NewCo than IBM – the split will fuel IBM's growth in hybrid cloud and AI. The shift also will help its client enterprises innovate with the latest technology across the ecosystem. We have been advocating for IBM to shed the sluggish parts of its business; we'll be watching keenly to see how this plays out.

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