Understanding Lenovo's Server Position

As a leader in the client market, Lenovo has the opportunity to be a major disrupting force in the server market

Executive Summary

In today's server market, there is much focus on the big three, Dell, HP and IBM, who collectively hold approximately 70% of the unit shipments (68.4% in Q2 2013 according to IDC). The top two, Dell and HP truly control the market volume with IBM holding a very distant third, having declined over the last few years to just 11% of overall server unit shipments as of Q2 2013. Talk often focuses on Cisco, who is growing quickly particularly in blade servers but off of a very small base, as they are pushing hard to get themselves into the high volume market. Rarely does the name Lenovo come up unless someone is discussing the IT market in China, but Lenovo remains one of the few players who could break out of the "other" category in the market share reports, even surpassing Cisco and Fujitsu (the current #4 and #5).

However, to truly grow share, Lenovo needs to put a concerted effort on servers and has more than a few challenges to overcome. Below is our analysis of their current position and challenges, along with recommendations for areas they are missing.

Lenovo Server SWOT Analysis

To understand how the company is positioned in the market it is important to look at their strengths, weaknesses, opportunities and threats. The standard SWOT analysis covers the state of their current business.

Strengths	Weaknesses
• Price • Supply chain • China market position • SMB position • Perceived tie to IBM • Drafting off of ThinkPad branding	• Lack of complete product line outside of China • International coverage • No cloud offerings outside of China • No small core (ARM, Atom, etc.) direction • Weak storage offering • No apparent native network switch or fabric offering
Opportunities	**Threats**
• Acquire IBM's server business • Expand SMB in EMEA • China cloud market • Leverage mobile share	• Commoditization (supply chain) • Perception • Virtualization • Differentiation (tools)

Strengths

The following help to give Lenovo strength in the market:

- **Price** – While there are those that say the server market is not driven by price, few, if any servers are ever bought without some type of discount or negotiation. This is particularly true in the server tower, small business and emerging regions, but it extends all the way up into large enterprises. In reality, there is price elasticity – above a certain level of quality – and market share shifts happen because of this. Below that level of acceptable quality, the market is very inelastic. Lenovo has an aggressive price and appeals to the acquisition cost for customers, putting them in a good position, similar to Dell during the late 90's as they grew their business.
- **Supply Chain** – Lenovo has a leadership position on the client side, so there is an opportunity to leverage that with certain vendors like Intel and Samsung to help drive better costs. However, these adjacent product volumes do not guarantee the same cost levels as some of the larger players who are actually delivering server volumes to these suppliers. Lenovo's supply chain gives them the ability to act as a disruptor to some degree and can help drive the price positioning of the above point.
- **China market position** – Just as the Chinese economy continues to grow at a faster pace than the rest of the western world, the China IT market is also strong and moving towards becoming a top market. The fact that Lenovo holds a strong position here helps them as they expand in other regions. Having a leadership position in a fast growing market helps fuel overall growth.
- **SMB position** – Lenovo has done well in SMB, which (outside of government) is one of the largest markets in China. These customers tend to be more price-sensitive and are more open to alternate brands. Most of the SMB business runs through channel partners who have a trusted advisor position (versus the fulfillment/logistics role of the channel in larger/global customers.)
- **Perceived tie to IBM** – There is a halo over Lenovo because of the perceived tie to IBM. This does not bring Lenovo into the same class as the tier 1 providers, but it does help separate them from other Chinese OEMs like Sugon (Dawning), Great Wall and Inspur. More on this below.
- **Drafting off of ThinkPad branding** – Especially in the SMB space, Lenovo has an opportunity to capture business based on the continued success of the ThinkPad brand. The iconic notebook brand has survived the move from IBM to Lenovo and continues to be a quality brand. Using this success as an example of quality and durability can help Lenovo convince customers to "take a chance" on a Lenovo server, where other players in their position would not be able to compete.

Weaknesses

Along with those strengths come a set of weaknesses that will make it difficult for Lenovo to grow its footprint in the enterprise space:

- **Lack of complete product line outside of China** – Today's Lenovo server portfolio is much smaller than in the past. Four rack servers (all 2-way Intel) and two tower servers (both 1-way Intel) hardly cover the market. There is no 4-way server, which, while a small part of the market, helps project a more "enterprise" vision for the company. There is no 1-way rack server, no dense form factors or blades means that outside of SMB, customers would have a hard time standardizing on Lenovo as a server vendor.

- **International coverage** – While Lenovo enjoys a strong position in China, outside of their home country they have not done a good job of growing share. The largest IT markets (North America and Western Europe) have little or no representation from Lenovo. Lenovo products are offered but are rarely the lead products from channel partners.
- **No cloud offerings outside of China –** The growing cloud market requires low power, dense form factor products. While many of these are offered as special configurations for the largest cloud customers and not generally merchandised, they are an important part of any leadership portfolio. Lenovo is only offering these products in China, which leaves a large opportunity for competitors around the world. Even though China has a sizeable data center footprint, not offering those products outside of China limits a customers' ability to deploy worldwide.
- **No public small core direction –** Today's minimal product line is all Intel Xeon-based. As the market shifts to lower power solutions, ARM or for that matter Atom or MIPS, small cores need to be a part of the portfolio. They do not need to be delivering products based on ARM today, but need a clearly articulated direction for the future.
- **Weak storage offering –** Today's storage products are mainly rebranded Iomega systems being offered through a partnership with EMC. For the SMB market these are adequate, but a move into the corporate IT or cloud market will necessitate more storage offerings. Even if customers don't standardize on their storage products immediately, this is a critical part of the portfolio. Without a Lenovo enterprise storage option, HP, Dell, EMC, Fujitsu, Hitachi and others are in these customer accounts selling storage and have access to their own servers as well (either directly or through relationships like EMC has with all of Lenovo's competitors.)
- **No apparent native network switch offering** – Lenovo's networking/fabric strategy is currently tied to resale agreements with companies like Extreme Networks; they do not have native networking or fabric products. This is a weakness because from a partner perspective, the partner is fully vested in selling their product, but will generally not actively push Lenovo's product unless the end customer specifically requests it.

Opportunities

- **Acquire IBM's server business** – Through their close relationship with IBM, there is an opportunity to acquire IBM's x86 server business, but that is not without its challenges (see below.)
- **Expand SMB in EMEA –** Europe, especially Western Europe, has a high concentration of small and medium businesses. There is an opportunity to leverage in this region because of the strong channel pull by customers; Lenovo could gain a footprint by focusing on this volume market and expand outside of China.
- **China cloud market** – One of the fastest growing regions in the cloud market is China. Companies like Bai Du, Bao Feng and Tencent are examples of the great growth of cloud in China, and as a local incumbent Lenovo would have an opportunity to capture this business that is currently going to North American OEMs like HP and Dell.
- **Leverage mobile share –** With the strong growth in mobile computing, and a strong smartphone business already, Lenovo could leverage that position to attack the back end processing that all of these devices require. In addition, their experience in working

with ARM processors in smartphones should give them an advantage in trying to bring ARM into the data center.

Threats

- **Commoditization (supply chain)** – In today's server business, volume drives the market. The commoditization of the server market has not only driven price down on the customer side, but also on the supplier side. But in order to get the lowest costs, one needs volume. There are clearly suppliers like Intel and Samsung where Lenovo can leverage its client share to drive lower prices, but for more server-specific components, the big 3 can wield more supply chain power, preventing smaller server vendors from getting to the same level of discount. Most suppliers offer different discounts by component (for instance different discount schedules for Core i7 and Xeon processors); while Lenovo may be able to push for better pricing based on overall volumes, their low volumes in server-specific SKUs could be problematic. While Lenovo has the opportunity to be the disruptor to the likes of Dell and HP on the price side, they need to be sensitive to ODMs now going direct, like Mitac and Quanta, who could be a disruptor to Lenovo as well because they are driving volume on server-specific components.
- **Perception –** Because Lenovo grew out of a low-cost PC model, there is a perception issue that the company needs to overcome in order to be fully accepted in the enterprise space. Even after it achieved #1 North American share in the 1990's, Dell still had to deal with perception issues. Lenovo should assume that there is much work to change this perception. As well, while Lenovo is a publicly held company, there are many that are still critical of Chinese OEMs because the government is involved in many of them. The perception that the Chinese government may be involved, even in the background, has been difficult for companies like Lenovo and Huawei; just the same way that Cisco finds challenges in China, being perceived as too closely aligned with the US government.
- **Virtualization –** Virtualization is a key trend, but in analyzing the systems offered by Lenovo, these are less focused on virtualization than those of their competitors. Lenovo is making strides this year with more support for virtualization, but its competitors have a long head start and will be more apt to use their level of partnership with VMware as a wedge to win tenders where virtualization is the predominant workload.
- **Differentiation (tools) –** Every server vendor provides tools for managing their servers and Lenovo has a server management tool called EasyManage. EasyManage is built on technology from LANdesk, who is more known for their client management than server management tools. Larger customers tend to use enterprise consoles and eschew tools delivered by the vendors, but in the SMB market customers are more likely to leverage these tools. In this area Lenovo is behind the competition in capabilities and robustness.

The Elephant in the Room

There have been long-standing rumors in the market that Lenovo would be acquiring the IBM x86 server business. It is hard to address the status of Lenovo without taking this into consideration. If Lenovo were to purchase IBM's x86 business it would be most probable that they buy the whole business, rack, tower and blade. While the blade business is critical to IBM and it stretches over multiple product families (networking, storage and POWER-based server blades) the real volume and "stickiness" is in x86 blades, so it makes sense to tie that to the x86 business. IBM could potentially still hold the blade IP and license the IP to Lenovo for a nominal fee in order to maintain the product, but that seems less likely based on the ROI for such an action. In such an agreement, because of the overlap between POWER and x86, there would need to be an agreement in place to handle how the two companies work with customers who are buying IBM POWER systems and Lenovo x86 systems.

An acquisition would immediately catapult Lenovo into the #3 spot in the market, several points ahead of Fujitsu and Cisco, with a comfortable lead over those competitors. This is similar to how HP's acquisition of Compaq vaulted them to the #1 spot in servers overnight. However, in order to keep that lead, Lenovo would need to work very hard to keep the former IBM customers satisfied, lest they defect to HP or Dell. Very few enterprise customers are single source on their IT equipment; most have a preferred partner and an alternate to keep the preferred partner honest. In the case of IBM customers, however, most of their x86 business is tied to companies that also have IBM mainframe technology throughout their organization. When tens of millions could be consumed in those technologies and services, the x86 servers are more of an afterthought. If those servers lost the IBM brand (and most importantly the service), the door would probably be open to HP and Dell to bid on the business. Most IBM customers are more conservative, so the easy move is to one of the existing two market leaders instead of a new and untested company like Lenovo.

We believe that an IBM server acquisition, while it would bring Lenovo instant credibility and cachet, would not run as smoothly at the ThinkPad acquisition from past years. Specifically, there are a set of challenges that will make this more difficult:

- **Branding** – When Lenovo purchased the IBM client business, they also bought ThinkPad, the most iconic and well-known brand in notebooks. This helped ease customers into a Lenovo world as they viewed themselves as "ThinkPad customers" not "IBM customers" or "Lenovo customers." However, the IBM server business carries the less well known X Server brand. While this branding may work in an IBM world because it ties with the rest of their system branding (and even that is questionable), in a vacuum, the X Server brand has little or no equity. In the server world customers are "Dell shops," "HP shops," or "IBM shops," the brand name of the product does not carry over as well. There was cachet for Lenovo to have ThinkPad, but X Server has as much cachet as ThinkServer, so the instant credibility Lenovo saw on the client side will not transfer on the server side.
- **Vertical Markets** – IBM is famous for their vertical approach to servers. This hails back to the mainframe days and customers in the mainframe-centric world tend to be the best customers for IBM x86 servers. Finance, telecommunications and manufacturing are just a few of the key IBM strongholds. However, Lenovo does not have expertise in these verticals, nor do they necessarily have the channel partners or value proposition to attack those vertical markets in order to retain that business. For IBM software and partners drove their depth in those vertical and for Lenovo there is less there to help maintain the share.

- **Growth –** The growth markets today are in cloud/scale out, big data and other cutting edge businesses. The staid and traditional markets where IBM has a footprint simply aren't growth opportunities; they are maintenance markets rather than growth markets. Knowing that there would be some multiplier above the revenue of the business, it becomes impossible to justify the purchase knowing that one can't recoup that multiplier through growth.
- **IBM's Position** – IBM *is* your father's Oldsmobile. As the #3 provider of x86 servers (by volume), they have done little to differentiate their products to the market and drive excitement. Truth be told, they sell excellent but high-priced systems, built like tanks and well equipped. However they have not been able to turn that advantage over into something that provides a growth multiplier to the market. Instead they are marketing to the same people already bought into the IBM story. This gives continuity from top to bottom for customers, but does not give Lenovo a differentiator.
- **Culture –** This has nothing to do with Beijing versus North Carolina, it has everything to do with the design philosophy and market strategy. IBM is slow and cautious. Lenovo is fast and aggressive. Dropping the X Server portfolio into the Lenovo machine would mean changes to the platforms that would make them less like the old IBM systems, which could turn off the IBM customers. However, those changes will still not put Lenovo in a position to overcome their challenges and take on HP and Dell who have a considerable lead today.

Lenovo was able to keep the ThinkPad business active because a.) the product already had a lead and b.) IBM would reference-sell Lenovo products as a part of the agreement around the purchase. However, in the client world, customers accept a different service organization between the client and server products. But for the data center customers prefer a single service source and one of the key drivers for IBM in the x86 server business has been the same badge handling everything across the data center. Unless Lenovo can keep the same partner structure that IBM had, it would be difficult to retain that business.

Recommendations

In growing its business outside of the IBM world, Lenovo needs to focus in the following areas:

Cloud/scale out web market. Currently this is the growth engine for the server industry and Lenovo is underrepresented (or they are not doing an adequate job of signaling their participation to the market at this point.)

Fill out the portfolio to reach the large business market. Today's focus on SMB may be the right strategy for entering the market, but they do need to "grow up" if they plan to grow their share. Perhaps their newly scaled-down portfolio is a result of the plan to acquire IBM's business and less of signal that they are not interested in growing in the larger server market. When Dell entered the server market in a meaningful way (in 1996) they started out with a 1P system focused at SMB but quickly expanded their portfolio to grow beyond that space. We have used Dell as an example several times in this report as we feel that the Dell rise in servers could most closely resemble the trajectory for Lenovo if the right focus and resources were applied.

Focus on getting the message out. Lenovo has solid products and is one of the largest technology providers in the world. They have leadership positions in client devices and even smartphones. But that message is not translating in the server market. Enterprise customers move slowly when making changes, so they need the constant drumbeat to force the change.

Based on the fact that Lenovo heavily leverages Intel for its server products, has storage agreements through EMC and networking agreements with Extreme Networks, they have little IP in the enterprise space with which to support an enterprise business. If Lenovo is going to take a clean shot at the server business, they need to be developing or buying the IP that helps them differentiate their products.

Clearly, for Lenovo, purchasing the IBM server business would be a difficult challenge. In order to make that successful they would need:

- Reference-selling agreements to help maintain the share that IBM has today
- A revamped product line that takes X Server out of the traditional environments and into more of the growth areas
- Complimentary storage and networking products for the enterprise, along with differentiating IP

Summary

Overall we see that Lenovo is at an interesting crossroads in the server market. To be successful they need to be investing significantly in the server market as that is a long term play. Whether it is a build or buy decision, this will not be a small investment. The dividends, in terms of revenue growth and more margin to the bottom line can't be ignored. IBM is a weak third in the market today based on their still declining unit volume, Cisco is pigeonholed in their position in blades in the market, and Fujitsu has been in a fairly consistent position for several years (driven mainly by Japan and Germany.) Lenovo has an opportunity to break out of their position and quickly move up in the market; as well they remain a company that could disrupt the market the way that Dell did years ago. But in order to do that, they need to get into the market in a serious way first.

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