Dell Technologies

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Matt Cabral: I'm Matt Cabral. I cover IT hardware here at Credit Suisse, and we're very pleased to have Dell Technologies here with us, Tom Sweet, CFO, who on fairly short notice was able to make the trip out. So Tom, thank you very much for joining us.

Tom Sweet: Hey, I'm happy to be here. And Jeff Boudreau, who was supposed to be here, is snowed in, in Boston, so he claims. But always good to be here, so thanks for having us.

Matt Cabral: Yes, definitely. So I just wanted to kick the conversation off with a little bit of a bigger picture question. So it's been almost a year since you guys came back to the public market. I'm wondering if you could just talk a little bit about just what gets you most excited about the path forward for Dell and what you think are the biggest levers to value creation that you guys have?

Tom Sweet: I think it's been an interesting journey over the last 6 years for Dell Technologies, and in particular, we got the Class V transaction done a year ago and took the tracking stock out and became public through that transaction. I think we're very excited about the value creation opportunities that we have.

But we've talked about this in the sense of the five levers of value creation that we have, Matt, in the sense of if you look at the broad portfolio and the capabilities we have in terms of running the core business for growth; the synergy opportunity with VMware and the family of companies around Dell Technologies; the work we're doing on innovation; the work we're doing on delevering the balance sheet, which is a natural equity value creation opportunity; and then the work we're doing on capital structure and then the overall corporate structure. So if you look at those levers that we're pulling, and you can see--our vision is that we continue to drive this thing forward, and there's an interesting value creation story for us over time.

Matt Cabral: Got it. And I wanted to dig into your comments about the family approach to the portfolio. I wonder if you could talk a little bit more about what that means in practice, and in particular, just the relationship with VMware, how important that is to you guys going forward.

Tom Sweet: If you look at how we're running the company these days in the sense of both our presentation to our customers in terms of how we present ourselves as Dell Technologies to our customers as well as the innovation work as we think about solution capabilities, in particular with VMware. So unlike years prior to the combination of Dell and EMC, where those businesses were separate and apart and they didn't play in particular as tightly as we want them to play, since these companies have come together, we're very much integrated in the sense of go-to-market capabilities, go-to-market coverage models, the innovation story that's happening with the solution capabilities that we're driving.

Think of VxRail on the hyperconverged space. Think of Unified Workspace. Think of the work we're doing in networking with SD-WAN. Those are just the tip of the spear of the Dell Technologies Cloud as we put our engineering efforts in a more synergistic fashion. I think there's very much a value differentiator. And VMware, I think, is a differentiator for us in terms of the platform approach that it provides us.

Matt Cabral: Got it. And shifting over to the demand environment, I think 2019 has been a little bit of a more difficult year, particularly on the enterprise spending side. Last week on your earnings call, I think the words you used were slightly more cautious on the outlook as we're thinking about going into next year. Maybe if you could just expand a little bit about what do you mean by that comment, and just how are you thinking about the demand backdrop at this point?

Tom Sweet: What I was trying to get across is there's four or five big things we're watching as we think about next year, or looking at as we think about next year. There's clearly a macro dynamic, and we don't have to recite all the macro dynamics that are out there, whether it's China trade or you name it. And much of that, we're not as a company going to control that. It will be what it will be, and we'll have to navigate through it. But it does put a backdrop, if you will, on how do you think about the business environment. So the macro we're watching.

We're watching server demand and infrastructure demand projections in terms of how do people think about what does that spend environment look like next year. We're clearly looking at, we're interested in the storage environment from an ISG perspective. We've got what we think is, as we have now refreshed the entire product line and the data protection line, we think we've got the strongest portfolio that we've had in a while there. But yet the infrastructure spending we'll have to watch.

And then I think you're working your way through, from a client side, you're working your way through what has been a pretty strong year from a client perspective with the Win 10 refresh and what happens to the Win 10 refresh cycle, both from just a natural refresh cycle coming to an end at some point next year. We would guess or estimate sort of midyear. And then what does this Intel dynamic do to that cycle? Does it elongate it?

And so there's a number of questions in our minds that we're trying, as we work through our plans for next year, around the environment. And so that was what I was trying to convey. It's just, "Hey, there are some macro things out there and there are some industry dynamics that we'll have to work our way through."

I think long term, we're still positive on the technology cycle and the investment cycle. But look, there are going to be some dynamics that we're going to have to navigate as we go through the year.

Matt Cabral: Got it. And against that sort of backdrop, especially given some of the unknowns that you mentioned, how do you think about balancing growth versus profitability as we go into fiscal '21?

Tom Sweet: We've been fairly vocal about our operating model, and those of you that follow us would know this in the context of our whole proposition, as we think about it, is that we're in it for long-term value creation. And we're going to run the business with the following tenets around we want to grow, and we want to grow relatively faster than our competitive set and faster than the market, but that that growth has to be, over time, be profitable growth.

And so those of you who have followed the IT hardware segment or pieces of that segment know that you can go out and drive growth, and you can go--we would call it go rent share or buy share. That is transitory share. It doesn't tend to stay with you. And you can spend a lot of money doing that in terms of gross margin dollar impacts.

And that's not really what we want. We want long-term, sustainable growth and building a customer base that makes sense to us that allows us to, over time, over the life cycle nature of that customer, drive profitability in a way that makes sense to us. And that's what we've been focused on, is building that customer base. And that's the playbook we're running, but it's a balance. That does not mean, by the way, that I won't be aggressive where we need to be aggressive in terms of either acquisition plays that we're making to expand the customer base or where I'm defending, if you will, against a potential competitive threat in terms of what that might look like.

You would know that much of the IT hardware segments that we're in is--you would call it, quite frankly, a mature market. And what happens with mature markets is that over time, they consolidate. The supply base or the providers in that base consolidate. And I think we're in that natural cycle right now. And given our breadth, depth, and scale, we view ourselves as a consolidator over time, whether that's organic or otherwise. And so it's imperative in that sort of environment that you continue to grow, you continue to make sure that that growth is the right kind of growth, and that's the playbook that you run. So that's what we're focused on.

Matt Cabral: Got it. And you mentioned, at least within pockets of the portfolio, willingness to get a little more aggressive, either for new customer acquisition or at least to defend what you've earned until this point. Any particular pieces of the portfolio where you feel that's a little bit more of a necessity as opposed to not as aggressive out there in the marketplace right now?

Tom Sweet: Well, it's an interesting time in the business because we've been in a--particularly for those solution capabilities that are more commodity cost sensitive--you've been in a deflationary environment from a commodity cost environment for much of this--for all of this year. First there was an inflationary environment a year ago--a year and a half ago. And that has allowed, I think, certain dynamics around pricing in certain areas. We've seen that principally in servers. Server pricing at times has been relatively aggressive in certain areas. We would highlight China as being fairly aggressive on server pricing in terms of our competitive landscape. And I talked about in the call that the large enterprise, large-scale RFPs, our opportunities have been at times very aggressive.

Why is that? Well, you've got a couple of dynamics. One, the commodity cost deflationary environment has allowed--you're making choices. "Do I hold onto that commodity cost goodness in terms of margin, or do I price it?" And at times, we're seeing competitors price it. We've seen--and price quite aggressively in certain opportunities.

And so we've seen these cycles before. And our perspective is we're going to ensure that we continue to run the playbook that we've been running, which is where I need to be aggressive, we'll be aggressive. Where it doesn't make sense, there's going to be times where we're not going to look at some pieces of this business or pieces of the opportunity. And so I would tell--it's a long-winded way, I guess, of saying that servers has been a bit aggressive.

PCs have not. Why? Why have PCs not been very aggressive? Well, because you've got an Intel CPU dynamic right now. So where there's shortage, you don't tend to see price aggressiveness because people are trying to optimize or maximize their supply opportunity. So that's the dynamic we're living in these days.

Matt Cabral: And I think one of the things, particularly on the ISG side, is just the difference in behavior between the server market and the storage market.

Tom Sweet: Right.

Matt Cabral: Broad strokes, it's a somewhat similar competitive set. It's a somewhat similar buyer set. Yet the consistent feedback seems to be servers, aggressive; storage, relatively benign. Is that a sustainable dynamic or is there risk of, as NAND benefits and other sort of factors are playing through on the storage side, that trickling over to that portion of the portfolio as well?

Tom Sweet: I think you've got to look at what drives the value proposition in each of those spaces, and they are different. So the server market has tended to be, as much as we're going to say we have a great product and we are number one in the server space, that tends to be more sensitive to commodity cost and the fluctuations in commodity cost. The storage market is not. The storage market is much more an IP-driven conversation value sale.

So what is storage, at the end of the day? It's industry-standard hardware, and then you're layering in IP vis a vis software on top of it. So the value's in the software and in the IP. And customers, as they're making purchasing decisions around storage, tend to be much more oriented on workload dynamics, performance dynamics, and the value proposition is much more around helping them get to an outcome versus trying to drive to some lower commodity cost-based approach. And so that's just the dynamics within the data center.

So I do think they behave very differently, and we're seeing that behavior play out in the marketplace right now. If I look at my storage pricing, for instance, by family within the storage category, the pricing's been relatively benign. Obviously, there's mixed dynamics as you go from quarter to quarter which have different profiles, but in general, I think it's been a reasonably benign environment.

Matt Cabral: Got it. And maybe just to back up and just talk about overall margins for the business as a whole, I think one of the other comments that you made last week is operating margin is trending back towards last year's levels. And if you could help us unpack that a little bit, you talked about commodity costs several times and entering a little bit more of an inflationary environment. How much of that is driving it versus competition or mix or some of these other factors?

Tom Sweet: Yes, why we said what we said last week was based on a couple of things. One, I wanted the external community to begin to think about next year's dynamic relative to this year and what's changing. And there were certain constituencies out there that seemed to me to be taking this year's results and just sort of extrapolating. And I don't think that's the right way to think about next year, just because you've got some different dynamics happening in the environment.

And I've said now for a couple of quarters, Matt, that hey, we expect, for instance, CSG operating margins, client operating margins, to start to trend back to more historical norms as the commodity cost deflation flattens out. And as we look forward into next year, our point of view right now, talking to the supply base--and we do have the largest technology supply, in terms of supply--is that commodity costs move from deflationary to inflationary as you go through the year. Well, when that happens, you get a different dynamic within the pricing environment and the yield from the pricing and how do you think about the impact to the operating margin line.

And so what I wanted people to think about, our investors to think about, is, "Hey, as you think about next year, you've got to think your way through what happens when the commodity costs move." And those lobs that are more sensitive to commodity costs, which is PCs and servers.

And it seemed to us that some folks just hadn't thought their way through that, to be honest. And so my goal is to never surprise the market. And so I wanted that thought process to get out there. So that's probably the biggest driver.

So when you unpack that, what does that mean? Jeez, I guess that the client business, if things hold like we think they are, which is always subject to change, is we should see CSG operating margins trending back towards more historical norms, which is what we've talked in that 5% range, not sitting at 6.7% or 6.8% operating margins. And that has some dynamics when you think about the flow through to, through the P&L. And the same effect will be there somewhat for servers as you think about commodity cost movement.

So we're still watching all of this and trying, working with the supply base as we think our way through next year. But I thought it was appropriate to get those thoughts out there and let people start thinking their way through it.

Matt Cabral: Got it. And free cash flow tends to be fairly closely watched, especially for you guys, given debt pay-down and a whole host of other reasons. I know you guys don't guide specifically to free cash flow, but taking the conversation and the commentary about margins, how do we think about that translating into cash flow next year? And consensus operating profit is down a little over $500 million next year. Is there risk to cash flow declining in 2021?

Tom Sweet: Great question, Matt, and we don't guide to cash flow. But if you were just thinking holistically, which if your operating margin, our operating is under--is potentially going to decline somewhat, there would be some impact to cash flow. Now, the offset of that is all of the work we do around working capital, because we have been very focused on driving an efficient balance sheet. And I think the team that is charged with that has done a really nice job, generally, over the course of the last 5 years on that.

Now, last year what you saw--not this year, but the previous year--is you saw some inventory build, for instance, as we were working our way through some of the Intel dynamics, and this year you've seen the inventory turn around and come down as we've focused on that.

So the cash flow question, or the cash flow observation, is going to be dependent upon two things. One is around where does operating margin ultimately fall out--come to--as well as what do we do around the balance sheet and the efficiency of the balance sheet? And so you might imagine that to the extent that I think that there's some operating cash flow dynamic that we need to work our way through, that we'll be even more extraordinarily focused on how do we drive efficiency in the balance sheet.

I will tell you that it doesn't change our point of view at this point around we've been public about we're going to pay down $5 billion of debt this year. We've paid down $3.5 billion year to date, which simple math would say, "Well, that would say you've got about $1.5 billion in Q4 that you're scheduled to pay down, or you're anticipating to pay down," which is what we are. And then we've talked about the fact that next year is--our projection is roughly a $4 billion gross debt pay-down, which is what we still think makes sense.

And if we do that, then we're well over $23 billion of gross debt pay-down since the EMC transaction has happened, and that puts us in the conversation with the rating agencies at some point thereafter, and it will be their call around how do we think about the ratings upgrade to an investment-grade credit, which is what--and I think that then allows us the opportunity to think about capital allocation a little differently.

Matt Cabral: So maybe following up on that, why is the investment grade so important to you guys? And as we think about the path forward, when is the right time to start having that conversation with the ratings agencies?

Tom Sweet: Yes, I think it's important to us for a couple of reasons. One is we're an extraordinarily large company, and we have a captive financing sub. And so ensuring that we have the right cost of capital for that financing business is important. I think investment grade always gives you more flexibility in your capital structure. It will unlock commercial paper opportunities for us. And as we go through natural economic cycles, you'd rather have a stronger balance sheet than a more levered balance sheet. I think the team's done a nice job of working their way through it.

I would also add that clearly, our equity investor community is very focused on leverage. And so it's not lost on us around getting the leverage down to a rate that is more common with what they might see in the large-scale, large-cap tech companies. And so you couple that all together, and there's an interesting equity value creation story as you pay down debt in terms of equity value.

So I think there's lots of reasons why we want to get that down. I think it's the right thing to do for the business. And then ultimately, what it allows us is more flexibility to think about what do you do next with the business and how do you think about shareholder return and those things that begins to unlock.

I think it would be premature to talk shareholder return type activities right now until we get to where we need to be. And I think we've made a pretty strong commitment to the external community and to our credit rating agency partners that, "Hey, this is what we're focused on doing." And I would expect, if we do what we say we're going to do, which I intend to do what we say we're going to do, which is we're talking about the end of next year or shortly thereafter into the following year, you're beginning to have those conversations. It's ultimately not our call, as you know, when they might change or give us that rating upgrade, but I think we'd be in a position to start having those conversations.

Matt Cabral: And looking at the target to pay down $4 billion next year, why is that the right number? One of the questions I get from investors is it seems there may be some capacity that you have, just looking at the core cash sitting on your balance sheet, maybe accelerating that path to investment grade. How did you arrive at $4 billion as the right metric for (inaudible)?

Tom Sweet: Well, I think we're obviously thinking about the cash generation out of the business, and we're thinking about, if you think about what it takes from a global liquidity, just to run the business of Dell Technologies across the globe. So in terms of how I've got liquidity distributed across the globe, you roughly need sort of that $4 billion to $4.5 billion of just cash on the balance sheet to manage the liquidity profiles in the various geographies. And you're always working on things like, "Okay, yes, I've got $6 billion," or whatever the number is, "right now, but some of that's in China where I can't get at it in an efficient manner. I can only dividend that out once or twice a year." And so you've got these dynamics for managing your way through, Matt.

So yes, we've got cash on the balance sheet. You want to have a little bit of dry powder anyway. But as you put all of those factors together and you look at liquidity profile, cash generation, what's coming due from a debt stack, which is only $2.5 billion over the next 18 months, I think we think that $4 billion seems to be about the right number we should be targeting for next year.

Matt Cabral: Got it. One more and then I'm going to open it up to you guys if there are any questions out in the audience. You mentioned a little bit earlier, just in a mature market, we should see more consolidation over time. You mentioned, obviously, organic. That's what's played out largely in the PC space. As we think about getting closer to that investment-grade level, does M&A become more of a lever for you guys? Or are you more focused on the organic path forward?

Tom Sweet: I think--you never say never around M&A, because the minute I say we're never going to do M&A, we're going to do an M&A transaction the next day. So you're always looking at it. Does it make sense? Does it not make sense? To date, other than, obviously, the EMC transaction, it's made sense for us to organically push on the consolidation play. If you think about the PC space, there's three large players in the Windows space. At some point, does that consolidate to two? Not sure. But logically, if you followed the disk drive business, you would say ultimately it does at some point. How does that play out? When does that play out? We'll see.

We're always watching, but to date it hasn't made sense to us relative to what we're trying to do from a balance sheet perspective and business perspective. We've been fairly busy, as you know, Matt, on just getting EMC and Dell integrated together and making sure that we've got the operating motions and the innovation engines where we want them, and I think those have come a long way over the last 2 to 3 years. So as we get back to investment grade or as we look at the opportunity, we'll continue to look.

I might also add, just so everybody remembers, that we also have Dell Ventures--Dell Technology Capital, I should say--which is our venture fund, which has got about close to $1 billion of investment in there in terms of startups, which also gives us excellent visibility into new and emerging technologies and capabilities that we think about in terms of our portfolio. So we continue to be both focused organically, and we'll continue to watch for opportunities.

Matt Cabral: Got it. Maybe I'll open it up to the audience if there are any questions. If not, I've got several more and can keep going. Sure, got one over here.

Unidentified Participant: In terms of the CPU shortage, which is impacting your outlook, obviously, there's opportunity to diversify your portfolio so that you mitigate that risk going forward. How quickly can you implement that, and are there other margin-related benefits as you move down that path?

Tom Sweet: I get this question a lot, so thank you. The reality is that if you look at our product offering, and I'll bifurcate it a little bit for you in terms of if we look in the server space, for instance, we offer both Intel CPUs and AMD CPUs. And the receptivity of the AMD CPU in the server space has been reasonably good, and so we have a number of platforms. And if you look in the PC space, for instance, we continue to evaluate AMD in terms of are they an alternative supplier that could be of scale to us? To date, they're not. And they've got new CPUs coming out in the next generation of desktop that's interesting to us. And so we continue to evaluate it. But in the interim, there's not a large-scale play there; I'll say it like that.

And so as we--we've been an Intel partner now for 30-plus years. Obviously, they've had some issues over the last number of quarters. We haven't been very public about it. We just have worked our way through it, and it hasn't't--I think my supply chain team has done a really nice job of navigating through it. But we called it out this time just because we got some late-breaking news that the supply outlook from Intel was not going to match my shipped revenue forecast for the quarter, and I didn't see a way to plug it, to fix it. And that put some revenue pressure on the quarter and therefore the year, which is why we pulled down that range.

Doesn’t really impact the operating margin framework all that much. So the question that we're wrestling with right now is okay, is that just a demand shift? Does it move to Q1? And it's a bit of an unknowable answer. Some of that demand is perishable, and you can see that as evidenced by some of the lead times I've had to adjust. Because we're a direct business, and so you can see my lead times as you go out and say, "I want certain types of products." And so it's an interesting dynamic. We're working our way through it, but it's put some pressure on the short term. And the question will be does it translate into a different perspective for next year as we continue to work our way through the CPU dynamic. And that's a little bit unknowable right now.

Unidentified Participant: And just one last follow-up. Given the, particularly on the commercial side of the business, because you haven't been able to deliver in alignment with what you expected, are there typically make-goods that you have on the tail end of that so, "We promised you X. We can only give you Y. Whenever we do supply it, the pricing changes."

Tom Sweet: I don't want to get into--that's a great question, by the way. I don't want to get into specifics on that, but we're clearly having conversations about, "Hey, if I have extra costs associated with this, can you be helpful? Can you not be helpful?" And I won't go a whole lot further, but those conversations are always happening.

Matt Cabral: Maybe one last one from me just to wrap it up. The midrange refresh that you guys have coming, it's gained a lot of traction with customers, with the investment community. How should we think about the impact of that and the ramp of that launch as we go into next year?

Tom Sweet: Yes, the product release is right at the end of the year. I want you to think about storage buying cycles, though, because typically what happens with new product or new solutions is customers will procure one or two units and put them in the labs and test them for some period of time. So the buying cycle is a little long as they evaluate product. And so we think about it like this, is that you shouldn't really see a whole lot of impact in the first half of the year from that new product launch, which we're excited about. We think it's a great architecture, great capability, and it should be market-leading. I would expect to see impact in the second half of next year as those evaluation cycles, that process runs its natural course.

Matt Cabral: Got it. Perfect. Well, that makes a ton of sense. Unfortunately, we're out of time. So Tom, thank you very much. Appreciate you making your way up.

Tom Sweet: Hey, I appreciate it, guys. Thank you, everybody. Matt, thank you.