IBM
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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
22s

Thank you. I'd like to welcome you to IBM's first quarter twenty twenty five earnings presentation. I'm Olympia McNurney, 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. We're off to a strong start in 2025, exceeding our expectations for the quarter, driven by solid revenue growth, profitability and cash flow generation. While sentiment and the operating environment have been rapidly shifting, our performance reflects the continued success of our focused strategy on our hybrid cloud and AI, especially where clients are looking for cost savings, productivity gains and trusted partners to help them move fast and scale. Those needs remain front and center in today's market. Before going deeper into our results, let me start by saying that we appreciate the administration's focus on economic growth and rational regulation, which will strengthen The U. S. Competitive position. We believe this will result in long term value creation and make it easier for technology to contribute to economic growth. I'm going to now talk about our results for the quarter and then address the macro and how we are positioning within these conditions. Our performance this quarter reflects the flywheel for growth we discussed at our Investor Day. It all starts with client trust with a one hundred plus year history of delivering mission critical solutions and navigating different operating environments. Trust is complemented by the flexible solutions we offer in hybrid cloud and AI, the innovation value we provide, our domain expertise to help clients digitally transform and scale AI and our partner ecosystem to broaden our reach and impact.

Speaker 3
3m 6s

We saw these play out in the first quarter. Our growth was led by software, up 9% with strength across Red Hat, automation, data and transaction processing. Our early leadership in generative AI and the Consulting Advantage platform using digital assets to deliver client value have positioned us well in today's evolving market. In infrastructure, Z16 is our most successful program in history, highlighting customer adoption and the value proposition of the mainframe. In generative AI, we continue to see strong traction. Our book of business is now over $6,000,000,000 inception to date, up over $1,000,000,000 in the quarter. Approximately onefive of this book of business comes from software and the remaining fourfive is consulting. This is similar to last quarter. The AI portfolio we have built is designed to give clients a comprehensive set of tools to deploy AI within their enterprise. In software, the ability to deploy our AI assistants and agents as well as AI middleware in a hybrid environment, leveraging multi model capabilities is resonating with clients. AI agents will accelerate the ability of many enterprises to turn the promise of generative AI into real value. Consulting is helping clients design and deploy AI strategies and use cases.

Speaker 3
4m 37s

We continue to see our infrastructure segment play a larger role as clients bring AI to their data. Our clients will see these solutions at length at our client conference, THINK, in early May in Boston. We remain focused on accelerating innovation, speed and impact. Earlier this month, we announced the upcoming launch of Z17, which delivers enhanced AI acceleration through multi model AI capabilities, new security features to protect data and tools that leverage AI for improving system usability. Z17's value proposition particularly resonated with clients given significantly lower power requirements, higher capacity growth and increased performance over Z16. In Quantum, we are proud to partner with the Basque government to deploy Europe's First IBM Quantum System two in Spain, a milestone in global quantum leadership. M and A remains a key enabler of our strategy. This quarter, we closed the acquisitions of HashiCorp and AST. HashiCorp brings leading automation and security tools that integrate with our hybrid cloud strategy, and we're excited about the synergy opportunities ahead. Let me now touch on the macro environment. Technology remains a key competitive advantage, allowing businesses to drive cost efficiencies, productivity and preserve their balance sheets. In the near term, uncertainty may cause clients to pause and take a wait and see approach.

Speaker 3
6m 17s

However, the value of hybrid cloud automation, data sovereignty and on premise solutions becomes even more critical in volatile windows. Recent conversations that I've had with clients reflect this view of the current environment. These conversations vary by industry, business and geography. For example, our containerization and virtualization pipeline continues to grow with clients focused not only on near term costs, but also longer term savings driven by our modernization capabilities. There are also areas of our business where volatility acts as a catalyst for demand, driving increased capacity requirements, particularly across our mainframe environments. This played out over the last couple of weeks amongst our financial services clients. However, for clients with a more direct impact from current policy, the slowdown may be more pronounced. Consulting is also more susceptible to discretionary pullbacks and doge related initiatives. While no one is immune to uncertainty, we enter this environment from a position of relative strength and resiliency. Our clients run the world's most essential processes. Our diversity across businesses, geographies, industries and large enterprise clients position us well to navigate the current climate. We have an experienced team that is focused on areas we can control around our supply chain, accelerating our productivity initiatives and maintaining the strength of our balance sheet.

Speaker 3
7m 57s

With this backdrop, let me touch on our outlook. For the last several years, we have been strengthening our portfolio and building on our track record of execution, and our outperformance this quarter was another proof point. While it is still very early in the second quarter, we have not seen a material change in client buying behavior. With the caveat that the macro situation is fluid, based on what we know today, we are maintaining our full year guidance for accelerating revenue growth to 5% plus and about 13,500,000,000 of free cash flow. Over the longer term, I am confident in our ability to deliver on our model presented at Investor Day for sustainable higher revenue growth and strong free cash flow. With that, I'll turn it over to Jim to walk through the financials. Jim, over to you.

Speaker 4
8m 52s

Thanks Arvind. In the first quarter, we delivered $14,500,000,000 in revenue, dollars 3,400,000,000.0 of adjusted EBITDA, dollars 1,700,000,000.0 of operating pretax income and operating earnings per share of $1.6 And we generated $2,000,000,000 of free cash flow, our highest first quarter free cash flow in many years. Our revenue growth, scale and accelerating productivity drove two forty basis points of adjusted EBITDA margin expansion and 12% adjusted EBITDA growth. We exceeded our expectations on revenue, profitability, adjusted EBITDA and earnings per share. Our revenue for the quarter was up 2% at constant currency. As we discussed at our Investor Day, our mix shift towards software is driving growth. We saw this play out in the quarter with software up 9%, driven by growth of 15% in automation, 13 in Red Hat, seven percent in data and 2% in transaction processing. This performance reflects demand for our focused portfolio that provides end to end hybrid cloud and AI capabilities. Red Hat delivered another strong quarter, driven by bookings growth in the high teens. And OpenShift is now at $1,500,000,000 ARR, growing about 25%. About six points of our growth in software was organic, with contribution from our generative AI products like our AI Assistants and Agents and Watson X platform.

Speaker 4
10m 43s

We also benefited from our high value recurring revenue base, which comprises about 80% of our annual software revenue. Software's annual recurring revenue grew to $21,700,000,000 up 11% since last year. Consulting revenue was flat and a sequential growth improvement quarter to quarter with solid backlog growth of mid single digit. Strategy and Technology revenue declined 1% and Intelligent Operations revenue was flat for the quarter. While we are seeing clients delay decision making, especially in discretionary projects, which impacted our in period signings. We had good growth in transformational offerings like hybrid cloud and data, as well as application management and cloud platform engineering services. We also continue to build our Consulting Generative AI book of business, which is now over $5,000,000,000 inception to date. Infrastructure revenue declined 4%. Hybrid infrastructure was down 7%, driven by IBM Z, down 14%, as we wrapped on the twelfth and final quarter of the Z16 program, which delivered strong performance in both revenue and capacity. Distributed infrastructure revenue was down 4%, with product cycle dynamics impacting power, while storage delivered another quarter of double digit growth as our latest innovations continue to address the rising data demands of our clients. Now turning to profitability.

Speaker 4
12m 32s

In the current environment, we are focused on taking action to control things we can to protect supply chain, margin and free cash flow. IBM has been driving a productivity mindset for many years and this quarter's margin performance reflects that intentional discipline and our flexibility of our operating model. During the quarter, operating leverage and yield from accelerated productivity initiatives drove expansion of operating gross profit margin of 190 basis points, adjusted EBITDA margin of two forty basis points and operating pre tax margin of 50 basis points. Excluding year over year divestiture dynamics and net year to year workforce rebalancing, operating pre tax margin was up 180 basis points, ahead of our expectations and well above our model. We delivered very strong segment profit margin expansion in Software and Consulting of over three seventy basis points and two eighty basis points respectively, while infrastructure was down about 150 basis points reflecting product cycle dynamics and continued investments in innovation. Let me give you some more color on our productivity initiatives. As discussed at our Investor Day, we remain laser focused on accelerating our productivity initiatives. We are transforming our enterprise operation, leveraging technology and embedding AI across more than 70 workflows such as HR, IT support, procurement, finance, quote to cash and more.

Speaker 4
14m 27s

We have built a best in class enterprise IT platform leveraging our own IBM software solutions across hybrid cloud, automation and AI, decreased our vendor spend by more than $1,000,000,000 by optimizing our supply chain and service delivery and right sized our physical infrastructure. We exited 2024 at $3,500,000,000 of annual run rate savings achieved and we continue to see these efforts play out in our margin performance this quarter. These actions create a flywheel that allows us to invest back in our business, both organically and inorganically, increase our financial flexibility and deliver margin expansion. Our ability to toggle these actions up or down depending on the operating environment adds significant flexibility to our financial model. The combination of our revenue scale and productivity enabled solid contribution to free cash flow generation. In the quarter, we generated $2,000,000,000 of free cash flow, up $100,000,000 year over year, resulting in our highest first quarter free cash flow margin in reported history. The largest driver of this growth comes from adjusted EBITDA, up over $350,000,000 year over year. Partially offsetting this, given global trade dynamics, we proactively took actions to bolster our supply chain ahead of our Z17 launch, resulting in higher inventory levels.

Speaker 4
16m 14s

Despite these actions, we are a couple points ahead of our three year average attainment levels through the first quarter. Let me briefly address our supply chain dynamics. As Arvind mentioned, IBM has a long track record of operating globally and managing supply chain complexity. Over the last several years, we have strategically diversified and streamlined our supply chain. Goods imported to The U. S. Represent less than 5% of our overall spend and under current U. S. Tariff policy, the impact to IBM is minimal. While we have limited direct exposure outside The United States, we are tactically evaluating alternative sources and other strategies to mitigate tariffs. We continue to maintain a strong liquidity position, solid investment grade balance sheet and a disciplined capital allocation policy. We ended the quarter with cash of $17,600,000,000 which is up $2,800,000,000 from the end of twenty twenty four, including spending $7,100,000,000 in acquisitions, driven largely by the closing of HashiCorp. In February, we accessed the debt markets, raising over $8,000,000,000 on attractive terms. Our debt balance ending the quarter was over $63,000,000,000 including $10,000,000,000 of debt for our financing business, with a receivables portfolio that is over 75% investment grade. In addition, we returned just over $1,500,000,000 to shareholders in the form of dividends.

Speaker 4
18m 5s

Now, let me talk about what we see going forward. As everyone knows, there is a level of macro uncertainty that exists and is hard to predict. That said, we are operating from a position of relative strength. The combination of our repositioned and focused portfolio, investment in innovation and our diversity across businesses, geographies, industries and large enterprise clients positions us to perform in a variety of macro scenarios. Our flywheel for growth begins with the incumbency and trust we have with clients from decades on the ground in over 175 countries, which is a real point of differentiation in the current environment. Our client base is diverse, operating across almost 20 industries, spanning 95% of the Fortune 500. Based on what we know today, we are maintaining our full year guidance for accelerating revenue growth of 5% plus and about $13,500,000,000 of free cash flow. Let me go through the drivers of these key metrics. As discussed at our Investor Day, our mix shift towards software is a key driver of our growth acceleration. Software is now about 45% of our business with 80% recurring revenue. As a reminder, in the first quarter, we generated 21,700,000,000 of ARR, growing 11%.

Speaker 4
19m 45s

The combination of our portfolio strength, investment in innovation and contribution from acquisitions to drive our full year performance in software. And we continue to expect mid teens growth for Red Hat, underpinned by six month revenue under contract, which is growing in the mid teens. In Consulting, we are encouraged by this quarter's sequential growth in revenue, our solid backlog up 6% and our book of business in Gen AI. But given the current environment, we are appropriately more cautious on Consulting's contribution to IBM this year. With our new mainframe launch, innovation across the portfolio and capacity dynamics that could benefit our mainframe environments and storage needs, we expect infrastructure to grow. While we feel good about the core growth drivers of our business, there are areas of our portfolio that could see greater variability in the event that the macroeconomic environment deteriorates. This includes consulting, which is more sensitive to discretionary pullbacks and Doge related initiatives consumption based services and software, including in Red Hat and areas of distributed infrastructure. We continue to expect IBM's full year operating pre tax margin to expand by over a half a point driven by productivity initiatives, revenue scale and mix mitigated by the impact of dilution from acquisitions.

Speaker 4
21m 27s

And our tax rate expectation for the year remains in the mid teens. As always, the timing of discrete items can cause the rate to vary within the year. For free cash flow, we expect to generate about $13,500,000,000 in 2025, driven primarily by growth in adjusted EBITDA. The headwinds I discussed last quarter of higher cash taxes and higher CapEx remain the same. As I mentioned earlier, we have been accelerating our productivity initiatives to plan for various scenarios and to protect our profitability and free cash flow. As we look forward to the rest of the year, we will remain disciplined about managing our costs. The strength of our balance sheet and strong liquidity position allow us to make investments in our business for the longer term. As Arvind mentioned, while still early, through the first three weeks of the second quarter, we have not seen any material change in client buying behaviors. We expect revenue growth of at least 4% at constant currency. And given the increased currency volatility, a revenue range of $16,400,000,000 to $16,750,000,000 And second quarter operating pre tax margin expansion should be consistent with the full year with our tax rate in the mid to high teens.

Speaker 4
23m 1s

Let me conclude by saying that we have a durable and differentiated business model that positions us well to navigate a range of economic environments. While there is uncertainty, we remain laser focused on taking actions to control what we can and executing our strategy to accelerate revenue growth and free cash flow. We believe our focused portfolio, disciplined investments in innovation, diverse set of businesses and clients, relentless focus on productivity and strong liquidity drive the durability of our performance. Arvind and I are now happy to take your questions. Olympia, let's get started.

Speaker 2
23m 46s

Thank you, Jim. Before we begin the 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 multi part questions. Operator, let's please open it up for questions.

Speaker 1
24m 3s

Thank you. And at this time, we'll begin the question and answer session of the conference. Our first question comes from Jim Schneider with Goldman Sachs. Please state your question.

Speaker 5
24m 36s

Good afternoon. Thanks for taking my question. I was wondering if you could maybe start off with sort of framing the macro impact that you're seeing on both software and consulting. You talked about some of the potential drivers, but I'm sort of curious at this point, are you seeing any kind of significant softening in say the consumption portion of the portfolio either Red Hat or otherwise? And do you see any slowdown in specifically transaction processing for the year that wouldn't will allow you to not sort of hit the target you laid out at the Investor Day? Similarly on consulting, are you seeing the Doge impact sort of significantly impacting the near term results? Or is this more of an expectation of a slowdown in a broader sort of enterprise mix of business? And then just broadly speaking, you could address the sort of sub segment guidance you had provided at Investor Day approaching double digits in software and low single digits in consulting and whether we'd expect either of those to change very much? Thank you.

Speaker 3
25m 41s

Okay. Jim, I'm hoping I can remember, I think it was five parts to your question. Let me address the macro pieces and then I'm going to ask Jim Cavanaugh to address the last piece on the sub segment guidance. So if we look at what happened in the first quarter and then if you project forward, there's a difference. We did not really see much of a slowdown in 1Q on the consumption parts of the software business, whether it's in TPS or whether it's in Red Hat, just to be straightforward. We are projecting though that if there is slowdown in global GDP, there could be a small slowdown, not a big slowdown in the Red Hat part of the consumption business, which just to remind you is only between 1020% of the total business. If I look at transaction processing, if anything, we see tailwinds right now, not headwinds. So we expect that part of the portfolio to remain strong unless we approach a recession or negative GDP, which we are not projecting from everything that we can see and read. Going to consulting and doge, yes, we are not immune from all those activities just like everybody else.

Speaker 3
27m 0s

We had a couple of contracts that were impacted in the first quarter. You would expect USAID where we did some work was impacted, but not really in most other cases. The work we tend to do is much more mission critical, is much more about building the government systems, which make them more efficient And so we see them carry on. Now, it's hard to predict where that goes over the rest of the year. So I'm not going to try and make that prediction on Doge and Consulting, except to caution, as Jim said in his prepared remarks, if there is pressure in the economy, consulting tends to see headwinds before other parts of the business. I think that was three or four of your five parts and sub segment compared to Investor Day. Jim, I'll leave to you.

Speaker 4
27m 48s

All right. Thanks, Jim, the question overall. If you go back to Investor Day, what did we talk about? We talked about the strategic repositioning of our portfolio and our company overall to much more software centric, platform centric model. And we laid out a financial investment thesis. We called it our shareholder value creation thesis that said we would take this business from a no growth profile to the last three years, kind of low single digit profile, to an accelerating revenue growth profile, a mid single digit plus. And that's how we guided 2025. Underpinning that was an accelerating revenue growth profile of software. And right now, when you look at us maintaining our guidance in 2025, we are right on path to that. And I'm sure we could talk about the underpinnings of software a little bit later. Second, what was a big change we made? We said with the new innovation investments and the repositioning of infrastructure that we were moving that business from a cyclical business to a secular grower. And in our guidance for 2025 of the five plus percent, we are the first instantiation in 'twenty five of a secular grower as we're very excited about the new innovation of our mainframe that was just launched here in the April.

Speaker 4
29m 15s

And then we said consulting. Over time, the market, which we have confidence in, that's been growing on average, you know, 5%, six % over a decade long. Yeah, are there some years up and down? Absolutely. But we have confidence in the long term growth factor of consulting and more importantly, the integrated value of what consulting brings to our portfolio. The tip of the spear, driving and pulling our technology and driving that attractive economic multiplier effect. So you look at '25, we started the year out this year and we said, given the demand environment, we were prudently cautious at the low end of low single digits. We started out first quarter. Here, we stabilized the business flat. We see that pretty much the same. There's a lot of dynamics going on in the year, but you know, we're kind of confident in that stat flat stabilized area overall. So hopefully that gives you some perspective.

Speaker 2
30m 17s

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

Speaker 1
30m 20s

The next question comes from Wamsi Mohan with Bank of America. Please state your question.

Speaker 6
30m 26s

Yes, thanks so much. Maybe just a follow on in terms of just the way to get to your 5% plus guide for the full year. It'd be helpful if maybe it'd be helpful if you could maybe just give us some sense both on Red Hat, which is going to face tougher comps and transaction processing, which is starting off at 2%. How we get to sort of this double digit software or approaching double digit software contribution. And Jim, noted, maybe it's prudent to be a little more cautious on the contribution from consulting. Is that largely going to be offset maybe by better expectations on infrastructure as well? Thank you so much.

Speaker 4
31m 11s

Yes. Thanks Wamsi. I'll take this. Let's take a step back. You go through what we talked about in January and then we played out to Jim's question around our strategic investment thesis for a long term perspective, which aligned overall about how we accelerate this company and leverage all the work we've done on building a durable, sustainable, inflecting higher growth business. We talked entering the year. One, we were coming into the year with a position of strength. That was centered around our software portfolio, our high value recurring revenue and our investment in innovation. Two, Red Hat momentum. The opportunity in front of us on virtualization AI was going to grow mid teens. Three, our next generation mainframe that was coming out late in the first half that would fuel second half. Four, our early leadership position in Gen AI. And five, our disciplined capital investment allocation and what we've seen with regards to M and A growth and synergies. I would tell you right now coming out of first quarter, I'm actually feeling more confident on each one of those five. And let me put some numbers to it. We just exited it as strong 2% growth here in the first quarter.

Speaker 4
32m 44s

We maintained our full year at five plus percent. How do you get there? Well, in that 2%, we got about four points of contribution from software. We had a one point headwind given we were at the last twelve quarter cycle of our infrastructure business and consulting stabilized was flat. What goes forward? Number one, that new innovation in our infrastructure turns a point headwind in 2Q to a point tailwind for the full year. That's a full two point change. So you go from 2% already to 4%. Number two, we are very excited we closed HashiCorp at the February. Our actual contribution around inorganic in the first quarter, give or take, was about a point and a half. To IBM for the full year at '25, it's going to be north of 2.5. We get another point of M and A. So now you're up to 5% growth. Now you get to, okay, how do we get north of that 5% growth, which is what our guide is? Three, Red Hat, seventh consecutive quarter of high teens ACV bookings. We are seeing great demand around virtualization, around automation, around our Linux capability. By the way, all three grew double digits here in the quarter, pervasive and grew share.

Speaker 4
34m 13s

Our acceleration in Red Hat coming off of roughly 13.5% in the first quarter, we're going to commit and we maintain mid teens for the year. We get another half a point out of Red Hat. I haven't even went to our annuity profile, which is in a strong position with strong renewal rates, etcetera. And we'll see how the consulting backlog plays out. But I think to your question, we are being very prudent and cautiously prudent on consulting and not expecting any contribution. So that's kind of a walk from a first quarter to full year.

Speaker 2
34m 49s

Operator, let's take the next question.

Speaker 1
34m 52s

Our next question comes from Amit Daryanani with Evercore ISI. Please state your question.

Speaker 7
34m 58s

Thanks a lot. I guess I was hoping you could talk a bit more on the consulting side and you've talked about there's a lot of noise happening on consulting, especially from the federal and DOGE exposure. So I'd love to understand how big is the federal business for you folks? And do you think about the discretionary part of your consulting business stacking up in the back half of the year given some of the macro noise? Just anything on the consulting side would be really helpful. And then Jim, if I could just follow-up, you folks normally don't give a quarterly explicit revenue guide. You're doing it this time around for June. So I'm just curious what led to the decision to give a more explicit June guide other than you were afraid we were all going to miss model it?

Speaker 4
35m 39s

Yes. Let me first of all, thanks Amit. Let me take the second question first and then I'll go into the Doge specifics to ground us in numbers and then if Arvind has any of the client pieces back as we've been actively engaged with the administration as you can quite imagine. But let's take a look at, you know, on currency in particular and given a quarterly guide. Why do we do that? Full transparency, we feel obligated with our credibility on what we see in the near term, given we're operating as we talked about in a very dynamic and uncertain macroeconomic environment. Our best visibility right now is probably in the next ninety days. And given that credibility and transparency to investors and also in light of the significant U. S. Dollar, devaluation that's happened over the last three weeks. Let's put that in perspective. The rate, the magnitude, and the breadth of the US dollar depreciation, we have not seen in quite some time, like 8% to 9% devaluation. So what did we do? We gave you both. We always guide on constant currency and we guide it on constant currency. And we could talk about the underpinnings a little bit later.

Speaker 4
37m 4s

Second, just given the extreme volatility in the market, we guided on an absolute dollar range all in. Why did we do that? Because at 4% constant currency growth, if you just dial back to where the FX rates were as we entered April 1, that would put you at $16,400,000,000 If you actually take that same 4% and you look at today's actually today's spot rate devalued or actually, appreciated about a point. So we already gave a point back. But if you look at it from yesterday, we'd be at $16,750,000,000. So we're not in the business of predicting the f FX volatility. We're giving you a range, but we're saying as always, what we can control, which is the underlying dynamics of the operational performance of our business, we feel confident of at least 4%. So hopefully that gives you that. On Doge, let me ground some data and facts here. One is Arvind said, no one's going to be immune from this, but our U. S. Federal business is less than 5% of IBM's total annual revenue. About 60% of that is consulting, which is more susceptible to discretionary efficiency type programs. 40% of it is technology, which is all high value annuitized revenue under contract.

Speaker 4
38m 33s

Let's put that off to the side. In consulting, our U. S. Federal is less than 10% of the total. By the way, we have less than 3% market share overall. Now, when you look at it, Arvind indicated, and by the way, all this data is public. 've had a handful of contracts, either statement of work that have, or canceled. And on our annualized backlog of over $30,000,000,000 in total consulting, this is like less than $100,000,000 of backlog over a duration of multiple years. So while no one's immune, we are absolutely focused on monitoring the dynamic process. And I think back to Wamsi's question, we're prudently cautious around consulting for the year.

Speaker 3
39m 25s

Look, Jim, I think the best thing for you to understand, Amit, consulting is less federal consulting is less than 10% of consulting. I think that's statement number one. Within that, the vast majority is critical work. We actually process veterans benefit claims. We help process how the GSA does procurement. We help implement payroll systems. I don't think of these as optional. Now, are there some areas around the edges which could be viewed as discretionary? Yes. But in our case, that is the minority of our business, not the majority.

Speaker 2
40m 9s

Operator, let's take the next question.

Speaker 1
40m 12s

The next question comes from Ben Reitzis with Melius Research. Please state your question. Ben Reitzis, your line is open. Please unmute yourself.

Speaker 9
40m 27s

Yes, thanks. Sorry about that. If you can hear me now, I wanted to talk about the Red Hat business. It decelerated, I guess, hundred basis points sequentially. And I was wondering if we could just talk a little bit more about the dynamics, why that occurred? I think you said the consumption business didn't get hit. And then it looks like it's going to reaccelerate because of the great bookings. And then you mentioned virtualization. I don't know if you've mentioned that before in the conference calls, but wondering how much of a driver that is for Red Hat given some of the changes going on at VMware. So thanks a lot for that.

Speaker 4
41m 11s

Thanks, Ben. Let me take some of the numbers around Red Hat and then Arvind can add some of the color around the portfolio, etcetera. I would tell you we're very pleased with our Red Hat performance entering the year, very different profile than where we were a year ago by the way, when we were trying to accelerate to get the double digits for the year. Yes, it decelerated, but let me unpack some of this for you. One, we grew 13.5%. I think well within our guidance range of where we wanted to start the year. Underpinning that, the most important thing, as you called out, Ben, thank you. Our seventh consecutive quarter of strong ACV signings bookings, high teens overall. The way I like to look at this business, you got to break it out between the different compositions. 80% of our portfolio is subscription based businesses. We continue to see strong performance, high mid teens level overall. Pervasive double digit growth across the portfolio, as I stated earlier, and gaining share. RHEL up 13%. Red Hat OpenShift up 23%. Oh, by the way, 1,500,000,000.0 ARR business overall, capitalizing on virtualization, hybrid cloud application modernization, Ansible up strong mid teens overall, capitalizing on clients, cost efficiency, productivity agenda, and oh, by the way, very strong synergistic value of the IBM portfolio overall.

Speaker 4
42m 42s

So a very healthy profile and within that, as we always do, we give you a CRPO next six months. We only see that actually accelerating overall. Now to Arvind's earlier point to 20% of the business on consumption base, we did not see a decline. We saw a moderation. Remember ninety days ago, we actually were surprised to the upside. We grew our consumption based services low mid teens. In first quarter that moderated to high single digits. By the way, our model can take high single digits. It's just when you look at the quarter to quarter growth that had about a point and a half plus, you know, deceleration overall. But growing high single digits on consumption, given the acceleration of our Red Hat portfolio overall, we feel pretty good. And to your point, excited about the portfolio and growth prospects around the growth factor of virtualization, around AI, around automation, around containerization, and the moderations happening there. And just to put some numbers to it, you know, virtualization already, just the last couple quarters, we've already notched in over $200,000,000 of annualized bookings. And we've been building a pipeline that is well north of a half a billion dollars worth of virtualization.

Speaker 4
44m 7s

That gives us the confidence as we go through the remainder of 2025 and why we feel confident in guiding mid teens.

Speaker 3
44m 16s

Yes. So thanks, Shiv. Ben, let me just add a little bit of color on the portfolio. So OpenShift has become the leading platform, which clients were using for both containerization, but also how you run a collection of servers on premise and in private clouds. Now, as they look forward, it's not just containerization. They're saying, if I'm doing containerization, why wouldn't I also do virtualization on that environment? Since that set of products is sold by the number of cores or processes managed, then as they add virtualization, that adds to the footprint. Now, of course, as we all know, once they make a platform decision, then most new applications, most migrated applications tend to come on to that infrastructure. Their skills around that platform grow and you get a flywheel that over time, but then we believe include both HashiCorp and Ansible that will come in there. That is the way I think you should think about virtualization, not so much as vis a vis competitors only. It's going to be much more about a platform and people are making a decision, which platform can I depend upon for the next ten to twenty years?

Speaker 2
45m 29s

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

Speaker 1
45m 31s

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

Speaker 10
45m 38s

Hey, guys. Thanks so much for taking my question. Jim, I just want to dig into your free cash flow guide. Just you reiterated the full year revenue guide in constant currency, but FX just went from a two point headwind to a 1.25 tailwind. So an incremental, call it, 2,000,000,000 of rev from FX alone, you maintained your full year PTI margin expansion target. So obviously really strong flow through to the bottom line. And so I guess my question is why aren't we seeing that necessarily show up in a higher free cash flow guide for the year? Are we just being conservative because it's early in the year or are there any new kind of incremental free cash flow offsets that we now need to think about? Thanks so much.

Speaker 4
46m 24s

Yes, thanks Eric. I really appreciate the question. As we talk about, we've got two key measures in this company. One is to continue to accelerate the top line growth profile of this company, which we committed to 5% plus. And second is that free cash flow generation engine. We're very pleased about the start to the first quarter, '2 billion free cash flow print, highest free cash flow margin in a first quarter in the history of our company overall. And by the way, historically, compared to where we're at attainment wise, we're a few points ahead. Now to your point, we're 15% of our free cash flow attained through first quarter. You know, I think it's prudent for us right now. We feel even stronger about our position around the $13,500,000,000 but why take that up right now in this environment? It doesn't benefit us at all. We're focused on the durability, resiliency, and driving the disciplined execution overall. Now with regards to currency overall, as you know, we spent a lot of time both through the last recession of COVID about when we see fundamental unprecedented rate, magnitude and breadth changes in currency. It's always good to refresh our investors about how we handle currency.

Speaker 4
47m 47s

Number one, per gap, you can't hedge revenue. That revenue is going to flow whether the dollar is appreciating or devaluing. But I think a couple of important points overall. We have a very robust hedging program, but around that we hedge only cash flows as a proxy for earnings. That's all you can do. We don't hedge all a hundred plus currencies we operate in today. We only hedge about 30 because it's not economically viable to hedge more than 30. So when you take a look at it at today, we don't also hedge out more than 12 because we don't speculate. So when you look at it, the interesting thing is we have to overcome a operating pretax margin headwind when the dollar actually devalues because we have to wrap around on the hedges from last year, right? You'll get absolute profit dollars, yes, but it's mitigated because we try to hedge as much as we can in quarter, read that about 100%. In outer quarters, we hedge about 75%. So around that, do we have some tailwinds on free cash flow? Absolutely. But the most biggest driver of our free cash flow continues to be the same thing we talked about ninety days ago.

Speaker 4
49m 12s

The driver of high quality adjusted EBITDA, which by the way, we grew 12% in the first quarter, up two forty basis points of margin and adjusted EBITDA in the first quarter. Our free cash flow is going to be driven by double digit EBITDA for the year and it's going be driven by a hundred plus basis point margin overall. That hasn't changed. So nothing changed overall. I would say net more conservative, but prudently given we have 85% of our free cash flow to go.

Speaker 2
49m 45s

Operator, let's take the next question.

Speaker 1
49m 48s

The next question comes from Brian Essex with JPMorgan. Please state your question.

Speaker 10
49m 54s

Hi, good afternoon. Thank you for taking the question. Arvind, I know it's super early here with regard to the mainframe cycle. But given the experience that you have with previous cycles, what do you anticipate from a macro perspective on for an impact on the mainframe cycle? And would you consider taking on more balance sheet risk, maybe to ease the pain of any customer CapEx for that business this year?

Speaker 3
50m 20s

Okay. Brian, thanks for the question. Actually, last part of the question, Jim can add more, but it's actually pretty straightforward. We've been happy to lease our own hardware and software where our client wants it for decades. And so if they don't want to spend the CapEx, if they prefer to lease it, that is in our financing business, it's in the model and it is surprising on how many people, even those with great balance sheets of their own, often choose to do that in order to maximize it. It doesn't really impact our balance sheet because in that case, we have a receivable against the debt that we take on to do that. So we would happily do that for any credit worthy client. Let me just put that one caveat, that's it. And that is across all countries that we operate in. We don't do this only in The United States. Okay. The other part of your question, as you can imagine, we start testing very early with our clients, a good six to nine months in sort of more private confidential gatherings on what their reaction is going to be. Given what we showed them around security, around AI and around increased capacity, almost all of them resonated very positively to the mainframe.

Speaker 3
51m 36s

The ones I would expect to be early have already come and said to me that, yes, we are extremely interested. So I actually expect the volatility plays in our favor because those who are thinking about capacity expansion in the end of the year are wondering whether it's more advantageous to them to do it earlier because there is a financial benefit if you have it as opposed to pay for overage, which is certainly possible. I expect that through this year 2025 and the first half of twenty twenty six, it will be a very strong cycle. If we see any weakness at all compared to the previous cycle, just one is to one, maybe it'll be in late twenty twenty six or early twenty twenty seven, where some clients in smaller geographies, smaller countries may choose to say, should I wait another six months or nine months? I don't expect that, let me be clear. But I think that is the only caution I would put. So in the first year, I expect this to be very much like the previous cycle.

Speaker 4
52m 44s

Yes. And Brian, on your question on the balance sheet and capital structure, let me take it up a level. Yes, mainframe is an integral part of our business portfolio overall, and it is an enduring platform that we are going to ensure that we prudently, but aggressively manage both the client value equation, which is very important because remember, we run 45 of the top 50 banks around the world, nine of the top 10 retailers, four to five top 10 airlines of the world. We are gonna protect those clients and what the mainframe brings to the table. But I want to take a step back, you know, in we are confident in our capital structure overall and our liquidity position. And I think over the last four or five years, hopefully all our investors agree, we have a proven track record around being disciplined allocators of capital. We take that very seriously in this company overall. In times of uncertainty around dynamic macro environment, which is what we're operating in today in a very fluid environment, I would tell you as a CFO, as I tell Arvin all the time, our job is to preserve the balance sheet, is to make sure we have enough liquidity.

Speaker 4
54m 5s

Why? Because we have to continuously invest in bringing new innovation, both organically and inorganically, to this business to create long term sustainable competitive advantage. And I would tell you we are very comfortable. We have over $17,500,000,000 of cash on the balance sheet. We got a free cash flow engine. We just talked about what Eric's question, we feel very confident in $13,500,000,000 of free cash flow and we got the capital structure and it's solid investment grade that gives us optionality to ensure we continue that durability and resiliency of our performance going forward.

Speaker 2
54m 45s

Operator, let's take our next question.

Speaker 1
54m 48s

The next question comes from Matt Swanson with RBC Capital Markets. Please state your question.

Speaker 8
54m 56s

Thank you guys so much for taking my questions. Arvind, across 2024, every time we had new Gen AI product announcements, it was always really centered on this ROI focused approach, and that was in a much better macro. Now we're in a more challenging macro. I'm just interested, are you seeing in any spaces, whether it be through the consulting arm or just more customer interest in this ROI driven approach, whether it be the hybrid or the Gen AI and does that make your product set a bit more defensive?

Speaker 3
55m 29s

So Matt, thanks for that question. If you don't mind, I'm going to like go up a few feet and then come back to answer your question explicitly. Every time there's a new technology, you kind of see three waves. The first wave typically lasts one, two or three years, which is around the semiconductors that enable that new wave. Think PC and the microprocessor walls, think mobile phone and the hardware was. You then switch to the system. So pretty quickly, if I think about the PC, people stop caring about the microprocessor. Yes, it was Intel as the winner, but they cared about, I have a Bangor Compact or a Dell or an HP or take your favorite pick of PC. You go to the system. That kind of lasts a year or two. And then you get a long tail of twenty years where people worry about the application because that is what gives them value. I think we're exactly at that point in AI. So the client conversations have shifted from, well, which GPU, which cloud, which model, I think of that all as the lower two layers too. Is this going to improve customer experience?

Speaker 3
56m 39s

Is this going to improve enterprise operations? And I'll reflect on one yesterday from a mid sized client. They are 9,000,000,000 client. They're not a massive, so I'll call them mid sized. And their question was, if we believe that we can get 30% savings in our back office finance process and they meant procurement and payments and receivables, we're all in. So I think it is right at this moment, it is shifting to those conversations. And I believe that that is where the next two to three years of success in AI is going to go.

Speaker 2
57m 14s

Operator, let's take one last question.

Speaker 1
57m 18s

Thank you. And this question comes from Param Singh with Oppenheimer and Company. Please state your question. Param Singh, your line is open. Please unmute yourself. No response from that caller.

Speaker 2
57m 46s

I think we can end. Let me turn it back to Arvind to close.

Speaker 3
57m 49s

Thank you, Olympia. Look, as I mentioned earlier, the diversity across our business positions us well to navigate the current climate. Our portfolio and track record of execution reinforce my confidence on this next chapter of our growth. I look forward to sharing our progress as we move through the rest of the year. Thank you all for listening.

Speaker 2
58m 12s

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

Speaker 1
58m 17s

Thank you for participating on today's call. The conference has now ended. You may disconnect at this time.