



COVER STORY • TECHNOLOGY

BETTING BIG ON RED HAT

A \$34 billion acquisition is paying off for Big Blue as Raleigh-based R continues to see striking revenue growth.



By Lauren Ohnesorge – Senior Staff Writer, Triangle Business Journal
June 11, 2021

Is IBM considering a headquarters move to Raleigh?

No.

At least that's the word from the IBM (NYSE: IBM) leaders in Armonk, New York – despite the investments, new hires and cloud technology focus the company is shoveling toward the City of Oaks.

Jim Whitehurst, the former CEO of Red Hat and current president of IBM, can't help but call it an enticing idea, though.

Speaking at a press conference in May, the Triangle resident joked that, "if you were asking me, you might get a different answer."

"We have a lot going on," Whitehurst said. "We're worried about getting people returned to work. We'll worry about facilities in the future."

But two years after technology's biggest deal, what's clear is IBM is turning red. IBM reported revenue of \$17.7 billion for the first quarter, up 1 percent. But Red Hat revenue was up a whopping 17 percent, according to the company's latest financials.

Regardless of any potential HQ switch, more and more technology observers who follow Big Blue and the impact Red Hat is having on the giant tech company's top line, agree Red Hat is going to play a bigger role with every quarter as cloud computing becomes the mainstay to connect businesses.

And having one of IBM's largest campuses in the world inside Research Triangle Park and near the downtown Raleigh Red Hat tower may already have paid dividends for Big Blue.



Jim Whitehurst, the former CEO of Red Hat and current president of IBM. JOHN WEST

The HQ talk

The biggest argument for a headquarters move could be made in terms of cost. IBM has been cost-cutting, aggressively looking to streamline what's not working in order to fund its high-growth businesses: cloud and artificial intelligence.

And an argument can be made that being in New York is not working for fiscally minded companies, says economic development expert John Boyd of The Boyd Company.

New York's corporate income tax rate is 7.25 percent, compared to North Carolina's 2.5 percent.

"Other state business taxes like workman's compensation and unemployment insurance are also significantly higher in New York state," Boyd said. "Add to this a much more favorable tort system and labor climate, including right-to-work legislation in North Carolina, which is not in effect in New York."

In recent months, some businesses have moved their headquarters to the Triangle primarily to capitalize on savings, such as Avaya and Phreesia (NYSE: PHR). Tech firm Avaya quietly relocated from California last year – but largely on paper, as its headcount is primarily remote with the pandemic and many of its executives live elsewhere. Like IBM, it had long had a presence in the region, having acquired Nortel's assets a decade earlier. Health-focused firm Phreesia made a similar move – designating its physical headquarters is now in downtown Raleigh instead of New York, while keeping much of its headcount in the Big Apple.

It's unclear how much money the companies saved with the move, but that's just one of the benefits.

When Advance Auto Parts (NYSE: AAP) formally agreed to move its headquarters to Raleigh in 2018, it finagled a deal for \$12.5 million in incentives. While Advance Auto already had an executive team and sizable headcount growing in Raleigh with or without the headquarters designation, state officials jumped at the opportunity for an official Fortune 500 address – aware of the economic development prestige its presence would bring. And the state's economic investments committee has not been shy about incentives this year, having recently approved Apple for a record \$846 million in potential reimbursements.

And state officials would likely step up again for a project as high-profile as an IBM headquarters.

“When comparing each state's economic development program, its experience, professionalism and business acumen, New York's program plays checkers while North Carolina's very winning program tends to play chess,” Boyd said. “It continues on a roll, especially in the tech and the life sciences sectors.”

But economic developers say it's talent – not dollars – that closes headquarters deals for North Carolina.

Lee Perry, senior managing partner for East West Partners and currently working on Bandwidth's new Raleigh headquarters, said there is plenty of interest from technology companies in the Triangle – and that it comes down to talent. He points to Apple (Nasdaq: AAPL), which recently committed to bringing more than 3,000 jobs to RTP, as just one example.

“More and more companies are seeing the region as a place that makes sense for a lot of reasons,” he said, noting “the talent base, universities and research, the affordability we still have compared to many other markets.”

Chris Chung, CEO of the Economic Development Partnership of North Carolina, said each new economic development announcement can be leveraged into even more interest from technology firms. Tech firms, in particular, want to be somewhere where they know the talent is – and as IBM likely knows from being in RTP for so long, the talent is here.

When Blue adds shades of red

For IBM, the red tide is coming – with or without a Raleigh address.

IBM closed on its \$34 billion buy of Red Hat two years ago, on July 9, 2019, on the promise of creating the “leading hybrid cloud provider” in the world.

“As the leading hybrid cloud provider, we will help clients forge the technology foundations of their business for decades to come,” then-CEO Ginni Rometty said at the time.

And the deal has delivered, according to both analysts and company executives.

CEO Arvind Krishna pushes hybrid cloud as a constant bragging point on earnings calls – and Red Hat Tower can't help but notice.

“Certainly, if you look at the things that Arvind Krishna said on earnings calls, the focus on IBM is now hybrid cloud and AI,” said Mike Ferris, senior vice president of corporate development and strategy at Red Hat. “Red Hat is the hybrid cloud component of that. ... They bet big on the success of Red Hat.”

The deal has delivered so much that IBM has gradually been taking bigger and bigger bets on hybrid cloud, realigning its sales strategy to put more of an emphasis on Red Hat and, recently, announcing the pending spinout of its managed-services business.

It's chipping away at legacy IBM and funneling more attention on what's working today. And quarter by quarter, it's clear that's what's working is Red Hat, centered not at IBM's legacy headquarters campus in New York but at Red Hat Tower in downtown Raleigh.

And the pandemic has only heightened that focus.

“What we've seen throughout this pandemic is really an acceleration of clients' digital transformations and journeys to cloud,” Chief Financial Officer Jim Kavanaugh said at a JPMorgan conference in May. “And if you look at it, we've actually been capitalizing on that.”

Enterprise-based spending rebounded in the firm's first quarter, in particular around hybrid cloud, “around Red Hat,” he said.

For its first quarter, IBM's revenue of \$17.7 billion included total cloud revenue of \$6.5 billion.

“You effectively have the first quarter of growth before foreign exchange impacts in a year, and that's a big deal for IBM,” Edward Jones analyst Logan Purk said.

For its last full year, IBM reported \$73.6 billion in revenue, down about 5 percent. But Red Hat, which it bought out two years ago, saw its revenue increase 18 percent.

Red Hat is simply where the growth is.



As CEO of IBM, Ginni Rometty drove the \$34 billion acquisition of Red Hat, a deal she said would help “all of IBM.” Michael Cohen

A separate culture

One particular sticking point when the deal was announced was the so-called “wall” IBM would put around Red Hat. While IBM would upsell Red Hat, Red Hat would need to keep its neutrality – so that it could continue to work with IBM competitors.

And its ability to maintain that neutrality got some of the most blunt questions at forums – both internal and analyst events – when the deal was announced.

Ferris said IBM has respected the wall. While IBM has allowed Red Hat to use its girth and synergies “in addressing our mutual customer needs,” it’s allowed Red Hat to keep its neutrality in place, he said. And it’s worked out because as Red Hat grows, IBM grows as well.

Ferris said it has just been good business strategy. With such a high price tag on the deal, IBM has extra impetus in ensuring Red Hat’s success, he said.

Analyst Purk takes it a step further. IBM has bet the farm on Red Hat, and needs the deal to deliver for the sake of Big Blue’s entire future. There is no backup plan.

While Big Blue as a business has aligned around Red Hat, so, too, has the culture, Kavanaugh said at the JPMorgan event. IBM has pulled in its “entrepreneurial mindset,” he added.

Ferris said Big Blue has made a concerted effort to keep Red Hat’s culture.

Early on, analysts said that commitment to culture would be key in the deal's success. For IBM's hybrid cloud vision to be realized, it needed Red Hat team members on board – a team that, for decades had prided itself on its “open-source culture.”

And the culture component appears to be working, as Red Hat has grown locally since the closure of the deal.

For Red Hat, the roadmap hasn't changed.

“We're just accelerating it,” Ferris said.