

DEAR FELLOW INVESTOR,

Last year at this time, Lou Gerstner said 2001 would be a “show me” year for IBM. We knew heading into 2001 that global economies were decelerating, and that IBM wouldn’t be immune from the slowdown. We also knew that a tight economy would provide an acid test of our competitive position, and that of our major competitors. No hiding. No getting swept along by a booming economy. *Show me.*

A handwritten signature in blue ink that reads "Sam Palmisano". The signature is fluid and cursive, with the first name "Sam" and last name "Palmisano" clearly legible.

In 2001, I believe IBM showed the world three things:

- The strategies we've been following for the past several years are correct.
- We've produced results through disciplined market-place execution.
- If we can gain share in a declining economy—which IBM did in 2001—then we can keep winning when a rebound occurs.

We delivered strong results in an environment that took a heavy toll on the high-tech sector. For the first time in nearly a decade, the information technology industry shrank. Yet, measured in constant currency, IBM's revenue was up 1 percent. That's a modest increase, to be sure—but it was the first time since the early 1990s that IBM outperformed the industry. Our gross profit margins improved, and we reduced our indirect expense by more than \$1 billion, reinvesting these savings in direct expense that can drive future revenues and share gains. Earnings declined from 2000 levels, yet we delivered very strong profitability—net income of \$7.7 billion for the year and more than \$14 billion of cash from operations.

Our continued strong cash flow gave us the flexibility to make investments in our future—\$5.8 billion in research and development, \$5.7 billion in capital expenditures, and \$1.1 billion for strategic acquisitions to strengthen our portfolio. The bulk of our acquisition investment was used to acquire the database assets of Informix Corp., which improved our share position and

growth potential in the battle for database software leadership. After making all those investments, we used our strong cash position further to increase shareholder value by raising our common stock dividend 8 percent and by repurchasing \$5.3 billion in IBM common shares. We ended the year with a cash balance of \$6.4 billion.

The strength of our performance relative to our mainstream competitors was reflected in a 42 percent increase in our stock price—this during a year when the S&P 500 index declined 13 percent and the NASDAQ was down 21 percent. While market valuations were being decimated across the high-tech sector, our market capitalization at year end was \$208 billion, up 41 percent.

Most encouraging of all, we consistently outperformed our major rivals and gained share in every strategic business segment. This is the overriding message of 2001. We won a lot more than we lost, and based on that record alone, IBM enters 2002 far stronger and better positioned than when last year began.

In an environment in which revenue growth was hard to come by, our two principal growth businesses—software and services—delivered the strongest results.

Software

Our software growth was fueled by strong momentum across our middleware products—the integrating software layer of e-business infrastructure.

- In database and transaction management, we grew and took significant share from the market leaders in both categories.

- WebSphere—our suite of products that allow businesses to build, deploy and manage all manner of e-business operations, grew 50 percent and significantly outpaced its competition.
- Lotus remains the market leader in collaborative middleware, and Tivoli, which develops security and software management products, got stronger throughout 2001 after working through management and product transitions.

Services

In the early 1990s, I was one of the starry-eyed optimists who were flying around closing the initial services contracts. Well, today, IBM is a services-led business in a services-led industry.

Our services story in 2001 mirrors what happened across our entire portfolio: some businesses up, some down, but on balance a solid performance—with underlying dynamics that point to continued strength this year.

The positives start with a dramatically improved services profit performance, contributing nearly half of all IBM pre-tax profit for the year. We increased revenues from services associated with e-business and strategic outsourcing; and revenues from Web hosting jumped 35 percent. Contract signings remained strong, and we closed the year with contracts for \$102 billion in future services revenue.

Even in difficult economic times, customers invest in services to manage technical complexities and financial risks—and especially in the world of e-business, to transform their businesses. However, while some areas of services are countercyclical, others tend to correlate very closely with economic conditions. That's especially true of high-value I/T consulting services—a business that had to work through a significant transition in 2001. As the market shifted and customers deferred spending on consulting engagements, we were initially slow to respond. Throughout 2001, we took steps to rebalance skills in our consulting and systems integration businesses. Based on that work, and a strong pipeline of signings headed into 2002, we expect a markedly improved performance across our services business this year.

Enterprise Systems

Across enterprise systems—eServers and storage subsystems—we had a strong year and gained 3 points of share.

- Revenue from our zSeries mainframes increased—our first full year of revenue growth in the mainframe business since 1989—and we saw a double-digit increase in shipments of computing capacity.
- Our UNIX servers gained significant share. Literally five years to the day after we promised leadership in microprocessor technology on a UNIX platform, our technical team delivered Regatta, the world's fastest UNIX server. Customer demand has been strong.

FINANCIAL HIGHLIGHTS *International Business Machines Corporation and Subsidiary Companies*

(dollars in millions except per share amounts)		
FOR THE YEAR	2001	2000
Revenue	\$ 85,866	\$ 88,396
Net income	\$ 7,723	\$ 8,093
Per share of common stock:		
Assuming dilution	\$ 4.35	\$ 4.44
Basic	\$ 4.45	\$ 4.58
Net cash provided from operating activities	\$ 14,265	\$ 9,274
Investment in plant, rental machines and other property	\$ 5,660	\$ 5,616
Cash dividends paid on common stock	\$ 956	\$ 909
Per share of common stock	\$ 0.55	\$ 0.51
AT YEAR END		
Cash, cash equivalents and marketable securities	\$ 6,393	\$ 3,722
Total assets	\$ 88,313	\$ 88,349
Working capital	\$ 7,342	\$ 7,474
Total debt	\$ 27,151	\$ 28,576
Stockholders' equity	\$ 23,614	\$ 20,624
Common shares outstanding (in millions)	1,723	1,743
Market capitalization	\$ 208,438	\$ 148,146
Stock price per common share	\$ 120.96	\$ 85.00
Number of employees in IBM/wholly owned subsidiaries	319,876	316,303

- In high-end data storage, the product we call “Shark” continued its strong comeback. We grew Shark revenue 32 percent and gained share.

Our major challenges in 2001 came in the two businesses that were most affected by the industry downturn. Our Technology Group—which sells component technologies to high-tech companies and telecommunications firms—was hit hard by the industrywide slump. We also felt the effects of a declining market for personal computers. Throughout 2001 and continuing into this year, we’ve taken steps to improve our long-term competitiveness—rebalancing resources and cost structures in both units. We expect these businesses to show better results in 2002, regardless of economic conditions.

Looking ahead to 2002, we are, like everyone else, watching the economy and anticipating a slow recovery. However, we have not built our 2002 plans around an economic rebound that’s not within our power to control. We’re executing plans to help our customers thrive in this environment; to continue to gain share against our competitors; to drive turnarounds in our underperforming businesses; and to keep advancing productivity gains.

Beyond that, we’re building on what we learned in 2001. Because in addition to being a “show me” year, it was also a “shake out” year. I’m not only talking about all the dot-coms that were flushed out of the system. More important than that, 2001 was a year when the reality of e-business—the serious, pragmatic reality IBM has been talking about for years—finally took hold. As that has happened, more and more people have come to see the

strategic vulnerabilities of many of our one-product, or “pure play,” competitors.

This is important to understand, because the setbacks our competitors have experienced—and the share gains IBM has achieved—are not primarily driven by short-term economic conditions. As Lou Gerstner explains in his letter to you, the I/T industry is undergoing fundamental change. We see the new competitive and customer landscape taking shape around three domains.

INFRASTRUCTURE

The demands of real e-business computing have launched a full-blown movement toward open, secure, reliable, enterprise-scale systems built on integrated, industrial-strength technologies—in other words, the kinds of computing systems that have defined IBM’s franchise. We gained share in every key segment of hardware and software infrastructure last year.

BUSINESS INSIGHT

Customer investment decisions increasingly are being made in favor of partners who can provide industry-specific insight (e.g., on financial services, or life sciences, or retail), in addition to technical expertise. One implication of this shift is obvious: Companies that deliver this kind of industry-based know-how will be able to influence customers’ technology investment decisions.

TECHNICAL INNOVATION

We know—and more important, our customers know—that the computing infrastructure for e-business will be orders of magnitude more complex and sophisticated

than anything that preceded it. That's the kind of challenge that gets the juices flowing across IBM's technical communities. Not only are our scientists and engineers energized by what's ahead, but we've spent decades hiring, investing in and building our technical prowess to prepare for just such a moment.

One indication: In 2001, we became the first enterprise to earn more than 3,000 new U.S. patent awards—our ninth straight year of global patent leadership. Our total (3,411) exceeded the combined total of 12 of the largest I/T companies in the United States.

Every time this industry has moved through a major evolutionary shift, the value of technical leadership has come to the fore. The companies that set the technical agenda also earn the mind share and market share that come with leadership.

In this next phase, those advantages will accrue to the companies that do more than deliver standalone hardware and software. The leader will create the technologies for a new computing infrastructure for e-business. For instance:

- The global I/T infrastructure will have to be able to handle a coming flood of transactions, operations and complexity. And because there aren't enough technologists in the world to manage it all, the systems themselves must become much more spontaneous and "autonomic"—able to regulate, protect, configure and even heal themselves. In 2001, we delivered an autonomic blueprint for the industry and the academic community, and launched our own comprehensive autonomic initiative, beginning with our Project eLiza.

- At the client end of this spectrum, there will be explosive demand for custom-designed, highly energy-efficient chips. They'll be the brains inside everything from tiny medical devices to billions of Net-enabled consumer electronics products. (And, by the way, they'll also be found inside the world's largest servers and storage systems.) Fulfilling that demand is a proposition far different from stamping out millions of look-alike microprocessors for personal computers. Every kind of device will require a slightly different chip design. Our custom logic business is the largest in the world.

- Finally, at the 40,000-foot level, "grid computing" architectures will turn the Internet itself into a gigantic virtual computer that can tap and interconnect all the I/T resources—not just information, but also tools—across multiple enterprises. We're already building one such grid with the University of Pennsylvania, to bring the most advanced techniques in breast cancer screening and diagnosis to patients across the United States.

* * *

I can't close my first letter to IBM's shareholders without a word about the person I succeed in this job, and the legacy that he leaves to all of his IBM colleagues and to anyone with a stake in the success of this company. So I'll just say this: When all's said and done, Lou Gerstner is the man who recreated IBM.

When Lou arrived, IBM's very viability was in question. Even those who thought we'd survive weren't sure it mattered. After all, many technology companies have

CEO'S LETTER

risen from their deathbeds—but they came back smaller, diminished and, frankly, irrelevant. On top of that, many people, even inside IBM, didn't believe an outsider could do the job.

About the only person who didn't have doubts (about almost anything, it seemed!) was Lou. From his first day, he said IBM was going to get back on top. Then he set to work making it so. Nine years later, it's hard to imagine an IBM without a world-class services capability, without a self-renewing capacity for technical innovation and without the strongest product line in its history. Even more astonishing, it's becoming hard to remember an IBM whose culture wasn't grounded in simple-but-vital principles like marketplace obsession, speed, shareholder return and the make-or-break importance of talented, energized people.

That's all part of the IBM Lou envisioned in 1993, and the IBM we've built under his leadership. Along the way, Lou did one more thing. He made all of us in IBM winners again. And because he did, I'm able to tell you, our investors, that your company and its people are strong.

I'm humbled not only to be here at one of the most exciting moments in our industry's history, but to be given the privilege of leading this truly meaningful company, with the finest workforce in business. We've got the right strategic vision—one that is being emulated by many. And if there is one thing this team has proved again and again—whether it was betting on services, creating e-business, embracing Linux, or in the ongoing

work to restructure our PC business—it is that we have the smarts, the agility and the guts to seize a new direction and to lead change.

Together, we're going to build on everything we've done to this point, and make IBM the most successful company in the information technology industry—and a leader among businesses in any industry. The work has already started. In fact, it never stops.



Samuel J. Palmisano
President and Chief Executive Officer