Speaker 1
Start

Welcome and thank you for standing by. At this time, all participants are in a listen only mode. Today's conference is being recorded. If you have any objections, you may disconnect at this time. Now I will turn the meeting over to Olympia McNurney, IBM's Global Head of Investor Relations. Olympia, you may begin.

Speaker 2
25s

Thank you. I'd like to welcome you to IBM's third quarter twenty twenty five earnings presentation. I'm Olympia McNerney, and I'm here today with Arvind Krishna, IBM's Chairman, President and Chief Executive Officer and Jim Cavanaugh, IBM's Senior Vice President and Chief Financial Officer. We'll post today's prepared remarks on the IBM investor website within a couple of hours, and a replay will be available by this time tomorrow. To provide additional information to our investors, our presentation includes certain non GAAP measures. For example, all of our references to revenue and signings growth are at constant currency. We provided reconciliation charts for these and other non GAAP financial measures at the end of the presentation, which is posted to our investor website. Finally, some comments made in this presentation may be considered forward looking under the Private Securities Litigation Reform Act of 1995. These statements involve factors that could cause our actual results to differ materially. Additional information about these factors is included in the company's SEC filings. So with that, I'll turn the call over to Arvind.

Speaker 3
1m 27s

Thank you for joining us today. In the third quarter, IBM delivered strong results across revenue, profit and free cash flow exceeding our expectations. Revenue growth accelerated to 7%, our highest growth in several years with all our segments accelerating sequentially. These results underscore the strength of our business model and portfolio and the innovation we are delivering to clients. Clients continue to turn to IBM as a trusted partner to help them modernize, embed AI and build resilient infrastructure. Let me touch on the economy before I turn to our execution. Last quarter, I said we had moved from being cautiously optimistic to optimistic. Technology remains a key driver of growth and competitive advantage. AI adoption is accelerating and hybrid cloud remains the foundation of enterprise IT. Clients are leaning on enterprise technologies to scale, innovate and drive productivity. There are always macro uncertainties, but overall, we continue to see broad based demand from clients and remain optimistic. Now turning to our execution this quarter. Our strategy remains focused, hybrid cloud and artificial intelligence. Our products and services fuel growth and productivity for our clients. You can see this in our results for the quarter. Software growth accelerated to 9%, led by strength in automation.

Speaker 3
3m 2s

Automation was up 22%, highlighting our end to end portfolio of leading solutions that optimize operations, automate infrastructure and workflows, build resiliency and drive cost efficiency for clients. Many of our automation products are infused with AI enhancing their capabilities. HashiCorp also continues to accelerate within IBM, benefiting from our go to market distribution and joint product innovation, highlighting our synergy potential. Consulting accelerated, reflecting growing demand for AI services as clients need help designing, deploying and governing AI at scale. And Infrastructure delivered robust performance, growing 15%, driven by continued strength in z17, our strongest February launch in history. The Spire Accelerator, which will be available in Q4, will bring advanced generative AI and real time inferencing capabilities inside IBM Z, redefining how enterprises capture AI value within their most mission critical environments. In addition to being a demand driver, AI is also a powerful productivity driver for IBM, contributing to our strong financial performance. In 2023, we set out on a goal to achieve $2,000,000,000 of productivity savings and today we are well ahead of that with an expectation of $4,500,000,000 of annual run rate savings exiting this year. I believe we have significant opportunity ahead of us to continue to become even leaner and more nimble.

Speaker 3
4m 48s

Our client zero approach sets us apart as we have internally identified and addressed pain points on data readiness, siloed and vertical workflows, application and IT sprawl, using our own technology and domain expertise. Clients see these results and look to us to help them on their own transformations, driving over 1,000 client zero engagements this year. The breadth of our AI offerings is a key differentiator, combining an innovative technology stack with consulting at scale and our client zero journey. Our Gen AI book of business continues to show momentum at over $9,500,000,000 inception to date. In consulting, we are embracing disruption and leading the way with our digital asset and services as software strategy. While we are early in this journey, we have over 200 consulting projects using digital workers at scale. In software, demand for Watson X and Red Hat AI remains strong with early momentum in our agentic platform Watson X Orchestrate. Watson X Orchestrate helps enterprises deploy AI by connecting agents, models and workflows with governance and security. Orchestration will be critical as enterprises run a variety of models to optimize cost and performance. Our hybrid approach to models enables clients to use the best option for each use case, IBM's Granite models, third party models or open models from Hugging Face, Meta and Mistral.

Speaker 3
6m 29s

We recently launched Granite four point zero, our next generation family of open small language models. Granite four point zero delivers high performance and cost efficiency using 70% less memory and offering twice the inferencing speed of conventional models. We also partnered with Anthropic to infuse Claude into IBM products to unlock new Gen AI features and capabilities. This week, we announced a partnership to run Watson X on Grok, giving clients access to their inferencing technology, which provides ultra high speed, low latency AI capabilities at lower costs. All this leads to real tangible value for clients. Companies like Deutsche Telekom and S and P Global are embedding Watson X into core workflows. In infrastructure, clients such as Nationwide, State Street and Credit Agricole are turning to AI to manage increased workloads and use z17 for its advanced AI inferencing capabilities and enhanced resiliency. Accelerating innovation remains a core focus for IBM. At our recent IBM Tech Exchange Developer and Builder Conference, we showcased how we are helping clients and partners with innovation that blends enterprise strength and AI speed. We had almost twice the number of participants as last year with speakers including United Airlines, T Mobile, Prudential, UPS, Morgan Stanley, Verizon and Cigna.

Speaker 3
8m 5s

We announced Project Bob, facilitating AI powered software development, helping teams ship higher quality code faster. We have more than 8,000 developers within IBM that are using Project Bob, reporting productivity gains averaging 45%, another powerful client zero use case. We also announced new automation capabilities, including a real time infrastructure graph connecting applications, services and ownership through HashiCorp Terraform. As outlined at our Investor Day, we are on a path to demonstrate the first error corrected quantum computer by 2028 and continue to deliver key milestones in our quantum roadmap. As we collaborate with our ecosystem of over two eighty partners, we are making tangible progress on near term use cases. For example, HSBC achieved a notable improvement in bond trading predictions using IBM's Heron quantum processor. Vanguard announced a breakthrough in optimizing portfolio construction using IBM's Quantum Computing as a Service. We recently announced a partnership with AMD to build quantum centric supercomputing architectures leveraging IBM's quantum expertise and AMD CPUs, GPUs and other accelerator technologies. Just last week, IBM and the BaaS government unveiled Europe's first IBM Quantum System two. This marks the second installation outside The United States and underscores our commitment to global leadership in quantum computing.

Speaker 3
9m 48s

In closing, we are executing on our strategy of accelerating revenue growth and delivering higher profitability. Given these results and the momentum in our portfolio, we are raising expectations for revenue growth to more than 5% and free cash flow to about $14,000,000,000 for the year. With that, let me hand it over to Jim to go through the financials.

Speaker 4
10m 14s

Thanks, Arvind. In the third quarter, our revenue growth accelerated to 7%, our highest growth in several years, with all of our segments accelerating sequentially. Revenue scale, mix and productivity drove two ninety basis points of adjusted EBITDA margin expansion, 22% adjusted EBITDA growth and 15% operating earnings per share growth, highlighting the significant operating leverage in our business model. And through the first nine months, we generated $7,200,000,000 of free cash flow, our highest nine month free cash flow margin in reported history. We exceeded our expectations on revenue, profitability, adjusted EBITDA, earnings per share and free cash flow, reflecting the strength of our portfolio and the disciplined execution across our business. Software revenue grew 9%, fueled by accelerating organic growth, up a few points since last quarter and continued contribution from our high value annual recurring revenue base, which grew to $23,200,000,000 up 9% since last year. Growth in automation accelerated to 22%, driven by strength in the organic portfolio and early synergies with HashiCorp, which maintained momentum and delivered its highest bookings quarter in history. Red Hat bookings growth accelerated to about 20% and revenue grew 12%. This performance was driven by a softening in consumption based services and RHEL trending back towards single digit growth as we wrap on last year's exceptional double digit performance.

Speaker 4
12m 9s

Demand for our hybrid cloud products remained strong, and all three of our major subscription offerings gained market share again this quarter, with growth accelerating for both OpenShift and Ansible. OpenShift ARR is now $1,800,000,000 growing over 30%. Data was up 7% driven by continued strength in our AI portfolio and transaction processing revenue declined by 3%, reflecting another quarter of z17 outperformance as clients continue to prioritize hardware spend on our latest IBM z system. While this dynamic impacts near term revenue, we're encouraged by a healthy pipeline that positions us well for future demand. Infrastructure delivered another strong quarter, growing 15%. Hybrid infrastructure grew 26%, and infrastructure support was flat. Within hybrid infrastructure, IBM z delivered its highest third quarter revenue in nearly two decades, up 59% year to year fueled by the early success of our z 17 platform, purpose built for AI and hybrid cloud with breakthrough capabilities in real time inferencing, quantum safe security, and AI driven operational efficiency. Clients are investing in z 17 not only for its reliability and scalability, but because it enables secure high performance computing at the core of their digital transformation strategies. Distributed infrastructure, up 8%, reflects broad based growth across our storage portfolio as clients scale capacity to meet rising data and AI demands.

Speaker 4
14m 13s

Consulting returned to growth in the third quarter with revenue up 2%, improving sequentially and marking a positive inflection point in performance. Intelligent operations was up 4%, while strategy and technology revenue stabilized with both lines of business showing quarter over quarter momentum. This growth reflects solid demand for our strategic offerings, business application transformation, application modernization and migration, and application operations as clients focus investments on solutions that accelerate AI transformation and maximize return. As Arvind mentioned, we are embracing AI disruption and leading with the software driven services delivery model. We are transforming into a hybrid model of people plus software that delivers efficiency and scale. This approach is already driving internal productivity, reflected in the two twenty basis points of segment profit margin expansion year to date and resonating with clients seeking to operationalize AI strategies. By combining domain expertise with scalable technology platforms, we reinforce our role as a strategic provider of choice in this evolving landscape. Our consulting generative AI book of business accelerated to over $1,500,000,000 in the quarter with the number of projects more than doubling year to year, underscoring our momentum. While total signings declined this quarter, the quality of signings continued to strengthen with more strategic wins from new clients and expanded engagements within existing ones.

Speaker 4
16m 10s

Turning to profitability, we have delivered nine consecutive quarters of operating pretax margin expansion, highlighting the evolution of our portfolio mix and our laser focus on productivity, which again played out this quarter. Revenue scale, mix and productivity drove expansion of operating gross profit margin by 120 basis points, adjusted EBITDA margin by two ninety basis points and operating pretax margin by 200 basis points, ahead of our expectations and well above our model. Segment profit margins expanded by four twenty basis points in infrastructure, two seventy basis points in software and 200 basis points in consulting, with consulting margins at the highest level in three years. Revenue scale and mix contribution from IBM z is a significant source of profitability and free cash flow. And combined with the three to four x stack multiplier helps fuel our investment in innovation and drive growth. Productivity is also a key driver of profit margin expansion as we deploy AI at scale across IBM in areas including finance, supply chain, sales, HR, service delivery, and customer support to improve efficiency and reduce costs. While we have made progress on this journey and expect $4,500,000,000 of run rate savings exiting this year, there is still significant opportunity ahead for us to drive even more efficiency and cost savings.

Speaker 4
18m 7s

Through the third quarter, we generated $7,200,000,000 of free cash flow, up about $600,000,000 year over year, resulting in our highest year to date free cash flow margin in reported history. The largest driver of this growth is adjusted EBITDA, up $1,800,000,000 year over year, partially offset by proceeds from the Palo Alto Q Radar transaction, which resulted in a reduction in CapEx in the third quarter of last year and working capital dynamics. Our strong liquidity position, solid investment grade balance sheet, and disciplined capital allocation policy remain a focus for us. We ended the quarter with cash of $14,900,000,000 Our debt balance ending the quarter was $63,100,000,000 including $11,300,000,000 of debt for our financing business with the receivables portfolio that is over 75% investment grade. In addition, year to date, we returned $4,700,000,000 to shareholders in the form of dividends. Now let me talk about what we see going forward. Through the first nine months of the year, we delivered 5% revenue growth, 17% adjusted EBITDA growth, 10% operating earnings per share growth, and 9% free cash flow growth. The strength and diversity of our portfolio, disciplined capital allocation and relentless focus on productivity continue to drive the durability of our revenue and free cash flow performance.

Speaker 4
20m 3s

Given the strength of this performance, we are raising our expectations for revenue, adjusted EBITDA and free cash flow. We now expect to deliver revenue growth of more than 5%, adjusted EBITDA growth of mid teens and free cash flow of about $14,000,000,000 for 2025. Let me focus on full year growth for the segments. We continue to expect software revenue growth of approaching double digits for the full year. Through the first nine months, we delivered growth above our model of 17% in automation and inline model growth of 7% in data, and these trends should continue. And we continue to expect mid teens growth for Red Hat, albeit at the low end. This is underpinned by strong bookings growth in the third quarter of about 20% and our revenue under contract, which is growing in the mid teens. As we wrap an elevated growth in consumption based services last year, we expect double digit revenue growth in the fourth quarter with an accelerated growth profile heading into 2026. While transaction processing was down 1% year to date as clients prioritize spend on our high value innovation Z17, the strength of the new cycle provides future monetization value across the ZStack.

Speaker 4
21m 41s

We are seeing this strength in our pipeline as we enter the fourth quarter, which we expect will return to growth. With continued strength in z17, we now expect infrastructure to contribute over 1.5 points to IBM's revenue growth this year. In consulting, we are encouraged by our return to growth this quarter and continued progress in our Gen AI book of business. And now we see an inflection in growth going forward with fourth quarter revenue performance similar to our third quarter growth. Now turning to profitability. We started this year expecting over 50 basis points of operating pretax margin expansion. And through the first nine months of this year, we delivered 130 basis points of expansion, well ahead of our expectations. This performance is driven by our revenue scale, portfolio mix and progress with productivity initiatives, enabling operating leverage while providing investment flexibility. We are raising IBM's full year operating pretax margin expansion to over a point, and our operating tax rate expectation for the year remains in the mid teens. For the fourth quarter, we are comfortable with consensus estimates for constant currency revenue growth and profitability. Let me conclude by saying we are pleased with our continued disciplined execution and look forward to capturing growth opportunities ahead of us.

Speaker 4
23m 27s

Arvind and I are now happy to take your questions. Olympia, let's get started.

Speaker 2
23m 34s

Thank you, Jim. Before we begin Q and A, I'd like to mention a couple of items. First, supplemental information is provided at the end of the presentation. And then second, as always, I'd ask you to refrain from multipart questions. Operator, let's please open it up for questions.

Speaker 1
23m 50s

Thank you. And at this time, we'll begin the question and answer session of the conference. You. And our first question comes from Amit Daryanani with Evercore ISI. Please state your question.

Speaker 5
24m 29s

Thanks a lot. Good afternoon, everyone. I guess maybe just I want to focus on free cash flow. So I really appreciate the quantification of free cash flow at $14,000,000 for the year. And if I get my math right, this sort of implies free cash flow is up double digits in 2025 and your conversion rates are on 125% give or take. Can you just touch on if there's any one off dynamics that we should be aware of that are helping in free cash flow in 2025? I'm really just trying to think that as we get into 2026 and if your growth is in line to your longer term model, is there anything that could preclude free cash flow growing a few points higher than sales growth sort of the way you folks have talked about it? I'd love to just kind of spend a little bit of time on free cash flow and if anything all does on the capital allocation as well. Thank you.

Speaker 4
25m 14s

Thanks, Simon. I appreciate the question. And it's right at the heart of how Arvind has repositioned this company around the two key measures. One, accelerating revenue growth and two is driving that free cash flow engine that's going to fuel the investments for us to continue to make to drive long term sustainable competitive advantage. But if you take a step back first, as we said in prepared remarks, we're very pleased with our free cash flow engine, starting out the next evolution of our journey coming off the midterm model. Year to date, $7,200,000,000, up $600,000,000 year over year, highest free cash flow margin reported history through three quarters for our company. And I'll just state that underneath it, we overcame in the third quarter a $500,000,000 headwind from last year as a result of the Palo Alto QRadar transaction that was recorded as a asset sale and reduction in CapEx. So we got through twenty twenty five's headwind around that. What's driving that free cash flow? Probably the most important thing is the underlying fundamentals of our business, an accelerating top line revenue growth profile and an operating leverage engine that is driving productivities like we haven't seen in a long period of time.

Speaker 4
26m 39s

I think we're nine quarters in a row of driving operating leverage and significant margin productivity. So I would tell you, high quality, high sustainable free cash flow. And that's what gave us the confidence for the second quarter in a row to take up our free cash flow estimate for the year. Now about $14,000,000,000. Why do we do that? We took up revenue. We took up operating margin. We took up adjusted EBITDA. We took up our profitability, and all that leads to free cash flow. When you take a look at what's driving that $14,000,000,000 2,500,000,000 give or take year to year growth in adjusted EBITDA, mid teens growth, well above our model. And underneath that, you take a look at some of the dynamics we've been talking about since back in January. Yes, higher profitable based engine will pay higher cash tax. Yes. We're investing long term for this business. We are gonna have higher CapEx outside of the QRadar transaction. And yes, we made a significant strategic acquisition. We've got acquisition related charges and foregone interest. All of that is embedded in twenty twenty five's guidance. Now you take a step back to the heart of your question at 2026. 2026, I would tell you, what is our free cash flow generation engine flywheel?

Speaker 4
28m 7s

It's accelerated revenue growth, the five plus percent in this company, it's driving operating leverage, and it's leveraging an efficient balance sheet. We see all that continuing to play out in 2026. And those underlying fundamentals, yeah, they deliver a sustainable realization number, by the way, in the mid to high one twenties, kinda to your question. By the way, we've been there for four years in a row already, so we can handle that. So you bring that all together, I think it talks to the statement and the confidence of our focused portfolio, our disciplined capital allocation, the diversity of our business model, and the relentless focus of us driving productivity and operating leverage that gives us the investment flexibility to continue driving long term sustainable competitive advantage. Thank you very much for the question.

Speaker 2
29m 3s

Great. Operator, let's take our next question.

Speaker 1
29m 6s

Thank you. And your next question comes from Wamsi Mohan with Bank of America. Please state your question.

Speaker 6
29m 13s

Yes. Thank you so much. Arvind, you said AI adoption is accelerating right at the top of the call. And I'm wondering if you can maybe help us think through the financial impact in maybe revenue terms for IBM, how we should think about the progression for that? Are we hitting some kind of inflection that we should see meaningful upside into 2026 on the AI front? And maybe quickly, your quick thoughts on maybe the impact of the federal government shutdown, if there's any materiality to that to IBM here in the fourth quarter? And if I could, Jim, if you could just clarify the organic growth in software in third quarter and expectations for transaction processing going into the end of the year? Thank you so much.

Speaker 3
30m 0s

Pamsi, thanks for those questions. Let me try and unpack it. Let me go with the easiest one first. The easiest one is on the current government shutdown. I would tell you that we see a de minimis impact to IBM. It's always hard to say zero because something could happen. We still got two months to go in the quarter. But so far, we have not seen any impact from the shutdown. And the reason for that is the makeup of our business. Our technology business is largely comprised of hardware as well as software, software mostly on a subscription basis. These are running critical systems, payments for social security, benefits for the VA. All of these are considered essential, so I don't really see that at risk. A little bit over half of the business is consulting projects, but the consulting we do is of a similar nature, ERP, benefits, helping people reduce paper, reduce errors, back to payments. These are all considered essential. And that is the reason that we may be in the minority of not seeing any direct impact so far. Now I just leave it at that because so far we have not. Nobody has come to us about any of these projects.

Speaker 3
31m 23s

And so that's the first question that is straightforward. Next, you asked about AI. Look, our book of business, we talked about it being over $9,500,000,000 adjusted consulting piece was 1,000,000,000 point dollars in the quarter itself. These are very real numbers. So as those consulting projects start to get executed and as that backlog builds up, certainly the contribution to consulting is going to be very real. We talked about another number to tie it there, which is not a different number, is the 200 projects in consulting, which are already using digital workers, which effectively are the AI agents that we have built that get deployed by our consultants on behalf of our clients. About not quite, but close to 20% of our overall book of business is technology and software. And there, that is mostly subscription revenue as well as products that people are purchasing from us. So those numbers certainly begin to add up. And I would tell you that a big fuel behind both our OpenShift growth as well as our automation growth is due to the AI capabilities that are infused inside those products. So if I sort of put the first two pieces together, de minimis on the government shutdown and definitely the AI piece is a strong contributor to the software growth.

Speaker 3
32m 57s

And I believe it's a big piece of why consulting is beginning to return to growth because we called the play to move towards AI almost two years ago. So as that book of business has built up, it is overcoming the headwinds from staff augmentation projects going away and people getting rid of discretionary spending and consulting. Jim, I'll let you take the third piece.

Speaker 4
33m 19s

Yes. Just to amplify the last piece and then I'll get into your question about software organic and TP. To Arvind's point, year to date from a software perspective, we're growing 8.5% overall, approaching 9% right now. About two points of that growth is coming out from our Gen AI book of business. So we're getting very good realization and penetration. To Arvind's point on consulting, north of a 7,500,000,000 book of business, I put that up against any consulting company right now. We called that play to Arvind's point a few years ago. We do think we have a differentiated competitive value proposition of a company with a integrated tech stack plus strategic partnership AI plus a consulting business at scale with an integral part of IBM Client Zero that drives distinctive, use cases and references. We've already had over a thousand client engagements year to date around GenAI from an enterprise software and consulting perspective overall. In consulting, it's already north of 22 of our $31,000,000,000 backlog. And in this quarter, we eclipsed double digit composition of our revenue, 12% of our revenue, growing very nicely at still a two to three point competitive advantage in terms of margin overall.

Speaker 4
34m 46s

And by the way, you see that play out in our consulting margins, you know, year to date up 220 basis points, the highest margins we've had in a long time. Now to your point about software. Software, you know, we're very pleased, growing 9% in the quarter. We accelerated about three three points organically quarter to quarter. This wasn't an inorganic contribution. In fact, our inorganic contribution came down as we wrapped on some of these. It's being driven by the strong contribution of our high value recurring revenue. Now a book of business, $23,000,000,000 up 9%. And when you look underneath it, you know, TP TP right now get just given the strength of the mainframe cycle driving cycle dynamics, we're very encouraged around the future monetization value opportunity. And as you heard in prepared remarks, we're calling a return to growth in TP in the fourth quarter with the strong pipeline we got. By the way, if you map it back to the z 16 cycle, what happened? In '22, our TP revenue was flat. In '23, we grew high single digit. In '24, we grew double digit. You look at '25 right now, we're calling back to growth probably a quarter early compared to a historical cycle.

Speaker 4
36m 7s

We feel very good about that growth profile. And given the strong z 17 where we've shipped over a 100% more MIPS than the P16 or the Z16 cycle, we're actually feeling pretty good about that valuation opportunity moving forward.

Speaker 2
36m 25s

Great. Operator, let's take our next question.

Speaker 1
36m 29s

Next question comes from Ben Reitzis with Melius Research. Please state your question.

Speaker 7
36m 35s

Hey, guys. Thanks a lot. Appreciate the question. Arvind, I appreciate that fourth quarter reported software growth is set to accelerate in your guidance, sounds like above 10%. I was just wondering about next year. You do wrap the Hashi acquisition in the spring, I think March. Do you are there signs that it can accelerate from here? Obviously, with Red Hat decelerating a little, I just think folks would like to know broadly if you can keep double digit next year or even accelerate based on the portfolio realizing that you're wrapping the acquisitions in that timeframe? Thanks so much guys.

Speaker 3
37m 17s

Yes, Ben, great question. So let me decompose it into the four parts of software that we talk about and then we'll touch on acquisitions and their contribution. And then I'll ask Jim to try to put it all together back into the financial model for you. So let's take Red Hat. We talked about 20% signings growth this quarter. We had similar numbers in the previous quarter. As that becomes the bulk of the Red Hat book of business entering 2026, we do expect to see Red Hat returning to mid teens or close to mid teens growth. So that would be an acceleration from where we are this quarter. Then next, we talked about and in the last question, Jim touched on transaction processing or mainframe software. We have seen this happen multiple times. In the first couple of quarters of a new cycle, TP tends to come down because people are very much focused on getting their hardware capacity. As that hardware capacity gets deployed, then the TP revenue begins to come up along with some of the ELA cycle dynamics that are there and we begin to see that. So I expect to see TP grow, not quite in double digits to be clear, but let's call it low single digits for sure into next year.

Speaker 3
38m 38s

Automation has been growing in this last quarter at 22%. Yes, the HashiCorp acquired revenue was a piece of it. And as you point out, that will go away in the second quarter. However, the acquired properties we have tend to provide continued growth for quite a while. Because of the Hashi bookings, which are significantly ahead of where we had planned them to be, I expect we'll continue to see growth out of Hashi through 2026 as well. Not quite as much as an acquired growth, but I do expect that we'll continue to see automation in the double digits for sure if but maybe not north of '20. And we've continued to see the data and AI portfolio grow in the mid to high single digits. Now that does put aside what other acquisitions we will do. Part of our model for software is that we'll get a couple of points of growth from acquired revenue and we see a good market for targets. Yes, that is yet to play out. But in the current regulatory environment combined with what we can see out there, we expect that we should be able to do that as well. So that was sort of giving you color on the portfolio and the different pieces.

Speaker 3
40m 5s

I'll ask Jim to get into then closing it back up in terms of sort of what is the organic and inorganic and overall software numbers.

Speaker 4
40m 13s

Yes. Thanks, Ben, for the question overall. I mean, obviously, software, we are a software centric platform company overall. So it's at the heart of both our top line growth factor profile and also, more importantly, from a free cash flow generation engine overall because it delivers about three quarters of our profit. And you take a look at '25, I think we positioned extremely well with regards to accelerating revenue growth throughout the year, off of tougher comps at the end of '24. We got to remember that. And I think that's a reflection of the strength of that portfolio, the diversity of our portfolio across the board, and to the, you know, disciplined execution. Now when you look at '26, early indicators, I'll put them in some big buckets. Arvin went into some of the detail. First, I I think we shouldn't forget, and Arvin called this out ninety days ago, which I think surprised many of you. We're operating in an attractive TAM and a positive backdrop from a technology perspective overall. We feel very good about technology being a source of competitive advantage and you're seeing that play out in areas around hybrid cloud modernization, around AI, around automation in many areas.

Speaker 4
41m 28s

See that continue. So the market backdrop, we couldn't be more optimistic around '26. Two, the strength and diversity of our portfolio, not only has it been repositioned over the last three or four years to accelerate growth. What is happening? More and more of our composition of software is now aligned to higher growth end markets, which gives us a better vector of growth even as we go into '26. Three, our annuity portfolio. And I don't think we get a lot of value for this, and we keep bringing it up. Over a $23,000,000,000 ARR book of business, we feel we're gonna exit the the fourth quarter at double digits. That's a great indicator for 2026 because that is 80% of our software portfolio overall. Four, new innovation, Gen AI. I already talked about Gen AI, the book of business and the acceleration we got. And all of the capital investment that's going into the infrastructure providers, I think, is just gonna accelerate the innovation curve for enterprise AI overall. And we are a leader in enterprise AI just given our tech stack, our software portfolio, and consulting, and that should deliver a few points. Five, Red Hat.

Speaker 4
42m 48s

You know, our bookings are three month, are six month, are nine month, are twelve month RPO shows accelerating growth coming off a 20% bookings overall. By the way, we actually had more opportunity to do even better than that 20%, and that should fuel an inflected growth. Next, m and a. The point I would bring up on m and a, Arvind already talked about, it's embedded in our model. We've said that all along. But again, I think we've got to continue selling the investor narrative because that m and a drives a much higher organic growth engine because those synergies play to those acquisitions. That's how we pay for control premiums. That's how we get an accelerated top line growth. That's how we get an accelerated bottom line growth, and we get accretive value in free cash flow in two years. So our organic engine continues to grow. Then finally, TP monetization. Arvin wrapped up on it. Let's just remind all the investors. TP gets monetized based on hardware installed MIP usage. I already said two quarters in, albeit early, we're a 130% program the program on z 17. Off of a z 16 was that was the most successful program in the history of IBM.

Speaker 4
44m 14s

We're at a 130%. So I do my math and calculation. Higher capacity opportunity creates higher monetization opportunity, creates higher price opportunity, creates higher value creation opportunity. So I think when you look at it, we feel pretty good about delivering our model and software.

Speaker 2
44m 35s

Operator, let's take the next question.

Speaker 1
44m 38s

Your next question comes from Eric Woodring with Morgan Stanley. Please state your question.

Speaker 8
44m 44s

Hey guys, thank you very much for taking my question. Just one quick clarification question there, Arvind. The growth rates you just provided in the response to that question for 2026 or into 2026, I just wanted to confirm those were all organic growth rates or whether they included M and A embedded in them. And then my question just taking a step back Arvind is, we've seen cloud providers experience exceptional growth recently, particularly in infrastructure services and large scale AI workloads. How does IBM view that trend? Do you see a similar opportunity for IBM Cloud to capture long term infrastructure driven demand? Thanks.

Speaker 3
45m 25s

The growth rates that we talked about, we tend not to do much M and A or any in both our mainframe or TPS as well as in some of the other areas. The growth rates I mentioned, would call it, are largely organic without having any significant M and A, but tuck ins, small M and A are probably all included in there, Eric. But if we do anything substantial, it would help accelerate those growth rates. Let's just put it that way. I'll also let Jim comment on it after I talk about the cloud opportunity. We actually partner deeply with all the hyperscalers. A thing that we haven't talked about, but it's certainly no secret. For example, we are one of CoreWeave's large clients. We also tend to use a lot of infrastructure at AWS, at Azure, as well as at GCP. So as opposed to that it's an opportunity for us, Eric, it's the flip. We got a huge opportunity to do both consulting projects as well as deploy our software on those infrastructures for our clients. As an example, if I take one of our very large health insurance clients, as they think through where they're going to deploy their AI models, they do not like deploying in a public instance, but they are perfectly fine getting a private instance in a cloud and deploying models there, deploying our software stacks there and getting growth.

Speaker 3
47m 6s

So we tend to do that. We also tend to, in some cases, for example, with Grok, we are deploying Grok in people's own data centers. So that's a big opportunity that comes there. That'll show up in revenue for us both in consulting as well as in software because on top of the Grok infrastructure, we tend to put our software stacks in some instances. So it's less about us getting an opportunity in our cloud only, but much more that that's a growth vector that we are able to ride and that helps increase overall growth rate in both software as well as in consulting. And lastly, let's not forget, our biggest beneficiary of AI infrastructure is our mainframe and our storage portfolio at this time. The latest generation mainframe, we will surprise you with some of the numbers. This quarter, fully populated single system is capable of doing four fifty billion inferences per day. As clients purchase that capability, that will be both a further accelerant to mainframe infrastructure growth, but it also comes with a software stack that helps them do all of that inferencing. If I look at our storage portfolio, as many people have realized, you need a lot of storage to be able to do AI training.

Speaker 3
48m 36s

And we are going to be beneficiaries of that inside our storage portfolio as people deploy that. So I would much more say, we are actually the direct beneficiary of the hyperscaler growth of AI capability and capacity as enterprises use this capability. And two, we will be a beneficiary in our mainframe and storage stack in a direct way. I think that that would I hope Eric addressed that part of the question.

Speaker 4
49m 5s

Yes, Eric, and just to the numbers piece. I mean, first of all, we are all focused here to execute a very important fourth quarter to finish a very successful 2025 for IBM. But we're both Arvind and I are given some color about '26, about the confidence we have in our portfolio. But let me just take a step back and remind you on software. Our software model shared at Investor Day approaching double digits. That is all in. That has two to three points give or take at each year, maybe a point more and maybe a point less depending on our disciplined capital allocation around M and A of inorganic contribution and six to seven to eight points of organic. When you look at 2025, you go do the math, we're probably going to be approaching six plus percent organic growth overall, and we're going to have somewhere three to four points this year because we took advantage of a very strategic opportunity with HashiCorp this year. But when you take a look at 2026, the TP growth monetization value that I talked about, the Red Hat accelerated growth profile that's on our revenue under contract, the annuity growth profile that is, you know, approaching or now gonna be double digits at the exiting the year.

Speaker 4
50m 28s

Each of those are gonna fuel that organic growth engine overall. So I think, you know, big picture, the model is pretty much what we kind of look at right now for 2026.

Speaker 2
50m 41s

Great. Operator, let's take the next question.

Speaker 1
50m 44s

Your next question comes from Jim Schneider with Goldman Sachs.

Speaker 9
50m 48s

Arvind, was wondering if you could maybe elaborate a little bit on how you're thinking about M and perspective. You've previously stated M that you're looking to accelerate growth and you're looking for things that fit strategically with the portfolio. But on the margin, anything in any way you're thinking about differently about either the portfolio or the product piece of it or the potential size of transaction you might like to undertake? And specifically, would you consider undertaking a somewhat larger, transformative transaction, maybe not quite as big as you did with Red Hat, but of sort of similar scale relative to your overall portfolio? Thank you.

Speaker 3
51m 32s

Yes. Jim, thanks for the question. Look, M and A is extremely important part of our strategy. So I want to just perhaps reiterate because this has come up on prior calls as well. We look at it always in a multiyear window. So we kind of look at what is our excess cash flow over a few years. And once we have that window, that means we can sort of buy ahead, which means we can sort of lean in. Or if we don't find a good target like we didn't, for example, I think in 2023, then we actually spent much less than we could have. So that's just a backdrop to the amount of financial flexibility that we have, which if I remember at our Investor Day earlier this year, we laid out that we have somewhere in the mid-20s, perhaps a bit more flexibility over a three year window. That's kind of a way to sort of look at it. Next, we are very focused on the areas that we have already explained as our strategy. Very top level, we say hybrid cloud and artificial intelligence. That translates into our hybrid portfolio, our automation portfolio and our data and AI portfolio.

Speaker 3
52m 47s

And you've seen us do acquisitions in there. For example, we bought a AI company that does BLLM, but it fit into our hybrid portfolio because it's a direct part of the Red Hat and OpenShift portfolios. We did HashiCorp, which fits directly into automation. We did DataStax, which fits into data. When I look at the target lists, there is, I think, a pretty rich list of opportunities that are out there in the private markets, in the PE world and the public markets across those opportunities that we think will some of them will be actionable. It's hard to predict upfront, which are and which are not. So I think that if I put it that way, and just to be clear, anything that is of size has to fit three criteria. It has to fit with the strategy we just laid out. There has to be synergy, aka the growth rate inside IBM will be above what it was as a standalone entity. Some of that comes from our geography spread. We have a sales team in most countries in the world. Some of it comes by the ability to bundle more attractive offerings together and it comes from faster deployment, for example, leveraging our consulting team or the rest of our sales team.

Speaker 3
54m 19s

All three will be able to add to more to a faster growth rate. Third, if it is of size, then we are very disciplined also that we like it to become accretive to cash by the end of the second year. So those are the criteria. But as you've seen, we have found plenty in the last few years that do fit that whole criteria. So I hope that that gives you a sense. Now your question on larger, I'll just use that word larger. We will never rule anything out, but it has to meet all the criteria that we just laid out. It is not for size alone. Red Hat allowed us to enter a new space, helped accelerate IBM's overall growth rate, by the way, in software and in consulting. So that was the sort of the synergy piece that was there. And you many people forget, Red Hat also had a very attractive free cash flow profile that we have been able to leverage since the acquisition.

Speaker 2
55m 28s

Great. Operator, let's take one final question.

Speaker 1
55m 32s

Thank you. And that question comes from Brian Essex with JPMorgan. Please state your question.

Speaker 10
55m 39s

Hi, good afternoon and thank you for taking the question. Arvind, maybe as a follow-up as to part of Eric's question and I appreciate your hybrid exposure here. But could you generalize what you're seeing with regard to MiX's enterprises focus on AI readiness? Cloud native ISV based agentic applications maybe targeted at task and point solution automation? Are those low hanging fruit to prove ROI before pursuing self hosted projects? And then maybe within the IT budgets, where is the spending coming from? What's at risk of getting trimmed as companies focused adopting AI based technology?

Speaker 3
56m 22s

So Brian, let me address the first part of your question with a bit of, depth. I actually think that these are an and. Are people going to leverage ISV? Otherwise, I'll call it SaaS applications for getting exposure to AI and agents either as part of those entities or as added value onto them. And there are hundreds, if not thousands of little boutique companies that provide some of those agents that are out there. I think they will absolutely do that. They'll kick the tires on it. They'll get some value. But at the end of the day, to get real value from AI, people have to be able to integrate their existing applications. How do they tie what is happening in their payroll system and HR system to perhaps something that is happening in the CRM system to perhaps something that is happening in their ERP system As people begin to want to build much more profound agents, that is where a lot of the action that we see is happening. As people try to build those agents out, then they get deeply concerned about what is that data, where is that data going and they're going to deploy those either in their own data centers or in a private instance.

Speaker 3
57m 39s

Note, a private instance of the cloud is quite protected and people do deploy a lot of critical applications that are there. But if I think about our clients, in the regulated industries, banking and insurance still is very much a data center as well as a cloud picture. If I look at healthcare, healthcare data tends not to go out very much from their own data centers. If I look at telecom, most people build their own backbones and their data and applications reside there, but certain other things like marketing may well reside in the public cloud. So as we begin to look upon all that, I believe that we are at the very beginning. I would actually characterize this, Brian, if I was to use the baseball analogy, we're still in the first innings of enterprise AI rollout. And I expect that we'll be seeing and we will see more SaaS AI usage, we will see more public cloud AI usage, and we will begin to see a lot more private AI usage as people begin to get into more critical applications and agents. On the IT budgets, look, IT budgets have been growing ahead of GDP.

Speaker 3
58m 57s

That's simply an observation. I think this began four or five years ago, but IT budgets are growing typically two to three points ahead of GDP growth. You combine that then with inflation because GDP after all is real, not nominal. I see IT budgets staying healthy. So a lot of the growth comes from the fact that the IT budgets are growing as opposed to the cost of something else. That said, I think people are getting very, very effective at trying to run and maintain with lower costs and putting more money towards newer projects. Five, ten years ago, that ratio used to be seventy, thirty. 70 are running what is, 30 are new. I think that is shifting more towards a sixty-forty spread. And where it will go is where we'll get the benefit. That is why our automation portfolio and our hybrid portfolio get a lot more growth because people are using that. So it's sort of substituting for labor and in some cases for services by letting those capabilities move into software.

Speaker 2
1h 0m

Great. Operator, I think we have time for one last question.

Speaker 1
1h 0m

Thank you. And the next question comes from Mark Newman with Bernstein. Please state your question.

Speaker 11
1h 0m

Hi, thanks for taking my question. Very good to see the growing AI book of business and thanks for those comments just now. Arvinda, I don't think you've given any specific breakdown yet on the breakdown between software and consulting of the AI book of business. Is there any clarity on that? I think it used to be eightytwenty. Just want to clarify if there's any clarity you've given on that today. And then a follow-up on consulting. I think there's two quarters in a row now where we are seeing the book to bill ratio a touch below one. I know you point in the earnings to a book to bill ratio greater than one if you're looking at the trailing twelve months. But I would just like to understand more on a shorter term basis, last six months, it seems like the book to bill ratio is below one. And if you could explain kind of why maybe why that's the case, why we shouldn't be worried, especially considering, I think, around 30% of signings you mentioned are AI, which I believe are longer duration. So just a little bit of clarity around consulting and how AI plays into the book bill ratio and that recent number being below one would be appreciated.

Speaker 11
1h 1m

Thanks very much.

Speaker 4
1h 1m

Okay. Mark, this is Jim. I'll take both of those. Let's start with the second one first and then I'll come back to your clarification question on Gen AI and in particular around the software portfolio overall. I want to dive a little bit deeper in that. But when we take a look at consulting, let's dial back ninety days ago. I think we surprised many just compared to what many other consulting companies have been talking about publicly. We talked about green shoots that we saw entering second half. But I think at that time, we were prudently cautious about how we were gonna monitor client buying behaviors, and we didn't expect growth in the second half, although we saw many green shoots overall. Now we posted, I think, a marked inflection point of consulting back to growth, up 2%. And it's been driven by what we're seeing is continued opportunity for growth as clients accelerate investment in AI driven transformation, what we've been talking about on many of these questions here. Why? Companies are looking to unlock efficiency, business model innovation, and growth, growth, growth, and AI is accelerating overall. When we take a look at right now fourth quarter and more importantly, '26, we again see momentum around those key metrics, our backlog position, our Gen AI book, strategic partnerships, and around productivity.

Speaker 4
1h 3m

You know, backlog, $31,000,000,000, healthy growing 4% right now. Our best ever, erosion in, I think, multiple years. What does that say? Clients' commitment to IBM consulting, the quality of our delivery, and the value of our differentiated offerings are doing extremely well. Now to your point about signings, signings were down 5%. By the way, signings been down five in the last six quarters, something like that. But as I've said many times before, why do I always start with backlog? That to me is the most critical component that's closest to the outcome measure. The outcome measure is revenue. Revenue growth revenue growth, as Arvin always likes to say in this conference room with our operating team. Indicators are backlog. Indicators are signings. But signings are not all equal. And those signings numbers had been driven down. I think we posted down 5% based on lower large deal renewal volume. By the way, I would argue that's at best no revenue realization and probably worst, dilutive revenue because renewals typically drive more price and more more productivity. But underneath that, what are we seeing? We're seeing a tremendous improvement in the quality of our signings. Our net new business penetration, again, another quarter in a row, up double digits year to year on a penetration.

Speaker 4
1h 4m

Over 300 new clients year to date fueling our backlog. Our backlog realization is up over four points year over year. And when we take a look at our backlog run out, it's pretty healthy, growing at market level growth rates here over the next three, six, nine, twelve months. Lot of work still to go to sell and bill within quarter, but a lot of good indicators. And that Gen AI, to your point, over 22% of our backlog, 30% of our signings, 12% of our revenue, that's what's inflecting the growth overall. So we feel pretty good, and that's why we called the mark inflection, and we said we're gonna grow consulting here in the fourth quarter. And we we feel pretty good about getting back to market growth levels in 2026. Now, GenAI, the over $9,500,000,000 book of business, Arvind already talked about over $7,500,000,000 in consulting, well over a 1,000,000,000 point dollars almost approaching 2,000,000,000 in software. You know, we're what, seven, eight quarters in here. That number might vary quarter by quarter as far as the composition, but we're we're still pretty damn close to that twenty eighty overall. But the underpinnings behind that of the software book in the generation, you know, you see that play out and how it's accelerating automation growth, but also Red Hat.

Speaker 4
1h 6m

I know there's been a lot of questions around Red Hat. Let me just spend a minute just to close the call on Red Hat. Red Hat, we delivered 12% growth. We were down a couple points quarter to quarter. In year to date, we're at 13% low teens. Right? Let me break down some of the performance. One from a position of strength and Arvind talked about a few points. OpenShift, up nearly 40% bookings. Our ARR, dollars 1,800,000,000.0, up mid-30s year over year, accelerating profile. Virtualization, now we've closed total contract value of bookings over $400,000,000 We got a $700,000,000 pipeline over the next five plus quarters. And Ansible, 20% bookings in the quarter accelerating the high teens. So what happened on the sequential decline? One, as we knew we were facing tougher compares on the consumption based services That impacted us by about a point and REL, about 50% of our portfolio. We've been talking about we've been growing REL abnormally in the mid teens. We reverted back to our model, growing 6% and had about a point. Now taking a step back, Red Hat models mid teens. And when you look at it, our 80% subs business, we got to grow low end of that high teens.

Speaker 4
1h 7m

The consumption base, we got to grow high single digit. When you look at our year to date, Arvind talked about our bookings year to date, we're well positioned on that subscription based business growing high teens already on bookings. And when you look at that six, nine, twelve month revenue under contract, we're accelerating that growth as we go into '26. That gives us confidence in that acceleration comment that Arvind talked about and I talked about as qualitative statements about confidence in '26. And when you look at fourth quarter, let's put this in perspective. We're going to accelerate Red Hat growth in '25. It's going to be a nice acceleration on the subs and we got about a two point headwind on consumption based services. We knew about that because last year, we grew consumption based services high teens. And when you look at fourth quarter, we're going to wrap on that. We've known about that all year long. So when we look at fourth quarter, double digit, solid double digit growth in Red Hat, low teen growth for the year, nice composition of where that acceleration is, but the most important thing, we're well positioned for 2026.

Speaker 4
1h 8m

So with that, I'll turn it back over to Arvind to close out the call. Thanks, Jim. Look, to close out, we are pleased with our performance this quarter. All of our segments accelerated sequentially. Our portfolio strength, business model and relentless focus on productivity reinforce our confidence in the trajectory. I look forward to sharing our progress as we close out the year.

Speaker 2
1h 9m

Thank you, Arvind. Operator, let me turn it back to you to close out the call.