
IBM Q2 2024 Earnings

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CONTEXT

IBM reported a [robust second quarter](#), surpassing expectations across key financial metrics. The company continues to capitalize on its hybrid cloud and AI strategy, driving solid performance in software and infrastructure. However, consulting services experienced slower growth due to macroeconomic challenges.

This research note provides a detailed analysis of IBM's Q2 performance, strategic initiatives, and future outlook.

FINANCIAL PERFORMANCE

Key Financial Metrics:

1. Revenue:

- Total revenue for Q2 2024 was \$15.8 billion, representing a 4% year-over-year growth at constant currency.
- This growth was primarily fueled by strong performance in the software and infrastructure segments.

2. Operating Pre-Tax Income:

- IBM reported an operating pre-tax income of \$2.8 billion, a significant 17% increase compared to the same quarter last year.
- The improvement in pre-tax income was driven by a combination of revenue growth and margin expansion.

3. Operating Earnings Per Share (EPS):

- Operating diluted EPS for the quarter was \$2.43, reflecting an 11% year-over-year increase.

- This increase in EPS highlights the company's strong profitability and efficient cost management.

4. **Free Cash Flow:**

- IBM generated \$4.5 billion in free cash flow in the first half of 2024, the highest level reported in many years.
- This strong cash flow performance was supported by robust earnings and effective working capital management.

SEGMENT PERFORMANCE: **CONSULTING**

IBM's consulting business in Q2 2024 showed resilience amid challenging economic conditions, driven by strong demand for AI and large transformational projects. The strategic focus on AI integration, automation, and productivity enhancements positions IBM well for future growth.

Despite short-term headwinds, the consulting segment is poised to benefit from the increasing adoption of AI and digital transformation initiatives in the long run.

Revenue and Growth:

- **Overall Growth:** IBM's consulting revenue grew by 2% year-over-year. This growth rate reflects challenges in the macroeconomic environment, specifically discretionary spending constraints due to higher interest rates and inflation.
- **Segment Performance:** Despite these challenges, the consulting segment continued to see solid demand for large transformational projects in areas like finance, supply chain, cloud modernization, and application development.

Key Factors Affecting Performance:

- **Macroeconomic Impact:** The consulting business faced headwinds from prolonged inflation and interest rate increases, which led to a cautious approach by clients on discretionary spending.
- **Discretionary Spending:** A pullback in discretionary projects affected the smaller engagements within the consulting segment, impacting overall revenue realization.

- **Large Transformational Projects:** IBM experienced strong demand for extensive transformation engagements, which are longer-term and contribute significantly to the backlog.

Strategic Focus and Initiatives:

- **Generative AI:** IBM's consulting business has been pivotal in helping clients design and implement AI strategies. The book of business related to generative AI exceeded \$2 billion, with approximately 75% of this being consulting signings, indicating strong traction in AI-driven transformation projects.
- **AI and Automation:** IBM is leveraging its AI capabilities to drive productivity and optimize client operations. The company's automation portfolio, including recent acquisitions like HashiCorp, enhances its consulting offerings by simplifying cloud infrastructure management.

Productivity and Profitability:

- **Gross Profit Margin:** The consulting segment saw a 40 basis points improvement in gross profit margins, driven by productivity enhancements and pricing actions.
- **Segment Profit Margin:** Despite the improvements in gross margins, the overall segment profit margin was modestly down, reflecting continued labor inflation and currency impacts.

Future Outlook:

- **Growth Expectations:** Given the current macroeconomic pressures, IBM adjusted its growth expectations for the consulting segment to low single digits for the year. However, the company remains optimistic about the medium- to long-term prospects as AI and large-scale transformation projects gain momentum.
- **Strategic Provider of Choice:** IBM's early leadership in generative AI positions its consulting business as a strategic provider of choice for enterprises undergoing digital transformation. This strategic positioning is expected to drive long-term growth and client engagement.

SEGMENT PERFORMANCE: **INFRASTRUCTURE**

IBM's infrastructure business demonstrated robust performance in Q2 2024, driven by strong growth in IBM Z and distributed infrastructure. The integration of AI capabilities, ongoing investments in quantum computing,

and strategic client wins highlight the segment's critical role in supporting secure and scalable hybrid cloud environments.

Despite short-term margin pressures due to strategic investments, the long-term outlook for IBM's infrastructure segment remains positive, supported by continued innovation and strong client demand.

Revenue and Growth:

- **Overall Growth:** The infrastructure segment reported a 3% year-over-year increase in revenue.
- **Key Contributors:** Strong performance was driven by IBM Z mainframe solutions and growth in distributed infrastructure.

IBM Z Performance:

- **Revenue Growth:** IBM Z revenue grew by 8%, reflecting the continued success of the z16 cycle, which is now more than two years in and outperforming prior cycles.
- **Client Adoption:** IBM Z remains a critical component of clients' hybrid cloud environments, driving secure and mission-critical workloads. The mainframe's Talen processor, which offers real-time in-line AI inferencing, has been a unique differentiator.
- **Workload Demands:** The increasing demands for workloads due to business expansion, regulatory requirements, and cybersecurity threats have driven more capacity needs (MIPS) for IBM Z, which have tripled over the last few cycles.

Distributed Infrastructure:

- **Revenue Growth:** Distributed infrastructure revenue grew by 5%, supported by strong demand for Power and storage solutions.
- **Power Systems:** Growth in Power systems was fueled by data-intensive workloads, particularly SAP HANA, leveraging the capabilities of Power10.
- **Storage Solutions:** IBM's storage offerings saw growth, especially high-end storage tied to the z16 cycle and solutions designed to support generative AI by managing large volumes of unstructured data.

Product and Technology Enhancements:

- **Real-Time AI Inferencing:** IBM Z is equipped with real-time AI inferencing capabilities, enhancing its utility in applications like real-time fraud detection.
- **Quantum Computing:** IBM expanded its quantum computing capabilities by enhancing Qiskit, its quantum computing software. The updates focus on optimizing performance on utility-scale quantum hardware, supporting advanced quantum algorithm development and broader industry adoption.

Profitability and Margins:

- **Gross Profit Margin:** The infrastructure segment experienced solid gross profit margin expansion.
- **Segment Profit:** Segment profit accelerated quarter-over-quarter to the high teens. However, the profit margin was down 230 basis points, reflecting key investments in AI, hybrid cloud, and quantum computing, as well as a nearly 1-point impact due to currency fluctuations.

Strategic Focus and Future Outlook:

- **Hybrid Cloud Integration:** IBM's infrastructure solutions, particularly IBM Z, are integral to clients' hybrid cloud strategies, providing scalability, security, and resilience.
- **Investment in Innovation:** IBM continues to invest in emerging technologies like AI and quantum computing, ensuring its infrastructure offerings remain at the forefront of industry advancements.
- **Long-Term Growth:** The strong performance and continued innovation in the infrastructure segment position IBM for sustained growth, as clients increasingly rely on its solutions for their evolving IT needs.

SEGMENT PERFORMANCE: SOFTWARE

IBM's software business demonstrated strong growth and profitability in Q2 2024, driven by the successful integration of AI and hybrid cloud capabilities. Strategic acquisitions, innovative product enhancements, and strong client demand for AI-powered solutions positioned IBM's software segment for continued success.

The company's focus on recurring revenue and strategic partnerships further strengthens its market position and long-term growth prospects.

Revenue and Growth:

- **Overall Growth:** IBM's software revenue grew by 8% year-over-year, driven by strong performance in the Hybrid Platform & Solutions and Transaction Processing segments.
- **Recurring Revenue:** Approximately 80% of the software revenue is recurring, providing a stable and predictable revenue stream.

Key Drivers of Growth:

- **Hybrid Platform & Solutions:** This segment saw significant growth due to increased client adoption of AI and hybrid cloud platforms. The Annual Recurring Revenue (ARR) for Hybrid Platform & Solutions reached \$14.1 billion, up 9% from the previous year.
- **Transaction Processing:** Revenue from transaction processing grew by 13%, reflecting strong demand for IBM's mission-critical hardware stack, including IBM Z, Power, and storage solutions. The new watsonx Code Assistant for Z contributed positively to this segment.

Strategic Initiatives and Innovations:

- **AI Integration:** IBM continued to integrate AI capabilities into its software products, notably through the watsonx platform and AI-powered tools like watsonx Orchestrate.
- **Red Hat Growth:** Red Hat showed robust performance with annual bookings growth accelerating to over 20%. Within Red Hat, OpenShift annual bookings grew over 40%, and both RHEL and Ansible exhibited double-digit growth, highlighting strong demand for IBM's hybrid cloud solutions.
- **Generative AI Offerings:** New AI offerings, such as watsonx and IBM Concert, contributed approximately \$0.5 billion to the AI book of business since inception. These innovations demonstrate IBM's leadership in generative AI and its ability to drive value through AI-powered software.

Product Enhancements:

- **Open-Source AI:** IBM open-sourced its Granite models under Apache 2.0 licenses, making them available on Hugging Face and GitHub. This move

promotes open innovation and allows clients to customize and refine AI models using their data.

- **InstructLab:** Introduction of InstructLab, a tool for rapid model tuning through synthetic generation, enabling clients to efficiently customize AI models.

Profitability and Margins:

- **Gross Profit Margin:** The software segment saw gross profit margin expansion, driven by operating leverage and a favorable product mix.
- **Segment Profit:** Software segment profit increased by over 350 basis points year-over-year, reflecting strong revenue growth and efficient cost management.

Acquisitions and Partnerships:

- **Strategic Acquisitions:** IBM's recent acquisitions, such as Apptio, StreamSets, and webMethods, have been integrated into the software portfolio, contributing to growth and enhancing IBM's capabilities in areas like cost management, API management, and data ingestion.
- **Partnerships:** IBM formed strategic AI partnerships with industry leaders such as Adobe, AWS, Microsoft, Meta, Salesforce, and SAP, which bolstered its software offerings and expanded its market reach.

Outlook:

- **Increased Growth Expectations:** Given the strong first-half performance, IBM raised its growth expectations for the software segment to high single digits for the year.
- **Continued Innovation:** IBM plans to continue investing in AI and hybrid cloud innovations, driving further growth and maintaining its competitive edge in the software market.

OUTLOOK & GUIDANCE

IBM's outlook for 2024 is optimistic, with expectations for solid revenue growth, margin expansion, and strong free cash flow generation. The company's strategic focus on AI, hybrid cloud, and quantum computing, coupled with disciplined execution and strategic partnerships, positions IBM well for sustained growth and long-term success.

However, the company remains cautious about macroeconomic uncertainties and competitive pressures, emphasizing the importance of continuous innovation and operational efficiency.

Revenue Growth:

- **Full-Year Revenue:** IBM expects full-year constant currency revenue growth to be in line with its mid-single-digit model, prudently positioned at the low end.
- **Software Segment:** Given the strong first-half performance, IBM raised its growth expectations for the software segment to high single digits for the year. This increase is driven by solid recurring revenue and contributions from new AI offerings.
- **Consulting Segment:** Due to continued pressures on discretionary spending, IBM expects low single-digit growth for the consulting segment. However, the company remains optimistic about long-term growth driven by generative AI and large transformational projects.
- **Infrastructure Segment:** Following strong performance in the first half, IBM expects the infrastructure segment to be about neutral for the year, with segment profit margins in the mid-to-high teens.

Free Cash Flow:

- **Raised Guidance:** IBM raised its full-year free cash flow guidance to greater than \$12 billion, driven primarily by growth in adjusted EBITDA and strong cash flow generation in the first half of the year.

Profit Margins:

- **Operating Pre-Tax Margin:** IBM expects operating pre-tax margin expansion of over 0.5 points year-over-year.
- **Software Segment Profit Margin:** Given ongoing productivity initiatives and operating leverage, IBM now expects the software segment profit margin to expand by over 1 point.
- **Consulting Segment Profit Margin:** IBM anticipates the consulting segment profit margin to expand by about 0.5 points, reflecting efforts to manage labor inflation and enhance productivity.

Key Strategic Initiatives:

- **Generative AI:** IBM's book of business related to generative AI now stands at over \$2 billion. The company expects continued growth in this area as clients increasingly adopt AI-driven solutions.
- **Strategic Partnerships:** IBM will leverage partnerships with industry leaders such as Adobe, AWS, Microsoft, Meta, Salesforce, and SAP to enhance its AI and hybrid cloud offerings, driving further growth and market penetration.
- **Product Innovations:** IBM will continue to invest in AI, hybrid cloud, and quantum computing innovations to maintain its competitive edge and drive long-term growth.

M&A and Strategic Investments:

- **HashiCorp Acquisition:** IBM expects the acquisition of HashiCorp to close by year-end, with anticipated revenue and profitability contributions beginning in 2025.
- **Productivity Initiatives:** IBM will take structural actions related to the Palo Alto Networks transaction to address stranded costs and accelerate productivity initiatives.

ANALYSIS

IBM's Q2 performance shows that it's continuing to find success with its hybrid cloud and AI strategy. The company's focus on integrating AI across its portfolio and fostering open innovation positions it well for sustained growth.

While consulting faces short-term headwinds, the strategic emphasis on AI and cloud solutions, coupled with a strong financial position, supports a positive long-term outlook.

With a strong emphasis on AI, hybrid cloud, and open-source innovation, IBM is well-positioned to drive growth and deliver value to shareholders. Continued investment in innovation and strategic partnerships will be crucial in maintaining IBM's competitive edge.



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