DELL INCORPORATED

Moderator: Robert Williams
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7:00 a.m. Central

Robert Williams: Thanks Regina.

Good morning and thanks for joining us. With me today is our Chief Financial Officer, Tom Sweet; our President of Infrastructure Solutions Group, David Goulden; and our Treasurer, Tyler Johnson.

We've posted our second quarter press release and web deck on our website, where this call is also being webcast. Q2 financial results will be filed on Form 10-Q tomorrow, September 8th. I encourage you to review these documents for additional perspective.

Consistent with prior periods, our Q2 non-GAAP operating income excludes approximately $2.5 billion of adjustments. The majority of these are non-cash and relate to purchase accounting and amortization of intangible assets. Please note that due to the EMC merger and to a lesser extent the Dell go-private transaction, there will continue to be significant bridging items between our GAAP and our non-GAAP results for the next few years, although the impact will decline in each subsequent quarter. Please refer to the web deck as well as our SEC filings for more details on our total non-GAAP adjustments.

As a reminder, please note that our Second Quarter Fiscal Year 2017 historical results do not include EMC and, unless otherwise specified, all growth percentages refer to fiscal year-over-year change, which may not be comparable due to the merger.

During this call, we will generally reference non-GAAP financial measures, including non-GAAP revenue, gross margin, operating expenses, operating income, net income, EBITDA and adjusted EBITDA on a continuing operations basis. A reconciliation of these measures to its most comparable GAAP measure can be found on Form 10-Q and in the supplemental material of our web deck.

Finally I'd like to remind you that all statements made during this call that relate to future results and events are forward-looking statements, based on current expectations. Actual results and events could differ materially from those projected due to a number of risks and uncertainties, which are disclosed in the cautionary statement section in our web deck. We assume no obligation to update our forward-looking statements.

Now, I'll turn it over to Tom.

Tom Sweet Thanks, Rob.

Today marks the first anniversary of the Dell and EMC merger, and I want to highlight what our Dell Technologies family of businesses have accomplished over the last year.

We've combined two great companies creating the essential infrastructure company with over 140,000 employees.

We've unified two global, world-class sales forces and launched an integrated Channel Program. Both of which are helping to drive strong velocity and revenue synergies across the segments, specifically for client, servers and VMware.

We've rapidly de-levered, paying down approximately $9.5 billion dollars of gross debt, after excluding DFS-related debt, and we've repurchased approximately 19.7 million shares of Class V Common Stock totaling $1.1 billion dollars.

We've expanded our Dell Financial Services or DFS portfolio to approximately $6.7 billion in financing receivables, up 30 percent year over year, and we are now the exclusive originator of the Dell EMC business and the preferred finance partner for VMware. And we're driving industry leadership in multiple categories including newer solutions such as all-flash and hyper-converged infrastructure.

We've also closed multiple large deals recently, including a multi-year, multi-solution agreement with General Electric. This is just one example of the interest we are seeing from our customers to enter into large, multi-year agreements, which further validates the powerful combination we've created for our customers.

We have been pleased with the velocity in many areas of the business and with the strong demand for our newer solutions. While the integration has gone relatively smoothly in many areas, we recognize that we still have work to do to drive profitability higher and improve the velocity in our storage business. As we work to improve these areas, we'll continue to stay focused on balancing growth and profitability.

Moving to our results for the second quarter, we were pleased with the top-line momentum in the client business, servers and networking, hyper-converged infrastructure and all-flash arrays. Margin pressure persisted in parts of the business given the component cost environment and mix dynamics within the Infrastructure Solutions Group.

For Q2, GAAP revenue was $19.3 billion with a GAAP operating loss of $1.0 billion.

Non-GAAP revenue was $19.6 billion. While year-over-year compares for ISG and VMware segments are not meaningful, the Client Solutions Group revenue grew 7 percent to its highest revenue level in three years. On a standalone basis, VMware reported a growth rate of 12 percent.

Gross margin at the consolidated level was $6.1 billion or 31.1 percent of revenue, which was impacted by a challenging component cost environment and mix shifts within ISG. We continue to believe memory costs will be a headwind through the remainder of the year, even as we work to minimize the impact on the P&L.

Opex was $4.5 billion, or 23.2 percent of revenue. We remain focused on cost optimization and executing our cost initiatives while also investing back in the business for the long-term success of the company.

Operating income was $1.6 billion or 7.9 percent of revenue.

I will now turn it over to Tyler to provide commentary on adjusted EBITDA, cash flow, and capital structure.

Tyler Johnson: Thanks Tom.

We had a strong quarter of cash generation in Q2 and paid down additional debt. Cash from operations was $1.8 billion dollars, driven predominantly by profitability and ongoing working capital initiatives. Cash flow was impacted by interest payments, tax payments and strong growth in our DFS business. As a reminder, the majority of our interest payments occur in Q2 and Q4.

This strong cash flow generation enabled us to repay $1 billion dollars of core debt during the quarter.

Our cash and investments balance was $15.3 billion dollars, up approximately $300 million dollars versus the prior quarter.

Adjusted EBITDA for the quarter was up 19 percent sequentially to $1.9 billion dollars or 9.5 percent of non-GAAP revenue. Please see Slide 19 in the web deck for more details on our EBITDA adjustments.

We ended the second quarter with $49.9 billion dollars in total principal debt, down $800 million from the prior quarter as the $1 billion dollars of core debt pay-down was partially offset by an increase in structured financing debt that funds DFS. Our core debt ended the quarter at $40.5 billion dollars, which is down from $48.8 billion dollars at the time we closed the transaction last September. The remaining $9.4 billion dollars of principal debt consisted of debt that funds our DFS business, the $2.0 billion dollar margin loan, and the $1.5 billion dollar bridge facility backed by VMware legacy intercompany notes due to EMC Corp.

Early in the third quarter, VMware completed a $4.0 billion debt offering and used a portion of the proceeds to repay $1.23 billion dollars of the legacy intercompany notes. Dell Technologies used the proceeds from this partial payment of the intercompany notes, along with other cash, to re-pay the $1.5 billion dollar bridge facility. Including these latest debt payments, we've paid approximately $9.5 billion dollars of gross debt, excluding DFS-related debt, since closing the EMC transaction.

We've provided a breakdown of our capital structure on Slide 8 of the web deck. To simplify the discussion going forward, in addition to categorizing the DFS-related debt as non-core, we are creating a new line-item for subsidiary debt that will include the recent VMware debt issuance. This aligns with how we present our capital structure to the rating agencies and should help limit confusion, focusing our leverage discussions on core debt for Dell Technologies.

As we mentioned on the last earnings call, we continue to see growth in our DFS business. In Q2, originations were approximately $1.6 billion dollars and financing receivables grew to approximately $6.7 billion dollars, up 30 percent year over year, as DFS continues to benefit from the expanded base now including EMC and VMware.

We also expanded our DFS operations to Australia and New Zealand in the second quarter. I want to remind everyone that as the DFS business grows, so will our DFS-related debt, which includes both allocated corporate debt and structured financing.

In Q2, DFS-related debt ended approximately $600 million dollars higher than the prior quarter. We realize this increases the total gross leverage of the company, but this debt is supported and repaid by financing receivables and does not impact our overall de-levering plans.

Jumping to our share repurchase program, we have repurchased approximately 19.7 million shares of Class V Common since inception of the program. This includes 13 million shares under the Class V Group Repurchase Program. On August 24th we announced that our board has approved a second amendment to our existing Class V Group Repurchase Program, for up to $300 million dollars over six months, which we intend to solely fund through a new Class A Stock Purchase Agreement with VMware. This combined arrangement remains an efficient way to repurchase shares, benefiting both Dell Technologies and VMware shareholders.

We are pleased with our continued cash flow generation and the progress we've made on our de-levering goals to date, and we remain committed to our conservative financial policy and overall capital allocation strategy.

Let me turn it over to David.

David Goulden: Thanks Tyler.

ISG continued to drive solid overall demand with orders up mid-single digits year-on-year. While server orders velocity remained strong, storage orders declined in the mid-single digits consistent with the last two quarters. We have robust plans to improve our storage order growth rate, which I'll expand upon in a moment. But before I get further into our results, I wanted to highlight some of the broad trends across the business.

This quarter showcased the power of the Dell Technologies portfolio as we drove revenue synergies across the family and signed several large, multi-year strategic deals. The largest of these deals was a landmark partnership with GE. The new agreement was one of the largest non-government contracts in our history, and makes us GE's primary IT infrastructure provider.

Our broad portfolio and position as a privately controlled company gives us the flexibility to partner with our customers on a long-term basis in the manner that best matches their needs. And we've made some proactive decisions to lean into these long-term relationship opportunities with our major customers.

A key example is the introduction of a new set of Flexible Consumption Models, or FCMs. These include long-term utility-like structures that are billed monthly and new Transformational Software License Agreements, or TLAs, that are billed or financed up-front and make it more flexible for customers to substitute titles and pay for maintenance.

Both utility and TLAs have ratable revenue recognition characteristics that over time should drive more predictable and recurring revenue streams through our P&L.

Turning to results for the quarter, total Q2 revenue for the ISG business was approximately $7.4 billion, up 7 percent quarter-on-quarter. The sequential increase was driven by our server and networking segment with revenue of $3.7 billion, up 16 percent both year-on-year and quarter-on-quarter.

We saw good demand for our recently launched 14th generation PowerEdge server portfolio and are making good progress against our revenue synergy targets. Overall, server demand grew in each of our major regions.

In networking, our Open Networking strategy continues to gain momentum in the software defined data center and with strategic cloud and service provider customers. Our focused investments in the service provider market helped drive more than 20 percent orders growth across the ISG portfolio.

Our storage revenue of $3.7 billion was roughly flat quarter-on-quarter, with orders up mid-teens quarter-on-quarter. The primary differences between our reported sequential revenue and orders demand was growth in our product backlog and an increase in flexible consumption deals.

We also continue to see strong growth in our Virtustream enterprise class public cloud with revenue growing more than 50 percent each quarter since the merger.

As a reminder, the change in our fiscal year will cause third party storage market share figures to compare different year-on-year fiscal periods until calendar Q2, 2018. Our storage market share figures are also impacted by FCMs as more business is recognized ratably.

Business model and calendar shifts aside, we still have work to do to improve our storage velocity, especially in the higher transaction volume commercial segment of the market.

Our action plan includes better alignment of our sales teams through quota changes and modified incentive programs to better emphasize and capture storage opportunities. We are also adding several hundred storage sales specialists across our commercial go-to-market segment, our global storage specialty team, and our channel team to increase our storage go-to-market capacity. We expect the impact of these changes to build over the next few quarters.

To go hand-in-hand with these go-to-market initiatives, we will continue to arm our sales teams with the leading portfolio of products and are seeing good traction from the product introductions at Dell EMC World this past May.

For example, demand for Isilon scale-out NAS grew double-digits this quarter driven by our new Infinity architecture which offers up to 6 times the IOPS, 11 times the throughput, and 2 times the capacity of the prior generation.

We also started shipping our new Integrated Data Protection Appliance late in the quarter and have a strong pipeline heading into Q3.

In all-flash, we continue to see good growth at scale and are more than two times the size of our nearest competitor. Our portfolio was enhanced with a strong first quarter for our new VMAX 950 solution, and in Q3 we expect further benefit from the launch of our new XtremIO solution, X2.

Our hyper-converged portfolio continues to grow triple-digits with strength in both XC and VxRail. Since the global launch of VxRail in March 2016 we have sold more than 14,000 nodes to more than 2,000 customers.

In addition, we have several exciting announcements planned for later this year to further strengthen our storage market position.

Moving down the income statement, our operating income for ISG was $430 million or 5.8 percent of revenue.

During Q&A on the last call we talked about five factors that would drive operating income improvement through the year. These factors were: A seasonal volume improvement; a mix shift towards storage; more normalized backlog; pricing actions; and improved storage go-to-market capabilities. Let me walk you through how these played out.

During the quarter seasonal volume improvements drove higher operating income dollars from servers and, while we experienced solid seasonal volume improvements in storage orders, storage revenue was approximately flat sequentially, due to flexible consumption models and a build of higher margin storage backlog. This impacted the server/storage revenue mix within ISG.

The pricing actions we took offset a portion of the commodity cost increases, but we still faced headwinds in the quarter.

Lastly, we are seeing storage go-to-market momentum with larger customers and have solid plans in place to improve order velocity in the higher transaction volume commercial segment of the market. Overall storage growth rates, storage order growth rates were similar in Q2 to Q4 and Q1. We expect to see improving storage order growth rates in the second half.

So to net things out, from an orders perspective improvements started to play out as expected, but the increase in flexible consumption models and an in-quarter backlog build dampened the impact to the P&L. Notably, the impact to cash flow from these items is less than the impact to the income statement.

We expect these factors to continue to be key drivers of operating margin improvements through the rest of the fiscal year.

In summary, we continue to drive hard against operational improvements targeting our go-to-market, product portfolio, and cost out initiatives.

We are encouraged by the overall velocity in the ISG group and are seeing the rationale behind the Dell EMC merger playing out. We are leveraging our product portfolio and ownership structure to build long-term customer relationships and believe we have an unmatched set of capabilities in the marketplace.

Let me turn it back over to Tom who will walk you through the Client Solutions Group.

Tom Sweet

Thanks David.

The client solutions business had another strong quarter as we continued to take share globally while growing profitably.

According to IDC, Dell outperformed the worldwide market, growing units 3.7 percent in calendar Q2 compared to a total industry decline of 3.1 percent. We gained share year-over-year for the 18th consecutive quarter and hit our highest market share since 2006, with unit gains across every major region. We expect to continue to take share in this consolidating market, with our focus on balancing growth and profitability.

Moving to fiscal Q2 results, revenue for CSG was $9.9 billion, up 7 percent and was our highest revenue quarter since Q2 of fiscal 2015. Consumer revenue was up 10 percent driven by growth in notebooks, continued strength in gaming, and by initial traction from our CSB key country expansion program. Commercial grew 6 percent due in part to expansion of our customer base as well as strength in the channel, mobile solutions and attached services.

Operating Income was $566 million, up 17 percent, or 5.7 percent of revenue. CSG did benefit from a vendor settlement of approximately $70 million, which impacted the OpInc rate by approximately 70 basis points. We continue to execute on profitable growth, despite ongoing challenges from the component cost and competitive environments.

Let me go into a bit more detail on our momentum in CSG. This segment is benefiting from the execution of our strategic investments in growth areas of the market. We saw strong momentum continue across both high-end commercial and consumer notebooks as Latitude, Mobile Workstations and XPS each had double-digit growth during Q2.

In calendar Q2, Dell ranked number one in unit share for workstations worldwide. The expansion of our Consumer and Small Business focus to 12 countries also helped drive growth in revenue and profitability.

In addition to strength in notebooks, we are having success driving higher attach of services and accessories. Specifically, displays revenue grew double-digits during fiscal Q2, and according to DisplaySearch in calendar Q1, Dell remained the Number One display provider worldwide, which marks the 16th consecutive quarter. We also saw higher attach rates for our premium client services offering, ProSupport Plus, primarily driven by commercial client.

CSG has been performing well while managing a tough component cost environment. As we continue to work through these cost headwinds, we remain focused on continuing to drive velocity in our commercial client business and on expanding our customer base through profitable share gains.

Now, shifting to the VMware segment and Other Businesses. VMware had another strong quarter. Revenue from the VMware segment was $1.9 billion and operating Income was $561 million, or 29.4 percent of revenue.

Standalone, VMware reported license and subscription bookings up double-digits along with strength in NSX and vSAN.

We are pleased with the momentum we've seen in cross-selling across the portfolio between the VMware and Dell sales forces, as we leverage the family of businesses to expand our customer base.

We look for this business to continue to grow as it goes to market with its new product offerings, including VMware Cloud on AWS and VMware AppDefense announced at VMworld last week.

We are excited about another announcement made last week at VMworld that truly exemplifies that Dell Technologies is better together. VMware and Pivotal launched Pivotal Container Service or PKS, in collaboration with Google Cloud, delivering a simple way to deploy and operate production-ready Kubernetes containers on VMware vSphere and Google Cloud Platform.

Revenue from our Other Businesses, which includes SecureWorks, RSA, Pivotal, and Boomi, was $472 million.

Pivotal again delivered strong top-line results, with rapid growth in Pivotal Cloud Foundry software solutions. In addition, the team continues to increase its customer footprint and expand its partner ecosystem.

SecureWorks released its standalone earnings yesterday where it reported double digit revenue growth to $116 million, continued gross margin expansion, and solid operating cash flow. This business continues to focus on growing revenue and improving profitability as it looks to accelerate momentum heading into next year.

In closing, we've had many bright spots over the past year in the Dell Technologies family of businesses with good velocity in client, servers, all-flash, hyper-converged infrastructure and software defined data center; great progress on debt pay-down; and steady expansion of our DFS portfolio.

But, as we've said on past calls, we did expect some disruption due to the many changes brought into the organization, particularly in go-to-market. I think it's also fair to remind everyone that we've been doing this while managing our way through the most challenging cost environment in over a decade.

We believe we are making the right decisions for the long-term health of the business and, though we have made progress, we have more work to do and some of the decisions may take longer to impact the results as we move forward. As a privately-controlled entity, we have the flexibility to make these long-term decisions.

We are the only provider that has this level of flexibility and breadth of solutions that can offer a single set of solutions and this is resonating with customers and partners.

We're pleased with how far we've come over the past year and are excited about the opportunities that lie ahead. We will continue to focus on growing faster than the market, accelerating in growth opportunities like all-flash and hyper-converged, and winning in the hybrid and multi-cloud environment. We remain committed to driving cash flow generation, de-levering the balance sheet, and balancing cost actions with investments to position the business for long-term success.

With that, I'll turn it back to Rob to begin Q&A.

Robert Williams: Thanks, Tom. Let's get to Q&A.

We ask that each participant ask one question, with one follow-up if you have one.

Regina, can you please introduce the first question?

Operator: Our first question will come from the line of Frank Jarman with Goldman Sachs.

Please go ahead.

Frank Jarman: Great. Thanks for taking my questions, guys.

I guess, first, I just wanted to focus on the ISG segment margins a little bit. You talked about the five factors that would drive sequentially better performance, and you did show 110 basis points of operating margin improvement in the quarter on a sequential basis. But historically we would have seen a little bit better quarter over quarter growth, and obviously on a year over year basis it was down.

So can you just help me better understand was it -- obviously you should have had the seasonal uplift, but when you think about the storage business in particular how do we think about improving the trajectory of the business and how quickly can that happen with regards to thinking about the sales force additions and other actions you're taking there?

Thank you.

David Goulden: Frank, thanks. This is David. Let me handle that for you.

So yes, as you said, we did see more improvement sequentially, and the five factors that we talked about that would have kind of let us improve through the year are the key factors.

From a storage point of view, we saw what we expected in terms of sequential growth to play out from an orders point of view. We had a sequential order growth in storage in the mid-teens, which is kind of where you would expect to go from a Q1 to a Q2.

As I've mentioned, sequentially, the revenue was roughly flat. That was impacted by two factors. One was a build in storage backlog due to the timing of when the orders came in in the quarter and our decision not to try and chase that backlog all out of the door in the actual quarter. And also our choice to lean into these flexible consumption models, which let us have long-term relationships with customers, but basically those are recognized ratably.

So we did see things playing out from a sequential order growth point of view. But the two factors that I mentioned dampened the impact on the sequential growth. The last factor that you mentioned was the go to market adds where we're doing very well in two of the major growth markets in storage in all-flash and hyper-converged.

The third area is the traditional mid-range storage system which is heavily weighted to the commercial marketplace where, as I mentioned, we're adding several hundred sales specialists, we're modifying our incentives, and really engineering the way we go after that midmarket opportunity more aggressively. And that will start to build over the next several quarters.

So those are the things that kind of all together impacted what you saw happening in the storage business in the quarter.

Frank Jarman: Got it. Thank you.

And so as I sort of walk that forward and think about a year ago, right, 3Q2017, we typically seasonally see a pretty big bump in terms of margin performance for the segment. And so when I think about the seasonal uplift into 3Q plus the backlog that you've essentially held back for the quarter and the order momentum that you're generating there, plus the sales force, should we expect a typical 3Q margin trajectory for the ISG segment?

David Goulden: Frank, the biggest driver of that is going to still be the storage business. And typically, just to kind of go back to the heritage EMC model, typically Q2 and Q3 are relatively similar from a top line point of view. So any changes in operating margin are kind of more related to kind of mix and backlog movements and things like that.

Obviously exactly how much of the quarter winds up being in flexible consumption models has yet to be figured out. That's the kind of lumpy factor. A few larger deals make a big difference.

But from a top-line point of view don't expect any significant difference, really, in the storage segments, which will be perhaps the biggest driver of the operating margin as you move forward sequentially into Q3. Obviously Q4 is the much bigger quarter.

Frank Jarman: Great, thank you.

Operator: The next question will come from the line of Thomas Egan with JP Morgan.

Thomas Eagan: Good morning. Thanks for taking my question.

On the last quarter you coached us to thinking that this quarter would be maybe the worst quarter for the component headwinds. And while the revenue that you produced was about in line with what we were thinking, the actual cost, especially on the client solution side, was better than what we thought.

So I wondered, you talked a little bit, Tom, about things that you were doing to offset those costs on the cost to sales side. Maybe you could just give us a little bit more color on that. Then I have a follow-up.

Tom Sweet: Sure, Tom. So look, we did tell you, I think back in Q1 when we did this call that the sequential jump in component costs from Q1 to Q2 was relatively significant. And as we look forward we still think memory cost will be a headwind for the year, although we do think that Q2 to Q3 the sequential jump will be significantly less than what we saw in Q2. But it's obviously going to be a headwind.

But, having said that, look I mean, we haven't been static about what we're doing in the sense of managing configuration. We have adjusted price a number of times as we balanced both list price moves and our overall discounting framework that we've used, particularly in our commercial base.

And I would tell you that in general we've seen reasonably good success sort of navigating through this. It's obviously not perfect. And in general what we have seen is a gradual mitigation of the component cost environment.

Now the question as you go forward is balancing that, those pricing actions and component, or configuration actions that you're doing and trying to balance that growth velocity with profitability. And so it's a careful balance here, because as you know, Tom, we're a believer in premium growth to the market. And you've got to be careful around making sure that as you adjust prices appropriately you're not somehow stymieing demand.

And so it's been a balance and I think the team has done a pretty good job, particularly in the client and in the server space on sort of navigating through that.

There's more work to do. So I want to tell you that we haven’t been perfect in that execution, particularly as I look at the server business, I think that there's an opportunity to continue to adjust and we're pleased with the performance so far that we've seen early in Q3 in that area.

Also, as you think about some of the storage and server space particularly you get a bit more lag in terms of how effective the price moves are, given some of the longer nature of the contracts. And so price moves feather in over a bit longer timeframe, particularly in the data center space.

So all in all, look, I think the team has done a pretty reasonable job. We'll see how the environment migrates over the next couple of quarters and on into next year. And we'll continue to manage to drive both the velocity of the business as well as margin dollars. So that's the balance we're trying to thread right now.

Thomas Eagan: Okay, thanks. And then for my follow-up, I just want to be clear on the takeaway that you want us to have regarding de-leveraging. I'm sure everyone appreciates the details of getting a level of core debt and other debt, and subsidiary debt. I want to make sure that we walk away with the right thought process on how you think about de-levering.

When you talk about de-leveraging are we talking about all debt to all EBITDA, the way that you book it, or are we talking about subtracting out VMware debt, or subtracting out VMware EBITDA, or some other measure. When you say that you're de-levering, how should we think about what that means?

Tom Sweet: Hey, Tom, and I'll let Tyler do most of the heavy lifting on this question, but let me just be real clear with everybody as we think about de-levering. We are focused on de-levering the balance sheet and we tend to talk about de-levering as it relates to core debt, okay. And Tyler will take you through what we mean by core debt.

Clearly the capital structure is getting a bit more complicated as we think about core debt, debt that supports our DFS business, which is backed by the cash flow from the financing receivables and now we have subsidiary debt with VMware, which is backed by the VMware cash flow.

So I am very focused on core debt de-levering. That's been our focus. That's what you've heard us talk about. And Tyler perhaps can go into a bit more detail on how we're managing through that and trying to provide you actually a bit more detail about it so that it's clearer to you and you can give us feedback whether we're successful in that area.

Tyler Johnson: Yeah, Tom, I think that the way Tom described it is correct. And it is complicated, right, because of the relationship with VMware. And VMware's desire and need to balance their own capital structure to drive their own strategic initiatives. But keep in mind, right, we've always talked about VMware, or our cash balance ex-VMware.

So when you look at VMware's ability to pay off or to manage the debt load that they've taken on, the $4 million dollars, is obviously -- they're obviously very comfortable with that and the rating agencies are very comfortable with that.

And then we want to always be very distinct about DFS. And I think you've heard me talk about it historically where I almost refer to that as good debt, because that's debt which is allowing our business to grow, it's supporting our customer needs, it's being settled through the financing receivables that come with that and as those kind of amortize down, or pay down, that's what settles that debt.

So to Tom's point, we look at everything, but core debt is where you'll really see the emphasis of the de-leveraging, right, which includes the term loans and the investment-grade notes and the debt that was really there to fund the acquisition of EMC, the debt which is ultimately settled through our cash flow generation and EBITDA generation.

Thomas Eagan: Okay, so just to be clear, Tyler, then it's core debt, which excludes the VMware debt and financing debt and also divided by EBITDA that excludes VMware EBITDA?

Tyler Johnson: Well, we look at it all ways. But to your point I think there are different ways you can slice and dice it and I know the rating agencies do the same thing. So we're going to report, recognizing that we still have this disconnect because of the trailing 12 months that we need to really start reporting leverage ratios. But we're going to look at it all ways.

Thomas Eagan: Okay, thanks.

Operator: Your next question comes from the line of Jeff Harlib with Barclays.

Please go ahead.

Jeff Harlib: Good morning, just following up in the storage business, can you just talk about if there are any further changes or challenges in the overall industry regarding the shift to flash and weakness in traditional kind of mid-market. And what gives you confidence you can improve the orders in the second half of the year from where they've been on a year-over-year basis?

David Goulden: Yeah, Jeff, thank you. This is David. Let me take that.

So within the storage industry I think the bigger trend which you see is a shift in the market mix towards more of the midrange storage systems. So the high end of the market, the systems of over $500,000, that market is declining and has been declining in the mid-teens percentage range. And the growth in the market is in the midrange, the midrange systems just become more capable.

There's still a significant difference, in terms of the core capabilities of the multiprocessor, scale-up scale-out high end systems, but nevertheless the growth is in the midrange.

So that's a big dynamic that's going on. In terms of the movement towards all-flash, that has now represents the majority of shipments in the high end of the marketplace where the price performance benefits of all-flash really play out strongly.

They're starting to take a bigger impact of the mid-tier market, as well. Below $50,000 systems there's not a lot of all-flash right now. There probably won't be for a couple of years.

In terms of where the growth opportunities are in the storage market, as I mentioned briefly before, there are really three major areas of growth within the overall storage marketplace. One is all-flash in general, where we're doing very well. We're growing nicely at scale. We're two times the size of our nearest competitor in all-flash. The next is in hyper-converged, where again we're doing well partnering with VMware, triple digit growth in that segment of the business. And the third area, back to my earlier comment of growth in the market, is in that midrange price and, which is where we have more work to do. And that's where we are focused upon adding the sales resources which I talked about, changing our quota and compensation schemes to put more emphasis on the midmarket within storage, introducing new products, et cetera. And we believe that that investment in that midmarket storage opportunity is the thing that's going to help us do better in the second half from a growth point of view than we did in the first half.

Tom Sweet: Hey, Jeff, it's Tom. I do think it's fair to say that that sales force expansion will ramp over the next number of quarters. That's not going to be an immediate impact even as we build that capacity.

So, Jeff, I think that you're going to see perhaps the storage velocity ramp more towards the latter half of the year versus -- of the second half, I should say, versus the first half of the second half, so to speak. So I do think that this is going to be a gradual build as we adjust the coverage models, particularly in that commercial space.

And lots of other levers being pulled, by the way, in terms of marketing programs and other things that we're doing around incentives and things of that sort, but, look, I think this is one of those things that's going to take a little bit of time to work our way through, but our focus there is to build back that velocity, because it's clearly an area of the market that we're not performing as well as we should be, and it's just a focus area for us to drive velocity, and it drives a nice margin flow as well. So we've got to get it fixed.

Jeff Harlib: Got it. Okay.

And just my follow-up on free cash flow, were there any major unusual items during the quarter? I know you were going to pay significant taxes related to prior asset sales, how much was that? And anything you can say about what will drive free cash flow over the next few quarters, be it actions the company is taking or other seasonal issues.

Tyler Johnson: Yeah, look, I think you're right. I mean we talked the last quarter about the taxes that were related to divestitures, which was -- that would have been netted into that cash flow. I don't have the exact number in front of me, but I think it was somewhere around $800 to $900 million dollars. And so that was obviously fairly impactful.

I think the good news is, and your question is the right question because you're thinking about it correctly, I think now as we move forward you're going to start to see more the cash flow is less impacted by integration or acquisition or divestiture type charges. And so you'll see it be more related to profitability and working capital.

We're making great progress on our working capital initiatives. You can see there was a good benefit this quarter, that was partially driven by the P&L growth, which because of the negative cash conversion cycle obviously it always throws off good cash.

But then within there also there's great progress around getting the suppliers coordinated on both sides between the legacy EMC and Dell and moving channel partners to channel financing programs. And so those actions are continuing to happen. Great progress will continue. We expect to see some more benefits flow through the P&L.

But, like you said, a lot of the one-offs I think are going to be behind us.

Tom Sweet: Hey, Tyler, though, and Jeff, I think it's fair to say, though, as we think about things like the storage business, David mentioned it in his talking points that we are seeing more interest in these multi-year structures, and particularly like these TLA structures, where what used to be ELA which were billed up-front, revenue was recognized up-front. Those things are highly profitable.

And we are seeing, because of customer interest in flexibility around the software titles that perhaps they're interested in, those structures are changing. And as a result of that, from an accounting perspective, we're deferring that revenue, deferring that margin, but I'm still getting the cash flow up-front from that.

And I think that's a phenomenon we're going to continue to see, because as customers are navigating through sort of a more flexible environment, which is what they demand. So I do think that's going to be an area that we're going to have to continue to talk about and provide visibility to as we go forward, because I think our EBITDA and our adjusted EBITDA numbers are going to be -- well, obviously, a calculation. We're going to have to think about how we think about some of these new types of structures.

Jeff Harlib: Thank you.

Tyler Johnson: And just related to this, as we think about the cash generation for the second half of the year, one thing, I think I mentioned this on the last call as well, we're real happy with the debt pay down we did this quarter, the million dollars. And you'll continue to see us pay down the debt as we've talked about.

But we do have those maturities in the first half of next year, so you might see our cash balances or you will see our cash balances start to increase as we get towards and into Q4 as we position ourselves to settle those maturities. So I just want people to be aware of that.

Jeff Harlib: Thanks.

Operator: Your next question comes from the line of Arun Seshadri with Credit Suisse.

Please go ahead.

Arun Seshadri: Good morning, everyone. Thanks for taking my questions.

First maybe for David. I just wanted to understand a little bit better about your flexible consumption models on the storage side. Is there any way to quantify the storage backlog, I guess the proportion of your backlog, what proportion would be under those models, and how do you -- when you look at the backlog overall what is the tenor of the backlog and when do you expect to see realization of revenue under those -- with the backlog that you have?

David Goulden: Okay, thanks.

Let me clarify a couple of things. When we talk about backlog, we're not talking about FCMs. I'm going to come back to that in just one minute. Backlog is the product that we take orders for in the quarter and we don't ship in the quarter. So that's different and I'm going to come back and explain the FCMs in just one moment.

But the backlog is simply product backlog that is not shipped at the end of the quarter. That is impacted by a couple of things, the timing of order flow through the quarter and also just how much inventory we keep waiting of those orders to come in, how much we ship out during the end of the quarter.

Tom Sweet: Arun, it's Tom. Remember what we said earlier on earlier calls, which was that we were not going to, unless the customer needed it, we were not going to drive extraordinary measures to try and optimize shipments at the end of the quarter from a rev rec perspective. We would let the shipments fall in the natural period in which they fall. Quite frankly because it's more cost-effective and more economical to do it that way.

And so David is right, we had a skew in linearity where orders came in very late in the quarter from pure storage product demand and those are just typical products that will ship out in Q3.

Now your follow-on question has to be, well, how do you think about backlog in Q3, and that question is going to be we'll have to see how the linearity works in Q3 as we work our way through that.

We have driven some changes in our comp plans to perhaps drive some incentive to bring those in earlier in the quarter. I've had mixed success over my career trying to mix shift that curve, so we'll have to see. But backlog will just ship in the normal course and we'll have to see what linearity looks like in the quarter as it relates to pure product backlog.

David Goulden — Exactly. So now let me come back to the flexible consumption models that are different, specifically there are two things that are within this bucket of flexible consumption models.

The first are these transformational software license agreements, we call them TLAs. As Tom mentioned earlier, we used to have things called ELAs, which were enterprise license agreements. Those were revenue up-front, multi-year commitment, revenue up-front. The TLAs are the next generation of that. They are typically for our storage software. They cover a multi-year period. The customer is basically taking a commitment to a basket of software products for a multi-year period, and under the structure of the TLAs we give the customer more flexibility in terms of how they can substitute titles. We let them choose when they want to basically start introducing maintenance on those products. And therefore because of the nature of a TLA it is now recognized ratably. So that's one form of flexible consumption model.

The other form of flexible consumption model which we are seeing growth in is our product utilities where previously a customer would have bought a fair amount of storage product typically up-front, storage or backup, and now moves to a model where it's a utility purchase. They're paying it based upon use again over a multi-year period of time.

So those are the two things that in total go into this category called flexible consumption models. You asked for sizing, so to put it into perspective if we look at the total storage demand in the quarter, the flexible consumption models represent the kind of mid-teens percentage of total storage demand. So it does have a meaningful short-term impact on the difference between what we're getting from a sequential growth in orders versus less of a growth in revenue.

So that hopefully clarifies the dynamics around FCMs.

Tyler Johnson — And remember what we talked about earlier, Arun, which is, again, on the TLAs we'll build those up front, so the cash flow comes up front just like historically the ELA would, the utility is clearly an over time, depending upon usage or whatever the mechanism is.

So, look, I mean that's why I was trying to explain earlier. There are some dynamics that we'll have to help you guys with as we move forward from a how you think about EBITDA, how do you think about cash, how do you think about order velocity within the business of the storage business, given what I think is going to be continuing interest with our customers to explore these different types of structures, given the flexibility that they're asking for.

And quite frankly, Michael and I have told the team to lean into these things, in the sense of their great arrangements. They typically built out a framework for a customer relationship for a number of years. They tend to be nicely profitable over that period of time.

But it is a bit of a transition that we're seeing right now, even as, quite frankly, we still do need to drive midrange storage and some of those others. There's some classical transactional demand generation that we need to do.

So we've got to do both. And that's the focus that we have right now.

Tom Sweet: Thanks, Arun.

Regina, I think we've got time for one more question.

Operator: Our final question will come from the line of David Phipps with Citi.

Please go ahead.

David Phipps: Hi, thanks for taking my question. Can we talk a little bit about the server business? You did extremely well there versus our model and you introduced the 14th generation of PowerEdge. Was there a bit of a build-up from sales for the new PowerEdge that helped drive some of the sales or was it more systematic or more selective when you look at the server business performance in the quarter?

David Goulden: David, let me take that. So yes, we introduced and just started to ship toward the end of the quarter the 14G. So it started to ramp what was a kind of a small percentage of our overall mix. I think what happened in servers was a couple of things.

People really liked the 13G family, particularly our strength in the rack scale systems. We're seeing a lot of synergy. We're seeing a lot of cross-sell in servers, a lot of growth is coming from the enterprise segments where obviously we've been able to take the server business into traditional high end accounts that were the stronghold of the data center sales force that the EMC side brought.

But also we're seeing good growth in midmarket, as well. So the server business is, I think relative to the top line, firing on all cylinders right now, 14G I think gets a lot of people excited. They like to see that there's a roadmap out there. It's kind of future-proofing their decision invest in the Dell portfolio there. But didn't make a very significant part of the quarter from either a bookings or revenue point of view yet.

Tyler Johnson David, I do think it's fair to say, though, as you think about the server business that there is a particularly like hyper-converged and V-SAN some of these other solutions that were software defined that we're driving that also falls and that generally takes a server with software. So we are seeing incremental interest in some of these new form factors and solutions, which is also helping drive that number, as well.

David Goulden Absolutely, which again goes back typically to those who are running on rack scale systems, which is kind of where our strength is in the server marketplace. So, yes, they're kind of moving towards software defined, software-defined data centers, hyper-converged is certainly one of the drivers in the server market. And of course, working very closely with VMware it's been a big driver of the server business, as well.

David Phipps And then as my follow up, you're driving from great strength now in the PC market, with 18 consecutive quarters of taking market share. The server business is performing very well and as everyone has asked about I'd like to have the storage business move a little bit more rapidly forward.

So with some of the sales momentum that you've had in those lines of business, when you look at the ISG group, are you starting to gain some of the cross-selling traction that you might have expected from the combination of all the entities with EMC?

Tom Sweet Look, this is Tom, and I'll let David comment since it's his business. But look, I think we've been very pleased overall with the cross-selling activities that we have seen. And that was one of sort of the key thesis of the deal, which was, hey, between the family of businesses with VMware and Pivotal and our core business of client, server, storage and the fact that the customer basis didn't really overlap that well in terms of share, relative share for these respective business units, or respective lobs I should say, that we have seen very good velocity in the VMware capabilities, good velocity in client, pretty good velocity in server.

We've got some work to do in storage, to be blunt. But that part of the structure, or how we've thought about that, I think has performed quite well, David, from my perspective.

David Goulden I'll agree, Tom.

And just bear in mind, David, that we have set our go-to-market structure up this way, we have two distinct go-to-market motions. One, the enterprise go-to-market segment focused upon the 3,000 biggest customers in the marketplace and then the commercial go-to-market segment books on everything else. Obviously the enterprise segment was largely comprised of the legacy EMC business and that's here we've seen great lift in the cross-sell there, where we've seen server, client. We've also let that group start to resell VMware, as well, which has proven to be a lift and helpful.

And then in the commercial business, which is largely, again not entirely, largely the ex-Dell team, although we've obviously moved the related part of ex-EMC in there, seeing strong growth, again, with server and client, VMware is doing well. And just that one area we still have to do some more work is in the storage momentum in the commercial market segment.

So if you kind of look at all -- if you look at that kind of matrix of kind of different go-to-markets versus different product segments I think we've seen everything we expected to see with one area for further improvement.

Tom Sweet: I think overall, though, as we think about the year, so it's been a year now since we closed this merger that in general what we wanted to do was get out of the gate strong from a velocity perspective. And I think in general that's happened.

Obviously, we've done a lot of things that I think have worked reasonably well. We've got some things that we have to continue to focus on, whether it's storage velocity or some of the other, continue the cost optimization work. But, again, those are all things that are in process that we'll continue to focus on and drive.

But, again, I want to make sure everybody understands that the goal here is to get the velocity in the business back, make sure that we're driving the right margin dollar profile here, and then continue to de-lever the balance sheet from a core debt perspective, because you will see, I believe, DFS debt continue to grow as the financing structures continue to grow given the interesting opportunities we have with DFS.

So that's the balance we're trying to drive and trying to make sure that folks that follow us understand how we're approaching this as we move forward.

Robert Williams Great. Thanks, David. Thanks, Tom.

That wraps the call this morning. As a reminder, a replay of the webcast as well as this transcript will be available on Investors.DellTechnologies.com.

Thanks for joining us.

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