Dear IBM Investor:

What will we make of this moment—as businesses, as individuals, as societies?

What will we make with a planet generating unprecedented amounts of data? What will we create from—and with—global networks of consumers, workers, citizens, students, patients? How will we make use of powerful business and technology services available on demand? How will we engage with an emerging global culture, defined not by age or geography, but by people determined to change the practices of business and society?

To capture the potential of this moment, IBM is executing a bold agenda. It is reshaping your company, and we believe it will reshape our industry. In this letter I will describe the actions we have taken and are taking, and the changed company that is emerging from this transformation. I believe that if you understand our strategy, you will share our confidence in IBM's prospects—for the near term, for this decade and beyond.

Let's start with the phenomenon of our age—data.

"Traditional computing systems, which only do what they are programmed to do, simply cannot keep up with Big Data in constant motion. For that, we need a new paradigm."

A planet of data

Today, every discussion about changes in technology, business and society must begin with data. In its exponentially increasing volume, velocity and variety, data is becoming a new natural resource. It promises to be for the 21st century what steam power was for the 18th, electricity for the 19th and hydrocarbons for the 20th. This is what we mean by enterprises, institutions and our planet becoming smarter.

Thanks to a proliferation of devices and the infusion of technology into all things and processes, the world is generating more than 2.5 billion gigabytes of data every day, and 80 percent of it is "unstructured"—everything from images, video and audio to social media and a blizzard of impulses from embedded sensors and distributed devices.

This is the driver of IBM's first strategic imperative: To make markets by transforming industries and professions with data.

The market for data and analytics is estimated at $187 billion by 2015. To capture this growth potential, we have built the world's broadest and deepest capabilities in Big Data and analytics—both technology and expertise. We have invested more than $24 billion, including $17 billion of gross spend on more than 30 acquisitions. We have 15,000 consultants and 400 mathematicians. Two-thirds of IBM Research's work is now devoted to data, analytics and cognitive computing. IBM has earned 4,000 analytics patents. We have an ecosystem of 6,000 industry partners and 1,000 university partnerships around the world developing new, analytics-related curricula.

IBM provides the full array of capabilities our clients need to extract the value of Big Data. They can mine multiple structured and unstructured data sets across their business. They can

apply a range of analytics—from descriptive to predictive to prescriptive. And importantly, they can capture the time value of data. This matters, because the battle for competitive advantage in this new world can be lost or won in fractions of a second.

Our data and analytics portfolio today is the deepest in the industry. It includes decision management, content analytics, planning and forecasting, discovery and exploration, business intelligence, predictive analytics, data and content management, stream computing, data warehousing, information integration and governance.

This portfolio provides the basis for the next major era in computing—cognitive systems. Traditional computing systems, which only do what they are programmed to do, simply cannot keep up with Big Data in constant motion. For that, we need a new paradigm. These new systems are not programmed; rather, they learn, from the vast quantities of information they ingest, from their own experiences, and from their interactions with people.

IBM launched this era three years ago, when our Watson system defeated the two all-time champions on the quiz show *Jeopardy!* Watson has since matured from a research grand challenge into a multifaceted business platform, enabled globally via the cloud. Earlier this year we launched the IBM Watson Group. It will comprise 2,000 professionals, a $1 billion investment and an ecosystem of partners and developers that we expect to scale rapidly. In the process, we believe Watson will change the nature of computing, as it is already beginning to change the practice of healthcare, retail, travel, banking and more.

Taken together, our investments in data and analytics are driving significant growth, with 40,000 service engagements to date, growing by double digits. In 2013 our business analytics revenue rose 9 percent—led by Global Business Services and Software. This is already a nearly $16 billion business for us, and we have raised our expectations for it.

An IT industry remade by cloud

At the same time that industries and professions are being remade by data, the information technology infrastructure of the world is being transformed by the emergence of cloud computing—that is, the delivery of IT and business processes as digital services. It is estimated that by 2016, more than one-fourth of the world's applications will be available in the cloud, and 85 percent of new software is now being built for cloud.

This is driving IBM's second strategic imperative: To remake enterprise IT infrastructure for the era of cloud.

As important as cloud is, its economic significance is often misunderstood. That lies less in the technology, which is relatively straightforward, than in the new business models cloud will enable for enterprises and institutions. This is creating a market that is expected to reach $250 billion by 2015.

IBM today is the leader in enterprise cloud, a position we have enhanced through investments of $7 billion on 15 acquisitions, most notably SoftLayer in 2013. We provide the full spectrum of cloud delivery models—infrastructure as a service, platform as a service, software as a service and business process as a service. IBM's cloud capabilities are built on 1,500 cloud patents and supported by thousands of cloud experts. Eighty percent of Fortune 500 companies use IBM's cloud capabilities.

Our cloud foundation at the infrastructure level is SoftLayer, the market's premier public and private cloud environment, with "bare metal" dedicated servers that provide unmatched compute power,

Virginia M. Rometty

Chairman, President and Chief Executive Officer

deployed in real time, with hundreds of configuration options. Our public cloud processes 5.5 million client transactions every day.

In terms of technology, security, flexibility and pricing, IBM surpasses all our major competitors. And our rapidly growing roster of 30,000 client engagements—including companies like Honda, Sun Life Stadium, US Open Tennis and hundreds of top online games with a user base exceeding 100 million—is a testament to that.

These companies and a growing number of others understand that their customer-facing applications—which they deploy on public clouds for reasons of cost, accessibility and speed—must be integrated with their core enterprise systems—such as finance, inventory, manufacturing and human resources. This is why one analyst predicts that by 2017, nearly 50 percent of large enterprises will use hybrid cloud environments that are part public, part private and integrated with back-end systems.

It is also why a new class of "cloud middleware services" is emerging to manage these complex environments. Last month we announced several capabilities that will connect enterprise data and applications to the cloud. IBM's entire enterprise software portfolio is becoming available to developers in an open, composable business environment to build applications with flexibility and scalability. A "cloud first" approach is being implemented in IBM software development labs globally.

For line-of-business users looking to drive innovation—including heads of finance, marketing, human resources, procurement and other functions—we offer an unmatched array of more than 100 software-as-a-service (SaaS) offerings. IBM's SaaS offerings today support 24 of the top 25 companies in the Fortune 500. Going forward, companies will continue to unlock the value of these business applications. For example, nearly 70 percent

of organizations are currently using or planning to use composable business services.

Finally, enterprises will want—and need—to manage their data in the cloud with the same rigor as if it were on-premises. Companies will do this in order to ensure auditability, visibility, change control, access control and data loss protection. Indeed, data management will arguably be the single most important design point for enterprise cloud environments, driven not only by security and cost, but also by regulation.

To meet growing demand for greater speed, and legal requirements for compliance and data residency, IBM is aggressively expanding its global cloud footprint. We currently have 25 data centers globally, and the new $1.2 billion investment announced in January will see the opening of 15 more, in the US, the UK, Australia, Brazil, Canada, China, France, Germany, India, Japan and Mexico.

The impact of our cloud investments shows up clearly in our results. IBM's cloud business grew 69 percent in 2013, delivering $4.4 billion of revenue. As we actively embrace cloud in order to deliver "IBM as a Service" to our clients, we expect to see significant benefits in client experience, revenue growth and enterprise productivity.

Engagement in a world of empowered individuals

The phenomena of data and cloud are changing the arena of global business and society. At the same time, proliferating mobile technology and the spread of social business are empowering people with knowledge, enriching them through networks and changing their expectations.

This leads to IBM's third strategic imperative: To enable "systems of engagement" for enterprises.

Complementing traditional back-office systems of record, enterprises are now taking a systematic approach to engagement with all of their constituencies—customers, employees, partners, investors and citizens. Indeed, 57 percent of companies now expect to devote more than a quarter of their IT spending to these new systems of engagement by 2016, nearly twice the level of 12 months ago.

They are doing so because the way their customers and their own workers expect to engage is undergoing profound change. Seventy percent of people who contact a company via social media today expect a response within five minutes. Nearly 80 percent of adult smartphone users keep their phones with them an average of 22 hours a day. This is why we launched IBM MobileFirst in 2013, and why we have made eight acquisitions to advance our mobile initiatives. We have 3,000 mobile experts, and have been awarded hundreds of patents in mobile and wireless technologies.

When these individuals use their mobile devices to engage with a company, they expect personalized service. Indeed, 80 percent of people are willing to trade their information for a customized offering.

The good news is that this is increasingly possible, thanks to social business and data analytics. But it's not that simple. One only needs to follow the news to see rapidly rising concerns— legitimate concerns—about data security and institutional trust. Two-thirds of US adults say they would not return to a business that lost their confidential information. And the economic stakes are enormous. One analyst estimates that by 2016, there could be an additional $1 trillion of growth in global online retail—if the industry can enhance trust.

We have strengthened our already clear leadership in enterprise-class social business and in security. Our acquisitions in social include Kenexa, which helps companies use behavioral science not just to connect with people, but to understand and build lasting engagement with them. And we have made a dozen acquisitions in security, building a capability of more than 6,000 security experts, 3,000 patents and 25 labs worldwide.

Finally, IBM is leading by example in building modern enterprise systems of engagement and learning. Our social platform, Connections, has 300,000 IBM users and 200,000 communities. There are more than 30,000 IBMers active on Client Collaboration Hubs for our top 300 accounts. Last year, hundreds of thousands of IBMers worldwide shaped the practices that define how we work. And they are enhancing their skills daily through a massive open online learning system called THINK Academy.

In 2013, we achieved year-over-year growth of 69 percent in mobile, 19 percent in security and 45 percent in social business.

Our performance in 2013
You can learn more about the IBM Strategy on pp. 10–23. This is the context in terms of which to understand our performance in 2013.

By many measures, it was a successful year for IBM. Our diluted operating earnings per share in 2013 were $16.28, a new record. This marked 11 straight years of operating EPS growth. We grew operating net income by 2 percent, to $18 billion.

In 2013 we invested $3.1 billion for 10 acquisitions. We invested $3.8 billion in net capital expenditures. We invested $6.2 billion in R&D, while earning the most US patents for the 21st straight year.

Generating Higher Value at IBM

A long-term perspective ensures IBM is well-positioned to take advantage of major shifts occurring in technology, business and the global economy.

1. We continuously remix our business toward higher-value, more profitable markets and opportunities.

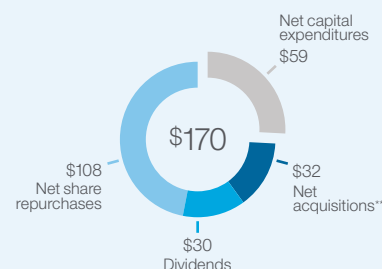**Segment Pre-tax Income Mix***
($ in billions)

— Operating Pre-tax Income Margin*
█ Hardware/Financing
█ Services
█ Software

10%   21%

2000   2013
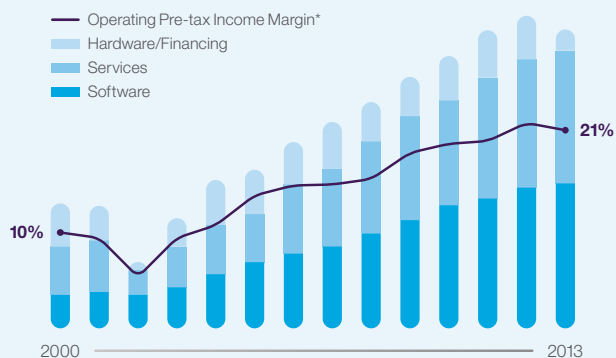
2. This generates significant profit and cash, which allows us to invest in future sources of growth and provide strong returns to shareholders.

Free Cash Flow
($ in billions)

$165

2000   2013
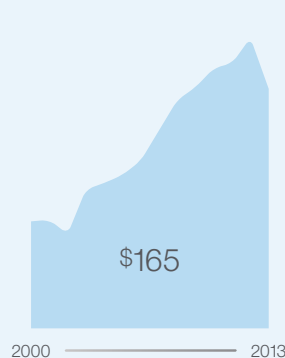
Primary Uses of Cash Since 2000
($ in billions)

Net capital expenditures $59

$170

$108 Net share repurchases

$32 Net acquisitions**

$30 Dividends

3. We deliver long-term value and performance while achieving our 2015 operating EPS target along the way.

Key drivers:

Revenue Growth
A combination of base revenue growth, a shift to faster-growing businesses and strategic acquisitions.
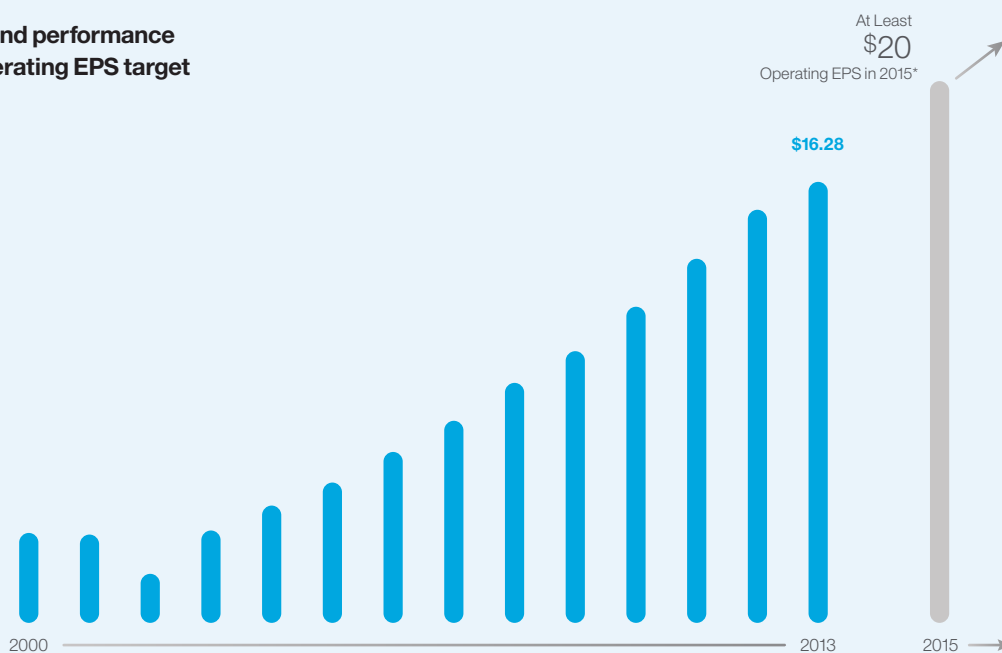
Operating Leverage
A shift to higher-margin businesses and enterprise productivity derived from global integration and process efficiencies.

Share Repurchase
Leveraging our strong cash generation to return value to shareholders by reducing shares outstanding.

█ Operating Earnings Per Share*

At Least
$20
Operating EPS in 2015*

$16.28

2000   2013   2015

* Excludes acquisition-related and nonoperating retirement-related charges.
** Net acquisitions include cash used in acquisitions and from divestitures.

"Every generation of IBMers has the opportunity—and, I believe, the responsibility—to invent a new IBM. This is our time."

While making all these investments in IBM's future capabilities, we were able to return $17.9 billion to you in 2013—approximately $13.9 billion through gross share repurchases and $4.1 billion through dividends. Last year's dividend increase was 12 percent, marking the 18th year in a row in which we have raised our dividend, and the 98th consecutive year in which we have paid one.

However, we must acknowledge that while 2013 was an important year of transformation, our performance did not meet our expectations. Our operating pre-tax income was down 8 percent. Our revenue in 2013, at $99.8 billion, was down 5 percent as reported and 2 percent at constant currency.

So, while we continue to remix to higher value, we must also address those parts of our business that are holding us back. We have two specific challenges, and we are taking steps to address both.

The first involves shifting the IBM hardware business for new realities and opportunities. We are accelerating the move of our Systems product portfolio—in particular, Power and storage—to growth opportunities and to Linux, following the lead of our successful mainframe business. The modern demands of Big Data, cloud and mobile require enterprise-strength computing, and no other company can match IBM's ongoing capabilities and commitment to developing those essential technologies.

We also announced, in January, an agreement to sell much of our Intel-based x86 server business to Lenovo. This divestiture is consistent with our continuing strategy of exiting lower-margin businesses, such as PCs, hard-disk drives and retail store solutions. But let me be clear—we are not exiting hardware.

IBM will remain a leader in high-performance and high-end systems, storage and cognitive computing, and we will continue to invest in R&D for advanced semiconductor technology.

The second challenge involves the world's growth markets. While IBM's growth in Latin America and Middle East and Africa was strong, enterprise spending slowed in other key growth markets. We are intensifying focus on new growth opportunities. Overall, the opportunity in the world's growth markets remains attractive.

On being essential
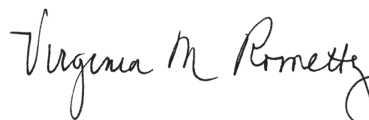
As we have learned throughout our history, the key to success is getting the big things right, innovating and investing accordingly, and challenging our organization, operations and especially our culture to adapt.

When you do all those things, you do more than stay abreast of change. You lead it. You invent entirely new capabilities — such as cognitive computing and Watson. You translate these innovations into sustainable economic value — such as building cloud infrastructure that is enterprise-class and societally robust. And you make yourself a laboratory for the future — of work, of engagement, of the modern enterprise.

The progress we are making on these strategic imperatives is highly encouraging. No company in our industry is positioned as strongly as 103-year-old IBM for the world now taking shape. We are confident in our vision, our strategy and our prospects.

Every generation of IBMers has the opportunity — and, I believe, the responsibility — to invent a new IBM. This is our time. We are working to make this not just a successful business, but an essential institution for our clients and the world in a new era.

I am deeply proud of the global IBM team for bringing us here, and I am grateful to you, our shareholders, for your unwavering support. I hope you share our excitement about your company's path and the shared opportunity we have, together, to build a brighter future on a smarter planet.

Virginia M. Rometty

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Chairman, President and Chief Executive Officer