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Buffett steps into the cloud with his bet on Big Blue

By Richard Waters

Warren Buffett has famously steered clear of the tech sector on the grounds that he is ill-equipped to assess the periodic disruptions that sweep through the industry. Yet with the $10.7bn bet he has just placed on IBM , he has stepped into the middle of the biggest disruption since the emergence of the PC.

The rise of cloud computing is exactly the sort of secular tech shift that has kept the Sage of Omaha on the sidelines in the past. That he has invested regardless is a testament to the fortress IBM has constructed around its business. It also represents a bet that the cloud disruption will be different, and that old names like IBM are in a position to manage this one to their advantage.

In many ways, the surprise is not that Mr Buffett has finally taken the plunge in tech, but why it took him so long.

It's not just that IBM has been a fixture of the US business establishment for decades. As an executive at one of the company's biggest competitors ruefully admits, IBM is exactly the kind of business that Mr Buffett loves. Its relationships with its customers are the most durable in tech and its single-minded mission – to win a progressively bigger "share of wallet" from the chief information officers who have come to rely on it – has been remorselessly effective.

With its push into services and business consulting, IBM has cemented those relationships in a way that no rival has been able to match. There is no surprise here: IBM's approach has long been seen as the model to copy in tech. But its rivals have been either too slow or have mishandled their response, with HP's belated acquisition of services company EDS – and troubles integrating the business with the rest of its salesforce – just the most visible example.

Behind the giant services division, meanwhile, lies Big Blue's real secret weapon: a software business that has been the main driver of its earnings and margin growth. There is little natural operating leverage in services, which relies on hiring more people the more work there is to do. But software has given IBM a way to enshrine repeatable processes in code, increasing the bang for the buck it gets from its services engagements.

Perfecting this approach to services and using it to drive hardware and software sales also accounts for Sam Palmisano's success in defusing the threat from low-margin Indian IT services companies during his decade as IBM's chief executive.

While fine-tuning this business model, Mr Palmisano has also made IBM a machine for delivering higher shareholder returns. There has been little overall growth: revenues, which hit $88bn in 2000, were still under $100bn last year. But as Mr Palmisano has shuffled IBM's portfolio of businesses, the net profit margin has climbed from 9 per cent to 15 per cent. Also, aided by the buy-backs and other shareholder-friendly actions so praised by Mr Buffett, earnings per share have risen from $4.44 to $11.52.

With his five-year "roadmaps" laying out detailed financial targets, Mr Palmisano, who retires at the end of this year, has left an unrivalled process for holding his successors accountable. With IBM, he promises, what you see is what you get.

How defensible will IBM's high-margin citadel be in the cloud disruption that lies ahead? The centralisation of computing resources in larger data centres, along with the transformation of the output of IT into easily consumable services, promise to bring massive reductions to unit costs in computing.

IBM has stood partly aloof from this. Rather than bet on the shared "public clouds" that will have the biggest economies of scale, it is betting that it can bring ingredients of the technology to bear in company-specific "private clouds". The pay off will be smaller, but the upheaval to IT functions less. The natural conservatism of IT managers suggests that this is a solid bet.

Yet most corporate IT departments are also under pressure. Departmental business managers are impatient: they want to equip their workers with the latest smartphones and tablets. Rather than wait for the IT department to allocate the resources to back their latest projects, they would rather tap into the new online services that public clouds are starting to foment.

These forces will create dynamic new businesses with growth rates that far exceed the plodding progress of IBM. From the makers of new cloud-connected devices to software-as-a-service providers and suppliers of the technology infrastructure to support the public cloud platforms, there will be many hotter stocks in the tech world.

Mr Buffett is prepared to let such opportunities pass by. His bet is that Big Blue's brand will remain the gold standard in corporate IT, and that generations of CIOs to come will grow up repeating the mantra of their forebears: You can't get fired buying from IBM.

Richard Waters is the FT's West Coast Managing Editor