

Red Hat is a bright spot in the dreary IBM picture

Big Blue stumped up \$34 billion for the open-source pioneer back in 2019, but was the huge outlay worth it?



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May 16, 2022

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Primary colors supposedly mix to create beautiful hues, but when the Big Blue of IBM absorbed Red Hat in 2019, some onlookers foresaw an ugly mess. The aging titan of IT, which made nearly \$80 billion in sales the year before, was splashing \$34 billion on an open-source zealot that made only a tenth that much in annual revenues. Red Hat's fans feared that the corporate culture of IBM would be toxic, stifling growth and choking innovation. However, Red Hat has remained a bright spot for IBM in an otherwise dreary picture.



Founded in 1993, Red Hat has been through more guises than Doctor Who in its 29-year history without ever abandoning the open-source faith. It made history in 2012 as the first open-source company to cross the \$1 billion sales milestone. The cloud platforms it sells and supports underpin IT workloads for enterprises and network operators alike, and business continues to grow impressively.

While IBM does not separate Red Hat's results, it has continued to publish Red Hat's sales growth rates ever since completing the acquisition in July 2019. An estimate based on those disclosures is that revenues last year topped \$5.6 billion, nearly twice what Red Hat made in 2017, the year before IBM announced its move. Red Hat appears to have thrived because IBM has left it alone to function as an independent unit.

	2016	2017	2018	2019	2020	2021
Red Hat revenues	\$2,400	\$2,900	\$3,400	\$4,012	\$4,734	\$5,634
Red Hat sales growth	N/A	21%	17%	18%	18%	19%
Red Hat operating income	\$332	\$472	\$512	\$602	\$710	\$845
Red Hat operating margin	14%	16%	15%	15%	15%	15%
Red Hat net income	\$254	\$259	\$434	\$522	\$615	\$732
Red Hat net margin	11%	9%	13%	13%	13%	13%
IBM revenues	\$79,919	\$79,139	\$79,591	\$77,147	\$73,620	\$57,350
IBM net income	\$11,872	\$5,753	\$8,728	\$9,431	\$5,590	\$5,743
IBM total debt	\$42,169	\$46,824	\$45,812	\$62,899	\$61,538	\$51,703
IBM employees	380,300	366,600	350,600	352,600	345,900	282,100

Notes: From 2019 onwards, the revenue figures for Red Hat are Light Reading estimates based on growth rates published in IBM's annual reports; similarly, profit figures for these years are estimates that assume Red Hat had the same levels of profitability it reported for 2018.(Source: Red Hat, IBM)

Despite this, IBM's revenues grew just 2.7% last year on an organic, constant-currency basis, to about \$57.4 billion. Remove Red Hat's estimated contributions each year and the rate of sales growth drops to about 1.2%. For all its individual flair, the smallish Red Hat has been unable to reinvigorate IBM so far, showing the IT old-timer how to perform in a cloud native world.

Determined to make itself more presentable to investors, IBM has continued to carry out self-amputation of its putrefying parts. Last October, in a move applauded by markets, it lopped off its managed infrastructure services unit, a low-margin business that generates \$19 billion in annual sales and is today known as Kyndryl. This and other cuts have triggered a precipitous drop in headcount. IBM had more than 380,000 employees back in 2016. Today, it employs about 280,000.

But while IBM's operating income has plummeted from \$13 billion in 2016 to just \$4.7 billion last year, net debts have swelled like a tumor. Before the Red Hat takeover, IBM carried \$45.8 billion in total borrowings. Flinging \$34 billion at Red Hat forced it to borrow heavily, and the figure surged to nearly \$63 billion in 2019.

IBM has done a good job of reducing debts since then, finishing last year with \$52 billion in total. But this remains substantially more than it had on its books as a bigger business pre-Red Hat. The ratio of net debt to operating income has risen from 3.2 in 2016 to 11 last year.

Outrageous investment

The price IBM paid for Red Hat still seems like an outrageous investment, given Red Hat's size. If calculations are right, Red Hat has generated total sales of about \$14.4 billion in the last three fiscal years. Assuming its profit margins for those years were the same as they were in 2018 when it last reported results, Red Hat has probably made about \$2.2 billion in operating profit and less than \$1.8 billion in net income.

Nor is there any guarantee that it can sustain sales growth rates of around 18% or 19%. New competitive threats must be a worry for Red Hat's owner. They include none other than Google, following its own recent takeover (for an undisclosed amount) of MobileEdgeX, a software startup whose biggest owner was previously Deutsche Telekom. Google has already said it will open source MobileEdgeX's software as it goes after telco cloud business.

Another possible rival is Rakuten. In February, the telco arm of the Japanese Internet company – Rakuten Mobile – snapped up another software developer called Robin.io, which sometimes partners with Red Hat. Rakuten is now using Robin.io's open-source Kubernetes system to phase out an older OpenStack platform provided by Cisco and Red Hat. Tareq Amin, Rakuten Mobile's CEO, claims that Robin.io is twice as cost-effective.

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This should concern IBM because Robin.io is not just for the Japanese mobile network. Rakuten is including the technology as part of Symphony, a portfolio of software applications it is pitching to other telcos and enterprise customers.

"From Symphony's point of view, the go-to-market strategy is to offer any customer 50% less than what they pay today," Amin told Light Reading during a recent interview. Savings are available largely because Robin.io brings lightweight, cloud-native software compared with the clunky virtual machines Rakuten used on OpenStack, he said.

The potential danger is not that Red Hat has fallen behind. It appears to be the world's second-largest contributor to Kubernetes, behind Google, and boasts its own range of cloud-native software under its OpenShift brand. But as companies make that leap from virtualization to cloudification, Red Hat may be at risk of losing business to an aggressive Rakuten sporting an array of products.

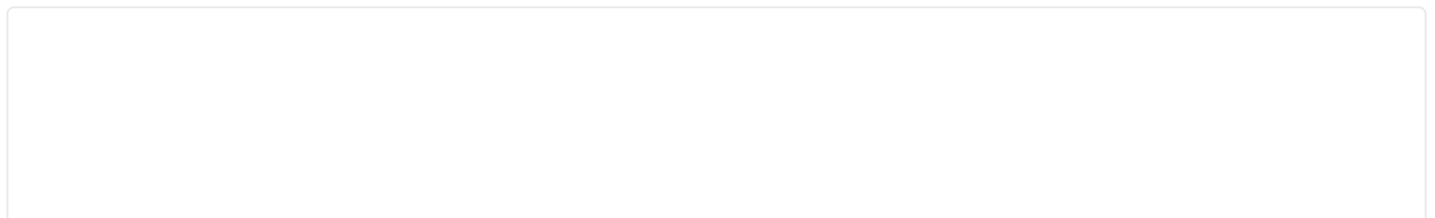
Red Hat's ability to sustain current levels of sales growth would silence many skeptics. If it can pull that off for several years, its annual revenues would surpass \$10 billion by the mid-2020s. Such an increase would obviously buoy a 111-year-old owner that has faced no shortage of challenges this century. Even better would be signs that some of Red Hat's flair is rubbing off on IBM.

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Iain Morris joined Light Reading as News Editor at the start of 2015 -- and we mean, right at the start. His friends and family were still singing Auld Lang Syne as Iain started sourcing New Year's Eve UK mobile network congestion statistics. Prior to boosting Light Reading's UK-based editorial team...

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