IBM bets its future on Red Hat acquisition

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On 28 October 2018, IBM announced its agreement to acquire Red Hat for almost USD34 billion in cash, declaring that the deal will make IBM the top hybrid cloud provider. IBM is paying a 63% premium on Red Hat's previous closing price, though only 7% above Red Hat's highest share price earlier this year. Many superlatives can describe this deal: it is one of the largest-ever tech deals and it is IBM's biggest acquisition to date. This is an emphatic statement that cloud solutions are the future of computing. It also indicates that IBM's internal development efforts over the last decade, and its USD2 billion acquisition of SoftLayer 5 years ago, have been insufficient. IBM is now betting USD34 billion (essentially betting the company) that hybrid clouds will dominate future IT spending and, by implication, that public cloud solutions will not improve quickly enough to displace the need for hybrid clouds.

The three keys to this deal's success include:

- The growth of hybrid cloud deployments;
- Red Hat's leadership in container technology;
- IBM's ability to leverage Red Hat's leadership to win professional services work.

IBM and Red Hat claimed in their joint follow-up analyst briefing on 29 October 2018 that the hybrid cloud market will reach USD1 trillion annually by 2020 and that the combined IBM/Red Hat company will become the leading provider in this market. The USD1 trillion market is the justification for a USD34 billion investment. However, public cloud solutions pose the most-significant market threat if they successfully expand to provide more-complete solutions that reduce the need for hybrid clouds.

The success of this investment depends upon two assumptions: that there are significant revenue opportunities available in the hybrid cloud market, and that IBM will become a leading supplier for this market. Analysys Mason believes that there are two key requirements that will determine IBM's leadership in this market: containers and professional services.

Containers represent an important method of cloud application deployment and management. For example, Google's cloud is built on containers. Kubernetes is a primary means of managing containers and Red Hat is a leading Kubernetes provider through its Red Hat OpenShift product. In their joint analyst briefing, IBM and Red Hat compared the strategic value of containers in cloud computing to the strategic importance of HTTP in Internet access; these technologies are not required, but they are the de facto solutions. IBM is betting that the hybrid cloud applications of the future will require containers and that Red Hat will be the main provider of container development technology. However, this depends upon IBM (a 100-year old business with 370 000 employees) preserving the initiative of 12 000 Red Hat employees.

IBM claims that 80% of enterprise applications have not yet moved to the cloud and that 94% of existing cloud customers use more than one cloud. IBM's expectation is that enterprises will want to develop their own cloud applications and deploy them in some combination of public and private clouds. While much of this technology

is open-source and therefore free, the deployment of open-source technology is not free. Enterprises that use open-source technology must develop expertise, integrate the open-source coding with their own applications, deploy it in cloud environments and manage the application execution environment. Large enterprises may be able to achieve this using internal resources, but enterprises (both large and small) turn to outside systems integrators, such as IBM Global Services, to handle many of these tasks.

In 2017, business and technology professional services accounted for USD56.2 billion for IBM, which represents 71% of its total revenue. This is IBM's core business. In order for its USD34 billion investment in Red Hat to pay off, IBM needs to leverage Red Hat's cloud technology leadership to win the business of deploying that technology for businesses around the world and in every industry vertical.

What does this mean for the telecoms industry?

In telecoms, IBM, though a big supplier, has languished, while Red Hat has been growing. First, Red Hat specifically targeted business from telecoms companies, which are big users of Linux, and from which it derives most of its revenue. Then, to capture more telecoms virtual networks business, Red Hat hired experienced telecoms professionals and partnered with network equipment providers (NEPs) such as Nokia. As a result, it has been winning important telecoms operator virtual networking deals, including with Verizon, Telenor and Telefónica. Red Hat is the leading provider of virtual infrastructure management software in Analysys Mason's recently published *Network Automation and Orchestration: worldwide market shares 2017 report*. However, IBM is not among the leaders in either software or professional services in any of our network automation and orchestration (NAO) segments, after showing early promise in network function virtualisation/software-defined networking (NFV/SDN) 3 or 4 years ago. IBM is, however, one of the leading providers of automated assurance software and professional services. If IBM can successfully combine Red Hat's strong position in network software with its own strengths in managing networks, it will become a much stronger player in the USD100 billion telecoms software and services market.

IBM's role in delivering hybrid cloud solutions to other industries also has implications for the telecoms industry. Analysys Mason's enterprise research shows that to offset declines in traditional business telecoms, many network operators are investing in expansion into the IT services businesses in their local markets, including delivering hybrid cloud solutions. A stronger IBM presence in hybrid clouds is a threat to the telecoms network operator's own enterprise business.

The telecoms industry may be more important to future hybrid clouds. In our recent research, we note that edge computing and network slicing are new telecoms technologies that can be particularly useful in cloud application latency, flexibility and security.[1] To make the most of the hybrid cloud opportunity, IBM will need to work closely with telecoms operators on edge computing and network slicing.

IBM is making a big bet on an enormous opportunity. The opportunity depends upon a growing hybrid cloud market, which could be threatened by the continued success of the public cloud providers. The opportunity also depends upon preserving Red Hat's unique role as a cloud technology provider and then leveraging that position to win massive amounts of professional services work in the hybrid cloud market.

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[1] For more information, please see Analysys Mason's *Network slicing: the future of connectivity in a 5G and fibre era*. Our strategy report on edge computing is forthcoming.