# The IBM Spinoff of Kyndryl:

## *Who, What, and Where does the Company Fit in the IT Services Landscape?*

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## Summary

Appointed CEO in January of 2020 and assuming the role in April 2020, Arvind Krishna wasted no time in plotting a strategy that would allow the company to be a leaner and more focused organization — one well positioned for growth and having a strong focus on hybrid cloud and AI capabilities. Part of Krishna's strategy moving forward was revealed in an October 2020 announcement setting the stage for a spinoff of IBM's Global Technology Services unit – the company's managed infrastructure services business – into a separate and independent company initially referred to as "NewCo" in the announcement. It's expected that this spinoff will occur during the last quarter of 2021.

This move was intended in part to help alleviate the drain this business was having on revenue, profitability, and the company's bottom line. But it also offered a strategic opportunity for the unit to forge new partnerships and business opportunities that were not possible while part of IBM as it seeks a path to growth and profitability.

That new company was subsequently named Kyndryl, and IBM's spinoff of this business unit will result in some 90,000 employees — a quarter of its workforce — and almost $20 billion in annual revenue — leaving IBM and transitioning to the new Kyndryl entity. The remaining IBM teams will be laser-focused on transforming IBM into a Cloud and AI focused business, offering products and consulting services, along with long-term strategic outsourcing engagements.

## The IT Services Landscape

The market for IT services management is a fragmented one, with no global player commanding more than 10 percent market share. Competition for business is fierce and full of providers such as TCS, HCL, and Wipro, who have leveraged successful offshoring models to reduce the cost of their offerings. But it is a large and growing market. As IBM stated in their Sept 28th filing with the SEC regarding Kyndryl:

> "We project this market, which is a subset of the total IT services market, to represent a $415 billion opportunity in 2021, growing 7% annually to $510 billion in 2024. Growth in this market is driven by services that are aligned to customers' transformations and represent an incremental $75 billion opportunity… including public cloud managed services (compounded annual growth of 11% from 2021 to 2024), data services (compounded annual growth of 18% from 2021 to 2024), security services (compounded annual growth of 12% from 2021 to 2024), and intelligent automation services (compounded annual growth of 27% from 2021 to 2024)."
>
> *— IBM statement in September 28, 2021 SEC filing*

There are many factors driving this growth, including the acceleration of technology deployments, the increased complexity of IT implementations, and a growing need for highly specialized skills and talent.

Over the past couple of years, enterprise organizations have seen both their business models and technology infrastructure disrupted. In fact, 72 percent of business and technology leaders recently surveyed by the Futurum team said they believed their organization's mindset regarding technology, business processes, and operational needs had significantly changed as a result of ongoing trade issues and a global pandemic. Not surprisingly, a whopping 96 percent additionally stated they've accelerated their digital transformation and technology modernization plans.

As organizations have accelerated their transformation plans, their IT infrastructure has become more complex — a point echoed by 93 percent in that same study. We believe that this increase in complexity is likely to continue to occur as IT departments modernize applications and migrate their compute and storage systems into a hybrid cloud model. Note that the 82 percent of respondents in our study expect hybrid cloud architectures to be their primary compute environment within two to three years from now.

With this increased complexity and accelerated technology deployments comes the inevitable requirement to upskill IT talent, a requirement reinforced by 99 percent in our study who agreed they need to improve their organizations' current technology skills and talent in order to keep pace with new technologies and business processes.

But even as the demand for highly skilled IT talent is at an all-time high, we continuously hear from organizations that report having a difficult time recruiting for skills in areas such as AI, cloud and edge computing, data analytics, and security.

These factors are collectively driving the demand for managed services providers capable of bearing the load of IT management, thus allowing organizations to concentrate their focus and resources on their core business operations.

## The Launch of a New Brand — NewCo Concept Becomes Kyndryl

Shortly after Krishna's announcement of the split, NewCo was subsequently branded as Kyndryl, a combination of the words "kinship" and "tendril" intended to represent new growth and working together. At present, most of the soon-to-be-Kyndryl team within IBM's Global Technology Services unit have shifted email addresses from @ibm.com to @kyndryl.com.

New name aside, Kyndryl will continue the offerings of IBM's Global Technology Services unit and offer managed IT infrastructure services. And given that this unit was a discrete business within IBM we don't foresee any noticeable disruption for either the Kyndryl team or IBM's existing clients as they navigate the transition.

We note that in news out of IBM this last week around the upcoming spinoff of Kyndryl, **IBM is renaming its service business IBM Consulting** with a goal of simplifying areas of focus and differentiation. Those focus areas will be around delivering strategy, experience, technology, and operations expertise and consulting services centered on driving innovation through the application of technology needed in a world dominated by hybrid cloud environments.

## Unpacking Kyndryl's Business Model

Kyndryl's business model is focused on serving organizations that don't see IT service delivery as core to their business objectives and who recognize the value of having a strategic partner they can rely on for the outsourcing and management of their IT infrastructure. Kyndryl's value proposition is tied to both the offloading of IT management and the deep technical expertise of its highly skilled IT staff.

It doesn't matter whether the hardware, software, or even the cloud an organization is using comes from IBM or any other vendor or provider – Kyndryl, like its predecessor, is intended to be agnostic to the source of a client's technology. But now from a branding perspective, Kyndryl's independence from IBM makes it easier to pitch this agnostic position and allow it to cast a much wider net for potential clients and partners.

There is, of course, much we don't know in these early days about what to ultimately expect from Kyndryl, but we do know it will be organized into six global managed services practices and a customer advisory practice that will combine managed services, advisory services, and implementation offerings. The six global practices will each focus on a different aspect of the IT technology stack as follows:

- Applications, Data and AI
- Cloud
- Core Enterprise and zCloud, IBM's mainframe-as-a-service offering
- Digital Workplace
- Network and Edge
- Security and Resiliency

It is interesting to see Kyndryl breaking out the zCloud business, although it is currently not clear how many mainframes will fall under the management of Kyndryl once the split from IBM is complete. At this point, we estimate that to be in the neighborhood of 1,000 discrete systems, but we don't yet know for certain. What we do know, however, is that by some margin, Kyndryl will be the largest provider of mainframe based managed services in the market and will have the deepest bench of skills in this technology stack.

We'll be watching closely to see how the relationship develops between IBM's Systems Business Unit and Kyndryl in the coming quarters, as Kyndryl will be the hardware division's largest client by some extent, eclipsing the relationships it has with the likes of Cap Gemini, Deloitte, Accenture, and DXC.

## What We Know About the Kyndryl Team

Kyndryl has taken an approach that blends some of the best of the IBM management bench with experienced, but non-IBM, leaders who offer a fresh and independent perspective. That's an important issue as Kyndryl is essentially an existing entity that needs continuity, yet it needs to think like a startup with new ideas and new opportunities.

The Kyndryl CEO role has been assumed by IBM veteran Martin Schroeter, whose name was originally bandied about as a potential replacement for former IBM CEO Ginni Rometty. Previously a senior vice president of global markets, Schroeter left IBM in June 2020 before the spin-off was announced, in what was perhaps a well-timed sabbatical, before returning as the leader of Kyndryl in January 2021.

In March of 2021, another raft of senior appointments was announced, including the return of IBM veteran Elly Keinan as group president. At one point the leader of IBM's North American region, he recently departed IBM after 33 years to move into the venture capital market.

Maria Bartolome Winans was also appointed as Kyndryl's CMO, spinning into that position directly from her role as CMO for IBM Americas. She'll be tasked with building the Kyndryl brand as well as the day-to-day execution of the Kyndryl marketing engine. She's a proven leader and will no doubt work to build a separate and distinct brand identity for Kyndryl and play a key role in the company's ultimate success.

Other notable IBM alumnus joining the Kyndryl team include General Counsel Edward Sebold formerly the chief legal officer for IBM's Watson Health division; Chief Transformation Officer Nelly Akoth, formerly with IBM Global Business Services; Leigh Price, who will be handling  strategy and corporate development; Stephen Leonard previously working as the GM of the UK&I and former lead of the Power Systems team; and Vineet Khurana stepping into the role of controller after five years in three different CFO roles at IBM.

Some non-IBMers in key leadership positions, and bringing in an outside perspective, include:

- Global Head of Corporate Affairs, Una Pulizzi, who previously had a similar role at GE
- CIO Michael Bradshaw, having previously served as CIO at NBC/Universal and as CIO for Mission Systems at Lockheed Martin
- CTO Antoine Shagoury, a former CIO of US Bank State Street and of stock exchanges in the U.S. and London, and most recently, working with strategic advisory partnership Ridge-Lane
- Head of Customer Advisory Practice, Vic Bhagat, a former CIO for Verizon Enterprise Solutions, EMC, and several units of GE
- Chief Human Resources Officer Maryjo Charbonnier, formerly with Wolters KluwerCFO David Wyshner, who previously headed up finance at XPO Logistics, a supply chain management outsourcer, and before that helped Wyndham Worldwide split into separate companies
- COO Harsh Chugh, most recently CFO at SaaS provider PlanSource

What we can see from this list of key executives is that the culture at Kyndryl as it launches will be quite similar to that of IBM, which is to be expected. That said, Martin Schroeter is his own man, and it will be interesting to see him and this new team steer Kyndryl forward and work to make inroads in the market.

One final note on this front, although Kyndryl starts off with the 90,000 staffers it inherited from IBM, the company is also on a hiring spree. The company is seeking to fill some 1,500+ lower-level jobs, 300 of which are in the United States and the remainder in markets like Brazil, Costa Rica, Hungary, Poland, and the Czech Republic. Half the openings are for technical specialists, with more than 100 openings in each of systems architecture and sales.

With this rapid expansion, and the inevitable staffing changes and right-sizing of teams we would expect with any spin out, some disruption is inevitable. But we expect the management team to focus hard on minimizing any disruption to the frontline teams that engage directly with clients while also working to ensure the stability and reliability of key service delivery and client management functions.

## What Will the Partnership Between Kyndryl and IBM Look Like and Who Else Will Likely Be Involved?

A key, and unanswered, question centers on just what form the partnership(s) between IBM and Kyndryl will take shape. Stephen Leonard has been tasked with leading Kyndryl's Global Technology Alliances and we believe this will be a key role for the company as it looks to establish its independence from IBM. We expect this role will require a fine balance of working with IBM, as many Kyndryl clients will be heavily dependent on IBM technologies.

That said, it will also be incumbent upon Leonard to foster relationships with IBM competitors across the realms of software, hardware, and networking, and perhaps most crucially, cloud.

IBM Cloud has neither the breadth, market share, nor completeness of execution to be the sole public cloud offering upon which Kyndryl relies. This of course means that Kyndryl will also be working with hyperscalers like AWS, Microsoft Azure, and Google Cloud Platform in order to serve all clients' needs most effectively. We'll be watching announcements from Leonard and his team closely in the months ahead, not only for the tone of the partnerships forged but also with a view toward the key technical architecture choices made along the way.

One such choice Kyndryl must make involves plans to provide the underlying tooling for its clients in the cloud native and containerization space. While no doubt IBM will be hoping that Kyndryl doubles down on the Red Hat flagship product OpenShift, Kyndryl will have to temper the desire to partner with their former parent company and work to forge relationships with a multitude of hybrid cloud players if they are to truly deliver choice and options to their client base. There is every reason to believe that Schroeter, Leonard, and team are up to the task.

## Kyndryl By the Numbers — A Look at What's Ahead Financially

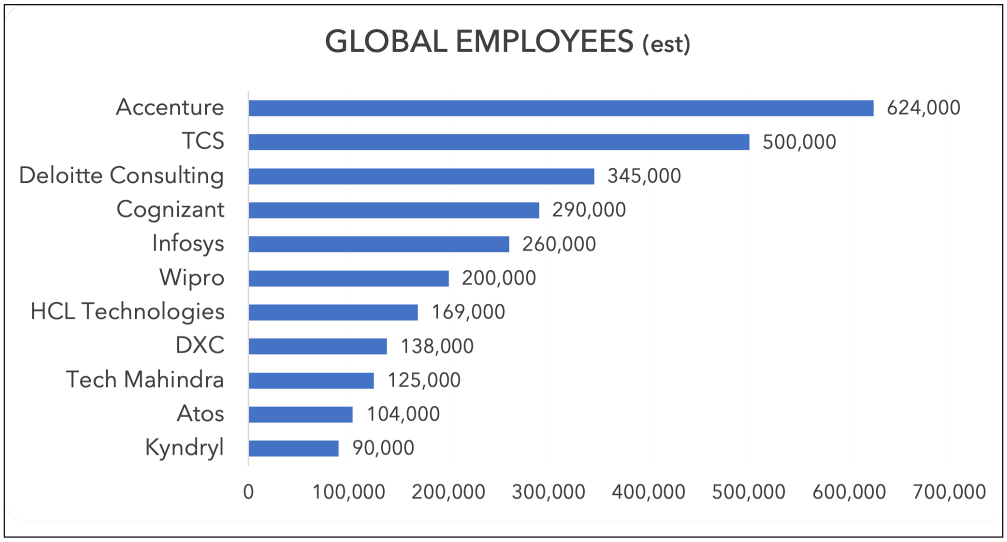
Following a market overview and a look at the new Kyndryl leadership team, we wanted to next take a dive into Kyndryl by the numbers. Pursuant to IBM's Sept 28th filing with the SEC, the company will offer a "pro rata distribution to IBM stockholders of at least 80.1% of the outstanding shares of Kyndryl" which will trade on the NYSE under the ticker KD. IBM intends to publicly offer the remaining 19.9 percent within the following 12 months to pay down IBM debt – a potentially smart bet if Kyndryl CEO Martin Schroeter can manage, and beat, investor expectations alongside its competition.

When Kyndryl is officially spun out of IBM, it will be bringing with it some considerable assets, including over $19 billion in annual services revenue derived from more than 4,600 clients in 115 countries (representing 75 percent of the Fortune 100), staffed by over 90,000 employees to make it all work. But while those are impressive numbers, Kyndryl is still a small kid on the block and will continue to be challenged by a group of global competitors that are typically larger and more diverse in their offerings. These include, but are certainly not limited to, providers such as Accenture, Atos, Cognizant, Deloitte, DXC, HCL Technologies, Infosys, TCS (Tata Consultancy Services), Tech Mahindra, and Wipro.

While some of these providers offer a range of services that go well beyond Kyndryl's offerings, like Kyndryl they are all focused on helping enterprise customers plan and implement digital transformation initiatives, migrate to the (hybrid) cloud, modernize applications, distribute compute resources to the edge, transform the workplace, and ensure it all happens in the most secure, trusted environment possible.

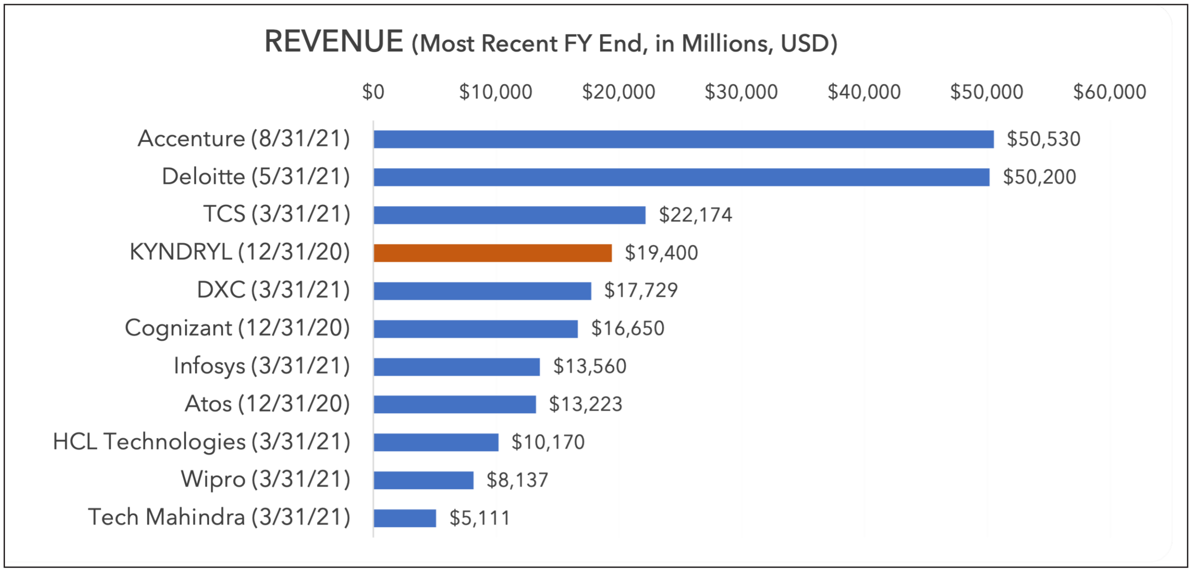
### ▶ Key Point: 90,000 is not a lot of employees

Among the top tier providers, Kyndryl's 90,000 employees place it well below industry heavyweights Accenture (624,000) and TCS (500,000). Why is this important? There is a global shortage of talent in many of the key technology areas core to Kyndryl's offerings, from artificial intelligence to cybersecurity. As it attempts to grow, particularly if the global pandemic continues, staffing could become a factor as the larger players continue to expand rapidly (ex: Deloitte has grown from 286,000 to 345,000 employees over the past three years).

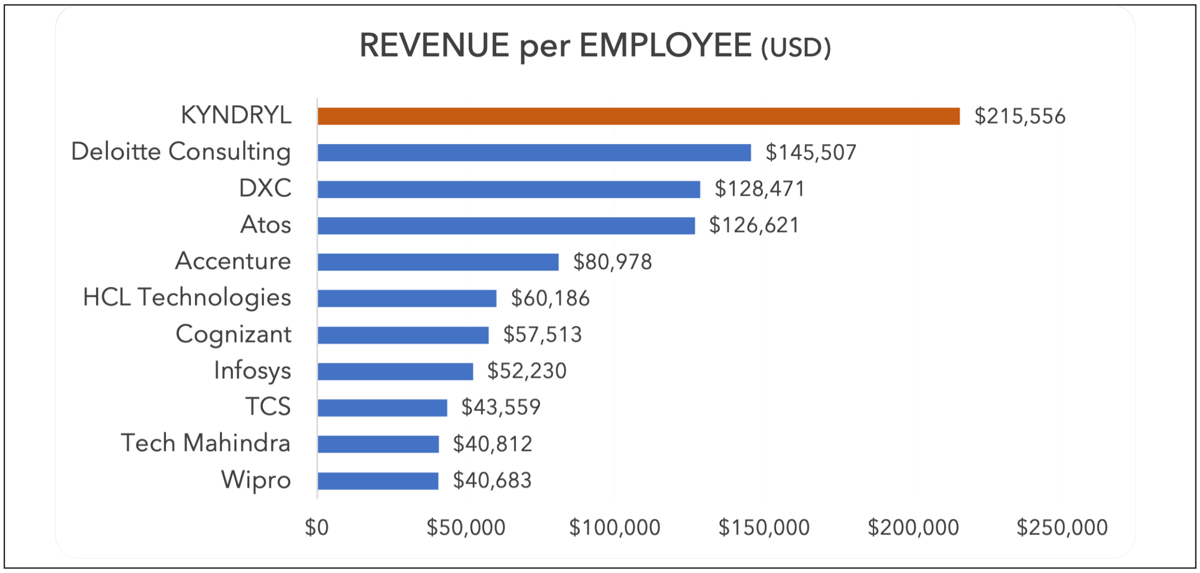


## ▶ Key Point: Kyndryl has phenomenal Revenue/Employee

From a pure revenue perspective, based on IBM's reported $19.4 billion for the FY ending 12/31/20, after the spin out, Kyndryl could enter the market at the end of 2021 in a very solid position trailing only Accenture, Deloitte, and TCS, all of which have more expansive service offerings.



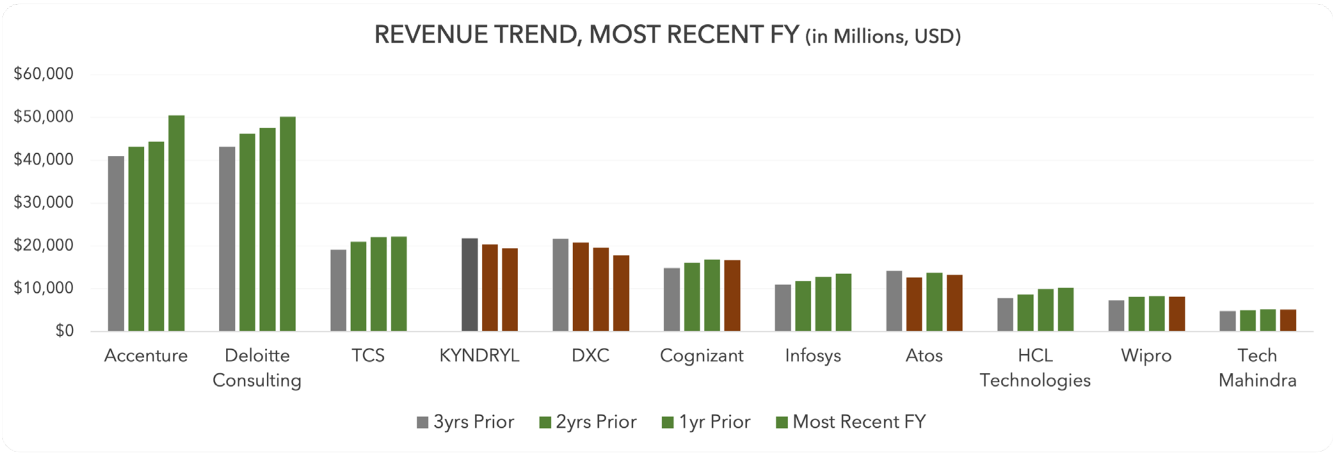

What we find impressive about Kyndryl's revenue stream is the revenue per employee it generates and the potential that represents. Kyndryl's offerings, which are more tightly woven around technology than some of its competitors with extensive staffing-based outsourcing operations, allow it to generate over $215k per employee. If the firm can continue to maintain that level while improving operational efficiencies and cost controls, it could greatly improve its margins in the long run.



## ▶ Key Point: Kyndryl revenue is impressive, but declining

Credit years 2020 and 2021 have been very challenging for managed services providers. Two difficult years on top of a much larger trend to near-source or re-shore business operations and pulling back talent-based operations closer to home. But while we believe Kyndryl's singular focus on technology services and digital transformation *should* have the firm in a growth position, it's important to note that revenue has declined for at least the past two years.

- FY2018 Revenue: US$21.8 billion
- FY2019 Revenue: US$20.1 billion (↓ 7% Y/Y)
- FY2020 Revenue: US$19.4 billion (↓ 4% Y/Y)




However, according to IBM's SEC filing, Kyndryl has revenue of $9.523 billion for the first six months of 2021, which does include a slight positive Y/Y for Q2:

- FY2021 Q1 Revenue: US$4.772 billion
- FY2021 Q2 Revenue: US$4.751 billion (↓ 0.44% sequentially but ↑ 0.3% Y/Y)

| | Three Months Ended June 30 | | Percent/ Margin Change | Six Months Ended June 30 | | Percent/ Margin Change |
|---|---|---|---|---|---|---|
| | 2021 | 2020 | | 2021 | 2020 | |
| Revenue | $ 4,751 | $ 4,737 | 0.3% | $ 9,523 | $ 9,569 | (0.5)% |
| Gross profit margin | 11.1% * | 10.9% | 0.1pts. | 10.3% * | 10.7% | (0.4)pts. |
| Total expense and other (income) | $ 845 ** | $ 803 | 5.3% | $ 1,700 ** | $ 1,903 | (10.7)% |
| Loss before income taxes | $ (319) *** | $ (284) | 12.2% | $ (722) *** | $ (879) | (17.9)% |
| Provision for income taxes | $ 74 | $ 89 | (16.4)% | $ 165 | $ 176 | (5.9)% |
| Net loss | $ (393) *** | $ (373) | 5.4% | $ (887) *** | $ (1,055) | (15.9)% |
| Net loss margin | (8.3)% | (7.9)% | (0.4)pts. | (9.3)% | (11.0)% | 1.7pts. |

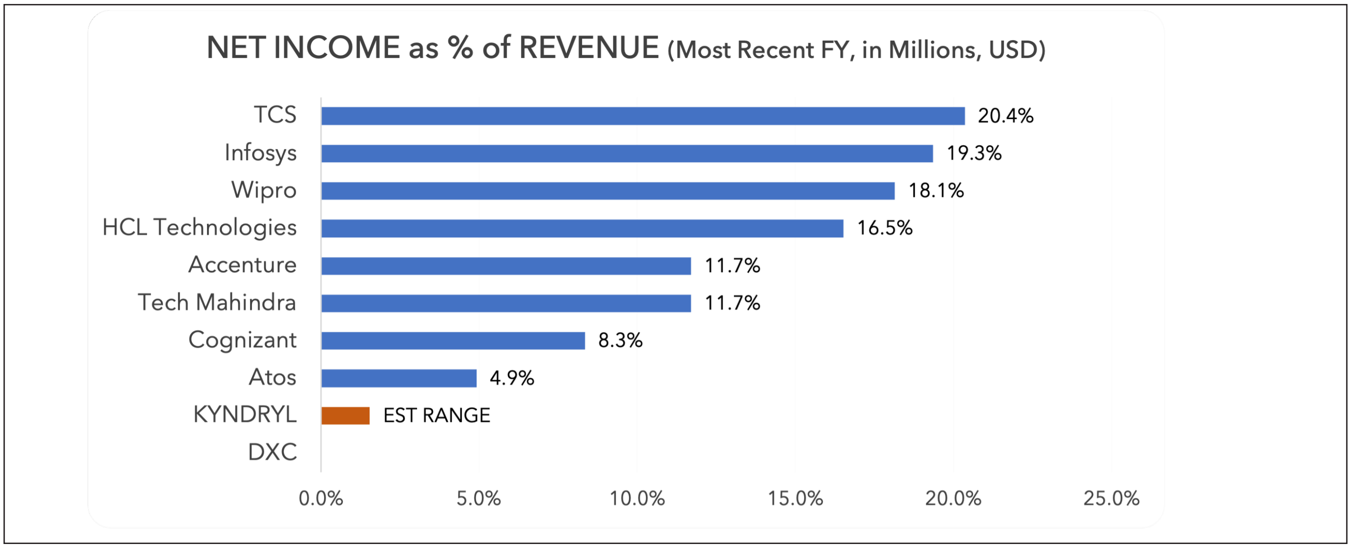
Source: IBM

* Includes impact from $58 million and $61 million of pre-tax spin-off-related charges in the second quarter and first half, respectively.

** Includes $119 million and $171 million of pre-tax spin-off-related charges in the second quarter and first half, respectively

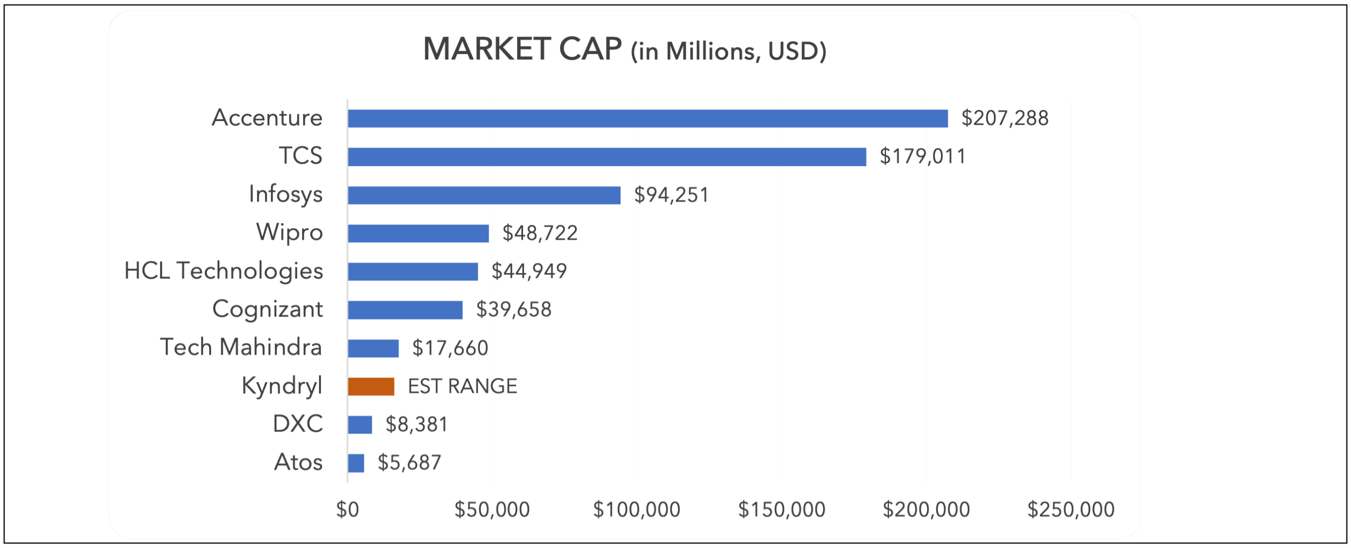
*** Includes $177 million and $232 million of pre-tax spin-off related charges in the second quarter and first half, respectively.

But despite generating a very high revenue/employee number and a slight positive Y/Y growth, we believe Kyndryl still has work to do through the remainder of FY2021 in order to generate the type of margins that would bring its estimated net income as a percent of revenue in line with its competitors for 2022 and beyond.




## ▶ Data Point: Operational efficiencies will drive market capitalization

As Arvind Krishna stated during the original announcement of the Kyndryl spinoff, "the new company will be able to build a more efficient operating model focused on service delivery excellence and designed to offer the next generation of transformational managed infrastructure services.

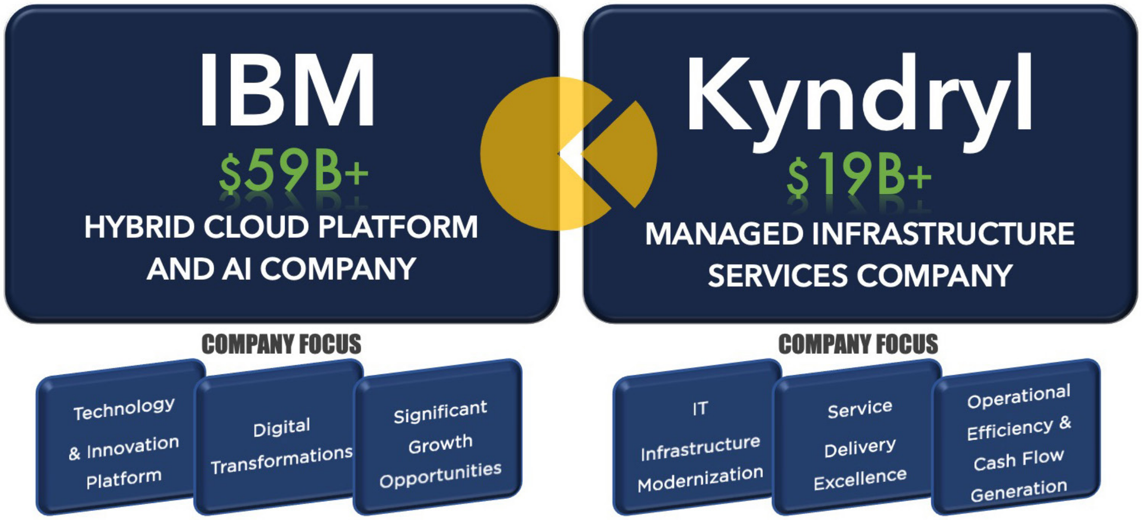



This is exactly what Kyndryl management will need to deliver in order to meet both financial targets and beat the competitive threats it will face. If it is unable to grow top line revenue while concurrently holding costs down, it will face the difficult challenge of implementing additional cost controls which could limit potential growth in the short term. But we do believe that can be achieved. In a nutshell:

- We're bullish on the growth of the market opportunity for Kyndryl's managed infrastructure services,
- We believe Kyndryl's services are well-matched to market need,
- We believe that an independent Kyndryl will have significantly more flexibility and agility in the market than it had within IBM, (including partnerships and services development, and
- We have a high level of confidence in the ability of the management team Schroeter has assembled to streamline operations and execute on plan.

## Unpacking Kyndryl's Business Model

The Kyndryl spinoff from IBM will essentially allow both companies to focus on what they do best. IBM can double down on its hybrid cloud platform and its AI capabilities, helping to spur innovation, digital transformation, and take advantage of some significant growth opportunities that are necessary for its continued success. Kyndryl can strive to be a best-in-class managed infrastructure services company, working with customers in need of IT infrastructure modernization, service delivery, and helping customers spur operational efficiencies that impact cash flow. These models will look a bit like this:




Spinning off Kyndryl pivots IBM from a services-led company to an organization whose revenue largely comes from software and solutions. Each company is focused on helping clients on their digital transformation journeys, each in different ways, which is needed in the market today.

With Kyndryl, Schroeter and team get a 90,000-person startup that's filled with top level talent, both from former IBMers and other industry leaders. We look forward to what's ahead – for each of these companies — in the months to come.

## Important Information About This Market Insight Report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