

TRANSCRIPT

DELL - Q2 2023 Dell Technologies Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Fiscal Year 2023 Second Quarter Financial Results Conference Call for Dell Technologies Inc. I'd like to inform all participants, this call is being recorded at the request of Dell Technologies. This broadcast is the copyrighted property of Dell Technologies Inc. Any rebroadcast of this information in whole or part without the prior written permission of Dell Technologies is prohibited.

I'd now like to turn the call over to Rob Williams, Head of Investor Relations. Rob, you may begin.

Robert Williams - Dell Technologies Inc. - SVP of IR

Thanks, everyone, for joining us. With me today are Jeff Clarke, Chuck Whitten and Tom Sweet. Our earnings materials are available on our IR website, and I encourage you to review our presentation which includes rich content to complement our discussion this afternoon. Guidance will be covered on today's call.

During this call, unless otherwise indicated, all references to financial measures refer to non-GAAP financial measures, including non-GAAP revenue, gross margin, operating expenses, operating income, net income and earnings per share. A reconciliation of these measures to their most directly comparable GAAP measures can be found in our web deck and press release. Growth percentages refer to year-over-year change unless otherwise

specified. 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 web deck and SEC filings. We assume no obligation to update our forward-looking statements.

During the call today, Jeff will recap Q2, including the current demand and supply chain environments. Chuck will cover CSG and ISG operating performance, and Tom will cover our financial results and guidance.

Now I'd like to turn it over to Jeff.

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Hello, everyone. Thanks for joining us. In Q2, we executed well and delivered strong financial results despite a rapidly changing and challenging macro environment. We also advanced our long-term strategy, growing the core while innovating for our customers and enabling their opportunities in the data era. We delivered record Q2 revenue of \$26.4 billion, up 9%, with growth in both CSG and ISG. And diluted EPS was \$1.68, up 14%. Our differentiated business model and execution enabled us to outperform in the segments we serve. And in calendar Q2, we gained PC share and expect to gain share in server and storage when IDC releases Q2 results.

I'd like to take a couple of minutes and talk about the macros that provides important context for our remarks today. Since we last spoke in late May, our view of the demand environment through the back half of FY '23 has changed. The demand environment slowed and pushed to the right over the course of the quarter, particularly in CSG. We saw a decline in PC demand as we went through the quarter with higher ASPs, partially offsetting a unit decline. Our supply chain execution was excellent throughout the quarter, and we were able to offset the CSG demand weakness with backlog reduction in CSG.

We saw ISG demand while still growing slow and pushed throughout the quarter. The Q2 and second half macro dynamics have become more challenging as customers are taking a more cautious view of their needs given the uncertainty. We have responded swiftly by managing inventories down and reducing our expenditures.

Now let me turn to the supply chain and innovation. Like Q1, we are still seeing shortage of parts and embedded integrated circuits, including power supplies and mix. ISG backlog, particularly servers, remains elevated. PC backlog is now at normal levels as Q2 PC shipments significantly outpaced demand and the portfolio is on standard lead time across the board. On the cost front, we expect modest deflation in aggregate component costs in Q3, while logistics rates are beginning to decline. Our strength in ASPs over the last year have been a result of richer configurations and product mix, but the lower cost environment could have an impact.

Turning to innovation. We are proud of the significant advances we have made in the first half of the year developing new solutions for our customers. Expanding our multi-cloud ecosystem and delivering new cloud experiences that include all major public clouds, Project Alpine, which brings our enterprise-class data services into public clouds for bursting, test and development, cloud-based analytics and data and container mobility. The largest release in PowerStore history and the new PowerMax OS 10 software deliver more than 500 new Dell storage software advancements that help customers deliver faster insights, achieve better multi-cloud data control and increase cyber resiliency.

New APEX offerings like Dell APEX Cyber Recovery Services that extend beyond storage, compute and data protection and deliver APEX as a full stack solution. And in CSG, we continue to deliver new commercial devices for our hybrid world, including the Latitude 9330, the world's first laptop with a collaboration touch pad.

We also recently celebrated 25 years of Precision innovation, driving many industry firsts along the way. I actually led the workstation business when we launched Precision, so I'm particularly proud of this 1 in our #1 position worldwide. As we've highlighted, we're also innovating in strategic growth areas like telecom, and I'd like to provide a few examples of our progress in this important area. In May, we announced that we joined forces with T-Mobile to make it easier for enterprises and government customers to embrace 5G. T-Mobile's 5G private mobile network combined with Dell's edge computing technologies will bring customers the power of 5G connectivity on-premise where they need it.

In June, DISH marked a major milestone in building the world's most advanced cloud-native 5G Open RAN network. They now offer 5G broadband service to over 20% of the U.S. population on a cloud-native network built on Dell's open IT infrastructure, software and services. As we think about the second half of the year, we remain focused on what we can control: execution, relative performance, prudent cost management and delivering for our customers and shareholders like we did during Q2. What we have shown over the years is regardless of the environment, we are agile and built to outperform.

Now let me turn it over to Chuck.

Chuck Whitten - Dell Technologies Inc. - Co-COO

Thanks, Jeff. We delivered strong financial results and excellent relative performance in CSG and ISG while managing the shifting demand dynamics as the quarter progressed. Starting with CSG. We delivered record Q2 revenue of \$15.5 billion, up 9%, with operating income at 6.3% of revenue. Consistent with our Q1 commentary, commercial continues to fare better than consumer. Commercial revenue grew 15%, while consumer revenue declined 9%. An important measure of our success in any market environment is relative performance, and we again drove differentiated share results. We gained over 200 basis points of worldwide PC unit share and over 100 basis points of display share in calendar Q2 according to IDC. We have now gained PC unit share in 34 of the last 38 quarters. And in commercial PCs, our focus on the most profitable segment of the market, we gained over 300 basis points of unit share in calendar Q2 to claim the #1 spot worldwide.

Turning to ISG. We delivered another record Q2 with ISG revenue of \$9.5 billion, up 12%, our sixth consecutive quarter of growth, with operating income at 11% of revenue. Servers and networking grew 16% and storage grew 6%, our seventh consecutive quarter of servers and networking growth and our fifth consecutive quarter of demand growth in storage. The breadth of our storage portfolio continues to be a competitive advantage with #1 positions across storage categories. The breadth of leading capabilities is a real differentiator for us as one-size-fits-all architectures simply do not meet customers' diverse needs in the data era.

In Q2, we saw modest storage demand growth with strength in the high end and in our marquee midrange product, PowerStore, which grew double digits and has grown every single quarter since launch. And in servers, we saw demand growth in most geographies, albeit at a moderating pace. As Jeff mentioned earlier, we expect to gain server and storage share in calendar Q2 when IDC releases results in September.

Finally, in ISG, I'd call out our momentum on APEX, our offerings for customers looking to buy infrastructure as a subscription. Our APEX ARR is now over \$1 billion, and we grew orders 78% year-on-year in Q2 while adding almost 200 new customers. Customers like Federal Home Loan Bank in San Francisco, who is using APEX private cloud to support its growth and cloud strategy and realizing significant cost savings as the financial institution serves its members, and customers like Montage Health, who's using APEX private cloud to provide clinicians better access to critical applications and information for patient care and staff collaboration.

Stepping back, the near-term market outlook is marked by mixed signals, as Jeff highlighted in his macro comments. That said, we remain confident in the long-term health of our markets and in our competitive position. There has been a clear and significant increase in the size of the PC market from prepandemic levels as hybrid work has become the default approach for companies worldwide. And automation and digital transformation remain the backbone of our customers' strategies necessary for productivity and growth. Done right, technology investments are key to competitive advantage in the data era and can reduce costs while combating an environment with high inflation and labor shortages.

So we remain confident in the long-term attractiveness of our core markets and our opportunity to build meaningful new businesses in the data and multi-cloud era and in our durable competitive advantages that enable us to outcompete in any environment.

Now I'll turn it over to Tom for the financials.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Thanks, Chuck. We delivered record Q2 revenue of \$26.4 billion, up 9%, driven by strength in both CSG and ISG. We highlighted in late May that we thought fiscal year '23 would see a more robust infrastructure investment cycle, while PC growth would moderate. While we did see modest infrastructure demand growth in Q2, we now see a more challenging ISG demand environment as we head toward the back half of the year. And in CSG, we are seeing demand weakness in both consumer and commercial.

Overall gross margin was \$5.7 billion, roughly flat and 21.4% of revenue. Gross margin as a percentage of revenue was 200 basis points lower than last year, primarily due to an increase in our cost and FX headwinds not yet entirely reflected in pricing as we balance profitability with competitive positioning.

Operating expense was \$3.7 billion, down 3% and 14% of revenue. During the quarter, we instituted a number of cost reduction measures, including a slowdown in external hiring. Operating income was \$2 billion, up 4% at 7.4% of revenue. Our tax rate was 19.9% and net income was \$1.3 billion, up 9%, primarily driven by growth in operating income and a decline in interest expense due to our lower debt balances.

Fully diluted earnings per share was \$1.68, up 14%, with diluted share count decreasing sequentially to 755 million shares as a result of repurchases.

Note that our GAAP profitability was impacted by a \$255 million net adjustment to the value of our strategic investment portfolio given market conditions and \$189 million charge relating to exiting our business in Russia, both of which are primarily noncash items.

Our recurring revenue is approximately \$5.2 billion a quarter, up 8%. Our remaining performance obligations, or RPO, is approximately \$41 billion, up 2% and includes deferred revenue plus committed contract value not included in deferred revenue. Dell Financial Services originations were \$2.3 billion, up 24%, driven in part by our technology rotation solutions. We have historically seen stronger originations when the macroeconomic environment slows and DFS ended the quarter with \$13.5 billion in assets.

Turning to our cash flow and balance sheet. Our cash flow from operations was \$700 million in Q2 and is \$5.7 billion on a trailing 12-month basis. Q2 cash flow was primarily driven by growth in profitability, partially offset by a use of working capital. Working capital was impacted by an increase in receivables due to the timing of sales later in the quarter, partially offset by a \$400 million sequential reduction in inventory. The quality and aging of our receivables is strong and the team did a nice job on inventory this quarter, which will remain a focus as we move through the rest of the year.

Our core debt balance is \$16.1 billion, and we ended the quarter with \$7.1 billion in cash and investments, down \$1.4 billion sequentially, principally due to \$900 million in capital returns and a \$300 million strategic investment portfolio write-down on a gross basis. We repurchased 13.6 million shares of stock in Q2 for \$608 million and paid \$242 million in dividends. Going forward, we will continue our balanced capital allocation approach, repurchasing shares programmatically to manage dilution while maintaining flexibility to be opportunistic like we were in Q1 and in Q2.

Turning to guidance. As Jeff highlighted, we're seeing customers become more cautious given the current macroeconomic environment. We saw a softening in CSG specific to consumer and chrome in Q1. In Q2, the decrease in demand velocity extended to commercial clients, and we are seeing more cautious spending within our ISG business. Currency also continues to be a headwind for us, roughly 500 basis points for Q3 and roughly 400 basis points for the full year. Against that backdrop, we now expect Q3 revenue between \$23.8 billion and \$25 billion, down 8% at the midpoint, with CSG declining in the high teens and ISG growing in the low teens. We do expect gross margin rates to increase sequentially as mix shifts to ISG.

Given the cost controls we have in place, we expect OpEx spend to be down versus Q2. For our non-GAAP tax rate, you should assume 20% plus or minus 100 basis points. We expect diluted share count to be roughly 750 million to 755 million shares. Netting this out, we expect diluted earnings per share in the range of \$1.53 to \$1.79, flat year-on-year at the midpoint. The environment we saw in late May translated to a 6% growth expectation for the full year with diluted earnings per share growing 12%. Given the change in the demand environment, our current view for fiscal year '23 is revenue flat to up 2%, with diluted earnings per share between \$6.60 and \$7, up 9% at the midpoint.

In closing, we delivered strong second quarter financial results but are more cautious as we enter the second half. We are actively managing our cost and spending, and we remain focused on what we can control, executing our strategy to consolidate and modernize our core and build new growth engines that enable our customers' multi-cloud future. And we expect to deliver revenue and earnings per share growth with strong free cash flow to our shareholders over time.

Now I'll turn it back to Rob to begin Q&A.

Robert Williams - Dell Technologies Inc. - SVP of IR

Thanks, Tom. Let's go ahead and get to Q&A. Operator, can you go ahead and take the first question?

QUESTIONS AND ANSWERS

Operator

Our first question comes from Toni Sacconaghi with Bernstein.

A.M. Sacconaghi - Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst

Yes. I'm just wondering if you can elaborate on the kind of linearity you saw in the quarter, specifically like was the book-to-bill greater than 1 in the first month and well below 1 in months 2 and 3? And your demand outlook seems strikingly more cautious than some other enterprise peers like Cisco and NetApp. And I'm wondering why you might think that your view is somewhat different from what they are seeing.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Toni, look, let me start and I'll ask Jeff and Chuck to chime in as appropriate. Look, as it relates to Q2 and how the quarter flowed, what we saw shortly, the typical pacing in a quarter is that it builds -- pipeline builds and converts as we go through the quarter more so as we get to the mid and late in the quarter. What we saw in Q2 was pipeline particularly in the client business did not build and/or pushed to the right. And we also saw ISG demand our pipeline pushing to the right.

So from a linearity perspective, typically, the month 2 of the quarter is when we typically would see bigger velocity growth in the pipeline. And we, quite frankly, did not see it this quarter. And what we saw, as we highlighted in our talk track, is just an overall cautiousness with our customer base as they're sorting through the macro dynamics.

So as a result of that, I mean, clearly, as we talked about in May, we had expected that we would see softer CSG demand, but we actually saw softer demand actually much softer than what we had seen, particularly for commercial clients. And because of that, as we talked about, although we had elevated CSG backlog, we did reduce backlog as part of our shipment profile for client in Q2.

Look, as it relates to our cautiousness around enterprise demand or infrastructure, all we can tell you is what we see. And as a reminder, since we have the largest direct selling organization of all of the technology companies, we feel like we have a pretty good pulse on sort of current demand and environment. And we're just seeing more cautiousness on the -- on behalf of the customers as they're sorting through spend, as they're thinking through projects. We are seeing projects come to fruition. They're taking longer to close. And the size of the projects are somewhat reduced from what we've seen in the past.

Jeff, Chuck, I don't know if you'd add anything to that.

Chuck Whitten - Dell Technologies Inc. - Co-COO

Yes. Maybe, Toni, I'll add a little observation from what we're hearing from customers on enterprise dynamics. I think, look, texturally, if I start with the PC business, commercial customers are just citing multiple reasons for sort of delaying purchases. That's caution around future hiring, trade-offs within their IT budgets given the macroeconomic uncertainty, customers reducing the size of orders and buying for only immediate requirements, but the net was we saw a meaningful shift in corporate sentiment over the course of the quarter.

I think ISG dynamics were a bit different. So we saw demand growth in both servers and storage but at a moderating rate as just more caution entered the environment. So where commercial PC spending paused, infrastructure spending split, companies are putting more scrutiny on spend. As Tom said, deals took longer to close throughout the quarter, and we generally just saw more deliberate customer behavior. So what you see us calling out today is us trusting that better demand signal that Tom cited and what we're hearing from customers.

Operator

Our next question will come from Erik Woodring with Morgan Stanley.

Erik William Richard Woodring - Morgan Stanley, Research Division - Research Associate

I just wanted to get your take on your ability to maintain kind of pricing power as some of these demand trends now start to flow through the business. Do you believe you have pricing power more so in 1 business versus the other? Maybe by product, I would love to just have you guys tease that question out a little bit more.

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Sure, Erik. This is Jeff. Maybe a couple of comments. I'll start with PCs and work our way through the product line. I think it's important in PCs when you look at our mix of business being commercial versus -- or more weighted towards commercial versus consumer, we get a natural uplift there. And we're seeing, while we commented demand is slowing, richer configurations we saw consistently through the quarter, primarily from our premium products like our Latitude notebooks, our Precision class of workstations. So we're seeing a higher mix of our higher-end products as well as richer configurations. And I think that bodes well long term when you think about where we play.

Then in addition, because of how we do business that you know very well, but I think it's worthwhile mentioning, our ability to attach software and peripherals, our ability to attach services and financing options to those PCs, I think, is a differentiated capability over anyone else in the marketplace. So while the market may be softening as we're referring to, our ability to continue to outperform with the quality of mix, the quality of our business, the mix towards commercial and richer configurations we feel good about.

Similar trend in servers. If you think about the growth of our ASPs over time in servers, they've expanded, driven by our ability to drive richer content, by selling deeper into the data center, selling higher-value workload solutions around GPUs as an example, driving artificial intelligence-related workloads across our servers, we're getting richer and greater content in each and every server. And because of the challenges that we've had with supply for the better part of 6 quarters now, we've been able to pass through the incremental inflation that's been associated with servers to end users.

And similar in storage. We think storage is an opportunity for us to continue to drive higher revenue. We have the broadest portfolio in the marketplace. We cover every aspect of the storage market from a high end to the mid-range, to the entry level, to the unstructured space, to the data protection space, all highly valuable categories in storage, which allows us to drive a differentiated revenue in our storage business.

Operator

Our next question comes from Simon Leopold with Raymond James.

Simon Matthew Leopold - Raymond James & Associates, Inc., Research Division - Research Analyst

Hopefully, you can hear me. I wanted to ask about what actions you might be taking in response to the weakening environment, specifically, whether you're looking to cut operating expenses. I know you guided for sequentially lower but something more permanent or whether you're adding promotions to PCs, cutting prices, trying to get a better sense of what your response is to the weakness from those perspectives.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Thanks, Simon. It's Tom. So let me just -- I'll start and ask Jeff or Chuck to chime in as appropriate. So look, first, let me just say, Simon, as you know, we've seen economic cycles before. And I think the teams and the company's ability to navigate, it's pretty much -- we've got a long track record of doing so and optimizing the business as we go.

So as we think about sort of sets of actions that we're driving right now, obviously, we saw the weakening environment. We have instituted a number of cost measures as a result of that, including effectively limiting external hiring. We've looked at discretionary spending and have pulled that back. All the normal type things that you would do from an OpEx perspective, quite frankly, when you see environment starting to soften. And we'll continue to monitor that as we shape the P&L to the best of our ability to make sure we deliver profitability that's in line with our expectations.

From a pricing perspective, though, in terms of how do you think about what do you do from a price perspective or a promotional perspective, I think we're going to be very thoughtful as we do that only around the fact that in the environment, as we see right now, particularly in consumer, we don't see a lot of elasticity. And so we're going to be very direct and directed in any promotional spend that we do, principally focused on how do you think about product in the channel and things of that sort of that we have some of, although clearly not as much as our competitive set.

So I do think you're going to see us continue to be disciplined in pricing. We'll be -- I am pretty low to test elasticity right now, given what I think the environment looks like, but we also need to remain competitive. And so we'll be watching the market dynamics pretty closely from a pricing perspective.

Maybe, Jeff, I'd ask you to add a few things.

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

I mean, I would add, Simon, I think we have demonstrated discipline in pricing. Our product portfolio [on the low] across the 3 is in price position.

Our win loss at each type of segment, whether it's small business, medium business, large corporation global remains consistent and consistently good at release set our share gains over the past decade. So we're going to remain disciplined there in PCs. Consumer is aggressive, as Tom said, given what is happening in the marketplace. We are not that tilted, if you will, or biased towards consumer. And where we play in consumer tends to be in the premium side and the gaming side, which tend to be less competitive. It tends to be an area where we have a differentiated advantage. The same is true on the commercial side, as I mentioned in the last question.

When we move our way towards servers, the pricing environment is relatively benign. The pricing environment, we have large backlogs, we have demand ahead of supply because of what the supply chain has gone through for the past 6-plus quarters. And we see that pricing environment or the pricing environment there enables us to pass along our increased costs, as I mentioned, and the same is true on storage.

And then even when you step back, I'd ask all of us to reflect back, note on being ushered down here, sorry, as we work our way through this change in demand, we are unbelievably optimistic about the long term. Hybrid work is here to stay, which drives higher mobile mix, which drives greater configurations and more peripherals. PCs are more pervasive in the education system worldwide. We're approaching the 3-year replacement cycle of what we put in to respond to COVID and triaging the work from home event from 3 years ago. And we're still starting at a market that's larger than it was pre-COVID, which we're excited by.

And then you look at what's happening on the infrastructure side, the world continues to digitize at a nonlinear rate. Data is being created at unprecedented levels. We had data gravity pulling the infrastructure resources out to the edge. The new digital highways being built with 5G. So we absolutely are very bullish and optimistic about the long-term characteristics of the marketplace.

Operator

Our next question will come from Shannon Cross with Credit Suisse.

Shannon Siemsen Cross - Crédit Suisse AG, Research Division - Research Analyst

I wanted to ask about Project APEX. You're over \$1 billion now. Curious as to the response from customers. It seems that ratable or Infrastructure as a Service might be something that would be more attractive if we are going into a downturn, which appears we are. So maybe if you can talk about how you think about growth. And then also, how we should think about margin potential for that business as it becomes albeit a small part now, but a bigger part of your revenue over time.

Chuck Whitten - Dell Technologies Inc. - Co-COO

Thanks, Shannon. It's Chuck. Good to hear from you again. I'll start and let the team layer on. Look, as you said, we're pleased with our momentum on APEX, and we're excited to share the milestones today. APEX ARR is now approximately \$1 billion. We grew orders 78% year-on-year in Q2, and we added 200 new customers. If you dissect it a bit, we've seen a lot of strength in our custom solutions. So our APEX Flex on Demand offer, that's effectively customized infrastructure across storage, server, HCI, data protection with committed and then buffer capacity and also our APEX data center utility offer, which is effectively customers that want to move all or part of their data center to a Dell-managed pay-per-use model.

And as you said, look, in the current macro environment, we're naturally seeing lots of interest from customers who are looking to manage cash outlays by pivoting to a pay-as-they-go scale on-demand type model. So really good momentum in the business. Look, from a P&L and reporting and growth and margin, we don't want to get ahead of ourselves. We'll continue to report out periodically on our progress like we did today, and we're going to continue to remain focused on extending the offer set in APEX and hitting our technical milestones. So more to come from us on APEX.

Operator

Our next question will come from Rod Hall with Goldman Sachs.

Roderick B. Hall - Goldman Sachs Group, Inc., Research Division - MD

I guess as I sit here, I think a lot of people are going to look to come away from this call with what they can maybe read across, obviously, Dell, a very important company, both in enterprise and consumer. So I wondered if maybe starting with the commercial, the enterprise side of things, if you could give us any further color or double-click on the types of customer, maybe where you've seen this slowdown. Are these large enterprises smaller? Any kind of trends you see there that might help us learn what's going on in the environment. And then likewise, in consumer, even though there's less exposure, I know you guys have a lot of good data there. One thing in particular on consumer we're interested in is higher-end consumers. Do you think that you've seen any evidence that those are weakening?

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Sure, Rod. Jeff here, I'll take a run at this and then Tom and Chuck can certainly add. If we start with just commercial PC or enterprise, as you described, I think we said it in a variety of ways, but I try to make it crystal clear. One of the things that we had seen through the quarter, and Tom referenced how the pipeline did not build through the quarter as expected and as it most traditional or historically does, we saw the buying characteristics of large companies slow or what we call large bids. And the large bid part of our business slowed. And what large bids we did have were a smaller size.

And as Chuck said in his comments, which I think are very appropriate, what we saw was the corresponding -- that's a corresponding behavior of customers buying to their more urgent needs, not their future needs, that they were being very cautious because of the macro environment we are all operating in. And that made its way down through the large multinationals, to the large corporations, and across our customer set.

SB and NB were least impacted or at least impacted in that way on a relative basis. So they performed better on a relative basis, which is encouraging, but large businesses primarily in both servers and in PCs. We're the ones that slowed as those large bids became less frequent and more of smaller size, and that was the challenge throughout the quarter.

On consumer, we didn't really -- we don't compete in the very low end of that marketplace. And that's certainly what you've seen now as I'm sure your channel checks tell you that the channel has ample inventory, the competitiveness in consumer has grown because of the ample inventory. And certainly, you're seeing that in some of the other reported earnings through the last couple of weeks.

In terms of the high-end gaming and the XPS business or premium consumer as we like to call it, I mean certainly, we're impacted. You can't have a consumer business that has exposure to those 2 subcategories and not be impacted. They were impacted less. I think that answers your question. If I didn't, I'll give -- break Rob's rule here and let you qualify it a little more.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Jeff, maybe let me add on in terms of -- you did a great job talking about the PC demand from an enterprise or ISG infrastructure demand perspective. As we said in our talk track that, look, we did see ISG demand moderate across the quarter in terms of the overall demand growth. What we are seeing is customers with decision cycles elongating customer deal size reducing and, quite frankly, pipeline pushing a little bit.

Obviously, digital technologies is an underlying theme and trend is here to stay, and we do see customers that are continuing to spend, just in the overall environment is cautious. And so as we thought about -- quite frankly, what informed some of our guide is that we look back and thought about where we were in May versus where we are now, although we still see ISG demand sort of in that low double -- or ISG revenue, I should say, in the low double digits for the year. It is a bit softer. And quite frankly, as we talked about backlog and elevated backlog within ISG, that's -- as we think about the back half of the year, that's an area that will probably bring backlog down as we go through the year depending upon ultimate demand signals and supply chain.

Roderick B. Hall - Goldman Sachs Group, Inc., Research Division - MD

That's great. Okay. I'm afraid of Rob, so I don't want to break his rules, so I appreciate all that detail.

Operator

And our next question will come from Jim Suva with Citi.

James Dickey Suva - Citigroup Inc., Research Division - MD & Research Analyst

And I'm not smart enough to ask more than 1 question, so I'll stick to one. And that is -- with these delays, is your sense that there's an opportunity for share shifts that will actually favor Dell? Are there some actual surprise cancellations you're having? Is it kind of a quarter or 2 pause here? Or any sense about share shifts in this pause of duration?

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

We didn't hear the first couple of words of your questions. If you could set that up again, that would be very helpful, please.

James Dickey Suva - Citigroup Inc., Research Division - MD & Research Analyst

You bet. So with these pause that you said about demand, do you think that there's big share shifts occurring or technology transitions that companies are pausing on, especially on the enterprise side? Or do you think that companies are like customers canceling their orders and plans and the duration? I'm just trying to get a sense about, is it just changing more quickly and more broader than one may think?

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Well, I think we can't underestimate the impact of the macro environment that we are operating in and companies being cautious. And that cautionary view is impacting how fast things will be built out in the future. Again, I think our characterization would be companies are buying to their urgent and immediate needs. I won't say they're postponing their longer-term build-outs, but they're actually reevaluating the timing of those. And I think that's probably an important way to think about it.

The notion of digital transformation, the world digitizing the things that I referenced a few moments ago are still here. We're going to live in a world that is clearly more connected, more distributed, building data everywhere with data-driven sites, and that's going to require technology to bring to life. I think an immediate opportunity, I think our direct model in the way that we operate and how I think agile and nimble we are, we typically do well when markets are up and we typically do well when markets are down. So our direct model has allowed us our belief with our listening posts to see this early, position our company appropriately, and we intend to take share in the marketplaces we serve. And we think we're positioned to do that.

And the ability to help, if you will, soft land some of the units slow down by having a model that -- or access to the market that allows us to sell higher-end configurations across PCs, servers and storage and attached peripherals, services and financing, I think, gives us an advantage in a marketplace that may be, I'll use your word, pausing. We would prefer the word slowing for the reasons that I outlined. I hope that helped.

Chuck Whitten - Dell Technologies Inc. - Co-COO

Yes. I mean I can't help myself but to say, to build up Tom's prior conversation and our -- what we can control in our playbook in these times of economic uncertainty. Look, we have a playbook that has worked over multiple cycles. That is basically we're going to focus on what we control and we're going to position to play offense in this market, and that is we intend to accelerate our strategic position in both our core businesses and in these adjacent businesses. So while we saw -- yes.

Sorry, just to finish my thought. Look, I think the cost actions that we took in Q2 that were incredibly prudent were also strategic and not uniformly applied. So we maintained our critical innovation investments. We made critical investments in our priority growth businesses like telecom edge and multi-cloud. And we stay externally focused. As Jeff said, we're a company that has gained 570 bps of commercial unit share over the last 5 years, almost 600 in mainstream servers and are the #1 leader in storage. We -- that -- this is an opportunity for us, and that's how we're trying to position.

Operator

Our next question comes from Aaron Rakers with Wells Fargo.

Aaron Christopher Rakers - Wells Fargo Securities, LLC, Research Division - MD of IT Hardware & Networking Equipment and Senior Equity Analyst

Yes. I want to go back to kind of Rod's question a little bit. I guess if I were to look at the guidance, I think you said low teens on the ISG segment this quarter. I'm assuming that implies year-over-year growth. It doesn't seem like that's really dissimilar to normal seasonality. Actually, I think you could even argue it's a little bit above seasonality. So I guess my question is, as we look at this next quarter and even the quarter after that, should

we think about like backlog just burning down relative to demand deteriorating? And just help me bridge that -- that bridge between what's going on with backlog versus what you're actually seeing as far as slowing ISG demand.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Yes. That's actually what I was alluding to, right? So the setup of this conversation, if you think about what we just talked about in Q2 was moderating ISG demand as we went through the quarter. And so our expectation is that moderating demand continues. I think if you look overall for -- into the back half of the year, we -- particularly in the ISG space, you got to think about these things separately. We are a bit more optimistic about storage demand than we are about server demand at this point.

And my comment around how we frame the guidance and the components of the guidance, particularly within ISG, has ISG growing sort of in that high single digits, low double digits through the back half of the year, principally both through whatever the current demand generation is in that quarter and then with elevated backlog using backlog to drive incremental shipments, all of this obviously predicated on the supply chain being there. And I think we have more confidence in the availability in the supply chain, particularly in the ISG supply chain.

Jeff, I don't know if you'd add anything to that.

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

No. I think you called it out correctly. As we look at the second half and the demand environment that we've been talking about from a supply chain perspective, the things that have impeded us to be able to ship what we sell in any given quarter, we believe are clearing the way in the second half of the year, which is what we're supposed to do in the supply chain organization. So working through -- the things that I've called out in the past that voltage regulators, embedded controllers, the associated ICs with the power supplies and the mix, our line of sight to them in the second half of the year continues to improve. And we're in a good supply position.

Operator

And our next question will come from Wamsi Mohan with Bank of America.

Wamsi Mohan - BofA Securities, Research Division - MD in Americas Equity Research

Yes. Last quarter, you talked PCs could be about 330 million units. I was wondering if you could give us an update on your current view in '22 and maybe any early thoughts into '23. And if we look at your free cash flow, right, your LTM free cash flow is very impressive. But over the last 6 months, it's been negative. As you look through this weakening demand environment and particularly declining revenues in CSG, I know you've got elevated levels of inventory as well. So there are quite a few moving pieces. So any help you can give us in trying to think through as you burn through that inventory and look at the elevated backlog, the rate and pace of that beginning of, how we should be thinking about your potential free cash flow generation over the next couple of quarters?

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Sure. Wamsi, I'll address since I'm the one that put 330 million out there on our last call where our current thinking is. So I'm sure you saw last night that IDC came out with their new forecast, certainly, a significant change. Second half, obviously, particularly changed in the market now in their definition of roughly 305 million units, which I believe takes the market down on their side or just under 13%.

Our view, so tying it to the 330 million that I talked about last time, our view is built on a proprietary model. That proprietary model uses many industry sources, that uses what we learn from our supply base and what we hear from our customers. And our model is a little more pessimistic

than that. We're centering around 290 million units for the year, roughly 151 million sold in the first half of the year. You can do the math of how you get or what it would be in the second half.

So we have the second half down more than IDC does based on our insight, our listening posts and our proprietary model that allows us to at least manage and navigate the business. So that's our current outlook, 290 million. It will be wrong tomorrow. The precision of these tools isn't that specific to the decimal, but it is an approximation of where we think the market is now in driving our behavior.

Operator

And our next question will come from Amit Daryanani with Evercore.

Amit Jawaharlaz Daryanani - Evercore ISI Institutional Equities, Research Division - Senior MD & Fundamental Research Analyst

I guess maybe if I think about the back half expectations that you have for ISG, could you just maybe talk about what are you seeing in storage versus servers and one is more weaker versus other? That would be really helpful to understand. And then, Tom, if revenues are down the way you're alluding to the back half, can we still have positive free cash flow generation back half of the year?

Chuck Whitten - Dell Technologies Inc. - Co-COO

Yes, let me take that. Let me start with just the storage side. So look, we're pleased with the storage performance. You saw that fifth consecutive quarter of demand growth in storage and that streak is now extended to the P&L, we're 6% growth in Q2 after 9% growth in Q1, so that's 8% growth for the first half.

Look, I think we saw strength across a number of portions of our portfolio. Our breadth of portfolio continues to be an advantage. And so we saw growth in storage around the high end, PowerStore continued to grow, entry, unstructured. And I'd sort of call out that as we've said in the past, the storage business can be lumpy in any one quarter. And if we pull the lens back to the first half, our core storage business, data protection, hyperconverged infrastructure businesses all grew at a very healthy clip.

So looking ahead on storage, we would say, look, we do see demand growth moderating as the caution that enters the environment sort of extends to storage. But from where we sit today, we see more moderation in server buying than in storage buying. And so we do expect storage demand growth again in Q3.

Operator

And our next question will come from Sidney Ho with Deutsche Bank.

Sidney Ho - Deutsche Bank AG, Research Division - Director & Senior Analyst

My question is on the margin side of things. I think last quarter, you expect the gross margin to be kind of flattish in Q3 and up slightly in Q4. Given what you're seeing right now and also the incremental foreign exchange headwinds, how are you seeing gross margin trending? And also while you're at it, can you talk about what your expectations by operating -- by segment in terms of operating margins, given your comment on reducing expenditures?

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Sidney, let me talk about the margin dynamics that we're seeing, and I won't parse it down to an operating segment level. But at an aggregate level, if you recall what we said in the guidance when we talked about this in May, we expected Q2 gross margins to decline given the mix of the business, given foreign currency, again, some of the backlog dynamics. And effectively, that's what you saw happen in the Q2 results.

What we just said in the guidance for Q3 was that we do expect operating our gross margin, excuse me, to increase in Q3, just given the mix of the business, the pricing actions that we have taken to try to offset the currency, although that continues to be dynamic. But we think the mix of the business is helpful and we mix a bit more towards commercial PCs in the back half of the year as well. So our expectation right now with what we know today is that gross margins move upward in Q3 and then relatively stable as you go through the remainder of the year.

Operator

Our next question will come from Steven Fox with Fox Advisors.

Steven Bryant Fox - Fox Advisors LLC - Founder & CEO

Just wanted to clarify a couple of things you said on storage or just maybe understand timeline. So I understand what you said looking back on mix and trends and how you're still seeing overall demand growth and the broad advantages in the portfolio. But when you think about mix over the next 2 to 3 quarters, can you sort of dig into that? And what sort of some of these macro pressures might mean for the overall storage mix going forward?

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Well, let me try to work my way to that question. So I think we've tried to say that as we think about our businesses, we've talked about the PC business and the demand, the forward-looking server part of our business and its associated demand. And I think Chuck just referenced, we expect the storage marketplace to grow in the mid-single digits -- and we expect to gain share and outperform the market. Where are the sources of that performance? The sources of those performance are going to be our #1 positions across the portfolio. We're a market leader in the high end. We just put version 4 of PowerMax into the marketplace. It's unmatched in the market, and we continue to believe we can grow that.

PowerStore, Chuck made some references of how PowerStore is doing. It's nearly half of our midrange mix now. 24% of the customers are new. We just put our third software release into the marketplace with a new controller. We now have a feature that certainly, we wish we had earlier, but it's now in the marketplace, a native metro sync replication. We don't have any market deficiencies in the mid-range. And we have the most modern architecture in the marketplace, and we expect to lean on that. Our PowerScale and structured product is new. Our PowerFlex software-defined storage product is unmatched in the marketplace. Those are going to be sources where we go drive differentiated growth and attempt I believe we'll be successful in outperforming the marketplace.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Jeff, I think in addition to that, given the product portfolio that we have, there's a couple of macro things that help us as well. Clearly, the mainframe refresh cycle so the high end are PowerMax should benefit from that. Now it's early innings, but we do expect there to be some benefit as a result of that. And the reality of the world is that data is still getting created. So the need and the ability of a company to store data continues to grow. And with the solution capabilities that you just outlined in our positioning in the market, I think we feel pretty good about the opportunities.

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Right. And maybe if you think about it, I think I mentioned this before, but if you summarize that, our priorities in the storage business are really consolidating the high end with the best product in the marketplace. Innovating and taking share in the mid-range where we are the market leader, but want to create more space and then lead in the HCI and software-defined infrastructure business. So we have the leadership position in all 3, and we continue to lean on them to grow.

Operator

Our next question comes from Samik Chatterjee with JPMorgan.

Samik Chatterjee - JPMorgan Chase & Co, Research Division - Analyst

I guess you've mentioned a few times on the call that you've obviously managed the business through economic downturns in the past as well. I was just curious if you can talk about parts of the business that will be countercyclical. I know financial services was called out as one. And particularly, as some of the slowing reverses from your customers, hopefully, in some time, when we should expect to see the rebound first? Any insights on that from your experience.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Yes. Let me start and then the guys can jump in here. As you think about what might be countercyclical in our business, you rightly pointed out that what we have seen in the past with DFS is that in times of macro uncertainty or macro weakness, customers tend to want to preserve cash balances and liquidity opportunities and move towards financing. And clearly, the originations that we saw in DFS this quarter are opportunities for us.

So I would also talk -- point you to thinking about APEX is an opportunity, right, in terms of the as a service and subscription frameworks that many customers are interested in, the lack of preservation of capital or CapEx is an opportunity to lean into APEX, which will be interesting for us. If you think about sectors or verticals within the marketplace, and you think about the macro dynamic that's going on right now and where governments, in particular, are spending money or where investments are going into think -- within the government space, the defense sector, education and health care within the government space are interesting opportunities depending upon how budgets get released and how they flow. You've seen the macro around energy. And so investment flowing into the energy verticals and energy companies will require infrastructure build out.

So there are a number of areas within this broad context of a slowing economy that are interesting to us that we are -- we will exploit as appropriate to try and drive velocity. I would also remind you that Jeff highlighted in his conversation around supply chain that we expect deflationary component costs in Q3. Obviously, you guys have been following this industry for a while and know that in times of deflationary component costs, historically, we've tended to do well in those types of opportunities as we think about margin opportunity there.

So look, we'll have to navigate through it. It's what we do. But I'm confident that we'll be positioned to take advantage of any growth vectors that are out there.

Operator

Our final question will come from Krish Sankar with Cowen and Company.

Steven Chin - Cowen and Company, LLC, Research Division - VP

This is Steven calling on behalf of Krish. Just 1 question on ISG server refresh later this year. Obviously, the new x86 server chips that are coming out this year are probably 1 of the most anticipated product releases. Can you talk about your customer feedback on expected demand [this year] within the context of macro slowing? And also just given that AMD-based service systems have increased as a percentage of the overall market, but do you anticipate your portfolio to also be in line with that?

Jeffrey Clarke - Dell Technologies Inc. - Co-COO & Vice Chairman

Well, let me see if I work my way through that. So we talked about a slowing server demand independent of technology and architecture. It's probably we're saying for the last 6 quarters, we've been in a growth mode. The sector has really grown for us. It's been 7 quarters in a row, and you've seen this massive consumption of infrastructure. In this case, we're talking about servers. Servers, we benefited from that by taking tremendous share in this marketplace.

So as I look forward, as we get through the consumption cycle, and I'm not here, I can't cast how long that consumption cycle is going to be delayed or paused as we go through what's called a digestion period. We're poised quite well when the consumption button gets turned back on again. We'll have refresh products, both classes of x86 architectures. We'll be in a performance position of the progress we've made strategically across high-value workloads. Our ability to sell deeper into the data center, what we're doing in the software-defined space across the board, I think, positions us quite nicely to take advantage of when that consumption period resumes. I can't forecast that. We talked about the demand slowing. We didn't say it was stopped. So I think that's an important notification.

And then the longer-term attributes continue to really drive a demand, a multi-cloud world, a decentralized world, a data-intensive world, a world that requires more data-driven insights, automation and embedded intelligence. Those are the things that we built for our customers. So longer term, I feel really good. I'm not a market forecaster in terms of what happens in the next period of time, but we're positioned quite well.

Robert Williams - Dell Technologies Inc. - SVP of IR

Good. We had a couple of second questions that I intentionally didn't address that were related to cash flow. And I just feel like it's probably better that we just hit those. So Tom, questions on cash flow in the second half, given the linearity and demand dynamics.

Thomas Sweet - Dell Technologies Inc. - Executive VP & CFO

Yes. Look, obviously, I think it was Amit pointed out that over the first half of the quarter -- or first half of the year, we've seen free cash flow sort of a bit softer, given some of the sequential dynamics -- demand dynamics and revenue dynamics in the business. So as we think about the back half of the year, we will generate free cash flow. Yes, our model, as you guys all know, is when we expand revenue with our negative working capital model, we tend to generate a lot of cash flow when revenue demand or revenues flatten. You tend to have a little bit of a pullback in that. We've got a number of actions in place right now, particularly around how do you think about driving working capital down to drive more efficient utilization of working capital. You saw our inventory came down \$400 million in the quarter. We'll continue to work our way through that being cognizant of ensuring that continuity of supply and supply capabilities are there to help us serve our customers.

We did build receivables this quarter doing some of -- as a result of some of the sales linearity that we saw the receivable agings in great shape. We're not seeing any signs of stress from the customer base there at this point. And so we'll work hard to get that back in the profile. Tyler, what else would you add to that?

Tyler Johnson - Dell Technologies Inc. - Senior VP & Treasurer

No, I would probably just add. I mean, look, if you look back over the last several years, obviously, it's been a great demand environment, and we benefited from working capital efficiency, and you saw our free cash flow conversion to net income was well above 1x, right? And obviously, that's

our target, although I would say for this year, given where we are and what we're seeing, I would expect us to be below that 1x target. But we'll obviously migrate back towards that over time.

Robert Williams - Dell Technologies Inc. - SVP of IR

All right. Thanks, Tyler. That wrapped the call today. Just as a reminder, we'll be at a multitude of conferences this quarter with additional IR activities in Asia and Europe. So we look forward to seeing you when we're out on the road, and thank you for joining us today.

Operator

Thank you. This concludes today's conference call. We appreciate your participation. You may disconnect at this time.
