Dell Technologies Q3 FY'25 Earnings Call

Tuesday, November 26th, 2024

Paul

- Thanks everyone for joining us. With me today are Jeff Clarke, Yvonne McGill and Tyler Johnson.
- Our earnings materials are available on our IR website and I encourage you to review these materials.
- Also, please take some time to view the presentation which includes additional content to complement our discussion this afternoon.
- Guidance will be covered on today's call.
- During this call, unless otherwise indicated, all references to financial measures refer to non-GAAP financial measures, including non-GAAP gross margin, operating expenses, operating income, net income, diluted earnings per share, free cash flow, and adjusted free cash flow.
- A reconciliation of these measures to their most directly comparable GAAP measures can be found in our webdeck and our press release.
- Growth percentages refer to year-over-year change unless otherwise specified.

- 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 discussed in our webdeck and our SEC filings.
- We assume no obligation to update our forward-looking statements.
- Now, I'll turn it over to Jeff.

Jeff

- Thanks Paul and thanks everyone for joining us.

Q3 highlights

- We continued to execute well and delivered strong performance in Q3.
- Revenue was $24.4 billion, up 10%, on strong ISG revenue growth.
- Diluted EPS was $2.15, up 14%, and cash flow from operations was $1.6 billion.
- Our focus on balanced profitability paid off, with improved Operating Income, Earnings Per Share, and Cash Flow.
- We're proud of the fact that year-to-date, our team has delivered 10% revenue growth in ISG and CSG combined and overall EPS of $5.31.

ISG

- In ISG, our AI server momentum continued, and we saw substantial expansion in our five quarter pipeline.
- Orders demand was a record $3.6 billion, up 11% sequentially, primarily driven by tier 2 cloud service providers with continued growth in Enterprise customers.
- We have seen sequential orders demand growth every quarter since the launch of the XE9680.
- We shipped $2.9 billion of AI servers in Q3, resulting in AI server backlog of $4.5 billion.
- Our five quarter pipeline grew more than 50% sequentially with growth across all customer types.
- We continue to gain traction with Enterprise customers, large and small, with over 2,000 unique Enterprise customers since launch.
- Increasingly, Enterprises see the disruptive nature and the innovation opportunities with GenAI resulting in growing GenAI experimentation and proof of concepts.
- Underpinning our success is broad enterprise coverage, professional services, engineering leadership, and large scale system design, all done with incredible speed and time to market.
- These highly specialized workloads and deployments require high-value engineering, and a solutions mindset where custom designs and fast deployments are the norm.

- Beyond the AI servers, we like the profit pools that surround them, like power management and distribution, cooling solutions, network switches, network cables, optics, storage, deployment, maintenance, professional services and financial services.
- We have accelerated the speed of innovation to respond to our customers' GenAI needs over the past year.
- A few highlights from the past two months:
- We launched our 21-inch ORv3 Integrated Rack 7000, in both a 44 and 50 OU rack design with integrated cooling, power and networking that is multi-generational and future-proofed up to 480 kilowatts per rack.
    - This rack falls in our Integrated Rack Scaleable Solutions (IRSS), which are focused on at-scale deployment ensuring Dell's AI Factories can meet the demands of foundational training at the Data Center scale.
    - We are shipping the industry's first enterprise ready GB200 NVL72 server racks with our new XE9712, with direct liquid cooling that holds up to 72 GPUs per rack.
    - We also announced at SuperCompute 24 a new AI server supporting NVL-4, also with liquid cooling, supporting up to 144 GPUs per rack – one of the industry's most dense designs.

  - And we have the M7725, a dense compute design, which supports up to 27k CPU cores per rack to meet high-performance computing demands.
- Our IR 5000 can achieve up to 96 GPUs per rack with a more traditional 19-inch rack design.
- Within the IR5000, which includes the XE9680L, we introduced the XE7740 and 7745, designed for Enterprise customers focused on inferencing.
- We've increased the density and performance of our PowerScale products, updating the PowerScale F710 with 61TB of QLC SSDs and capacity density of 614TB per rack unit.
- And with a new software release that, when combined with our 200GbE support, increases our streaming write performance by 163% and streaming read performance by over 2x versus the previous generation.
- An application of this technology that I'm excited about is a biomedical research center using the PowerScale F710 and the XE9680 to take their own unstructured data and train AI models that will advance personalized treatment plans resulting in better prevention, diagnosis and treatment of various types of cancers.
- The opportunity in AI is enormous and we are pushing the boundaries with our engineering, and all of this innovation is making its way into the Enterprise.

- In Traditional servers, demand improved double digits in Q3, making four consecutive quarters of Y/Y growth, driven by growing units and ASPs with denser core counts, memory, and storage per server.
- Customers are focusing on consolidation and power efficiency by modernizing their data centers with more efficient and dense 16G servers, freeing up valuable floor space and power that will support their AI infrastructure.
- In Storage, the demand environment continues to trail Traditional servers.
- PowerStore and PowerFlex demand grew double digits in the quarter, indicating that our focus on the midrange market, with product and software enhancements, will drive future growth and margin over time.
- The PowerScale F910 and F710 continue to ramp nicely, driving double digit demand growth in the Unstructured All Flash portfolio.

CSG

- In CSG, we saw continued stability with demand growth in Commercial PCs for the third quarter in a row.
- More Enterprise customers are beginning to refresh, albeit modest and in a more price competitive environment.

- We are seeing an indication that customers are lining up their upgrade cycles with new AI PCs in the first half of next year.
- A clear signal that enterprises are balancing their need to refresh and their desire to future-proof their purchases.
- Consumer demand and profitability continues to be challenged.
- We are optimistic about the coming PC refresh cycle as the install base continues to age, and with Windows 10 reaching end-of-life in 46 weeks.
- The significant advancements in AI-enabled architectures and application development are welcomed tailwinds.

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- In closing, AI is a robust opportunity for us in both ISG and CSG and interest in our portfolio is at an all-time high, with no signs of slowing down.
- That said, this business will not be linear, especially as customers navigate an underlying silicon roadmap that is changing.
- Regardless, we are winning deals at a price premium to our competition, delivering value across a much broader AI ecosystem.
- We have the balance sheet to grow the business and the credibility to deliver on our commitments to our customers.

- When you pair this with a recovering Traditional server market, impending PC refresh, and our updated storage portfolio, we are extremely well-positioned.
- Now over to Yvonne for the financials.

Yvonne

- Thanks Jeff.
- Let me begin with an overview of our performance then I'll jump into the specifics of ISG, CSG, cash and guidance.
- In the third quarter, we delivered strong results - including double digit revenue growth - while maintaining our focus on profitability.
- This resulted in EPS growth that out-paced revenue.
- Additionally, the business delivered strong cash performance.
- Our total revenue was up 10%, to $24.4 billion dollars. This was driven by continued strength in AI and Traditional servers. And our combined ISG and CSG business grew 13%.
- Gross margin was $5.4 billion dollars, or 22.3% of revenue. This is down 140 basis points due to an increase in our AI optimized server mix and a more competitive pricing environment, specifically in CSG.
- Operating expense was down 2% to $3.2 billion dollars, or 13.3% of revenue.

- We remain focused on unlocking efficiencies within our cost structure, and leveraging AI to reimagine our business and drive higher productivity.
- All of this while continuing to grow the business.
- Now, let's look at operating income.
- We delivered a 12% increase to $2.2 billion dollars, or 9.0% of revenue. This was driven by higher revenue and lower operating expenses, which were partially offset by a decline in our gross margin rate.
- Finally, Q3 net income was up 11% to $1.5 billion dollars, primarily driven by stronger operating income.
- And our diluted EPS was up 14% to $2.15.
- Now let's move to ISG, where we delivered another quarter of strong performance.

ISG

- ISG revenue was $11.4 billion dollars, up 34%.
- Servers and networking revenue was $7.4 billion dollars, up 58%. This was a Q3 record for us.
- And we continue to see strong demand across both Traditional and AI servers.
- Storage revenue was up 4% to $4.0 billion dollars.
- The overall demand environment in Storage continues to lag that of Traditional server.

- However, as Jeff mentioned, we saw double-digit demand growth in PowerStore and PowerFlex, two of our marquee midrange offerings.
- We had strong ISG operating income of $1.5 billion dollars, up 41%. This was driven primarily by higher revenue.
- Our ISG operating income rate was up again sequentially to 13.3% of revenue. The rate improvement of 230 basis points was the result of improving gross margins, especially in servers, and reduced operating expense.

CSG

- Now, let's turn to CSG.
- CSG revenue was down 1% to $12.1 billion dollars.
- Commercial revenue was up 3%, to $10.1 billion dollars, while Consumer revenue was down 18% to $2.0 billion.
- CSG operating income was $694 million dollars, or 5.7% of revenue. This is 50 basis points lower sequentially due to a more competitive pricing environment, primarily in the Consumer space.
- Enterprise demand was promising, though less than expected as we saw some demand push into future quarters.

- Profitability in the Commercial space held up well sequentially as customers continue to purchase more richly configured devices.
- Our Consumer business was weaker than expected as demand and profitability remain challenged.
- The PC refresh cycle is pushing into next year, but has significant tailwinds around an aging install base, AI-driven hardware enhancements like battery life, and Windows 10 end of life.

DFS

- Shifting gears, Dell Financial Services originations were down 11% to $1.6 billion in the third quarter.
- When you normalize for the exit of our VMware resale business and the sale of our Consumer revolving portfolio, DFS originations were up 4%, driven by strength in AI-optimized servers.

Cash flow and B/S

- Now, let’s move to cash flow and the balance sheet.
- Q3 cash flow from operations was $1.6 billion.
- This was primarily driven by profitability, partially offset by working capital.

- Our cash conversion cycle was negative 38 days with $6.7 billion in inventory, which is elevated compared to historical levels due to our AI server business and AI order linearity.
- We ended the quarter with $6.6 billion in cash and investments, up $0.6 billion dollars sequentially.
- This is the result of free cash flow generation partially offset by capital returns of $0.7 billion dollars.
- We repurchased 3.7 million shares of stock at an average price of $107.53 and paid a dividend of $0.45 cents per share.
- Since our capital return program began at the beginning of FY23, we've returned $9.8 billion dollars to shareholders through stock repurchases and dividends.
- Finally, our core leverage ratio was flat sequentially at 1.4x.

<u>Guidance</u>

- Now turning to guidance.
- The IT spending environment continues to be dynamic, with certain areas experiencing faster growth than others.
- That said, our business model is advantaged. We have a broad portfolio of solutions and a go to market engine that is poised to capture these opportunities.

- We expect the strength in our server business to continue.
- However, enterprise and large customers are being more mindful of their PC and Storage IT spend in the short-term.
- Against that backdrop, we expect Q4 revenue to be between $24 billion and $25 billion, up 10% at the midpoint of $24.5 billion.
    - With ISG and CSG combined growing 13% at the midpoint.
- We expect the ISG revenue growth rate to be up mid-twenties year-over-year, driven by AI and traditional servers.
- And we expect the CSG revenue growth rate to be up low-single digits year-over-year.
- Opex is expected to decline mid-single digits, as we continue to drive efficiencies in the business.
- We expect the Operating income rate to be up sequentially with continued improvement in ISG.
- We expect our Q4 diluted share count to be between 715 million and 719 million shares.
- And our diluted non-GAAP EPS is expected to be $2.50, plus or minus $0.10, up 14% at the midpoint
- At the midpoint of our full year guidance, revenue is expected to grow 9% and diluted non-GAAP EPS is expected to be $7.81, up 10% year over year

- Now turning to our fiscal year 2026.
- We'll provide formal guidance on our Q4 call, but I know that many of you have questions about our view on next year, so let me walk you through our current thinking.
- We expect multiple tailwinds going into next year.
- Including more robust AI demand supported by our strong five quarter pipeline. There's also an aging install base in both PCs and traditional servers that are prime for a refresh.
- We expect ISG growth to be driven primarily by AI servers, followed by traditional servers then storage.
- We expect CSG to grow, as enterprise customers refresh a large and aging install base.
- We'll continue to balance growth and profitability, managing price within the competitive landscape and input cost environment.
- And we'll continue to invest in the business while driving cost efficiencies across the portfolio.

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- In closing, I'm incredibly proud of the team and how we executed operationally.

- We remain focused on growth and profitability, always looking to optimize our margin rates and dollars.
- We have a unique operating model and strategy, where we leverage our strengths to extend our leadership positions and capture new growth.
- We have a strong control environment, differentiated cash conversion cycle, a strong balance sheet, financing capabilities with DFS, and investment grade ratings.
- All of these elements position us to win incremental business.
- Our confidence is underpinned by our forty year history of success and durable cash flow generation.
- I'll echo Jeff - we are extremely well-positioned as we look to Q4, FY26, and beyond.
- We are winning in AI, Traditional servers are recovering, we are positioning Storage for the long-term, and Commercial PCs are stabilizing and on the cusp of a refresh.
- As always, we'll continue to provide differentiated solutions for our customers and drive shareholder value.
- Now I'll turn it back to Paul to begin Q&A.