

Dell Inc.

**February 24, 2010
11:15 AM ET**

David Bailey: Good morning, everyone. I'm David Bailey from the Goldman Sachs hardware team and we'd like to welcome you to day two of the Goldman Tech and Internet Conference and we're very excited to kick off the day with Dell Computer. Brian Gladden, the CFO, and Peter Altabef, President of Dell Services, thank you very much for joining us this morning.

Brian Gladden: Good to be here.

Peter Altabef: Thanks, David.

David Bailey: And if it's okay with you, we'll jump right in with questions.

David Bailey: So we want to make sure that we focus on a lot of the longer-term topics today, but there clearly was a lot of controversy around your earnings call last week and we just want to address that with a couple of questions right up front and then we can move on to some of the longer-term things.

Specifically, Dell saw a 90 basis point decline in gross margin on both a sequential and a year-over-year basis, which you attributed to the consumer business. So maybe you can talk about that in a little bit more detail and if it did all come from the consumer business, why shouldn't we see that snap back as early as the April quarter?

Brian Gladden: Yeah. I think we've spent a lot of time talking about the consumer business. Just to put it in the right context, I mean, it's 20% of our business and it's an important part of the company where we've made great progress in terms of driving growth and taking share and built a \$6 billion retail business over the last couple of years. So there are positive aspects to that business that we feel good about and good progress there.

You know, we were disappointed in the profitability in the consumer business. It is a quarter where we see typical seasonality because of the holidays and consumer takes on a larger piece of the business in the fourth quarter, which contributed a portion of the pressure, because the margins are lower there. We also saw challenges in the retail market during the quarter, as you look at pricing that we saw for the quarter, but also component pricing when you look at, specifically, DRAM and how that price really flew up in November, that was one of the pressures that we felt during the quarter.

And we took actions in January, but frankly it was too late and that contributed as well. So, I think we've got some plans in place to improve the profitability of consumer. I think the two big challenges there, one is continuing to cost out and we've consolidated our consumer business with our SMB business from a leadership standpoint and we've consolidated the product development teams there, which will force us to consolidate some platforms, continue to take more cost out and, I think, simplify the business a bit.

And we need to continue to run the retail business better and we've got some actions in place around how we match up the cost of commodities with the pricing that we do in the marketplace for longer-term commitments.

So I do feel like you'll see some pretty dramatic improvement coming back quickly in the consumer business, but I would also, in terms of gross margins in total, they were generally very strong in the commercial side of business. And, in aggregate, that business sequentially improved gross margin rate and we continue to see pretty strong demand improvements over the last four to six, kind of, months. And as that business continues to see demand come back, where it's been very depressed for the last 18 months, there's real leverage in that business that I think we'll see going forward.

So we're bullish and I think, fixing the consumer business is something we have plans in place and feel good about that and the rest of our business, 80% that's focused on commercial, is in good shape and getting in better shape as we get better demand.

David Bailey: And let's move beyond the consumer business a little bit, because you did see a 10% basis point drop-- a 10 basis point drop in the consumer business, but that was relatively small. You saw a much larger drop, around 100 basis points, in your SMB business. So maybe you can talk about the drivers of that and how that's going to turn around?

Brian Gladden: Yeah, we're happy with SMB. I mean, that's a business that suffered through the first half of the year unit volumes down 25% to 30% globally. It took a lot of cost out in that part of the cycle and, what we typically see in the fourth quarter is some seasonality as regions in the world mix differently.

So margin rates in APJ in that business are a bit lower and we saw more growth there in the fourth quarter, which we typically do. So, we're pretty bullish about SMB and how that's going to come out in the first quarter.

David Bailey: And then, more broadly, how do you prioritize revenue growth, market share gains, op margin improvement, cash flow, earnings growth?

Brian Gladden: Yeah. I think we've been pretty clear throughout this challenging cycle, through the last 18, 24 months that we were focused on profitability and, in many cases, walked away from share that was low calorie or low margin. The reality is we continue to do that. I mean, favoring profitability for us is important and I think, as we look at what we've done in terms of the share gain, we're more focused on profit share and, frankly, revenue share is even a better measure, because we're really winning at the high price points and that's the share that we see as valuable.

As we talk about our enterprise business and expanding our footprint into higher margin enterprise solutions, those are the customers that, frankly, are very important for us to be able to do that. So margins continue to be the priority. As we get into cost position, you'll see us effectively play in the market and effectively maintain our gross share in some markets.

So-- but profits are important and, as with our model the cash flow has been terrific and I think that will always be a priority and with a cash conversion cycle of minus 36, it's a powerful machine when you start to see some revenue growth, which we expect to start to see now.

David Bailey: And, Peter, the world is clearly changing and with Oracle's acquisition of Sun, HP-EDS, as well as Dell and Perot. So how does Dell stack up versus the other major competitors when you look at sort of end-to-end hardware-software services solutions.

Peter Altabef: Thanks, David. That's a great question. And this is the first time I've been at this conference in this capacity, because Dell Services is new and was formed in November as a result of the acquisition of Perot Systems by Dell.

That enlarged the addressable market in services that Dell could play in. So if you look at the services that Dell was offering before the acquisition in November, Dell had a very nice business in services, in a part of the services business that represents about a \$170 billion of worldwide spend. If you look at the addressable market now, with the addition of the Perot Systems' capabilities, that addressable market goes from about \$170 billion to \$800 billion.

So it really opens up a much bigger spend for Dell. And it also opens up more capabilities.

So the Dell Services unit today has revenue of about \$7.7 billion on a run rate, roughly 1% of market. There is no company in the market that has more than 7.5%. So unlike the hardware market, this is a wide open market and no more than two companies have more than 3% of market share.

So it's a wide open market and if you look at it from a size standpoint, Dell Services today, right out of the box, if you will, is one of the 15 largest IT services organizations in the world. If you eliminate some companies that are geographic specific or really market-focus-specific, for instance an ADP, then Dell Services today is one of the top ten from a revenue standpoint, of IT services organizations.

But when you talk about where the market is going in terms of capabilities and alignment and you look at the depth of the services, one of the things that Dell Services now brings is experience and capabilities throughout the portfolio of IT services. And that starts with product warranty and support work, it goes to managed services. It goes to cloud computing and data center services, to application development, to business processes, to IT consulting and to business consulting. And I actually think when you start looking at companies with that breadth of services you come down to four.

So I do think it's a very exciting time, because it's a very large addressable market that is wide open and we're in pretty good shape in terms of being a major player out the gate as Dell Services.

Brian Gladden: Let me just add. Services now makes up 13% of the company by revenue. We expect that to grow. The enterprise business, when you take services plus enterprise hardware business, storage-- storage, servers and software, would be about a \$15 billion or \$16 billion business for us now. So, it's becoming relevant in terms of our financial model and as you see us make investments, organic and otherwise, that's where you're going to see us making the investments to grow that part of the business.

David Bailey: And so can we just follow up on that a little bit? I mean, HP and IBM have been solution selling for quite some time and Dell has been traditionally known as sort of a box company. Can you talk about how you're changing and what you're offering that's different from HP and IBM?

Peter Altabef: That's a great question, too, David. So Dell Services is new, but the team doing services at Dell is not new. So, again, the heritage there, if you will, on some of the enterprise side has come from Perot Systems. Of course, the IT outsourcing industry, that \$800 billion marketplace, was actually founded by Ross Perot, Sr., in the 1960s. And there's a huge legacy of experience now at Dell Services about how to run a services organization.

The question is, how do you take that services business, which will grow fine on its and how do you create a real solutions business that can take advantage of the rest of what Dell has. Obviously, HP and IBM are two of the other three companies that have that breadth of services.

I would say to you, just that one sentence, to me, is a pretty big deal. When you think about the fact that you're now thinking of Dell as, okay, well, HP and IBM and one other company have this, how is Dell going to differentiate itself? Out the chute, the fact that Dell is one of those four companies and I think will get its fair share of the market is a dramatic change from where Dell was before November. That's number one. I'm not going to say that's a victory in itself, but it is.

Where we will begin to differentiate ourselves is a little bit in the structure of an organization. It's interesting to me, being relatively new to Dell, Dell is a \$60 billion organization that actually operates as an operating company. It's not a holding company. There's a unified team, whether it's product design, manufacture, solution development. This is one, gigantic \$60 billion operating company.

And I think that as you move into the solution stage, which Dell is in now and really has been in since the summer of last year and you start saying, well, how are we going to build in services, right into the BIOS of computers and how are we going to build in remote configuration and managed services and how are we going to build out our stock to really create solutions that will be competitive and will be superior to some of the others, the fact that this particular company is an operating company, not a holding company, differentiates itself somewhat and, I think, is actually a very powerful advantage for Dell.

So part of it is the culture that the company has. The other part is it's not wedded to a legacy approach. The ability to do solutions, now, absolutely we have long-term outsourcing contracts and absolutely we have legacy revenue, but we don't have legacy revenue to the extent that we're-- we wake up every morning saying, well, if we put in a new product or service it's going to-- it's going to eat our existing revenues. We just don't operate that way.

I think that's an advantage, too.

David Bailey: And as you build out these solutions, maybe you can talk a little bit about where you are in that process and when you think you'll be ready to sort of launch those? And then what holes do you have to fill?

Peter Altabef: Well, it's-- okay, two different questions. In terms of true end-to-end solutions there are some already that exist at Dell, but probably haven't been packaged or marketed or even

thought inside Dell that way. There are others that are in the research and development stage and will be launched over the next year.

I'll give an example of one of each. So in terms of the things that already exist in a true solution, in areas such as education and healthcare, Dell is already a market leader in its approach. In fact, it's the largest provider of healthcare IT services in the world. Probably also true on education services, although I don't have real good data on that.

But, for instance, we have a suite of solutions that will go in and create an online classroom or a wired classroom that you can put into colleges and high schools and we are doing that regularly now, not only in the US, but across the world. But it's not necessarily packaged as a complete solution. So you have to buy eight of these and 14 of these and you've got to package it and we ask our sales team to really help create that almost every single time.

So creating a single solution with various choices so that the educators and school administrators can say, well, I want this instead of that and this instead of that and you give them five choices in five different areas for a total of 25 choices rather than you sit down and try to make it up is going to be a huge deal as we roll this and really scale it. So that's an example of solutioning.

Examples of solutions that are under development are things like simplified data center infrastructure management. We do a lot of data center management, both from a services standpoint where we're operating private clouds and hyper clouds for clients, as well as from a sales standpoint we're basically selling clients private cloud solutions where we're going in and selling them the hardware, the networks and the software to go ahead and stand up their own private clouds.

Putting that together with very specific IP points that allow you to really manage those private cloud environments and doing that as a combined solution is something, again, we do in pieces right now. Over the course of the next year, you'll see a real focus on solutioning that I think will, I believe, change that perception from Dell selling point products to Dell selling combined solutions and I think that's a very big deal.

David Bailey: And then maybe the other part of that is, given Dell's heritage, what are you doing from the sales perspective, once you get these solutions set up? Do you need to change the way your sales force attacks the market?

Peter Altabef: That's a fascinating question. Since the acquisition in November, we are now working on 190 sales opportunities, which we call revenue synergy opportunities, which are opportunities that we don't think either company would have had but for this transaction.

And so the sales teams have been very eager to try to bring the Perot Systems capabilities in and are doing that with success. Our pipeline for new opportunities is significantly higher than it was six months ago.

But it's-- it is a process. You know, when you talk about re-educating a sales force the size of Dell's to sell solutions instead of selling point products, that's a process. We've actually budgeted a significant amount of money to do that across the field and, when you have thousands of sales executives, that's a big process.

Specifically on services, what we have done, is we've taken several hundred of the Dell sales executives that were focused on services and we've actually brought them into the new Dell Services organization directly. So we're training those people up.

And I will tell you, there are really pleasant surprises. I was at a Dell sales executive meeting three weeks ago and I was telling them about some of our capability. Again, it's an education process and you have to tell somebody and then you have to tell them again, but one of the capabilities we have now, which is a sweet spot for when you think about Dell's heritage, is the ability to take clients and take applications that are mainframe-based and put them on to a Windows environment.

So we just completed, in December, what I believe Microsoft considers the largest mainframe-to-Windows conversion, at least in the public sector. Supply chain organization was the client. They had a 25-year-old mainframe application. The client had tripled in growth in the last six years and they were creaking with that mainframe operation.

We took the mainframe operation and we converted it to a Windows platform, 10 million lines of code, 40 applications, 500 interfaces. And the reason for the conversion was twofold. They were struggling under the license fees to keep the old mainframe environment up to speed and they were struggling with the ability to expand and update the mainframe environment.

The day we turned on the Windows replacement environment, same functionality as the mainframe environment. This wasn't moving to a new system. This was taking the existing functionality and moving it over, they saved \$6 million of annual licensing and run-rate costs that day, which they are, then, taking and plowing back into application development.

About 80% of a typical CIO's budget is spent on maintaining their infrastructure and applications environment, about 80%. They only have about 20% of their budget for new development. So if we can do these types of things, we can move that 80/20 to a 50/50, not increase the technology spend of our clients, but dramatically increase their development dollars and their ability to help their clients grow. We think that's a differentiator and, again, when I said that we don't have that legacy, there might be some other companies that would think twice about taking clients off mainframe environments and moving them to Windows environments and we don't think twice about it, we think it's a great opportunity to sell more X86 servers.

Brian Gladden: David, I would also say, we made decisions last summer as we started to see the beginning of demand coming back for commercial and understanding a little bit better the client refresh potential to go ahead and-- to begin to change out some of our sales force. And, over the course of the fall, we'll continue to do this, really transitioning to more solutions-based sales and taking some of our box-based, hardware-centric sales team and moving them to a more solutions-based.

So there's some investments we're making there that are very consistent with what Peter talked about in terms of building out that go-to-market capability.

David Bailey: And just to follow up on that, you started to see some environment in the enterprise, you know, last year and I assume it's continued into this year. Can you talk a little bit about that, particularly giving a little detail around whether it's servers or storage or client and where that stands and what you expect for this year?

Brian Gladden: Yeah, I mean, I-- we suffered through-- I think we've figured out now that the trough was sort of the early part of Q2 and we started to see a little bit of life towards the end of the second quarter. What we saw in the fourth quarter and really coming into the fourth

quarter was a broad-based pickup across, really, all regions. Europe, I would say, is lagging the most, but between APJ and the Americas and then the sequential growth we saw in Europe, in most of Europe, pretty broad-based.

And I think it's across all product lines. I mean, if you saw in our fourth quarter, servers were up 26% year-over-year and you saw our storage business was up, I think, almost 20% sequentially and then again, client was up very strongly, as well.

So I think it's broad-based. I think there was a small piece of budget flush that in some cases we talked to customers about. But, you know, as you talk to CIOs and CEOs today, they're going to pay for productivity. If they can find ways to take cost out of their IT infrastructure, they're going to move forward with client refreshes in this environment. And I think client and data center and that's what we're seeing right now. They're beginning the process of scheduling those RFPs and getting the planning done to get that activity going.

So the strength that we saw in the fourth quarter continued into January and, frankly, has continued into February.

David Bailey: In the past, Dell has made comments about making a series of small and mid-sized acquisitions to build out the solutions portfolio. What's your appetite for acquisitions right now, given where you are in the Perot integration?

Brian Gladden: Yeah, we've spent some time building out capability. I think that's-- we recognized that we didn't have the skills and capability and resources to do that. We effectively built the right size team, the right capability around the Perot integration and we feel very good about how that's progressing.

As you know, we hired a great talent from IBM, Dave Johnson, who is an acquisition machine. And he's not only built a process around the acquisitions themselves and targeting and beginning the process of identifying the right targets, he's also built the process for us around integration and we've added resources there.

So, you'll see us continue to become more acquisitive. I think we do have to build out some more of this solutions capability that Peter's talked about and, I think we'll do more in the short term, too.

David Bailey: And what do you consider small and mid-size? Is that based on revenue levels, price? How should we think about that?

Brian Gladden: Yeah, I mean, we have to think about what we need to build this capability and the services side of the business is a great platform. We've got the platform now. It's a matter of additional bolt-on things that geographically or vertical markets where we can grow.

There's a couple places where we may need some more scale and we've been most successful with these mid-size acquisitions. EqualLogic is a great example in storage where we spent \$1.4 billion and we've now taken the business from \$125 million revenue run rate to a \$600 million run rate business. So that with our scale, with our customer footprint, that's a pretty good recipe. And if we can continue to do that, we'll feel pretty good about that and that's not a size that scares us at all.

Peter Altabef: David, from a point of view of how we grow the services business from a geographic and from a business mix standpoint, about 44% of our services revenues today are in what we'd consider the public sector. So that's working in education. That's working in

healthcare. That's working in governments around the world. About 56% of the revenue is in the commercial sector.

So that's an interesting balance. It's slightly higher public revenues than most of our competitors because we have such a big position in healthcare and in education. But 56 and 44 is a very balanced approach and it's going to allow us to grow both of those sectors.

From a geography standpoint, about 71% of our revenue comes from North and South America and about 29% of our services revenue currently is coming from EMEA and APJ. That's a percentage you'll see changing and you'll see whether-- some of it will be through acquisition, some of it will be through organic growth. But you'll see the non-Western Hemisphere revenues starting to grow as we continue to fill out that portfolio.

Again, in fairness, there's a history there, which is you look at healthcare spend, if you go back three years, almost all of the spend in healthcare IT services in the world was located in North America. You just didn't have a lot of healthcare IT spend. That's changing dramatically in the last three years. So you're seeing us do that work now in India. You're seeing us do that work now in China. You're seeing us do that work now in the Middle East.

So not all of this growth outside of the U.S. is going to be inorganic. Some of it will. But the markets are simply changing and that market is growing very fast for us.

David Bailey: Can you just give us a little bit more detail around that? I mean, if you're going after other geographies or other verticals beside healthcare, what are your priorities there?

Peter Altabef: Well, from a geographic standpoint, we acquired a company in China a couple of months ago, which has given us substantial more services on the solutions and services side in China. That was a very, very nice acquisition for us.

We have already started in India to expand our go-to-market team. So, often in India you have a strong delivery organization. About 35% of the Dell Services team is actually in India from a delivery standpoint. You're now seeing us turn that into a marketplace where we're going after revenue and we've been successful in that.

Where we need to drive more revenue from a services standpoint today in the BRIC countries is in Brazil and you'll see us starting to focus in Brazil and South America. We have a decent-sized services revenue stream there from a product support and services standpoint, but not yet from a deep solutioning. But we have all the capability to do it, so you'll see us probably look at some inorganic opportunities in Brazil.

David Bailey: And then, obviously, your cash balance is extremely strong and cash flow. And you've talked about acquisitions some. So how do you think about buy-backs or dividends and why isn't now a good time to do more buy-backs, given where the stock is?

Brian Gladden: Yeah, I mean, it was a tremendous year for cash flow, generated, 2.4 times net income with almost \$4 billion, which fundamentally pays for Perot with this year's operating cash flow. We can continue to maintain very strong capital performance going forward.

Our challenge, as is U.S. liquidity continues to be a challenge. Over time, we've had some activities that allow us to gain access to some of that foreign cash. We'll continue to work at that. But that's one of our regular challenges around what we'll do with that cash.

We clearly do have more strategic things to do, in terms of acquisitions and that'll be the short-term priority for us. We'd like to get back to a point where we're regularly in the market with a buy-back program, but we still have some strategic things we're going to prioritize, given the U.S. liquidity.

David Bailey: Now we're very confident there's going to be a corporate upgrade cycle this year on the client side. It sounds like you're pretty positive about that, as well.

Two questions, I guess. One is, Dell has lost some share in the large enterprise client space over the last few years to HP. So what do you do to reverse that? Why don't we start with that?

Brian Gladden: Yeah, again, we've made some conscious decisions around protecting profitability over this challenging cycle. I think as we look at where we are with our largest customers, with the customers that, frankly, are important from an enterprise solutions opportunity standpoint that offer us opportunities to get reasonable returns on those transactions, we're in pretty good shape. We don't feel like we've lost a lot of critical customer mass in the commercial side of our business.

It continues to come down to being in the right cost position, being in the right price position and having a broader set of solutions. Many of those transactions today are becoming much broader discussions than just client. As customers look at desktop virtualization and the whole data center as part of the solution, you want to be able to walk in and have a broader set of solutions and that's clearly the energy that we have today is around being at that table and we haven't historically been there, necessarily.

Peter Altabef: So, David, I spend a lot of time with Chief Executive Officers as well as CIOs of our clients and I would tell you, I think the mood and the atmosphere there is very positive. I think you're seeing in the next generation of products such a leapfrog in terms of computing power, storage capability and, frankly, such a decrease in the electricity required from a standpoint of operating those machines that the return on investment analysis is pretty good.

Server virtualization, which was coming on two or three years ago, isn't even coming on. It's just a given. I mean, you never have to go into a client at this point and try to sell server virtualization.

So with the new servers coming online and the new storage devices coming on line, if you're going to do server virtualization, you don't have to buy new stuff, but with the new stuff, there's no reason not to, because of the return.

The interesting thing in the discussions I'm having at the CEO and CIO level is really almost one of philosophy. So what you're seeing in the marketplace now is an interesting change, I would say. You're now seeing stacks, solution stacks, being developed by different companies with markedly different philosophies.

Some of the philosophies are to move to a proprietary stack. Whether or not it's called a proprietary stack, it is seen as a proprietary stack, which is a fully integrated stack which provides some ease in terms of how quickly you can deploy it and price it, but has some disadvantages. And the disadvantages are it's a proprietary stack. And so as technology changes, if the proprietor is on top of that technology changes, that's a good thing. And you are beholden to that stack continuing to be cost effective, if it is cost effective even to start with.

Another approach, philosophically, is to say that you're actually going to have a stack that includes IP points, it includes secret sauce, proprietary technology, but provides meaningful choice at different levels through the stack. And the meaningful choice isn't just you can get company A's server one, server two or server three, but you can get different pieces of hardware from different companies that are certified, standardized products, that will work in the stack in a highly efficient way.

And I will tell you there isn't a CIO that I've talked with who doesn't prefer philosophy B, because it gives them the most freedom to be able to feel like and to actually participate in lower prices and more technology, going forward. The challenge with stack B is you have to convince the client that the certified solution is integrated, that the standards are not only published but effective and that this is a solution that not only will work in the future, but will work today in a more effective way.

To do that, you have to package it and I will tell you, one of the things that Dell hasn't historically done has been a great job of packaging these solutions, which is what you're hearing Brian talk about. There's a huge emphasis of doing that now and we really are creating a community of vendors and suppliers that are really thrilled to work with us and see us as the leader of this, if you will, non-proprietary stack environment. And that's a philosophically different approach than some other people.

As I said, from a receptivity standpoint, it's clearly one that CEOs and CIOs would prefer.

David Bailey: And then just to wrap up, Brian, what milestones should we look at, either fundamentally or financially, for Dell over the next 12 months as proof points that you're making progress on these initiatives?

Brian Gladden: I think we rolled out a financial framework last year at the analysts meeting that we think we can drive this business with above-market growth, 5% to 7% sort of top-line regular over a long period of time. We think we can get back to a 7% sort of operating income rate on a GAAP basis and we think we can generate strong cash flow. That's the broad framework that we're focused on.

We're still in the midst of a pretty big transformation within the company. A lot of cost is coming out. I think we're in the process of repositioning the client business and becoming more competitive there and a lot of the cost activities has made progress there. We've got more to do, as you can see with the consumer business, but I also think you're going to see us really mix up the enterprise side of our business and in the short term we're looking to make that a more relevant piece, a much more impactful piece in terms of the financial statements with more recurring revenues, more solution sale and that'll transform the company over some period of time.

And as we look at that mix of revenue, that's pretty fundamental, a pretty fundamental shift for the company that you should look for. And that's what we'll continue to talk about, what we're doing there to make investments.

Some of that will be acquisitions, but some of it will be just focus and energy and having the right sales force selling to our big, broad customer base, all these solutions. So, we feel like the commercial business right now is positioned for a pretty good period of time and the client refresh will give us some nice financial leverage on that business, which, as we took a lot of cost out, we should see some nice improvements there, and that will help us over the short term fund some of these investments and that's what we intend to do.

David Bailey: Great. Peter, Brian, thank you very much. We appreciate it.

Brian Gladden: Thanks, David.