Dell Technologies Q3, FY'21 EARNINGS CALL

Tuesday, November 24, 2020

Robert Williams

- Thanks Erica and thanks everyone for joining us. With me today are our vice-chairman and COO, Jeff Clarke, our CFO, Tom Sweet along with our Treasurer, Tyler Johnson.
- Our press release, financial tables, webdeck, prepared remarks and additional materials are available on our IR website. The guidance section will be covered on today's call.
- During this call, unless we otherwise indicate, all references to financial measures refer to non-GAAP financial measures, including non-GAAP revenue, gross margin, operating expenses, operating income, net income, earnings per share, EBITDA, adjusted EBITDA and adjusted free cash flow.
- A reconciliation of these measures to their most directly comparable GAAP measures can be found in our webdeck and press release.
- Please also note that all growth percentages refer to year-over-year change unless otherwise specified and that VMware historical segment results have been recast to include Pivotal results.
- Additionally, I'd like to remind you that all statements made during this call that relate to future results and events are forward-looking statements, based on current expectations.
- Actual results and events could differ materially from those projected due to a number of risks and uncertainties, which are discussed in our webdeck and SEC filings. We assume no obligation to update our forward-looking statements.
- Finally, before I turn it over to Jeff, I want to touch on the amended 13D we filed in July regarding our exploration of potential alternatives with respect to our ownership interest in VMware.
    - We believe a tax-free spin could drive significant shareholder value by simplifying our capital structures and enabling greater strategic flexibility, while maintaining a strong commercial partnership between Dell and VMware.
    - Both Dell and VMware have publicly highlighted mutual interest and the potential benefits of such a transaction and have engaged on key work streams including

mutually beneficial commercial arrangements and Dell's expectation of a substantial cash dividend to VMware stockholders in connection with such a transaction.

  - As a reminder, the earliest a transaction could close would be Sept 2021 with an announcement coming between now and then assuming we can come to an agreement. There is also the possibility that we will not do anything and we would maintain our current ownership structure.
  - With that said, we will not address the discussions any further or take questions related to this topic on today's call.

- Now, I'll turn it over to Jeff.

Jeff Clarke - Business

- Thanks Rob.

Reflection

- We have now been through three quarters of navigating an uncertain and--at times--difficult year. We have been tested across our global society, across industries and companies, as teams and as individuals like never before.
- I could not be prouder of how the Dell Technologies team has responded. We're growing, innovating and delivering for our customers in extraordinary ways - when and how they need us most.
- Through it all, one thing is clear, the mega technology trends that we have long called out are accelerating, and these trends are highly favorable to Dell Technologies. We are uniquely positioned to win in the growing markets of 2020, and we are making the right investments and innovating to capture growing the markets of tomorrow.

Observations/Customer Insights

- For the vast majority of companies, Digital transformation is now a "must-have" and accelerating. We see it in our customers' interactions and we see it in our data. In October, we released the third installment of our latest Digital Transformation Index where we have been tracking digital transformation patterns of more than 4,000 customers since 2016.

- Our 2020 Index revealed that 80 percent of organizations globally have fast-tracked digital transformation programs. And when compared to the 2018 study, nearly 25 percent of respondents have progressed from being digital “laggards” or “followers” to a more advanced stage of their digital journey.
- This is great news for our customers' future and more broadly for the global economy. And it's also great news for us with major investments going towards Edge, distributed work and modern consumption, cybersecurity, 5G infrastructure, digital experiences and data management.
- Together, these trends are taking us to a future that is highly distributed ...with distributed workforce, learning and healthcare — enabled by distributed technology infrastructure — computing, analytics and real-time outcomes at the edge. Organizations investing today will have the advantage tomorrow. And they are turning to Dell Technologies as their strategic partner.
- Let me use a real customer example to talk about the Edge. FedEx CIO, Rob Carter, was with me last month at Dell Technologies World where we talked about low latency, decentralized computing and data driven insights they need to lead in the ‘Internet of Everything’.
- FedEx uses an array of our hybrid cloud technology to bring simplicity and speed to the edge – including VxRail and VMware and Pivotal in cloud-native environments – all to keep our world connected and moving.
- Now we are building on that relationship, working with FedEx and Switch, a leading exascale data center company, to develop technology hubs across the United States to bring IT resources closer to where applications and data reside, enabling the benefits of 5G and AI technologies.
- This is a perfect example of how we take our deep IT experience and make it easy for customers to manage data and workloads across all their operations.
- We also had another exceptional quarter in CSG, in what has become a multi-quarter trend as customers turn to Dell to enable their remote, hybrid workforce. Our wide range of PCs, including Chromebooks, are providing students everywhere with the essential learning tool they need.

- The pandemic has expanded consumers' use of online purchasing, which is a big area of focus for us. While we did lose share in calendar Q3, this is a result of strategic decisions we made earlier in the year. We moved from retail to our advantaged direct and online selling for consumers. Our strong financial performance reinforces that strategic decision, and we believe this is the right long-term balance for our business.
- Finally, customers are looking for choice in the way they consume and pay for IT. That's why at Dell Technologies World we announced Project APEX to unify our as-a-Service and cloud capabilities. We have committed to providing all of our solutions as-a-Service. And launched the Dell Technologies Cloud Console enabling a consistent Cloud operating model across a customer's entire IT environment — from the edge to core to cloud.
- In the past year, we've seen increased interest in our as-a-service and flexible consumption offerings, and this type of transformation expands recurring revenue, providing even more stability as we navigate industry seasonality, mix and demand.
- The accelerated digital transformation we are experiencing today plays directly to the thesis we had when creating Dell Technologies. We are number one in everything all in one place. We have the breadth and diversity to lean into pockets of growth when and where they happen, and we can deliver consistent long-term returns as a result.

Q3 Business Performance — Strong execution through dynamic environment

- Now let's move into the third quarter performance and the team's strong execution.
- Revenue was $23.5 billion, up 3 percent and operating income was up 12 percent to $2.7 billion, or 11.6 percent of revenue.
- As I mentioned earlier, our Client Solutions Group had an outstanding quarter, delivering record shipments, revenue and operating income. Revenue for Q3 was $12.3 billion, up 8 percent. The PC is the essential device for this remote everything environment we're living in today— evidenced by the ongoing demand we're seeing for work and learn from home solutions along with double-digit growth in education, government — particularly our North America Federal business — and consumer verticals.
    - Demand for Notebooks remained strong – with orders up 24 percent, driven by double-digit orders growth across the majority of our commercial and consumer notebook lines. In addition, orders for Commercial Chromebooks more than doubled.

    - Our Consumer business had another impressive quarter driven primarily by our premium XPS and Alienware brands, which combined were up 43 percent on an orders basis.
    - The consumer direct business was up 47 percent on orders and our consumer direct online business was up 62 percent based on orders as we seized what we believe is a multi-year e-commerce penetration opportunity.
- Infrastructure Solutions Group revenue was $8.0 billion, down 4 percent. While the overall market for ISG has been soft this year, we are seeing improvement.
    - Server demand improved and PowerEdge orders were up single-digits sequentially. Large enterprise remains challenged, but we saw better velocity from our small business and medium business customers.
    - Storage demand was mixed, but we were pleased with our relative performance given current market dynamics. Bright spots included PowerMax and hyperconverged infrastructure — each growing double-digits in the third quarter on an orders basis.
    - PowerStore is gaining traction. We delivered nearly double the orders revenue achieved in the second quarter, albeit on a small base, and we are still early in the ramp. We're pleased with PowerStore progress and are seeing early wins as customers transition from existing Unity, SC, VNX, Equallogic and XtremIO products.
    - And more than 15 percent of PowerStore customers are new storage buyers. We feel great about the future of PowerStore and our storage leadership.
- Our VMware business segment had another strong quarter, delivering revenue of $2.9 billion, up 8 percent. The VMware partnership and teaming remains strong and our cloud capabilities continue to build.

Year-to-Date Summary

- Year-to-date performance has been amazingly consistent in the light of what has turned out to be an incredibly challenging macro environment. We have delivered $68.2 billion of revenue, flat year-on-year, as we executed against growth opportunities, and we delivered $7.5 billion of operating income and $8.9 billion of adjusted EBITDA.

- In the first quarter, we saw dramatic surge from large enterprises, healthcare and the financial sector for work from home and business continuity solutions. This drove strong growth in our commercial client and with our VMware solutions. Toward the end of that quarter, we started to see signs of slowdown in small and medium businesses.
- Then in Q2, demand shifted to government, education and consumer as remote work continued and learn from home needs soared. Similar to GDP and given our third quarter results, our second quarter appears to be a trough for the year.
- In Q3, strength in government, education and consumer continued, and it was encouraging to see double-digit orders growth from our small and medium business customers given the number of jobs this sector creates around the world.
- And though some companies have moved to the public cloud for certain workloads or immediate business continuity needs, hybrid cloud momentum is building as the longer-term answer — a new operating model where workloads will be distributed between public and private clouds, traditional data centers and increasingly out to the edge.
- Like Australia's largest retailer Woolworths, where we recently announced a deal to enable their hybrid cloud strategy by bringing together their public and private clouds onto a single platform — utilizing as-a-Service with Dell Technologies on Demand.
- With our hybrid cloud capabilities, the depth and breadth of our portfolio, industry-leading global supply chain, go-to-market and services reach, we have significant competitive advantages to be the partner of choice.
- Put it all together and you get a track record of consistent execution, profitable growth, disciplined share gains, innovation and financial returns — regardless of the environment.

Look Ahead

- Looking ahead, I see an extraordinary opportunity as technology continues to drive our society forward and Dell Technologies fulfills its role as the essential technology company for the data era.
- And with 5G, data driven insights, automation and embedded intelligence, we will see an explosion of edge computing in smart cities and transportation, factories, hospitals and schools around the world.

- We know how to get technology into the real world at scale – providing a consistent approach to infrastructure, data, applications and security across the entire environment from multiple clouds to the edge.
- What the last nine months have shown is that Dell Technologies is resilient. Ready to meet the needs of customers today and for what's to come.
- According to IDC, the expected compound annual growth rate for IT excluding telco through 2024 is 4.7 percent. It's clear, the digital future is bright and we're excited about the opportunities that lie ahead.
- Now, I'll turn it over to Tom for a look at the financials.

Tom Sweet - Financial Results and Liquidity

- Thanks, Jeff.

Solid Execution Navigating through Uncertainty

- Overall, we have executed well this year, navigating through an uncertain macro environment. We've delivered stable and differentiated performance by leveraging our diversified IT platform and leaning into the current growth opportunities in a disciplined way. And, we're driving value by expanding profitability faster than revenue and generating strong cash flow, which has enabled significant debt pay-down.
- For the third quarter, revenue was better than expected and above our typical seasonality at $23.5 billion, up 3 percent both year-over-year and sequentially. FX this quarter did not have a meaningful impact on our financial results. Also a reminder that we completed the sale of RSA in early September.
- Gross margin was $7.8 billion or 33.0 percent of revenue. Gross margin dollars were flat, which I believe is a good result given the demand that we've seen from education, government and consumer customers typically tends to deliver less margin dollars.
- Operating expense was $5.0 billion, up slightly by 1 percent sequentially, and better than expected as we continued to benefit from the cost containment actions we instituted earlier this year.
- Operating income was up 12 percent to $2.7 billion, or 11.6 percent of revenue driven primarily by our ongoing operating expense controls and strong profitability in CSG.

- Consolidated net income was $1.7 billion, up 18 percent, and EPS was $2.03, up 16 percent.
- Adjusted EBITDA was $3.2 billion, up 13 percent at 13.7 percent of revenue. For the trailing twelve months adjusted EBITDA was $12.1 billion.
- Total deferred revenue was $28.7 billion, up 11 percent year-over-year. Our recurring revenue, which includes deferred revenue amortization, utility and as-a-Service models, is now approximately $6 billion a quarter, up 13 percent.
- As announced at Dell Technologies World, we will broaden our as-a-Service solutions for our customers across our entire portfolio over the next year, giving them more flexibility to scale their IT to meet their business needs and budgets. We're seeing adoption of our portfolio delivered as-a-service through flexible consumption solutions and expect this to continue to grow over time.

Segment Results

- Turning to the business units, our Client Solutions Group results were above our expectations driven by ongoing strong demand for work and learn from home solutions, along with gaming systems. CSG revenue was a record $12.3 billion, up 8 percent as we delivered record shipments in the quarter.
    - Commercial revenue was up 5 percent to $8.8 billion as we saw strong growth in Latitude and Precision notebooks and Commercial Chromebooks. Not surprisingly given the remote nature of this year's working and learning environment, we continue to see reduced demand in commercial desktops.
    - Consumer revenue was $3.5 billion, up 14 percent, driven by strong growth across all of our consumer notebooks and gaming systems. Our premium consumer products XPS and Alienware combined saw strong double-digit revenue growth for both notebooks and desktops.
- CSG Operating Income was also a record at $1.0 billion, up 36 percent and 8.2 percent of revenue. The strong profitability was driven by our record shipments, product mix and our operating expense discipline.
- This has been a great year for our client solutions business and it's clear that the PC is still the platform of choice. The revenue stability of this business has been beneficial and it has consistently generated strong cash flow that has enabled us to weather different

cycles and demand fluctuations. Over the past five fiscal years, CSG revenue has grown at a 3 percent CAGR, while the CAGR for operating income was nearly triple that rate.

- ISG revenue was $8.0 billion, down 4 percent. Though disappointed in the decline, the overall server and storage market has been softer than we expected coming into this year. Given the dynamics in the macro environment, we executed against the growth opportunities within these markets while delivering solid profitability.
  - Storage revenue was $3.9 billion, down 7 percent. PowerMax and HCI, specifically VxRail were highlights as both were up double-digits based on orders. We continued to see softness in other areas of core storage, including midrange. As Jeff described, PowerStore is trending in the right direction and we expect it to ramp through the rest of this year and into FY22.
  - Servers and networking revenue was $4.2 billion, down 2 percent. Overall, server demand was softer than expected, but we did see improvement in orders with our mainstream servers growing sequentially. We also saw improved transactional demand for our mainstream servers as we moved through the quarter. We continue to look for balanced growth, being disciplined and selectively leaning into opportunities that make economic sense. For instance, our high-value servers built for artificial intelligence and machine learning workloads had another quarter of positive growth, with orders up mid-single-digits and is a growing piece of our server revenue mix.
- ISG operating income was $882 million or 11.0% of revenue, which was down 90 basis points as higher component costs for servers and networking and product mix more than offset lower operating expense.
- The VMware business unit had another strong quarter, delivering revenue of $2.9 billion, up 8 percent, and operating income of $837 million, or 28.9 percent of revenue.
  - Based on VMware's stand-alone results, Subscription and Software-as-a-Service revenue grew 44 percent.
  - The business saw better than expected growth in the VMware Cloud Provider Program, Modern Applications and VMware Cloud on AWS.
  - VMware Cloud on AWS continued to show great traction in Q3, with triple-digit revenue growth.

- Dell Financial Services growth continued in the third quarter with originations up 4 percent to $2.1 billion. DFS ended the quarter with $12.6 billion in total managed assets, up $1.9 billion year-on-year. DFS enables sales, drives profitable growth and retains customers through a number of traditional financing and innovative payment solutions including consumption and as-a-service offerings.

Capital Structure and Balance Sheet

- Moving to our capital structure and balance sheet, cash flow from operations was quite strong and above typical seasonality at approximately $3.0 billion, driven by improvement in net income and diligent working capital management.
- Adjusted free cash flow in Q3 was $2.7 billion, and on a trailing-twelve-month basis, adjusted free cash flow was $8.8 billion.
- We ended the quarter with $13.0 billion of cash and investments. Our liquidity position is strong and we made excellent progress on de-levering.
- During the third quarter, we paid down approximately $4.6 billion of debt, including $3.1 billion of core debt and $1.5 billion of VMware debt.
- With the debt payments made in Q3, our total debt balance ended the quarter at $50.4 billion and includes DFS-related debt of $10.1 billion and subsidiary debt of $4.8 billion.
- Our core debt ended the quarter at $31.4 billion. We are on track to reduce core debt by approximately $5.5 billion in FY21 as we expect to pay down at least $2.4 billion in Q4.
- With our continued debt pay-down and strong profitability, our core leverage is now below 3.0x and at the top-end of our target core leverage range of 2.0x – 3.0x. Recognizing leverage is only one metric used by the rating agencies, based on our calculations, we believe this puts us inside the current investment grade target range for S&P.
- We are pleased with the progress we've made against our de-levering plan, and debt pay-down will continue to be our capital allocation priority as we work toward investment grade metrics.

Guidance

- Moving now to our outlook for the fourth quarter.
- Though the latest global GDP and industry data for infrastructure demand indicate gradual improvement into the next year, there continues to be a high degree of

uncertainty as COVID-19 infections increase globally and some geographies have implemented new restrictions.

- Given the macro backdrop and the trends we've seen in our business, we expect Q4 revenue to be up 3 to 4 percent sequentially, which is slightly below typically seasonality of 5 to 6 percent sequentially. We expect strong CSG results, with revenue expected to be slightly above normal seasonality of plus 2-3 percent sequentially. For ISG, we expect revenue to track slightly lower than last year's 4 percent sequential growth based on the continued softness in data center spending.
- From an operating income standpoint, we expect CSG margins to remain strong and above historical averages but lower sequentially due to a higher mix of consumer PCs and commercial Chromebooks along with holiday promotions. We are a bit more cautious on ISG margin dollars given the uncertainty in the macro, while VMware should benefit from typical seasonality in Q4. Taking all of this into account, we expect consolidated operating margin dollars to be slightly higher versus Q3.
- Our breadth and diversity of portfolio has driven stability in our performance through the year, and we will continue to adjust to opportunities we see in the business. Given the aforementioned risks, we believe it is still too early to talk about next year.
- That said, looking at the current global GDP and IDC forecasts, we are cautiously optimistic about the potential for recovery post Pandemic-related pressures. GDP expectations and IT spend (ex. Telco) estimates from both IDC and Gartner, see 4 to 5 percent growth in 2021.
- We hope to have better perspective on the global economy and our outlook after we close the current fiscal year.

<u>Close</u>

- In closing, we have a history of navigating through challenging environments and this year has been a great example of our strong operational heritage. The steady execution in our core businesses and ability to leverage our broad portfolio have enabled stability and generated strong cash flow through these uncertain times.
- The teams are executing our strategy and we're managing the business for long-term, consistent growth.

    - We're using our unique strengths to win in the consolidation of the markets in which we compete — running the business to outgrow the industry.
    - And, we are creating differentiated Dell Technologies solutions through innovation and integration across the entire family.
- This year has also been a good example of maximizing value creation for all shareholders.
    - We've outgrown our competitors, grown profitability faster than revenue and generated strong cash flow.
    - We've made good progress on our de-levering goal and are committed to getting back to investment grade.
    - And, we've taken the appropriate corporate structure steps as evidenced by the ongoing simplification of operations, the divestiture of RSA and the exploration of a potential tax-free spin of VMware.
- We're focused on what we can control and leaning into the areas of growth, which will continue to be the way we navigate through any environment or cycle.