International Business Machines Corp. (IBM) Management Discusses Q2 2013 Results - Earnings Call Transcript

Executives

Patricia Murphy - Vice President of Investor Relations for IBM

Mark Loughridge - Senior Vice President, Chief Financial Officer - Finance and Enterprise Transformation

Analysts

Ben Reitzes - Barclays

Toni Sacconaghi - Sanford Bernstein

Steven Milunovich - UBS Securities

Scott Craig - Bank of America-Merrill Lynch

Chris Whitmore - Deutsche Bank

Jim Suva - Citi

Bill Shope - Goldman Sachs

Katy Huberty - Morgan Stanley

Mark Moskowitz - JPMC

Brian White - Topeka

David Grossman - Stifel Nicholas

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Operator

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 Ms. Patricia Murphy, Vice President of Investor Relations. Ma'am, you may begin.

Patricia Murphy

Thank you. This is Patricia Murphy, Vice President and Investor Relations for IBM. I am here with Mark Loughridge, IBM's Senior Vice President and CFO, Finance and Enterprise Transformation.

Thank you for joining our second quarter earnings presentation. The prepared remarks will be available in roughly an hour and a replay of this webcast will be posted to our Investor Relations website by this time tomorrow.

Our presentation includes certain non-GAAP financial measures in an effort to provide additional information to investors. All non-GAAP measures have been reconciled to the related GAAP measures in accordance with SEC rules. You will find reconciliation charts at the end and in the Form 8-K submitted to the SEC.

Let me remind you that certain comments made in this presentation may be characterized as forward-looking under the Private Securities Litigation Reform Act of 1995. Those statements involve a number of factors that could cause actual results to differ materially. Additional information concerning these factors is contained in the company's filings with the SEC. Copies are available from the SEC, from the IBM website, or from us in Investor Relations.

Now, I'll turn the call over to Mark Loughridge.

Mark Loughridge

Thank you for joining us today. In the second quarter, we reported revenue of $24.9 billion and operating earnings per share of $3.22. Our EPS includes $1 billion charge for workforce rebalancing. Excluding workforce rebalancing activity in both years, our operating EPS was $3.91, up 8% year-to-year. We had good performance in our high-value, higher-margin businesses, contributing to sequential improvement in our year-to-year revenue performance and to margin expansion.

Software return to mid-single-digit growth, in fact this was the best constant currency software growth since the first quarter of 2012. Performance was led by 10% growth at constant currency and our key branded middleware and we gained share in all five brands.

In services, GBS improved revenue performance and returned to growth at constant currency, while GTS revenue growth was consistent with last quarter. With a significant amount of new business in the quarter, our total services backlog was up 7% at constant currency, or 3% at spot rates to $141 billion.

Our hardware performance was mixed. We had strong performance in system, the mainframe, which generated double-digit revenue growth at constant currency. Power and storage had a modest improvement in year-to-year performance though still declined.

Across our segments, Smarter Planet was up over 25% and cloud over 70% for the first half. Business Analytics growth improved this quarter to 11% with good performance across GBS and software. These initiatives address key market trends, like mobile, social and big data.

From a geographic perspective, our growth markets performance was consistent with first quarter at 1% constant currency growth. Major markets declined year-to-year, though improved from last quarter's rate. Overall, we improved our performance in several areas of the business this quarter and our first half operating EPS is nearly flat and that's after fully absorbing the $1 billion workforce rebalancing charge. This puts us on a good footing as we entered the second half.

So, let me spend a minute on our view of the full year. 90 days ago, when we made our first quarter earnings announcement, we said that on an all-in basis, we expected at least $16.70 of operating EPS for the full year, we also said that excluding the second quarter workforce rebalancing charge and second-half gains, we felt confident that we could achieve at least $16.70 of EPS for the year. As you will see, we are taking this view of our business up $0.20. So, let me update this statement for new information.

First of all, the substantial second-half gain that we were counting on in our all-in view of EPS, will not likely close by the end of this year, but we are still in active discussions. As you know, we have a very disciplined M&A a process. We're not going to under price our Russia divestiture simply to close within 2013.

Consequently, we need to fully absorb the workforce rebalancing charge in the all-in view without offset from this gain. The value of this charge is roughly $0.65. Based on our performance in the second quarter, our solid prospects for growth initiatives, tough decisions on spend management and potential tax settlements were increasing our full year view of operating EPS, excluding the second quarter workforce rebalancing charge by $0.20 to at least $16.90, and I think this is a pretty positive statement given the currencies have moved significantly against us in the last couple of weeks, especially in those that are largely unhedged such as the yen and emerging market currencies.

With that we have updated our all-in view of the year to at least $15.25, with a net impact of $0.45 driven by the elongated discussion for a larger divestiture project. We are driving to our objective of at least $20 in 2015 on an all-in basis. And in our current view, we will establish our 2014 trajectory off the 2013 base of $16.90. In other words, we will position the all-in view as if we closed the divestiture transaction to establish our future trajectory, since fundamentally whether we close the large divestiture this year or not will not have any effect on our ability to achieve our 2015 objective of at least $20 per share on an all-in basis.

So, now, turning back to the second quarter, I will walk through the financial metrics. Our revenue growth, at constant currency, was down 1%. This is a two point improvement from the first quarter rate, driven by services, software and hardware. We entered the quarter with a modest currency headwind but it became more pronounced with the strengthening of the dollar. When you look at the recorded revenue for the quarter, currency impacted our revenue growth by two points. In the current spot rate, this increases to a three point impact in the second half.

Turning to profit metrics. We expanded operating gross margin nearly a 1.5 point, led by services and mix to more profitable segments. The $1 billion workforce rebalancing charge impacts our PTI and net income dynamics. Excluding the workforce rebalancing activity in both years for comparison purposes, our operating PTI was flat year-to-year with margin up 0.8 point. Now within this profit performance, we absorbed a significant impact from currency movements.

This as a greater impact was when the Yen devalued sharply because of the limited cross-border cash flow that we can hedge. At current spot rates, the currency impact will continue. IBM's tax rate in the quarter includes a discrete benefit associated with that tax ruling received this quarter. So our operating net income, excluding the impact of the workforce rebalancing activity, was up 3% with margin expansion of 1.1 points.

With over $12 billion in gross share repurchase over the last 12 months, we reduced our share count by 4%. When you look at the major year-to-year drivers of our second quarter operating EPS performance, the 3% decline in revenue at constant margin impacted our earnings growth by $0.12. The contribution from margin, excluding this year's charge, was $0.24 but this was more than offset by $0.59 year-to-year impact from higher workforce rebalancing charges. The lower share count contributed an additional $0.18. So, operating EPS of $3.22 was down 8%. You can see the operating EPS, excluding workforce rebalancing, is $3.91, which is up 8% year-to-year on a comparable basis.

Now, I will get into the results. Starting with revenue by geography on a constant currency basis. America's revenue was down 3% with declines in both the U.S. and Canada, though both improved the growth rate slightly from last quarter. But once again we had really strong performance in Latin America, led by Brazil. Our EMEA revenue was down 1%. That's three points better than our growth rate in the first quarter. We had improvement in the growth rate of several of the major countries. UK and Spain not only improved but grew in the quarter. In Asia-Pacific, revenue was flat. Within that, Japan's revenue was up 3% with good performance across hardware, software and services. This is the third consecutive quarter of revenue growth. So clearly the team in Japan has done a great job to return the business to growth. Growth markets revenue was up 1%. In the first half, we have had strength in Latin America and the Middle East and Africa region but declined in some of our larger markets like China and Australia have impacted the overall performance.

Turning to revenue by segment. Year-to-year constant currency revenue performance in our combined services business improved from the first quarter. At constant currency, GBS performance improved a couple of points led by consulting and systems integration, while GTS revenue growth was unchanged. In software, we had broad-based strength across our strategic brands led by our offerings in smarter commerce, social business, security and storage management.

In systems and technology, we had good performance in System Z mainframe, while we had some improvements in Power and Storage, they continue to decline. Looking at our gross profit, our operating gross profit margin improved almost 1.5, driven by a combination of good margin expansion in Services and Software and improving segment mix.

Now, let us take a look at our expense profile. Our total operating expense and other income was up 11%, or down 1% excluding the year-to-year impact of workforce rebalancing charges, so well managed on an operating view.

Acquisitions over the last 12 months drove 1 point of expense growth. Currency contributed a point of expense decline, driven almost entirely by translation. Consequently, our base expense excluding currency and acquisitions was better by 2 points excluding the charges.

The workforce rebalancing is the one item in expense that had significant year-to-year impact to our profit. This year's charge was about $1 billion, in line with what we told you back in April. This compares to last year's rebalancing charge of about $150 million, so about $850 million impact to profit year-to-year. We will see some of the benefits from the rebalancing activity in the second half.

Now, I want to comment on the impact of currency this quarter. In the second quarter, the hedge activity was fairly neutral year-to-year with modest gains in both periods. The dollar strengthened against many currencies, but we were significantly impacted by the depreciation of the yen.

Because our business in Japan is more heavily skewed to local services, we have less ability to hedge cross-border cash flows as compared to most other countries. I mentioned this last quarter, but the year-to-year profit impact was much larger in the second quarter. This would continue at current spot rates through the rest of the year. We saw a similar trend in the growth market currencies.

So, now let me go into the segments. This quarter, the two services segments generated $14 billion in revenue. Pre-tax profit was down 17%, reflecting the impact of the workforce rebalancing charge. Excluding workforce rebalancing in both years, profit was up 2% and pre-tax margin expanded just over a point.

Total backlog was $141 billion, up 3% of spot rates, but up 7% of constant currency. Backlog again grew in both, the transactional and outsourcing businesses. And, in fact, we had the best growth of our book of business at constant currency in four years. Within that, both major markets and growth markets grew backlog this quarter and our major markets accelerated the growth at constant currency from last quarter. We had 15 deals over $100 million including a megadeal in Europe.

Turning to the two segments, Global Technology Services revenue was $9.5 billion, down 5%, or down 2% at constant currency. Our outsourcing business was down 3% at constant currency with the bulk of this decline, driven by previous actions to restructure lower margin contracts. While this impacted revenue, it raised the profitability of the outsourcing portfolio, will wrap on the year-to-year dynamics in the second half though the business will continue to operate at this higher profit base.

For the quarter, we estimate the impact to revenue to be about 1.5 to GTS and a point to services in total. In Integrated Technology Services, revenue was up 1% at constant currency, led by Japan with its third consecutive quarter of double-digit growth.

Last week, we close the acquisition of SoftLayer Technologies, the world's largest privately held cloud computing infrastructure provider. As businesses add public cloud capabilities to their on-premise IT systems, they need enterprise grade reliability security management. IBM has built a portfolio of high-value private, public and hybrid cloud offerings.

With SoftLayer, IBM will accelerate the build out of our public cloud infrastructure to give clients the broadest choice of cloud offerings to drive business innovation. This quarter, GTS pre-tax profit decline, but adjusting for the workforce rebalancing activity, profit was up 3% and pre-tax margin was higher year-to-year by 1.3 points on this basis, margin expansion reflects improved efficiency and productivity as well as tough minded spend actions.

Turning to Global Business Services, revenue was $4.6 billion, down 1% as reported and up 2% at constant currency. This represents an improvement of two points at constant currency from last quarter's year-to-year rate. From a geographic perspective, North America led the improvement and was up mid single-digit. Growth markets in Japan continued to drive solid performance and Europe slowed its rate of decline versus last quarter.

Looking at the GBS business by or two major categories, we had good result across the portfolio. Within the digital front office, we again delivered double-digit growth across the initiatives, Business Analytics, Smarter Planet and cloud. Within our back-office solutions that we call the globally integrated enterprise, we returned to growth in implementation services that support the traditional packaged applications. Turning to profit. Adjusting for workforce rebalancing activity, GBS profit grew 2% year-to-year and PTI margin expanded by 0.5 point.

So to wrap up services, growth initiatives continued to perform well and we are investing to accelerate our transformation. We have made good progress in transition areas like traditional packaged application implementations and have largely wrapped on the outsourcing contract restructuring. We are entering the second half with the strongest backlog growth at constant currency in years.

Software revenue of $6.4 billion was up 4% year-to-year or 5% at constant currency. Software PTI was down 2% year-to-year or on an adjusted basis was up 6% to $2.7 billion. Key branded middleware, which was over two thirds of total software revenue grew 9% or 10% at constant currency. Each of the five key brands gained share in second quarter. Four of the five grew double digits at constant currency. We built a portfolio of solutions that target the faster growing segments of the market including mobile, social and security. Differentiated by advanced analytics these solutions provide value to a new set of IT buyers in the front office and many these are delivered through our SaaS offerings, which were up over 50% this quarter.

Now, let me take you through the key brands. WebSphere grew 10% at constant currency. Within WebSphere, the key contributors, Smarter Commerce and mobile, grew double digits. IBM Smarter Commerce initiative helps our clients transform their business processes to rapidly respond to shifting customer demands in today's digitally transformed marketplace. Our mobile portfolio led by MobileFirst combines security, analytics and apps development software to manage clients' mobile infrastructure regardless of device. Information management software grew 6% at constant currency. Analytics runs through our portfolio of solutions, enabling clients to develop and execute a big data strategy that connects their existing business data to new data sources delivering business insights in real-time.

Tivoli software was up 14% at constant currency with growth in each of the three key business areas. Our security business had a great quarter with growth of 20% at constant currency. In the age of mobile access, [AUDIO GAP] sturdy intelligence is critical for safeguarding data, transactions and everyday business operations. Within Tivoli, storage was up 17% at constant currency. Storage software delivered its 10th consecutive quarter of double-digit growth.

Social workforce solutions grew 23% at constant currency, driven by the recent acquisition of Kenexa and our existing smarter workforce offerings. In the second quarter, IBM was ranked number one in enterprise social software for the fourth consecutive year by IDC. Across the board, software had a good quarter with solid top line performance [AUDIO GAP], 12% year-to-year or 7% at constant currency, adjusting for the divestiture of retail store solutions.

System Z grew 11% at constant currency. MIPS were up 23% year-to-year and we continue to have more than half of this MIPS from specialty engines which were up double-digits. Last week, we announced an agreement to acquire CSL International, which expands System Z's cloud capabilities, including simplified management of virtualized Linux on Z. In PureSystems, we have now sold over 6,000 systems in over 100 countries in the five quarters since announced.

While Power revenue was down 24% at constant currency, this does represent a 7-point improvement from last quarter's rate. Power continue to outperform the UNIX competition and gained share again this quarter and we continue expand our power platform to go after the Linux opportunity. We expect a sequential improvement in Power will continue in the second half as adoption of our new POWER7 plus products continues.

System x was down 10% at constant currency. Storage hardware revenue was down 6% at constant currency, but flat including storage software, which is reported in Tivoli. Strong double-digit growth in our mid-range Storwize product was offset by declines in our legacy OEM mid-range offerings and softness in the high-end. Our/products offerings contributed 2 points of year-to-year growth to total storage. Systems and Technology returned to profitability in the second quarter, excluding workforce rebalancing charges, and we expect to remain profitable for the full year.

Moving onto cash flow in the quarter, we generated $2.7 billion of free cash flow, down about $1 billion year-to-year. Through the first half, our free cash flow of $4.4 billion was down about the same. The first half year-to-year performance was impacted by a significant increase in cash taxes and lower accounts receivable collections. This was mitigated by year-to-year benefit from our capital expenditures and the benefit associated with the timing change of funding our 401(k).

Looking at the uses of cash in the first half, we acquired three smaller companies, StoredIQ, Star Analytics and UrbanCode. In the first week of July, we closed the larger SoftLayer acquisitions. We returned just over $8 billion to shareholders. Of that, $6.1 billion was in share repurchases, and at the end of June, we had $7.7 billion remaining in our buyback authorization. We took our dividend up 12% in April and through June we paid out $2 billion. This is the 18^{th} consecutive year that we raised our dividend and the 10^{th} year in a row of double-digit increases.

Turning to the balance sheet, we ended the quarter with a cash balance of $10.4 billion. Total debt was $34.1 billion, of which nearly $25 billion was in support of our financing business which is leveraged at a ratio of 7.21.

Our non-financing debt was $9.3 billion and our non-financing debt to cap was 39%. We continue to have a high degree of financial flexibility and our balance sheet remains strong to support the business over the long-term.

So, let me wrap up the quarter. We had good performance in our higher margin businesses, like Software and Systems z mainframe and we had continued strong performance in our growth initiatives of Smarter Planet, Business Analytics and Cloud. We returned to growth in Global Business Services, led by consulting and systems integration. And for total services, we had the strongest backlog growth at constant currency in years.

At the same time, we took actions to better position our business for the future. We rebalance the workforce to align resources to the best opportunities and we announced and recently close the acquisition of SoftLayer to enhance our capabilities in cloud.

As we move into the second half, we expect to continue our progress in areas like Analytics and Cloud and Smarter Planet, leverage the benefits from our workforce rebalancing activity, capture additional opportunities in cost and expense through net income. And, of course, continue to return value to shareholders.

At the same time, we are dealing with a more challenging currency environment. Taking all of this into consideration we are increasing our full year view of operating EPS, excluding the $1 billion workforce rebalancing charge to at least $16.90. This is the $0.20 increase from our previous view. Because, we are no longer counting on a gain from a large divestiture in the second half, our all-in view of operating EPS is now at least $16.25. All of this is consistent with our objective to achieve at least $20 of operating EPS in 2015.

Now, Patricia and I will take your questions.

Patricia Murphy

Thank you, Mark. Before we begin the Q&A, I would like to remind you of a couple of items. First, as always, we have supplemental charts at the end of the deck that complement our prepared remarks. Second, I would ask you refrain from multipart questions. When we conclude the Q&A, I will turn the call back to Mark for final comments.

Operator, please open it up for questions.

Question-and-Answer Session

Operator

Thank you. At this time, we would like to begin the question-and-answer session of the conference. (Operator Instructions). The first question comes from Ben Reitzes with Barclays. You may ask your question.

Ben Reitzes - Barclays

Mark, what gives you confidence in the second half. It would seem that basically without the benefit of the tax rate, the operational increase is really $0.5 or so from what you thought previously. I just wanted to also be clear on that. What gives you confidence that you can hit those numbers? Perhaps there is specifics around how the charge closed through in terms of cost saves and then what segments could possibly grow? Where do you seem some leverage? Thanks a lot.

Mark Loughridge

Okay, Ben. A very good question. Maybe the best way for me to answer that is to take a look at a headwinds, tailwind basis. So if you look at the second half of the year, obviously, we have a headwind on currency and more specifically, within that, the Yen. We pointed it out in the attached ones that even though currency was impact of 2% in the first half, we see about 3% in the second half.

Our hardware business has been an impact. It was in the first half of the year and we are obviously dependent on the Asian GMU economy which have been challenging in the first half. But I will tell you, as we look at the second half, we have some very, very distinct tailwinds that we have driven to drive our performance.

So, first of all, software pipeline, we have got a very good software pipeline going into the second half of the year and if you look at that software performance in the second quarter, boy, they really hit the ball. So, not only did software grow the total by 5% but that key branded middleware was up 10% and we gained share in every single one of the sub brands in that software business. So we see real momentum going from that second quarter into the second half of the year.

Secondly, very, very important. We have services backlog growth on a constant currency basis up 7%. That is the best backlog growth positioning we have had in four years going into the second half, 3% at actual but that 7% at constant currency, the best we have seen in four years.

Now against that, in the second quarter, break it down by service lines, GBS returned to growth in the second quarter. They should further profit on that improvement in the interim backlog and I would expect GBS to be firmly in that mid-single-digit revenue growth in the third quarter.

Likewise on our GTS business. GTS was down in the second quarter about 2% but they had about a 1.5 point impact from those restructured contracts last year that we spent a lot of time talking about in the last year's earnings call. So if you adjust for that, they came very close to a neutral performance in the second quarter. With that, I would expect GTS to return to low single-digit revenue growth in the third quarter as well.

So now we have had good performance, a flow-through to second half from our software business, better performance from our GTS and GBS businesses driving performance, our workforce rebalancing yield. We did a great job closing that right on the $1 billion that we had advised we you we would as we close the first quarter. That will begin the yield in the third quarter of the year and will get a full quarter's benefit in the fourth quarter and I think that is quite significant.

I clearly alluded to the potential tax settlement that we would see being a positive impact in our fourth quarter. But along with that, we have had real strength in our growth initiatives. Cloud, through the first half of the year, up very, very strong. We had very good positioning on our Business Analytics in the second quarter, up 11%. Strong performance in our Smarter Planet content and we have taken a very tough position on spending.

So you put all that together, I think we have the ingredients for that second half of year and with base of all of that, in aggregate, they gave us the confidence along with the second quarter performance to drive that additional $0.20 to $16.90 excluding the second quarter workforce rebalancing charge.

Patricia Murphy

Thanks, Ben. Can we go to the next question, please?

Operator

The next question comes from Toni Sacconaghi with Sanford Bernstein. You may ask your question.

Toni Sacconaghi - Sanford Bernstein

Historically, you have provided EPS guidance, including all rebalancing charges and any one-time gains whether it'd be from IP or from dispositions. I am hoping you can clarify, because it's a little nebulous about whether you are changing your guidance definition of operating earnings or not.

So, the traditional metric of operating earnings would include the rebalancing charge in there and then guidance would be $16.25 at least for the year. Is that what we should be putting our models, or are you changing the definition and saying what we are going to exclude these kinds of charges this year and on a go forward basis and $16.90 should be what analyst put in your model, so if you could address that and I would also like to understand to the degree that what checks and balances to the degree that you may continue to include them, but not match them in a given quarter what checks and balances are there going to be offsetting that gains and charges are ultimately offsetting as they have been historically.

Mark Loughridge

Okay. Very good question, Toni. First of all I want to be very, very clear that when we attach our objective for 2015 of $20, that at least $20 is on an all-in basis, and I think in this earnings announcement, I hope to be very clear on the basis for performance in the year. So, if you look at the performance that we would view for the year, we've been clear on the all-in basis and we've also been clear excluding the gains and charge.

Now, let me provide some distinctions on that base and why I think both of those are very important. First of all, on all-in basis, we had said that that second fourth quarter workforce rebalancing charge would be offset by a future divestiture gains. And, frankly, as we look at it now, we are in active discussions, but very likely on a timeline basis it's been likely that simply closes in 2013, so that would impact that original view of our business on all-in basis of at least $16.70 by $0.65, and then you would add the improvement of $0.20 to that. That gives us $16.25, but I won't say that on the other view of our business excluding gains and charges, that now would be $16.90, and I am reassuring you and the investors that that $16.90 that we will be using of our starting point to set our objectives for 2014 on all-in basis in 2015 on all-in basis.

So in other words, as if we have closed the divestiture. Now, why do I think that's important? I think that's important because whether we close that divestiture this year or not, would not impact that operational performance exactly as always fund it in 2014 and 2015. Number two, I wanted to be very clear to investors that when we start the positions that trajectory for performance going from 13 to 14 to 15, that number start to $16.90 Not $16.25. So, from my perspective the view of our business is best established the trajectory we are on going from 13 to 14 to 15 is an end state of $16.90 increased by $0.20 from our results $16.70 view of the business given that the large divestiture has moved out of the year we would assess the all-in at $16.25, but you know we are certainly working on other divestiture content in that we will be adding back for our basis as well. But, to reiterate, assessing this trajectory for this year, I think is best evaluated, excluding the second quarter charge and $16.90 that will now be the basis for establishing that trajectory for 2014 and 2015, and achieving our objective of at least $20 in 2015 on all-in basis.

Patricia Murphy

We'll go to the next question, please?

Operator

The next question comes from Steve Milunovich with UBS. You may ask your question.

Patricia Murphy

Steve, do you have it on mute? We can't hear if you are speaking.

Operator

Please don't push any buttons.

Steven Milunovich - UBS Securities

Can you hear me now?

Patricia Murphy

Yes, we can now. Now you could start.

Mark Loughridge

Steve, are you there?

Operator

The next question comes from Scott Craig with Bank of America-Merrill Lynch. You may ask your question.

Scott Craig - Bank of America-Merrill Lynch

Mark, can you maybe elaborate a little bit more on the services business as far as the impacts that you see going forward in renegotiating contracts or maybe even exiting some of the contracts and some of the impact on the profitability that we should see as you move forward? You mentioned in your prepared remarks that you start to run into the comp issue where you are sort of getting beyond all that in the back part of the year but I am just curious as to how you see impact of that playing out have for the rest of the year? Thanks.

Mark Loughridge

Well, I think on that view of the business on our contract negotiations with customers, the biggest reference point is really those restructured contracts that we drove in 2012 and as I said for GTS, that was an impact of about 1.5 point to their growth rate. So outside of that, it would have been down about 0.5 point and now with the improved backlog performance and starting forward, going into the third quarter, we would expect that our GTS business should be returning to growth in third quarter in low single-digit. So if you are looking at the impact of those restructured businesses on our year-to-year growth with this year, by the third quarter it is less than a point and it is fully wrapped by the time we get to the fourth quarter.

So the really strong signings performance we have seen from our two services business and the positive impact that tailed on come backlog, now as I said earlier, up 7% on a constant currency basis, 3% at actual should give them a very good starting point as we go in the third quarter and that restructured contract impact on growth rates should start to ameliorate in third quarter and fully wrap in the fourth.

Patricia Murphy

Thanks, Scott. Can we go to the next question, please?

Operator

The next question please next question comes from Chris Whitmore with Deutsche Bank. You may ask your question.

Chris Whitmore - Deutsche Bank

Thanks very much. Mark, I was curious to get an update on the $400 million worth of mainframe and software deals out of Q1. Did those in Q2? Just looking at some simple math, assuming half of those deals did close in the software business in Q2 or signed the software it implies the underlying demand and growth of software really wasn't all that robust. It was pretty tepid. Maybe flat to up 1% or so. So can you comment on how those deals closed and what the underlying demand looks for your software products, excluding the timing of those deals? Thanks a lot.

Mark Loughridge

Yes, very, very good questions. So if you look at those rollover deals that we had as we exited the first quarter, they frankly distributed across the months within the quarter on a typical rollover basis and we closed a little less than half of them, which is also a typical closure rate. Though it really did not provide within the quarter a spike, if you will, and assume a normal profile for rollover deals they went through the quarter.

Now, as you look at it going into the third quarter, especially within that software business, which has very high margin content for us, we actually have even more rollover content going for software business from the second quarter to the third quarter and if you just looked at the firm pipeline that we have had for the third quarter compared to the second, we are actually in a little better shape going into the third than we were not even in the second. So I think that the performance that we saw out of software in the second quarter is a good indication of the kind of performance we had achieved from our software business going into the third quarter and I think that when you look at the mainframe business that we also had a very strong performance in the quarter. We should expect another double-digit quarter from mainframe in the third as well.

Patricia Murphy

Thanks, Chris. Can we go to the next question, please?

Operator

The question comes from Jim Suva with Citi. You may ask your question.

Jim Suva - Citi

Thank you, Mark. Congratulations to you and your team at IBM. I know this is just one metric, but when you look at the signings number, which was quite strong, healthy of 16.4 and last quarter was 16.9, I mean very, very strong there. Shouldn't that equate to some pretty neutral revenue growth for IBM? And, if so, am I missing something about others some larger contracts that are and how should we think about multiple quarters of back-to-back strength you've had in that metric that we use along with others? Thank you.

Mark Loughridge

Well very good question. We look at the services content. The great thing about our Services business is you sign those contracts that give you a lift and it give you lift over many, many years, right? So, an advantage, I think, that we built into our business equation is at long string annuity content services base of business, so you are not so dependent on the volatility that transactional business.

So, when you look at that that improvement in backlog entering a given quarter that is distributed over a number of years, but you started to see the impact and the benefit of that even in the second quarter. So, again, I would reiterate in the second quarter our GBS business returned to growth. As we look at the additional backlog, performance we have going into the third [now] be back to mid single-digit growth.

Our GTS business was impacted by the restructured contracts in the rearview mirror, but adjusting for that we think they were very close to kind of flat performance on an unadjusted basis, so that gives us confidence going into third quarter that our GTS business should also returned to growth in low single-digit.

Now we did sign in the second quarter 15 deals over $100 million and we signed a multi billion-dollar mega outsourcing deal in Europe. Now, the European deal is a very interesting one in itself, because IBM for this customer will transform the underlying technology including new analytics and cloud models enabling business innovation for the client, so this is great example of how the outsourcing business is evolving as clients look to IBM for supporting leveraging new technologies such as cloud.

So, as you pointed out two quarters is a very good signings performance as we have always said (Inaudible) you got to be in the backlog ensuring that the backlog did show up as we enter the second half and we are going to see that revenue impact as we start to move that equation north with positive revenue performance from GTS low single-digit and mid single-digit revenue performance in GBS.

Operator

The next question comes from Bill Shope with Goldman Sachs. You may ask your question.

Bill Shope - Goldman Sachs

Thanks. I hate to ask the tax rate question, but I really want to try and understand the guidance best I can. Mark, you had mentioned that you had a tax benefit as well coming in the second half is that additional to the tax benefit you had this quarter? I believe your guidance before was a pointing towards roughly at 25% rate and that's within most models, so how do we think about the tax rate in the second half relative to that and how that drives the earnings guidance for full-year?

Mark Loughridge

Okay. So, I would you look at our book's tax rate in 2013 to be in the range of 25%, excluding into discrete tax benefit charges. Now, we did get a tax benefit in the second quarter that we recognize which relatively improved that rate. And, if you look at a forward-looking basis, regarding tax settlement we do have a number of audits and disputes around the world including the 2008 to 2010 U.S. federal tax audit. We expect to conclude some of these audits and disputes later this year that could results in a favorable settlements in the fourth quarter.

Operator

The next question comes from Katy Huberty with Morgan Stanley. You may ask your question.

Katy Huberty - Morgan Stanley

Yes. Thanks, Mark. Given the cash flow was down considerably in the first half of the year, can you do a similar walk through of the headwinds and tailwinds you see that could help improve cash flow and also talk about whether the weaker cash generation impacts your flexibility to step up buybacks and make acquisitions to help hit the $20 2015 target if needed?

Mark Loughridge

Okay, when you look at the first half of 2013, our cash flow was down $1.1 billion. Now within that decline we did a substantial increase in our cash tax payments of $700 million. In addition, we had a deterioration of our accounts receivable days outstanding by over a day and a half and that comes at a metric of about $250 million per day. So we should have done better there and we certainly could have done better in our profit performance from the business.

Now if you look on a forward-looking basis, I fully expect that we will improve on that receivables equation and pull that cash back into the business and we should have better profitability from unit performances going to the second half as well, but I got to say that on a full-year basis, we do have a cash tax headwind of $2 billion and I don’t think we are going to overcome that on a year-to-year basis.

Now, even with that positioning, however, I feel very confident in the overall positioning for the roadmap of $50 billion in share repurchase, $20 billion in dividends and the opportunity for $20 billion in overall acquisitions. If you gauged our performance against those metrics, given this kind of a half point of the model, you know we have done $33 billion in share repurchase of the $50 billion, we have done $6 billion of the $20 billion in overall acquisitions, $9 billion of the $20 billion in dividends which puts us just reasonably ahead of pace.

So, I think we are in good position there. We do have a cash tax headwind this year but I do not think it’s going to impact our ability to complete the expenditures on share repurchase, acquisitions and dividends through 2015 roadmap.

Patricia Murphy

Thank you, Katy. Can we go to the next question, please?

Operator

The next question comes from Mark Moskowitz with JPMC. You may ask your question.

Mark Moskowitz - JPMC

Just in terms with all-in EPS is in terms of what it was historically and what you are you going to do going forward? Maybe you can help us out one piece. Can you try and quantify, Mark, what the quarterly EPS benefits in the fourth quarter is going to be due to the workforce restructuring?

Mark Loughridge

Well, if you look at the workforce restructuring, let me give you a little color behind that. Now if you look at the workforce rebalancing, as we pointed out, that concluded at about $1 billion. In that $1 billion, the vast majority of that is spent overseas, outside the U.S. that has longer paybacks. Now from a business unit standpoint, you can see that in the math that we have provided to you, about $600 million of that would be benefiting the services business and about $200 million each for the hardware and software businesses. That will distribute across the third quarter and fourth-quarter as well as the first two quarters of 2014.

Now, given that it has generally world trade driven, we are not going to payback that $1 billion in the year, but we will see the first increment of contribution from it in the third quarter and we are going to see a full quarter of contribution in the fourth quarter of this year and then ongoing contribution in the first and second quarters of 2014.

Patricia Murphy

Thanks, Mark. Can we go to the next question, please?

Operator

The next question comes from Brian White with Topeka. You may ask your question.

Brian White - Topeka

Mark, I want to get a big picture view of what you are seeing on the IT spending landscape. So it is obviously a little light, did well on margins, but just what are customers spending on now and how are they feeling about spending in the second half of the year? Thanks.

Mark Loughridge

Yes, I think if you look at overall spending, let's look at it from a couple of perspectives. First of all, just based on the dynamics we see in our business, the major markets' performance actually improved for IBM in the second quarter compared to the first quarter by about two points. Within that, as I had said earlier, Japan did a great job in this but I thought Europe as well did a pretty good job in a different environment but we do see, when you look at the growth market business, they are moving more from infrastructure-based offerings to offerings with real solutions capability like Business Analytics and Smarter Planet capabilities as they improve performance.

So, as we see that spending profile and as it exhibits itself for IBM, we see improved prospects for our services revenue base as we go into the third quarter. Ongoing strength in our software base. We do think that hardware will still be a challenging equation, but it certainly will be a mix of demand patterns mapped to our capabilities to support our objectives for the third and fourth quarter and right now we would look at the third quarter that analyst models are reasonable and we see higher double-digit performance in the fourth on our way to achieve that $16.90, at least for the year, excluding the second quarter workforce rebalancing charge.

Patricia Murphy

Thanks, Brian. Operator, can we take one last question please?

Operator

Your last question comes from David Grossman with Stifel Nicholas. You may ask your question.

David Grossman - Stifel Nicholas

In the GMUs and the corresponding impact on the three different business.

Patricia Murphy

I am sorry David, can I ask that you start again we missed the beginning of the question.

David Grossman - Stifel Nicholas

Sure. I was wondering if you could just expand on the last question a little bit and help us understand the relationship between the growth and weakness from the various GMUs and the corresponding impact on the growth of the three business units as we go through the second half of the year and into 2014?

Mark Loughridge

Yes. Absolutely. So, if you look at our GMU performance in the second quarter did prove to be more challenging. Again, 1% growth in the second quarter as we saw in the first quarter, but underneath it was mix. So, we actually had very strong performance, I think in Latin America up 12%. And, within Latin America. Brazil was up 15%, so the whole Latin America content, I would count as a real plus for us. Middle East, Africa likewise we had 11% growth, so good performance there as well.

The areas that we had more difficulty in our growth markets, frankly, can be I think best attributed to kind of three large countries China, Australia and Russia, and they account for about 40% of the GMU base of business without those three countries GMU frankly would have been up 7% now. Within those three countries, I would tell you that China and Russia who are both, down in the second quarter '13 had a very, very big, comp to overcome. Last year China achieved 24% growth in the second quarter of 2012 and Russia had 39% growth in the second quarter 2012, so very good big compares now.

That said, we will remain cautious as we go into the second half of year in GMU, so we start to see more demand pattern driving that more typical performance level that we have seen in the past.

So, with that let me wrap up the call.

So, first of all, we are exiting the quarter stronger than we entered with good growth in our high margin businesses, a better book of business and services, and we execute as a workforce rebalancing actions that will start to yield in the third quarter. We had some opportunities I mentioned earlier, but also some headwinds but all of this was considered in our decision to take up our expectation for EPS by $0.20, excluding the workforce rebalancing charge with the second half increase in the fourth quarter.

Now earnings per share of $16.90 will provide the base for operational trajectory into 2014, consistent with our objective of at least $20 in 2015 on an all-in basis. So, once again, thanks again for joining us today. Now as always, it's back to work.

Patricia Murphy

Operator, could I turn it back to you, please?

Operator

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

Executives

Patricia Murphy - Vice President of Investor Relations for IBM

Mark Loughridge - Senior Vice President, Chief Financial Officer - Finance and Enterprise Transformation

Analysts

Ben Reitzes - Barclays

Toni Sacconaghi - Sanford Bernstein

Steven Milunovich - UBS Securities

Scott Craig - Bank of America-Merrill Lynch

Chris Whitmore - Deutsche Bank

Jim Suva - Citi

Bill Shope - Goldman Sachs

Katy Huberty - Morgan Stanley

Mark Moskowitz - JPMC

Brian White - Topeka

David Grossman - Stifel Nicholas

International Business Machines Corp. (IBM) Q2 2013 Earnings Call July 17, 2013 4:30 PM ET

Operator

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 Ms. Patricia Murphy, Vice President of Investor Relations. Ma'am, you may begin.

Patricia Murphy - Vice President of Investor Relations for IBM

Thank you. This is Patricia Murphy, Vice President and Investor Relations for IBM. I am here with Mark Loughridge, IBM's Senior Vice President and CFO, Finance and Enterprise Transformation.

Thank you for joining our second quarter earnings presentation. The prepared remarks will be available in roughly an hour and a replay of this webcast will be posted to our Investor Relations website by this time tomorrow.

Our presentation includes certain non-GAAP financial measures in an effort to provide additional information to investors. All non-GAAP measures have been reconciled to the related GAAP measures in accordance with SEC rules. You will find reconciliation charts at the end and in the Form 8-K submitted to the SEC.

Let me remind you that certain comments made in this presentation may be characterized as forward-looking under the

Private Securities Litigation Reform Act of 1995. Those statements involve a number of factors that could cause actual results to differ materially. Additional information concerning these factors is contained in the company's filings with the SEC. Copies are available from the SEC, from the IBM website, or from us in Investor Relations.

Now, I'll turn the call over to Mark Loughridge.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Thank you for joining us today. In the second quarter, we reported revenue of $24.9 billion and operating earnings per share of $3.22. Our EPS includes $1 billion charge for workforce rebalancing. Excluding workforce rebalancing activity in both years, our operating EPS was $3.91, up 8% year-to-year. We had good performance in our high-value, higher-margin businesses, contributing to sequential improvement in our year-to-year revenue performance and to margin expansion.

Software return to mid-single-digit growth, in fact this was the best constant currency software growth since the first quarter of 2012. Performance was led by 10% growth at constant currency and our key branded middleware and we gained share in all five brands.

In services, GBS improved revenue performance and returned to growth at constant currency, while GTS revenue growth was consistent with last quarter. With a significant amount of new business in the quarter, our total services backlog was up 7% at constant currency, or 3% at spot rates to $141 billion.

Our hardware performance was mixed. We had strong performance in system, the mainframe, which generated double-digit revenue growth at constant currency. Power and storage had a modest improvement in year-to-year performance though still declined.

Across our segments, Smarter Planet was up over 25% and cloud over 70% for the first half. Business Analytics growth improved this quarter to 11% with good performance across GBS and software. These initiatives address key market trends, like mobile, social and big data.

From a geographic perspective, our growth markets performance was consistent with first quarter at 1% constant currency growth. Major markets declined year-to-year, though improved from last quarter's rate. Overall, we improved our performance in several areas of the business this quarter and our first half operating EPS is nearly flat and that's after fully absorbing the $1 billion workforce rebalancing charge. This puts us on a good footing as we entered the second half.

So, let me spend a minute on our view of the full year. 90 days ago, when we made our first quarter earnings announcement, we said that on an all-in basis, we expected at least $16.70 of operating EPS for the full year, we also said that excluding the second quarter workforce rebalancing charge and second-half gains, we felt confident that we could achieve at least $16.70 of EPS for the year. As you will see, we are taking this view of our business up $0.20. So, let me update this statement for new information.

First of all, the substantial second-half gain that we were counting on in our all-in view of EPS, will not likely close by the end of this year, but we are still in active discussions. As you know, we have a very disciplined M&A a process. We're not going to under price our Russia divestiture simply to close within 2013.

Consequently, we need to fully absorb the workforce rebalancing charge in the all-in view without offset from this gain. The value of this charge is roughly $0.65. Based on our performance in the second quarter, our solid prospects for growth initiatives, tough decisions on spend management and potential tax settlements were increasing our full year view of operating EPS, excluding the second quarter workforce rebalancing charge by $0.20 to at least $16.90, and I think this is a pretty positive statement given the currencies have moved significantly against us in the last couple of weeks, especially in those that are largely unhedged such as the yen and emerging market currencies.

With that we have updated our all-in view of the year to at least $15.25, with a net impact of $0.45 driven by the elongated discussion for a larger divestiture project. We are driving to our objective of at least $20 in 2015 on an all-in basis. And in our current view, we will establish our 2014 trajectory off the 2013 base of $16.90. In other words, we will position the all-in view as if we closed the divestiture transaction to establish our future trajectory, since fundamentally whether we close the large divestiture this year or not will not have any effect on our ability to achieve our 2015 objective of at least $20 per share on an all-in basis.

So, now, turning back to the second quarter, I will walk through the financial metrics. Our revenue growth, at constant currency, was down 1%. This is a two point improvement from the first quarter rate, driven by services, software and hardware. We entered the quarter with a modest currency headwind but it became more pronounced with the strengthening of the dollar. When you look at the recorded revenue for the quarter, currency impacted our revenue growth by two points. In the current spot rate, this increases to a three point impact in the second half.

Turning to profit metrics. We expanded operating gross margin nearly a 1.5 point, led by services and mix to more profitable segments. The $1 billion workforce rebalancing charge impacts our PTI and net income dynamics. Excluding the workforce rebalancing activity in both years for comparison purposes, our operating PTI was flat year-to-year with margin up 0.8 point. Now within this profit performance, we absorbed a significant impact from currency movements.

This as a greater impact was when the Yen devalued sharply because of the limited cross-border cash flow that we can hedge. At current spot rates, the currency impact will continue. IBM's tax rate in the quarter includes a discrete benefit associated with that tax ruling received this quarter. So our operating net income, excluding the impact of the workforce rebalancing activity, was up 3% with margin expansion of 1.1 points.

With over $12 billion in gross share repurchase over the last 12 months, we reduced our share count by 4%. When you look at the major year-to-year drivers of our second quarter operating EPS performance, the 3% decline in revenue at constant margin impacted our earnings growth by $0.12. The contribution from margin, excluding this year's charge, was $0.24 but this was more than offset by $0.59 year-to-year impact from higher workforce rebalancing charges. The lower share count contributed an additional $0.18. So, operating EPS of $3.22 was down 8%. You can see the operating EPS, excluding workforce rebalancing, is $3.91, which is up 8% year-to-year on a comparable basis.

Now, I will get into the results. Starting with revenue by geography on a constant currency basis. America's revenue was down 3% with declines in both the U.S. and Canada, though both improved the growth rate slightly from last quarter. But once again we had really strong performance in Latin America, led by Brazil. Our EMEA revenue was down 1%. That's three points better than our growth rate in the first quarter. We had improvement in the growth rate of several of the major countries. UK and Spain not only improved but grew in the quarter. In Asia-Pacific, revenue was flat. Within that, Japan's revenue was up 3% with good performance across hardware, software and services. This is the third consecutive quarter of revenue growth. So clearly the team in Japan has done a great job to return the business to growth. Growth markets revenue was up 1%. In the first half, we have had strength in Latin America and the Middle East and Africa region but declined in some of our larger markets like China and Australia have impacted the overall performance.

Turning to revenue by segment. Year-to-year constant currency revenue performance in our combined services business improved from the first quarter. At constant currency, GBS performance improved a couple of points led by consulting and systems integration, while GTS revenue growth was unchanged. In software, we had broad-based strength across our strategic brands led by our offerings in smarter commerce, social business, security and storage management.

In systems and technology, we had good performance in System Z mainframe, while we had some improvements in Power and Storage, they continue to decline. Looking at our gross profit, our operating gross profit margin improved almost 1.5, driven by a combination of good margin expansion in Services and Software and improving segment mix.

Now, let us take a look at our expense profile. Our total operating expense and other income was up 11%, or down 1% excluding the year-to-year impact of workforce rebalancing charges, so well managed on an operating view.

Acquisitions over the last 12 months drove 1 point of expense growth. Currency contributed a point of expense decline, driven almost entirely by translation. Consequently, our base expense excluding currency and acquisitions was better by 2 points excluding the charges.

The workforce rebalancing is the one item in expense that had significant year-to-year impact to our profit. This year's charge was about $1 billion, in line with what we told you back in April. This compares to last year's rebalancing charge of about $150 million, so about $850 million impact to profit year-to-year. We will see some of the benefits from the rebalancing activity in the second half.

Now, I want to comment on the impact of currency this quarter. In the second quarter, the hedge activity was fairly neutral year-to-year with modest gains in both periods. The dollar strengthened against many currencies, but we were significantly impacted by the depreciation of the yen.

Because our business in Japan is more heavily skewed to local services, we have less ability to hedge cross-border cash flows as compared to most other countries. I mentioned this last quarter, but the year-to-year profit impact was much larger in the second quarter. This would continue at current spot rates through the rest of the year. We saw a similar trend in the growth market currencies.

So, now let me go into the segments. This quarter, the two services segments generated $14 billion in revenue. Pre-tax profit was down 17%, reflecting the impact of the workforce rebalancing charge. Excluding workforce rebalancing in both years, profit was up 2% and pre-tax margin expanded just over a point.

Total backlog was $141 billion, up 3% of spot rates, but up 7% of constant currency. Backlog again grew in both, the transactional and outsourcing businesses. And, in fact, we had the best growth of our book of business at constant currency in four years. Within that, both major markets and growth markets grew backlog this quarter and our major markets accelerated the growth at constant currency from last quarter. We had 15 deals over $100 million including a megadeal in Europe.

Turning to the two segments, Global Technology Services revenue was $9.5 billion, down 5%, or down 2% at constant currency. Our outsourcing business was down 3% at constant currency with the bulk of this decline, driven by previous actions to restructure lower margin contracts. While this impacted revenue, it raised the profitability of the outsourcing portfolio, will wrap on the year-to-year dynamics in the second half though the business will continue to operate at this higher profit base.

For the quarter, we estimate the impact to revenue to be about 1.5 to GTS and a point to services in total. In Integrated Technology Services, revenue was up 1% at constant currency, led by Japan with its third consecutive quarter of double-digit growth.

Last week, we close the acquisition of SoftLayer Technologies, the world's largest privately held cloud computing infrastructure provider. As businesses add public cloud capabilities to their on-premise IT systems, they need enterprise grade reliability security management. IBM has built a portfolio of high-value private, public and hybrid cloud offerings.

With SoftLayer, IBM will accelerate the build out of our public cloud infrastructure to give clients the broadest choice of cloud offerings to drive business innovation. This quarter, GTS pre-tax profit decline, but adjusting for the workforce rebalancing activity, profit was up 3% and pre-tax margin was higher year-to-year by 1.3 points on this basis, margin expansion reflects improved efficiency and productivity as well as tough minded spend actions.

Turning to Global Business Services, revenue was $4.6 billion, down 1% as reported and up 2% at constant currency. This represents an improvement of two points at constant currency from last quarter's year-to-year rate. From a geographic perspective, North America led the improvement and was up mid single-digit. Growth markets in Japan continued to drive solid performance and Europe slowed its rate of decline versus last quarter.

Looking at the GBS business by or two major categories, we had good result across the portfolio. Within the digital front office, we again delivered double-digit growth across the initiatives, Business Analytics, Smarter Planet and cloud. Within our back-office solutions that we call the globally integrated enterprise, we returned to growth in implementation services that support the traditional packaged applications. Turning to profit. Adjusting for workforce rebalancing activity, GBS profit grew 2% year-to-year and PTI margin expanded by 0.5 point.

So to wrap up services, growth initiatives continued to perform well and we are investing to accelerate our transformation. We have made good progress in transition areas like traditional packaged application implementations and have largely wrapped on the outsourcing contract restructuring. We are entering the second half with the strongest backlog growth at constant currency in years.

Software revenue of $6.4 billion was up 4% year-to-year or 5% at constant currency. Software PTI was down 2% year-to-year or on an adjusted basis was up 6% to $2.7 billion. Key branded middleware, which was over two thirds of total software revenue grew 9% or 10% at constant currency. Each of the five key brands gained share in second quarter. Four of the five grew double digits at constant currency. We built a portfolio of solutions that target the faster growing segments of the market including mobile, social and security. Differentiated by advanced analytics these solutions provide value to a new set of IT buyers in the front office and many these are delivered through our SaaS offerings, which were up over 50% this quarter.

Now, let me take you through the key brands. WebSphere grew 10% at constant currency. Within WebSphere, the key contributors, Smarter Commerce and mobile, grew double digits. IBM Smarter Commerce initiative helps our clients transform their business processes to rapidly respond to shifting customer demands in today's digitally transformed marketplace. Our mobile portfolio led by MobileFirst combines security, analytics and apps development software to manage clients' mobile infrastructure regardless of device. Information management software grew 6% at constant currency. Analytics runs through our portfolio of solutions, enabling clients to develop and execute a big data strategy that connects their existing business data to new data sources delivering business insights in real-time.

Tivoli software was up 14% at constant currency with growth in each of the three key business areas. Our security business had a great quarter with growth of 20% at constant currency. In the age of mobile access, [AUDIO GAP] sturdy intelligence is critical for safeguarding data, transactions and everyday business operations. Within Tivoli, storage was up 17% at constant currency. Storage software delivered its 10th consecutive quarter of double-digit growth.

Social workforce solutions grew 23% at constant currency, driven by the recent acquisition of Kenexa and our existing smarter workforce offerings. In the second quarter, IBM was ranked number one in enterprise social software for the fourth consecutive year by IDC. Across the board, software had a good quarter with solid top line performance [AUDIO GAP], 12% year-to-year or 7% at constant currency, adjusting for the divestiture of retail store solutions.

System Z grew 11% at constant currency. MIPS were up 23% year-to-year and we continue to have more than half of this MIPS from specialty engines which were up double-digits. Last week, we announced an agreement to acquire CSL International, which expands System Z's cloud capabilities, including simplified management of virtualized Linux on Z. In PureSystems, we have now sold over 6,000 systems in over 100 countries in the five quarters since announced.

While Power revenue was down 24% at constant currency, this does represent a 7-point improvement from last quarter's rate. Power continue to outperform the UNIX competition and gained share again this quarter and we continue expand our power platform to go after the Linux opportunity. We expect a sequential improvement in Power will continue in the second half as adoption of our new POWER7 plus products continues.

System x was down 10% at constant currency. Storage hardware revenue was down 6% at constant currency, but flat including storage software, which is reported in Tivoli. Strong double-digit growth in our mid-range Storwize product was offset by declines in our legacy OEM mid-range offerings and softness in the high-end. Our/products offerings contributed 2 points of year-to-year growth to total storage. Systems and Technology returned to profitability in the second quarter, excluding workforce rebalancing charges, and we expect to remain profitable for the full year.

Moving onto cash flow in the quarter, we generated $2.7 billion of free cash flow, down about $1 billion year-to-year. Through the first half, our free cash flow of $4.4 billion was down about the same. The first half year-to-year performance was impacted by a significant increase in cash taxes and lower accounts receivable collections. This was mitigated by year-to-year benefit from our capital expenditures and the benefit associated with the timing change of funding our 401(k).

Looking at the uses of cash in the first half, we acquired three smaller companies, StoredIQ, Star Analytics and UrbanCode. In the first week of July, we closed the larger SoftLayer acquisitions. We returned just over $8 billion to shareholders. Of that, $6.1 billion was in share repurchases, and at the end of June, we had $7.7 billion remaining in our buyback authorization. We took our dividend up 12% in April and through June we paid out $2 billion. This is the 18th consecutive year that we raised our dividend and the 10th year in a row of double-digit increases.

Turning to the balance sheet, we ended the quarter with a cash balance of $10.4 billion. Total debt was $34.1 billion, of which nearly $25 billion was in support of our financing business which is leveraged at a ratio of 7.21.

Our non-financing debt was $9.3 billion and our non-financing debt to cap was 39%. We continue to have a high degree of financial flexibility and our balance sheet remains strong to support the business over the long-term.

So, let me wrap up the quarter. We had good performance in our higher margin businesses, like Software and Systems z mainframe and we had continued strong performance in our growth initiatives of Smarter Planet, Business Analytics and Cloud. We returned to growth in Global Business Services, led by consulting and systems integration. And for total services, we had the strongest backlog growth at constant currency in years.

At the same time, we took actions to better position our business for the future. We rebalance the workforce to align resources to the best opportunities and we announced and recently close the acquisition of SoftLayer to enhance our capabilities in cloud.

As we move into the second half, we expect to continue our progress in areas like Analytics and Cloud and Smarter Planet, leverage the benefits from our workforce rebalancing activity, capture additional opportunities in cost and expense through net income. And, of course, continue to return value to shareholders.

At the same time, we are dealing with a more challenging currency environment. Taking all of this into consideration we are increasing our full year view of operating EPS, excluding the $1 billion workforce rebalancing charge to at least $16.90. This is the $0.20 increase from our previous view. Because, we are no longer counting on a gain from a large divestiture in the second half, our all-in view of operating EPS is now at least $16.25. All of this is consistent with our objective to achieve at least $20 of operating EPS in 2015.

Now, Patricia and I will take your questions.

Patricia Murphy - Vice President of Investor Relations for IBM

Thank you, Mark. Before we begin the Q&A, I would like to remind you of a couple of items. First, as always, we have supplemental charts at the end of the deck that complement our prepared remarks. Second, I would ask you refrain from multipart questions. When we conclude the Q&A, I will turn the call back to Mark for final comments.

Operator, please open it up for questions.

Question-and-Answer Session

Operator

Thank you. At this time, we would like to begin the question-and-answer session of the conference. (Operator Instructions). The first question comes from Ben Reitzes with Barclays. You may ask your question.

Ben Reitzes - Barclays

Mark, what gives you confidence in the second half. It would seem that basically without the benefit of the tax rate, the operational increase is really $0.5 or so from what you thought previously. I just wanted to also be clear on that. What gives you confidence that you can hit those numbers? Perhaps there is specifics around how the charge closed through in terms of cost saves and then what segments could possibly grow? Where do you seem some leverage? Thanks a lot.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Okay, Ben. A very good question. Maybe the best way for me to answer that is to take a look at a headwinds, tailwind basis. So if you look at the second half of the year, obviously, we have a headwind on currency and more specifically, within that, the Yen. We pointed it out in the attached ones that even though currency was impact of 2% in the first half, we see about 3% in the second half.

Our hardware business has been an impact. It was in the first half of the year and we are obviously dependent on the Asian GMU economy which have been challenging in the first half. But I will tell you, as we look at the second half, we have some very, very distinct tailwinds that we have driven to drive our performance.

So, first of all, software pipeline, we have got a very good software pipeline going into the second half of the year and if you look at that software performance in the second quarter, boy, they really hit the ball. So, not only did software grow the total by 5% but that key branded middleware was up 10% and we gained share in every single one of the sub brands in that software business. So we see real momentum going from that second quarter into the second half of the year.

Secondly, very, very important. We have services backlog growth on a constant currency basis up 7%. That is the best backlog growth positioning we have had in four years going into the second half, 3% at actual but that 7% at constant currency, the best we have seen in four years.

Now against that, in the second quarter, break it down by service lines, GBS returned to growth in the second quarter. They should further profit on that improvement in the interim backlog and I would expect GBS to be firmly in that mid-single-digit revenue growth in the third quarter.

Likewise on our GTS business. GTS was down in the second quarter about 2% but they had about a 1.5 point impact from those restructured contracts last year that we spent a lot of time talking about in the last year's earnings call. So if you adjust for that, they came very close to a neutral performance in the second quarter. With that, I would expect GTS to return to low single-digit revenue growth in the third quarter as well.

So now we have had good performance, a flow-through to second half from our software business, better performance from our GTS and GBS businesses driving performance, our workforce rebalancing yield. We did a great job closing that right on the $1 billion that we had advised we you we would as we close the first quarter. That will begin the yield in the third quarter of the year and will get a full quarter's benefit in the fourth quarter and I think that is quite significant.

I clearly alluded to the potential tax settlement that we would see being a positive impact in our fourth quarter. But along with that, we have had real strength in our growth initiatives. Cloud, through the first half of the year, up very, very strong. We had very good positioning on our Business Analytics in the second quarter, up 11%. Strong performance in our Smarter Planet content and we have taken a very tough position on spending.

So you put all that together, I think we have the ingredients for that second half of year and with base of all of that, in aggregate, they gave us the confidence along with the second quarter performance to drive that additional $0.20 to $16.90 excluding the second quarter workforce rebalancing charge.

Patricia Murphy - Vice President of Investor Relations for IBM

Thanks, Ben. Can we go to the next question, please?

Operator

The next question comes from Toni Sacconaghi with Sanford Bernstein. You may ask your question.

Toni Sacconaghi - Sanford Bernstein

Historically, you have provided EPS guidance, including all rebalancing charges and any one-time gains whether it'd be from IP or from dispositions. I am hoping you can clarify, because it's a little nebulous about whether you are changing your guidance definition of operating earnings or not.

So, the traditional metric of operating earnings would include the rebalancing charge in there and then guidance would be $16.25 at least for the year. Is that what we should be putting our models, or are you changing the definition and saying what we are going to exclude these kinds of charges this year and on a go forward basis and $16.90 should be what analyst put in your model, so if you could address that and I would also like to understand to the degree that what checks and balances to the degree that you may continue to include them, but not match them in a given quarter what checks and balances are there going to be offsetting that gains and charges are ultimately offsetting as they have been historically.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Okay. Very good question, Toni. First of all I want to be very, very clear that when we attach our objective for 2015 of $20, that at least $20 is on an all-in basis, and I think in this earnings announcement, I hope to be very clear on the basis for performance in the year. So, if you look at the performance that we would view for the year, we've been clear on the all-in basis and we've also been clear excluding the gains and charge.

Now, let me provide some distinctions on that base and why I think both of those are very important. First of all, on all-in basis, we had said that that second fourth quarter workforce rebalancing charge would be offset by a future divestiture gains. And, frankly, as we look at it now, we are in active discussions, but very likely on a timeline basis it's been likely that simply closes in 2013, so that would impact that original view of our business on all-in basis of at least $16.70 by $0.65, and then you would add the improvement of $0.20 to that. That gives us $16.25, but I won't say that on the other view of our business excluding gains and charges, that now would be $16.90, and I am reassuring you and the investors that that $16.90 that we will be using of our starting point to set our objectives for 2014 on all-in basis in 2015 on all-in basis.

So in other words, as if we have closed the divestiture. Now, why do I think that's important? I think that's important because whether we close that divestiture this year or not, would not impact that operational performance exactly as always fund it in 2014 and 2015. Number two, I wanted to be very clear to investors that when we start the positions that trajectory for performance going from 13 to 14 to 15, that number start to $16.90 Not $16.25. So, from my perspective the view of our business is best established the trajectory we are on going from 13 to 14 to 15 is an end state of $16.90 increased by $0.20 from our results $16.70 view of the business given that the large divestiture has moved out of the year we would assess the all-in at $16.25, but you know we are certainly working on other divestiture content in that we will be adding back for our basis as well. But, to reiterate, assessing this trajectory for this year, I think is best evaluated, excluding the second quarter charge and $16.90 that will now be the basis for establishing that trajectory for 2014 and 2015, and achieving our objective of at least $20 in 2015 on all-in basis.

Patricia Murphy - Vice President of Investor Relations for IBM

We'll go to the next question, please?

Operator

The next question comes from Steve Milunovich with UBS. You may ask your question.

Patricia Murphy - Vice President of Investor Relations for IBM

Steve, do you have it on mute? We can't hear if you are speaking.

Operator

Please don't push any buttons.

Steven Milunovich - UBS Securities

Can you hear me now?

Patricia Murphy - Vice President of Investor Relations for IBM

Yes, we can now. Now you could start.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Steve, are you there?

Operator

The next question comes from Scott Craig with Bank of America-Merrill Lynch. You may ask your question.

Scott Craig - Bank of America-Merrill Lynch

Mark, can you maybe elaborate a little bit more on the services business as far as the impacts that you see going forward in renegotiating contracts or maybe even exiting some of the contracts and some of the impact on the profitability that we should see as you move forward? You mentioned in your prepared remarks that you start to run into the comp issue where you are sort of getting beyond all that in the back part of the year but I am just curious as to how you see impact of that playing out have for the rest of the year? Thanks.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Well, I think on that view of the business on our contract negotiations with customers, the biggest reference point is really those restructured contracts that we drove in 2012 and as I said for GTS, that was an impact of about 1.5 point to their growth rate. So outside of that, it would have been down about 0.5 point and now with the improved backlog performance and starting forward, going into the third quarter, we would expect that our GTS business should be returning to growth in third quarter in low single-digit. So if you are looking at the impact of those restructured businesses on our year-to-year growth with this year, by the third quarter it is less than a point and it is fully wrapped by the time we get to the fourth quarter.

So the really strong signings performance we have seen from our two services business and the positive impact that tailed on come backlog, now as I said earlier, up 7% on a constant currency basis, 3% at actual should give them a very good starting point as we go in the third quarter and that restructured contract impact on growth rates should start to ameliorate in third quarter and fully wrap in the fourth.

Patricia Murphy - Vice President of Investor Relations for IBM

Thanks, Scott. Can we go to the next question, please?

Operator

The next question please next question comes from Chris Whitmore with Deutsche Bank. You may ask your question.

Chris Whitmore - Deutsche Bank

Thanks very much. Mark, I was curious to get an update on the $400 million worth of mainframe and software deals out of Q1. Did those in Q2? Just looking at some simple math, assuming half of those deals did close in the software business in Q2 or signed the software it implies the underlying demand and growth of software really wasn't all that robust. It was pretty tepid. Maybe flat to up 1% or so. So can you comment on how those deals closed and what the underlying demand looks for your software products, excluding the timing of those deals? Thanks a lot.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Yes, very, very good questions. So if you look at those rollover deals that we had as we exited the first quarter, they frankly distributed across the months within the quarter on a typical rollover basis and we closed a little less than half of them, which is also a typical closure rate. Though it really did not provide within the quarter a spike, if you will, and assume a normal profile for rollover deals they went through the quarter.

Now, as you look at it going into the third quarter, especially within that software business, which has very high margin content for us, we actually have even more rollover content going for software business from the second quarter to the third quarter and if you just looked at the firm pipeline that we have had for the third quarter compared to the second, we are actually in a little better shape going into the third than we were not even in the second. So I think that the performance that we saw out of software in the second quarter is a good indication of the kind of performance we had achieved from our software business going into the third quarter and I think that when you look at the mainframe business that we also had a very strong performance in the quarter. We should expect another double-digit quarter from mainframe in the third as well.

Patricia Murphy - Vice President of Investor Relations for IBM

Thanks, Chris. Can we go to the next question, please?

Operator

The question comes from Jim Suva with Citi. You may ask your question.

Jim Suva - Citi

Thank you, Mark. Congratulations to you and your team at IBM. I know this is just one metric, but when you look at the signings number, which was quite strong, healthy of 16.4 and last quarter was 16.9, I mean very, very strong there. Shouldn't that equate to some pretty neutral revenue growth for IBM? And, if so, am I missing something about others some larger contracts that are and how should we think about multiple quarters of back-to-back strength you've had in that metric that we use along with others? Thank you.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Well very good question. We look at the services content. The great thing about our Services business is you sign those contracts that give you a lift and it give you lift over many, many years, right? So, an advantage, I think, that we built into our business equation is at long string annuity content services base of business, so you are not so dependent on the volatility that transactional business.

So, when you look at that that improvement in backlog entering a given quarter that is distributed over a number of years, but you started to see the impact and the benefit of that even in the second quarter. So, again, I would reiterate in the second quarter our GBS business returned to growth. As we look at the additional backlog, performance we have going into the third [now] be back to mid single-digit growth.

Our GTS business was impacted by the restructured contracts in the rearview mirror, but adjusting for that we think they were very close to kind of flat performance on an unadjusted basis, so that gives us confidence going into third quarter that our GTS business should also returned to growth in low single-digit.

Now we did sign in the second quarter 15 deals over $100 million and we signed a multi billion-dollar mega outsourcing deal in Europe. Now, the European deal is a very interesting one in itself, because IBM for this customer will transform the underlying technology including new analytics and cloud models enabling business innovation for the client, so this is great example of how the outsourcing business is evolving as clients look to IBM for supporting leveraging new technologies such as cloud.

So, as you pointed out two quarters is a very good signings performance as we have always said (Inaudible) you got to be in the backlog ensuring that the backlog did show up as we enter the second half and we are going to see that revenue impact as we start to move that equation north with positive revenue performance from GTS low single-digit and mid single-digit revenue performance in GBS.

Operator

The next question comes from Bill Shope with Goldman Sachs. You may ask your question.

Bill Shope - Goldman Sachs

Thanks. I hate to ask the tax rate question, but I really want to try and understand the guidance best I can. Mark, you had mentioned that you had a tax benefit as well coming in the second half is that additional to the tax benefit you had this quarter? I believe your guidance before was a pointing towards roughly at 25% rate and that's within most models, so how do we think about the tax rate in the second half relative to that and how that drives the earnings guidance for full-year?

Mark Loughridge - Senior Vice President, Chief Financial Officer

Okay. So, I would you look at our book's tax rate in 2013 to be in the range of 25%, excluding into discrete tax benefit charges. Now, we did get a tax benefit in the second quarter that we recognize which relatively improved that rate. And, if you look at a forward-looking basis, regarding tax settlement we do have a number of audits and disputes around the world including the 2008 to 2010 U.S. federal tax audit. We expect to conclude some of these audits and disputes later this year that could results in a favorable settlements in the fourth quarter.

Operator

The next question comes from Katy Huberty with Morgan Stanley. You may ask your question.

Katy Huberty - Morgan Stanley

Yes. Thanks, Mark. Given the cash flow was down considerably in the first half of the year, can you do a similar walk through of the headwinds and tailwinds you see that could help improve cash flow and also talk about whether the weaker cash generation impacts your flexibility to step up buybacks and make acquisitions to help hit the $20 2015 target if needed?

Mark Loughridge - Senior Vice President, Chief Financial Officer

Okay, when you look at the first half of 2013, our cash flow was down $1.1 billion. Now within that decline we did a substantial increase in our cash tax payments of $700 million. In addition, we had a deterioration of our accounts receivable days outstanding by over a day and a half and that comes at a metric of about $250 million per day. So we should have done better there and we certainly could have done better in our profit performance from the business.

Now if you look on a forward-looking basis, I fully expect that we will improve on that receivables equation and pull that cash back into the business and we should have better profitability from unit performances going to the second half as well, but I got to say that on a full-year basis, we do have a cash tax headwind of $2 billion and I don’t think we are going to overcome that on a year-to-year basis.

Now, even with that positioning, however, I feel very confident in the overall positioning for the roadmap of $50 billion in share repurchase, $20 billion in dividends and the opportunity for $20 billion in overall acquisitions. If you gauged our performance against those metrics, given this kind of a half point of the model, you know we have done $33 billion in share repurchase of the $50 billion, we have done $6 billion of the $20 billion in overall acquisitions, $9 billion of the $20 billion in dividends which puts us just reasonably ahead of pace.

So, I think we are in good position there. We do have a cash tax headwind this year but I do not think it’s going to impact our ability to complete the expenditures on share repurchase, acquisitions and dividends through 2015 roadmap.

Patricia Murphy - Vice President of Investor Relations for IBM

Thank you, Katy. Can we go to the next question, please?

Operator

The next question comes from Mark Moskowitz with JPMC. You may ask your question.

Mark Moskowitz - JPMC

Just in terms with all-in EPS is in terms of what it was historically and what you are you going to do going forward? Maybe you can help us out one piece. Can you try and quantify, Mark, what the quarterly EPS benefits in the fourth quarter is going to be due to the workforce restructuring?

Mark Loughridge - Senior Vice President, Chief Financial Officer

Well, if you look at the workforce restructuring, let me give you a little color behind that. Now if you look at the workforce rebalancing, as we pointed out, that concluded at about $1 billion. In that $1 billion, the vast majority of that is spent overseas, outside the U.S. that has longer paybacks. Now from a business unit standpoint, you can see that in the math that we have provided to you, about $600 million of that would be benefiting the services business and about $200 million each for the hardware and software businesses. That will distribute across the third quarter and fourth-quarter as well as the first two quarters of 2014.

Now, given that it has generally world trade driven, we are not going to payback that $1 billion in the year, but we will see the first increment of contribution from it in the third quarter and we are going to see a full quarter of contribution in the fourth quarter of this year and then ongoing contribution in the first and second quarters of 2014.

Patricia Murphy - Vice President of Investor Relations for IBM

Thanks, Mark. Can we go to the next question, please?

Operator

The next question comes from Brian White with Topeka. You may ask your question.

Brian White - Topeka

Mark, I want to get a big picture view of what you are seeing on the IT spending landscape. So it is obviously a little light, did well on margins, but just what are customers spending on now and how are they feeling about spending in the second half of the year? Thanks.

Mark Loughridge - Senior Vice President, Chief Financial Officer

Yes, I think if you look at overall spending, let's look at it from a couple of perspectives. First of all, just based on the dynamics we see in our business, the major markets' performance actually improved for IBM in the second quarter compared to the first quarter by about two points. Within that, as I had said earlier, Japan did a great job in this but I thought Europe as well did a pretty good job in a different environment but we do see, when you look at the growth market business, they are moving more from infrastructure-based offerings to offerings with real solutions capability like Business Analytics and Smarter Planet capabilities as they improve performance.

So, as we see that spending profile and as it exhibits itself for IBM, we see improved prospects for our services revenue base as we go into the third quarter. Ongoing strength in our software base. We do think that hardware will still be a challenging equation, but it certainly will be a mix of demand patterns mapped to our capabilities to support our objectives for the third and fourth quarter and right now we would look at the third quarter that analyst models are reasonable and we see higher double-digit performance in the fourth on our way to achieve that $16.90, at least for the year, excluding the second quarter workforce rebalancing charge.

Patricia Murphy - Vice President of Investor Relations for IBM

Thanks, Brian. Operator, can we take one last question please?

Operator

Your last question comes from David Grossman with Stifel Nicholas. You may ask your question.

David Grossman - Stifel Nicholas

In the GMUs and the corresponding impact on the three different business.

Patricia Murphy - Vice President of Investor Relations for IBM

I am sorry David, can I ask that you start again we missed the beginning of the question.

David Grossman - Stifel Nicholas

Sure. I was wondering if you could just expand on the last question a little bit and help us understand the relationship between the growth and weakness from the various GMUs and the corresponding impact on the growth of the three business units as we go through the second half of the year and into 2014?

Mark Loughridge - Senior Vice President, Chief Financial Officer

Yes. Absolutely. So, if you look at our GMU performance in the second quarter did prove to be more challenging. Again, 1% growth in the second quarter as we saw in the first quarter, but underneath it was mix. So, we actually had very strong performance, I think in Latin America up 12%. And, within Latin America. Brazil was up 15%, so the whole Latin America content, I would count as a real plus for us. Middle East, Africa likewise we had 11% growth, so good performance there as well.

The areas that we had more difficulty in our growth markets, frankly, can be I think best attributed to kind of three large countries China, Australia and Russia, and they account for about 40% of the GMU base of business without those three countries GMU frankly would have been up 7% now. Within those three countries, I would tell you that China and Russia who are both, down in the second quarter '13 had a very, very big, comp to overcome. Last year China achieved 24% growth in the second quarter of 2012 and Russia had 39% growth in the second quarter 2012, so very good big compares now.

That said, we will remain cautious as we go into the second half of year in GMU, so we start to see more demand pattern driving that more typical performance level that we have seen in the past.

So, with that let me wrap up the call.

So, first of all, we are exiting the quarter stronger than we entered with good growth in our high margin businesses, a better book of business and services, and we execute as a workforce rebalancing actions that will start to yield in the third quarter. We had some opportunities I mentioned earlier, but also some headwinds but all of this was considered in our decision to take up our expectation for EPS by $0.20, excluding the workforce rebalancing charge with the second half increase in the fourth quarter.

Now earnings per share of $16.90 will provide the base for operational trajectory into 2014, consistent with our objective of at least $20 in 2015 on an all-in basis. So, once again, thanks again for joining us today. Now as always, it's back to work.

Patricia Murphy - Vice President of Investor Relations for IBM

Operator, could I turn it back to you, please?

Operator

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