Q1 EARNINGS CONFERENCE
DAN KAFERLE
(10/24/95) 10/24/94 9:00MDT
RESV#1390047

Ladies and gentlemen, thank you for standing by. Welcome to the Digital Equipment Corporation first quarter financial results teleconference call. At this time, all participants are in a listen only mode. Later, we will conduct a question and answer session. At that time, if you have a question, you will need to press the one, followed by the four, on your push button phone. As a reminder, this conference is being recorded. I would now like to turn the conference over to Mr. Dan Kaferle. Please go ahead, sir.

Welcome and thank you for joining us. Our first quarter results news release is available on line through PRNewswire and Business Wire. This morning I have with me, Vin Mullarkey, Vice-president of Finance and Digital's Chief Financial Officer and Bill Strecker, Vice-president of the Advanced Technology group and Chief Technical Officer. Vin will take you through the quarter's results and then we will throw it open for questions. The teleconference will end promptly at 11:45. Vin --

Thank you, Dan. Good morning and thank you for calling in. I will review Digital's financial results and operational performance for the quarter and we will then take your questions.

Last quarter we stated that, in fiscal '96, management would focus on growth and improved profits as the company moves into what we have called our strategic growth phase. We are off to a very solid start. We are poised for continued market share growth and improved profitability.

For the first quarter of fiscal '96, we reported net income of forty-eight million dollars or twenty-six cents per common share compared with net loss of a hundred and thirty-one million, or ninety-eight cents per common share for the same period a year ago. This is the fourth consecutive quarter of profit for the company and represents a two hundred and forty-four million dollar improvement in operating profit on a year over year basis. The total operating revenues as reported for the quarter were three point three billion compared to three point one billion for the same quarter a year ago, a five percent increase. When adjusted for divestments, total revenue from ongoing businesses grew eleven percent on a year over year basis. On this basis, we record a strong revenue growth in our domestic and international markets. We had impressive growth in both the Americas as well as Asia Pacific. Europe, though somewhat softer, achieved growth as well.

I am pleased with the performance in our key product areas. Product revenues as reported increased ten percent year over year. When adjusted for divestments, total product revenues from ongoing operations grew by twenty-two percent reflecting the sixth consecutive quarter of year over year product revenue growth. In fact, this twenty-two percent level of product revenue growth positions Digital ahead of many of the industry leaders.

Our ALPHA systems business grew forty percent, driven by increase in demand for our scalable line of 64-bit ALPHA servers. Digital continues to receive favorable market reception and very positive ratings on the price performance advantages of mid-range service in high end 8000 family products.

With the new line of workstation products introduced this quarter and a new aggressive sales and marketing plan, we expect to see increasing demand and a (ramp) in the order rate as the year progresses. We are targeting specific technical markets including electronic and mechanical design, software development and science and research, where we have a clear competitive advantage. We are partnering with top application providers in each of these areas to ensure leadership application performance on ALPHA.

In September, we announced a new line of Intel and ALPHA based personal workstations that provide workstation performance at PC prices running Microsoft's Windows NT. The new line is easily upgraded from Intel to ALPHA 64-bit architecture.

ALPHA UNIX systems continue to grow approximately fifty percent year over year and we continue to see exceptional demand for Windows NT on our ALPHA platform, which grew over two hundred and fifty percent year over year with revenues now greater than two hundred million dollars annualized.

Our personal computer business, once again, captured market share growing at thirty-two percent year over year. I am particularly pleased with this performance. During the quarter, we developed additional retail sales channels including Circuit City and Office Max in the retail space. As you may recall, management has been taking action to balance the performance of our PC business, focusing on profitability, cash neutrality, and continued growth in market share. We are making good progress and expect that reasonable profits will be delivered in the second half of this fiscal year.

Our other products, business that grew by more than thirty percent, again after adjusting for divestments -- this includes network products, storage subsystem products, and Digital software products.

Service revenues declined one percent over last year. This is due mainly to the expected continued decline of older VAX maintenance business coupled with improved product liability and the associated lower price maintenance contracts of our new ALPHA product line. Digital's opportunity for growth in the service and support sector is excellent, however. Our successful multi-vendor customer service business continues to evidence significant growth and as our service partnerships and key technology alliances with Microsoft, Dell, Compaq, Novell and others develop, the revenue potential here is substantial.

Let me move to gross margins. At the beginning of the quarter at thirty-two percent, consistent with our short term business model. I expect margins to remain in this range in the short term with the potential for some improvement in the second half. While product gross margins improved some five points year over year, service gross margins declined approximately two points. This was expected as our very successful third party maintenance business, which has lower margins, continues to grow quite considerably.

Total operating expenses for the quarter were nine hundred and ninety-one billion dollars, compared to a billion one a year ago. This represents a twelve percent decrease in expenses year over year. Digital has achieved significant reductions in operating expenses. In fact, it has been eight years since expenses have been under one billion dollars. We continue to manage our cost structure while making the necessary investments to pursue new market opportunities. This next quarter we will make significant investments in demand generation activities in order to fully capitalize on our leadership products and services. We are investing to capture share.

In absolute dollars, I expect to see an increase in operating expenses in our December quarter, as the corporation rolls out a new demand generation marketing campaign and as volumes continue to increase.

Digital ended this quarter with sixty-one thousand five hundred employees. This represents a two hundred person reduction from the fourth quarter and a year over year decrease of seventeen percent or twelve thousand three hundred employees.

Relative to the balance sheet, cash increased six hundred and twenty million dollars versus quarter one a year ago to one point five billion. For the third consecutive quarter, we generated positive cash flow from operations before restructuring. Sequentially, our cash position was down a hundred million from quarter four. This was due, primarily, to increased inventory purchases to support demand for AlPHA products. I am confident in our asset management improvement programs as the company continues to work towards specific deliverables and targets which have been identified in each of the businesses. We have had positive cash flow, now, from operations for three consecutive quarters. I expect this to continue during the remainder of this fiscal year.

Relative to currency, with the strengthening of the U.S. dollar over the past three months, Digital experienced a slight unfavorable impact on the company's revenue in quarter one. Non-dollar denominated cost in foreign exchange option contracts, however, offset any negative impact to the bottom line.

So, in summary, our product revenue growth is accelerating to levels consistent with the industry leaders. Our profit performance continues to improve significantly. This past quarter, operating profits increased two hundred and forty-four million over the same quarter a year ago, representing the fourth consecutive quarter of profitability. Our product and service capabilities continues to win strong endorsements from customers and partners, particularly relative to our 64-bit system and software capability. We have a one to two year lead versus our competition and, finally, the outlook for the future continues to be positive.

Thank you. We will now take your questions.

Carla, will you please poll those on the line for any questions?

Ladies and gentlemen, we will now begin the question and answer session. If you have a question, you will need to press the one, followed by the four on your push button phone. You will hear a three tone prompt acknowledging your request and your questions will be polled in the order they are received. If your question has been answered and you would like to withdraw your polling request, you may do so by pressing the one, followed by the three on your push button phone. If you are using a speaker phone, please pick up your handset before pressing the numbers. One moment for the first question.

Terry Shannon, please state your company name, followed by your question.

Terry Shannon, Shannon (Knows DEC). Thank you very much and congratulations on your fourth consecutive quarterly profit. I have two very brief questions. First off, is the Computer Systems Division profitable yet and, secondly, what is the breakout of indirect versus direct revenue?

Yes, Terry. Relative to Computer Systems Division profitability, let me, I think, answer that question without the P.C. business. The answer is no. It was close, however. The, as you may recall in the June quarter, Enrico and his team were within twenty million or thirty million dollars of profitability. What they have going against them in the September quarter are the seasonally low revenues, so we did not plan for profit this quarter for that unit, nor did they achieve it. We expect that situation to be different, of course, as we move forward. The indirect channel mix for the September quarter was fifty-six percent, down a bit from the position of fifty-eight percent in the last fiscal year. You should not read that as negative but instead read that as a solid strength in both indirect and direct channels, in that total sales are up, as I said earlier, by twenty-two percent in the product area and, if direct sales factor element outgrew modestly the indirect channel, that's good news on both parts. So (now) a material change in the program in indirect channel areas continues to work quite well. Next question.

Thank you very much.

Maryanne Magee, please state your company name, followed by your question.

Yeah, hi. This is Maryanne Magee from Information Week. I just want to make sure I understood you correctly. You said that you thought operating expenses would increase the next quarter because of a new demand generation market campaign. I just want to make sure that I understood you correctly and maybe you could tell me a little bit about what that means.

Yes, you heard me correctly. We have had, in absolute terms -- I'm not moving away from percentages in terms of absolute dollars. We have had consistent reductions in expenses in this company for quite some period of time. This upcoming quarter, the December quarter, attempted to set an expectation here that we will see a slight change in that direction and a slight uptake in the expense levels and, although there are many areas of the company that we are still cutting back, there are some important areas that we are investing in and will continue to invest in.

This is a very important part of our strategic turnaround. The specific investment area that I referred to in my comments earlier, dealt with basically marketing support programs that are being introduced this quarter. There are everything from brand level activities to product specific activities to local show activities. The level of investment that we have in that area is quite significant this quarter compared to anything we have had over the last several quarters and, again, the objective is to capitalize on our very strong both product and service division today in the marketplace.

Okay.

I think if you watch ?? television over the course of November and December, some aspects of that program and the associated investments would be quite evident.

Right. So advertising and other types of marketing.

Yes, but we have a very -- but there's a -- in addition to that, a very aggressive marketing support program that has -- marketing, of course, goes well beyond advertising, that requires our resources throughout the world and, again, it is quite extensive and it's taking the story upward and taking advantage of today's strong position so it's -- but the part that will be most visible to you is likely to be in the advertising, in the advertising area both in media, as well as television.

Okay. Thank you.

Ken Johnson, please state your company name, followed by your question.

Hi. Ken Johnson, The Eagle Tribune. Would you talk a little bit more about your service business and while you feel that there is a potential for growth in revenues there?

Yes, Ken. Well, first of all, let me again point out that service business was down this past quarter by one percent as we had planned and I don't expect we will see growth in the service business for quite some time yet. The prospects for the service business, as I indicated in my earlier comments, are very positive as we look out a couple of years. These prospects are driven, are enfueled by a number of factors. One of the most significant elements is in the, what we call the multi-vendor service piece or, if you prefer, a third party maintenance piece. Witness the recent announcement that we made together with Compaq, Compaq Computer, where Digital was awarded the contract to provide worldwide service support to Compaq's server business. That's similar to a contract that we won some time ago with Dell Computer for their European business and so it goes. Those are two of a number of our major contracts that we won and more that we intend to win that takes excellent advantage of Digital's very strong and global service capability particularly with those companies that relative weak in service capability. This will translate into revenue growth of some significance in the service area; however, again I caution you, it's not imminent considering it takes a while to ramp this activity up. It's more a one and a half to two year time frame. There are many other aspects of our service area, as well, that are growing that would contribute to this opportunity that I refer to and they include our very successful PC utility program that continues to win awards, our software utility program, our network integration capability and our excellent system integration capability, among others.

Thank you.

Paul Nesdor, please state your company name, followed by your question.

Yes, Paul Nesdor, publisher Digital News and Review. I would like to know if you see the Microsoft Alliance or the so called Alliance for Enterprise computing as contributing significantly to CSD revenues in the next two quarters.

No, and the word I am keying on here, Paul, is the word significant. We will see our revenues this year -- well, let me say it this way. You were specific around CSD, which as you -- which includes the PC business and I assume that was your intent.

Yes.

This year we will do several hundreds of millions of dollars of business in the Windows, with Windows NT product and that's up from virtually zero a year ago. To my knowledge, there is no other vendor in the RISC arena that is, in the RISC architecture arena that is operating at that level of business. That would equate to approximately under ten percent of the business in CSD, seven or eight percent, so not significant. Of course, as we move out towards the end of the decade, we expect that to be very different. Digital endorses some of the projections that it has seen from many industry analysts that positions the Windows NT operating system at roughly forty percent or so of the IT systems industry as we approach into this decade, again, from zero or thereabouts in the recent past. There is no other vendor that is as well positioned as Digital to capture a sizeable piece of that emerging market so that, although it is not significant this year in the seven to eight percent range, we fully expect it to be very significant in the two to three year time frame.

Thank you.

Liz Gallese, please state your company name, followed by your question.

Yes, hello. This is Liz Gallese at Bloomberg Business News. When you commented on the Computer Systems Division's profits on the PC business, what is the story on the P.C. business? Is that profitable yet and, if not, when will it be profitable? What it profitable in the quarter?

Thank you for your question, Liz. No, it was not profitable in the quarter; although, it performed better than planned and certainly demonstrated some improvement over the June quarter. I expect it will be close to break even here in the December quarter and profitable in the second half of our fiscal year.

Okay, thank you.

Next question, please.

Chris Christianson, please state your company name, followed by your question. Mr. Christianson, go ahead.

Hi. This is Chris Christianson from International Data Corporation. If you would go into a little bit more detail on the change in revenue from products as well as the change in gross margins, that would be appreciated.

Yeah, I'll, Chris, I'll make a few comments on that. The ALPHA business overall is up forty percent growth wise this quarter. The growth levels within the ALPHA arena are very strong on the high end, the 8000 family and they are not strong on the lower end, the workstation arena. The mid range server business also continues to be very strong. The VAX business continues to decline as we planned and have been managing to, in fact, for several years now and is now a relatively insignificant part of Digital's systems business. It is about five percent, so we no longer see that as a significant factor as it relates to the revenue dynamics moving forward and continues to be a very significant factor in terms of our commitment to those customers and the ongoing supply, as well, of VAX platforms for those that prefer to operate VMS and the VAX environment versus the ALPHA environment. The transition from that VAX environment is going extraordinarily well to the ALPHA environment.

Thank you.

The PC -- one other point -- the PC business is growing at, this past quarter, at thirty-two percent and that includes the systems (cut).

Thank you very much.

Yes, Chris.

Aaron Zitner, please state your company name, followed by your question.

Yeah, Boston Globe. I just wanted to make sure I understood what you just said. Forty percent growth in the ALPHA business, thirty-two percent growth in the P.C. business, is that compared to the year ago quarter?

Yes, Aaron.

And that's on a revenue basis.

That's correct.

And when you say that VAX is five percent of the systems business, that means that within the computer systems business, selling hardware, VAX sales represent five percent of total systems sales.

VAX sales represent five percent of the company's product sales.

Of the whole company's product sales?

That's correct. None of my comments had to do with the CSD except for where the question was explicit around CSD. My comments are at the corporate level, Aaron. The -- but again, the key point that I made here is ALPHA growth at forty percent, approximately two times the growth rate in the industry for, particularly at the server level, doing extraordinarily well and exceeding our plans. PC growth, again, nearly two times, one and a half to two times the growth rate in the PC industry and, again, we are back to, back on the curve again for market share gains and overall growth, adjusted for divestiture, at twenty-two percent in the product area, putting Digital up there with all of the leaders, and ahead of many, in terms of product growth in the industry.

Can you say more about why the systems business is -- you said that is not profitable. Can you say why it is not profitable and when it will be?

Sure. The -- let me remind of a piece of important history here.

Sure.

Before Enrico Pesatori took over this business, when he was appointed by Bob Palmer approximately a year and a half ago, this business was losing a billion dollars.

A year?

A billion dollars a year.

Okay.

And that's roughly twenty-five percent of revenues. I mean, think of it. I mean, that's a very significant challenge for any manager to take on. The goals that Enrico took on, that were given to Enrico by Bob, were to bring this business to break even as soon as possible. So, here we are a year to a year and a half later on the edge of break even, an extraordinary accomplishment, an accomplishment that was achieved through a combination of our revenue growth, albeit modest, a significant upgrade and advancement of the product line, significant improvement in gross margins resulting from consolidating factories and distribution sites around the world and an extraordinary reduction in expenses, something on the order of a forty percent reduction collapse of expenses. So, all of that puts us on the edge of break even and we will be profitable very soon in this element of the business. Another point that I have mentioned, is that the, when assessing the profitability of our mainstream systems business, there are two elements to it, even though we are not organized the way I am going to explain it. There is the systems business and the associated after market product sales and that's what I was describing. Then there's the after market service business. It's the maintenance contract that goes with the refrigerator, if you would, or the lawn mower, or what have you. That latter piece of the business is not under, is not managed by Enrico but it is very much a part of the same business. When you put those two businesses together and look at the total business for Digital in the systems arena with after market products and services, it's quite profitable, double digit after tax return, today and, again, that would not have been the case had we not had the success over the last eighteen months as a result of Enrico's leadership. Is that clear, Aaron?

Yes, it is. Could I ask, in Mr. Pesatori's division, is profitability going to come exclusively from revenue growth or do you see more reductions in the work force there?

Primarily the former, revenue growth.

Are layoffs behind Digital now?

For the most part, yes. We have some modest layoffs planned for some parts of the world but, in the overall scheme of things, insignificant. I would say that on a net basis, I would expect population to be flat to up as we move forward over the next few quarters. In fact, even though this part quarter, the September quarter, even though our total population was down by some two hundred people, the company had hired some fifteen hundred people new to the company. This is reskilling. This is the company's commitment to a very successful strategic turnaround.

That's fifteen hundred within the quarter?

Within the quarter. It's commitment to bring in the skills that are required, particularly in the technical areas, whether it be to support our Mircosoft program that you may recall we announced recently or many of our other important technical programs. So, on a net basis, even though we will continue to see some level of reductions, on a net basis I would expect we will continue with the reskilling of the company and particularly in these technical areas as well as some of the marketing areas where we are upgrading our marketing capability and, overall, I would expect it to be flat to somewhat up over the next few quarters in terms of population.

Thank you.

Yes, next question, please.

Mr. Christianson, please state your follow up question.

Hi. This is Chris Christianson from International Data Corporation. I apologize if I missed the discussion, but is there any news on a semiconductor partner?

You didn't miss the discussion. The -- however, I will repeat what we have said previously and that is that as soon as we have news, we will disclose it. Of course, there is a lot of news in that we are very active on the support program and, as we communicated previously, we expect to have something announced before the end of the calendar year. We will not announce anything until we have consummated a definitive agreement with a partner. Next question, please.

Andrew Ellison, please state your company name, followed by your question.

Ellison. What is the current percentage of product revenues represented by ALPHA shipments?

Approximately twenty-four percent of -- excuse me. It is twenty-four percent of the company's product, total product revenues.

Thank you.

Just one other point on that, Andrew -- I know you are off the line, but one other point on that. That's for system level product sales. That could be, that should be increased by another ten points, or so, if you were to comprehend the after market product sales along with it. Next question, please.

Susan (Amahl), please state your company name, followed by your question.

DEC Computing Magazine, Susan (Amahl). I am a little unclear as to which parts of the business are profitable. So far you have said which ones aren't, so which ones are?

We -- as a matter of policy, don't disclose the, all of the financial performance of our business; although, we seem to be getting ourselves into that situation here with a, on an exception basis, but let me say that all other parts of the business are profitable. All other parts of the business are profitable and the two exceptions are the ones that I mentioned. On the other hand, let me repeat what I said on the systems business. The systems business is also profitable if you look at it as a total business and comprehend the service piece that compliments and, in that regard, it's fair to say that all of our businesses in Digital are profitable except for P.C.'s.

But the services part, is that profitable?

Yes, very profitable.

But you said revenue growth was down.

That's correct. That doesn't mean it's not profitable.

Right. Okay. What percentage of revenue do you expect the -- do you expect connectivity to contribute in the next two years?

Percentage of total revenues or product revenues?

Percentage of total revenue.

Approximately five percent. Again, that's specifically a software question or a total products?

Well, you set up the new connectivity software unit earlier this year and I am just wondering how much profit that will bring in.

In that time frame, approximately five percent. Total connectivity revenues, of course, would be much more significant, approaching twenty-five percent of the company's business.

Okay.

Next question, please.

If there are any additional questions, please press the one, followed by the four, at this time. Liz Gallese, please state your follow up question.

Hi. I just want to clarify, was that five percent of total revenue or total product revenue for the connectivity software business.

Product revenue.

Product revenue. Could I ask you how close you are to finding a new P.C. boss?

We are close to having something to announce here and I am not going to announce it on this line.

This week?

Let's say in the next few weeks. We expect it will be over the next few weeks.

Can I ask you one more?

Certainly.

The consensus for the year is around three ninety. Do you agree with that? Are you comfortable with it?

It would be the same answer I have given you in the past, I'm afraid. We don't make that level of projection on the company in terms of earnings, whether it be for the year or next quarter and I didn't realize it was three ninety but I guess it has been hovering in the three fifty to four dollar share range. The company is clearly on a track, a very firm track, of continuous improvement and, for the most part, has been doing extraordinarily well, particularly in the CSD unit, as I said earlier and so I think it is appropriate for you expect continuous improvement and I am not going to be specific in terms of quantifying the full year position at this point.

Is it appropriate to assume that the losses are behind you?

Absolutely. Thinking back about eighteen months, you might recall a couple of goals that Bob Palmer had not only set for the company but got the entire corporation to rally around quite successfully. One of those was to achieve break even or better in the December quarter of last year as a company and the second one was to achieve a sustainable level of profitability.

Incidentally, those two goals were among a number of others, but those were two of the highest priority goals for the entire company and, as you know, that first goal was achieved in the December quarter. In fact, it was exceeded by quite a bit. The second goal, on sustainability, the real test for that goal was this past quarter, this past September quarter and the reason for that is that we traditionally have a significant decline in revenues from a June quarter to the September quarter, driven by the significant amount of business that we do in Europe, which tends to be a weak quarter given the vacation patterns of Europe. So, although we had planned profitability for the quarter, we recognize that there was some risk that we wouldn't achieve it and that that would be the real test for this company in terms of sustainability and I am absolutely delighted to have the opportunity, on behalf of the company's management and employees this morning, to share with you that we have passed that test with flying colors at the, given the level of profit that we released and we look forward, with tremendous confidence, that we will improve upon this in the year's ahead.

May I ask one more?

Yes, you may.

Okay. The five percent increase in sales, is that what you see for the foreseeable future or where do you want to see that figure and within what time frame?

Well, again, I am going to be careful here of how much I disclose but let me say this. First of all, let me emphasize that the five percent in sales corresponds with an eleven percent sales growth level when you exclude divestitures. Now, again, the impact of divestitures is quite significant. As time passes, just because of that dynamic alone, you will see a fairly significant growth in our revenues, but having said that, looking forward from here, whether you look at it at the reported level, from a reported level of five percent or the other base, which is after divestitures, you can expect continuous improvement, quarter two as well as the second half of the fiscal year.

Thank you.

Carla, we have time for one more question.

Thank you. Aaron Zitner, please state your follow up question.

Mine has been answered. Thanks.

Thank you.

Terry Shannon, please state your question, followed by your company.

Terry Shannon, Shannon (Knows DEC). I have some questions on the ALPHA business. First off, what is the shipment split between ALPHA workstations and servers and, secondly, can you characterize what percentage of your ALPHA systems moved with open VMS, Digital UNIX and Windows NT?

Approximately two-thirds of the ALPHA business is server based and of the operating system, it's approximately fifty/fifty or forty-five -- roughly forty-five percent of the total ALPHA business today is UNIX, in fact, a little over forty-five percent. A little under forty-five percent is VMS based. The remaining, roughly, ten percent is the emerging Windows NT business which, as I pointed out earlier, is approaching a level of a couple of a hundred million dollars, or so, annualized at the system level, much greater than that in terms of total revenue.

Okay. In other words, back to the workstations and servers, if two-thirds of your business now is server based, that's a dramatic improvement over a year ago when it was between twenty-five and thirty percent server based.

It's extraordinary. The server line, particularly the 2100 line, has been consistently doing well over the last year with extraordinary growth levels, consistently it's gaining market share and ?? growth in the market and, as you know, the 8000 family that was announced this past June quarter which we have very high expectations for, we continue to exceed those expectations. There is no yearly growth factor because we weren't in that business a year ago and, as I pointed out in my opening comments, the market reception to that product has been extraordinary and we are quite optimistic that this will continue as we move forward. These are also systems that have fairly rich margins associated with them and they are also frequently complicated, large complicated applications that require significant service, have significant service content with them, as well.

Okay. Thank you very much.

It's a pleasure.

This concludes Digital's first quarter results teleconference. If you have further questions, please call me at 508-493-2195. Thank you for joining us.

Ladies and gentlemen, this does conclude your conference for today. You may all disconnect and thank you for participating.

End of conference +++

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Welcome and thank you for joining us. Our first quarter results news release is available on line through PRNewswire and Business Wire. This morning I have with me, Vin Mullarkey, Vice-president of Finance and Digital's Chief Financial Officer and Bill Strecker, Vice-president of the Advanced Technology group and Chief Technical Officer. Vin will take you through the quarter's results and then we will throw it open for questions. The teleconference will end promptly at 11:45. Vin --

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Our personal computer business, once again, captured market share growing at thirty-two percent year over year. I am particularly pleased with this performance. During the quarter, we developed additional retail sales channels including Circuit City and Office Max in the retail space. As you may recall, management has been taking action to balance the performance of our PC business, focusing on profitability, cash neutrality, and continued growth in market share. We are making good progress and expect that reasonable profits will be delivered in the second half of this fiscal year.

Our other products, business that grew by more than thirty percent, again after adjusting for divestments -- this includes network products, storage subsystem products, and Digital software products.

Service revenues declined one percent over last year. This is due mainly to the expected continued decline of older VAX maintenance business coupled with improved product liability and the associated lower price maintenance contracts of our new ALPHA product line. Digital's opportunity for growth in the service and support sector is excellent, however. Our successful multi-vendor customer service business continues to evidence significant growth and as our service partnerships and key technology alliances with Microsoft, Dell, Compaq, Novell and others develop, the revenue potential here is substantial.

Let me move to gross margins. At the beginning of the quarter at thirty-two percent, consistent with our short term business model. I expect margins to remain in this range in the short term with the potential for some improvement in the second half. While product gross margins improved some five points year over year, service gross margins declined approximately two points. This was expected as our very successful third party maintenance business, which has lower margins, continues to grow quite considerably.

Total operating expenses for the quarter were nine hundred and ninety-one billion dollars, compared to a billion one a year ago. This represents a twelve percent decrease in expenses year over year. Digital has achieved significant reductions in operating expenses. In fact, it has been eight years since expenses have been under one billion dollars. We continue to manage our cost structure while making the necessary investments to pursue new market opportunities. This next quarter we will make significant investments in demand generation activities in order to fully capitalize on our leadership products and services. We are investing to capture share.

In absolute dollars, I expect to see an increase in operating expenses in our December quarter, as the corporation rolls out a new demand generation marketing campaign and as volumes continue to increase.

Digital ended this quarter with sixty-one thousand five hundred employees. This represents a two hundred person reduction from the fourth quarter and a year over year decrease of seventeen percent or twelve thousand three hundred employees.

Relative to the balance sheet, cash increased six hundred and twenty million dollars versus quarter one a year ago to one point five billion. For the third consecutive quarter, we generated positive cash flow from operations before restructuring. Sequentially, our cash position was down a hundred million from quarter four. This was due, primarily, to increased inventory purchases to support demand for AlPHA products. I am confident in our asset management improvement programs as the company continues to work towards specific deliverables and targets which have been identified in each of the businesses. We have had positive cash flow, now, from operations for three consecutive quarters. I expect this to continue during the remainder of this fiscal year.

Relative to currency, with the strengthening of the U.S. dollar over the past three months, Digital experienced a slight unfavorable impact on the company's revenue in quarter one. Non-dollar denominated cost in foreign exchange option contracts, however, offset any negative impact to the bottom line.

So, in summary, our product revenue growth is accelerating to levels consistent with the industry leaders. Our profit performance continues to improve significantly. This past quarter, operating profits increased two hundred and forty-four million over the same quarter a year ago, representing the fourth consecutive quarter of profitability. Our product and service capabilities continues to win strong endorsements from customers and partners, particularly relative to our 64-bit system and software capability. We have a one to two year lead versus our competition and, finally, the outlook for the future continues to be positive.

Thank you. We will now take your questions.

Carla, will you please poll those on the line for any questions?

Ladies and gentlemen, we will now begin the question and answer session. If you have a question, you will need to press the one, followed by the four on your push button phone. You will hear a three tone prompt acknowledging your request and your questions will be polled in the order they are received. If your question has been answered and you would like to withdraw your polling request, you may do so by pressing the one, followed by the three on your push button phone. If you are using a speaker phone, please pick up your handset before pressing the numbers. One moment for the first question.

Terry Shannon, please state your company name, followed by your question.

Terry Shannon, Shannon (Knows DEC). Thank you very much and congratulations on your fourth consecutive quarterly profit. I have two very brief questions. First off, is the Computer Systems Division profitable yet and, secondly, what is the breakout of indirect versus direct revenue?

Yes, Terry. Relative to Computer Systems Division profitability, let me, I think, answer that question without the P.C. business. The answer is no. It was close, however. The, as you may recall in the June quarter, Enrico and his team were within twenty million or thirty million dollars of profitability. What they have going against them in the September quarter are the seasonally low revenues, so we did not plan for profit this quarter for that unit, nor did they achieve it. We expect that situation to be different, of course, as we move forward. The indirect channel mix for the September quarter was fifty-six percent, down a bit from the position of fifty-eight percent in the last fiscal year. You should not read that as negative but instead read that as a solid strength in both indirect and direct channels, in that total sales are up, as I said earlier, by twenty-two percent in the product area and, if direct sales factor element outgrew modestly the indirect channel, that's good news on both parts. So (now) a material change in the program in indirect channel areas continues to work quite well. Next question.

Thank you very much.

Maryanne Magee, please state your company name, followed by your question.

Yeah, hi. This is Maryanne Magee from Information Week. I just want to make sure I understood you correctly. You said that you thought operating expenses would increase the next quarter because of a new demand generation market campaign. I just want to make sure that I understood you correctly and maybe you could tell me a little bit about what that means.

Yes, you heard me correctly. We have had, in absolute terms -- I'm not moving away from percentages in terms of absolute dollars. We have had consistent reductions in expenses in this company for quite some period of time. This upcoming quarter, the December quarter, attempted to set an expectation here that we will see a slight change in that direction and a slight uptake in the expense levels and, although there are many areas of the company that we are still cutting back, there are some important areas that we are investing in and will continue to invest in.

This is a very important part of our strategic turnaround. The specific investment area that I referred to in my comments earlier, dealt with basically marketing support programs that are being introduced this quarter. There are everything from brand level activities to product specific activities to local show activities. The level of investment that we have in that area is quite significant this quarter compared to anything we have had over the last several quarters and, again, the objective is to capitalize on our very strong both product and service division today in the marketplace.

Okay.

I think if you watch ?? television over the course of November and December, some aspects of that program and the associated investments would be quite evident.

Right. So advertising and other types of marketing.

Yes, but we have a very -- but there's a -- in addition to that, a very aggressive marketing support program that has -- marketing, of course, goes well beyond advertising, that requires our resources throughout the world and, again, it is quite extensive and it's taking the story upward and taking advantage of today's strong position so it's -- but the part that will be most visible to you is likely to be in the advertising, in the advertising area both in media, as well as television.

Okay. Thank you.

Ken Johnson, please state your company name, followed by your question.

Hi. Ken Johnson, The Eagle Tribune. Would you talk a little bit more about your service business and while you feel that there is a potential for growth in revenues there?

Yes, Ken. Well, first of all, let me again point out that service business was down this past quarter by one percent as we had planned and I don't expect we will see growth in the service business for quite some time yet. The prospects for the service business, as I indicated in my earlier comments, are very positive as we look out a couple of years. These prospects are driven, are enfueled by a number of factors. One of the most significant elements is in the, what we call the multi-vendor service piece or, if you prefer, a third party maintenance piece. Witness the recent announcement that we made together with Compaq, Compaq Computer, where Digital was awarded the contract to provide worldwide service support to Compaq's server business. That's similar to a contract that we won some time ago with Dell Computer for their European business and so it goes. Those are two of a number of our major contracts that we won and more that we intend to win that takes excellent advantage of Digital's very strong and global service capability particularly with those companies that relative weak in service capability. This will translate into revenue growth of some significance in the service area; however, again I caution you, it's not imminent considering it takes a while to ramp this activity up. It's more a one and a half to two year time frame. There are many other aspects of our service area, as well, that are growing that would contribute to this opportunity that I refer to and they include our very successful PC utility program that continues to win awards, our software utility program, our network integration capability and our excellent system integration capability, among others.

Thank you.

Paul Nesdor, please state your company name, followed by your question.

Yes, Paul Nesdor, publisher Digital News and Review. I would like to know if you see the Microsoft Alliance or the so called Alliance for Enterprise computing as contributing significantly to CSD revenues in the next two quarters.

No, and the word I am keying on here, Paul, is the word significant. We will see our revenues this year -- well, let me say it this way. You were specific around CSD, which as you -- which includes the PC business and I assume that was your intent.

Yes.

This year we will do several hundreds of millions of dollars of business in the Windows, with Windows NT product and that's up from virtually zero a year ago. To my knowledge, there is no other vendor in the RISC arena that is, in the RISC architecture arena that is operating at that level of business. That would equate to approximately under ten percent of the business in CSD, seven or eight percent, so not significant. Of course, as we move out towards the end of the decade, we expect that to be very different. Digital endorses some of the projections that it has seen from many industry analysts that positions the Windows NT operating system at roughly forty percent or so of the IT systems industry as we approach into this decade, again, from zero or thereabouts in the recent past. There is no other vendor that is as well positioned as Digital to capture a sizeable piece of that emerging market so that, although it is not significant this year in the seven to eight percent range, we fully expect it to be very significant in the two to three year time frame.

Thank you.

Liz Gallese, please state your company name, followed by your question.

Yes, hello. This is Liz Gallese at Bloomberg Business News. When you commented on the Computer Systems Division's profits on the PC business, what is the story on the P.C. business? Is that profitable yet and, if not, when will it be profitable? What it profitable in the quarter?

Thank you for your question, Liz. No, it was not profitable in the quarter; although, it performed better than planned and certainly demonstrated some improvement over the June quarter. I expect it will be close to break even here in the December quarter and profitable in the second half of our fiscal year.

Okay, thank you.

Next question, please.

Chris Christianson, please state your company name, followed by your question. Mr. Christianson, go ahead.

Hi. This is Chris Christianson from International Data Corporation. If you would go into a little bit more detail on the change in revenue from products as well as the change in gross margins, that would be appreciated.

Yeah, I'll, Chris, I'll make a few comments on that. The ALPHA business overall is up forty percent growth wise this quarter. The growth levels within the ALPHA arena are very strong on the high end, the 8000 family and they are not strong on the lower end, the workstation arena. The mid range server business also continues to be very strong. The VAX business continues to decline as we planned and have been managing to, in fact, for several years now and is now a relatively insignificant part of Digital's systems business. It is about five percent, so we no longer see that as a significant factor as it relates to the revenue dynamics moving forward and continues to be a very significant factor in terms of our commitment to those customers and the ongoing supply, as well, of VAX platforms for those that prefer to operate VMS and the VAX environment versus the ALPHA environment. The transition from that VAX environment is going extraordinarily well to the ALPHA environment.

Thank you.

The PC -- one other point -- the PC business is growing at, this past quarter, at thirty-two percent and that includes the systems (cut).

Thank you very much.

Yes, Chris.

Aaron Zitner, please state your company name, followed by your question.

Yeah, Boston Globe. I just wanted to make sure I understood what you just said. Forty percent growth in the ALPHA business, thirty-two percent growth in the P.C. business, is that compared to the year ago quarter?

Yes, Aaron.

And that's on a revenue basis.

That's correct.

And when you say that VAX is five percent of the systems business, that means that within the computer systems business, selling hardware, VAX sales represent five percent of total systems sales.

VAX sales represent five percent of the company's product sales.

Of the whole company's product sales?

That's correct. None of my comments had to do with the CSD except for where the question was explicit around CSD. My comments are at the corporate level, Aaron. The -- but again, the key point that I made here is ALPHA growth at forty percent, approximately two times the growth rate in the industry for, particularly at the server level, doing extraordinarily well and exceeding our plans. PC growth, again, nearly two times, one and a half to two times the growth rate in the PC industry and, again, we are back to, back on the curve again for market share gains and overall growth, adjusted for divestiture, at twenty-two percent in the product area, putting Digital up there with all of the leaders, and ahead of many, in terms of product growth in the industry.

Can you say more about why the systems business is -- you said that is not profitable. Can you say why it is not profitable and when it will be?

Sure. The -- let me remind of a piece of important history here.

Sure.

Before Enrico Pesatori took over this business, when he was appointed by Bob Palmer approximately a year and a half ago, this business was losing a billion dollars.

A year?

A billion dollars a year.

Okay.

And that's roughly twenty-five percent of revenues. I mean, think of it. I mean, that's a very significant challenge for any manager to take on. The goals that Enrico took on, that were given to Enrico by Bob, were to bring this business to break even as soon as possible. So, here we are a year to a year and a half later on the edge of break even, an extraordinary accomplishment, an accomplishment that was achieved through a combination of our revenue growth, albeit modest, a significant upgrade and advancement of the product line, significant improvement in gross margins resulting from consolidating factories and distribution sites around the world and an extraordinary reduction in expenses, something on the order of a forty percent reduction collapse of expenses. So, all of that puts us on the edge of break even and we will be profitable very soon in this element of the business. Another point that I have mentioned, is that the, when assessing the profitability of our mainstream systems business, there are two elements to it, even though we are not organized the way I am going to explain it. There is the systems business and the associated after market product sales and that's what I was describing. Then there's the after market service business. It's the maintenance contract that goes with the refrigerator, if you would, or the lawn mower, or what have you. That latter piece of the business is not under, is not managed by Enrico but it is very much a part of the same business. When you put those two businesses together and look at the total business for Digital in the systems arena with after market products and services, it's quite profitable, double digit after tax return, today and, again, that would not have been the case had we not had the success over the last eighteen months as a result of Enrico's leadership. Is that clear, Aaron?

Yes, it is. Could I ask, in Mr. Pesatori's division, is profitability going to come exclusively from revenue growth or do you see more reductions in the work force there?

Primarily the former, revenue growth.

Are layoffs behind Digital now?

For the most part, yes. We have some modest layoffs planned for some parts of the world but, in the overall scheme of things, insignificant. I would say that on a net basis, I would expect population to be flat to up as we move forward over the next few quarters. In fact, even though this part quarter, the September quarter, even though our total population was down by some two hundred people, the company had hired some fifteen hundred people new to the company. This is reskilling. This is the company's commitment to a very successful strategic turnaround.

That's fifteen hundred within the quarter?

Within the quarter. It's commitment to bring in the skills that are required, particularly in the technical areas, whether it be to support our Mircosoft program that you may recall we announced recently or many of our other important technical programs. So, on a net basis, even though we will continue to see some level of reductions, on a net basis I would expect we will continue with the reskilling of the company and particularly in these technical areas as well as some of the marketing areas where we are upgrading our marketing capability and, overall, I would expect it to be flat to somewhat up over the next few quarters in terms of population.

Thank you.

Yes, next question, please.

Mr. Christianson, please state your follow up question.

Hi. This is Chris Christianson from International Data Corporation. I apologize if I missed the discussion, but is there any news on a semiconductor partner?

You didn't miss the discussion. The -- however, I will repeat what we have said previously and that is that as soon as we have news, we will disclose it. Of course, there is a lot of news in that we are very active on the support program and, as we communicated previously, we expect to have something announced before the end of the calendar year. We will not announce anything until we have consummated a definitive agreement with a partner. Next question, please.

Andrew Ellison, please state your company name, followed by your question.

Ellison. What is the current percentage of product revenues represented by ALPHA shipments?

Approximately twenty-four percent of -- excuse me. It is twenty-four percent of the company's product, total product revenues.

Thank you.

Just one other point on that, Andrew -- I know you are off the line, but one other point on that. That's for system level product sales. That could be, that should be increased by another ten points, or so, if you were to comprehend the after market product sales along with it. Next question, please.

Susan (Amahl), please state your company name, followed by your question.

DEC Computing Magazine, Susan (Amahl). I am a little unclear as to which parts of the business are profitable. So far you have said which ones aren't, so which ones are?

We -- as a matter of policy, don't disclose the, all of the financial performance of our business; although, we seem to be getting ourselves into that situation here with a, on an exception basis, but let me say that all other parts of the business are profitable. All other parts of the business are profitable and the two exceptions are the ones that I mentioned. On the other hand, let me repeat what I said on the systems business. The systems business is also profitable if you look at it as a total business and comprehend the service piece that compliments and, in that regard, it's fair to say that all of our businesses in Digital are profitable except for P.C.'s.

But the services part, is that profitable?

Yes, very profitable.

But you said revenue growth was down.

That's correct. That doesn't mean it's not profitable.

Right. Okay. What percentage of revenue do you expect the -- do you expect connectivity to contribute in the next two years?

Percentage of total revenues or product revenues?

Percentage of total revenue.

Approximately five percent. Again, that's specifically a software question or a total products?

Well, you set up the new connectivity software unit earlier this year and I am just wondering how much profit that will bring in.

In that time frame, approximately five percent. Total connectivity revenues, of course, would be much more significant, approaching twenty-five percent of the company's business.

Okay.

Next question, please.

If there are any additional questions, please press the one, followed by the four, at this time. Liz Gallese, please state your follow up question.

Hi. I just want to clarify, was that five percent of total revenue or total product revenue for the connectivity software business.

Product revenue.

Product revenue. Could I ask you how close you are to finding a new P.C. boss?

We are close to having something to announce here and I am not going to announce it on this line.

This week?

Let's say in the next few weeks. We expect it will be over the next few weeks.

Can I ask you one more?

Certainly.

The consensus for the year is around three ninety. Do you agree with that? Are you comfortable with it?

It would be the same answer I have given you in the past, I'm afraid. We don't make that level of projection on the company in terms of earnings, whether it be for the year or next quarter and I didn't realize it was three ninety but I guess it has been hovering in the three fifty to four dollar share range. The company is clearly on a track, a very firm track, of continuous improvement and, for the most part, has been doing extraordinarily well, particularly in the CSD unit, as I said earlier and so I think it is appropriate for you expect continuous improvement and I am not going to be specific in terms of quantifying the full year position at this point.

Is it appropriate to assume that the losses are behind you?

Absolutely. Thinking back about eighteen months, you might recall a couple of goals that Bob Palmer had not only set for the company but got the entire corporation to rally around quite successfully. One of those was to achieve break even or better in the December quarter of last year as a company and the second one was to achieve a sustainable level of profitability.

Incidentally, those two goals were among a number of others, but those were two of the highest priority goals for the entire company and, as you know, that first goal was achieved in the December quarter. In fact, it was exceeded by quite a bit. The second goal, on sustainability, the real test for that goal was this past quarter, this past September quarter and the reason for that is that we traditionally have a significant decline in revenues from a June quarter to the September quarter, driven by the significant amount of business that we do in Europe, which tends to be a weak quarter given the vacation patterns of Europe. So, although we had planned profitability for the quarter, we recognize that there was some risk that we wouldn't achieve it and that that would be the real test for this company in terms of sustainability and I am absolutely delighted to have the opportunity, on behalf of the company's management and employees this morning, to share with you that we have passed that test with flying colors at the, given the level of profit that we released and we look forward, with tremendous confidence, that we will improve upon this in the year's ahead.

May I ask one more?

Yes, you may.

Okay. The five percent increase in sales, is that what you see for the foreseeable future or where do you want to see that figure and within what time frame?

Well, again, I am going to be careful here of how much I disclose but let me say this. First of all, let me emphasize that the five percent in sales corresponds with an eleven percent sales growth level when you exclude divestitures. Now, again, the impact of divestitures is quite significant. As time passes, just because of that dynamic alone, you will see a fairly significant growth in our revenues, but having said that, looking forward from here, whether you look at it at the reported level, from a reported level of five percent or the other base, which is after divestitures, you can expect continuous improvement, quarter two as well as the second half of the fiscal year.

Thank you.

Carla, we have time for one more question.

Thank you. Aaron Zitner, please state your follow up question.

Mine has been answered. Thanks.

Thank you.

Terry Shannon, please state your question, followed by your company.

Terry Shannon, Shannon (Knows DEC). I have some questions on the ALPHA business. First off, what is the shipment split between ALPHA workstations and servers and, secondly, can you characterize what percentage of your ALPHA systems moved with open VMS, Digital UNIX and Windows NT?

Approximately two-thirds of the ALPHA business is server based and of the operating system, it's approximately fifty/fifty or forty-five -- roughly forty-five percent of the total ALPHA business today is UNIX, in fact, a little over forty-five percent. A little under forty-five percent is VMS based. The remaining, roughly, ten percent is the emerging Windows NT business which, as I pointed out earlier, is approaching a level of a couple of a hundred million dollars, or so, annualized at the system level, much greater than that in terms of total revenue.

Okay. In other words, back to the workstations and servers, if two-thirds of your business now is server based, that's a dramatic improvement over a year ago when it was between twenty-five and thirty percent server based.

It's extraordinary. The server line, particularly the 2100 line, has been consistently doing well over the last year with extraordinary growth levels, consistently it's gaining market share and ?? growth in the market and, as you know, the 8000 family that was announced this past June quarter which we have very high expectations for, we continue to exceed those expectations. There is no yearly growth factor because we weren't in that business a year ago and, as I pointed out in my opening comments, the market reception to that product has been extraordinary and we are quite optimistic that this will continue as we move forward. These are also systems that have fairly rich margins associated with them and they are also frequently complicated, large complicated applications that require significant service, have significant service content with them, as well.

Okay. Thank you very much.

It's a pleasure.

This concludes Digital's first quarter results teleconference. If you have further questions, please call me at 508-493-2195. Thank you for joining us.

Ladies and gentlemen, this does conclude your conference for today. You may all disconnect and thank you for participating.

End of conference +++

DIGITAL EQUIPMENT CORPORATION
2nd Quarter Financial Results Teleconference
January 23, 1996

MOD: Ladies and gentleman, thank you for standing by.

Welcome to the Digital Equipment Corporation conference call. At this time all participants are in a listen only mode. Later we will conduct a question and answer session. At that time if you have a question you will need to press the "1", followed by the "4", on your push button phone. As a reminder this conference is being recorded today, January 23, 1996. Your speakers for today are Mr. Dan Kaferle, Manager of Financial Media Relations for Digital Equipment, Mr. Bob Palmer, Chief Executive Officer for Digital Equipment and Mr. Vin Malarkey, Vice President and Chief Financial Officer for Digital Equipment. I would now like to turn the conference over to Mr. Kaferle. Please go ahead, sir.

DK: Good morning and welcome to Digital Equipment's second quarter earnings teleconference. Thank you for calling in. Our second quarter earnings release is available on PR Newswire and can be accessed through the Digital home page on the World Wide Web. We will also have a post view number to call to hear a recording of the teleconference, beginning at 12:30, the details will be discussed at the conclusion of the teleconference.

This morning I have with me Digital Chairman Bob Palmer and Digital Chief Financial Officer Vin Malarkey. Bob will open the teleconference with an overview of the quarter and then Vin will go over the numbers in more depth. We will then open the session up to questions. The teleconference will end promptly at 11:45.

Bob.

BP: Good morning and thank you for joining us today. It was just one year ago that Digital announced its return to profitability, a watershed event in our financial turnaround. The real test was whether we could sustain and build upon that achievement. With net income increasing to $149 million in the second quarter of our fiscal 1996, we have now reported five consecutive profitable quarters. Of course, our return to profitability was just the first proof point of Digital's turnaround. We also needed to show that we could grow the revenue. That is a top priority for fiscal year '96 and beyond and I am pleased to report that our Q2 results contain strong evidence of our progress. Digital's revenue growth accelerated in the last quarter. In fact, we achieved the highest quarterly revenues in the company's history, almost $4 billion. We reported significant growth in product revenues, which were up 26% year over year. This demonstrates very clearly that market demand for Digital's products and services is growing and I expect continued progress as we move into the second half of our fiscal year.

We are seeing growth all across our company, from PCS and servers to storage sub-systems, network products, and multi-vendor customer services, and across all geographies. What I want to emphasize this morning is the growing market demand for 64-bit computing, in particular Digital's Alpha systems. Vin is going to go through the quarterly numbers in a moment but let me give you some facts about our Alpha systems business. Sales of Alpha systems grew 50% over last year, driven by strong market demand for our Alpha server systems. However, we also reported revenue growth and strong order rate growth in our Alpha workstation business, with particularly significant growth in workstation shipping with Windows NT.

Total cumulative product and service revenue from the Alpha family now exceeds $7 billion and we have shipped almost 170,000 Alpha systems in less than three years. Few other new architectures have been accepted so rapidly. Customers are beginning to fully appreciate the benefits of working in the 64-bit environment. They want affordable client/server computing at blinding speeds. They want 64-bit UNIX, with all of its robustness and security. They would prefer to grow for the next decade and beyond without needing to endure additional operating system and architectural migrations. Digital's Alpha systems meet these requirements.

The transition to 64-bit computing is not only inevitable, it is already under way. With Alpha we are giving customers compelling reasons to move today. I can think of no better example than our powerful new servers, the Alpha Server 8000 family. With 64-bit Digital UNIX and the very large memory capabilities made possible by Oracle's 64-bit database software, these systems do more than just speed up current business processes. They enable entirely new standards of cost performance for mission critical applications, from data warehousing to online transaction processing. Customers can run some database intensive, mainframe operations at 200 times the speed of a mainframe for 1/20th the cost of ownership.

The evidence of our leadership is more than anecdotal. We now have solid proof of the industry-leading performance and price performance that Alpha 64-bit computing delivers to customers. Over the last three months Digital and its partners announced a number of database and application performance benchmarks for Alpha Server 8400 systems, running Digital UNIX, a 64-bit operating system. Two excellent examples are Oracle's very large memory database TPCC benchmarks and the SAP software benchmark for SAP R3. These benchmarks shattered previous records and clearly established Digital's superiority in high-performance enterprise computing.

Demand is growing rapidly. In only nine months we have sold 1,000 Alpha Server 8000 systems. Sybase, Informix, Software AG, and other leading database vendors are all working with us on their own 64-bit VLM database software. They see big growth opportunities in this market and they intend to be part of it. Windows NT is also going to be a key driver of our Alpha business.

You may recall that as part of our alliance for enterprise computing Microsoft agreed to release Windows NT server software simultaneously on both Alpha and Intel architectures. Even though Windows NT is a 32-bit operating system it runs faster on Digital's Alpha platform than on any other system.

Our partnership with Microsoft continues to build momentum as we develop cooperative sales and marketing opportunities, solidify our joint engineering relationships, expand our customer service capability, and work together to bring Windows based solutions to enterprise computing. The alliance is a key factor in the growth of our Windows NT business. Windows NT revenue was up more than 100% in Q2.

We also see another exploding market where 64-bit computing will play an increasingly important role, the Internet. Many of the emerging applications on the Internet, like interactive video and three dimensional animation, will absolutely require instant access to massive databases. These applications will have to handle thousands of simultaneous requests from thousands of concurrent users. Digital believes that there are at least three reasons why this new environment will demand 64-bit computing. First, sheer speed. For example, to enable rapid response to informational queries or to enable complex modeling and real-time simulations to be efficiently performed. Second, virtually unlimited memory addressability for instant access to massive databases. Third, affordability. Better than mainframe performance at prices usually associated with workstations and servers.

Just look at the Internet Super Spider technology that Digital introduced last month under the code name Alta Vista. It provides fast, easy access to more than 16 million Web pages on the Internet at speeds that are orders of magnitude greater than any other search service. It is the largest, fastest Web search engine in the world, with an average query answered in under one second. After only three weeks the average number of hits on this Alpha server is more than 2 million each day.

Although we've established a leadership position in 64-bit enterprise and technical computing, we recognize that we will soon face increasing competition in the 64-bit market. Some of our major competitors will finally ship 64-bit systems in the near future, more than three years after we began to do so. But let me point out that they will still have a very difficult and complicated transition to make from 32-bit computing. Having the chips in a box is a good start, but you also need a 64-bit operating system, and application migration tools, and training, and so on. The application migrations are usually not trivial. In some cases, competitors are telling their customers that they will need to make multiple migrations in the next few years as they change the underlying architectures. That gives Digital a significant opportunity to grow our business and solidify our position as the industry leader in 64-bit computing, with a consistent scalable architecture and modern 64-bit standards compliant UNIX.

I would like to now turn the program over to Vin Malarkey, our Chief Financial Officer.

VM: Thank you, Bob. Good morning. Our story at Digital for fiscal '96 is revenue growth and improved profitability. Last quarter Digital delivered record level quarterly revenues and achieved our best financial performance in over five years. Quarter two was our fifth consecutive quarter with improved bottom line performance, reporting a net income of $149 million. This performance is the result of continued operational improvements across the company. With a Quarter Two net profit level of 4% we have achieved an 8 point profit improvement in eighteen months and we are within a margin point of the 5% net income goal that we set early last fiscal year.

Last quarter revenue performance is another proof point of our successful corporate strategy. The 14% revenue growth was our highest in nearly five years. The 26% product sales growth, which is 30% adjusted for divestments, is our strongest growth since 1984 and positions Digital with the leaders of the computer industry.

We are seeing strong demand in all of our key product areas. Alpha Systems are up over 50% year over year, driven by increasing demand for 64-bit computing. We achieved growth at all levels of the Alpha product line, entry service as well as workstations. We're seeing continued very strong demand for Turbo Laser, with revenues that are doubled over last quarter, and an increase in list of new customer wins. Last quarter Digital rolled out a new line of workstations, coupled with an aggressive sales and marketing plan. We are beginning to see positive results from these efforts, as we achieve growth in our Alpha workstations business.

Our component products businesses grew by more than 30%. This includes our network product business, with its successful enVISN architecture, and the storage business unit, with their industry leading Storage Works product line. Our personal computer business continued to capture market share, growing over 40% last quarter. Our service businesses also performed well during the second quarter. The multi-vendor maintenance business had sales growth over 35% and the overall networking and systems integration business achieved improved growth performance. We continue to see a predictable decline, on the order of some 5%, in our Digital product maintenance business. We expect to see our higher growth service offerings pull our total service business into a growth mode over the next several quarters.

We continue to show overall gross margin improvement with our Quarter Two performance at 32.6%. This is ahead of our short term business model. I expect to see continued improvements in gross margins, with product gross margins improving at a rate faster than the decline in service margins. Product gross margins are on a consistent continuous improvement path, up some seven points or nearly 30% over the last 18 months.

These improvements are the result of higher volumes on fewer products, higher margin product mix, improved focus on designing for lower cost, and the divestiture of non-strategic low margin products.

As previously projected, service margins declined for the quarter. This was a result of more growth in profitable but lower margin multi-vendor services. Total operating expenses for the quarter were $1.1 billion. This represents a slight reduction over the comparable quarter last year. Sequentially, expenses have increased $122 million, driven by previously announced demand generation activities and variables sales and marketing expenses associated with a nearly $700 million sequential revenue increase.

Digital has achieved significant reductions in operating expenses over the last few years. There remain a number of cost reduction programs going on within the company, primarily in general administrative and support areas. With our significant strength and competitive position we will continue to invest to capture market share in key areas. Despite these investments I expect the relationship of expense levels to improve as a percentage of revenues.

Relative to the balance sheet, cash increased $362 million versus Quarter Two to $1.5 billion. The inventory levels reflected our solid improvement and inventory turns improved considerably from 4.2 turns to 5.0 turns versus last year. Property, plant and equipment levels also improved substantially, with turns at 7.2, up from 4.9 a year ago.

Our accounts receivable/DSO performance was negatively impacted by an unusually high percentage of shipments late in the quarter. This is largely supply related and I expect it to improve over the next quarter or so.

So, to summarize, our revenue growth particularly in the product area has accelerated to levels consistent with industry leaders. Our profit performance continues to improve and we are now within a point of our short term model. Our strong balance sheet continues to strengthen in most respects. Based on our continuous progress these past 18 months we are on track to achieve our short term model during the second half of this fiscal year. Management is now focused on finalizing the next phase of our financial plans, which will bring Digital's profit margins in line with industry leaders over the next year or so.

Thank you. Bob and I will now take your questions.

DK: We are now ready to take questions.

MOD: Thank you, sir. Ladies and gentleman, we will now begin the question and answer session. If you have a question you will need to press the "1", followed by the "4", on your push button phone. You will hear a three-tone prompt acknowledging your request and your questions will be polled in the order they are received. If your questions have been answered and you would like to withdraw your polling request, you may do so by pressing the "1", followed by the "3", on your push button phone. If you are using a speaker phone today, please pick up your handset before pressing the numbers. One moment please for the first question.

Terry Shannon, please state your company name and your location, followed by your question.

TS: Good morning, this is Terry Shannon, from Shannon Knows DEC in Ashland, Massachusetts. I have two brief questions for Mr. Palmer. First off, what was the percentage of indirect revenue versus direct revenue for the quarter just ended? And secondly, what was the -- on the Alpha product line, what was the percentage of workstation revenues versus server revenues?

BP: Terry, thank you for your questions. Indirect revenues were approximately, talking about our products, 57% during the quarter. The split between servers and workstations was approximately 70% servers, 30% workstations.

TS: Thank you very much.

BP: Thank you. Next question please.

MOD: Hiawatha Bray, please state your company name and your location, followed by your question.

MOD: We will move on to the next question. Brian Richardson, please state your company name and your location, followed by your question.

BR: Yes, the Medigroup in Stamford, Connecticut. Congratulations on some more continuing excellent results. Terry Shannon addressed the first part of my question but could one of you elaborate a little on the proportion of product revenue sold through your direct top 1000 or so accounts versus indirect?

VM: Yes, the growth was balanced. We have not -- we generally don't disclose the business revenues by business unit. But I would say this, that the growth that we enjoyed this past quarter was balanced between direct revenue and indirect.

BR: Thank you.

MOD: Liz Gallese, please state your company name and your location, followed by your question.

LG: Yes, hello. This is Liz Gallese, at Bloomberg Business News. I would like to know if your core computer business was profitable? I recall from our last teleconference in the first quarter it was not. The same question for the PC business. If not, in both instances, when do you expect that?

VM: Yes, Liz, this is Vin speaking. Our core business was profitable this quarter when taking into account both systems sales and after market sales, that's after market products and services. Relative to the PC business, the goals that we had for our PC unit this quarter, among others, were to break even. I'm pleased to announce that that goal was slightly exceeded and we're well positioned to move up into the higher profit levels in the second half.

Next question please.

MOD: Ken Johnson, please state your company name and your location, followed by your question.

KJ: Hi, Ken Johnson, I'm calling from the Eagle Tribune. You had some reductions in work force from the same period last year. I was wondering if those were going to continue in '96 or have we pretty much seen the end of work force reductions?

BP: I don't think that anybody can know the future and we certainly don't. But assuming that the marketplace remains reasonable and we continue to enjoy strong demand for our products and services, which we fully expect, we're not planning any significant work corps reduction. Of course, any company the size of Digital has ongoing improvements in productivity, just driven by the technology, and you have changes in the population as opportunities present themselves. In some cases, adding people. For example, in our alliance for enterprise computing with Microsoft, we are already well into the recruiting and training of Microsoft certified engineers to support Windows NT for enterprise computing, so those are additions. We have some technology issues over time that will drive some reductions. But certainly nothing of the magnitude that we've experienced in achieving this turnaround is anticipated for the future, given my caveats about a reasonable economic environment on a worldwide basis.

MOD: Jennifer Goran, please state your company name and your location, followed by your question.

JG: My name is Jennifer Goran, I'm from WBUR is Boston, and because I missed just the very beginning of the conference I wanted to ask specifically what accounts for this tremendous surge in this quarter.

BP: I think that you're seeing the result of a number of strategic initiatives that we took, beginning with the reorganization of the company in our fiscal '94, at the end of '94. Organizing the company by product business unit, making sure there was clear accountability, and giving each of the leaders of the business units, product and service business units, the opportunity to invest and creating new products and services and bringing those to market. What you're seeing is the growth in our 64-bit servers that are driven by the market recognition, as I described, of very large memory databases, the advantage of having very large file sizes, the cost performance advantage of Alpha servers, both in the mid-range and the high end. That's clearly driving our products business. We're having excellent success in our networks product business, which we're leaders in switched architecture. In our storage, which we've addressed, as rate storage for not only Digital but really platform neutral rate storage that's growing very rapidly. Our network integration services is growing, software utility services. So if you look at each of the business units, PC has been already been mentioned, I mean it's hard to name any business unit that doesn't have a successful product and service strategy for growing the business. We're starting to see those now as the recognition that Digital is positioned where the market wants to go, is being realized. So I'm very optimistic. If you think the world is moving to 64-bit computing, it will be happening over the next several years, and Digital is two to three years ahead of the market. Those are some brief overviews as to what's fueling this growth.

MOD: Greg Garry, please state your company name and your location, followed by your question.

GG: Yes, Greg Garry, Data Quest, San Jose. A couple of things I was interested in. What is the latest snapshot of the operating system mix for the three OSs that you guys are supporting and also do you have a break down of the mix of Intel inside systems as opposed to Alpha based systems?

VM: On the second question, Greg, the business is approximately 50/50. That is to say the core Alpha business is approximately comparable to the growth for Intel based systems in terms of the revenue mix. The Intel based system is slightly larger. Relative to your first question on operating system mix, our VMS business was essentially flat this quarter, down slightly. Our UNIX business continues to do extraordinarily well, up 65% growth. That is solid growth and a strengthening. Our Windows NT business has grown well over 100% this quarter. But obviously that successful Windows NT program and our UNIX program is what's fueling the systems growth of the company.

MOD: Mike Wilmen, please state your company name and your location, followed by your question.

MW: Yes, hello. My name is Mike Wilmen from Data Quest in England, UK. Congratulations again on the good financial results. I'd just like to ask out of your total worldwide services revenues, what percentage of that emanates from Europe? Out of that European total, what percentage is actually MCS revenue, please?

VM: I don't know the MCS breakdown offhand, but approximately 50% of our service business is in Europe. The MCS element of our service business, at the corporate level, is approximately 70%.

MOD: Paul Taylor, please state your company name and your location, followed by your question.

PT: Paul Taylor from the Financial Times in London. Looking at your PC performance, as you said that's somewhat better than you had been hoping, is that a reflection of the success of the notebooks or is it your desktop systems that are helping there? And is that across the board or is it primarily US?

BP: We've had good acceptance worldwide of our PC products and we've had good acceptance in the portables, the desktops, and the servers. But the financial performance in servers carry an inherently higher margin. It's certainly been driven by the servers and also by the change in management that we made in the last quarter, to get a little more focused. As you probably recall at the last conference we talked about making sure we had a good balance in the PC business between growth and profitability. As Vin noted, we were quite pleased to achieve essentially break even in that unit and we're positioned for reasonable profits in the unit through the rest of our fiscal year, assuming a reasonably stable PC market out there. So we're doing well, the products are well recognized for quality and reliability and features, and we expect our success to continue.

MOD: Laurie Valigra, please state your company name and your location, followed by your question.

LV: Yes, this is Laurie Valigra with Reuters in Boston. My questions relate to the service business. The industry leaders seem to be at a 25% growth in their service business, even Unisys has a 20% growth. I'm wondering when and how Digital will move to achieve those rates, if that is a target, and more specifically how non-product revenue from the Microsoft NT service business figures in. If you could attach some numbers to that.

VM: Yes, Laurie. The Digital service business, unlike the other systems vendors in our industry, is just under half of our total revenues. It's a much more significant share of the company's business than it is, again, in the other computer companies.

Having said that we have several elements of our business. I'll give you a very brief high level profile. There are four or five elements that are in high growth mode, areas that we have been investing in in the recent past. For example, our PC utility program, our network integration services program, systems integration activities, among others. Our multi-vendor service capability is also another good example. These units are growing and accelerating, in most cases, in terms of their rates of growth. We have what you might characterize as the traditional Digital base, the second largest installed base in the computer industry, that is being serviced with our remedial maintenance service. That piece of business is declining at a rate of about 5%. Our growth in the new businesses and the declines in the older business are about even at this point. One is pretty much offsetting the other. Over the next year or two we expect a growth in these newer businesses, as they continue to expand, to far exceed the decline in growth in the traditional business. Again, we'll see that develop over the next year to two years.

LG: OK and can you put some figures to what the Microsoft NT portion of that would be?

VM: We have not disclosed that level of our plan, Laurie. It is quite significant, it's certainly measured in hundreds of millions of dollars, but we have not disclosed the particulars on that. Next question please.

MOD: Eric Convey, please state your company name and your location, followed by your question.

EC: This is Eric Convey of the Boston Herald in Boston. My question is for Mr. Palmer. Is Digital a company that's still in a recovery mode from your point or is it just sort of a regular healthy company moving along? And, secondly, did either of you - the demand for the chips across the board as compared to your own goals?

BP: I would say that at this point Digital is a healthy enterprise. We have completed the financial turnaround of the company, we have developed an organizational structure that has accountability and focus. We have developed a clear strategy for growth that we've disclosed to the industry and has been well accepted by industry analysts, as well as by our customers. Now we're executing that strategy, which should lead to continued growth of the enterprise. That being said we're not yet at acceptable levels of profitability. Our objective is to be equal to the leaders in growth rates and profitability and we haven't yet accomplished that. On the other hand, if you look at earnings as a percent of revenue during the current quarter, they're approximately 4%, which is within one percentage point of our originally stated near term objective of 5% after tax.

As soon as we achieve that objective we expect to announce an intermediate objective that, of course, is better than that. After achieving that we'll have a long term objective to be at the absolute leadership position in the industry, right up there with the best, in terms of profit after tax. So a healthy company, but still need to focus on execution and growth in order to deliver leadership profit and that's our objective.

EC: And the second part is how Alpha demand across the board is.

BP: Alpha demand is continuing to grow, as I mentioned. If you're talking about the systems it's very strong. As we said it was up over 50% year over year, driven by very strong results in both UNIX and Windows NT, with a very slight decline in VMS. That is expected to continue and I think accelerate. If you think about it, up until this point really the only database vendor out there that was recommending the Digital platform until recently was Oracle, for its performance and because they were the first company to recognize the importance of 64-bit database capability and the applications that run on top of that. As I mentioned, we now have virtually every database company in the world trying to get a 64-bit implementation of their database on our platform. In fact, our platform is the only choice because we're the only 64-bit platform that has not only the chip, but also the operating system necessary to enable the applications. Our competitors are going to start shipping some 64-bit boxes pretty soon, but none of them have a 64-bit operating system for commercial applications. Depending on which company you're talking about they're between one and three years away from doing so. So we have a tremendous window of opportunity to continue to grow our products based on Alpha.

In addition to that something else happened in the last quarter that was very interesting. Intel brought out a two chip, two large chips actually, implementation of their architecture called the Pentium Pro. These two large chips in an expensive package provide more performance than any other RISC architecture except Alpha. This has caused each of our competitors on the other architectures to have to rethink their strategy because they had always assumed that their RISC processors would stay ahead of Intel. That turns out to be a fallacious assumption. Only Digital has an architecture that can maintain a sustained lead on the Intel architecture, in my opinion. Therefore, I expect us to getting more new designs in at the chip level in the future.

MOD: Lucy Ness, please state your company name and your location, followed by your question.

LN: Yeah, I'm calling from DEC Computing in London and my question has actually already been answered. But there was one earlier, could I just check that the systems business unit was profitable this quarter. Is that correct?

VM: That is correct. The total systems and business, systems sales in the after market, product service sales, was profitable. As was the PC systems business, which I pointed out also earlier.

MOD: Hiawatha Bray, please state your company name and your location, followed by your question.

HB: Yeah, hi, Hiawatha Bray at the Boston Globe, a couple of things. One question I wondered about was to the extent to which the growth of the Internet is driving the growth in demand for Alpha equipment.

BP: Well, I think that it is not yet driving tremendous growth, although clearly the introduction of Alta Vista has made a very good showcase for Digital's technology. As I mentioned in my remarks, Alta Vista is a server capability that does a search of the World Wide Web. We've already indexed over 16 million pages of data, which is some 8 billion words, and we're adding to that every day. In only three weeks we went from just basically never advertising the thing, just almost word of mouth that we had it available and it's free to the user, to two million hits a day, which puts it in the top five or so of Internet sites around the world. The reason that it's so popular is because it's so rapid and the reason it's so rapid is because it's 64-bit Alpha server based. Just as now an 8 CPU system of 21164 chips with 8 gigabytes of memory attached and 250 total gigabytes of memory serving the network and growing. So it's very impressive and I think that, as I mentioned in my remarks, as more innovative applications become available on the Internet, multimedia, simulations, more data mining, things of that nature, clearly 64-bit servers will play a major role and that should drive demand for Alpha's products. So at this moment I wouldn't say so much of our current results are reflective of that. In that regard it's very positive because that's an untapped opportunity.

HB: Of course the other question is the obvious one, are you guys going to buy Apple?

BP: No, we're not -- in the first place we wouldn't comment on rumors in that case -- but we're not in the acquisition mode as a company. We have a clear strategy and we're focused on executing that strategy.

HB: Thank you.
BP: You're welcome.

MOD: Jose Perez Laco, please state your company name and your location, followed by your question.

RM: Hello, this is Rodney McVeigh at IDC in London. You said that revenue growth was across all geographies. Can you tell me how you performed in Europe?

VM: Certainly. The overall revenue growth in Europe for Digital this past quarter was up to a level of 10%. And that compares to the corporate level reported revenue of 14%. That's also up from a no growth situation as recently as six months ago. So we're very pleased and encouraged by the improvements in the recent past in Europe. Particularly in Germany which has done extraordinarily well.

MOD: Brian Messler, please state your company name and your location, followed by your question.

LM: Lou Menada, Nashua, New Hampshire. I just wanted to follow up on some of the 64-bit points. You mentioned earlier that you shipped 1,000 Turbo Lasers, or 8,000. I was wondering if you could give a characterization of how those are configured. I mean, not exactly, but just a general -- what are customers using them for typically today, rather than what they will use them for in the future. Are they all going out basically with an Oracle parallel server on them?

BP: I would say that more than half -- of the data that I last reviewed -- is more than half are going out with an Oracle database on them, which means of course roughly half are going out for other applications. I think we've just begun to scratch the surface in terms of the opportunity for very large memory databases. What's interesting about this particular technology is that applications written to run on top of a database automatically perform better on a 64-bit database. There's not any migration or recompiling or a big headache that you normally have to take advantage of a new architecture. So the database technology will enable all of these applications, things like SAP, SAS, and any number of others, to run much faster on the Alpha platform and at a much better price performance. If you saw the recent announcements around the benchmark that we established at 11,456 TPCCs with the Oracle database, at essentially half the cost of the next closest competitor, which in this case was Hewlett-Packard. So the price performance there is compelling, the overall performance is compelling, and I think we've just begun to scratch the surface in terms of 64-bit capability. As I said, virtually every other competitor is now scrambling to catch up.

LM: Is there any target window about how long the next one will come along, so that you don't have sort of -- well, you've cornered the market on 64-bits right now. Is there anybody else and how soon will they be there?

BP: I think all of them have plans. In fact, Silicon Graphics is shipping technical workstations today that use 64-bit chip, based on the MIPS architecture. Sun Microsystems has announced that they have the Ultra Spark and they're introducing it into the marketplace.

Hewlett-Packard has announced that the PA8000 will be available this year. By the way, in the case of the latter two, they're both more than a year late in terms of their announced schedule. But neither one of those companies, Sun Micro or Hewlett, has an operating system that's 64-bit. Although their 32-bit applications run a little better on these new chips, just because the chips are faster. But they can't fully exploit the address capability until they have a 64-bit operating system. By the way, IBM had announced that they had put their 64-bit effort, a Power PC 620, on hold primarily because it didn't have the performance forecasted to compete with the Pentium Pro. So in every case Digital has a compelling story, a lead of a year or two years, depending on the competitor, and we mean to exploit that advantage.

LM: Thank you and congratulations on your good quarter.
BP: Thank you for your congrats.

DK: Joel, we can take one more question.

MOD: Alright, thank you. Bobbie Jergivitch, please state your company name and your location, followed by your question.

BJ: Annex Research from Phoenix, Arizona but I'm actually calling from New York. I have one question for Bob and one question for Vin. Bob, the question that I have for you dovetails in what you've just been talking about. What you said about the 64-bit system needing more than just chips to make it a success in the marketplace is roughly the echo of a comment that I recall some AS400 executives making about May of 1995. In your comment about the Power PCs you didn't address yourself to the competition with the AS400. So I wondered if you could do that.

BP: I think the AS400 was an excellent solution to the marketplace problem and it showed that our competitor was focused on what the customer needs were. It was not a particularly impressive machine in terms of bits and byte speed and speeds and all that, but it came with the applications that customers wanted and it was easy to use and install in a relative sense. So it enjoyed great success. I think that, as our architecture, it proves that if you listen to the customer needs and you bring out an innovative product you will be successful. On the other hand, it's somewhat run out of gas in terms of its performance and, as I understand it, again you should ask these questions of Lou Gerstner, my counterpart at the IBM company, but as I understand it they're rethinking where their migration path is now for the AS400 in light of Intel's very surprising performance on the Pentium Pro. I think that fundamentally though the lesson of the AS400 and a lesson that I hope all of our executives at Digital now thoroughly understand is it's important to listen to the customer. What problem the customer is trying to solve and to bring an effective solution to address that problem. It's not just about technical excellence, although that's a necessary condition, it's insufficient. So at this company what you find is yes, a continued focus on excellence, a continued focus on leadership and computing, but a renewed focus on customer satisfaction.

In fact, my executives, the ones that report to me and the ones that report to them, their bonus program has a direct component that is impacted by improving customer satisfaction metrics. So we're quite serious about it. A lot of opportunity for this company to improve on the current results, although we're quite gratified to see the continued success of the programs we've put in place. Thank you.

BJ: Thank you, Bob. The question for Vin is I was intrigued by the fact that you now have 4,500 people less than a year ago. Yet the operating expenses are flat. Can you explain to me why that is so?

VM: There is not a direct relationship between population and spending. It is increasingly so a common practice in industry today to divest of capabilities that they have internally that are non-competitive and to outsource that service or that requirement to another company. So in that case you're still spending, although you're spending at a lower level. The population resources are not under your company's ownership but under the ownership of an outsourced enterprise.

BJ: Alright, that makes sense. Thank you very much.
VM: You're most welcome. Thank you for joining us today.

DK: Thank you Bob and Vin. This concludes Digital's second quarter financial results teleconference. If you have any additional questions, please call me at (508) 493-2195. Thank you.

MOD: Ladies and gentlemen, there will be a rebroadcast of this conference call starting today, January 23rd, from 12:30 Eastern Standard Time until 2:30 Eastern Standard Time. The phone number to dial is 1-800-633-8284. You will need to enter the reservation number 1529139. Again, that phone number is 1-800-633-8284. You will need to enter reservation number 1529139. Ladies and gentlemen, that does conclude our conference for today. You may all disconnect and thank you for participating.

END OF CONFERENCE CALL
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DIGITAL EQUIPMENT CORPORATION
Q3 FY'96 Teleconference

Moderator: Dan Kaferle
4/23/96

OPERATOR: Ladies and gentlemen thank you for standing by. Welcome to the Digital Media Industry Analyst Teleconference with Digital's Vice President and Chief Financial Officer, and Dan Kaferle as your host.

At this time I will be in a listen only mode. Later we will conduct a question and answer session. At that time if you have a question you will need to press the 1 followed by the 4 on your push button phone. As a reminder, this conference is being recorded today, April 23rd, 1996.

Post view will be available today from 12:30 until 2:30 Eastern Standard Time. The phone number is 1-800-633-8284. You will need to press a reservation number. The number is 1703487. Once again, post view will be available today from 12:30 to 2:30 Eastern Standard Time. The phone number is 1-800-633-8284, and you will need to press the reservation number of 1703487.

I would now like to turn the conference over to Mr. Dan Kaferle. Please go ahead.

DAN KAFERLE: Good morning and welcome to our third quarter teleconference. Our third quarter news release is available on PR Newswire if you have not yet received it.

This morning I have with me, Vin Mullarkey, Vice President for Finance and Digital's Chief Financial Officer. Vin will take you to the quarter's results and then he will throw it open for questions. The teleconference will end promptly at 11:45. Vin --

VIN MULLARKEY: Good morning and thank you for calling in. Digital delivered another quarter with significantly improved financial results. We reported a 68% view of the year increase in net income for the quarter, representing our sixth consecutive quarter of profitability. We continue to gain share in most of our key strategic focus areas, and cash flow from operations is at its highest in five years.

Our Q3 and year to date results continue to validate that our strategy is working. We see strength in demand for our 64-bit computing architecture and we continue to form strategic relationships in order to offer the best solutions available in the marketplace. We are the recognized leader in the world in the growth market for Windows NT enterprise solutions, and in high performance UNIX solutions. In addition, we will soon roll out our Internet and Intranet connectivity strategy with a new robust product portfolio. We are confident that our new Internet business will become another growth engine for Digital.

For the third quarter of fiscal 96, we reported net income of one hundred and twenty four million or seventy-four cents per common share compared with net income of seventy-four million or forty four cents per common share for the same period last year.

Representing the highest third quarter profit level in six years. On a fiscal year to date basis, we have earned three hundred and twenty one million dollars or a three hundred and fifty-nine million dollar improvement over the same period last year. Total operating revenues as reported for the quarter were 3.6 billion compared to 3.5 billion for the same quarter a year ago, a 4% increase, adjusted for divestitures. Total revenue from ongoing businesses group by 8%. This was the highest third quarter revenue ever reported by the company.

Despite a decline in PC revenues, product revenues grew at 5% year over year. When adjusted for divested businesses, total product revenues from ongoing revenues grew by 9%. This represents the eighth consecutive quarter of year-over-year growth in the product revenue area.

We continue to see strong market demand in most key product areas -- the Alpha Systems Business Group by almost 60%, driven by increased demand for our scalable line of 64-bit Alpha servers. Digital has shipped 200,000 ALPHA systems and upgrades with Alpha revenue now approaching the nine billion dollar level since the first product was introduced back in the Spring of 1993. We are seeing exceptional ongoing demand for our high end 8000 product family, and have shipped some fifteen hundred systems since the direction of Q4 in fiscal year 95.

We continue to see increased demand for our Alpha workstation products in clear signs of increased market acceptance. We continue to strengthen our industry of leading Alpha family of products and services to support this ongoing growth. We recently announced our new UNIX TruCluster Solutions. The performance of the UNIX TruCluster Solution consisting of four AlphaServer 8400's, is one and a half times faster and less than one-third the price of the industry's previous performance leader. Alpha UNIX Systems grew a solid 70% year over year. We continue to see exceptional demand for Windows NT on both Alpha and Intel platforms which grew approximately 115% year over year.

In total our network products in storage systems business group by over 50%. Network products continue to gain share and out pace the market in key growth areas such as switching and remote access. There continues to be continued demand for our storage works products especially in combination with the AlphaServer 8000 series, among corporate enterprise customers. Approximately 1 1/2 million modular storage works building blocks have been shipped to date.

Relative to Q3, we are clearly disappointed at our PC business results. As pointed out in a previous teleconference, there were a number of contributing factors. Among them an industry decline in US commercial PC demand. In response we have since adjusted our plans to support lower levels of growth. We had greater price pressure than we planned or have seen previously. We have responded with a competitive price actions and we are also tightening up on cost controls to minimize the impact on company margins. We, along with much of the PC industry, had too much product in the distribution channel.

To respond we had made good progress in balancing our channel inventory over the last few weeks. We expect to be at the proper level by June.

While PC revenues declined during Quarter 3, we have established that sales out from channel partners had modest growth. I expect Digital's PC sales in the June quarter to get back on the growth track, highly leveraged by Windows NT servers and personal workstations. Additionally, I expect the PC unit to return to profitability in the next few quarters.

Relative to our service business, revenues grew 4% compared to the same period last year. Driven by strong growth in our multivendor service and our integration business. This level of growth in that service business is the largest in twelve quarters. When adjusting for the December quarter of divestiture of our educational service business, Q3 growth is even higher at 6%. Which did show an improvement in overall our gross margins with our Q3 performance at 54.6%, well ahead of our short term business model.

Product gross margins improved sequentially over four points, and is particularly strong due to higher margin product mix and solid reductions in product cost.

Service growth margins declined sequentially approximately one point and I continue to believe that the margin decline in our service business will stabilize in the relative short term.

A few comments on our balance sheet. We entered the quarter with 1.74 billion in cash. The company generated positive cash flow from operations in excess of four hundred million dollars, representing our strongest performance in five years. We continue to see improvement in overall asset management, except for Accounts Receivable (BSO) performance, where we have a couple of aspects that need some additional focus.

In summary, our overall strategy is working. We continue to significantly improve profits. We continue to grow revenues and gain market shares in most of our key strategic focus areas. Our strong product and service capabilities continue to strengthen and our management remain confident that we will stay on the continuous improvement track that we have been on now for a couple of years or more.

Thank you and I will now take your questions.

DAN KAFERLE: Kelly, we are now ready to take questions.

OPERATOR: Thank you. Ladies and gentlemen, we will now begin the question and answer session. If you have a question you will need to press the 1 followed by the 4 on your push button phone. You will hear a three tone prompt acknowledging your request and you questions will be pulled in the order in which they are received. If your question has been answered and you would like to withdraw your point of request, you may do so by pressing the 1 followed by the 3 on your push button phone. If you are using a speakerphone, please pick up your handset before pressing the numbers. One moment please for the first question.

Bob (Georgebick), please state your company name followed by your question.

BOB (GEORGEBICK): Yes, Bob (Georgebick) Annex Research in Phoenix. I have a- first a clarification question. Did I understand you correctly that the NT business was up 115%?

VIN MULLARKEY: That is correct Bob. That was our NT systems platform business and that is both the Alpha platform and the Intel platform combined.

BOB (GEORGEBICK): Okay, now given that NT is a 32-bit system, and the very good success that you are enjoying with the 64-bit AlphaSystems, how do you reconcile the fact that the 32-bit system is growing faster than the 64-bit revenue?

VIN MULLARKEY: It is the same -- I am not sure I understood your question totally there Bob. The Alpha platform -- I didn't indicate to you what the Alpha platform growth was on Windows NT.

BOB (GEORGEBICK): Well there was a release that said the figure was 50%.

VIN MULLARKEY: That was for the total Alpha business which includes Windows NT, it includes UNIX, and it includes VMS.

BOB (GEORGEBICK): But is it true or false that the NT portion is growing the fastest?

VIN MULLARKEY: It is true.

BOB (GEORGEBICK): Well that is then my question, how do you explain that something which is a 32-bit architecture is growing faster than let's say a native Alpha at 64-bit?

VIN MULLARKEY: First of all I would say that they are both growing very strong, and I would add to that in the Alpha area in particular our successful programming strategy of positioning Windows NT to operate in a relatively seamless way from our VMS platform, our so-called Affinity program, which is what's fielding the stronger growth in the -- on the side you related your question to. Any other questions, Bob?

BOB (GEORGEBICK): No, that's it. Thanks.

OPERATOR: Eric Convey please state your company name followed by your question.

ERIC CONVEY: Hi, it is Eric Convey at the Herald. My question is whether the cost reduction in the PC line will result in any layoffs anywhere?

VIN MULLARKEY: I am not sure Eric at this point. I would say that the company's cost structure adjustment program continues to be under way and there are layoffs in many parts of our company that continue and will continue as we move forward. What the exact nature is by business unit, I don't happen to have it at my fingertips and it is also not what we would typically disclose. Any other questions Eric?

ERIC CONVEY: No, I am all set, thank you.

OPERATOR: Terry Shannon please state your company name followed by your question.

TERRY SHANNON: Good morning, this is Terry Shannon from Shannon Knows DEC, Vin congratulations on your sixth consecutive quarter of profitability. Digital currently enjoys a 100% marketshare in the very large memory marketplace and you will very likely enjoy this unique differentiator for about another year. As you have indicated you have done quite well with VLM on turbo laser and VLM support will be extended to the mid range in about two weeks. My question is, how does Digital plan to fully exploit this opportunity.

VIN MULLARKEY: Operator we are picking up another conversation here on the line.

TERRY SHANNON: It must be, it wasn't me.

VIN MULLARKEY: It wasn't this end either. Terry, the -- I am not sure we have enough time to go through all aspects of our plan in that regard, but certainly the company totally recognizes the size of the opportunity that we have. It is to date somewhat demonstrable with the success that we are enjoying as indicated in our numbers as you point out. This window of opportunity is significant. We see it as at least a year out. And the year that you refer to. Let me emphasize as well that there is a lot more involved in the success in this area than 64-bit microprocessors. There is also extensive requirements in the operating system arena, middleware applications and the surface side to make this -- make for the success that you have alluded to. We are putting more wood behind this era when our company in terms of marketing programs, demand generation support programs, service programs, across most aspects of our business than we are virtually in any other area. And as you pointed out we expect to have a lot of exciting announcements coming up here in a few weeks on extending our capability downward price point wise into the mid range ALPHA area.

TERRY SHANNON: Okay, thank you very much.

OPERATOR: Liz Gallese please state your company name followed by your question.

LIZ GALLESE: Yes, Liz Gallese at Bloomberg Business News. A couple of related questions about PC's. Were sales in the quarter actually below those of a year ago and by how much. Was the business unprofitable in the quarter. The analysts said you indicated that you would be back to profitability by the end of the year, is that correct?

VIN MULLARKEY: Yes, sales were down in the quarter. Year over year they were down approximately 10%. Relative to profitability it is our expectation that over the next few quarters that we return to profitability and you should read that Liz as being before we enter this calendar year.

LIZ GALLESE: Was there a loss in the business in the quarter?

VIN MULLARKEY: And as for the current quarter as we had indicated in our March 20th release on this subject matter, we did have a loss in the quarter.

LIZ GALLESE: May I ask you to reiterate what lead then to the profit -- the growth margin improvements on the profit end. I know you said it but I would like you to just run through that again.

VIN MULLARKEY: There were a number of factors. Some were positive, some were not positive. Some were negative. The most significant ones were reductions in cost, both costs internally in terms of our manufacturing processes as well as lower prices for key components such as DRAMS among many others that go into our computer systems. That was the most significant factor contributing to our improved product of those margins. Additionally, there are some products that carry higher gross margins than others. In our mix in that regard it showed some improvement this past quarter.

LIZ GALLESE: The analysts said that you indicated that that product margin improvement can be sustained.

VIN MULLARKEY: I said that I felt that it was sustainable and that we would talk more about that in the July timeframe when we release our -- when we release our so-called intermediate model which will give the investment community a look out a couple of years thereabouts in terms of what we intend to achieve in terms of financial results and also how we intend to achieve them.

LIZ GALLESE: In other words, after the release of year end?

VIN MULLARKEY: That is correct. We will probably do that Liz simultaneously in the same session.

LIZ GALLESE: Why do you think your stock is moving up today?

VIN MULLARKEY: I think today's announcement is another solid improve point which the investment community has been seeing now quite consistently from this company over the course of two to three years that this both financial and strategic turnaround lead by Bob Palmer and his team is for real. There may have been a bit of a hesitancy on the part of some a few weeks back when we had this release on our PC situation, which as we pointed out then, we see as a short term temporary situation, and I believe what we are seeing in Q3 results is another strong prove point that the company is back and doing quite well.

LIZ GALLESE: Thank you.

OPERATOR: Chris Christiansen please state your company name followed by your question.

CHRIS CHRISTIANSEN: Hi, this is Chris Christiansen from International Data Corporation. Vin, if you could talk about the profitability of the systems business unit a little bit and also the effect going forward as the reorganization of this storage business unit and what possible impact it might have on profitability. Thank you.

VIN MULLARKEY: I don't have a lot to say on the systems business unit profit. That situation continues to improve. We don't generally release - disclose -- the profitabilities of our different divisions and segments in the company. Relative to the storage business change let me emphasize a couple of key points. This is for the most part a reporting relationship change on the storage business where that unit will now report into our system business unit as you alluded to. There are a number of reasons for this. The two more significant ones Chris, one is to help streamline and take advantage of our leverage -- our significant leverage with our indirect channel partners from the SBU and to bring together these two important businesses to take better advantage of that leverage, and to streamline the associated management activities in that regard, so that our channel partners are dealing with one management unit in the company rather than multiple.

Secondly, the success that we are enjoying, particularly at the high end, the 8000 product line family in particular, with our storage works, our product line is quite considerable. We see significant opportunity here. As you know, the storage requirements on the high end are quite extensive. As you also know, the success with this sector is a very significant part of our company strategy. Undoubtedly you ?? (BREAK UP) storage content is a very significant part -- component -- content part of a total systems value. Accordingly, we see a lot of leverage by bringing these two units together from a product design and business management point of view. Next question please.

OPERATOR: Lori Valigra please state your company name followed by your question.

LORI VALIGRA: This is Lori Valigra with Reuters. and I wonder if you could be a bit more specific about the adjustments you did make in the PC business in terms of cost controls. Were there any layoffs of temporary staff for example, and what you would expect reasonable inventory to be in the channel and what it is now?

VIN MULLARKEY: We have taken immediate action going back several weeks to begin to bring our costs in line with a lower level of revenue. I do not happen to know whether or not that entails layoffs or not. I don't think so, but I am not certain. That is a rather normal business practice when you are constantly tuning your operations and model to conform to the realities of the marketplace, and sometimes -- usually that is upside. Sometimes it is going the other way.

Your other question was --

LORI VALIGRA: It was in terms of the channel --

VIN MULLARKEY: Channel -- I'd say we have had several weeks of additional inventory in the channel over and above what we normally would want to carry. This was inventory that was pulled by our channel partners. Inventory that probably that they felt was supported based on the demand that they were seeing, particularly through the December quarter.

So as per their request we responded. We simply learned that it was a few weeks too high. As I put out earlier, we've got that probably fixed. It is roughly half way back in line and the other half will develop over the course of the June quarter.

LORI VALIGRA: Just one other non related question. On Thursday can you talk a bit about what will be going on with computer automation in New York and Bob Palmer's meeting down there.

VIN MULLARKEY: Well one of the things that I learned very early in my career was not to steal the thunder of your boss. Let me just make a very brief comment on it. And that is that we have signed a worldwide strategic agreement with Computer Associates under which we will collaborate on a range of both products and services to support the delivery of a comprehensive enterprise set of management solutions. The formal as you put it out -- conference -- the press conference on that and industry conference is tomorrow. I believe it is in New York City and full details will be made available at that point in time. Just one other brief point, this is -- again consistent with the new direction lead by Bob Palmer -- the third strategic alliance the company has developed or are developing in the software industry. The two others being with Microsoft as well as with Oracle Corporation. As you undoubtedly know, these companies are the three leading companies in the software industry in the United States. So stand by for the appropriate details tomorrow.

LORI VALIGRA: Thanks a lot.

OPERATOR: Jeff Bliss please state your company name followed by your question.

JEFF BLISS: Hi, this is Jeff Bliss at Computer Resellers. I see that the service business has been relatively flat over the past couple of quarters. I was wondering what your plans are to improve the service business and will these plans lead to any increased channel conflict?

VIN MULLARKEY: First of all, the -- you are right, it has been relatively flat but if you stand back Jeff, a little further, and look at the curve you will find that over time that our service revenue growth this past quarter is the highest it has been in quite some period of time. So we see it on an increasing trajectory at some level. And believe that the leadership that John Rando in particular has provided in this area will improve that situation over time. There are many strategic aspects to that, including the one I alluded to earlier, our alliance with Microsoft Corporation.

Relative to the matter of channel conflict, in each of our service segments we have worked out a specific strategy that makes it very clear where and how we are going to support our channel partners that have decided or who are proposing to pursue the service sector on Digital products, and in which areas we are going to begin to pursue internally. My understanding of that situation is in most parts of our business that situation is working well and improving. It continues to be a major goal of the company in an area that gives appropriate ongoing focus and management attention to eliminate or certainly minimize channel conflict. We feel we have come an awful long way in that regard. We may have a few -- a couple of minor open issues at the moment.

JEFF BLISS: Okay, thank you.

OPERATOR: Stuart McCarthy, please state your company name followed by your question.

STUART MCCARTHY: Stuart McCarthy, MV Ottawa Sun in Ottawa, Canada, these figures sort of represent a good news/bad news story that has been happening here at the facility in Ottawa. Obviously we have seen layoffs of at least 300 contract workers in recent months on the PC side, yet the ALPHA sales are obviously (going) well because of the worldwide mandate that the plant here has. Are you able to give any kind of a revenue breakout on the Canadian operations?

VIN MULLARKEY: No, I generally don't do that. I will say this though, that I think our Canadian business overall this past quarter has one of our best performances in terms of growth and marketshare gain. Beyond that it is not our practice Stuart to disclose the specifics at our country level message. It is required by local law.

STUART MCCARTHY: Okay, I have a follow up on that. There has been some talk of moving some high note production here and are there any plans to expand Alpha production?

VIN MULLARKEY: Not that I am familiar with. We could -- why don't we -- I'll help you engage with the right people on that question after this conference through Dan off line.

STUART MCCARTHY: No problem. Thank you.

OPERATOR: Jeremiah Leibowitz, please state your company name followed by your question.

JEREMIAH LEIBOWITZ: Hi, I am Jeremiah Leibowitz at the Maynard Beacon. I was wondering what Digital's continual strong performance may mean for its future and prospects in Maynard?

VIN MULLARKEY: Jeremiah I am not sure I understand your question. In terms of employment in the future, is that the --

JEREMIAH LEIBOWITZ: Yeah, in terms of employment and any affect it may have on decisions as to whether to stay here or to move more of the operation out of Maynard?

VIN MULLARKEY: We have no intent of leaving Maynard. We have been there about 39 years thereabouts. We have significant operations here. We are constantly adjusting certain concepts of our business, many which are headquartered or present in one form or another in Maynard, and as we move things around or consolidate with other businesses, these sort of changes affect the activities that we have within the Maynard geography. But I can certainly speak for the corporation on this matter. We have no intention of leaving our operations in Maynard. That is not to say that there wouldn't be further downsizing or layoffs, depending upon the situation in a given segment of our Maynard operations.

JEREMIAH LEIBOWITZ: Okay, thank you very much.

OPERATOR: Margaret Kane please state your company name followed by your question.

MARGARET KANE: Hi, it is Margaret Kane at PC Week. My question is about the PC sales -- I mean how -- you said you were clearly disappointed in the PC results. Can you talk to that a little bit? I mean how badly does this bother -- how badly does this affect the company when PC sales are read for such a stretch?

VIN MULLARKEY: The company has been on a fairly successful growth trajectory in the PC business for something over three years. And rather consistently has gained market share in the PC arena. I sort of liken the situation in the third quarter to a bump in the road if you would, that would hopefully be a one quarter incident. As I pointed out earlier, it is an incident that was highly influenced by a slow down on the commercial sector of the industry which is where we focus. It affected the company in terms of our earnings at some level although we don't disclose the specifics in that regard. We main confident that we will be back on a growth curve year in a relative short term and back in the profitability mode over the next few quarters in that regard.

MARGARET KANE: Just so that I understand you straight, you will be back into growth in the next quarter and in the black by the end of the year?

VIN MULLARKEY: By the end of the calendar year.

MARGARET KANE: Calendar year -- okay. Also you mentioned before you said your inventory at this point is a couple of weeks too high and you want to continue to reduce that. But what will it be when you are back down to where you want to be? A couple of months --

VIN MULLARKEY: I didn't mention that point Margaret and again it is not our practice to disclose that.

MARGARET KANE: Okay -- Thank you.

VIN MULLARKEY: You are welcome Margaret.

OPERATOR: Brandon Messler please state your company name followed by your question.

BRANDON MESSLER: (Illuminata) -- My question is given the explosive growth of ALPHA NT, I was wondering if in the future if Digital will be more committal or less ambiguous about positioning its three operating systems, since we do see NT taking off dramatically right now.

VIN MULLARKEY: As the market develops, I expect that you will see more information flowing from the company in that regard. It is my view that we have been quite clear around how our strategy relative to three operating systems and we have been particularly clear around the opportunity that we see in the Windows NT arena and what our strategy is there around it. This is a huge opportunity. In our view there is nobody better positioned to take advantage of it in our industry than Digital and we are pursuing it quite aggressively as you have seen the results this quarter.

BRANDON MESSLER: Right, it is just -- it seems that your UNIX business which is also doing well is still -- depending upon how you count -- third or maybe fourth amongst the leading OEM's and yet you probably are I would say the No. 1 NT vendor amongst OEM's.

VIN MULLARKEY: In the UNIX business I would say that we are the No. 1 systems provider in the industry on the high end. At the enterprise level, particularly in the database application area. There is nobody close to Digital's performance that we've consistently demonstrated and enhanced upon in that area. And so again, if it came back to the strategy that the company very clearly communicated some six or eight months ago, I would argue that would be quite clear on all three of our operating systems and also quite clear what our intentions are in terms of improving upon our success and capturing more share and essentially gaining a leadership position which we believe we have now or if not have, we are close to it in both these key areas.

BRANDON MESSLER: Would it be fair to characterize the UNIX business as being disproportionately profitable in the positive sense then since it is a very high ended oriented business right now, relative especially to NT?

VIN MULLARKEY: No -- Both of these areas are areas of extraordinary investment on the part of the company and depending upon your investment streams over time that affects the margins as you would expect. I would not conclude that.

BRANDON MESSLER: I see -- thank you.

OPERATOR: David (Brousell) please state your company name followed by your question.

RICK WHITING: Hi, this is Rick Whiting in Client/ Server Computing. First, can you clarify the number of the growth for the NT systems, was it 115% - 115 or 150? Beyond that could you break that down a little bit more and say how much demand you are seeing for NT on INTEL platforms versus NT on ALPHA platforms and beyond that how do you expect to see that split change as you begin selling more Pentium Pro based systems?

VIN MULLARKEY: The answer to your first question Rick is 115. It is approximately 50-50, a little stronger on the INTEL side. And generally we would expect that mix to ?? (BREAK UP) significant strength in both of these areas, but the mix to shift more to the INTEL side.

RICK WHITING: Okay, thank you.

VIN MULLARKEY: Next question please?

OPERATOR: Greg Gatlin please state your company name followed by your question.

GREG GATLIN: Hi, Greg Gatlin, Middlesex News in Framingham, MA. Vin you mentioned cost controls as part of the strategy to return the PC business to profitability. Are there other parts of the strategy that you can outline for us?

VIN MULLARKEY: Well I've mentioned also Greg that the -- bringing our channel inventories in line was a key aspect of it. I also mentioned that the pricing -- being competitive in the pricing area which is -- some associated incentives for our channel partners in particular. Those are probably the three more significant ones.

GREG GATLIN: Thank you.

VIN MULLARKEY: Kelly we have time for one more question.

OPERATOR: David Brousell please state your follow up question.

DAVID BROUSELL: Hi, this is David Brousell from Client/ Server Computer Magazine. Just to pick up again on the NT question, could you give us some feel for NT sales in relation to the existing VMS base that may be going over to NT versus brand new customers that may be adopting the NT platform from you?

VIN MULLARKEY: I will give you some indication. First of all on your VMS point, there is no question that the company's Affinity Program is working and working quite well, the Affinity Program, basically providing relatively seamless access to the Windows NT operating environment from a VMS platform -- a VMS ALPHA platform. Sales in that area were up 30 to 40% this past quarter -- that is VMS sales associated with the ALPHA platform. We believe that was predominately driven by the Affinity Program, which of course is built upon this seamless connection with Windows NT. I believe I have covered both aspects of your question. Did I not?

DAVID BROUSELL: I think you did. Could you put it in percentage terms with regard to of that increased sales, how many are not existing customers but new customers to Digital on NT?

VIN MULLARKEY: I don't have current data on that but if I was to go back about a quarter or so, over half of the opportunities were new customers. I do not know which way that went in the March quarter. This is typically done through sampling work a couple of months after each quarter.

DAVID BROUSELL: But it was about half in the prior quarter.

VIN MULLARKEY: That is correct.

DAVID BROUSELL: Thank you very much.

VIN MULLARKEY: To summarize, the conference call here, let me reiterate a couple of points that I made earlier. There is little question that the data continues to be demonstrable as we release it from quarter to quarter, that the company's strategy is working and working quite well. We continue to significantly improve our profits and we are on a very consistent continuous improvement track now for something on the order of two years. And those markets where we have chose to focus our attention we continue to gain marketshare. Further, our very strong, in many cases, industry leading capability in terms of products and services, continue to strengthen.

Finally, our management is confident that we are going to be able to maintain this track of continuous improvement and meet deliverables of expectations that we know the investment community and other constituencies have.

Thank you again for participating today.

DAN KAFERLE: Thank you, that concludes Digital's Third Quarter Results Teleconference. If you have further questions please call me at 508-493-2195. Kelly if you could please restate the post view number I would appreciate that, and thank you.

OPERATOR: Ladies and gentlemen, that does conclude our conference for today. The post view will be available today from 12:30 until 2:30 Eastern Standard Time. The phone number is 1-800-633-8284, The reservation number you will need to input is 17034878. You may all disconnect and thank you all for participating.

Q4 FY'96 EARNINGS TELECONFERENCE
DAN KAFERLE
7/30/96 9:00MDT

OP: Ladies and gentlemen, thank you for standing by. Welcome to the Digital Media and Industry Analysts conference call. At this time all participants are in a listen only mode. Later we will conduct a question and answer session. At that time if you have a question you will need to press the "1" followed by the "4" on your push button phone. As a reminder this conference is being recorded, Monday, July 30th, 1996. I would now like to turn the conference over to Mr. Dan Kaferle, Director for Corporate Public Relations at Digital. Please go ahead.

DK: Good morning and welcome to today's fourth quarter, full year's results teleconference. Thank you for joining us. I have with me today Digital Chairman Bob Palmer and Digital's Chief Financial Officer Vin Mullarkey. Following opening remarks by Bob and Vin we'll open the session up for your questions. The teleconference will conclude promptly at 11:45. Before we begin I want to state that comments made in this teleconference, which are not historic fact, are forward looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995. All forward looking statements are subject to the risks and uncertainties which could cause actual results to differ from those projected. Such risks and uncertainties are discussed more fully in the Company's latest quarterly report on Form 10Q and the Company's other filings with the Securities and Exchange Commission. Now it is my pleasure to introduce Digital's Chairman Bob Palmer.

BP: Good morning and thank you for joining us today. You should all already have received a copy of our fourth quarter and year end earnings release and, as you can see, our results were consistent with the preliminary announcement that we made four weeks ago. Vin Mullarkey is going to discuss the quarterly numbers in more detail but I wanted to touch on a few of the highlights from our full year results. I also want to bring you up to date on the progress we're making in the two areas that we discussed at some length earlier this month, Digital's PC business and our European operations.

While I'm disappointed with our Q4 earnings I believe our results for the entire fiscal year demonstrate solid progress. Excluding the restructuring charge our earnings improved by $258 million over the previous fiscal year, or by more than 210%. Although we still have a lot of work to do in a number of areas I'm confident that the company is well positioned strategically and I expect a stronger and more profitable year in fiscal '97.

As I told you a few weeks ago our strategic businesses, the ones we expect to drive our growth for years to come, are healthy. At the time I was able to tell you only that those businesses were growing at strong double digit rates. Today I can be more specific. Alpha Systems revenues for fiscal '96 were up 45% over the previous year, driven by demand for our enterprise level Alpha Server 8000 family and more recently for our new mid-range Alpha Server 4100 systems. We've now generated $10 billion in revenue from Alpha products and services since their introduction. Growth in our UNIX business continued to accelerate. Revenues were up more than 50% for the year, compared with a 40% increase in the previous year on a smaller base. We experienced strong growth in Windows NT across both our Alpha and our Intel based platforms. Revenues more than doubled over the previous year on Windows NT. And we reported significant growth in other key businesses, including our network products, our storage products, Intel servers and multi-vendor services. In each of these areas revenues for the year were up by more than 30%. Although our open VMS business overall continued to decline, OpenVMS on Alpha revenues were up 23% versus last year. This reflects customer confidence in the capabilities of OpenVMS and its seamless interoperability with Windows NT.

As we said during our last teleconference Digital's failure to meet our original earnings expectations in Q4 was largely the result of problems in two areas; PCS and Europe. I've spent a lot of time in the last four weeks meeting with teams managing our PC and European businesses and I'm pleased with the progress we're making and with our plans to fix the problems that remain. Specifically in the PC business our revenues in Europe and Asia Pacific were up in Q4 over the same quarter last year. Although PC revenue declined in the US year over year, sales out of the channel were up 20% from Q3. As a result we made steady progress in reducing our channel inventory and we continued to drive operating expenses to more competitive levels. I'm confident that these improvements, together with the other steps that were taken to strengthen our business, are going to lead to better results in our PC business in Q1.

In Europe we're implementing plans to strengthen our management focus, to expand our direct sales coverage, to recruit new channel partners, and to reduce our expenses. One step that we're taking is to focus on a smaller core group of European channels partners. This will allow us to reduce channel competition and conflict, improve our support, move effectively and more effectively target our marketing programs and better manage our channel relationships. And we're also attracting new management talent with more experience in channel development and direct sales in Europe. Now, while we cannot control European economic conditions or currency fluctuations, we can do a much better job of managing and growing our business in Europe and that's clearly our objective.

As I look back on fiscal '96 I see many strategic accomplishments that bode well for Digital's future. Most important perhaps was the introduction of a clear corporate strategy focused on three major growth opportunities. They are high performance 64-bit UNIX platforms, Windows NT across the enterprise, and Internet connectivity within and between enterprises. This strategy positions Digital for where the market is going. It also builds on our historic strengths in high-performance plans and operating systems, in enterprise computing, networking, and service and support. In each of these strategic growth areas we've made substantial progress over the last year. With powerful new 64-bit systems, both 64-bit UNIX and 64-bit OpenVMS operating systems, and a rapidly growing portfolio of 64-bit applications from our partners, Digital has solidified its position as the undisputed leader in delivering 64-bit solutions to customers. A position that we intend to sustain.

Together with Oracle and other leading database and applications partners we've created an entirely new market for very large memory database technology and applications. Demand grew as companies discovered a cost effective way to turn huge databases into competitive advantages. During fiscal year '96 we sold more than 1800 Alpha server 8000 systems to companies throughout the world. Just last week we announced that Lycos, the premier Internet search and guide company, will power its surface with Digital 64-bit turbolasers and workstations, 64-bit Digital UNIX, and StorageWorks systems.

One of the main highlights of fiscal '96 was the alliance for enterprise computing that we announced with Microsoft last August. It firmly established Digital as one of the clear leaders in delivering products and services based on Windows NT for both Alpha and Intel based platforms.

Let me read you a quote from a recent report by the Patricia Seybold Group, a high tech consultant. "Of all of the major system vendors Digital remains the most committed to Windows NT. Even though Hewlett-Packard and IBM have adopted Windows NT friendly strategies, neither has as comprehensive a technical strategy as Digital." The benefits of this alliance are considerable, including Microsoft's recently announced decision to develop a 64-bit version of Windows NT that will run, first, on Digital's Alpha platforms. This is yet another sign of Alpha's growing acceptance in the marketplace as the preeminent 64-bit architecture.

Just last month we announced a 500 megahertz Alpha microprocessor that runs up to 2 billion instructions per second and is sampling now. It sustains Digital's substantial performance advantage over all competing architectures and we intend to maintain that advantage, indeed to expand it. At the same time we're working with Mitsubishi Electric, a second source manufacturer of Alpha chips, to develop a low-cost high-performance Alpha microprocessor focused on the Windows NT desktop market. Called the 21164 PC this chip will bring the power of Alpha to systems in the $2500 price range.

Together with Digital's new FX!32 software translation technology, which is schedule for release later this year, this is going to give customers access to both Alpha 64-bit applications and all of those 32-bit Windows applications on Windows NT.

We also plan a number of joint market development activities with Samsung, our newest Alpha semiconductor partner, to create worldwide demand for Alpha products. Samsung is one of the world's leading semiconductor manufacturers and this strategic alliance represents a significant endorsement of Alpha. We expect Samsung to produce its first Alpha chips in 1997.

Now although Digital has been intimately involved with the Internet for two decades, we established our credentials as an Internet leader last year with the introduction of our AltaVista search and index service. AltaVista has become one of the most popular sites on the World Wide Web with an average of more than 16 million hits per day. To build on this success we're providing a growing portfolio of AltaVista software products for the emerging Internet/intranet market. We're also building strategic alliances with other Internet leaders like Microsoft and MCI to develop comprehensive solutions for corporate intranets including hardware, software, and services.

Achievements like these are driving our strategic turnaround and I expect more progress in the year ahead. That's why I'm confident that Digital will overcome today's challenge and achieve a level of profitability and growth that is competitive with the industry's leaders. One sign of our confidence is our decision to use part of our growing cash balance to repurchase, as conditions warrant, up to 10 million shares of Digital's common stock, a step that was authorized by our board of directors. This will enable us to curtail dilution impact of the employee stock purchase plan. The stock repurchase program that we announced today not only demonstrates the underlying strength of our company but it's a good opportunity to enhance shareholder value.

Now I'd like to turn it over to Vin Mullarkey, the Chief Financial Officer of Digital Equipment. Vin.

VM: Thank you Bob. Our overall business and financial performance was largely in line with the expectations that we set back on July 2nd. Let me begin with our product revenues. Total product revenues were essentially unchanged when compared to the same period last year while growing 2% when adjusted for divestiture activity and 6% when adjusted for both divestitures as well as currency.

We performed well in most of our key product areas. Our Alpha business grew 34% compared to last quarter four. Growth was driven by continued solid demand for our Alpha servers. Our Enterprise class systems, primarily the Alpha 8000 product family, grew 68% in the fourth quarter. The rest of the Alpha server product line grew over 50%, with the recently announced Alpha 4100 contributing to this strong growth. Revenues for our Alpha workstations were essentially flat when compared with the same quarter of last year.

We continued to see exceptional demand for Windows NT, growing over 100% in the quarter, and UNIX systems continued to grow at upwards of 33%. The personal computer business declined 3% from quarter four a year ago. Within the PCA business revenue from servers and mobile products remained very strong. That growth, however, was offset by the expected decline in our desktop business. As Bob mentioned, our management team is making considerable progress in executing our corrective action plan in the PC unit.

Our storage and network products businesses grew at a combined 15% over last quarter four. Other product businesses declined 23% compared to the same period last year. This includes some businesses that are non-strategic such as printers and supplies which declined some 35%, as well as the memory business which we exited last quarter.

Service revenues declined some 2% as reported, adjusted for divestments of the learning services business revenues were flat compared to last quarter four. When also adjusted for both divestment and currency service revenues grew by some 3% year over year.

Our integration and outsourcing services showed continued growth in the quarter, as did our multi-services revenues. As planned, Digital's maintenance revenues declined in the fourth quarter, primarily as a result of improved product reliability and lower revenue per serviceable unit.

Digital ended the quarter with 59,100 employees, a year over year population decrease of some 2,600 people. Our balance sheet continued to strengthen this past quarter. We have some management programs that we've been focusing on over the last year have begun to show some very positive results. Our days sales outstanding for quarter four showed a seven day improvement. The quarter four inventory levels are at their lowest levels in some three years. We ended the quarter with over $2 billion in cash and generated positive cash flow from operations of $356 million.

As indicated in early July we took a restructuring charge of $492 million in the fourth quarter to enable us to move to the next level of operating efficiency. To further profile the elements of this charge we will remove 7,000 positions over the next 12 months, with approximately 75% of these positions coming from overhead areas in the company. We will close an additional 3-1/2 million square feet of space. We will consolidate our sales function across the business units, substantially increasing productivity in this area. We will continue with additional consolidations in our manufacturing plants and distribution sites and we will improve our service delivery model and profit margin performance in the service sector.

The population reduction is distributed largely in line with company revenues distribution by geography. Approximately 75% of the restructuring charge will be to support employee separations.

Fiscal year '96 was a successful year for Digital on many fronts. Although our quarter four performance was off plan we made progress in our financial turnaround and successfully executed many very important components of our strategy. The financial highlights of this past year include: we achieved the highest level of revenue in the company's history. We achieved this despite having divested in businesses during the past two years that generated over $1 billion in revenues. As reported, total operating revenues grew 5% and when adjusted for divestitures grew some 9% this past year.

We're beginning to see the benefits of a number of margin improvement programs that were implemented over the last few years. First, we ended the year with a product gross margin of 33.7%. Not only was the '96 improvement in product gross margins significant at 4.6 points, this was also the first time in eight years that we showed an improvement. Our continued emphasis on asset management enabled us to improve our cash position to a fiscal year end balance of $2 billion, a $437 million increase. This represents our strongest cash position in nearly five years. We generated cash flow from operations of $600 million for the year, our strongest in five years.

Fiscal '96 represents the second consecutive year of significant profit improvement. Excluding restructuring provisions net profit margins improved from a loss of 5% in fiscal '94 to a profit of 3% in fiscal '96. We remain confident that we will achieve levels of net profit competitive with industry leaders within the next two years.

So, in closing, we remain confident in Digital's future. Our strategy is working and is focused on markets that experiencing significant growth. We continue to strengthen our product and services offered, we are taking the necessary actions to address those areas of the company that are underperforming, and our balance is strong and getting stronger. With that we'll be happy to take your questions.

DK: We're now ready to take questions.

OP: Thank you. Ladies and gentlemen we will now begin the question and answer session. If you have a question you will need to press the "1" followed by the "4" on your push button phone. You will hear a three toned prompt acknowledging your request. Your questions will be polled in the order they are received. If your question has been answered and you would like to withdraw your polling request, you may do so by pressing the "1" followed by the "3" on your push button phone. If you are using a speaker phone please pick up your handset before pressing the numbers. One moment please for the first question.

Terry Shannon, please your company name and location, followed by your question.

TS: Good morning, this is Terry Shannon from Shannon Knows DEC in Ashland, Massachusetts and I have a question for Bob Palmer. Bob, two years ago you set an indirect revenue goal of 63% for Digital Equipment Corporation. What percentage of your revenue came from indirect channels in fiscal '96? And a quick follow up, how close are you to signing on a major vendor as an adopter of the Alpha architecture?

BP: Well, in the case of your first question we, if I remember correctly, achieved about 58% of product revenue through indirect channels in the quarter just ended. So we're running on a roughly 40/60 percent split, which we felt was about right, although frankly we just want our products to reach our customers through the most efficient channel, whatever that might be. Relative to the Alpha adoption question, of course most recently, as I mentioned in my remarks, we have the endorsement of Samsung, which they could have chosen virtually any RISC architecture to endorse and take into their market for microprocessors as they enter that marketplace. They chose Alpha after an exhaustive study of the available architectures out there. I was very pleased that, once again, we introduced not only the fact that we were operating at 500 megahertz but were sampling parts. As you know, very often our competition announces what they're going to have and you wait some time before there is parts available. So we're feeling pretty good about Alpha. With Mitsubishi Electric discussion that I had, they had I believe it was about 12 to 15 engineers here at Digital for several weeks working with us, actually a few months, in designing this 21164 PC that will bring Alpha to the low cost systems on the desktop as well. So we've got about 40 or 50 designs in, none of them are really major large companies at this point but I think as Windows NT 4.0 gets out there, as FX!32 gets out there, we'll begin to see the adoption of Alpha by other systems companies.

TS: OK, thank you very much.

OP: Molly Williams, please state your company, your location, followed by your question.

MW: Hi Bob, Molly Williams from Bloomberg. I had a question about Enrico Pesatori's replacement. Right now you're still overseeing the computer business? Can you talk a little bit about where that stands?

BP: Yes, at the present time I am acting as the vice president, I suppose of the computer systems division. I found out that my boss is fairly easy to get along with but, in any event, the way the thing is going is that I'm getting a lot more familiar with the details of the businesses in PCS, which is appropriate given the problems that we had. Also with our systems business which I'm not spending too much time on because it's running well and Harry Copperman is integrating the enterprise sales force worldwide now, that previously was the AB (less B) structure. So basically just making sure that these executives have sufficient management resources and support to improve their businesses as they've committed to do. I would say that at this point I'm pretty optimistic about the work I've seen so far. Bruce Claflin is doing an excellent job in executing the strategy that he laid out to focus our Intel architecture on the servers primarily, continuing to provide leadership mobile products, the desktops, but really our value added is primarily around server technology and that's where his focus is in addition to getting the channel inventories down. So it's going pretty well, I'm not looking for an active -- I'm not actively looking for a replacement for Enrico at this point. I'd like to take an extended period of time here and manage this directly myself.

MW: So you're not looking for a replacement right away?

BP: No, I'm not at all. I think that we have with the business unit structure and the leaders that we have in place there, we have an opportunity that perhaps we won't need to refill that position.

MW: OK, thanks.

OP: Jay Ertzman, please state your company name, followed by your question.

JE: International Data Corporation, Framingham, Mass. Just wondered if you could provide some additional information on acceptance of the 4100 server?

BP: Well, it really has done well. The 4100 was an exceptionally excellent product in terms of its engineering, as you know. With it we were able to introduce our true cluster UNIX capability and this provides very high availability and very large memory databases at a very low cost. We shipped more than -- actually, orders, let me talk about orders first -- we shipped on the order of 1000 units were ordered and shipped very rapidly after the introduction. That's a very strong endorsement of that product. I don't have the exact numbers sitting here but I think Kaferle can get it for you if that's of interest. But revenues were strong for that product. It's a very -- a lot of capability at a very attractive price point and we expect that growth to continue. The ability to use the true cluster solution so that you can mix 8000 series and 4100 series products in the same cluster seems to have been well received also.

OP: Bob Djurdjevic, please state your company name, location, followed by your question.

BD: Annex Research in Phoenix, Arizona. I wonder, gentlemen, if you could give us more granularity in terms of the international markets and how they performed, both in the latest period and for the year.

BP: Well, as we mentioned in the case of our European business Digital does more business in Europe as a percent of our total than most of our systems competitors. So the economic slowdowns that we've been witnessing in the major industrialized countries of Europe has impacted Digital more than others. We said that about four weeks ago and certainly that was the case. It's slow right now. At the same time I think that about half of our slowdown is related to the industry in general and about half of it is related to internal affairs at Digital that we can improve upon. So we're making some changes there to try and do a better job of covering the customers in Europe and are bringing on some additional talent and channels and I'm optimistic we'll get that turned around. Relative to Asia Pacific, we continue to do well. It's different by each geography, in some cases it's mostly the PCS that are doing really well, in other cases it's the servers. So since we do business in over 100 countries it's a little hard to be specific in this kind of a conference. But overall I think that maybe the most important thing is one that Vin mentioned and that's the core products of the company, our strategic products, are doing very well, particularly our Alpha products which now represent about one-third of the product revenues of the company.

BD: Can you -- a follow up to this -- can you be more specific, as I said, in terms of the geographic regions? I'm not asking you to give us revenue changes for 100 countries but can you do it to the extent that you have to do it in the annual report?

BP: Well, I think that the best plan for that would be to contact Dan Kaferle after this meeting and we'll try to get you some information from Investor Relations or something that would be more specific. But we'll be happy to get the answer to your question offline. May I have the next question please.

OP: Brandon Muceler, please state your company name, followed by your location, followed by your question.

BM: Hi, this is Brandon Musler of Illuminata, calling from New York. You've indicated that there's going to be a reduction in headcount of about 7000 employees over the next year and you indicated that 75% of those would be from overhead positions. I just wondered if I could get a definition of what the overhead positions are and I'm aware that Digital also seems to be undergoing a transition from geographic to vertical or industry oriented sales, I'm wondering what impact that's going to have on the company over the next couple of quarters?

BP: Well, in terms of the reductions what we've said is that as we have streamlined our operations and got more focused on the customer coverage models that there will be some support functions that really will bear the brunt of that reduction. About half of it should happen in the first two quarters and about half in the last couple of quarters. It's distributed geographically, pretty much like our revenues are. Although in the greater New England area on a percentage basis there will be fewer reductions because we've previously addressed that issue more aggressively. So fundamentally the reductions are by business unit in those areas where we feel like we have more skills on board at this time than we require. Incidentally, the last time the company got down to -- right now we're at around 59,000 employees -- the last time we were at about 59,000 employees was fifteen years ago and our revenues were about $3 billion.

DK: Next question please.

OP: Lori Valigra, please state your company name, followed by your question.

LV: Hello, this is Lori Valigra, Reuters. I have a question about the NT and I'm hoping I'm not repeating anything because the conference call cut out for quite an extended period. But I wondered if you could split what the sales are, given overall figures, split PCs versus servers and then talk a bit about future growth. I know it was 100% but do you expect that to continue even with IBM, HP, Apple and others entering the market? Can you give a little projection of what you see going forward?

BP: Well with respect to the NT market you're quite right that our growth year over year was more 100%. We don't see any signs of a slowdown at this point. Of course, as the number gets larger and larger, so that as the base that you're comparing to gets larger it's unlikely it will continue doubling since that's impossible for any particular length of time. But tremendous acceptance of Windows NT and with the announcement and the release of Windows NT 4.0 we're certainly anticipating increased vigor in that space.

Digital, because of our alliance for enterprise computing, is better aligned with Microsoft and better able to support the Windows NT phenomenon than any other systems company in our opinion. We should do very well with that. I don't know if that adequately answers your question but we're quite excited about it and we feel like we're in an excellent position because of our two platform strategy of having both Intel architecture and Alpha architecture, which can run -- and will run and does run -- the Windows NT operating system and runs all those applications. So a very good opportunity for Digital to be where the market is going.

LV: Bob, could you just try to elaborate a little bit, numbers or any kind of percentage you might give, in terms of PCs versus Alpha server sales of Windows NT.

BP: I'm not sure of the kind of split that you're looking for but I think we can probably do that at a follow up call. I think that roughly the Alpha versus PCs is about 50/50 in the company as I recall but don't hold me to precision there. But it's about half and half. Alpha products overall today make up about a third of the total product revenue of the company, as I remember. We're seeing good growth, as I said earlier, in UNIX it's growing at more than 50% year over year despite the fact that the base is getting pretty large now. The Windows is up by over 100% year over year, as I mentioned. By the way VMS, OpenVMS on Alpha, was up 23% year over year so I hope that will help you with what you were looking for. Next question please.

OP: Alea Fairchild, please state your company name, followed by your question.

AF: Yes, hello, it's Alea Fairchild with the European Consulting Network in Brussels, Belgium. Regarding your European management structure, I know you've made a lot of changes and restructuring in the last month, when will you be ready to announce what you're going to be doing with the channel partners and the direct sales coverage at more length?

BP: Well I think that we'll cover that at our September 3rd analysts meeting, which we're holding a worldwide analysts meeting that some people have been invited to and there will be some external messages as well. We'll have more to say about it but fundamentally we're strengthening the management team in Europe. We're increasing our direct coverage by a factor of three, that is when we're finished with the plan that we've laid out about three times as many accounts in Europe will be covered direct as are covered in the quarter just ended direct. In addition to that we're getting more focused on our indirect channels partners in Europe and we'll be more selective about who we align ourselves with in the various geographies.

That being said I should mention that we've had good success in a couple of geographies in Europe recently, notably the United Kingdom and Italy have done a good job. We've had a little more struggle in some of the other countries. Also in the emerging countries we've done pretty well. So it's very much a mixed picture, as it is throughout the world, and it reflects both the economies in those countries and the strength of the management teams within the countries. Next question please.

OP: Greg Gatlin, please state your company name, followed by your question.

GG: Hi, Greg Gatlin, Middlesex News in Framingham, Mass. Vin, I think you mentioned the company plans to close 3.5 million square feet of space and I didn't get the time span in which that will happen. You say you'll continue with additional consolidations in manufacturing plants and distribution sites and I'm wondering where. If you can give us some specifics on where the closed space will be?

VM: The planning for that is well under way at this point in time in terms of both the regions of the world where contraction will take place, as well as the specific sites from the manufacturing point of view. This will occur approximately over the next two years. We will disclose the specifics on that to the appropriate external constituencies after we inform our employees. Again, that will roll over the course of the next year.

BP: Vin, I think it's worth noting that these additional closings, that 3.5 million, comes off of many times that -- we're looking at 25 million or so have been closed to date. So we're looking at about 10% additional restructuring in this company. In many respects our turnaround suffers a slight setback in the quarter and we've recovered from that, we've taken some management actions to correct things. The problems that we have are quite containable and we've got some actions to turn it around. That's why we took that additional restructuring to get completely finished and competitive with the leaders. Very much like in the case of the Olympics, you know you've seen this last couple of weeks any number of teams and athletes have a slip, stumble on the beam maybe, get up and finish for an excellent performance. That's our situation today. We've stumbled a little, we've gotten up and we're still on the track and we're doing very well. Next question please.

OP: Mike Willman, please state your company name, followed by your question.

MW: Hi, I'm Mike Willman from DataQuest in London. I just wanted to pick up a little bit on the comment that was made about you wanted to grow the European business better. I wondered were there areas of your business in Europe that you've been disappointed in and which were they?

BP: Well if you mean areas in the sense of geographic areas we've had disappointments in France and Germany, that we've discussed in the past and we're working to address those. These are, of course, two huge economies and very important to Digital. We've been in France, for example, more than 30 years and it's an area where we have an excellent reputation with our customers and we've done a good job. On the other hand our costs are not in line in that country for the current open systems realities and we've got some more work to do there. In the German economy it's been slower than was anticipated during the start of the last fiscal year and we've been impacted by that. We hope that in both cases these economies will recover and our business will do better in those economies. But, as I say, our cost structures are still not quite competitive with the open system realities. We've built infrastructures there at a time when the computer industry was characterized by proprietary operating systems and platforms and margins were substantially different than they are today. Those competitors that didn't exist so long in those countries don't have those infrastructures and, as you know, it's very difficult to make changes in your headcount and your structures within those countries. Anyway, we're working on it, we've got excellent leaders in the countries, and we're optimistic that we'll make some progress during the next fiscal year. Other questions?

OP: Lawrence Zuckerman, please state your company name, followed by your question.

LZ: Yeah, I'm with the New York Times in New York. Bob, I had a question for you just about what you said earlier, that you expected other systems vendors to begin adopting Alpha in the years ahead. Just wondering if you could elaborate, what does that mean for Digital and how do you perceive the Alpha platform going forward, especially vis-a-vis Intel?

BP: Well, I think that one of the more interesting things is that, as we had predicted some couple of years ago, Alpha is the only architecture out there that has a sustainable performance advantage in both integer and floating point over the Intel architecture. What's happened is Intel has done an outstanding job of introducing their Pentium Pro series, which has made that prophecy come true.

They've outperformed the other RISC architectures that basically caused the industry to rethink the architecture choices that are out there for platforms. It's very clear that Intel will remain the leader in terms of volumes and revenues as a platform and, as you know, Digital has a significant commitment to the Intel architecture and we're very satisfied with our position there. We're making some changes and some improvements, particularly around the Intel based servers where we've come on and gained some serious market share, we're continuing to do well. But in the case of the other RISC architectures Alpha has a leading performance for four years and you've seen more and more recognition by that -- of that fact in the analysts that write about the industry. People are pointing out that Digital, when we announce a product, is actually sampling whereas most of our competitors announce what they're going to have. We just announced in July the 500 megahertz Alpha 21164 that's available for sampling today. It will be volume production in September. This is a product that delivers, at peak performance, two billion instructions per second. Alpha was the first chip to get to one billion instructions per second and the first to get to two billion instructions. With the advent of the FX!32 translator technology that enables you to run applications written for Windows on the Alpha platform seamlessly, no recompiling, no problems, we expect that when we introduce that in September that will drive more market demands for the Alpha performance because you could use Alpha to give greater performance on applications written for Windows NT or the Win32 interface. Digital will offer both platforms and we'll just have the broadest performance spectrum thereby of any of the competitors.

LZ: Excuse me, when you have a $2500 Alpha desktop system though, I mean what impact will that have on Digital? Are you talking about just really ramping up the volumes of Alpha in the marketplace?

BP: We surely expect that to be the case because at that kind of a price point there will be a lot of applications that -- of course, ported native will run very very rapidly on the Alpha platform and they'll run the other applications through the translator at Pentium class speeds at least. So we expect that that will drive a lot of demand for both Digital and Mitsubishi Electric, which is our partner. I think many of the other, personally think, many of the other RISC architectures have a declining outlook in terms of their prospects because of Intel's great success and continuing to engineer their Pentium architecture and now the Pentium Pro.

LZ: If you're going to be running Windows apps at Intel Pentium speeds aren't you then really going to go into competition against Intel?

BP: I would see it more as a complementary with Intel. The situation is that by using both Intel and Alpha platforms we can give a very wide spectrum of performance. Now there is certainly an element of competition. That is, a systems company that's looking at making a choice of one of the other might sometimes choose, we hope they certainly will sometimes choose to differentiate their product by performance, in which case they'll choose Alpha. So there is a competitive element but it's a very competitive industry. I'm sure Andy Grove is not losing a whole lot of sleep over this topic. He's got a very enviable position in the industry and Intel is both a good supplier and a good customer of Digital so we would emphasize the complementarity of the two architectures.

LZ: Great, thank you very much.

DK: We have time for two more questions.

OP: Jon Logan, please state your company name, followed by your question.

JL: Jon Logan, Aberdeen Group, we're in Boston. The question is more for Vin. Vin, we noted that SG&A went up $90 million approximately in the last quarter. Can you tell us is that the trend, what it consisted of, why, why such a large increase in that area that you've been working so hard to keep down?

VM: I certainly noticed it as well. Let me say it's one of the major disappointments for the quarter. The level of spending in SG&A in the June quarter relative to revenues is up over 23% and 2 to 2.5 to 3 points higher than we would have liked. The issue, however, is more that revenues are at a level much lower than we had planned. So our fixed cost structure here caught us a bit, if you will. Had we met our revenue plan the SG&A level would be in line with our expectations and a competitive position. It's going to take us a couple of quarters to get it back in line. That will come from a combination of additional cuts and cost containment, as well as revenue growth.

DK: Next question please.

OP: Jim Garden, please state your company name, followed by your question.

JG: Yes, we're based in Hampton, New Hampshire and my question is regarding the PC business unit. We see that overall the revenue is off 3% for the year and yet the server business was up 25%. This would lead us to the conclusion that the desktop side is not doing well at all and also Bob has been quoted as changing the focus in the PC business unit to reducing the focus at the desktop. Should this lead us to believe that Digital is going to jump out of the PC desktop business?

BP: We continue to have a strategy that depends on delivering leadership products on the desktop based on the Intel architecture for our customers and will continue with that strategy. So the real issue is what's the most efficient way to deliver desktops, mobile products and servers, to our customers. Bruce Claflin is certainly examining all of the elements of that question to make sure that we can do a more competitive job in terms of that execution. That being said I should point out that one of the reasons that you see in that revenue is that in the States we very much stopped putting a product into the channel, or at least reduced the rate in which we were putting product into the channel, and we focused on selling product out of the channels and quite successfully, about 20% growth in the revenues out of the channel. So it was primarily a US issue. We had growth in Europe and Asia in the PC business. So the issue for Digital is we've got to get back in control of the inventories in the channel. Bruce made a lot of progress on that during the quarter just ended, he'll make some more progress in Q1 and by the end of Q2, which is the December quarter, I expect that the PC business will be on the breakeven or profitable. That's his objective and my objective and he certainly focused on it. I believe that we've got time for one more question or two. What do we have?

DK: One more question.

BP: One more, OK.

OP: David Broussel, please state your company name, followed by your question. David Broussel. Terry Shannon, please state your follow up question.

BP: I'm sorry, I can't hear the question.

OP: There was no question. Molly Williams, please state your follow up question.

MW: Hi. Bob, I had another question for you on the PC company. As you're going to be running it, can you talk a little bit more specifically about what changes you're going to make in order to get to the breakeven level and could you just repeat which quarter you expect to be at the breakeven or profitable level?

BP: Actually, I'm not running it, Molly. Bruce Claflin is running it but Bruce is reporting directly to me. I'm very pleased with Bruce, he's an impressive executive, he's jumped in at a tough time. When he came, Digital things deteriorated rapidly, not his making, but he's jumped in there to start getting a handle on it and fixing it. We've begun to reduce our expenses significantly in the PCBU, we've begun to manage our channels much more aggressively to get those inventories down to competitive levels, and we've set an aggressive improvement plan.

We should see improvement in Q1 versus Q4 and we should see breakeven by the end of the calendar year, which is for us the fiscal second quarter. So I think Bruce has got a clear strategy, he knows what he wants to do, we're continuing to invest, we want to focus on those areas where we can really differentiate ourselves which, as you know, is in the server and balanced systems area. We'll continue to deliver competitive desktops and mobile products. We've done a good job, frankly, in the design and manufacturing of our products. I'm not at all disappointed in the quality of the products, the design features, nor is the market. They've been very well received; mobile, desktop and server. But in managing our sales channels we did a very poor job and we got caught with so much inventory, when prices declined more aggressively than anybody had forecasted, Digital was more adversely impacted because of that excess inventory out there in the channels and the need to price protect our partners. So we know what we need to do, it's not a fatal kind of issue, this is something you can understand, it's fixable, it's containable, and we've got good management leading the fixes so I'm optimistic that Bruce will achieve his objective at the end of the calendar year.

With that I need to wrap up here. I hope that you've heard we're very confident about our future, we've made a lot of progress since '94 in particular. We had a $258 million profit improvement over '95, before restructuring. We had the first gross margin improvement in five years and product gross margin, first improvements in eight years. So, clearly, a lot of our re-engineering has worked ...

BP: ... manufacturing side. We had the highest cash flow from operations in five years. We ended the year with $2 billion worth of cash, which is plenty for the restructuring efforts we've announced, as well as the stock buy back program that went out. That we feel that as far as the core products of the company and the strategy of the company we're on the right track. We think the numbers reflect that and the acceptance of our products and services will continue. So we're predicting that Digital will return to a level of competitive profitability within the next couple of years for sure with these strategies. So I want to thank you very much for your attention and calling in and following the company.

DK: That concluded today's teleconference. Thank you once again for joining us. Digital will distribute a video b-roll package with sound bytes from Bob Palmer at 2:00 p.m. Please call Michelle Hoey at 508-493-0295 for further details. If any of you encountered technical difficulties there is a post view line open from 12:30 to 2:30. The dial in number is 800-633-8284 in the US and 303-446-5399 for international callers. The reference number is 1830255. If you have any follow up questions I can be reached at 508-493-2195. Thank you.

OP: Ladies and gentlemen, that does conclude our conference for today. You may all disconnect and thank you for participating.

END OF TELECONFERENCE +++

DIGITAL EQUIPMENT CORPORATION

Q2 FY'97 TELECONFERENCE TRANSCRIPT

Moderator: Dan Kaferle
January 16, 1997
8:30 a.m. MT

Operator:

Welcome to the Digital Equipment conference call. The primary speakers will be DIGITAl's Chairman, Bob Palmer and Vin Mullarkey, Vice President and CFO. Dan Kaferle, Director of Public Relations at DIGITAL, is your chairperson. As a reminder, this conference is being recorded today, Thursday, January 16, 1997. Mr. Kaferle, please go ahead.

Dan Kaferle:

Good morning and thank you for joining us. Our earnings announcement was released at 7:00 this morning and is available on PR Newswire and the Business Wire. As you are aware, I have with me Bob Palmer and Vin Mullarkey. After opening remarks by Bob and Vin, we will open the session up for questions. The teleconference will conclude promptly at 11:15.

Before we begin, I want to state that comments made in this teleconference which are not historic fact are forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. All forward-looking statements are subject to the risks and uncertainties which could cause actual results to differ from those projected. Such risks and uncertainties are discussed more fully on the company's latest quarterly report on form 10K and the company's other filings with the Securities and Exchange Commission.

Now, it's my pleasure to introduce DIGITAL's Chairman, Bob Palmer.

Bob Palmer:

Good morning and thank you for joining us today. As you know from the press release we issued this morning, DIGITAL reported net income of $32 million for our second fiscal quarter, or 15 cents per common share. AS we told you in October, we knew that the comparison with last year's very strong second quarter, when we earned 91 cents a share, would be a difficult one. But our goal was to recover from our first quarter results, grow our revenue sequentially and return to profitability. I'm pleased to say that we did accomplish those things. I'm satisfied with our improvement on a sequential basis, and I'm confident that we'll continue to improve during the second half of the year.

Several factors contributed to our improved results. While the changes we made in our worldwide coverage model created disruptions in Q1, the organization was more stable during the second quarter, and as a result we were more focused on execution. The expansion of direct coverage from 1,000 to 2,500 accounts is beginning to produce results. We saw order growth in both medium-sized accounts and in our largest global and national accounts, when compared to last year. And we're rolling out new sales tools that will help the sales force become even more productive in serving customers.

At the same time, we continue to strengthen our relationship with distribution partners who have responded positively to our new coverage model. For example, our largest systems distribution partner, Pioneer, had a record quarter selling DIGITAL products and services. But we're still one or two quarters away from realizing the full benefit of these changes. For example, although Alpha systems revenue increased 33 percent from the first quarter, total Alpha revenue was up only 1 percent on a year-over-year basis. This due in part to weaker Alpha sales in Europe. In addition to the continuing effects of our sales changes, we also had a temporary supply contraint at the end of the quarter that affected the shipment of higher performance Alpha systems. I view this slowdown in Alpha's growth as a short-term issue that will be resolved as we further strengthen our sales and marketing, and bring our supply in line with strong server demand.

The strongest growth was in Alpha servers, which were up 43 percent, sequentially, at 13 percent over the same quarter last year. In fact, our Alpha installed base now totals more than 275,000 systems and total cumulative Alpha product and service revenues exceed $12 million.

Our success to date reflects Alpha's continued leadership in both performance and price performance, and we're determined to build additional volume demand for our Alpha-based products. Last week we announced substantial price reductions on Alpha station and Alpha server systems. This will enable even more customers in a broader range of markets to leverage the leadership platform and price performance advantages of the Alpha platform.

You know, Alpha is the only RISC microprocessor today, and for at least the next couple of years, that has the commitment of Windows NT support from Microsoft. Motorola and IBM have dropped power PC support for NT and Microsoft stopped NT development from IPs. That means that DIGITAL is the only company that can offer customers significant Windows NT performance and scalability beyond the high-end of the Intel architecture. In our view, that provides a clear opening to underscore Alpha's advantages and to increase demand for Alpha systems. Our competitive edge will be even sharper when Microsoft releases its 64-bit version of Windows NT for Alpha.

One of our most important success stories for the second quarter was the performance of the personal computer business unit. As you may recall, we said last summer that our goal for DIGITAL's PC business was to break even in the second quarter. It was a very aggressive goal, but Bruce Claflin and his team exceeded it, delivered a profit for the quarter and achieved all of their key operational goals. That is a significant turn-around from the beginning of the calendar year, when an oversupply of inventory in the channel and rapidly declining PC prices severely affected DIGITAL's growth and profitability.

It's the result of significant improvements in operational management and a strategy focused on establishing DIGITAL as the leader in providing Windows NT-based solutions for the enterprise. DIGITAL's Intel business is an essential element of our overall Windows NT strategy and we're pleased with the excellent progress that we've made. In fact, we announced yesterday that DIGITAL won a contract worth up to $1.5 billion over the next five years to provide PC hardware and software to the U.S. Department of Veterans Affairs and other civilian and Defense agencies.

The improved performance by our PC business is a good example of the progress that we're making in executing our operational plans more effectively. Of course, the real test for DIGITAL is our ability to execute our business strategies, to turn our leadership products and services, strategic alliances and business partnerships into long-term growth and profitability. One reason I'm confident about our long-term prospects is the progress that we're making in executing those strategies and implementing the go-to-market plans that we discussed with you in September.

I'd like to take a couple of minutes to give you a few additional examples of the success that we're having. Overall, our UNIX business continues to grow. One of our key growth opportunities in the UNIX market is Data Warehouse Solutions, which builds on our strategic alliance with Oracle and our important partnerships with other database software vendors like Informix, Sybase and Software AF. For example, ADT, one of the nation's leading providers of security systems, awarded DIGITAL a $33 million contract that includes a large data warehouse, as well as the infrastructure for six regional call centers, all using DIGITAL's high-performance AlphaServer 8400 systems. Other major Data Warehouse wins during the quarter, the second quarter, include the Dutch PTT, Blue Shield of Northern California and Human Resources Development of Canada.

Growth in our Windows NT business reflects increasing market recognition of our leadership products and especially our services, and the value of our strategic alliance with Microsoft. In one of our targeted markets, mail and messaging, we are establishing DIGITAL as the leader in delivering solutions based on Microsoft Exchange and Windows NT. What distinguishes DIGITAL from competitors is our ability to provide consistent design and implementation services on a worldwide basis, as well as the highly scalable servers, mail backbones and directory services that are necessary to run Exchange and NT throughout the enterprise.

Just since September, we've won several major contracts, beginning with the 120,000-year win at Lockheed-Martin. During the second quarter, DIGITAL and Microsoft won a large contract to design and implement British Telecom's next generation messaging system. This Exchange solution will serve 100,000 internal BT users. We also won Exchange accounts at Volkswagen and Northern Telecom, and many other such opportunities are under active discussion worldwide. Another area where we're building a leadership position is in the market for Windows NT-based personal workstations. Just last week, we announced two new models based on our fastest 64-bit Alpha microprocessor.

While our competitors are just shipping their first ever NT personal workstations, Digital is rounding out its second generation of both Intel and Alpha-based systems. In fact, we've already shipped 50,000 NT personal workstations worldwide, more than any other vendor. We are also solidifying DIGITAL's reputation as a leader in providing Internet solutions for the enterprise that build on our software, platforms, services and partnerships. During the last quarter, we celebrated the first anniversary of DIGITAL's AltaVista Search service, which is now accessed more than 24 million times each weekday, making it the most heavily used search and index service on the World Wide Web.

Also, an increasing number of Internet service providers are choosing our high-performance GIGAswitch as the cornerstone of their networks. DIGITAL delivers a complete range of Internet services. One of our strengths is in providing Internet solutions to our network and systems integration services business. We have a worldwide team of people committed to Internet solutions development and an aggressive Demand Generation program targeted at large and medium enterprises. Together with Microsoft, we are winning business with companies like Singapore CableVision and Post Newsweek, who have chosen DIGITAL to implement Microsoft's package of Internet server applications.

Operations Management Services continues to gain momentum. During Q2, we signed a $70 million contract with TransAlta Utilities of Canada to manage its information technology environment. And we won a three-year contract to provide a complete multivendor support program for Ford Motor Company. We also continue to build external momentum in our semiconductor business. In early December, we produced- we reduced prices substantially on Alpha microprocessors, a move that we believe will enhance the attractiveness of our products to other vendors who want to tap the expanding market for the Windows NT. In addition, a growing list of companies announced last quarter that they have chosen our StrongARM microprocessor to power their Internet applications and then-client competing products. Apple Computer, for example, selected StrongARM for its new MessagePad 2000. Microsoft announced that it's porting the new Windows NT operating system to StrongARM. And five companies, including two that account for almost 80 percent of the world's computer terminal sales have announced Internet appliance, based on StrongARM.

As I said earlier, I'm satisfied with the improvements we demonstrated over Q1. In the short term, our goal is steady improvement, leading to the intermediate financial targets that we outlined last summer. Over the long term, our objective is to achieve levels of growth and profitability that place DIGITAL among the industry leaders.

To get there, we need consistent improvement and execution and that is where we will continue to focus our efforts across the company.

Now, I'd like to turn it over to Vin Mullarkey, DIGITAL's Chief Financial Officer.

Vin Mullarkey:

Thank you, Bob, good morning. As Bob has indicated, we are pleased with the progress made in the second quarter. Our focus on improved execution is showing positive results, and I am confident we are on track of continuous improvement.

We achieved most of our operating goals for this quarter. Well, five of these goals were highlighted during our quarter 1 teleconference. The first goal was relatively-- was sequential revenue growth. Quarter 2 increased 15 percent versus quarter one, consistent with the guidance that we have given previously. Although this revenue level reflects a decline from the second quarter of FY '96. We are generally pleased with the progress being made in our sales and marketing operations.

The next goal was relative to gross margins. Product gross margins increased to 34.5 percent, which is considerable improvement over both the first quarter, as well as the last two years. I'm also pleased with service gross margins of 31 percent. We have begun to turn the corner toward service gross margin improvement. I continue to have confidence in our margin improvement plans and expect to see continued improvement during the second half of fiscal year '97. The third goal was to break even in the PC business. As Bob pointed our, this goal was exceeded.

It was also a goal for quarter 2 to improve the growth rate of the Alpha Systems revenue. This goal was not achieved. Although sequential growth was 33 percent, year-over-year growth was 1 percent. Alpha revenues in the quarter were negatively impacted by a temporary supply shortage that led to a shipment shortfall of over $50 million, as well as weak performance in Europe.

And, of course, our fifth goal was to be profitable. Operating expenses were down 6 percent, year-over-year. Selling, general and administrative expenses were at $817 million and reflect the effects of good control and further restructuring. Quarter 2 ending population was at 55,900, a net reduction of 1,100. Restructuring activities are progressing throughout the company. Additionally, we continue hiring in selective areas, with approximately 800 additions during the quarter.

On the balance sheet side, we also continue to make progress. Accounts receivable has improved by 12 days, versus quarter one. Inventory is at the lowest level in nine years. We had a full term improvement, reaching a level of 5.6 terms. This asset management led to a cash and short-term investment balance of $2.3 billion.

From a business unit perspective, essentially all businesses performed to expectations. Of particular note are services and our new Internet Software Business. Services achieved its planned performance targets through the first half of the year. The margin improvement programs that we announced in early September are progressing on plan.

New products from the Internet and Software Business product line are being very well-received in the marketplace. We launched this new business over the last six months and are encouraged with the business indicators.

We will now take your questions.

Dan Kaferle: Carrie, we are now ready to take questions. Would you please poll the callers?

Operator:

Thank you. Ladies and gentlemen, we will now begin the question and answer session. If you have a question, you will need to press the 1, followed by the 4, on your pushbutton phone. You will hear a three-tone prompt acknowledging your request and your questions will be polled in the order they are received. If your questions has been answered and you would like to withdraw your polling request, you may do so by pressing the 1, followed by the 3, on your pushbutton phone. If you are using a speaker phone, please pick up your handset before pressing the numbers. One moment please, for the first question.

Bob Djurdjebic, please state your company name, followed by your question.

Bob Djurdjevic: Bob Djurdjevic from Annex Research. I have a question for you both, Vin and Bob, with respect to the segments of the business performance. As I recall, in the past you would give the Alpha revenues, for instance, by platforms, such as NT and UNIX or VMS. I wonder if you can expand on that, as well as then give us the same overview about the performance of the various geographic units.

Vin Mullarkey: Certainly. Let me give a profile here. I'll come at it from a couple of points of view and this will take a minute or two. First of all, from a product perspective, the product revenues for the quarter, overall, as was just pointed out by both Bob and myself, the Alpha systems revenue growth was one percent--would have been, with the $50 million shortfall, had that not occurred in terms of the temporary shortages, that number would have been up in the double-digit range. This, however, puts us in a stronger position for Q3 in that those customer orders are available for shipment now. The Intel base line, or the PC line if you prefer, was down to 19 percent, year-over-year.

Bob Palmer: A couple of key points on that. As you recall from previous engagements, our Intel business has been in a period of adjustment for a couple of quarters. The adjustment is primarily in the area of the inventory in the distribution pipeline, as we contracted that inventory we reduce sales. We have done that consciously to bring inventories back in line with appropriate levels. In any case, this past quarter in the Intel business, we had extraordinary performance on the server dimension. And we have declines in the desktop site. That's consistent with the strategy, as you may recall, from previous sessions. The VAX business continues to move in a direction that it has been the last couple or three years, with reductions approaching 50 percent.

On the server side, nothing out of line, the growth in the integration areas and the stroke outsourcing areas, as well as the multivendor segment, with the maintenance piece, the captive maintenance piece declining somewhat.

That's a high level profile in terms of the year-over-year growth factors associated with the product and service side. From a sequential point of view, the Alpha growth at 33 percent is quite impressive, particularly given that the overall growth was on the order of 15 percent. The VAX business also grew sequentially at 19 percent, and the Intel system business and total grew at 33 percent, sequentially -- also an encouraging sign. The operating system dimensions, from a systems server perspective, again consistent with the company's strategy, we had good progress in the UNIX area with over 30 percent growth. Also consistent with our strategy, we had solid growth in excess of 75 percent in the Windows NT arena. That's both on the Intel platform, as well as the Alpha platform. Workstation sales were down. As you know, those are predominantly in the UNIX operating system environment and they were down for the quarter. That's a high-level profile, but I think appropriate for this forum. Next questions, please.

Dan Kaferle: Carrie, next question, please.

Operator: Larry Dignan, please go ahead with your question.

Larry Dignan: Yeah, good morning. I was just curious if you could-- one of you could just talk a little bit more about what happened with that shortfall on Alpha. What exactly was the problem there, and also a second question I had was what do the recent price cuts-- what effect are those going to have on gross margins, going forward?

Bob Palmer: I think that Vin pretty well covered the Alpha picture, but let me try it a little differently. As he pointed out, sequentially Alpha Systems revenue was up 33 percent. So that's pretty strong growth, but we had a very strong quarter for comparison on Q2 a year ago. And in fact, it might be helpful to think about the overall picture in a somewhat different dimension, as far as revenue is concerned. Let me see if I can help in a broad brush anyway.

Larry Dignan: No, actually I had a very specific question, which was the $50 million that you could have had. I'm just curious, what happened?

Bob Palmer: Oh, sorry. I didn't understand the question, then. On that case, we have the strong demand for the high end of the Alpha server product line that came in relatively late in the quarter, and is at the highest performance category, so, requiring our 500 megahertz chips and that sort of thing. And, given the time frame that we had and so forth, we just didn't capture that business or didn't ship it, at least in the quarter. We have the business captured and we expect to ship it in Q3.

So, Vin was pointing out that had we been more successful in shipping it, it would have changed the percentages-- I believe you said the double digit. So that was, I think, the answer to your question.

Larry Dignan: Well, I-- so was it the-- shortage with the high-- the 500 megahertz Alpha chip. That was the shortage.

Bob Palmer: Well, primarily it was the systems, not a chip shortage, but primarily the inability to build and deliver the systems in the time that we had available to us. You might say that the order skew was heavily toward the end of the quarter, and I think in general, I want you to understand that in general, I thought manufacturing did an excellent job. The company's inventories at the present time are at a lull, if memory serves correct for about nine years. And so, overall in manufacturing worldwide they did an excellent job. But you do need to get the order in somewhat in a reasonable time. But the demand was at the high-end, as I noted.

Larry Dignan: Thank you. My second question was just about margins going forward, if you've cut-- you've cut the prices substantially. What's--

Bob Palmer: Well, on the margins we expect that they'll be able to be maintained because of the increased volume that the price reduction should allow, as well as ongoing improvements in manufacturing and costs of goods sold. You know there were substantial memory price reductions and memory prices -- DRAMs in particular make up a large part of the cost of the system -- and we're basically passing those through to our customers in those price reductions. But we do expect additional volumes as a result of even more competitive price performance on those Alpha systems.

Larry Dignan: Thank you very much.

Dan Kaferle: Carrie, next question, please.

Operator: Paul Judge, please go ahead with your question.

Paul Judge: Good morning, I've got a couple of questions. One, just to follow up on the last question. Will there be price protection in place and will that further complicate the issue, in terms of the price cuts in Alpha systems that were announced earlier?

Bob Palmer: DIGITAL follows the norms in the industry, with respect to price protection for our partners and distributors worldwide. There's nothing unusual-- also the-- about this particular announcement. Also, the price reductions have been in the business plans, in the business units. So I don't think there's anything extraordinary, but price protection is the norm in our industry.

Paul Judge: OK, and secondly, are you realizing any significant revenues from sales of StrongARM yet and, if so, what are those?

Bob Palmer: We're beginning to see some demand. It's relatively early in that product's introduction, but we've been very satisfied with the amount of design that I mentioned in my remarks. I don't have in front of me the revenues exactly, but the demand has been very gratifying from the start. We might be able to give you some information. Do we have anything close at hand here we can share?

Vin Mullarkey: Specifically relative to StrongARM?

Bob Palmer: StrongARM --

Vin Mullarkey: Just add it and then what is it at this point? I think that--

Bob Palmer: OK, so I don't have the numbers, I'm sorry. But fundamentally, we do see the external volumes increasing and we're very pleased with the reception of the product.

Paul Judge: Thank you.

Dan Kaferle: Next question, please?

Operator: Terry Shannon, please go ahead with your question.

Terry Shannon: Good morning, this is Terry Shannon from Shannon Knows DEC. I have a question for Bob. Bob, it's nice to see DIGITAL back in the black again. Nevertheless, the 1 percent year-over-year Alpha growth rate indicates that Alpha sales still remain an issue. Without dignifying any of the recent M and A rumors, do you anticipate any OEM agreements which might broaden Alpha's appeal?

Bob Palmer: Well, I think the price reductions that we mentioned were very significant. And even at the highest end of the Alpha processor performance should enable other companies to incorporate Alpha in their broader plans as they move to Windows NT. Now, last count, I thought we had something on the order of 40 companies or so that had designed an Alpha into their system's products -- mostly newer companies that don't have an investment in some previous architecture. You know, it's very expensive for a company to change architectures. Start-up companies that don't yet have a particular choice are choosing Alpha, as they look at its performance advantage. But companies that have a substantial investment in software on alternative architectures, that's a big sell, really, although we do have some success, there's nothing major to announce in the near term.

Terry Shannon: OK, thank you very much and oh, one quick follow-up. Would either you or Vin have a breakout of what percentage of your revenues for the quarter came through indirect channels?

Vin Mullarkey: It was-- Terry, it was just over 60 percent.

Terry Shannon: OK, thank you very much.

Dan Kaferle: Next question, please.

Operator: Greg Gatlin, please go ahead with your question.

Greg Gatlin: Hi, Greg Gatlin, Middlesex News in Framingham, Mass. Wondering-- sort of a three-part question. To what extent is AltaVista contributing to the revenue mix at this point and I'm wondering what the schedule is for spinning that off and how that affects DIGITAL's revenue stream down the line when that happens.

Vin Mullarkey: First of all, the AltaVista business unit which, as you may recall the company launched over the last year, has had a very successful business development in the first half. The business unit has come together. Their first sizable quarter of business happened to be this past December quarter. They did very well. The incremental revenues associated with that business are quite impressive, however, at this stage of its development, not that material from a corporate perspective. Further, given the IPO potential of this unit, I would not be able to disclose the financials at this point in time.

Greg Gatlin: Got ya.

Bob Palmer: It is fair to say I think, Vin, that they're making their agreed-to plan. And so the unit, as Vin was alluding, they've achieved the numbers that they committed to the corporation, but as a start-up and, given that we're a, you know, a $14 billion company, it's not that material at this point.

Greg Gatlin: Thank you.

Dan Kaferle: Next question, please.

Operator: Gerard Meuchner, please state your company name, followed by your question.

Gerard Meuchner: I'm from Bloomberg News. I'd like to return to the issue of Alpha. You also mentioned conditions in Europe as having an effect. Can you give me some detail on exactly what is going on in Europe as it relates, not only to Alpha but company-wide. And also if there was any big currency effect in the earnings of this quarter.

Vin Mullarkey: OK, first of all, relative to our overall European business, I think if I -- this is Vin Mullarkey speaking. If I look at it from the perspective of the major markets in Europe, I think it would be helpful. There were four--there are many major markets, but there are four in particular, from a GDP point of view and a business volume point of view. Two of them we're doing quite well in, those - that being the United Kingdom and the other one being Italy. Germany and France, we clearly have the potential to do well, but we are still in the midst of some protracted negotiations associated with the required restructuring activities in both of those markets. And that tends to be a relatively public event in those countries, as you undoubtedly know. And this tends to - have an impact on slowing down our momentum. In those two markets, we're missing a plan and the business in not growing. In fact, it's declining. Additionally, in those two markets, as you undoubtedly know, the economies tend to be weaker. A second point I make, relative to Europe, is in the currency area. The foreign exchange area has been working against us, as the U.S. dollar has strengthened with respect to the European currencies.

Gerard Meuchner: To what degree, if I may ask?

Vin Mullarkey: The currency impact, from a profit perspective, was a negative impact in the second quarter of just over $20 million.

Gerard Meuchner: And is there any reason to believe that the conditions in Germany and France will be resolved shortly, or might they persist through the third quarter and into the fourth?

Vin Mullarkey: I think we have-- we're at a stage in both of these countries where we're attempting to reach agreement with the appropriate parties on the plan. Once that has begun, we would proceed forward with the implementation of that plan. So this will clearly be another couple of quarters.

Dan Kaferle: Next question, please.

Operator: Brandon Mussler, please go ahead with your question.

Brandon Mussler: Illuminata. My first question is -- this is general -- it's, what do you- what is the primary contributory factor for where your gross margin improvement and if you could comment on the service business especially. Or is it just something like plunging memory prices. Also, I thought I heard Vin say -- and I might have misheard this, that you had a 12-day improvement in AR and I'm just wondering if that's true, if you could comment on it. And for Bob, I just wonder if you can give us in your head what model you have for the progress of StrongARM. Is is analogous to any of your other previous products like Alpha, or maybe the rate at the NT business has increased?

Vin Mullarkey: This is Vin speaking. Why don't I begin with the first two questions that you asked. The gross margin improvements that I refer to have been key goals of the company for quite some period of time. We have demonstrable success in that regard, relative to product gross margins, where over the last couple of years has been some steady improvement. And we see that continuing. The fact is they're a multiple, but they primarily are the strength of the high rent mix that we have in the business today, versus a year ago or so, principally the success of the 8000 product family and the 4100 product family and the associated more rich margins, as it were.

Secondly, we have had continued success, in terms of cost reduction both in the production areas, as well as design for lower cost-type opportunities. On the service side of the equation, we have as has the service industry at large -- this sector of the service industry -- has had a steady decline in gross margins over the last four or five years. Again, it's a dynamic in the industry. One of the major goals that we disclosed this past September was to stabilize that decline and we projected at that point that over the next year or so we'd begin to see an improvement. I think that it's quite clear that we've stabilized over the last couple of quarters and we're hoping that we'll begin to see, albeit modest, some improvement in the second half. The key factors there are, again, improvements of mix in the business, withdrawing or de-emphasizing some of the more commodity service activities and de-emphasizing Digital's excellent capabilities in the higher-end, value-added type service capabilities, particularly in the integration areas, network integration, systems integration and also in the oursourcing areas.

Relative to your question on DSO, on day sales outstanding or accounts receivables, it's been a good performance. I think there's room there for more improvement and the basic factors behind that are improved focus. Bob pointed out earlier the improved execution in the company. And the 12-day improvement has also been influenced by improved systems. The company's implementing the SAP/R3 capability throughout the enterprise.

Bob Palmer: It might be worth noting, Vin, just for clarity, what the 12 days improvement is versus the first quarter. And on a year-over-year basis, I think it was more on the order of a couple of days improvement for clarity.

On the StrongARM question, my personal expectation is that StrongARM will ramp into volume much more rapidly than previous microprocessors because of its very attractive features of extremely high-performance and very, very low power consumption at a very low price point. There's nothing remotely like it in the industry, to my knowledge, and we've won so many designs in it that the actual demand is going to be a function of how rapidly the thin client or network computer market takes off, which is one of its primary targeted markets.

So I think there's every reason to expect a very rapid ramp in that product. And semiconductor operations remain on tract. They continue to achieve their budget, frankly, year after year, and they remain on track to become less of a drain on the corporate's profitability. We've stated previously that we expected semiconductor operations to achieve break-even status, I believe in 1998 and we're still on track.

Bob Mussler: Thank you.

Dan Kaferle: Next question, please.

Operator: Maureen O'Gara, please go ahead with your question.

Maureen O'Gara: Gentlemen, I was wondering whether you have made any changes in your compensation plans-- in your compensation.

Bob Palmer: No, there's not been any changes in our normal compensation plans. We have, of course, a cycle throughout the world of adjusting and meeting competitive prices in our salaries and that sort of thing, but there's nothing unusual. Maybe I didn't understand your question.

Maureen O'Gara: We understand that you may have changed the percentage of base, versus the percentage of commission.

Bob Palmer: Over the last two years we have been moving to a variable compensation plan throughout the company. I understand your question now. Digital one of the- perhaps the only systems computer companies that did not have a variable compensation plan for its sales executive, as well as for other employees throughout the company and we're moving more and more of our population to variable compensation to give people the opportunity to participate personally when the company does well. And the objective there is to align all of our employees' interests with our shareholders' interests.

Maureen O'Gara: We had heard that you had changed the base from 70 percent to 60 percent and commission from 30 to 40.

Vin Mullarkey: The-- if I could add to Bob's point. The implementation of the sales commission plan has been one that began about three years ago-- two and a half to three years ago. And there's been some evolutionary advancement in that regard. The strategy was to not implement the 60/40 mix, for example, in the first year, but to do it in step function over years. So in that regard, there have been some changes. However, they were planned a couple or three years ago. Further, our current position tends to vary by country, or said differently, we're further along on that evolution, for example, in the U.S. market than we are in some of the off-shore markets. So, you'll find a difference of level of implementation, depending upon what country.

Maureen O'Gara: Is that having any impact on your performance?

Vin Mullarkey: We believe the data would suggest it's having a favorable impact on the company's performance.

Maureen O'Gara: What about the 64-bit stuff? When do you expect to get something from Microsoft?

Bob Palmer: Well, Microsoft has made their own announcements relative to working on 64-bit Windows NT. They've been quite clear that Alpha will be the first processor targeted because of its availability today. They're also clear that when the Merced product, which is being worked on by Intel, is available in the marketplace, Windows NT 64-bit will run on Merced. This gives DIGITAL really an exceptionally good position because we will have, for some period of time -- hard to know until we actually see both the timetable for Microsoft's implementation and the Intel introduction of Merced -- but we'll have some period of time where we have the only RISC processor running 64-bit Windows NT and that's very favorable for DIGITAL. And over the longer term, we'll continue to have two platforms that run 64-bit operating systems. Today, we have been shipping 64-bit units for three years. Our competitors are still not, for the most part, able to ship a general purpose 64-bit operating system on their platform. And so that's an advantage and we'll continue that advantage. We'll have both architectures running 64-bits by the end of the decade, which is pretty exciting really.

Maureen O'Gara: Do you expect to have a pre-beta this quarter from Microsoft?

Bob Palmer: We won't talk about the internal engineering schedules of Microsoft, which is our partner. Those kind of questions are much more appropriate to ask them.

Dan Kaferle: Carrie, can we have the next question, please?

Operator: Michael Ellis, please go ahead with your question.

Michael Ellis: Hi, Bob. At the-- after the annual meeting in November, you said that you might have earnings for the year of over $1 per share. Now that you've beaten the analyst forecast for the second quarter, I wonder if that's still the case. And just can you give us maybe higher expectations for the year? Thanks.

Bob Palmer: Well, I wouldn't choose to forecast an expectation, but I was talking about what our objectives were, what our goals are. And just as we set some goals for Q2, we have goals for Q3 and Q4. But again, it's almost impossible to forecast in this business. I think that the issue of-- as you enter any particular quarter, significantly less than half of that quarter is in backlog, so you've got to book and ship a substantial amount of the quarter in the quarter. And we saw that that had a slight impact on our growth in Q2. Just can't forecast, but the expectations seem to be reasonable to me.

Dan Kaferle: We have time for one more question.

Operator: Jeff Bliss, please go ahead with your question.

Jeff Bliss: Yeah, hi, this is Jeff Bliss at Computer Reseller News. I was wondering if you could specify whether the shortfall problem was a problem getting the product to the channel or the channel delivering the system.

Bob Palmer: What shortfall are we talking about, again? I'm sorry-- in terms of revenue, opportunity or--

Jeff Bliss: Well, in terms-- apparently there was-- the shortfall problem was a problem in delivering the system to the customer, so what I'm wondering is was this a problem-- was it really the channel's responsibility, or was it really getting the product to the channel in the first place?

Vin Mullarkey: The shortfall of $50-plus million that was referred to is frankly a good problem. As Bob pointed out earlier, these are orders that came in relatively late. It reflected a much higher demand, or order rate if you prefer, than we had expected for the quarter and as a result, we did not have available the inventory and someone to support it because it was a much, much stronger performance than we had expected. So in that regard, it's a good problem, particularly in that we met our other financial goals, as was pointed our earlier. It also puts us in a stronger position than we otherwise would have been in, relative to the next quarter, going into it. So it's not a material factor, in terms of customer satisfaction, nor is it a problem that we see continuing for an extended period of time.

Relative to the issue of shortfall, however, let me share a couple of other points that I think would add some additional perspective. Bob pointed out earlier, and it was also quite evident in our release this morning, that the company's revenues, although showing impressive growth sequentially from quarter one to quarter two, were down on a year-over-year basis is relative to the question you just asked-- namely that $50-plus million of supply constraints.

Let me add a couple of other points to that, if I could. First of all-- or secondly, the businesses that we have divested from over the last several quarters, as well as businesses that we have exited over the last couple of quarters, for example the PC retail business, the memory business among others, represented about a 7 point decline in the business. I mentioned the supply constraint area, your last question was about a 3 point impact in terms of the decline factor in the business. Additionally, if one was to analytically look at the sales-- the higher than appropriate sales levels into the channels that we had a quarter to a year ago and normalize that situation, it represents about 8 points in growth. And finally, as I pointed out earlier, we had a currently impact this quarter that represents about 2 points in growth. Collectively, that explains about 20 of those points relative to the quarter two growth position.

Dan Kaferle: Thank you. That concludes today's teleconference. There's a post-view line open from 12:30 to 2:30. The dial-in number is 800-633-8284 in the U.S. and 303-446-5399 for international callers. The reference number is 2368218. If you have any follow-up questions, I can be reached at 508-493-2195. Thank you.

Operator: Ladies and gentlemen, that does conclude our conference for today. You may all disconnect and thank you for participating.

DIGITAL EQUIPMENT CORP.

Moderator: Dan Kaferle
October 16, 1997
9:00 a.m. MDT

Operator: Welcome to the Digital Equipment Corporation's teleconference. As a reminder, this conference is being recorded Thursday, October 16th, 1997. The primary speakers today will be Digital's vice president and CFO, Mr. Vin Mullarkey, and Digital's senior vice president and general manager of worldwide sales and marketing, Mr. Bruce Claflin.

Now, I would like to turn the conference over to the director of Digital's corporate public relations, Dan Kaferle. Please go ahead, Mr. Kaferle.

Dan Kaferle: Good morning, and welcome to Digital Equipment Corporation's first quarter earnings teleconference. Thank you for calling in. Our earnings release is available on PR Newswire and can be accessed through the Digital homepage on the World Wide Web. This morning I have with me Digital chief financial officer, Vin Mullarkey, and Bruce Claflin, senior vice president and general manager of worldwide sales and marketing. Vin will provide an overview of the quarter, and Bruce will talk about Digital sales and marketing. We'll then open the session to questions. The teleconference will end promptly at 11:45.

Before we begin, I would like to state that statements contained in this teleconference that are not historical facts are forward-looking statements as that term is defined in the Private Securities and Litigation Reform Act of 1995. All forward-looking statements are subject to risks and uncertainties, which could cause actual results to differ from those projected. Such risks and uncertainties are discussed more fully in the company's latest annual report on Form 10-K and the company's other filings with the Securities and Exchange Commission.

Vin?

Vin Mullarkey: Thank you, Dan. Good morning, and thank you for joining us. As you know from the press release we sent out earlier today, Digital reported net income of $25 million for the fiscal quarter, or 11 cents per common share. This represents a $91 million profit improvement over the same quarter of last year. We are pleased with the continued progress being made in nearly all operating areas of the company -- first, a return to revenue growth with strong growth in our strategic focus areas, and even stronger on a constant dollar basis, year-over-year gross margin improvements, solid expense controls, continuous profit improvement, and also improvement in all areas of the company's balance sheet.

One of the key factors, as Bruce Claflin will discuss in more detail in a moment, is the increased focus on stability in our sales and marketing organization. It's significant improvement from a year ago. We are now going to market as one company with a unified marketing strategy and common message that supports our growth strategy and our brand. Our new advertising campaign, which began last week, is one of the most visible results of this renewed focus. The early success of this approach is evident in the 4 percent in growth at product revenues, and even stronger growth in several of our strategic markets, including AlphaServers running UNIX in particular, enterprise-based servers running Windows NT, and storage systems.

Although service revenues were essentially flat with the same quarter last year, we continued to make progress in the areas we have targeted for growth, that being client server outsourcing, network and systems integration services, and multi-vendor maintenance services. We are very encouraged by the strength, which is building in our sales and marketing operations, and our many examples of success which reinforce this.

Bruce will now elaborate. Bruce?

Bruce Claflin: Thank you, Vin. Good morning, ladies and gentlemen. As you know, our fiscal year 1997 was a very disappointing year in terms of revenue performance. We had four consecutive quarters of year-over-year revenue decline. As we assess the reasons for this, we concluded that our products and services were competitive, our strategy was sound, and the markets we had targeted are growing at rapid rates, but that the problems were largely self-inflicted and operational in nature. While disappointing, it was also encouraging because we knew that we could fix them and to expect to see business improvement in very rapid order.

As we looked at the type of issues that affected us, we believe the fundamental issue was that our approach to market was fragmented. Our business unit model, while helpful at getting cost and expense under control and getting it competing to the cycle times of our major competitors, had caused our marketing and sales to become fragmented. And instead of the approaching the customer as a unified Digital Corporation, we approached them as several fragmented elements of the corporation. This approach was frustrating to our customers, partners and ISV's and it caused us to approach customers selling piece parts as opposed to solutions. From an organization standpoint, the first and lowest place in the organization where someone had the responsibility to speak for all of Digital was the chairman of the board. At the same time, our fragmented approach was not leveraging our services capability. Services are an exceptional differentiator in the marketplace and a great source of strength for our company. And lastly, our fragmented approach was not allowing us to invest and build the Digital brand and all that it stands for as an enterprise solutions company.

So as a result, we've made a number of changes starting with building an integrated sales and marketing organization and empowering our account manager to be responsible for all Digital revenue in relationship with our customers, effectively bringing what had been at the chairman of the board's level directly to the customer-facing people in our organization. Our country managers are responsible for all Digital operations, including revenue, profit loss, and customer satisfaction. And our approach is to sell solutions to customers' business problems. We believe that our four decades of enterprise experience uniquely position us to be an enterprise solutions provider, and the breadth and depth of our hardware-software services, in concert with our partners, again uniquely position us to solve customer business problems. By having a unified one face to the customer, we're now positioned to sell total Digital solutions with our partners to customers. The intent is, if you have a services relationship with the customer, expand it to products. If you have a products relationship, expand it to services. And if you have no relationship, solve the customer's business problem, oftentimes leading with services and following with products at a later point. This approach of maximizing Digital content on every sale is a dramatic change from our approach to market prior to this fiscal year.

Another change that we've made in the idea of unifying was our coverage of our largest global customers. Digital is blessed by having a large, loyal customer base, particularly in some of the largest global companies of the world. And they wanted and expected us to handle them and support them on a global basis. As a result, we have built an integrated, global account management organization with a vice president directly reporting to me, who line-manages our 26 largest global accounts and program-manages the rest. As a result, we deploy resources in support of the customer's global requirements regardless of where the revenue might flow. And we've already received exceptional feedbacks from our global customers that this was a step in the right direction.

And lastly, we are investing in building the Digital brand and all that it stands for in enterprises, particularly with our strong heritage in the technical community, CIO's of enterprises. And this has been manifested most visibly in a new advertising campaign, which was recently introduced. All of these changes that we've made, we believe, are beginning to show results, and we're very encouraged by Q1. As Vin said, our revenue was up 2 percent, our products revenue was up 4 percent. While services essentially were flat growth, exceptional growth occurred in our outsourcing business and our strategic network integration areas. Further, if you look at our business on a local currency view, you would see that total growth was, in fact, 6 points higher, and products grew at double-digit rates. Another indicator of improvement is the balance of inventory that's maintained by our channels, both the aggregate side and the quality of the inventory by age are the best shape that they have ever been, which positions us well for Q2 and beyond. And lastly, morale within our field organization is significantly higher than it has been in recent past. And we can find that in a number of indicators, but the most of encouraging of which is attrition. Field attrition last year had reached alarming rates. Today, it is in the single digits and is reassuring to both us and to our customers that our field organization has confidence in our products and our strategies.

Another reason that we're encouraged is we've had some enormous wins and successes. For example, more and more of our customers are coming to us for Internet-based business solutions, whether they're trying to build an extranet or extend their market reach through an Internet. During the first quarter, for example, we teamed up with Wells Fargo, Microsoft and VeriFone to offer customers a complete Internet-based electronic commerce solution. It's called the Virtual Store program, and it makes it simpler for retailers to understand and implement secure Internet commerce solutions that will help them expand their markets, reduce costs, and improve customer support. We also announced plans to build our second Internet exchange facility. This one will be in Kuala Lumpur, Malaysia, and it will replicate Digital's very successful Internet exchange that's in Palo Alto, California, which, as you know, provides customers with the benefits of a combined switching and commercial data center independent of any one Internet service provider or telephone company affiliation.

Digital's output server systems are increasingly regarded as a platform of choice for the most demanding Web sites. Digital won a multi-million dollar contract with America Online, for example, that includes multiple output server, 4,100 systems to support their growing Internet business. Lycos, one of the leading Internet search services, placed a multi-million dollar order for Alpha and Digital x86-based systems to support their expansion in Europe. And last week, Digital received two Dvorak Telecommunications Excellence awards, which recognized our AlphaServer 4100 and 8400 systems as the best high-performance Web server platforms.

Another of our keys to success is to deliver business solutions leveraging our services business. Last month, we announced the signing of multi-year outsourcing agreements with Dow Chemical, GE Aircraft and Perkin Elmer. The combined contracts total more than $165 million and include services ranging from custom telephone support to design and implementation of a worldwide roll-out of SAP R/3. We've had similar successes in Europe. GlaxoWellcome, the pharmaceutical giant, signed a multi-million dollar contract with Digital to manage and maintain its mission-critical information technology environment. In fact, the excellence of our systems integration business was acknowledged by a *Computerworld* magazine survey, which selected Digital as the number one systems integrator in its annual customer satisfaction survey in the United States. And IDC concluded recently that Digital is the leader in provided mission-critical support for both UNIX and Windows NT.

So while we're very encouraged by our progress in Q1, we're even more optimistic about Q2. As we begin this quarter, we start with a complete refresh of our product line, which will strengthen our presence in the marketplace. These include enhanced servers and clients, enhanced Digital UNIX capabilities, Affinity Wave 5 for OpenVMS -- that includes enhancements for OpenVMS servers and clusters -- improved integration solutions, and a guaranteed up-time program from services. There are AlphaServer speed-ups with supporting benchmark data that give us price performance leadership and new Windows NT systems, from notebooks to data center with complementary gold and platinum services. In addition, we are undertaking massive field training, both for our sales reps as well as our partners to make certain that they are fully capable of expressing the competitive advantage of our products and services as well as position them as solutions offering. And as I mentioned, on October 6th, we launched a worldwide advertising campaign. This campaign is designed to build the Digital brand and will feature our competencies as a company as well as selected products and services. It is being done in a consistent way around the world with a very unique and distinguished look that both gets attention and clearly links the campaign to the Digital brand. It speaks in aggressive tones, it is not afraid to go toe to toe with competitors, and it often uses our customers to tell our story. We believe it's an important part of building the awareness and preference for the Digital brand.

So, in conclusion, we implemented a very large number of changes at the beginning of the fiscal year and were able to get the benefits of those changes without any of the side disruption. The results are beginning to show, and in Q2 we will continue to focus on solution selling with our key partners, building our skills, enhancing the morale and aggressiveness of our field organization, raising our profile in the market through activities like our advertising, while keeping focus on expense margin and cash, all while we continue to grow the business.

Vin?

V. Mullarkey: Thanks, Bruce. I'll now address a summary of our financial results for the first quarter. These results reflect the continued trend of strengthening overall business performance. As you recall from our recent teleconferences, our planned return to competitive financial levels is based on steady and predictable improvement. Our first fiscal quarter is a seasonally weak one, and the couching situation presented an additional challenge for the company. However, we met this challenge, and we continued on a path of profitable improvement. At $3 billion, total revenue grew 2 percent over the first fiscal quarter of '97 and clearly aligned with our plans and expectations. Product revenue was up 4 percent, while service revenue showed a modest decline. The adverse effect of couching on a year-over-year basis was about 6 points of growth. This indicates that in cost and dollar terms, our underlying revenue growth and trend is solidly building momentum.

There are several facts which provide evidence that our solutions-based offering being well received that we are gaining ground competitively. First, our Alpha and Intel server revenue growth in total was 26 percent over the comparable period of a year ago. AlphaServer growth across all operating system environments improved considerably from last year, growing 78 percent. UNIX Alpha server growth was up 28 percent. And total Intel server growth was also very impressive at almost 70 percent, while the Windows NT Intel server business grew in excess of 140 percent. Clear progress in market share gains in all of these critical areas.

Within services, client/server outsourcing continues to grow at a very healthy rate, in excess of 40 percent. Additionally, the base for future revenue continues to grow in that, during the quarter, we added considerably to our book of business. Network and systems integration services gained strength as well. The order rate was particularly strong this quarter, increasing our confidence that we will be achieving our growth plans this fiscal year. Geographically, revenue growth in North America, Latin America, and in Europe was very encouraging, in spite of substantial currency challenges. In fact, in local currency terms, Europe experienced double-digit product revenue growth this past quarter. Asia Pacific was a disappointment, but we do expect to be back on plan as this fiscal year develops. Our storage product line continues to do well. Total storage revenues is growing at a rate in excess of 20 percent, and it represents growing importance to the company overall. Additionally, our new family of high-performance switches have contributed to a return to growth for our network products business.

Gross margins improved by two points over the first quarter of last fiscal year, driven by focused attention on productivity and our solutions-based platform strategy, which drives a richer mix of servers and services. Total operating expenses were slightly lower than the same quarter of last year. This is a result of continued good expense control, while at the same time maintaining our commitment of investing in critical areas, such as sales and marketing, advertising, and our strategic product line.

Our balance sheet progress continues. When compared to Quarter one of last year, we reduce receivables by some $300 million and inventory by $200 million, both achieved on a higher level of sales. And we ended the quarter with a cash and short-term investment balance of 2.4 billion, an increase of $300 million year-over-year. As evidence of our growing confidence, we repurchased some 3.7 million shares of stock at a cost of $160 million as part of the share repurchase program initiated in July of '96.

Looking forward, I would remind you that currency will continue to be a factor. It had a substantial impact on the first quarter results, and I remain concerned about the potential for future impact. We will continue to take actions to mitigate the effect of adverse currency movement to the extent that it does not compromise our key strategic investments or our plans to gain market share. Our plans for the remainder of fiscal year '98 reflect a commitment to revenue growth, market share gains in strategic areas, and continued improvement in profitability.

D. Kaferle: Before we commence with the question and answer period, I need to make a comment about subject matter we will not discuss. That is the litigation between Digital and Intel, and recent speculation in the media. We have nothing new to report, and as a policy, we do not comment on speculation or rumor. Consequently, please accept the fact that we will not answer questions of this nature and will move on to the next question. Thank you for your cooperation.

Christie, we will now take the first question.

Operator: Ladies and gentlemen, we will now begin the question and answer session. If you have a question, you will need to press the one, followed by the four on your push-button phone. You will hear a three-tone prompt acknowledging your request, and your questions will be polled in the order they are received. If your question has been answered and you would like to withdraw your polling request, you may do so by pressing the one, followed by the three on your push-button phone. If you are using a speaker phone, please pick up your handset before pressing the numbers.

One moment please for the first question. Michael Ellis from Reuters, please go ahead with your question.

Michael Ellis: Hi. Vin, I wonder if you can just go back over again on the server sales, just make sure I got them correct. Also, if you have any numbers for work station sales, and then if you can be specific about the impact in the currency. Thanks.

V. Mullarkey: Yes, Mike, let me try. The AlphaServer business-- To your question on server sales, the Alpha server business was up 17 percent. The very strong recovery over the weaker levels that were seen over the last couple of quarters, and again good measure an indicator of the progress that we're making, particularly on the sales and marketing front, referenced to points that Bruce made a few moments ago. AlphaServer-- I'm sorry. Intel server business grew by some 70 percent this past quarter with particular strength on the NT side, the company's strategic focus where growth was in excess of 140 percent. The client business overall for the company was down this past quarter, consistent with the previous quarter.

In terms of more specifics relative to currency?

M. Ellis: Yeah.

V. Mullarkey: The currency impact for the company in the first quarter was approximately $100 million.

M. Ellis: So it's 100 million-- off of profits?

V. Mullarkey: In profit.

M. Ellis: And one other quick question on servers -- I think you said something about up 26 percent year-over-year. Was that-- Is that Alpha? I thought I heard earlier something about AlphaServer sales of 26--

V. Mullarkey: I'm sorry. The UNIX segment of our AlphaServer business was up 28 percent year-over-year.

M. Ellis: 28 percent. Great. OK. Thanks

V. Mullarkey: Very strong performance.

D. Kaferle: Next question, please.

Operator: Terry Shannon from Shannon Knows DEC, please go ahead with your question.

Terry Shannon: Yes, good morning. I have a question for Bruce Claflin. I'd like to congratulate you on your results in a traditionally lackluster quarter. My question involves Alpha revenue growth and the size of the Alpha installed base. A recent trade press article claimed that DEC shipped only 55,000 Alpha systems in the last calendar year, which is way inconsistent with my own findings. Can you comment on the size of the Alpha-installed base and on current Alpha run rates?

B. Claflin: Yes, Terry. First, thanks for the kind words. It's nice to have some progress in Q1. As you know, Vin told you our AlphaServer business is up. Our overall Alpha business is up as well. Relative to the size of the installed base, I'm going to look to my colleagues around the table because I have no idea.

V. Mullarkey: Terry, to your point, the installed base is considerably higher than what you indicated. So your-- either your instincts, which you did not quantify, are clearly directionally more accurate than what you indicated somebody else had indicated. We don't disclose that data as a matter of our policy.

T. Shannon: OK. Thank you.

D. Kaferle: Next question, please.

Operator: Leslie Wines from AFX News, please go ahead with your question.

Leslie Wines: Yes, thank you. You had mentioned that you were optimistic about your performance in the second quarter, and I guess throughout your fiscal '98. Is there any way you can ballpark that? Do you see-- What sort of-- Do you see any improvement over the 11 cents this quarter? How far do you see that going up? Do you have any sorts of EPS predictions for the quarter, the second quarter of the year?

V. Mullarkey: Well, again, it's not our practice to be too specific in terms of guidance. We do expect a very significant improvement in the second quarter in terms of earnings versus the first quarter. We also expect a significant improvement versus the same quarter, that is, Quarter two, of a year ago. It's also quite evident that Wall Street expects a fairly significant improvement if you look at the consensus estimates on Wall Street. They're considerably advanced. But I'm not necessarily endorsing those numbers. I think it's also fair to say that the general expectations of the company are up if you look at the share price of the company. It has approximately doubled over the last several months since the April timeframe, obviously a very strong indicator of investment confidence in the track that the company's on and of its future earnings potential.

D. Kaferle: Next question, please.

Operator: Amy Wohl from Wohl Associates, please go ahead with your question.

Amy Wohl: Hi, Bruce. Congratulations on the numbers. I'm glad to hear that you've decided to replace the monkeys. I've seen the new ad campaign, and I think it's going to be much more effective for you.

B. Claflin: Oh, you like what-- Still, you haven't seen the best part yet, Amy. It's coming.

A. Wohl: Oh, well, I'm impatiently waiting. What I'd really like to try to understand a little better is with some of the competition reporting unimaginable numbers for revenues in the service sector, do you attribute Digital's flat revenue here to the fact that you weren't more focused on the solutions business or to something else?

B. Claflin: I think there are a couple of factors. The first is that within our mix of services, we have business associated with our traditional, older Digital products mostly associated with hardware and software maintenance, availability services, and that business continues to decline, as has been our plan. And so it offsets the very rapid growth we've had, particularly of outsourcing in our key network integration areas. So when you see an overall services revenue that's essentially flat, it masks what's happening underneath -- very rapid growth in the strategic areas offset by declines in our historic business.

Now, as you might have seen, we have some great strengths in key segments. For example, on our integration business, we're the world's leader at exchange roll-outs with over 1.3 seats under contract. We just dominate that market space, and that's largely through our services capability. I also mentioned to you some of the major outsourcing deals that we have won. So we do have strength there that the underlying numbers mask. Having said that, Amy, I would expect that the solutions focus that we are providing and the responsibility of the account managers to sell total Digital that we would see over time an increase in our services business. As I talk with customers about what's important to them, they continually tell me that the issues that keep them awake at night are how they integrate all the technologies that are coming at them with all the technologies they have, deploy applications sooner, and do it at lower cost. As you think about those issues, it's services that largely help them through these problems. So service is our-- the major differentiator in the customers' eyes, and it is a strength for our company, and by leveraging our services capability as a part of solutions, I would expect that our services business would have-- would grow at an absolute rate faster, obviously, than this past quarter.

A. Wohl: Great. I'm glad to hear that. Thank you.

D. Kaferle: Next question, please.

Operator: Paul Judge from *Business Week* magazine, please go ahead with your question.

Paul Judge: Bruce, I wonder if you could be a little more specific about what caused the upturn in AlphaServer sales, and also, what's your analysis of the fact that Intel servers are doing so much better in NT than the AlphaServers?

B. Claflin: Well, the AlphaServer sales, I think, are up because of a focus in the segments where we have absolute performance leadership. If you look at where we have been successful, you'll find that in high-performance technical computing, in large database environments, and particularly, for Internet search-- or Internet service providers and search engines, are three very high-growth segments where Alpha's performance has undisputed leadership. Let me give you an example. We dominate all of the high-end search engines of the world with our Alpha technology. If you were putting up a major search engine, you have to have very high scalability and high availability. Our own experience with AltaVista, where we brought it up in December of '95 and today have over 35 million hits a day, illustrates the kind of scalability you must provide. Digital's Alpha technology is unequaled in the ability to provide a highly scalable, highly available platform. And in that market, we have great strength.

Database is another area, where, through our 64-byte capabilities and very large memory, we can perform database applications that on non-VLM systems could take minutes and take only seconds today -- order magnitude improvements in productivity. And so I believe the strength of our AlphaServer is because we have more narrowly positioned it to the markets where we have exceptional capabilities, and then we partnered well with leading application providers to exploit that technology. That's why I believe that our Alpha business has grown so well, Paul.

On the Intel side, we've continued on the strategy that we began last year, which was the focus on NT. We believe that NT will be the platform of choice for deploying many Web-based services. We also believe that NT is the clear departmental server environment in the enterprise, and much of our strength in mail and messaging is on Intel-class products. So our x86 server business continued the very high growth that we'd started last year, I believe, largely because of the focus around NT.

P. Judge: Can you enlighten us at all about the impact that FX!32 is having and whether that's dragging any Alpha sales in the direction of NT?

B. Claflin: I don't think that it's had a dramatic positive impact, although I would expect to be increasingly important in the future as Microsoft actually integrates that into Windows NT 5.0.

P. Judge: Thanks.

D. Kaferle: Next question, please.

Operator: Mike Wilman from Dataquest, please go ahead with your question.

Mike Wilman: Hi. Good morning. Vin, you mentioned Europe earlier on. Can you be-- are you able to be a bit more specific about your product and services revenues from you're "up this quarter compared to the same quarter in '97"?

V. Mullarkey: Yes, I would. Inasmuch as that they were both up, and up considerably over the same quarter of a year ago, the growth levels on products were higher than the growth levels in services, but they both showed very strong growth.

M. Wilman: Great. That's good news and pretty much what I expected. Is it possible at any stage to get hold of the actual figures?

V. Mullarkey: We don't generally disclose that. I would say, however, that we've had good progress in most of the markets of Europe. I would particularly refer to England, France, Switzerland, Italy, the Netherlands as being the four or five markets where we had exceptional strength this past quarter.

M. Wilman: Yes, because I know countries like Germany have sort of hindered you a little bit in the past with the economic downturn there.

V. Mullarkey: The economy's not helping there, but we're optimistic that we'll see an improved situation develop as this fiscal year develops.

M. Wilman: OK, and then one last question -- you mentioned the impact of the currency situations are being about $100 million on profit. How much of that came from Europe in terms of, you know, percentage?

V. Mullarkey: Oh, about approximately 60, 70 percent.

M. Wilman: OK. Thank you very much.

V. Mullarkey: That, incidentally, was $100 million compared to Quarter one a year ago.

M. Wilman: Yeah, right. OK, thank you.

D. Kaferle: Next question, please.

Operator: Bruce Francis from CNBC, please go ahead with your question.

Bruce Francis: Yes, first of all, analysts have you at 62 cents in your second quarter. Do you feel comfortable with that? And I'd like to follow up.

V. Mullarkey: Bruce, it's not our practice to respond directly to the analysts' consensus figures for future quarters. We do feel confident in the company's outlook. We are providing guidance to the Wall Street investment community of a continuation of growth, in fact, improved growth moving forward to Quarter two, improved margins, a continuation of good expense controls, and we're also projecting again continued balance sheet strengthening. So certainly, the consensus at 60-some odd cents reflects that, something in that ballpark.

B. Francis: OK. And to follow up now -- understand I'm not asking you about the Intel case specifically, but what impact-- business impact-- Have you noticed any concern from your customers regarding this, and have you had any changes, negative or positive, in the availability of Intel components as a result of this.

B. Claflin: This is Bruce Claflin. Let me start with the end of your question first. We have had no issues on providing Intel-class technology, and, as Vin described, our Intel business grew very nicely last quarter, and was fully supplied, supportive in that growth. Relative to our Alpha products, obviously, after the press article, there was considerable inquiry. I sent a letter to our field, which has been widely reported in the newspapers, and the summary was there's no reason not to sell and no reason not to buy our Alpha-based products. We do not believe that there's any impact on our business going forward.

D. Kaferle: Next question, please.

Operator: Chris Goodhue from Gartner Group, please go ahead with your question.

Chris Goodhue: Hi, thanks. Good morning. This is a question for Bruce. I'm wondering if you could just comment a little more specifically on the decline in the client systems business and provide some indication of what you anticipate needing to do to turn that around.

B. Claflin: Yeah, let me comment first on the client side. That was an aggregate statement. In fact, our x86 clients had modest growth. Our Alpha-based clients declined, and it was largely based on our older VMS and to some degree UNIX workstation business, but the Intel clients actually had growth this past quarter, and that's the first time they've grown in over five quarters. Relative to-- Let's see. What was the rest of your question, Chris?

C. Goodhue: Just how-- what you'd expect to do going forward to ensure that you have sustainable growth in that part of the business, specifically on the Intel side?

B. Claflin: On the Intel side?

C. Goodhue: Yes.

B. Claflin: Yeah, well, we're going to continue on the strategy that we've had, Chris. As you know, we've narrowed our focus to commercial customers implementing client/server solution with leadership around Windows NT. That strategy works. And as you know now, we have had progressively improved quarters, each over the other, and while Vin didn't say it explicitly, I know, Chris, that you asked this question -- our PC business was profitable last quarter as well. So I'm very encouraged by the progress we've that made on PCs, and we would expect it would continue. I would comment that our server business has very high growth. Our desktop business has resumed growth at single-digit rates, and I would expect it to stay at that level. However, in this quarter, I would expect our notebook business to grow substantially as a result of the introduction of our Ultra 2000, and lightweight package. So we do believe that the notebook line will be a very high-growth segment within our PC business this quarter.

D. Kaferle: Next question, please.

Operator: Todd Wallach from *Boston Herald*, please go ahead with your question.

Todd Wallach: Sure. I noticed that you mentioned a lot of stellar growth in certain products, like AlphaServers and NT-based systems. I was curious, though, if the overall revenue increased at just 2 percent, what were some of the products that did not sell quite as well?

V. Mullarkey: There are categorically three areas of the business that from a product services perspective that haven't declined, at least two of which have been referred to. Bruce just referred to the Alpha workstation business, which is declining, and that is a continuation of the experience we've had in-- of the last few quarters, and the second area is in the VAX area, which has been under decline now for several years as we've transitioned to the Alpha platform. And that's a less significant factor today in the company. It's becoming less material, of course, as time goes time. And the third area of decline is in the maintenance on our older platforms, the maintenance service business of the marketplace. It's an important business. It's one that we're highly committed to support our customers from the last several decades that still use Digital products, whether they be VAX or PDP-11's or some of the earlier versions of Alpha, but as you would expect, that segment part of our business from a maintenance point of view, which is a sizable piece, also a very profitable piece, is declining at 5 or 6 percent a year.

D. Kaferle: Next question.

Operator: Rufus Williams from "Westminster Times Union," please go ahead with your question.

Rufus Williams: Bruce, please quantify the significance in the boost to your future Alpha business from the impending availability of 64-byte NT optimized for Alpha.

B. Claflin: Well, we think that the 64-byte availability of NT will be very important to our Alpha line directly and our overall NT business as well. The 64-byte implementation will allow us to exploit very large memory capability in an NT environment on Alpha. And as you know from my prior comments, it's the exploitation of VLM that has distinguished us so much in the UNIX-based market. We expect the same to occur in Windows NT and in the same type of application, particularly in database or data mart environments. I should comment, however, that some people just can't wait. And Oracle has already enabled their Oracle System 8 to run NT and to exploit VLM capabilities on our Alpha technology. At Oracle Open World, we demonstrated VLM exploitation on our Alpha-running NT and a Oracle System 8 with exceptional performance. So the market is clearly ready for this type of advancement. NT 5.0 will embed it into the core of its environment, but even other leading application providers are exploiting VLM earlier than NT, as exhibited by Oracle's commitment to us.

R. Williams: Thank you.

D. Kaferle: Next question, please.

Operator: Ladies and gentlemen, if there are any additional questions, please press the one, followed by the four at this time. Michael Ellis from Reuters, please state your follow-up question.

M. Ellis: Hi, Vin. I don't think I heard an overall figure for Alpha sales. Do you have something like that?

V. Mullarkey: Yes, Alpha sales overall was up 4 percent, a significant improvement from the last couple over the last couple of quarters, as I'm sure you can recall.

M. Ellis: Thank you.

V. Mullarkey: It's a-- Let me thank you again for joining us this morning. In closing, allow me to summarize a couple of very key points. First of all, our sales and marketing program, along with our product and service capability, both have strengthened considerably this quarter, and these improvements clearly contributed considerably to a return to growth for our company with very encouraging market share gains in these strategic areas which we've focused on here this morning. And finally, as we've indicated, our financial performance continues to reflect substantial improvement in every respect, and we remain confident that that will continue to move forward, not only in Quarter two, but in quarters to follow.

Thank you again for participating.

D. Kaferle: This concludes Digital's first quarter earnings teleconference conference. The post-view number is 1-800-633-8284 in the United States and 1-303-248-1201 for international callers. The line will be open from 1:00 p.m. to 3:00 p.m. If you have any additional questions, please call me at area code 978-493-2195. Thank you.

Operator: Ladies and gentlemen, that does conclude our conference for today. You may all disconnect, and thank you for participating.