JP Morgan Tech Summit at CES

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MIKE KIM, JP MORGAN: Welcome back here from the break and thanks, again, for participating in the 11th annual JP Morgan CES Tech Forum. I'm Mike Kim with the IT Hardware Team here at JP Morgan. We're pleased to have here two executives from Dell today. Phil Bryant, Vice President and General Manager North America Consumer and Small Business, and then David Mehok, Executive Director in Investor Relations.

I guess before we get started, David, do you want to read the safe harbor?

DAVID MEHOK, DELL: Yeah, the exciting part of the presentation. I'd like to remind you that all statements made during the meeting 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 Dell's annual and quarterly SEC filings and in the cautionary statement in Dell's press release and Web deck.

Dell assumes no obligation to update forward-looking statements. Please also note that we will be referring to non-GAAP financial measures, including non-GAAP gross margin, operating income, operating expenses, 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. I encourage you to review these documents.

MIKE KIM: Great. Let's start here with Phil. Dell is in the midst of a multi-year model transformation. How does the consumer segment fit into the overall strategy? What areas of the consumer are being emphasized or de-emphasized?

PHIL BRYANT, DELL: Yeah. I think there's probably three major areas. I mean, one, consumer is a big, big part of our end user computing strategy overall, right? It's both commercial and consumer focused. And I think, number one, we're going to continue with our focus on the mid- and the high-band systems, right? You're talking 699, 799, and up, right? That's really where there are profitable segments, all right, and still a lot of head room in the business overall.

I think the other area is, you know, you've seen Win8 launch. You know, a lot of noise associated with a launch, right? But we're going to continue to drive the touch platforms and, more importantly, I guess, the touch platforms in those mid- and high bands, right? Where there are good profits to be made and a lot of head room there.

I think probably the third major area would be, you know, it's really going to blend into something David's going to talk about in amount is around this consumerization of IT right from the commercial side, or the bring your own device side. And that's an area, right, where we're seeing, increasingly, businesses are allowing their employees to attach their personal devices to their corporate networks. And as we work with those companies to build out their infrastructure, right, around virtualization or those kinds of things, we want to make sure that it's not just bring any old device, we want to make sure it's bring a Dell device when they do that.

MIKE KIM: Great. And then given your role, you know, overseeing North America, could you talk about how Dell has changed its go-to-market strategy there to better serve the consumer market and how that may compare with other geographic regions?

PHIL BRYANT: Yeah. You know, the market models are pretty different as you go around the world, right, because the markets are different. I mean, if you look at when I was in Asia a number of years ago, I actually started our consumer business in India. And, you know, there really was no channel structure at all, right? So we had to good build it, right?

And so we built our own -- working with distributors, we built a model that was really in each state in India, and we had to go put in retail locations, right, with mom and pop shops across India. You go to China, a very well-developed channel strategy, very diverse strategy, though, right? 6,000 computer models scattered all over the country, so a very different approach.

In India, you look at the U.S., you've got very well-developed retail, very well-developed e-tail, right? You basically have all the channels available to you. And if you look at what we're doing, we're really participating in all those channels. We're a multi-channel or omni-channel business here. Right? We've got Dell.com, we've got -- you know, you can still call Dell, right, and get a consultation over the phone. By over the phone, you can chat, you know, and you can go into retail outlets, right? We're in all the major large-format retailers as well as, you know, any of the smaller specialty players around the country.

MIKE KIM: You touched on it briefly, but what other levers do you have in place to boost profitability here in the consumer segment over the next 12 to 18 months?

PHIL BRYANT: Yeah, well, I think a lot of it is some of the things we've been doing, right? I mean, particularly in North America, right? You know, we've got a good business focused at the mid and high bands here. You know, with that, you get great services attach. You get great software and peripheral attach. You get great financing product attach. All of those kind of things, right, add up to a good business. And we're going to continue to drive those.

As you see the touch platforms continue to grow, all right, you know, we're going to be at the forefront of that. I would hope that we're able to lead the market, actually, in the adoption of touch platforms as we go throughout the remainder of the year.

And the other area in that small office and professional space. Okay? You know, you've got really good ASPs in that part of the market, you know, really strong desktop business still, right, where we've got good share position and good profitability and we're going to continue to drive those.

MIKE KIM: Okay, great. And then could you comment a little bit on the tablet market? Is having a tablet portfolio necessary to seem relevant in mobile computing?

PHIL BRYANT: Yeah. I mean, I think we've launched two tablets here in the last several months, you know, the XPS 10 and now the Latitude 10. You know, we're going to continue to evolve those platforms. We've also got convertible form factors right now that kind of bring the best of both worlds together. I mean, I've got that one here on my desk. Okay, if you look at the XPS 12, okay, where you get the best of both worlds, carry it around with you, you know, tablet and a fully functioning PC.

So I think all of these kinds of things. You know, we're participating in them all now trying to figure out which ones are going to settle out and are going to be the dominant form factors.

MIKE KIM: Great. And then, given the tablet's momentum in the marketplace, will PC vendors be forced to introduce more tablet-like attributes to the PC in 2013?

PHIL BRYANT: I think with conversion devices like this, or even basic clamshells, right, I mean, even basic clamshells now, you know, we've got a 15-inch product out there now that's touch. We're launching another product this month that's a basic clamshell with touch capability. I mean, at that point, you know, are you using a keyboard, is it a PC, is it a tablet? I mean, it's like this device. You know, people on the plan coming out here yesterday, they didn't know if this was a tablet or a PC, okay? And, I mean, I was sitting there, you know, I had my reader, okay, and just setting there in my seat and I was reading my books, doing my e-mail, those kinds of things.

So I think you're naturally seeing that evolve, right? Just as touch gets more prevalent, you're naturally going to see those kinds of things converge.

MIKE KIM: Okay, great. Let's shift gears a little bit to David for a moment. Speaking of the transformation strategy, can you provide an update of Dell's push towards a solutions-based business model? You know, what are the strategic areas of focus, and what areas are being de-emphasized?

DAVID MEHOK: Sure. I might start with the second half of that question first in terms of areas being de-emphasized. We actually went through a pretty rigorous process. It's ongoing, but we went through a rigorous process about a year ago to assess the various areas of the business where we were present, we were looking to get into. And first and foremost, we were want to make sure that if we're going to be in an area of the business, we can make the necessary investments to be successful in that business.

Secondarily, we want to make sure that we can make the necessary returns. So we went through that process about a year ago. Prioritized some key areas of the portfolio and de-prioritized others, which is why you saw us get out of smart phones as an example.

So as you think now to where we are from a solutions perspective, our enterprise solutions services and software business now comprises well over a third of our revenue and over 50 percent of our gross margin, which a lot of people don't realize. And that's coming from a base last year of only 30 percent of our revenue and less than 50 percent of gross margin. So made some significant progress just over the last nine months and in Q3.

And you break it down a little bit further, in the server space, we've been able to gain some significant share over the last few quarters. We were time to market in terms of Romley. We've seen great penetration with our 12th-generation servers. Our networking business great at 40 percent last quarter, and we're seeing really strong services business despite some of the declines that we're seeing on the hardware side. So overall, we're feeling really good about the progress that we're making in those strategic areas of the portfolio.

MIKE KIM: Okay, great. Phil touched on it briefly, but what is Dell's strategy on BYOD and how does that kind of incorporate Dell's hardware and services capabilities here?

DAVID MEHOK: It's an exciting opportunity for us. And I was actually reading something the other day that had an interesting stab, and I believe it, it sounds inherently right. That about 50 percent of mobile devices in the corporate work space are going to be owned by employees come 2015. BYOD is going to be a trend that we're going to continue to see grow, there's no doubt about that.

And when we look at that environment and determine, you know, what do you need to be successful and what do you need to differentiate, there's a few key things. One is going to be security of the data first and foremost, secondarily, how do you manage the devices, and third, how do you optimize your infrastructure? And when you think about the portfolio that we built out over the last few years, we feel that we're inherently advantaged for those three key aspects and tenets of BYOD.

From a security standpoint, we've acquired numerous assets that help us play well in this space whether it be Quest with identity and access management, the firewall or VPN that comes with the SonicWALL acquisition that we had.

We just acquired a company called Credant about a month ago which is already being used in our Latitude products for endpoint security. So from a security standpoint, we feel we have a very robust solution.

And then you go to device management. You know, we've had KACE now for over two years, very successful in terms of managing the environments from a PC and/or device perspective, and it does so agnostic of the OS, which is something that, obviously, is very important.

We know that the environments are going to be heterogeneous, we've got to be able to manage them effectively. And Wyse as well. When you think about cloud-client computer manager that Wyse brings to bear, the ability to manage all of these devices through one pane of glass is something that we feel is going to be very important and inherently advantaged with some of the solutions that we have. And then in terms of optimizing the infrastructure, sort of the third tenet, we've done some key investments in terms of bringing on board some companies making clarity that are all about migrating applications, app modernization. That's going to be a key area of focus for us going forward and building out the apps that customers need to implement a BYOD process seamlessly and effectively.

So when you take a look at that holistically, you think that the portfolio that we built out is pretty strong and we're excited about the opportunities.

MIKE KIM: Okay, great. At Dell World back in December, Michael Dell reiterated the company's focus on small- and mid-sized acquisitions. Could you kind of talk about key potential areas of focus for the company as a whole and maybe potentially, you know, even within the consumer segment.

DAVID MEHOK: Predominately, it's going to be focused on the areas that I talked about initially. You know, we talked about some of the strategic areas of the business, so to speak, with the enterprise solutions, the services business, the software business. Those are going to be areas we're going to continue to enhance. And we're not going to telegraph specifically which sub-segments we're going to necessarily going to be more focused on than another, but that's going to be the area where almost all, if not all of the inorganic activity is going to take place. And there's going to be a lot of organic investments as well.

We've taken our R&D from under a point of revenue to 1.9 percent last quarter, that's something we're going to continue to grow. We feel it's very important to not only invest in some of our key assets that we've had from a legacy standpoint, but also invest in a lot of the assets that we've acquired. And that's something that we've done, it's showing up in the numbers, effectively. And in order to do that, we also recognize we've got to be able to cut costs in other areas, and G&A has been an area of focus for us where we've been able to take down some costs of the overall P&L still works even though we are making some key investments in sales as well as R&D.

MIKE KIM: Okay, great. And then, you know, does Dell really need to offer PCs to kind of initiate new customer engagement in the enterprise, and especially in emerging markets? You know, is it possible that Dell could lead with other parts of the business like servers or storage?

DAVID MEHOK: It is possible. And, look, we've had this legacy if you go back -- I've been at Dell for almost 16 years now, and historically, it was always lead with the PC. You lead with the PC, you get your foot in the door, and then you can get a foray into the server decision-maker, the data center decision-maker, and eventually you broaden your portfolio if you're successful and if you build customer trust. And that's been a model that's worked very well for us, particularly in the SMB space.

As you look at some of these emerging markets, while that model still works to an extent, to your point, we are able to lead with some of these ES&S sales before we even have a presence on the client side. A lot of these customers aren't tethered to any legacy apps and any legacy systems. So for us to enter their data center or enter their services arena and be able to offer them something that is forward thinking and, again, not tethered to legacy is something that's pretty compelling. Very cost effective, and at times we're seeing that lead to, then, client sales six months, 12 months, two years down the road.

MIKE KIM: Great, okay. And then let's just shift back to the consumer for a second with Phil. On the cost side, you know, Dell has discussed the opportunity to drive incremental cost reduction. Will any of those be kind of reinvested back into the business?

PHIL BRYANT: Yeah. I mean, I think you've seen -- we've said we're going to reduce about 2 billion over the next couple years, right? About a billion of that will be in end user computing, a lot of that will benefit the consumer business, right. And then there's probably even more benefit out of that, though, on the larger segment, the commercial space probably more of that. But as the company gets to that way of doing business overall, we'll just naturally benefit from all of that.

MIKE KIM: And what kind of areas are you talking about in terms of cost pick-ups or reinvestment in the business?

PHIL BRYANT: Well, it's across all elements of COGS. COGS and operating expense, as David mentioned.

MIKE KIM: All right. Let's take a quick break here. I have a few more questions, but I wanted to see if the audience has anything to ask the executives here. If you could raise your hand if you have anything.

QUESTION: Thank you. Wanted to just ask a follow-up on your comment around spending. You said you've taken it from under a point to I think 1.9 percent. And you said it was likely to increase from here. Is that as a percentage of revenue or on an absolute basis?

DAVID MEHOK: Over time, you might see slight increase as a percentage of revenue. I was talking more absolute dollars as you look forward, but you could see it creep up to 2.0, 2.1, we're not talking about taking it up to 4 or 5 percent of revenue by any extent. But we have, obviously, migrated up fairly significantly over the last year and a half as a percentage of revenue. Now is sort of a point where we don't give guidance, obviously, by line item, but we feel like the P&L shape is working pretty well. Whether or not it goes up 10, 15, 20 basis points from here, you know, potentially, but we're more focused on making sure that we're investing in the respective investments that we've made inorganically, and continuing to invest in a lot of legacy solutions that we have out there. But, again, not going to pinpoint exactly what we're going to be looking like from a percentage of revenue going forward. But we'll plan on growing the dollars.

QUESTION: (Inaudible, off-mike.) -- and I'm wondering is that sort of consistent with the environment today, and how do you see that playing out over the next sort of one to two years? Especially for the higher segment space that you're targeting.

PHIL BRYANT: Yeah, well, I think you've seen pretty good movement and aggression in those low bands, right? And you've even seen that tick up as far as a percent of market here in the last quarter or so. If you look in the mid and high bands, we still see that as a great profit opportunity, all right? And if anything, the introduction of touch, right, has given us the ability to take ASPs up in that kind of space.

MIKE KIM: I'll ask another here. Phil, if you could also kind of discuss your new portfolio of products and PCs that you've announced recently. You know, touch, as you mentioned, is a big factor. But what other -- some of the other type of features that could improve end demand here?

PHIL BRYANT: Well, I think, you know, Win8, while there's been a lot of noise and probably a little bit of confusion with the initial launch, I think it is a great catalyst, right? And as you look at Win8 across tablets, Win8 across all-in-one desktops, okay, Win8 across -- whether it's a conversion device like this one, the XPS 13 or a basic clamshell, I think being able to introduce touch and the new capabilities and the apps and everything that goes with that is pretty critical.

Some other things, you mentioned acquisition, and we talked where most of that has been focused in the small and medium business or midmarket space, okay, or more up-market. You know, there's kind of an aspect of that, right, with PocketCloud, though, that came with one of those acquisitions, okay, that we've introduced on all of our products right now. And PocketCloud is the only real cross-platform, you know, information-sharing device that's out there right now, right? Whether you've got an IOS device, an Android device, as soon as you boot up your Dell device, you can connect and get all of your information, your pictures, your music, and you can immediately share those kinds of things, right, across any of your devices. And, again, that's a consumer benefit from one of those acquisitions and something that's different out there in the market, right, that's pretty interesting and only we're doing right now.

DAVID MEHOK: Yeah, in addition to that, we announced this morning as part of those Wyse-based solutions what we're calling Project Ophelia. And you'll see a little more information on this in the coming months, but the way to think about it is it's essentially a solution the size of a USB key. And it allows you to access your content be it at work or be it at home, depending on how you configure it, wherever you are, as long as you have any type of screen.

You can have a TV where you hook up the USB key, utilizing the power from the TV, you have the ability to access all of your data, whether it be at home or at work, through a secure solution with this type of device. So when you start thinking about the use cases that make sense for a solution like this going forward, it's pretty interesting and pretty compelling.

So we're excited about solutions like that and some of the other thin-client-based solutions that Wyse brought with it when we acquired them.

MIKE KIM: Is there anything else from the audience? No? Okay. Let's go back to convertibles for a second here. You know, are consumers embracing the form factor?

PHIL BRYANT: Yeah.

MIKE KIM: Or do you think of it more as a niche product and kind of what are your expectations related to the durability of the new form factor?

PHIL BRYANT: Yeah, I'll kind of answer them in reverse order, okay? As far as durability, you know, again, if you look at our convertible device, right, it's this XPS model, right, that's got the flip hinge and lid. You know, we introduced the original version of those model a little over three years ago. All right? I've got two boys. At the time, they got the original version, right? They were 10 and 13. They're still using those as their homework computers and their basic computer.

They've done just about everything you could possibly do to those devices over three years, just like any other 12- and 13-year-old boys do. So, you know, my personal anecdotal experience with the form factor and some of the technology is pretty good.

If you're just looking at it from a pure business standpoint, those products have had the same basic returns rates or any kind of technology issues as any of our other products did, okay? So I think the design and the technology and the capability is pretty tested and pretty durable. All right?

If you look at where it's going to be over time, you know, we've had good success with the product so far. You know, whether the market gravitates more towards clamshells or these converged devices or tablets with a detachable keyboard, you know, we're going to have to wait a little bit and just see how time plays that out, right? Right now, we're in all of those areas, and then we plan to participate where the market goes.

MIKE KIM: Okay. And then back to Windows 8 for a second here. Does it really matter for the consumer? What really has changed for the consumer to be motivated to purchase a new PC?

PHIL BRYANT: Well, I think it's the touch is one of the biggest reasons, right? And the ability to get that same kind of experience, you know, that I guess we've all enjoyed on smart phones, right, extended to the PC and give you that capability. You know, and that's been good and I look forward to continuing to ramp that part of the portfolio through next year.

DAVID MEHOK: Yeah, speaking for the corporate side, I think we're fully anticipating that you're going to start to see a ramp up in refresh as you get to the second half of this year into the first half of the following year, particularly with the expiration of XP, which depending upon which service you listen to, is anywhere from 35 to 45 percent of the current install base. So there's going to be a driver and an impetus behind the refresh that's going to be coming. We see it happening towards the end of this year and into the following year, and it is a significant number of devices that need to be refreshed.

MIKE KIM: Great. Anything else from the audience? Otherwise, I guess we'll end it early here.

QUESTION: (Inaudible, off-mike.)

MIKE KIM: The question was on Windows 8.

PHIL BRYANT: Yeah, I think there's a good bit of confusion initially. I mean, you've seen some of the market data that was out there, right, from NPD and others. I think what we're starting to see is some of that subside a little bit. I think, you know, areas of opportunity, though, are around touch, having more touch-enabled products. And, again, that's why I'm pretty optimistic as we go through next year, right, as we're able to get more of those out there. I think you're going to see that continue to take off.

But, you know, I mean, we've offered Win7, right, in some transition SKUs as well as Win8 SKUs and we've seen the Win7 piece go to practically nothing, right? So consumers are interested in the Win8 piece right now. And as many of them as can get touch platforms and all, they're going for those right now.

MIKE KIM: All right, thank you Phil and David. Have one more.

QUESTION: What's the supply and demand situation like for touch?

DAVID MEHOK: I think from an industry perspective, as you know, you look at the same data points we do. There was a shortage of touch that's being worked through. We're starting to see progress made, and we feel very good coming out of this month and heading into the next couple of months, we're in a good position. I don't know if there's anything else from a consumer perspective.

PHIL BRYANT: No, I mean, that's it. I think we're starting to work through some of the that. Again, we're launching a new touch product here later this month, okay? So we expect to have that grow as a part of the portfolio.

MIKE KIM: (Inaudible, off-mike.) -- just hard drives versus flash drives and what you're seeing in that area in the future.

PHIL BRYANT: Yeah, to the point on some of the confusion, right? I think there has been a fair amount of confusion around RT, okay, and what it means. I think, you know, now that we've introduced a full Windows 8 tablet or Windows Pro tablet, you know, we just did the Dell World, and that was probably when we had all the CIOs and the number-one device that they wanted to look at, right? Because they all sort of immediately get that. Right? They all understand full Windows device, I can run basically anything I have, I know will work on this. My productivity suite, I can run any of my apps and those kinds of things.

So right now, we're offering both, okay? We have both of them out there, right? The adoption so far on the RT side has been good, but the adoption on the full Win8 has also been good, okay? Where that goes over time, I don't know. We're just going to kind of see. Right? But we'll continue to talk about both devices going into this next year, but as far as what we'll probably talk most about, we'll probably talk most about the full Win8 Pro type device as we go through next year just because if you look at the segments where we're so focused, professional, small office, those kinds of things, that's what they really get and that's what they're really looking for.

DAVID MEHOK: Yeah, you know, on the drive side, these devices, obviously, great form factors. We've seen some from our competitors as well, they're pretty cool as well. The problem that you're seeing from an industry standpoint is most of them are $999 and above, and they've got to start to get to a cost point that's going to be more attractive for mobility users. And I think drives is one of those areas of opportunities.

As you look out -- I'm not going to sort of set a timeline, but you know, over the course of the next year, you'll see hybrids introduced more and more into some of these systems, that's going to help us reduce cost and not compromise the efficiency and the performance.

So you're going to start to see that migration take place, and that's one of many cost areas where you're going to see cost come out of these solutions to get them down to price points that make them much more competitive, attractive and that whole ecosystem gets built out around the Windows 8 OS.

QUESTION: (Inaudible, off-mike.)

PHIL BRYANT: We offer both, okay. We give a choice as much as possible. Customers still, right, in terms of just overall percent are still favoring larger drives, okay? I mean, so that key inflection point, we haven't quite hit it yet.

DAVID MEHOK: You see a little bit of bifurcation, perhaps. You know, you see some that -- you continue to see the migration to larger drive sizes, right? But then you also got some users that are, obviously, migrating over to the cloud, don't need that capacity. But when you aggregate it, you're still seeing robust drive capacity to take both sets of users and combine them.

PHIL BRYANT: A lot of that's been around the ultrabook space. Right, I mean, there's kind of a natural fit with ultrabooks, right? But if you're sort of a full-featured laptop buyer, they're still overwhelmingly going with larger drives.

QUESTION: How are you think about component costs going forward? I think what I'm most interested in is DRM specifically. If you listen to some of the DRM makers, and I'm thinking specifically of Micron on their last earnings call they talked about how they're starting to see their cost curves diverge from historical patterns. And we can call it Moore's Law breaking down, whatever, but they're seeing it to the point where they're actually starting to guide for lower bit growth, structurally, going forward and talking about how pricing structurally is going to move higher. And I understand that's a self-serving comment, but at the very least, is Dell starting to think along those lines that perhaps the cost curves, and therefore the pricing that you get in some of these commodity markets, and maybe DRM specifically, you know, drives we've seen consolidation over the last year, or do you think that over the next, you know, four to eight quarters, we're really not going to see much of a difference in terms of commodity pricing?

PHIL BRYANT: We were talking about this this morning, actually, in another meeting. You know, while you expect to see a reduction in volatility based upon consolidation of suppliers, generally speaking, just based on normal economic law. We haven't necessarily seen that in the last year. So the question becomes, well, how much of that is based upon the fact that the demands variable has been much less than everybody anticipated coming in? It's really tough to normalize for all that and figure out, okay, is there actually a reduced span of volatility?

We're obviously aware of the consolidation that's taking place. We're looking forward and working with a lot of these suppliers to understand if, indeed, there's going to be any type of change, to your point. But it's not anything that we're seeing right now, but it's something that, obviously, we're going to keep our eye on, and we work very closely with all of our suppliers, and are going to continue to do so as we migrate through any type of further consolidation that may take place, or just based upon the consolidation that's happened in the past.

MIKE KIM: We have time for one more question. All right, thank you guys.

PHIL BRYANT: Thanks, appreciate it.

MIKE KIM: Thank you.

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