FINAL TRANSCRIPT

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PRESENTATION

Operator

Welcome and thank you for standing by. (OPERATOR INSTRUCTIONS). 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 - *International Business Machines - VP of IR*

This is Patricia Murphy, Vice President of Investor Relations for IBM. Here with me today is Mark Loughridge, IBM's Senior Vice President and Chief Financial Officer. Thank you for joining our third quarter earnings presentation.

By now the opening page of the presentation should have automatically loaded and you should be on the title page, chart 1. You will recall that last quarter we introduced the capability for the charts to automatically advance as we move through the presentation. If you prefer to manually control the charts, at anytime you can uncheck the synchronize button on the left of the presentation.

As always, the prepared remarks will be available in roughly one hour and a replay of this webcast will be posted to our investor relations web site by this time tomorrow.

This presentation includes certain non-GAAP financial measures in an effort to provide additional information to investors. All non-GAAP measures have been reconciled to their related GAAP measures in accordance with SEC rules. You'll find reconciliation charts at the end, and in the Form 8-K to be filed with SEC immediately following this call.

For those of you who are manually controlling the charts, please click on the next button for chart 2. Certain comments made in this presentation may be characterized as forward-looking under the Private Securities Litigation and 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 web site or from us at investor relations.

Now let's go to chart 3, and I will turn the call over to Mark Loughridge.

Mark Loughridge - *International Business Machines - SVP and CFO*

Thanks Patricia. IBM's third quarter results demonstrate the strength and breadth of our business model across our hardware business, software business and services business. In hardware, we continued our strong performance in midrange systems and successfully launched our z9 platform. In software, our key middleware brands had solid growth that should result in share gains. Our services signings grew double digits for the second consecutive quarter, and we had improved margin performance driven by benefits from our recently implemented productivity initiatives.

To describe IBM's results, I will use a format similar to the one we used last quarter. First I will start with results as reported. Then I will adjust for two non-recurring items, one in this period and one in last year's third quarter, to provide a more accurate view of our ongoing operational performance. Then, finally, I will show you how our results compare to last year's third quarter without the PC business.

Starting with reported results for the third quarter, we delivered $21.5 billion in revenue, which was down 8% as reported and at constant currency. Without PCs, revenue was up 4%. Our pre-tax income was $2.9 billion and we delivered $0.94 of earnings per share.

Turning to the non-recurring items, earlier this quarter we announced that we would bring cash back to the US under the Homeland Repatriation Provision of the American Jobs Creation Act of 2004. This quarter we recorded a onetime tax charge of $525 million associated with the planned repatriation of $9.5 billion. Remember also that in September of last year we recorded a onetime pretax charge of $320 million to settle legal claims against IBM's pension plan.

When you exclude the non-recurring charges, IBM delivered $1.26 of earnings per share, up 22% over last year's third quarter. But the most appropriate comparison is to last year's third quarter without the recently divested PC business. The details and description of the PC results are included in our supplemental charts.

On this comparable basis, revenue was up 4% both as reported and at constant currency. Our pre-tax income was up 18% and earnings per share was up 25%. With this third quarter performance, year-to-date through September we have delivered earnings per share growth of 7%. Without the non-recurring items I just mentioned, and those from the second quarter, EPS was up 14%. And if you then take out the PC business, EPS grew 17%.

Our third quarter profit performance reflects the breadth and flexibility of our business model and puts us back on track for the year.

Now let's get into the details starting with revenue, chart 4. Total revenue in the third quarter is down 8% year-to-year as reported, but up 4% without the PC business. Global Services was up 3% year-to-year as reported and at constant currency.

Our total signings were up 13% year-to-year; short-term signings were essentially flat. Our Strategic Outsourcing signings were up significantly year-to-year, which will provide a benefit over the longer term. Hardware revenue was down 32% as reported. But as we just discussed, the third quarter of last year included $2.7 billion of PC revenue. Without the PC business, hardware was up 7% and up 6% at constant currency.

We had double-digit growth in pSeries, iSeries and xSeries servers, total storage and our microelectronics OEM business. We successfully launched our z9 product in mid-September. With the benefit of the new product late in the quarter, we had 18% MIPS growth while revenue was down 4%.

Software revenue grew 5% as reported and at constant courtesy. We had good growth across all of our key middleware brands, and once again grew in all geographies. Global Financing revenue was down 6% as reported, or 7% at constant currency, driven by a continued decline in the asset base and yields.

Now let's turn to revenue by geography, chart 5. To provide the best view of our ongoing geographic performance, I will focus my comments on the results without PCs. Looking at the major geographies, America's performance was driven by solid execution. All regions grew, led by Latin America.

Overall demand remains good, with particular strength in the small and midmarket. The shift in customer buying behavior to solutions is continuing as customers are focusing more on business value than cost take out.

Growth in Europe improved without the benefit of currency. This quarter we implemented our new operating model, with a more streamlined management system. We're managing through the transition with little disruption.

Performance in the geography remained mixed, as the major countries -- the UK, France, and Spain -- grew, while Germany and Italy once again declined in a challenging economic environment. Asia-Pacific posted the weakest results of the major geographies. Japan, which represents about 60% of the Asia-Pacific revenue base, once again declined at constant currency in a soft but improving economic environment.

Execution issues impacted performance. We're in the process of implementing actions to improve our execution in the highly competitive Asian markets. On the other hand, ASEAN grew by double digits for the 13th consecutive quarter.

Across all of these geographies, we continued our pattern of strong growth in emerging countries. China, Brazil, India and Russia, together grew 33% in the third quarter without PCs, or 20% at constant currency.

I've mentioned in the past that growth in these emerging countries is driven by customer investment to build out their infrastructures, especially in the financial services sector. This quarter, Brazil performance reflected large infrastructure rollouts based on the new z9 platform. Last year we have significant growth in China, led by Agricultural Bank of China. This shows up in the relative growth rates.

At constant currency, Brazil grew 26% while China declined 1%. India grew 51% and Russia grew 88%. Finally our OEM growth was 12%, driven by the ramp up in our game chip processors.

Now we'll move onto revenue by customer sets, chart 6. This chart reflects our five worldwide industry sectors as well as our small and medium business customers. It excludes our OEM business. As in the geographic discussion, I will focus my comments on the results without PCs.

Our small and medium business organization posted its second consecutive quarter of double-digit growth in the third quarter. The growth was led by the Americas, where customers continue to focus on cost, efficiency, and business value in their IT decisions. Customers see the value in IBM solutions, including the Express offerings that we take to market through our strong network of business partners and ISVs.

Turning to the industry sectors, financial services revenue growth was led by banking and insurance as these customers continue to focus on back office efficiencies. Public sector performance was led by health care, as we launched new solutions to improve health care quality and lower costs, driving growth at both new and existing accounts.

Within the industrial sector, we had growth in chemicals and petroleum, electronics, and aerospace and defense. But sales to automotive clients continued to trend down. Distribution sector was led by consumer products and travel and transportation, offset by a decline in retail revenue. Communications sector performance was impacted by a slowdown in telecom growth.

Overall, our performance this quarter again indicates that clients increasingly are recognizing the value of IBM's unique industry-specific capabilities in shifting from point product sales to solutions.

Now we will turn to chart 7 for gross profit. Gross profit margin in the third quarter was 40.6%, up 4.1 points year-to-year. Without the improvement from divesting the low margin PC business, margin was up 0.6. Global Services gross profit margin was up 1.7 points year-to-year. Key drivers include yield from our productivity initiatives and a better contract profile. I will discuss the productivity initiatives and the margin dynamics for services later in the presentation.

Hardware gross profit margin improved almost 9 points year-to-year, but was down 1.4 points without PCs. A decline in storage margin due to have a mix of midrange disk and the revenue decline in our high margin zSeries platform were key factors. Partially offset by an improvement in our microelectronics margin.

In software, gross profit margin improved 0.2. Global Financing gross profit margin was down almost 6 points primarily due to the changing short-term interest rate environment. As we discussed in the past, this business is more appropriately measured on return on equity. This quarter, Global Financing's return on equity was 30%.

Now lets turn to expense, chart 8. Total expense and other income declined 8% in the third quarter as reported, but that reflects the $320 million pension settlement charge we took in last year's third quarter. If we back out this charge from last year, expenses would be down 3%.

Without PC results and the pension settlement charge in 2004, expense and other income was up about 0.5%. Based on revenue growth of 4% without PCs, expense to revenue improved about 1 point year-to-year. Underneath this, we improved our SG&A expense to revenue ratio by 0.9, down to 21.5%.

We executed well on our second quarter productivity initiatives. By the end of September, nearly 90% of the resources had exited the business. These departures drove high level of savings in the third quarter, yielding a large benefit to cost and expense in the period. We continue to expect essentially all other resources to leave by the end of the year.

In the short-term, more of the cost reduction goes to the bottom line. Over the longer-term these actions give us a more competitive cost structure, more pricing flexibility, and allow us to better deal with escalating labor costs such as pension.

Let me turn now to our roadmap of items that materially impacted earnings growth. Retirement-related plans, both pension and health, were a year-to-year help of $102 million as reported, including last year's pension settlement charge. Excluding the onetime pension impact in 2004, retirement-related plans were hurt (ph) of $218 million. We continue to expect the year-to-year impact in 2005 to be $1 billion.

The impact of retirement-related plans in 2006 will depend on several factors worldwide. Including market performance throughout 2005, our funding decisions, and the dynamics of the interest rate yield curves at year end. With the short end impacting the crediting rate in our cash balance plan, and the long end affecting the net present value calculation of the pension obligations. I will provide an update in January.

Partially offsetting this pension impact, total equity compensation, including the cost for restricted stock units and performance-based awards, was down $148 million year-to-year. We've included additional information on our equity compensation in the supplemental charts.

AR provisions were down $50 million, reflecting the improved credit quality of our customers and the reduced level of Global Financing receivables. This roadmap of items reflects different items every quarter. Let me mention some activity that we expect will be reflected in our fourth quarter operational results.

As part of our ongoing management of real estate, we initiated actions to rebalance our portfolio in the fourth quarter. My best assessment at this time is that we could record a pre-tax benefit of $75 million in the fourth quarter.

The first of these transactions is the sale of the building in Japan, which has been signed and is expected to close later this month. The sale will result in a pre-tax gain of approximately $300 million in the fourth quarter.

In addition, a couple other transactions are currently going through our internal review and approval process. If these are completed, we expect them to result in a pre-tax charge of approximately $225 million. We will give you more information on these transactions in our 10-Q filing at the end of this month, and at our fourth quarter earnings call in January. For the sake of clarity, we are excluding these items from our closing discussion on performance for the fourth quarter and the year.

Finally, before I move on I'll make a brief comment on currency. The US dollar has generally strengthened since year end, especially against European currencies. IBM hedges its major cross-border cash flows and, as a result, mitigates the effect of currency volatility in the year-over-year results. The impact of these hedging programs is principally reflected in other income and expense as well as cost of goods sold.

I'm not going to predict future currency moves, but at current spot rates currency will hurt revenue growth and to a lesser extent earnings in the next few quarters. Over an extended period of time, a stronger US dollar negatively impacts IBM's revenue and earnings.

The supplemental chart at the end of the presentation benchmarks currency's potential future impact on revenue, assuming Friday's exchange rates.

Now let's turn to cash flow, chart 9. Through the third quarter we had strong cash flow from operations, excluding the funding of our US pension plan in the first quarter. This cash flow analysis chart has one primary difference from the FAS 95 format. It considers our Global Financing receivables as an investment to generate profit, not as working capital that should be minimized for efficiency.

Year-to-date, net cash provided from operations, excluding the change in Global Financing receivables, was $5.3 billion. Down $1.2 billion from last year. You will recall that we funded $1.7 billion in US pension contributions in the first quarter. We also sold our PC business, which we estimate had a negative impact on working capital.

This quarter we received $775 million from Microsoft in settlement of certain antitrust claims, which was offset by about $800 million of restructuring payments associated with our second quarter actions.

Total inventory was essentially flat year-to-year. However, adjusted for the sale of the PC business, inventory was up approximately $150 million. The increase was driven by the continued ramp up for game chips in our 300 mm fab. Overall, we continued improvements in working capital driven by better receivable collections and declines in aged receivables.

Turning to our use of cash for investments, net capital expenditures were approximately $3.1 billion year-to-date, an increase of $300 million year-to-year, primarily due to lower asset sales.

Let me make a subtotal here, since many investors look at cash flow after capital expenditures. We had a cash source of about $2.3 billion, $1.5 billion less than last year. We spent approximately $1.3 billion on acquisitions year-to-date, primarily for the second quarter acquisition of Essential. We had net proceeds from divestitures of about $650 million driven by the sale of the PC business.

We returned $7.6 billion to investors year-to-date, an increase of $2.4 billion year-to-year. $6.7 billion of this was through share repurchase. We bought back over 78 million shares year-to-date and average diluted shares stood at 1.6 billion, down 4.5% from a year ago. We have approximately $2 billion remaining from our last Board authorization at the end of September. And through the third quarter we have paid out over $900 million in dividends.

Moving on to chart 10, we will discuss the balance sheet. Our balance sheet remains strong for the first nine months of 2005. Our cash on hand was $8.3 billion. 96% of our total debt of $21 billion was driven by our Global Financing business, and Global Financing was leveraged at an appropriate 6.8 to 1.

The remaining non-financing debt level was about $900 million, with non-Global Financing debt to capital at 3.1%. Our balance sheet remains very strong and we are well positioned to capitalize on future opportunities and meet our cash needs.

Now let's turn to our three key businesses, starting with Global Services, chart 11. Global Services delivered revenue of $11.7 billion, growing 3% both as reported and at constant currency. The segment profit was up 16% year-to-year and the pre-tax margin improved to 9.3%.

Signings for services this quarter were $11.7 billion at spot rates or $11 billion at constant currency. This was up 13% year-to-year in the quarter, and up 18% year-to-date.

We signed nine deals larger than $100 million this quarter. Our backlog is estimated at $113 billion, up$3 billion from a year ago. This increase was driven by long-term signings growth over the last two quarters, and a return to lower levels of erosion.

Turning to the three major segments, Strategic Outsourcing, which was over (technical difficulty) of Global Services, grew signings 18%. Revenue was up 2% as reported.

Third quarter signage growth was led by strong year-to-year performance in the Americas. Our largest signing this quarter was for $1.7 billion with ABN Amro. This was the second consecutive quarter of double-digit signings growth, and our fourth quarter pipeline is up both quarter-to-quarter and year-to-year. Although signings do not translate immediately to revenue growth, they provide substantial benefits over longer periods of time.

Integrated Technology Services, excluding maintenance, was up 1% year-to-year as reported. ITS signings this quarter were down 8%, with signings declines in the Americas and Asia-Pacific. However, we did see a return to growth in EMEA, which was up 9% year-to-year. We're working to rebalance our ITS portfolio of offerings and shift our business development and delivery capabilities and skills to higher growth areas.

Business Consulting Services grew 6% year-to-year. This was led by growth in the Americas and Europe, offset by declines in Asia-Pacific. Business Consulting Services signings were up 18% over last year, with consulting and systems integration up 14%. And business transformation outsourcing up 45%.

Our consulting and systems integration business had many areas of high growth. Sector performance was strong in the financial services and industrial sectors. Faster growing practices included strategy and change and supply chain. This overall growth was mitigated by weakness in Japan, Germany and our federal business in the US.

Across all practices, we drove improved utilization, and pricing trends remain stable to improving. Our business transformation outsourcing business continued its pattern of strong year-to-year growth, led by strength in our human resources and finance and administration offerings. BTO is an important offering to address the business performance transformation services opportunity.

Other elements include strategy and change practice, Engineering and Technology Services, and business performance software. Through the third quarter we had BPTS revenue of almost $2.9 billion, up 35% year-to-year.

Turning to margin, Global Services gross margin improved 1.7 points year-to-year while pre-tax margin improved 1.1 points year-to-year to 9.3%. The year-to-year improvement in pre-tax margin was primarily driven by a better contract profile, benefits from our restructuring action, and CNSI utilization improvements.

As we told you last quarter, Global Services is primarily a resource-based business resulting in services margins being more impacted by both pension and equity compensation expense. In 2005 the year-to-year declines in equity comp helped to mitigate the increase in pension expense.

So to wrap up, Global Services grew signings double-digit for the second consecutive quarter and year-to-date, increased backlog by $3 billion since the third quarter of last year, and improved both growth and pre-tax margins by over a point year-to-year.

Looking forward, we will continue to focus on building our pipeline, converting that pipeline into both long and short-term signings growth and driving the productivity actions to improve our competitiveness and margins.

Let's move on to chart 12, systems and technology. Systems and technology group revenue of $5 billion grew 7% year-to-year, or 6% at constant currency. On the continued strength of our midrange platforms in Engineering and Technology Services.

zSeries MIPS grew 18% year-to-year while revenue declined 4%. This MIPS growth was driven by our new, system z9. In late September we began shipping the IBM system z9, which delivers a new level of secure and resilient computing to our customers.

In the third quarter, we saw particularly strong performance in emerging markets such as Brazil and Russia. zSeries customers continue to add new workloads to this platform as they build their on demand infrastructure. These new workloads have accelerated Java and Linux adoption on the z platform.

iSeries revenue grew 25% year-to-year, driven by broad demand for business solutions on our POWER5-based products. This second consecutive quarter of double-digit growth reflects an increased commitment to the platform from ISVs, resellers and customers.

pSeries servers had another strong quarter with growth of 15%, growing in all geographies. Based on a rolling four quarter average, IDC recently named IBM the marketshare leader in UNIX, surpassing both HP and Son. We expect our double-digit growth this quarter to extend that market lead.

Earlier this month, we announced our new POWER5+ processors, which include the industry's first Quad Core module, which puts four processor cores on a single piece of ceramic. IBM Microelectronics was the first to offer a dual core processor four years ago, and is again first to market with this technology advancement.

xSeries server revenue grew 11% year-to-year driven by strong performance in emerging markets. Despite strong competitive pressure in Europe and Asia, particularly in France and Japan, we believe we have maintained our market share in all three major geographies.

Our momentum in blades remains strong, with revenue growth of about 90% year-to-year, extending our market leadership position.

Total storage delivered year-to-year growth of 11% driven by strong midrange disk performance. External disks grew 19%. When the information becomes available, we believe we will have gained share again in this space and will maintain our market leadership in tape. The MIPS impact of our strong midrange performance, along with intensified competition, reduced margin this quarter.

Microelectronics revenue grew 14% year-to-year. Yields on our game processors were above our initial expectations as we ramped production. OEM revenue from our 300 mm products more than doubled compared to a year ago. Partially offsetting that benefit was the softening of demand for some of our older technologies.

The primary mission of our Microelectronics business continues to be providing technology to our systems business. Both the new z9 and POWER5+ processors are two examples of technology leadership only available from IBM.

Engineering and Technology Services had another strong quarter with revenue growth of 68% year-to-year. This unit focuses on providing technical services to our clients, enabling them to leverage IBM's technology in their research and development.

E&TS has enabled us to collaborate with existing clients in areas outside the data center in the development of their own products and offerings. These collaborative relationships have translated into incremental sales for IBM, especially within Systems & Technology Group.

Now we'll move on to software, chart 13. Software at $3.8 billion was up 5% year-to-year as reported and at constant currency. Total middleware grew 6% while operating systems were down 2%. There was strong growth in many of our strategic offerings, as evidenced by branded middleware growth of 10%. Other middleware, which represents 37% of total middleware, was flat.

The software market remains highly competitive but demand for IBM software was good in the third quarter. We saw growth in all geographies led by the Americas. In the third quarter we believe we held share in total middleware and grew share in each of the five key brands.

The WebSphere family of software grew 14% year-to-year. WebSphere Portal grew 17%, and WebSphere Business Integration software grew 13%. In the quarter we announced WebSphere process server, which is an integral part of our services-oriented architecture. We continue to extend our market-leading position over our nearest competitor.

Information Management software grew 10% and reflects strong growth from Essential. Our DB2 database family of software was up 4% year-to-year. We are continuing to build our information management portfolio with advances in content management, information integration, and the core database technologies.

Lotus software was up 12% year-to-year. This is the third consecutive quarter of double-digit growth in Lotus, which is fueled by strong acceptance of our Notes/Domino Version 7 software as well as continued growth in Lotus Workplace.

Rational software was up 12% year-to-year with strong growth in all three geographies. This has been the best quarter of growth since our acquisition. We saw strong demand from our large customers and closed the largest single transaction for Rational since acquisition.

Tivoli software was up 8% year-to-year. Tivoli delivered double-digit revenue growth in the security and storage software business. Our security products were powered by our new SOA security offerings, which have been well received. Our storage software products were especially strong, with customer adoption of our virtualization technologies continuing to gain traction.

We've received a number of questions on our software strategy in the context of recent industry announcements. Let me take a minute to comment. On demand business requires application integration and flexibility based on open standards. Our middleware portfolio is designed to provide these characteristics regardless of how the application market evolves.

We will continue to partner with thousands of ISVs and system integrators, and will support in-house application development with software that provides the openness and interoperability that customers desire.

Overall, our software business had a good quarter. We believe we gained share in each of the five middleware brands and held share overall. Profitability improved as well, with solid growth in segment PTI margins.

Now I will wrap up chart 14. IBM delivered solid profit performance in the third quarter, reflecting the breadth and flexibility of our business model. Revenue growth continued at a pace consistent with the second quarter. In hardware we had strong performance in midrange servers and we successfully launched our new mainframe product.

Within software we continued the momentum in our key middleware brands. We continued to drive growth in the key opportunity areas of emerging countries and Business Performance Transformation Services. Our SMB organization continued its strong growth, and we had solid execution and a good demand environment in Americas. And Europe's performance improved.

Turning to the productivity and cash elements of our model, we had improved margin performance, with our portfolio actions and the execution of our productivity initiatives yielding benefits in the quarter. And our strong cash and balance sheet position allowed us to continue to return value to shareholders through share buyback and dividends. This all added up to good profit growth, and offsets the shortfall in first quarter to put us back on track through three quarters.

Based on this performance, you should roll through the third quarter EPS overachievement to full-year estimates. This positions us to achieve performance consistent with our longer-term model of double-digit EPS growth through the fourth quarter and the full-year 2005.

Our strategies, investments, and operational actions are all designed to deliver on our business model based on innovation and balanced performance across our hardware, software and services business. While it is early to comment on next year, based on what we know now, we remain confident in our longer-term model. Now Patricia and I will take your questions.

Patricia Murphy - *International Business Machines - VP of IR*

Before we begin the Q&A, let me comment on two items. First as always we have a few supplemental charts at end of the deck that complement Mark's prepared remarks. Don't forget to turn off the slide synchronization to freely navigate within the presentation. Second, as always, please refrain from multipart questions. This will allow us to take questions from more callers. Operator, let's open it up.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Ben Reitzes, UBS Warburg.

Ben Reitzes - *UBS Warburg - Analyst*

Mark, could you talk about how the fourth quarter looks on a revenue basis in particular? Should we expect similar type of revenue growth? And also with regard to the mainframe being launched at end of the quarter, could you give any color on whether there was revenue pushed into the fourth quarter from the third, with the timing of that launch being so close to the end of the quarter, and what your prospects are there?

Mark Loughridge - *International Business Machines - SVP and CFO*

First of all, I told you last quarter that we expected the second half to be characterized by more cost and expense management than revenue growth. We are executing to this view, including the restructuring actions we implemented in second quarter to improve our competitive cost structure. We've already seen the financial benefit this quarter.

As you look at that, I would say that I characterize the fourth is being similar in texture to the third; more cost and expense, and achievement of our model objectives. As far as the z9 announcement is concerned, one, we're very happy with that announcement. It did ship late in the quarter, so we will get the benefit in the fourth of a full quarter shipment. MIPS were up 18% and it was very well received by our customer set.

Patricia Murphy - *International Business Machines - VP of IR*

Let's take the next question please.

Operator

Tony Sacconaghi, Sanford Bernstein.

Tony Sacconaghi - *Sanford Bernstein - Analyst*

Mark, you had suggested that analysts should roll forward their estimates from Q3 into this year. I just wanted to clarify that statement. If you really did believe that Q3 was not unusually strong for any reason, and I'm not so sure there is, seasonality over the last few years would suggest $2 or more a share in EPS in Q4. That's significantly higher than consensus analyst estimates.

When you say roll forward, should we be thinking about rolling forward normal seasonal trends? Is that what you're implying? Given some of the positive things that affected you this quarter, such as gaming, productivity improvements and mainframe all likely to be as strong or stronger next quarter, why shouldn't we be thinking of at least normal seasonality on an EPS side looking into Q4?

Mark Loughridge - *International Business Machines - SVP and CFO*

Very good question. First of all, I think we did have a very good quarter. I would, though, go back to kind of year-to-date performance. You can see on that basis while we did have a very strong third year-to-date, our performance without the nonrecurring items is up about 14%. So we'd see fourth quarter consistent with our model.

Let me talk a little bit, as you raised, we do have some strong tailwinds, we also sat have some headwinds though. So number one, we do manage our business to hardware, software and services achievement on the longer-term, and again aim for double-digit earnings per share growth.

From a headwinds standpoint I would say that for services, to accelerate the revenue growth we do need to continue to grow signings double-digit over the next few quarters. Now we are encouraged that we had two quarters of double-digit growth, but we need to continue that.

Secondly as we pointed out both in the text and in the supplemental slides, there is a very strong trend toward the strengthening dollar. Which over time will negatively impact revenue in the fourth and to a lesser extent earnings.

As we go into 2006, we will continue to have pension as a headwind. But I would agree with you, when you look at tailwinds going into both '06 and '04, we continue to see our customer set shift towards solution, which biases to our advantage.

We continued to have a very competitive product line, including our recently announced z9 platform, which we will have for the entire quarter. Our strong midrange systems performance and now game chips for the quarter.

We will continue to benefit from our productivity initiatives which provide us more competitive cost structure. When you look at that cost structure it's both for our pricing environment and our investments to mitigate labor cost challenges as well as profit.

So I think on balance, I would conclude that I would encourage you to roll through the overachievement from the third to your full-year. And I feel confident that we have the right actions in place to achieve our model objectives.

Patricia Murphy - *International Business Machines - VP of IR*

Let's go to the next question please.

Operator

Laura Conigliaro, Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

On the hardware gross margin side, hardware gross margin was down year-to-year in the second and the third quarters. But with the mainframe cycle hitting full stride in the fourth quarter, is last year's strong fourth quarter gross margin totally out of reach?

Specifically, are elements such as price and mix exerting such a strong toward pull on hardware margins that that would be the case, that they are -- that it is out of reach?

Mark Loughridge - *International Business Machines - SVP and CFO*

If you look at our profit in S&TG, we did have a slight decline in profit the third quarter, about $8 million, despite our growth in revenue. The two main drivers of this are IP income, which is down somewhat year-to-year, and also the change in mix year-to-year driven by our zSeries product lifecycle and also by the strong growth we've seen in our midrange storage products.

But as we go into fourth quarter, I would reiterate we now have a solid quarter of the z9 shipments. Which is obviously at the high end of our product line, in both price per unit and margin.

Patricia Murphy - *International Business Machines - VP of IR*

Let's go to the next question, please.

Operator

Harry Blount, Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

You had mentioned that you expected to have 100% of the resources exit the business by the end of the calendar year. You also made another comment about having a substantial portion of margin flow-through already impacting the business. So I just want to make sure, I'm trying to understand this in the right framework.

Are you basically saying that on a year-over-year basis as we look in the first half of '06, you're not going to let a lot of the incremental margin flow-through? You're going to use that for incremental investment? I wasn't quite clear of that statement.

Mark Loughridge - *International Business Machines - SVP and CFO*

No. What I was saying is that obviously these improvements in our cost structure will not only flow to the bottom line, but also give us price advantage as we enter competitive engagements. And we will have to see how this plays out.

This quarter, the bulk of this did float the bottom line as you look at our performance. Going back to earlier comments on our restructuring, we have now by the end of the third quarter exited about 90% of that resource going into the fourth quarter. And we expect to have all of the resources exited by the end of the year.

We've had extremely good performance on that restructuring, especially in EMEA. I'm very proud of that unit for, one, maintaining their revenue momentum while got that work done.

Patricia Murphy - *International Business Machines - VP of IR*

Let's go to the next question please.

Operator

Richard Gardner, Citigroup.

Richard Gardner - *Citigroup - Analyst*

I was hoping you could give some more detail on the lack of bookings growth within the consulting business. In particular, was it more a decline in projects, more a decline in pricing? Could you talk about what practices are not doing as well as you would like? Can you talk about what you think it takes to get the business growing again? And finally, some more detail on the ITS portfolio rebalancing. Thank you.

Mark Loughridge - *International Business Machines - SVP and CFO*

Let me talk a little bit about that. First of all on the short-term signings in revenue growth, CNSI component of BCS actually had good growth in signings this quarter, up 14%. The real issue is ITS in the Americas and AP, where we started to take actions to improve this.

Those actions certainly really reshape our portfolio and increase our focus on higher growth areas, including shifting our business development and delivery capabilities and skills to these areas. So in that ITS area specifically, I think we should start to see benefit as we enter 2006. But once again, I would reiterate that really CNSI component in BCS had pretty good signings momentum this quarter, again up 14%.

Patricia Murphy - *International Business Machines - VP of IR*

Let's go to the next question please.

Operator

David Grossman, you may begin.

David Grossman - *Thomas Weisel Partners - Analyst*

Could you maybe update us on your thoughts on the pension for next year? Specifically, how should we think of the changing rate environment? And again, I guess interfacing that with the equity comp number for '06, should we think of a similar relationship in 2006 as we have seen in 2005?

Mark Loughridge - *International Business Machines - SVP and CFO*

As you recall, our retirement-related expense for 2005 is $1 billion higher than 2004. Earlier this year, we told you that applying year end 2004 assumptions to 2006 would drive pension expense up another $500 million in '06 year-over-year, again based on a year end 2004 assumption. So we have to see how 2005 in fact plays out.

But let me give you a little more background there. Number one, now that we are approaching year end it's important to note that the actual 2006 expense will be dependent on the year 2005 interest rate yield curves. We've seen a lot about the flattening of the yield curves and I'm going to explain how that affects us, both US and outside the US.

First of all, for the US, short-term interest rates will impact the interest crediting rate on US cash balance plans and related expenses in 2006. So in other words, the higher the rate, the more expense.

On the long-term interest rates impact, this affects the discount rate used to calculate the liability and pension expense for the following year. So the lower the rate, the higher the liability; and as a result, the higher the expense. This applies not only to the US, but also the non-US.

In addition, the returns on planned assets in each these country's plan during 2005 will affect 2006 expense, differences again from the expected ROA drives impact on 2006 expense. We will come back to you in January, once we know how the year end actually concludes, with an update on where we are for 2006 pension expense.

Patricia Murphy - *International Business Machines - VP of IR*

Let's take the next question please.

Operator

Richard Farmer, Merrill Lynch.

Richard Farmer - *Merrill Lynch - Analyst*

Given some of the consolidation that we've been seeing in the software applications base, particularly from Oracle, I wonder if you might be willing to comment on whether or not you see the competitive landscape changing at all there, and what the implications might be for IBM.

Specifically, is the probability now increasing that IBM might cross the line over the infrastructure space into applications? I guess if not, what level of industry consolidation in applications would cause IBM to think about that differently?

Mark Loughridge - *International Business Machines - SVP and CFO*

We've not really experienced a negative impact to our business from Oracle's recent acquisitions. Number one, we partner with Oracle on many fronts, including hardware, services and middleware. We've really had no loss to DB2 installed base in our legacy Siebel and PeopleSoft customers.

In September, IBM and Oracle announced a broad partnership to enable future Oracle applications on the IBM WebSphere platform. So really this IBM Oracle partnership was driven by customer demand for IBM middleware, particularly WebSphere. So we feel we had strong customer demand, which will dictate any expansion in this partnership.

But so far we've been pretty encouraged by this. And again I want to reiterate that we have a strong partnership with Oracle on this base.

Patricia Murphy - *International Business Machines - VP of IR*

Let's go to the next question please.

Operator

Richard Petersen, Pacific Crest.

Richard Petersen - *Pacific Crest - Analyst*

Good afternoon. You mentioned the opportunity with gaming customers several times. Can you give us a little bit more detail about how that impacted your quarter and how should we think about the opportunity in future quarters?

Mark Loughridge - *International Business Machines - SVP and CFO*

First of all, the game chip benefit is from the same technology and fab that supports our IBM systems. And as I said earlier, we're seeing better yields than we initially planned and we are on schedule for our output. So together with our process partners we're on schedule to support our clients' launch schedules. We've been very pleased, number one, with the yield on this chipset. It's been very positive in the quarter.

Number two, we have really met all of our customer requirements on this chip. You're quite correct that as we go into the fourth quarter we will have a full quarter of shipments on this base. But I want to reemphasize that the objective of our Microelectronics organization is, number one, to support our server organization. And really, you see that both in the growth of our server platform and the competitiveness of the server platform.

But you're correct. We will see three good months of shipments of our game chips in the fourth quarter.

Patricia Murphy - *International Business Machines - VP of IR*

Let's take -- let's go to the next question.

Operator

Rebecca Runkle, Morgan Stanley.

Rebecca Runkle - *Morgan Stanley - Analyst*

Just a couple of follow-ups as it relates to revenue breakouts. One on public. That was your weakest quarter year-to-date. If you could just provide some color in terms of whether or not that was in line with internal expectations, and if not, where the disappointment was.

And as it relates to Japan, clearly showing increasing signs of strength in that geo. Yet you're in the process of restructuring, so to speak, to improve execution. Can you talk to when you expect to be in a position to leverage some of the geo strength you're starting to see in that marketplace?

Mark Loughridge - *International Business Machines - SVP and CFO*

You bet. Why don't we talk about federal first, and public sectors. Number one, as you saw in our results our overall public sector grew 5% year-to-year without PCs, on really strength and health care. The place that we need to put more effort really is in our US federal, but we did believe we held share with the areas of strength and weakness.

We had strong hardware performance growing nearly 20% in both third quarter and year-to-date. Software had modest growth on a year-to-date basis. And we have been more challenged really in our performance here on services, but I will point out that we did grow signings in the quarter, so we're more encouraged about the prospects there.

As far as Asia is concerned, number one, I want to point out the IT market in AP remains attractive. We saw strength this quarter in ASEAN, with the 13th consecutive quarter of double-digit revenue growth. We had growth in emerging markets countries that's been driven by our customer investments to build out our infrastructure, especially in the financial services sector in India and China.

Japan, which represents about 60% of the Asia-Pacific revenue base, once again declined at constant currency in a soft but improving economic environment. But we're taking the actions to improve our performance in Japan.

I will point out that the growth in Japan is taking place in smaller accounts and through smaller deals. That's where our actions are focused, especially in our use of alternate channels and IBM.com to better engage for these new opportunities.

So I believe Japan is positioned for a fourth quarter similar to the third. The rest of AP I believe will continue to grow outside of Japan, and Japan should be I think poised for a recovery as we enter 2006.

Patricia Murphy - *International Business Machines - VP of IR*

Let's take one more question.

Operator

Stephen Fortuna, Prudential Equity Group.

Stephen Fortuna - *Prudential Equity Group - Analyst*

Just a couple things on the services side. You talked earlier about -- you have seen a better contract portfolio, you're benefiting from restructuring, improving utilization, and things like that. In light of that, moving into the fourth quarter, do you think it's possible that we were able to see double-digit operating or pre-tax margin in the services business? You did 9.3 in the third quarter.

And then secondly, maybe you can provide us some color in terms of how you're feeling about the strength and visibility of the deal pipeline. And maybe in that context as part of the restructuring that you guys have been undergoing, maybe talk about some of the specifics IBM is engaging in relative to improving the management of the deal pipeline, particularly on the short-term side.

Mark Loughridge - *International Business Machines - SVP and CFO*

First of all, let me talk about margin. I'm not going to get specific on margins for any one of the businesses. But I will tell you that given the success of our restructuring and productivity initiatives, we do expect to improve margins in the (technical difficulty) year-to-year and quarter-to-quarter.

To your question on pipeline, if you look at it, really our fourth quarter pipeline continues to show growth, both quarter-to-quarter and year-to-year. So the pipeline is at a level that supports signage growth in the fourth. Of course, as always, we need to execute and get out and convert that pipeline to signings.

Patricia Murphy - *International Business Machines - VP of IR*

Thanks Steve, and thank you all for joining us today. Have a good day.

Operator

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