Dell Inc.

Fiscal Year 2013 Second Quarter

Earnings Conference Call

August 21, 2012

OPERATOR: Good afternoon and welcome to the Dell Inc. Second Quarter Fiscal Year 2013 Earnings Conference Call. I'd like to inform all participants this call is being recorded at the request of Dell.

As a reminder, Dell is also simulcasting this presentation with slides at www.dell.com/investor.

Later we will conduct a question and answer session. If you have a question, simply press star then one on your telephone keypad at any time during the presentation.

I'd like to turn the call over to Rob Williams, head of Investor Relations.

Mr. Williams, you may begin.

ROB WILLIAMS: Thanks, Regina.

With me today are Michael Dell and Brian Gladden.

The web deck along with our Dell Shares vLog, featuring more insights on our Services business with Steve Schuckenbrock has been posted to our website, and I encourage you to review them for additional perspective.

Next, I would also like to remind you that all statements made during this call that relate to future results and events are forward-looking statements that are based on current expectations. Actual results and events could differ materially from those projected in the forward-looking statements because of a number of risks and uncertainties, which are discussed in our annual and quarterly SEC filings, and in the cautionary statement in our press release and web deck. We assume no obligation to update our forward-looking statements.

Please also note that will be referring to non-GAAP financial measures, including non-GAAP gross margin, operating expenses, operating income, net income, and earnings per share. Historical non-GAAP measures are reconciled to the most directly comparable GAAP measures in the Web deck posted in the Investor Relations section at Dell.com, and in our press release and 8-K filed today. I encourage you to review these documents.

Please also note that unless otherwise mentioned, all growth percentages refer to year-over-year progress.

Now, I will turn it over to Brian.

BRIAN GLADDEN: Thanks, Rob.

We are executing our strategy to deliver end-to-end solutions with a flexible design point. This helped drive our Enterprise Solutions and Services Business to $4.9 billion, up 6 percent, with 14 percent growth in our server and networking business. ES&S is now over a third of our revenue and over half of our non-GAAP gross margin. Year to date we've announced six acquisitions and closed five of them, all of which will help drive a higher mix of solutions with more predictable revenue and margin streams.

In the second quarter, we closed Wyse, the global leader in cloud client computing, and SonicWALL a leader in unified threat management and next generation firewalls. Both are off to great starts, and their pipelines are up more than 35 percent sequentially.

We're also excited about the pending acquisition of Quest Software, which we expect to close in the second half of the third quarter.

Growth in our ES&S Business, good cost execution and pricing discipline all contributed to solid profitability, and quarter on quarter improvements in gross margins while the client business deteriorated more than we expected, we maintain gross margins in a challenging macro and competitive environment in this space.

For the quarter, we delivered revenue of $14.5 billion, down 8 percent. I'll refer to non-GAAP financial measures going forward. Our gross margin was 22.6 percent, up 60 bases points sequentially, including a benefit of $71 million, or 50 bases points primarily related to a vendor settlement.

Sequentially, OPEX dollars were basically flat at $14.8 percent of revenue. We continue to aggressively manage G&A and discretionary spending. At the same time, we had a strategic spend approaching $100 million sequentially. This consisted of OPEX from the acquired companies, and incremental R&D.

Operating income was $1.1 billion, or 7.8 percent of revenue. Cash flow from operations was $637 million. Our cash convergence cycle of negative 30 days deteriorated by two days sequentially primarily driven by an increase in DSO of three days; a key driver of this DSO increase was a shift in mix to more complex ES&S opportunities. The customer terms are typically longer.

Our second quarter tax rate was 17.5 percent. We spent $400 million in the quarter. We repurchased 29 million shares of Dell stock. And ended the quarter with $14.6 billion in cash and investments. Earnings per share of 50 cents declined 7 percent, up 16 percent sequentially.

In June we announced that our board of directors approved a dividend policy with an expected quarterly rate of 8 cents per share, or 32 cents a share annually beginning in the third quarter. We're committed to maintaining our disciplined capital allocation program that will increase the distribution of capital to shareholders to 20 to 35 percent of free cash flow. This program includes our dividend, stock repurchase and strategic investments.

Now I'd like to turn to our global business units. Large enterprise revenue was down 3 percent. This business delivered ES&S growth of 9 percent including 17 percent growth in servers and networking, which was offset by declines in the EUC business. Operating income for the business expanded 40 basis points sequentially, driven by higher gross margins and OPEX reductions.

Our public business was down 6 percent, as we did not see the typical seasonal ramp in the state and local government business in the U.S. The softness was driven by continued budgetary challenges. Despite this we remain disciplined, driving operating income up 150 basis points sequentially. Looking at the third quarter, the U.S. Federal business is well positioned for the year-end of their fiscal year, which occurs September the 30th, and we expect to see normal seasonality here.

SMB revenue declined 1 percent, similar to large enterprise there was strong ES&S growth of 15 percent, including 27 percent growth in services, which is offset by a contracting EUC business. The stronger mix resulted in gross margin expansion and a sequential operating income increase of 50 basis points.

This business continues to be a great example of our ability to drive premium growth in strategic areas, by providing customers with broad-based solutions that help them efficiently solve their business challenges. Across the business segments we're rapidly expanding our channel network to approximately 113,000 partners, with an increasing percentage certified in enterprise solution sales.

The consumer business was a challenge, down 22 percent, with notebook revenue down 26 percent. Operating income declined 60 basis points sequentially, as the business increased gross margins, but the reduction in OPEX did not keep pace with the decline in revenue. While we held share in key mature markets like the U.S., emerging markets were very competitive with growth occurring predominantly in the low value space, where we have not participated. I'll address this in some more detail later.

Our BRIC revenue was down 15 percent, with Asia-Pacific and Japan down 12 percent. Within APJ our ES&S business increased 7 percent. Despite a challenging demand environment for desktops and notebooks, these are important markets for us, and we see improved growth potential going forward.

Turning to our lines of business, our server and networking business grew 14 percent, servers increased 8 percent helped by the success of our 12th generation server line launch. The time to market and competitive differentiation of these servers is resulting in higher gross margins than our previous generation and ramps very quickly to over 50 percent of our mix exiting the quarter. Our networking business continued to gain momentum, as our easy to manage and high-performing networking solutions are benefiting from the server transition to the 12th generation products.

Dell IP storage was up 6 percent to $416 million in the quarter. While this is the low where we would have liked it, we believe this is roughly in line with the market. We're confident in our portfolio and focused on accelerating growth and improving execution. As you may have seen in a separate press release this afternoon, we announced that Marius Haas has joined Dell to lead our enterprise solutions business. He inherits a business that is growing and in great shape. We want to thank Brad Anderson for his many contributions to Dell over the past seven years. He spearheaded the development of a world class server business, built our data center custom solutions business, and oversaw the acquisition and integrations of EqualLogic, Compellent, and Force10, among other contributions.

As a result, Dell now has a portfolio of differentiated intellectual property in servers, storage, and networking. Marius is a 20-year industry veteran who brings great business, strategic and operational expertise to Dell, and we're excited to have him on the team. The services business continues to deliver solid results. The business grew 3 percent to $2.1 billion, driven by 7 percent grow in support and deployment and 35 percent growth in our security business.

We're offsetting contraction in desktops and notebooks by selling more in-quarter services and increasing attach rates of our premium offerings. Gross margins increased sequentially for the sixth consecutive quarter, as we continue to improve our cost structure and focus on higher margin areas of the services landscape.

We continue to see very good leading indicators, as our new signings were $974 million and $1.8 billion on our trailing 12-month basis. The mix of our second quarter new signings is very encouraging, as approximately two-thirds are focused on infrastructure, cloud, and security, and one-third on apps and BPO. We continue to increase the breadth of our vertical capabilities. Many of these new signings are in verticals outside of our traditional areas of strength. Our services backlog increased 5 percent with balanced growth in contracted services and extended warranty.

Our third party software and peripheral revenue was down 9 percent with improved sequential gross margins. This business was impacted by the contraction in desktops and notebooks combined with continued pruning of low value product segments consistent with our strategy.

Our desktop and mobility business was down 14 percent as we continue to maximize operating income in a challenging environment. Our focus continues to be on mid and high value systems, which contracted at an industry level in the second quarter. Our Latitude and Optiplex products performed well in the commercial space, but we're seeing pressure on consumer and entry level corporate products. There's particular softness in pricing pressure in key emerging markets, like India and China, as well as Western Europe.

In the quarter, we saw the channel drawing down inventory in anticipation of the Windows 8 launch. We also continue to see discretionary spending directed to alternative mobile devices like tablets and smart phones.

In light of these results and market dynamics, I think it's important to reiterate our client strategy. We're focused on continuing to drive our cost out initiatives to maximize operating income versus units. We'll continue to deliver a strong portfolio of systems targeting the mid and high value spaces.

We've refreshed our Latitude and XPS portfolios with products that are thinner and more powerful. We're building strong capabilities in security and systems management and have an industry leading position in thin client solutions. And we're positioned to be a leader in addressing the emerging corporate BYOD trend with our current XPS 13, 14 and 15 notebooks, and their upcoming tablets and converged devices. In addition, you'll see new Windows 8 ultrabooks, all-in-ones, tablets and converged devices in the fourth quarter and headed into next year.

Now I would like to discuss our outlook. In the third quarter, given the macro environment and soft consumer business, we expect revenue to be down 2 to 5 percent sequentially. With the uncertain environment and competitive dynamics we're lowering our FY '13 EPS outlook to at least $1.70 per share. This incorporates the 2 to 3 cent diluted impact from the pending acquisition of Quest Software. For additional detail on the potential impact of this transaction please refer to Slide 23 in the web deck.

We expect continued solid growth in Enterprise Solutions, Services and Software combined with what we think is a realistic view of a challenging end user computing environment in the second half. We expect our full year tax rate to be between 20 and 22 percent.

Before we take questions, let me close with a few summary points. We're making progress on our strategy and we'll continue to invest in building end-to-end solutions capabilities. This is a long-term strategy and it will take time. In a tough environment, we did a solid job managing the business to optimize the P&L. And this will continue to be our focus.

We remain committed to a disciplined capital allocation program. This has allowed us to increase the amount of cash we're returning to our shareholders in the form of our recently announced dividend, and our ongoing stock repurchase program.

Now let me turn it back to Rob.

ROB WILLIAMS: Thanks, Brian.

Just a quick reminder to limit your questions to one with one follow-up.

Regina, can we have our first question?

OPERATOR: Ladies and gentlemen, we will now begin the question and answer portion of today's call. If you have a question, please press star one on your telephone keypad. You will be announced prior to asking your question. If you would like to withdraw your question, press the pound key.

Your first question will come from the line of Katy Huberty with Morgan Stanley.

KATY HUBERTY: Thanks. Good afternoon. Given the light PC revenue this quarter, what are your thoughts on whether Win 8 and the new ultrabook and tablet form factors can actually get the PC market back to positive growth territory? If so, when do you think that happens, when are we back in positive growth? And how aggressively can Dell really participate with those new form factors given the focus on margins over revenue? Thanks.

BRIAN GLADDEN: Katy, we are bullish about the products that we have coming, aligned with the Windows 8 launch. I think, as you know, our mix of business tends to be more on the commercial side, so there might be a little bit more delay in terms of that having an impact for us, as it sort of works its way through the consumer side of the business. But, we would expect, as you head into next year, seeing a bit of a benefit, clearly, as that works its way through the system and we see those products in the marketplace.

KATY HUBERTY: Thank you.

OPERATOR: Your next question will come from the line of Steve Milanovich at UBS.

STEVE MILANOVICH: Thank you. I wonder if you could give us an update on the sales execution issues that you had last quarter. That didn't seem to come up, and along with that how your vStart 321 selling bundling is going.

BRIAN GLADDEN: I would say we are seeing progress here. This is not a single quarter sort of benefit that you see from these kinds of changes, it's a broad set of actions that we are still in the process of implementing. You could see some of the elements of the portfolio in the second quarter actually showing some good results here. Clearly on the enterprise side we've seen some of the actions we've taken improve our execution. So, multiple quarter impact, early returns are pretty good and we continue to make progress there.

OPERATOR: The next question will come from the line of Mark Moskowitz with JP Morgan.

MARK MOSKOWITZ: Yes, thank you. Good afternoon. Brian, I just want to get a sense in terms of how investors should think about the cash conversion cycle going forward. The enterprise solutions transformation does seem to be taking hold here and you are showing some progress. So, how can it still stay in that negative-30 threshold? Should we start to think about maybe going into the negative 20s instead?

BRIAN GLADDEN: Yes, Mark, we've modeled it out and I would tell you I think it does sort of play out a little bit slower than you would expect, as you transition the overall mix of the company. There are some short term -- as you look at the DSO within the quarter, there are some elements of specific transactions with specific customers and a terms mix dynamic that plays out, that I think we get back some as we move through the year. And the impact of the mix of the business actually happens over a longer period of time. So, we're still comfortable in the low-30s, as you look at the remainder this year and as we exit the year we'll give you a bit of an update on that. But, I think it's a little bit more gradual than what we saw this quarter.

MARK MOSKOWITZ: Okay. Thank you.

OPERATOR: Your next question will come from the line of Toni Sacconaghi with Sanford Bernstein.

TONI SACCONAGHI: Yes, thank you. I was wondering if you could provide a little more color on some of the pricing environment that you discussed. I look at other PC vendors that reported like Acer and Lenovo and we actually saw their gross margins go up sequentially and their share performance be better than yours. So, perhaps you can discuss which vendors you think are driving pricing, what you think is ultimately driving it, and how you foresee that going forward. And I have a follow-up, please.

BRIAN GLADDEN: Toni, I think there were clearly pockets where we saw more competitive dynamics. I think we talked about emerging countries and a bit of a move to lower-value products in those markets, as a dynamic that played out. So, the lower-end, lower-value segments were places where we saw the most aggression and to be honest with you, we avoided some of that. I think if you look at the notebook business in total for us, the overall ASP change in the quarter was not that significant. So, I don't know that it was a big driver, in terms of the overall P&L, but there were pockets of aggressive competitive behavior, without getting into specific vendor details.

So, we're going to continue to watch that as we move forward. Again, where we saw very aggressive pricing behavior, those were places where we did not necessarily participate and that drives a lot of the revenue dynamics that you saw in the quarter.

TONI SACCONAGHI: And then secondly, you talked about managing the P&L and the tough environment, and you did a good job on the OPEX side, but relative to your expectations at the beginning of the year, your EPS guidance is dramatically lower. And I guess the question is, is there a trigger point for your looking at costs in a much more aggressive way than what you've done year-to-date, given your current outlook for EPS, relative to I think what you had hoped to do at the beginning of the year.

BRIAN GLADDEN: Look, I think what you saw in the quarter was a pretty good balance of being able to invest in the key areas for growth. We brought in the acquisitions; we invested incrementally in the enterprise business. But we were able to manage OPEX in general to about a flat level with some disciplined cost actions on the G&A side as well as really discretionary spending across the portfolio.

I think that's the approach we'll continue to take is, continue to support funding the important areas of growth in the business, but at the same time being aggressive on the cost reductions that we talked about at the analyst meeting. We're in the midst of really launching a broader program across the business that we think over the course of the next two to three years gets at $2 billion across as we talked about. And that will have broad implications across OPEX but also COGS.

OPERATOR: Your next question will come from the line of Shannon Cross with Cross Research.

SHANNON CROSS: Thank you very much.

I just wanted to try to understand relative to the plan that you put up at the analyst day in June where you talked about you could handle sort of a decline in core Dell of about 5 percent year-over-year. How do we think about what core Dell was this quarter? I mean, 14 percent, I think, for client. I'm sure there's some offsets there. And, again, sort of to Toni's question, flexibility in costs and margin and that, how should we sort of think about this in the context of the plan you put up in June?

BRIAN GLADDEN: Shannon, you have to look at both sides of it. Clearly on the enterprise side of the business we feel pretty good about the progress, and as we look forward, and even look at the outlook that we're providing for the total year in the second half, pretty consistent view with what we talked about in terms of that continuing to grow and contributing strong profitability. I think the PC business, and maybe when you talk about that EUC business, as we talked about in the analyst meeting, we had the client business as well as S&P in that part of the business.

The revenue sort of deterioration we saw in the quarter was clearly above anything we expected, and I think that's something that as we think about moving forward, you can't expect that that business will have that sort of deterioration over a long period of time.

We think, as you look at the second half of the year, it's going to be a challenging environment for that part of the business, but should stabilize as we come out of that and get Windows 8 sort of in the marketplace.

So, I think clearly a little more deterioration there than we expected, faster than we expected, and managed the P&L pretty well given that dynamic that we saw in the quarter.

SHANNON CROSS: And the second question is on linearity. Did things get worse in various geos or with various verticals, any color you can give there.

BRIAN GLADDEN: To be honest, I wouldn't call out any linearity in terms of the quarter that was different. I think as you look at the results overall, we were surprised at where the emerging markets showed up in terms of overall revenue. But I wouldn't say that that was getting worse or better as we exit. We're pretty consistent throughout.

SHANNON CROSS: Thanks.

OPERATOR: The next question will come from the line of Brian Alexander with Raymond James.

BRIAN ALEXANDER: Thanks, Brian. Just to follow-up on that, Asia down 12 percent, BRIC revenue down 15 you touched on a little bit earlier. But if you can go into more detail on how much of the change here is market versus market share, and how much is client versus enterprise. It's been a key growth driver for Dell over the last several quarters, so I just wanted to get some more color on the regions thing.

BRIAN GLADDEN: I would say those markets in general, what we saw there was a challenging consumer dynamic that drove the overall financials. We did see solid performance from the enterprise side of the business, and the commercial side of the business was clearly better. So, I think that's clearly what drove it, and when you look at that space in general we saw demand growth in the market really isolated to the low value segments of the PC business. And when you look at the mid to higher price, or higher value elements of the portfolio or of the market, they were actually down within the quarter. So, that was clearly where we were focused. We didn't participate in the lower value segments, and that's how you get that sort of result.

BRIAN ALEXANDER: And then just any additional thoughts on enterprise spend as we head into the second half. I know you had a solid pipeline coming into the quarter. You had some push outs from last quarter into this quarter. So, how did that progress as the quarter went on, and are you expecting a normal flush as we head into Q4? Thanks.

MICHAEL DELL: This is Michael. The enterprise demand obviously in the second quarter was solid. We think the 12th Generation PowerEdge refresh continues to be strong. We're well-positioned there. And increasingly we're changing the sale to be a complete data center sale. So, we feel good about that. We think the addition of Windows Server 2012 is going to be an additional catalyst in the second half of the year. And we're feeling good about our portfolio there.

BRIAN ALEXANDER: Okay. Thank you very much.

OPERATOR: The next question will come from the line of Amit Daryanani with RBC Capital Markets.

AMIT DARYANANI: Thanks a lot, guys. Just a question maybe on the PC-centric revenues and the level of degradation you saw. I think it was down about 14 percent between mobility and desktop. Could you just talk about how much of that issue was due to a channel draw down ahead of Windows 8 versus some of the other issues that may be a bit more secular in nature?

And then, could you maybe talk about given Microsoft is launching their own hardware with Surface, how do you think that plays out from your perspective, especially in the consumer arena? Thank you.

BRIAN GLADDEN: As we talked about, there clearly were slower growth or negative growth, more negative growth in the mid to higher value elements of the portfolio, and that's really what, I think, in our case drove a 14 percent sort of decline. And a lot more growth in that business, consumer specifically, has been at the low end. And our choice to participate or not participate clearly affected the revenue in the quarter. But that sort of is the market dynamic that we see.

There's also, as we said, as you sort of head through the quarter, the second quarter, we began to see the channel begin to push out and try and draw down inventory levels of Windows 7 based product as they move into the fall, which we would expect to be one of the key drivers moving into the third quarter for us. So, I think that's the overall framework that we see. There's really not a catalyst that would expect some growth in that space in the third quarter.

As you think about Microsoft entering the space, clearly as we think about it, we've spent time talking to Microsoft and understanding sort of how they're thinking about it. There clearly are opportunities for us as Windows 8 comes through in having differentiated products, and I think that at the same time they've announced the Surface product that will be in the space. We will have products in there, and I think you'll see a diverse set of offerings that take advantage of what Windows 8 brings to market.

MICHAEL DELL: I think there's been some understanding of the number of units that they're likely to roll, it's a relatively small percentage, maybe in the 1 to 2 percent range of the total PC units through the middle of next year. Certainly with our business being more focused on commercial, centered around the Windows 7 transition, which is still very much underway, feeling very good about the portfolio we have with Optiplex, Latitude, Precision, the XPS product line is in good shape. And we're ready for Windows 8.

OPERATOR: The next question will come from the line of Maynard Um with Wells Fargo.

MAYNARD UM: Thanks. I just want to drive into your revenue decline guidance sequentially. You talked about normal seasonality in U.S. Federal, it sounds like generally ES&S business is doing well, and it also includes some of the Quest revenue. So, it looks like the end user computing segment might be seeing a high single-digit decline sequentially, and I'm curious how much of that is market mix related of the higher end weakness versus ASP pressure versus you walking away form business, and when or if would you consider addressing the lower end markets? And I have a follow-up, if I could.

BRIAN GLADDEN: Maynard, I think it's a combination, clearly. I would expect that the market in general will suffer through a bit of this inventory adjustment during the third quarter. I think that's just the reality of a transition like this that we would expect to see. I also would expect that the dynamics around some of the macro environment of the emerging countries, and more growth being focused on the lower value segments versus mid to high was something that we would expect to continue over the next couple of quarters here. So, we're being conscious about that and managing the business for profitability and I think that's why we end up in that sort of a revenue range.

MAYNARD UM: And just given your free cash flow, where your free cash flow was, and then your commitment to share repurchase and dividends, how should we think about your M&A strategy? Should we expect a pause here, or maybe more offshore acquisitions? And I'm also curious, just given all of your acquisitions whether that drives a period of digestion before more consumption? Thanks.

BRIAN GLADDEN: Look, I wouldn't say there's a change in the strategy. We'll continue with the framework around capital allocation that we've talked about. Obviously that and the dividend, we continued to buy back in the quarter. We have done a fair amount of acquisition activity this year and we're in the process of obviously hopefully closing Quest as we enter the second half of the third quarter here. And that's a relatively large acquisition. So, there will be some digestion and execution around the integration of those specific acquisitions, but our growth plans as we move forward will continue to be a combination of organic investments and continued inorganic investments.

OPERATOR: Your next question will come from the line of Bill Shope with Goldman Sachs.

BILL SHOPE: Okay, great. Thanks. Digging into your server commentary from earlier in the call a bit more, it looks like you're gaining share in what appears to be a weakening market. Is there any macro-conservatism on servers in your second-half outlook, or are you generally assuming that share gains can counter any further macro-deterioration in that segment.

MICHAEL DELL: You know, I think we're well positioned. We have a number one position in North America. We were first to market, have been first to market with the x86 transition here in the first part of the year. The product line is lining up incredibly well versus others. As we do a better job of selling a converged solution, selling storage and networking, along with the servers, our blades are getting stronger. This is the best server line we've ever had and we feel very good about what we have planned for follow-on generations.

Also, workloads are moving to x86. So, we're seeing continued shift in our services business. We've got a very nice pipeline of application migration business that's developing around some of the capabilities we built through Dell services and other acquisitions like Make and Clerity that have added to that. So, the combination of new workloads, new capabilities, strong product line, I think we're well positioned to grow there.

BILL SHOPE: Okay. And then just as a quick follow-up, hopefully I didn't miss this earlier, but can you give us a quick update on how you're thinking about component prices for the second half? Is it still somewhat what you were thinking before?

BRIAN GLADDEN: Yes, Bill, I don't think it's changed much. As I'm sure you know, the demand environment and some of the weakness in unit volumes I think has driven a little bit more deflation into the entire component cost environment and we're seeing some of that, but not dramatically different than what we've talked about.

BILL SHOPE: Okay. Thank you.

OPERATOR: The next question will come from the line of Ben Reitzes with Barclays.

BEN REITZES: Yes, thank you. I wanted to ask; the first I guess is on Asia and some of the BRIC and growth markets. They were disappointing in the quarter you mentioned, then you said that the outlook for those markets, though, would improve. I was just wondering why and why you felt that way and then I had a quick follow-up.

BRIAN GLADDEN: Well, I think we're looking at sort of the macro forces in those markets and we don't see in the short-term a catalyst that changes that Ben. I also think this dynamic of moving to lower-value, lower-price sort of segments and that being the focus of the markets is a trend that I don't see changing over the next couple of quarters here. And as we get sort of into a better hopefully a better economic environment heading into next year with a new set of products, a new portfolio, including some to address those markets specifically; I think we would expect to see better growth.

BEN REITZES: Okay. And then just on storage, we saw a decline of 13 percent, obviously Dell IP was up, but the decline accelerated from the last quarter. And we must be getting to an end of that EMC related revenue. I was just wondering when you guys thought the storage line would start to grow.

BRIAN GLADDEN: Ben, look, I think we still have a fair amount to overcome next quarter. And then I think it sort of normalizes to something very close to current run rates. I hate to use that as an excuse, and I would tell you the 6 percent growth that we saw in the quarter was behind what we expected. That portfolio is in good shape. The businesses are in good shape. We're seeing overall I think the pipelines look good. Competitors continue to be generally aggressive in parts of this business. But, we would expect to see more growth there and heading into the second half the headwind from the compares on EMC becomes a much smaller issue, and we really don't want to kind of talk about that any more as we move forward.

BEN REITZES: Okay. Thank you.

OPERATOR: The next question will come from the line of Kulbinder Garcha with Credit Suisse.

KULBINDER GARCHA: Thanks. I just want to clarify on the server growth that you guys saw. Can you help us split out unit growth versus ASP increases, and in terms of this new server cycle that you guys speak about, can you give us any sense as to how significantly more gross margin accretive is from the previous cycle. Then the question I have for, I guess Brian, just to be clear, you guys spent $100 million more on R&D, which is incremental R&D spend by you, as well as the acquisitions, or was it just $100 million you spent more. I just want to understand why is Quest not making money? I thought it was historically. Have you guys decided to change the OPEX structure in the near-term? Thanks.

BRIAN GLADDEN: On the server question, clearly we've seen higher ASPs, and higher end configurations that we've launched in new products here, and as a result it's driven expansion in terms of margin rates within the business, 12G has had higher gross margins. And as that's mixed up to a higher percentage of our servers, at higher prices, that's helped the overall profitability in the business. On the OPEX line, specifically on Quest, Kulbinder, there is a purchase account element that drives the short-term dilution of that business. As you think about software acquisition, the right off of the deferred revenue over the first couple of periods of that business ultimately more than offsets the accretion.

On a cash flow basis the business will be accretive really in the first period that we bring it in. So, that's really the dynamic that we'll see in the second half of the year for Quest. As you think about the $100 million, what we did approximately between -- about $75 million is related to the acquisitions and their OPEX spend as you bring them into the portfolio in the quarter. Specifically SonicWALL and Wyse being the two largest.

In addition we've spent about $30 million incrementally in R&D, quarter on quarter, sequentially around the enterprise business. So, that provides a little more detail.

KULBINDER GARCHA: Okay. Thank you.

OPERATOR: Your next question will come from the line of Keith Bachman, with Bank of Montreal.

KEITH BACHMAN: Hi, thank you. I was hoping you could talk a bit more about the PC market, away from what's in front of you during the current quarter. And broadly speaking is Windows 8 enough to stimulate the market as you look out into the January and April quarters, or do you need better economic cycles here? And more specifically for Dell, with Dell having -- or with tablets having a bigger role in the market, and Dell having a much richer mix of clients, PC clients versus tablets, and consumers driving more of the change in growth rate, how do you see Dell positioned against that backdrop. And I do have a quick follow-up.

BRIAN GLADDEN: Yes, look, I think as you think about the next two quarters, there clearly is what we would see in a typical transition for an operating system and as our business is more heavily weighted towards the commercial side of the business, we still continue to feel good about the refresh opportunity. We've seen data that would suggest only about 50 percent of that Windows 7 transition is complete, and that's got to continue and will continue as we sort of play out over the next several quarters here, before anybody really thinks about Windows 8 on the commercial side.

Those areas in the corporate, or commercial customer base that are looking at tablets, clearly there is a wait and see sort of approach and how you think about that playing out in the commercial enterprise. And as Windows 8, as an alternative, with the tablet product that can work in the enterprise well, with security, is something that we hear a lot of our customers talking about, and really waiting for. So, we would expect that could be a catalyst and we'll be part of that. And our products are really focused on that part of the market.

KEITH BACHMAN: Okay. And, Brian, could you just speak to server and networking growth, net of acquisitions in the quarter? It was up 14 percent year-over-year and I was just wondering what the M&A impact was.

BRIAN GLADDEN: I guess I don't have that. I would tell you the server growth, which really there's not any M&A impact was 8 percent. And networking was up 94. So, clearly Force10 had an impact. We can get that for you.

KEITH BACHMAN: Okay. Thanks very much, guys.

OPERATOR: The next question will come from the line of Jayson Noland with RW Baird.

JAYSON NOLAND: Great, thank you. I wanted to ask about enterprise solutions. Marius is well known and respected, but it's tough to see the guy go that's built that portfolio up over the last few years. And I guess the question is, do you expect any change of direction and what's the resource commitment level, given all these new technologies, be it software-defined networking, or Flash out there?

MICHAEL DELL: Well, look, I think we have a great business, and I think we can make it even greater. I think the reason that the gross margins in that business have been expanding is because we have an increasingly differentiated portfolio of solutions. And our intent is to only drive that more and further. The kind of areas you're highlighting are the sorts of things that we would be focused on.

I would just also add to some of the prior questions, some of the shifts that are going on in the industry are obviously moving workloads into the data center, and we're benefiting from that as well. So, as you see more virtual -- insert your adjective here or down here -- in terms of the client, the network, the security, the storage, et cetera, those are all driving the enterprise growth for us. So, we're going to really make what is a great business today an even larger, more successful business.

JAYSON NOLAND: Thanks, Michael.

OPERATOR: The next question will come form the line of Brian Marshall with ISI Group.

BRIAN MARSHALL: Great. Thanks, guys.

You've had good success integrating deals in the past. Obviously, EqualLogic was a home run, KACE, both these were up probably anywhere from 5 to 10 X in a few years after you acquired them, but obviously you had to reinvest in the business. I think the case in point recently was the Compellent up 100 percent sequentially the first quarter you guys acquired it, but you do invest in it.

So, I guess the question is, can you help us think about how we should think of revenue growth from some o the new deals like Quest and SonicWALL, Wyse, et cetera, and how that sort of balances out with the level of investment you're going to make on the OPEX side? Thank you.

BRIAN GLADDEN: Brian, almost everything we've done from an acquisition standpoint clearly was a business case that was built around growth. And as part of the business cases, we clearly have considered the investment required to accelerate the growth and leverage the benefit of our sales capacity and customer relationships across the portfolio. So, I think you'll continue to see more of that, and we will make the necessary investments as part of the deal structure, as part of the deal models, to drive that growth as part of the strategy.

MICHAEL DELL: One of the other things we're finding is that many of these software acquisitions actually pull a lot of infrastructure. So, for example, when you think about we some time ago acquired a company called AppAssure, which is already growing very fast in the backup, recovery, replication, high availability space. And it turns out that a lot of customers are deploying unique server and storage environments for AppAssure. And so you're going to see us leverage our infrastructure strength with our emerging software capabilities as we complete the Quest acquisition to drive even further growth there.

BRIAN MARSHALL: Michael, is there a rule of thumb where you'd think of a ratio like a dollar of software maybe pulls forward three or five dollars of hardware in that instance? Thanks.

MICHAEL DELL: That sounds good, but I don't have a particular rule that I'm ready to give you today about that. I think your mileage could vary dramatically depending on the type of solution, but certainly we have a broad set of capabilities across services, security, software, enterprise, all manner of client devices, and so we're able to bring a much fuller suite of solutions that capture a much larger share of the opportunity.

BRIAN MARSHALL: Understood. Thanks.

OPERATOR: Your next question will come from the line of Chris Whitmore with Deutsche Bank.

CHRIS WHITMORE: Thanks. I wanted to ask about the demand trends you're seeing in the corporate client business. IT looked awfully weak to me, and yet you didn't really call it out as an area of weakness. For example, back of the envelope, SMB clients looked like they were down mid-teens, public down double digits.

Why are you seeing such soft demand in corporate client given your comments around Win 7, just help us understand that?

BRIAN GLADDEN: I would say, Chris, as you think about that, there has been a bit of a pause, I think, as you think about corporate budgets and IT spending, discretionary spending has been, to some extent, put on a back burner, and some of these, clearly these refresh activities have to continue, but they're just seeing a pause given the current environment and all the uncertainty in the environment. That's just kind of what we're seeing.

ROB WILLIAMS: I would add to that, Chris, when you think about the fact that China is down in total for the country for the first time in as far back as I can remember, and the declines in APJ in general and Western Europe, that happened in the commercial accounts as well. And that's a tough one to overcome when you've got a big impact in a region like that. And those are the types of things Brian talked about where you think about those are markets that are likely to snapback once we kind of work through what is a cautious environment. I think a lot of commercial customers are looking at their discretionary spend right now and saying, hey, I'm going to put some additional dollars to work in some of these enterprise solutions, but if I've got a decision to make, I might pull back a little bit on some of these client transitions and wait to see how things play out at a macro level. So, I think you're seeing a little of that.

CHRIS WHITMORE: To follow-up, I wanted to follow up on the storage question with the Dell-owned IP business. It looks like your server attach, thinking about Dell-owned IP attached to servers, it looks like it's actually declining. Michael, in your comments you talked about increasingly winning these whole data centers sales. So, can you help us understand is there a timing issue between the server and storage spend as they're upgrading server versus storage, or are you seeing some incremental competition translate into a decreasing win rate in that storage business? Thanks.

MICHAEL DELL: You know, I think we can definitely do more there. What I'd also tell you is that the line that separates what's a server and what's storage is not as clear as it might have been a few years ago. If you look at our 12th generation servers you'll notice that they have enormous disk capacities. So, you're seeing large amounts of storage show up inside the server itself. But, 12G is certainly strong. Storage was not as strong as we'd like and there's definitely room to grow that faster.

ROB WILLIAMS: Thanks, Chris.
Let's take one more question, Regina.

OPERATOR: Your final question will come from the line of Aaron Rakers with Stifel Nicolaus.

AARON RAKERS: Thanks, guys. Just under the bell. So, one question, one quick follow-up, when we look at your guidance and you look at the various factors impacting the gross margin, mix of the business, you talked about potentially a more deflationary pricing environment component-wise, can you help us understand what you're assuming on a gross margin perspective, particularly around the product gross margin over the next two quarters, as it relates to those two items, or put another way, are you assuming that a consistent solutions and PC implied gross margin trend?

BRIAN GLADDEN: Yes, Aaron, obviously we don't provide specific outlooks for gross margin or OPEX in detail, but what I would -- I'll give you a sense for the drivers and how we're thinking about them and maybe talk about he second quarter and then maybe how it moves forward.

Clearly, we got the benefit in the quarter of improved mix. We saw the higher margin elements in the business grow faster. The services business has expanded margins, as we said, six quarters in a row and that obviously helps. And then the lower margin, the consumer elements of the portfolio, which would have the lower margins, had the most sort of revenue weakness. Component prices were kind of a push in the quarter and then as I said, pricing was generally mixed. And a headwind in some parts of the business, but in some places not so much.

And I think also currency in the quarter was a bit of a headwind at the margin line and as we sort of move prices up around that we clearly would expect that to be less of an issue as we move forward. So, I think those are the dynamics and as you think about the second half, I would say a lot of those same dynamics would be what we would expect to continue to play out.

AARON RAKERS: Okay. And then, Brian, if I can a quick follow-up, in the context of your 20 to 35 percent spend on dividend and share repo, you also added a comment about strategic investment. I don't know if I misheard that, or I just want to understand. That 20 to 35, is that specifically just share repurchase and dividend, or is there something else that you might be thinking about?

BRIAN GLADDEN: The broader capital allocation sort of program that we have obviously has an element, which is continued strategic investments and M&A as part of that. But, that's beyond the 20 to 35 percent, 20 to 35 percent is for dividends and buy-backs.

AARON RAKERS: Perfect. Thank you.

OPERATOR: We'll now turn the call over to Mr. Williams for closing remarks.

ROB WILLIAMS: Thanks, Regina.

I look forward to seeing everyone. We'll be at the City Conference in the week of Labor Day in New York. We'll be at Deutsche in Las Vegas and CSLA in Hong Kong. So, I look forward to speaking to everyone over the coming quarter and thanks for joining us today.

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

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