Dell Technologies | Deutsche Bank Technology Conference

August 31, 2022

Sidney Ho:

Good afternoon, everyone. I am Sidney Ho. I cover semiconductor or semi cap equipment and IT hardware at Deutsche Bank. The next company we have is Dell Technologies. So Dell, as most of you know, is one of the largest end-to-end technology providers in the world, supplying PC, server systems, storage systems, and other software and services.

Today, we are very excited to have Yvonne McGill join us. Yvonne is the CFO of Dell's ISG business, the Infrastructure business. So welcome, Yvonne.

Yvonne McGill:

Well, thank you for having me today.

Sidney Ho:

Great. So before we get into Q&A, I have the honor to read out the Safe Harbor language, so bear with me here.

This discussion may refer to non-GAAP results, including non-GAAP diluted earnings per share. For reconciliations and the most directly comparable GAAP measure, please consult the slide labeled Supplemental Non-GAAP Measures in the performance review available on the fiscal 2023 Q2 results page on investors.delltechnologies.com. Dell Technologies' statements that relate to future results and events are forward-looking statements and are based on Dell Technologies' current expectations, actual results and events in the future periods may differ materially from those expressed or implied by these forward-looking statements because of a number of risks, uncertainties and other factors, including those discussed in Dell Technologies' periodic reports filed with the SEC. Dell Technologies assumes no obligation to update its forward-looking statements.

Well, with that out of the way, why don't we get started So Yvonne, would you mind just starting off with a quick background on yourself and your role, for any anyone who haven't had the opportunity to meet you.

Yvonne McGill:

Well, sure. Sure and thanks for hosting us today, Sidney.

I've been at Dell – I actually just celebrated my 25th anniversary there this month. And so, currently, as you mentioned, I'm CFO for our ISG business, which also includes APEX and – which is our as-a-Service business. I also have responsibility for accounting, tax, treasury and industrial relations. But as you can imagine, over the last 25 years, I've had a lot of different roles. I'd say some of my favorites, Chief Accounting Officer, and I actually had the opportunity to have two international assignments, my favorite of which was being the CFO of our APJC business located in Singapore.

In addition to that, I am a member of our Global Diversity Council and I sponsored two of our employee resource groups, Family Balance and Women in Action. And then, if that wasn't enough, I'm also a member of the Applied Materials' board of directors and I sit on the Audit Committee and the Corporate Governance and Nominating Committee, which also has responsibility for ESG oversight.

Sidney Ho:

Well, that's a lot. But let me kick it off with a high-level question. At last year's analyst event, Dell laid out the strategy and long-term value creation framework. Could you share a bit on your post-VMware spin framework the most important priorities and how you are tracking?

Yvonne McGill:

Sure. Well, let me start with saying we've made great progress on those priorities that we laid out, and it's hard to believe it's been almost a year since we laid out that framework, so great progress to date really trying to evidence our high say: do ratio.

Our strategy is twofold. One is to grow and modernize the core, and the second is to build adjacent businesses where we feel we have or we know we have a unique right to win. In our core businesses, we have number one positions across the entire portfolio, number one in client revenue, x86 servers, external storage, HCI, data protection. I could go on because there's a lot more examples.

We're a structural share gainer and we have a track record of doing that. We've been working a lot on modernizing our portfolio, whether it's in the PCs or across our ISG business. And we've really increased the breadth of our offerings with APEX, our as-a-Service portfolio.

Our core business generates significant cash flow. So, that's wonderful and that will continue. That gives us the financial flexibility we need to invest in areas like edge and telecom, really expanding meaningful businesses that we already have. Our market is measured in trillions, as you know. So, there's still a lot of room for us to grow.

And we are – feel like we've made progress against that strategy that we've laid out. If I look back to FY 2022, so last year, we delivered $101 billion in revenue. We grew double digits, we grew EPS faster and all that while generating significant cash flow. In our first half of FY 2023, our revenue grew 12%, so still strong performance, and we had EPS growing faster. We're also seeing traction in our storage portfolio, which is great to see and we'll probably talk more about that. We deployed a balanced capital allocation framework that we outlined last September and we're executing against it with share buybacks and dividend.

So, I feel like we're really positioned well for the long-term trends we're seeing. Customers want to drive their digitization journey faster. And with our broad IT portfolio, we feel like we have the unique opportunity to be our customers' primary technology partner.

Sidney Ho:

Wonderful. Maybe just – I know just last week, you announced your earnings and you mentioned a little bit about the first half of the year. But in general, how would you characterize your Q2 performance?

Yvonne McGill:

I think we feel and I feel we had strong results and that strong results in a more challenging environment than we were anticipating. We had record Q2 revenue at $26.4 billion, which was up 9%. We had growth in our CSG and our ISG businesses. We continue to gain PC share, and we – in calendar Q2, and we expect to gain share in server and storage when IDC announces in early September. Our EPS grew at 14%, so faster than revenue. And we deployed $850 million in capital between share repurchases and dividend payout.

Our CSG revenue was up 9%, and that's against a really strong prior year of 27% growth. We had commercial PCs growing at 15%, but we did see a weaker consumer performance, which was down 9%. The demand weakness that we started to see in the first quarter that we talked about extended to commercial in our second quarter.

The supply chain, though, did another great job of meeting our customer commitments. And now, I can say that our backlog, our CSG backlog is at normal levels.

ISG revenue was up 12%. That's the sixth consecutive quarter of revenue growth for ISG. And we saw storage demand grow for the fifth quarter in a row and saw the second quarter of P&L growth, revenue growth there. So, that was great to see also. Server grew – servers grew for the seventh consecutive quarter at 16%. So, we were pleased with the performance. We continue to innovate and customers are really adopting our latest 15G servers, as I'm speaking about servers, and continuing to increase that mix now over 50%. Servers are running heavier workloads, AI, ML, and that's requiring higher compute, higher content rates, and all of that results in higher ASPs.

As the quarter progressed, though, we saw demand growth slow a bit in servers versus prior quarters. So, we're seeing customers be a bit more cautious in the timing of their purchases given the macro environment. Q2 is a quarter that we continued our track record of strong performance. We leveraged that durable competitive advantage we have to meet customer commitments, which resulted in strong Q2 P&L performance.

Sidney Ho:

Great. Well, maybe just digging deeper into the second half outlook. I think a lot of people are interested in it. So last week, you did warn that demand has been slowing down, maybe starting with the PC side of things. As the PC market has been softening and expectations of change since the beginning of the year, how are you thinking about the rest of this year? What are the demand signals you are seeing from both commercial, as well as the consumer side?

Yvonne McGill:

Well, from a PC perspective, I want to maybe start with really thinking about the fundamental technology shifts we've seen over the last few years. The PC is the most essential productivity tool, whether it's for work, for entertainment, for gaming, for shopping, everything, right? It is a tool that everyone needs. The installed base is larger. We see more than one PC per household. And we believe hybrid work – I think all of us believe hybrid work is here to stay. That's going to put forth a refresh that's coming for PCs. If you think about all of the PCs, all of the notebooks that were put into service when the pandemic hit, we're about to wrap around three years when a lot of those devices were put into service. So, we think that's going to be an opportunity for us.

We saw Q2 had 71 million units, PC units, and pre-pandemic, it was 65 million, right? So even though we're saying things are slowing, we're seeing the continued higher level than pre-pandemic levels. Consumer revenue was down 9% but still up 6% from two years ago, right? So, we're trying to make sure that we have the proper perspective.

This year, we have the overall market at 290 million units. Now that's down from what we spoke about this time last quarter, right? We were expecting more of a 330 million unit market opportunity. IDC just came out last week with a 305 million view. And we're a little different maybe in the mix. We think consumer in Chrome decelerate faster in the market than maybe what IDC is reflecting, but generally aligned, right, lower than what we were expecting just three months ago. We did see that weakness in the consumer and Chrome space extend to commercial in Q2.

Customers still care about their productivity. They still care about the experience their employees are having. But they're scrutinizing and prioritizing how to spend their capital in the short term, we believe. Backlog positions, as I mentioned, are back in the normal zones. And what does that mean? Well, that means we're going to ship and reflect revenue on what we sell in the current quarter. Net-net, we see CSG declining in the high teens in the second half, so a shift from what we talked about last quarter.

We're going to manage through this environment, as we always do, with focus on customers and on driving our differentiated performance. We've been a structural share gainer over time through many cycles. In fact, over the last 38 quarters, we've gained share in PCs 34 of those quarters. We're focused on the most profitable and stable portions of the market, commercial PCs, which are 78% of our mix, high-end consumer and gaming.

So we're well-positioned overall, right? We're number one in commercial client, workstations, gaming. And then, you think about what surrounds the devices, right, that attach motion. It's also very strong. We're number one in displays and we're focused on really that untapped opportunity in the broader peripheral space. So in the long term, we have conviction that PC usage has reset to this higher level than pre-pandemic.

Sidney Ho:

Okay. No, that's great context. I think that's also kind of in line with what HP talked about last time as well in terms of that 290 million units. Great. Well, maybe moving on to ISG, which I think a lot of people are interested in this area, I also think what was the biggest surprise coming from last week's earnings, can you walk us through what you saw from a demand perspective since you reported results in May? Obviously, things changed quite a bit. Are there any discernible difference between server and networking storage and how do you think about the rest of this year and even into next year? And longer term, how do you think about the business growth – how the business can grow?

Yvonne McGill:

Well, I mean, let me start with saying we were happy with our – the progress and traction we've seen in our ISG business. We've seen robust growth in Infrastructure this year as we expected, right? We walked through the year expecting it and it's playing out, largely driven by server, but more recently, we've seen that success or growth in our storage portfolio, too. We've done lots of work in the storage portfolio to simplify and modernize holistically that portfolio. And we've also done go-to-market enhancements. And I think putting those two pieces together has led to the demand and the P&L growth that we're seeing in the storage side of the business.

Last week, we talked about the slowing demand environment with enterprise customers. And specifically around server, what have we been seeing? Well, we've grown for the last seven quarters in servers. And normally, after many quarters of growth, you would see moderating demand because customers really need to digest that compute that they've just brought in-house.

Customers are a bit more cautious given the macro environment. And so, we're seeing customers fulfilling their most immediate needs. And I'd say being more thoughtful or more cautious about capital spending holistically, right? So, they're double checking. There are more reviews. There's a more governed process on these purchases.

I'd say storage, though, it's faring a bit better from a demand perspective. We're executing and seeing or expecting tailwinds from the mainframe refresh that happened earlier this year. And then, we refreshed our PowerMax, PowerScale, PowerFlex portfolio. As we talked about in Dell Tech World earlier this year, we have had over 500 new software advancements in that portfolio.

As we think about rest of the year, we ended Q2 with elevated backlog, and that's in storage and in server. So delivering on those existing commitments is a priority, but that will also help us as the quarters progress, the second half progresses certainly part of that equation. There are still challenges with parts availability but we feel better about it than we did in Q1.

So net-net, between better supply availability in server and the tailwinds that we're seeing in storage, we expect ISG to grow in the low teens for the second half. We'll share thoughts, though, about the upcoming year as we get closer. Overall, for the long term, ISG is being fueled by digital transformation across data centers, multi-cloud and edge. And if companies slow purchasing now, we know that they'll need to catch up to continue on that digital transformation.

Sidney Ho:

Okay. That's fair. You touch upon a little bit earlier but you said the PC backlog is back to normal, server backlog or maybe ISG backlog in general is higher. But what are you seeing in terms of the current supply chain environment in terms of availability, as well as the components and logistics cost being higher, being elevated. Can you talk about that?

Yvonne McGill:

Sure. I wish I could tell you all these challenges are behind us because it's certainly been quite a journey over the last few years. But they're not behind us but I can say that they've improved.

Customers are looking for a technology partner like Dell that can deliver when they need the solutions to drive their businesses.

Supply chain is something that we know is our supply chain is world-class and we have a scale like no other, right, $76 billion in spend. So, that definitely gives us some purchasing power. We are leveraging our long tenured expertise there and those deep relationships which have served us really well, especially over the last few years. I'd say the broader market is still short of supply on trailing high seas. The issue is going to be with us for a while. So, we'll continue to navigate through it. But we're seeing better availability in these high volume leading edge components, CPUs, memory and storage.

Last quarter, I already spoke about we reduced CSG backlog to normal levels, and now, we have normal lead times across that portfolio. Backlog in ICG has been a bit more challenging. Again, those trailing edge components, and PSUs, have been a limiting factor for us. We think that's going to continue to be the case through the second half. Clearly, this has had an impact on inventory. And we know that with more parts on hand waiting for those match sets, we've had to keep those higher inventory levels. But with those signals we get from our direct sales force early on and improved parts availability that we're starting to see where we work down that inventory in Q2, but certainly, plenty more room to continue working that down.

We're laser-focused on our cash generation where we've had a really strong track record. On a total input cost, inclusive of logistics and such, we've seen inflationary numbers for quarters now. Q3, we expect modest deflation from a component cost standpoint. But really, another part of that equation is logistics. Getting parts where we need them, when we need them to manufacture and then getting the product to our customers continues to be a challenge. So we've seen that start to improve maybe from an ARR perspective, but certainly, the ports are still congested.

Overall, we expect logistics spend this year to continue to be higher than last year and a multiple of what it was two years ago. So coming back to our differentiated business model, this is what we do. We manage through these challenging times and deliver solutions to our customers. We have a track record of doing so and you can see it in our overall and in our relative performance.

Sidney Ho:

So just to clarify on the inventory side, is the inventory mostly on ISG side, meaning higher than normal or is CSG back to normal levels?

Yvonne McGill:

I would say that it's more predominant, the higher levels in the ISG space because as the demand has fallen off in CSG, there are more parts available in the – for us.

Sidney Ho:

Okay. That makes sense. Well, another question I've been getting from people is about pricing. So where are you seeing in terms of the pricing actions, the supply environment and competitive dynamics. Maybe touch on inventory, which was suggested both at Dell, but also in the channel and customer receptivity. And what's the reasonable trajectory to think about ASP going forward?

Yvonne McGill:

I mean, over the past quarters, as everyone's been talking about, right, it's been an inflationary environment. More recently, we've seen pretty dramatic currency headwinds also. We've raised prices, though, to offset those headwinds as we get visibility to it. A portion of the reasons ASP are up are just what I mentioned, but that's not the only reason they're up. We've seen mix shifts in CSG to more notebooks. We've seen richer configs driving PC ASPs and we've also seen more attached. So if you think holistically about the software and peripherals, et cetera, we've seen that increase. So, that's helping also and we think that's actually more durable. In servers, these higher content rates are also, in addition to cost inflation, such are driving ASPs.

Today's pricing environment, we think, is different by line of business. Chrome prices are back to pre-pandemic levels. Consumer has seen pressure given the demand environment and increased inventory. Now, we've done channel checks to see how things are going and we're getting some interesting feedback as we do those on how some of our competitors may be a little more aggressive in the channel. Of course, we're not as exposed to the channel from an inventory standpoint. So, it's been interesting to watch.

With commodity costs turning deflationary in Q3, that channel inventory, which is at a higher cost basis, will be an interesting dynamic to see play out, right? But again, in a deflationary environment, we normally benefit given our direct model and our low inventory. That's where our model runs quite well.

If I think through in Q2, we saw more favorable commercial pricing. We saw that environment driven by, again, those richer configs, the higher attach and the pricing increases. If I turn to server, the pricing is a bit more stable. We've been able to increase prices to reflect the higher input costs and FX impacts. And discounting has been pretty stable again supply and demand, right? And when I think of storage, it's really been a longer sales cycle. We've been able to raise prices to be reflective of the increased input costs, and we expect that going forward.

In a deflationary environment, right, or overall, ASPs typically ebb and flow with commodity costs. And so, we do expect that to continue. We typically see pressure and environment of slowing demand and rising inventory. But as I said, cost is just one element of how we've seen reflecting in ASPs.

There's new usage patterns and technology trends that we've seen over the last two years. We expect those to continue. And we expect that higher network mix to continue and commercial strength with richer configurations. So we'll continue to demonstrate our pricing discipline, which I think has only improved over the last few years, and we are focused on balancing demand velocity and profitability.

Sidney Ho:

Got it. That's a complicated thing.

Yvonne McGill:

It is. It is quite complicated.

Sidney Ho:

So maybe switching over to the cost side, everyone is worried about the potential transition. So in the current environment, how do you prepare for such a scenario? I noticed you did cut your full year -when you cut your full-year guidance by 5 percentage points on the revenue line, your EPS outlook at the midpoint is only down like 3%. So, you've got to be cutting a lot of things. So, just walk us through how you guys are doing on the cost side.

Yvonne McGill:

It's certainly not the first time we've managed through a cycle. And during these times, we really do focus on what we can control. That's our relative performance, right? We want to succeed in any market. And we are a proven structural share gainer. For example, in the last five years, we've gained 570 basis points of commercial PC share and 600 basis points of mainstream server, so consistent performance.

We also then move to controlling costs. If you think back not very long ago, but to when the pandemic hit, we reduced our OpEx by about $1 billion when it started. And more recently, in Q2, we reduced, as we started to see these signals, we reduced our OpEx sequentially, right? And so, again, that's a lever that we pull and we know how to do that.

Our portfolio is more diversified than ever and that really helps insulate us somewhat. And again, back to the breadth of our portfolio, that allows us to be in so many technology discussions with our customers, right? We saw that play out when PCs became essential during the pandemic. And we're seeing that rotation now as we're in more data center discussions. But you're right, we did revise our second half down and really retained our profitability expectations for Q3, but revised Q4 EPS down but less than revenue, which speaks to how our business is differentiated.

Our direct sales force sees demand signals quicker, which allows us to make changes either in our purchasing, so from an inventory standpoint, but also in our own OpEx spending. And what we're hearing from customers really hasn't changed. Hybrid work is the default. They need digital transformation to access and uncover insights that drive growth and productivity. In this environment, it's a great time for a subscription, right, subscription revenue. So, that's – it's a great time for customers to be leaning into our APEX or as-a-Service offering, and I think that provides another advantage.

I mean, we're generally seeing demand weaken in the macro environment. And as that gets softer, it's usually followed by a reacceleration. And so, again, customers need to continue along their digital agenda. So for the longterm trends, we have seen accelerate really during the pandemic. We don't expect that to change. We expect it actually maybe to even have a step function change, acceleration, again as 5G, edge, multi-cloud create bandwidth where more things are connected, more data is created, and when that happens, we believe you need more infrastructure.

Sidney Ho:

Got it. You touched on the – in the current environment customers want subscription revenue. So, that was actually my next question. How are you progressing, in your case and growth opportunities in APEX, right? We talked about that. And is there any additional context you can share with us in those programs?

Yvonne McGill:

Sure. Well, I think it's it is exciting to talk about our APEX offerings and exciting to see us modernizing our portfolio, and providing the stability that as-a-Service business gets for revenue, for cash flow predictability. We branded our as-a-Service model, APEX, a little over a year ago but as-a-Service isn't new to us. We've been offering it for years in our custom solution, which allows customers to pay for infrastructure as – on an as-used basis.

We continue conversations with customers and we want to support them wherever they are in their journey. We're about customer choice, right? So if you're ready for as-a-Service and subscription or if you're interested in CapEx or leasing, we help the customers make the choice that's right for them and then we deliver against it. We see customers constantly evaluating where should they spend their time, where do they want to get value out of their businesses, do they need more resources developing apps or they need more resources managing infrastructure. Those are where the discussions are with many of our customers right now.

Over the past year, we delivered really a broad range of services for compute, for storage and for backup services, and we dramatically expanded our APEX presence. We've taken APEX from the data center to colo to the public cloud. We offer APEX in 38 countries now and we've extended APEX to our channel partners.

So, we're excited also to share that we've reached a milestone in our ARR for our APEX businesses is greater than $1 billion now. In Q2, we actually grew APEX 78% year-over-year and we added almost 200 new customers. Customers try it, they like it, and then they want more. And so, that's what we're looking to see with more and more customers as the portfolio grows. So it's a great option right now, certainly, given the macro environment to pay as you go for what you use.

Sidney Ho:

Yeah. I definitely look forward to more disclosures in APEX in the future. But maybe we can wrap up a couple of questions. One is talk about capital allocation. What are your key priorities in the capital allocation framework? Any color that you can add on M&A expectations or the pace of timing of share buybacks?

Yvonne McGill:

Let me start with saying our core business is the fuel for our capital allocation framework. Over the last several years, we've used our cash primarily to pay down debt. But now, we have more financial flexibility as we become investment grade. And we laid out our more balanced, I'll say, capital allocation policy and framework last September.

So over the long term, we are going to return 40% to 60% of adjusted free cash flow to our shareholders in the form of share buybacks and dividends. We've executed against this already, with $2.7 billion in buybacks and – through the end of Q2, that is, and paying our second quarterly dividend, which is on a run rate of about $1 billion.

We've been thoughtful about how we deploy our capital, that buybacks are our priority to manage dilution, but we've also been opportunistic, certainly, given the – our share price. So – but we expect those dividends to grow over time consistent with our long-term value creation framework.

I'd say, for the rest of our adjusted free cash flow, we're going to use it to invest in our business, especially in those adjacent growth opportunities. And then, we're going to make sure that we're achieving our target debt to EBITDA ratio of 1.5x. We're at 1.7 right now. So, pretty close.

And then, M&A, people always ask about M&A. I think we will look for targeted, strategic and tuck-in M&A. I wouldn't expect anything large or transformational. In – on the tuck-in M&A, I would say we're looking to either further our IP or invest in growth areas like edge, telecom, 5G, AI, ML and data management. So our focus is on creating shareholder value in a very balanced way.

Sidney Ho:

Got it. Well, maybe a last question, just to wrap up, what would you like investors to focus on coming out of this?

Yvonne McGill:

I think I'd say that at Dell Technologies, we have a track record of strong execution, really, in any environment. We have strong core business and solid cash flow generation. We are a structural share gainer and we have durable competitive advantages, including our direct sales force. We have an eye towards the future and we plan to expand into adjacent markets where we know we have the unique right to win. We've talked about our balanced capital allocation framework and our return of value to our shareholders. So, I continue to be very excited about the future of Dell Technologies and I know you are, too.

Sidney Ho:

Great. I think that's all the time we have. Thank you very much for your time.

Yvonne McGill:

Thank you.