THE WORLD'S MOST ADMIRED COMPANIES

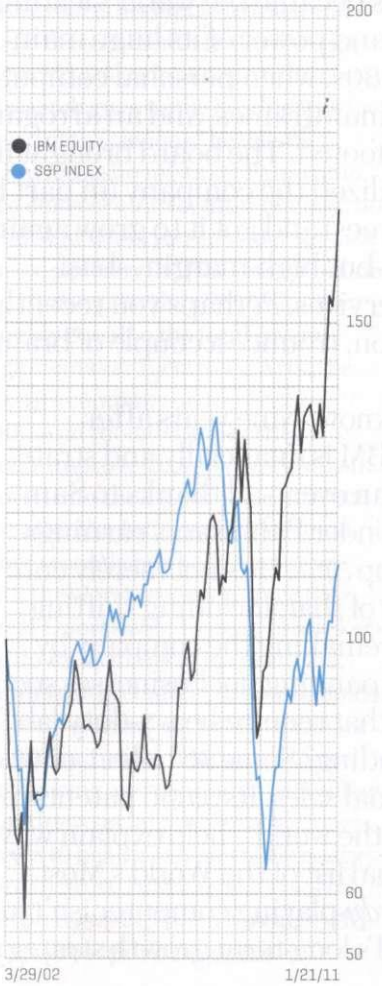
IBM's Super Second Act

BY JESSI HEMPEL

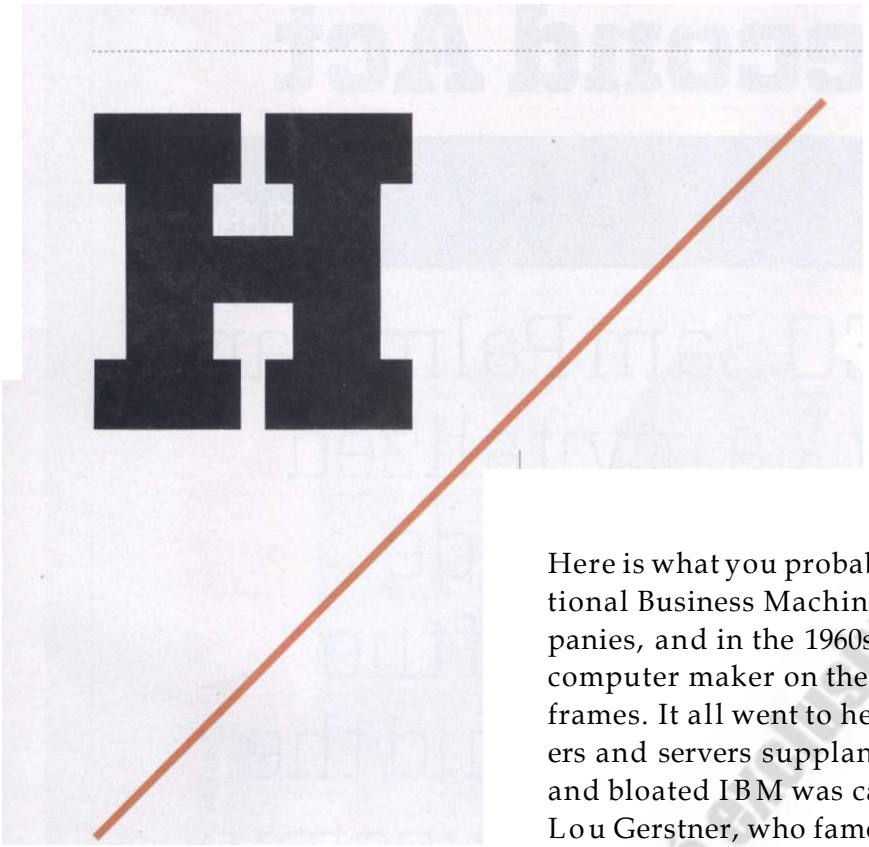
CEO Sam Palmisano took a revitalized IBM and made it the envy of the tech world and the darling of investors. His secret? He's restored Big Blue's focus on innovation and set it up for an even brighter future. (Move over, Lou Gerstner.)

Since he became CEO in 2002, Palmisano has steered IBM stock skillfully through two market crashes.

IBM STOCK PERFORMANCE



Photographs by GREG MILLER



Here is what you probably know about IBM. You know International Business Machines was one of Americas first tech companies, and in the 1960s and 1970s became the world's leading computer maker on the strength and power of its huge mainframes. It all went to hell in the 1980s, when personal computers and servers supplanted those mainframes, and an arrogant and bloated IBM was caught flat-footed. The board brought in Lou Gerstner, who famously stabilized the company (in part by firing tens of thousands of employees) and got it to grow again by steering IBM into the unsexy—but high-margin—business of systems integration and services. Perhaps you recently watched an IBM computer, Watson, trounce a couple of brainiacs on the game show *Jeopardy*.

Now, here's what you might not know: Nine years after Gerstner stepped down as CEO, IBM is financially and strategically stronger and, yes, sexier than ever—all thanks to Sam Palmisano, Gerstner's successor. Under Palmisano, earnings have quadrupled and the stock is up 57%. He's not merely cutting costs (though he's done plenty of that, including shifting work from the U.S. to India). He's remaking the company by pushing into new countries and expanding hot businesses such as supercomputing and analytics that require heavy-duty lab innovations. Last year's R&D spending? Some $6 billion, or 6% of IBM's nearly $100 billion in annual sales. Its 5,896 patents in 2010 more than any company in the world—help explain why it lands at No. 12 *on Fortune's* annual list of the World's Most Admired Companies. That *Jeopardy-playing* computer isn't just a gimmick; it is at the heart of IBM's long-term growth strategy.

IBM 2010
BY THE NUMBERS

EMPLOYEES
420,000

HEADQUARTERS
Armonk, N.Y.

REVENUE
$99.9 billion

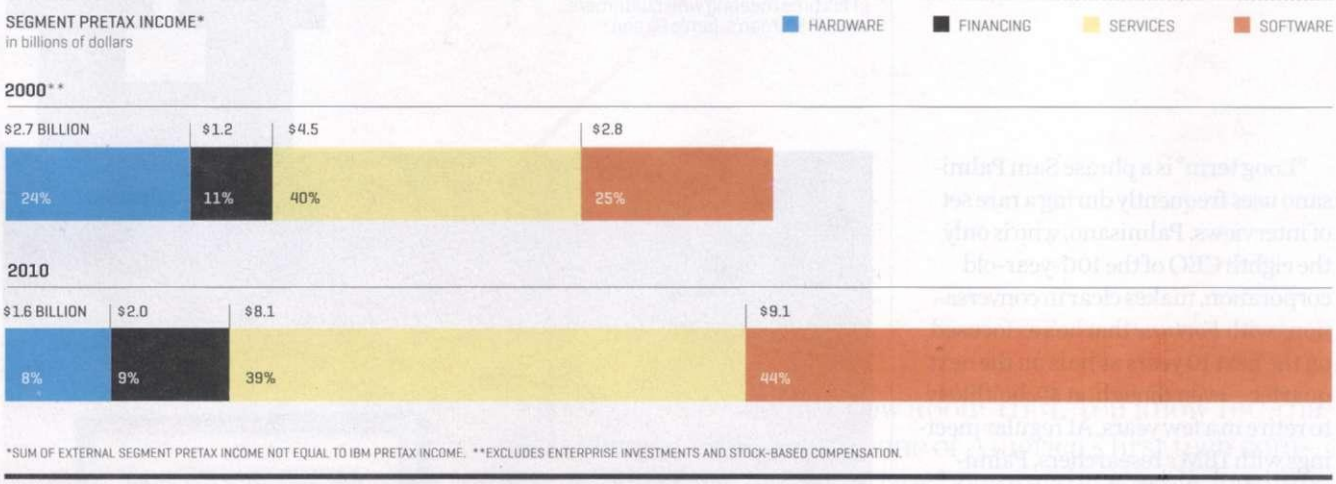
PROFITS
$14.8 billion

EARNINGS PER SHARE
$11.52

CEO
Sam Palmisano

BEYOND HARDWARE

Palmisano has remade IBM's profit mix, shifting income away from hardware (he sold the PC business in 2005) and toward high-end software.



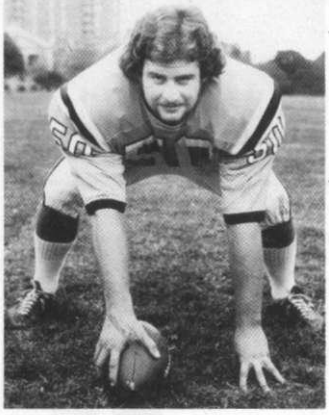
*SUM OF EXTERNAL SEGMENT PRETAX INCOME NOT EQUAL TO IBM PRETAX INCOME. **EXCLUDES ENTERPRISE INVESTMENTS AND STOCK-BASED COMPENSATION.

Palmisano, a Baltimore native, got his start in sales (he joined IBM fresh out of Johns Hopkins in 1973), and he conducts business with a pitchman's zeal. At 6-foot-2, his broad shoulders angle forward slightly as if he's always leaning in to tell you something. When he became head of global services back in the '90s, he blocked off 70% of his calendar for customer meetings, and he still speaks to at least one customer every single day. He remembers that Macy's CEO Terry Lundgren has planned a trip to China and calls to offer up some introductions. He golfs with New York City Mayor Michael Bloomberg. (Says the mayor: "He should keep his day job.") But he also lingers after a speech to exchange business cards with the mayor of a tiny Chilean neighborhood. And when he travels, he often leaves time for a solo walk around town to see what people are buying. "You can read all the economic data, but you're not going to get a sense" of your customers, he says, explaining, "If I'm not with somebody, I'm on the phone with somebody."

THE TINY CHILEAN DISTRICT of Peñalolén is home to some of Santiago's richest—and poorest—residents. From the plate-glass windows of modern million-dollar homes nestled into the Andes foothills, you have a sweeping view of the largest of Santiago's sprawling squatter villages. Residents have strung wires across rooftops to pirate electricity and thrown cardboard over the sewage channels they've dug. This is the front line for Palmisano's quest to make the planet smarter—and increase its customer base.

Peñalolén Mayor Claudio Orrego, 44, doesn't need to be persuaded that technology can improve living conditions in his neighborhood. A Harvard-trained former tech exec, he's an energetic idealist with a trimmed brown beard and his own Twitter account. When touring his neighborhood last fall, I visited a clinic where he had partnered with Cisco to digitize medical records. I drove by Internet kiosks he built with help from Intel. But until last year he had never worked with IBM. Orrego initially met Palmisano in fall 2009 when he flew to New York for IBM's first Smarter Cities forum (part of the Smarter Planet campaign), which he'd heard about at another conference. "It was sponsored and organized by a tech company, but it wasn't really about technology," he says. Of course technology played a part: With Smarter Planet, IBM is selling an idea that many of the systems that power our cities—electrical grids, transportation, buildings, factories—can be made to run more efficiently if you can better monitor them, analyze the information you collect, and use it to tinker. But as much as anything else, Palmisano is selling hope. His customers are government officials under pressure to make complicated and antiquated systems work better for less money, and Palmisano promises if they inject a little techie efficiency, things will be better.

Still, a Chilean neighborhood may seem an improbable place for IBM to devote resources when market opportunities the size of China and Brazil are looming, but it is part of



Palmisano, in a 1972 photo, played football at Johns Hopkins. He turned down a tryout with the Oakland Raiders to work for IBM.

Palmisano's ambitious plan to capitalize on every last corner of the emerging world. It's all in the numbers. He knows that while First World countries spend roughly 3% to 4% of their gross domestic product on infotech, emerging markets spend just 1% to 2%. As these countries attempt to propel themselves into the First World, Palmisano expects those percentages will double over the next five years. With a stable government and strong business ethics, Chile is one of 20 emerging countries IBM has identified as holding the most immediate promise. That's why Palmisano chose to hold and attend a Smarter Cities forum—one of 200 similar events the company has held to date—there last fall.

Palmisano arrived at the Santiago Sheraton early, took a seat in the front row, and sat through more than an hour of speeches without so much as checking his BlackBerry before his turn came at the podium. After Palmisano spoke, Orrego, by now an IBM customer (IBM's assessment was done on spec), and the Santiago governor joined Palmisano onstage for a discussion about tech strategies, like how technology could bring down costs for things like trash collection. When the moderator, a local news anchor, completed the interview, he turned to the audience and said, "Well, we got through the entire hour without talking about servers and switches."

The real purpose of IBM's forum was to close sales, of course, and Palmisano did his part. He left the event at lunchtime to make a sales call on Chilean President Sebastián Piñera. Palmisano doesn't like to ambush people, so he brought along only one colleague. Piñera's chief of staff, an energetic 27-year-old, showed them in to the President's office, which was adorned with a framed photo of the recently rescued miners. The group discussed having IBM hire a team of software experts, increasing its Chilean workforce. They also agreed to create a list of projects on which to work by the end of the first quarter.

Back in New York, I asked Palmisano what he thought of Chile. "In all these places there's an inherent optimism," he said. "There's a sense problems can be solved. There's really nothing in our way but ourselves. So let's just get to work."

SAM PALMISANO GREW UP in a large Italian family in 1950s Baltimore. There were two Palmisano families in town at the time. His dad was the auto mechanic, not to be confused with the delicatessen owner. Both families packed their kids off to Calvert Hall, the Catholic boys school where Sam's 10th-grade football coach, Augie Miceli, remembered him as a popular guy who never missed practice. "As an offensive center, he snapped the ball to the quarterback, so he had to make first line calls," says Miceli.

Palmisano also played sax in a band. The drummer's mother was the band's agent, and she once scored them a weeklong gig both opening and playing backup for the Temptations. He used his earnings—$1,000—to buy a station wagon so he could haul around his equipment.

At Johns Hopkins, Palmisano was a history major whose Beta Theta Pi fraternity brothers called him Baloo after the bear from *The Jungle Book*. He co-captained the football team but turned down an invitation to try out for the Oakland Raiders. In 1973, the year he graduated, the U.S. was at war with Vietnam, and many evenings he'd crowd around the 11 p.m. news along with his fraternity brothers for updates on the draft. The number he'd received his junior year was four, low enough that his chances of recruitment were high. "So I said, 'I've got to get a job,'" he remembers. A friend mentioned that IBM's recruiter had come to campus to look for women with backgrounds in math and science. Though he fit neither category, the next day Palmisano took and passed IBM's entrance exam, a staple for all new entrants at the time.

Palmisano joined IBM at the height of its glory, when the iconic figure of the IBM salesman symbolized a guaranteed ascendance to the upper middle class. The dress code was strictly observed: dark suits, white shirts, military striped ties, wingtip shoes. Liquor was off-limits. "If you had a customer luncheon and you had a drink with the customer, you were expected to go home," says Palmisano. Before he ever made a sales call, he went to Washington, D.C., to attend the requisite 15 months of classes on network design and accounting and sales presentations. (While in D.C. he met his future wife, Gaier Notman, known as Missy, who was the daughter of a prominent Maryland banker.) Then he went to work in the data products unit in Baltimore, hawking mainframes to local governments.

In 1989, Palmisano was chosen for a one-year term as executive assistant to CEO John Akers. It was the first sign

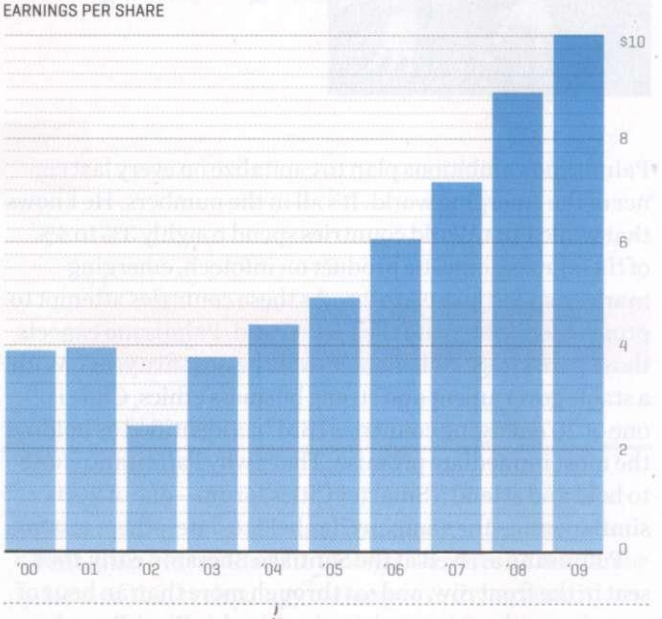
that his star was rising at the company, and he jumped from there to a two-year stint running IBM Japan. While Palmisano was learning to manage a workforce that didn't speak his language, the corporation struggled to find its place in a tech industry that had lost patience with IBM's monolithic approach to selling components like semiconductors, hardware, and software. By the time Gerstner parachuted in to turn things around in 1993, IBM had posted an $8.1 billion loss, its third straight year of losses. As the caustic chieftain raced to pull the company out of its near-death spiral by doubling down on the services business, embracing the Internet, and shaking up the culture, Palmisano returned and took a turn at running nearly every one of IBM's larger units, including the personal computers division, the server business, and global services. At Gerstner's retirement in 2002, IBM's stock price had risen to $90 from $11.

While Gerstner, who declined to comment for this article, gained a reputation for his quick temper, Palmisano honed a measured but uncompromising leadership style. Chief financial officer Mark Loughridge, who reported to Palmisano back when he took over the global services division, recalls an infamous phone call. "We were losing money every quarter. Sam got on the phone and said, 'I just want everybody to know we are never losing money in this business ever again,'" says Loughridge. Given the general condition of the business, it seemed like a ludicrous request, but Palmisano wasn't asking. He was demanding. "The executive team was like, 'Man, what's this guy talking about?' But we never lost money again."

Palmisano has long been well-connected politically. He has vacationed with members of the Bush clan, with whom he grew acquainted through his wife's family, since before George Bush Sr. was elected President, and he bought a Kennebunkport summer house from the Bushes in 1996. But, for a multimillionaire, he has kept his family life modest. For nearly two decades he has lived in the same century-old house in Southport, Conn. Until he was appointed IBM's CEO, he drove himself to work each day.

SHAREHOLDERS' GAINS

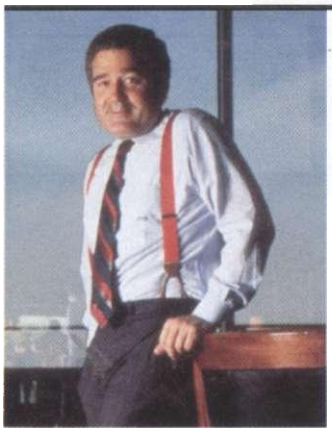
Annual earnings per share have quadrupled since 2002. Major stock buybacks—IBM okayed some $18 billion in repurchases in 2010—help raise EPS.



WATCHINGWATSON (named for founding CEO Thomas Watson Sr.) cream *Jeopardy* champs Ken Jennings and Brian Rutter was gripping television. (Winning answer: "Who is Bram Stoker?") But Watson's intelligence is more than trivial. Palmisano expects to see it make its way into hospitals, for example, where it could diagnose patients and recommend treatments more quickly and accurately than doctors.

Research is at the core of the way Palmisano sets strategy. The company maintains nine research labs around the world and seven "collaboratories" it has built with customers like a Beijing center to develop high-tech railroads. In addition to business-related projects like developing new services for Indian mobile-phone operators, IBM funds experiments such as materials research that may develop into new products. But Palmisano sees even those supertechnical "blue-sky" projects as critical to understanding where he needs to take IBM, and how he should organize its assets and businesses.

Once a year, in a knock-down, drag-out marathon of a discussion, he spends a day with lab directors predicting the future and adjusting corporate strategy to address it. You don't dare show up unprepared, lab directors say, because he understands your work and he has his own position on its value. This session is where he can observe chip improvements that will change the way IBM markets and sells servers, for example. It also is where he saw the cornerstones for Smarter Planet way back in 2002. "It was no longer going to be a PC era. It was going to be sensors and smartphones," he says. That seems obvious now, but lest one forget, the iPhone wasn't even invented until five



Lou Gerstner, Big Blue's CEO from 1993 to 2002, gets credit for stabilizing the tech giant.

years later. In 2005, Palmisano surprised the tech world when he sold IBM's profitable PC business to China's Lenovo. He continued to sell off hardware, and he stepped up acquisitions, picking up software and analytics companies by the dozens.

Shareholders were confused. Palmisano countered by wooing Wall Street. "If you're going to sell off all that revenue and go invest in more profitable things where you can innovate, there's going to be a period of time where you're not going to get a lot of top-line growth," he explains. "There's a lot of personal pressure on the leadership of the company to respond." He announced a five-year road map and held six-hour sessions with investors to answer questions about his strategy. He pledged to keep increasing profits and investor returns even as he changed the company's makeup. He replaced expensive workers in North America with low-cost laborers abroad, which has helped keep margins and profits growing. He and his board also authorized massive share buybacks every year, another tactic for increasing earnings per share.

The upshot: IBM today is a company that still gets most of its revenue from services and consulting—the business that Gerstner astutely pushed IBM into in the 1990s. But software now contributes more to pretax earnings than consulting, and analytics, the kind of sophisticated data-crunching and decision-making that Watson does, grew 19% last quarter, faster than any other line of business. Harvard Business School professor Rosabeth Moss Kanter calls this a "boldness of imagination," saying, "Sam accelerated what Lou Gerstner set in motion."

That boldness has helped IBM become once again the company that sets the agenda for enterprise technology. Companies from HP and Dell to Oracle have assembled consulting businesses to solve problems for customers rather than sell them servers and switches. And HP's Cense Network aims to pepper the world with sensors just as IBM plans to do with the Smarter Planet initiative. IBM has single-handedly helped raise the valuations of analytics companies. Somewhere the ghost of Tom Watson Sr. is smiling.

IBM WILL TURN 100 THIS YEAR, and Palmisano will turn 60. That age has long been the expiration date for an IBM CEO, and while he won't confirm it, people close to him think he'll step down just after the centennial. This past summer he reorganized the executive ranks in a move that suggests he has chosen a couple of contenders for his replacement. Both Virginia Rometty, who added marketing and strategy to her sales and distributions responsibilities, and Michael Daniels, who now oversees all of global services, are said to be in the running. So is Rod Adkins, who oversees the systems and technology group.

Can things possibly work as well at IBM when Palmisano leaves? Sales is about relationships, and at the highest level, he is their safekeeper. Consider Sunil Mittal, the rags-to-riches founder of India telecom giant Bharti Airtel. Last fall IBM was in the final stages of negotiating a 10-year contract to set up and manage the information technology supporting Bharti's move into 16 African countries when the contract nearly fell apart. "IBM is a huge machine, and sometimes it gets frustrating," says Mittal. "There were layers of lawyers and approval processes." Mittal was ready to walk, and then Palmisano popped up on Skype. Palmisano assured Mittal that IBM's work could be done quickly and efficiently. Six weeks later both men met in Nairobi to announce the landmark deal that would plant the Indian telecom giant in Africa.

Mittal trusts Palmisano. He has invited the man to dinner in his Delhi home, and hung out with the Palmisanos and three of their kids at the Beijing Olympics. "My personal connection with him is very strong. As for who will succeed him, and will I have the same chemistry?" says Mittal. "I don't know."

I ask Palmisano about it the final time we meet. We are seated in the perfectly preserved 1937 library of the senior Watson himself, every last mahogany panel of which has been lifted from his original office into the executive suite of a Midtown Manhattan skyscraper. Palmisano suggests Mittal's posturing is a bit of theatrics. Relationships are built because people act consistently over long periods of time, he tells me. "I'll do my term. Maybe it's 10 years. Think of it as 10% of 100 years. And then somebody else has got to keep it going," he says.

With that, he reaches for his coat. "I've got to go sing for my supper, young lady," he says. Traffic is bad in Midtown, and he needs to be on time for the sales call he's about to make on J.P. Morgan CEO Jamie Dimon. Forget the idling sedan. He takes off walking at a fast clip, a sales rep nearly sprinting to catch up.

GEORGE LANGE

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Fonte: Fortune, Amsterdan, v. 163, n. 4, p. 54-61, 21 March 2011.