Good day, ladies and gentlemen. Welcome to the Q2 2011 Intel Corporation's Earnings Call. My name is Chasity, and I'll be your coordinator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's call, Mr. Kevin Sellers, VP of Investor Relations. Please proceed, sir.

R. Sellers

Thank you, Chasity, and welcome everyone to Intel's Second Quarter 2011 Earnings Conference Call. By now, you should have received a copy of our earnings release and the CFO commentary that goes along with that. If you've not received both documents, they're currently available on our investor website, intc.com. I'm joined today by Paul Otellini, our President and CEO; and Stacy Smith, our Chief Financial Officer. In a moment, we will hear brief remarks from both of them followed by Q&A.

I'd like to tell you about a change to our company's guidance and Quiet Period practices. Beginning this quarter, the company's Quiet Period will be reduced by 2 weeks to enable an extended period of dialogue with investors. Intel will observe the Quiet Period from September 16 until publication of the company's third quarter earnings release.

Additionally, certain of our smaller business outlook items, the forecast for amortization of acquisition-related intangibles, impact of equity investments and interest and other and tax rate, will be pulled from guidance at the close of business, July 26, and not subject to an update by the company after that time.

We also want to make everyone aware of the annual Intel Developer Forum taking place September 13 through the 15 at the Moscone Center in San Francisco. In addition to keynotes from Paul and other senior leaders, we'll be beholding a number of investor briefings, and invite you to come and hope to see many of you there.

Before we begin, let me remind everyone that today's discussion contains forward-looking statements based on the environment as we currently see it and, as such, does include risks and uncertainties. Please refer to our press release for more information on the specific risk factors that could cause actual results to differ materially.

Also if during this call we use any non-GAAP financial measures or references, we will post the appropriate GAAP financial reconciliations to our website. So with that, let me hand it over to Paul.

Paul Otellini

Thanks, Kevin. I'm very pleased to report another record revenue quarter for the company. In May, we met with many of you at our annual investor meeting, and laid out our strategy and the opportunities we have before us. The transit of driving the growth of our business that we described then are playing out as expected. The Data Center business remains strong, our Embedded business is seeing rapid growth, the Enterprise PC refresh continues, and the emerging markets continue to be significant drivers of our broad based momentum.

In the comparison of our second quarter results versus Q2 of last year, we saw strong double-digit revenue growth across every business segment. For example, the Data Center business is up 15%; Embedded is up 25%; NAND is up 15%; and our PC Client business is up 11%.

If we look at the channel, which is an excellent proxy for emerging markets strength, our channel revenue was up 17% versus last year. In summary, this was a very strong quarter across all of our product lines and around the world.

Now let me take just a moment and provide a bit of color on performance of our major business segments. The Data Center Group had another very strong quarter with CPU revenues topping the $2 billion mark for the third consecutive quarter. Demand for our Westmere-EX family that was launched in April is very healthy, and this helped to strengthen server ASPs in the quarter.

At our Investor Day, we talked a lot about how the Data Center business was more than just servers. To highlight that, microprocessor unit shipments for storage applications set a record and we're up 38% from a year ago. Also, we grew our networking revenue 40% from a year ago. The non-server parts of our Data Center business are growing at an exceptional rate.

As for servers, the story is much the same. The market remains very strong, with demand from Cloud-based customers leading the way. The Cloud segment is up 50% in the first half of 2011 versus the first half of last year, demonstrating how fast that business continues to ramp. We believe that we are very early in the Cloud build out, and that Intel remains extremely well-positioned to profitably grow from the explosion of Mobile devices and Internet-based services.

In our Embedded business segment, I mentioned that revenues grew 25% from a year ago on record microprocessor unit shipments. We shipped over 1 million units of Atom processors into embedded applications for the first time ever, which is an increase of 76% from a year ago. Overall, we witnessed very broad-based strength in our embedded segment, with the fastest growth coming from the Medical Imaging segment, up 50%; Print Imaging, up 48%; Communications, up 40%; and Industrial applications, up 20%. We're starting to see many of the long cycle design wins that we've been tracking, turn into revenue, and expect Q3 to continue this trend.

McAfee turned in a very solid quarter with revenue beating our expectations. It was a second quarter record for McAfee in terms of revenue. Additionally, the number of large deals signed was almost double that of Q1. McAfee is executing very well and the importance of security has never been more evident. We are excited that later this year, Intel and McAfee will be shipping the very first products codeveloped by both companies that will greatly enhance security for computing applications.

This new solution is a combination of enhanced software from McAfee and security instructions built into the hardware from Intel. We look forward to providing more details of this product at our Developer Forum in September.

Lastly, the PC Client Group also had a very good quarter. Demand for Sandy Bridge processors has been very strong, with the ramp rate of Sandy Bridge ahead of the previous generation products by 20%. Today, 2/3 of all the products that we ship into PC clients are Core i3, i5, or i7.

Overall, the trends in PCs remain much the same as the last few quarters. The Corporate business remains consistent and healthy, consumer markets are mixed. The mature market consumer segment is still soft, but the emerging market consumer segment is healthy and growing.

Our guidance for the third quarter assumes a modest growth in the mature market consumer segments of the business. At this point in the year, we believe the PC unit growth will be around 8% to 10%, down a bit from our earlier view, but above that in revenue as Enterprise PC purchases continue to drive a very rich mix.

I previously mentioned that our channel revenue was up 17% from a year ago. Let me add some color to our emerging market results. In looking at the last 3 months of reported PC shipments, you can see why we're so optimistic about the emerging market's opportunity.

For example, Turkey and Indonesia are up over 70% each; India is up 17%; Russia is up 15%; and China is up 14%. The latest data on Latin America also showed growth of 12%. Brazil remains the key driver of this growth and is poised to become the third largest market for computers in 2012. In general, all of these are large, high growth regions, but PC penetration remains very low, while affordability of PCs continues to improve.

In closing, I want to highlight 2 important announcements made this quarter. The first was the process technology breakthrough that we made public back in May. Intel will be the first company to productize 3-D transistors. Our 22-nanometer process technology remains on track for high-volume production later this year, and will provide substantial improvements in power consumption and performance. This technology is very complex and very innovative, plus that we expect that the lead we have in process technology will expand going forward, providing Intel with important competitive advantages in the markets we're targeting.

Second was the Ultrabook announcement we made at Computex. Ultrabooks are the next evolution in personal computing that will combine the best of the consumer PC with tablet functionality, as well as consumer electronics features like instant on, and always on, always connected functionality. All in a stylish, thin and light system. We are very pleased with the industry response and customer commitments around this new product category, and will provide more details at our September Development Forum.

With that, let me turn the meeting over to Stacy.

Stacy Smith

Thanks, Paul. The second quarter was strong and better than expected, resulting in our first ever quarter with greater than $13 billion in revenue. From a market standpoint, the quarter played out as expected, with strength in emerging markets and enterprise, offset by softness in the mature market consumer segment. We continue to benefit from the strength of our product lineup, as mix within both servers and clients was better than expected.

Demand for our latest product, Sandy Bridge, remained strong and is the fastest ramping product in our company's history. As a result of the acquisitions of McAfee and the Infineon Wireless division, we will provide non-GAAP financial information in addition to GAAP for 2011 to provide additional visibility into the operational results of the company.

On a non-GAAP basis, we achieved record revenue of $13.1 billion. Gross margin of $8.1 billion was also a record for the gross margin of 62%. Operating profit of $4.2 billion was up 6% from a year ago. Net income of $3.2 billion and earnings per share of $0.59 were up 10% and 16%, respectively from a year ago. The rest of my comments will use GAAP financials unless otherwise called out.

Our business growth has accelerated over the past few years. Second quarter revenue of over $13 billion is up approximately $2.3 billion when compared to the second quarter of 2010, equating to 21% growth. The acquisitions of McAfee and the Infineon Wireless divisions contributed approximately $1 billion of the $2.3 billion increase from a year ago.

Gross margin in the second quarter was 61%, slightly down from the first quarter. As expected, our 22-nanometer startup cost peaked in the second quarter, and our costs were slightly higher as we ramped incremental factories on our 32 nanometer process technology. This was mostly offset by the reserves taken in the first quarter for the Cougar Point product issue, which were significantly less in the second quarter.

As we look forward to the third quarter of 2011, we are forecasting the midpoint of the revenue range at $14 billion, up 7% for the second quarter and in line with historical seasonality. We are forecasting the midpoint of the gross margin range to be up from the second quarter at 64%.

We are raising the midpoint of our outlook for R&D and MG&A by $500 million to $16.2 billion. Some of this increase is due to a significant increase in our business. For the larger portion is driven by investments we are making in innovation to drive future revenue growth. Our investments are focused on redefining the PC category with Ultrabooks, our server product offerings, strengthening our product offering in tablets and phones and further extending our process technology leadership.

Our long term goal here is to make these important investments that contribute to our growth, while still maintaining the progress we have made on efficiency and keeping spending as a percentage of revenue below 30%.

The cash generation of our business remains strong, with cash flow from operations of $4 billion in the second quarter. On top of investing in our business, we are increasing the amount of free cash flow allocated to the dividend and actively repurchasing shares. Consistent with the philosophy we outlined in May. This was apparent in the second quarter, as we purchased $2.5 billion in capital and are forecasting CapEx of $10.5 billion for the year, completed a $2 billion buyback, and announced a 16% increase to our dividend.

Our Intel-owned inventory was approximately flat to the prior quarter and the inventory that sits at our distributors were down slightly this quarter. As we look more broadly at the worldwide PC supply chain, we believe inventories are at a healthy level and did not grow this quarter.

As Paul mentioned, our business results in the second quarter continue to reinforce the key themes highlighted at our May Investor Meeting. The explosion of devices that compute and connect to the Internet continues to drive the buildout of the cloud and fuel our Data Center Group growth.

Our Embedded business is growing at a rapid pace, as the demand for both performance and low-power from the Internet of things drives architectural conversions for Intel.

Emerging markets already make up more than half of our revenue. And as the technology that we sell becomes more affordable to billions of consumers, we will continue to see robust growth from emerging markets. These are the market forces that drove first half revenue growth of 23% from the first half of 2010. And these are the market forces that give us confidence as we enter the second half of 2011.

With that, let me turn it back over to Kevin.

R. Sellers

Okay. Thanks, Stacy and Paul. We'll now move to Q&A. [Operator Instructions] Chasity, we'll take our first question.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Ross Seymore with Deutsche Bank.

Ross Seymore - Deutsche Bank AG

Just a question on your total PC unit forecast that you're looking at. I guess, if you're not really looking for anything different than seasonal in your full year guidance appears to be about the same, how do we reconcile a weaker addressable markets to the fact that your guidance has not changed?

Paul Otellini

Well, our guidance is in revenue dollars. And I said pretty clearly that one of the things we're seeing is less strength in the netbook segment and a stronger strength in the overall mix of PCs. In fact, our PC Client business, notebooks and desktops, non-netbooks is running double digits.

Ross Seymore - Deutsche Bank AG

And I guess, on that front, in the PC Client side of things, it looks like the core mix, it keeps rising. It's about 20%, I believe, of mixed now. How high do you think that can go and how long do you think it would take to get there?

Paul Otellini

Well, I think I said that 2/3 of our PC shipments were Core i3, i5, and i7. The branded portions of the product line. So the number is more than 20%. It's 66.5% [ph].

Ross Seymore - Deutsche Bank AG

My error, sorry.

Stacy Smith

Answering your question of, going forward, you can kind of see it in the gross margin recomp for Q3. We're expecting pricing to be relatively flat. It says kind of stable from here. So it surprises with our strength, but we believe that strength continues through this year.

Operator

Our next question comes from the line of Patrick Wang with Evercore.

Patrick Wang - Evercore Partners Inc.

I just want to see if you could maybe give us some milestones we should look for over the next couple of -- over the next quarter or so in terms of how your core business is growing in these emerging markets, geographies?

Paul Otellini

For the next quarter, I mean, the next milestone is our -- is 3 months from today.

Patrick Wang - Evercore Partners Inc.

Not specifically the next 3 months, but next few months. But just over the next couple of quarters here. Just maybe help us get a better sense of how to actually track the growth in those areas.

Paul Otellini

Well, I mean, there's no better way than understanding than putting feet on the street. To the extent that you have the opportunity to go, look at the -- I was just in Brazil. The fact that Brazil will become the third-largest country market in the world for computers next year is pretty astounding. It wasn't too long ago when they were number 6 or 7. And so it's the realtime dynamic of these markets waking up, increase in disposable income, a decrease in the cost of computing, a decrease in the cost of bandwidth and connectivity all coming together. And there's no one indicator I can point you to because as we've discussed before, some of this stuff is below the radar screen of some of the third-party trackers. But we see it realtime, because we've got a feet on the street and we're serving the market.

Stacy Smith

And I think you can see it -- where you see it pretty clearly is in our overall results. The emerging markets have been the big driver of incremental units over the last few years. Our prediction is that just continues as we go through the next few years.

Patrick Wang - Evercore Partners Inc.

That's helpful. And I know you guys have also shared that the graph in terms of number of weeks it takes to actually buy a PC. And I guess, my second question is also on the same topic here. Just in your emerging markets, what kind of product mix are you looking for the strength there? And I know that you guys are also pushing pretty hard for Ultrabooks. Just curious how that impacts your mix over time.

Paul Otellini

The strength -- the mix of the emerging markets is really historically is not much different than our overall mix. And every emerging market is different. For example, the Tier 1 and Tier 2 cities in China have a slightly richer mix than the United States on average. When you average China out across all the cities, you get a closer to average mix, maybe slightly down as you move into the Tier 5 and Tier 6 cities. But we really haven't seen the mix go down. The price should be dramatically different in these emerging markets because just like as you'd expect when it's your first time to buy a television, the first time to buy a computer, you want value. You want something that's going to last, that's going to be good for your company for more than a year or 2 and that tends to have you buy up a bit.

Operator

Our next question comes from the line Sumit Dhanda with Citadel.

Sumit Dhanda - Citadel Securities, LLC

A couple of questions. First, on the geographic trend, it seems like I hear on the mature markets that the Americas seem to do a lot better than Europe in the quarter, if you just looked at sequential sales growth. Any thoughts on the dichotomy there, especially given that North America had a tough comp as did Europe with the extra week in Q1?

Paul Otellini

Well, you have to be a little careful of that data because it's Billings data, Sumit, and now we're in a situation that worldwide supply chain builds and builds most of the notebooks in APAC. So I wouldn't draw too much of a conclusion from the Billings data. I do think we'd say that the consumer in North America was a smidge stronger than the consumer in Europe in the second quarter. And emerging markets across both regions was strong.

Paul Otellini

And Enterprise PC sales...

Paul Otellini

It's strong and good.

Paul Otellini

And the servers sales in North America...

Stacy Smith

Yes, and that's good point that Paul made. You tend to see more of the servers build directly in the market, so that also probably drives the North America numbers a little bit.

Sumit Dhanda - Citadel Securities, LLC

And then for my follow-up, Stacy, your comment that ASPs will be flat in 3Q despite that being typically the stronger consumer quarter, is that more an Enterprise driven phenomenon, i.e. PC Client business? Or is it just you think servers will be disproportionately strong in the third quarter?

Stacy Smith

No, it's more of an overall mix-within the different businesses, within the PC business and within the Server business. If I look back at what I've been predicting over the last several quarters, what I've been wrong on is that our mix to the core product line, Core i3, i5, i7, has been higher than I've anticipated. And so even with a bit of a seasonal uptick in the Consumer segment, I think that rich mix keeps me approximately flat from the same point of ASP.

Operator

Our next question comes from the line of Glen Yeung with Citi.

Glen Yeung - Citigroup Inc

If we look at your third quarter guidance, can you give us a sense as to what parts of your business are above your average sequential growth and what are below? And I think in the major groups, PC clients, Data Center, other IA, and software services.

Stacy Smith

Yes. I'd say across the major businesses, what we're expecting is seasonal. And so what it is, is kind of a continuation of the trends we've seen so far. We've seen relative strength in enterprise and we've seen relative strength in emerging markets. We think that continues into the back half of this year. We've seen relative softness in the consumer segment. But looking back at a decade of data in every year, be it a strong year or weak year, we see the second half stronger than the first half on a unit basis just because that's the buying season both for enterprise and consumer. And so off of that weak first half, we think there's a seasonal uptick in the second half. So nothing significantly different from a normal trend. So I am just starting from a weak starting point and some starting from a strong starting point.

Glen Yeung - Citigroup Inc

And then the other question I have is, when you look into the emerging markets client business, is there a difference there in the way inventories are managed, either from the perspective of overall PC inventories or from the perspective of stand-alone microprocessors? Is it harder to track, easier to track, do you feel like there they have control over that or they don't?

Paul Otellini

Actually, it's probably slightly better than we have in North America or Western Europe. And we have the same visibility into our multinational accounts, whether they ship in China or in Cleveland. That is we were off on these big hub. It's a system that basically they only draw what they need for their near term build. And in fact, we're seeing a conservatism there in terms of people moving a bit more to the air lanes versus shipping lanes just to be conservative. So in general, we feel pretty good about that part of the inventory. In emerging markets in general, a larger fraction of sales comes through the channel. A lot of that is white box and build-to-order. And by definition, build-to-order, if someone walks in and gives someone $200 and there's a computer that afternoon. So we get a much more real time feed there, and of course, we don't claim that revenue until it sells out through our distributors. So if anything, it may be slightly more realtime than the mature markets or the enterprise markets.

Operator

Our next question comes from the line of John Pitzer with Crédit Suisse.

John Pitzer - Crédit Suisse AG

Paul, you talked about the percent of the client business just sitting at core today. I think you said 2/3. I'm kind of curious, where are we now as Sandy Bridge as the percent of core. And I guess as you go from a Core i3, non-Sandy Bridge to Sandy Bridge, is that kind of both an ASP and a gross margin accretive event for you guys?

Paul Otellini

We're taking Sandy Bridge in the second half of the year down below the core brand and taking version to that into Pentium and Celeron. And as a percent of our core business today, it's over half. And what was the second part of the question, John? I'm sorry.

John Pitzer - Crédit Suisse AG

As you go from sort of like a core non-Sandy Bridge to a core Sandy Bridge, is that both an ASP and gross margin accretive event for you guys?

Paul Otellini

If we sell the same SKU at the same price, it's just slightly better, because you're selling one chip instead of the chip to CPU plus chipset. But what we're seeing with Sandy Bridge is the trend to sell up a bit for every SKU because of the demand for the performance and the graphics capability.

John Pitzer - Crédit Suisse AG

And then Paul, as my follow-up, can you talk a little bit on DCG. Some of the challenge checks we've done around customer's expectations around Romley are pretty high. And I'm kind of curious timeline on Romley, and as you think about introducing that new server architecture, do you think that's going to cause some stall out in the DCG group? Or how should we think about that for the back half of the year?

Paul Otellini

There's really no change for the schedule for Romley, which for those of you who don't follow our code names, is the Sandy Bridge version of the server products. We're public in saying that we'll be in production this year, nothing's changed. We still expect to be in volume production this year. We have not gone public on the launch date because our server customers are very conservative about putting the dates out for exactly the reason you point out. I don't expect to stall out given the timing that we've built into the product. I would add that as you've seen the product, it looks very exciting . The performance is really quite good.

Operator

Our next question comes from the line of Daniel Berenbaum with MKM Partners.

Daniel Berenbaum - MKM Partners LLC

Just wanted to revisit ASPs real quick. With ASPs up year-over-year, how much of that is being driven by the client platforms and the brand name you've driving there? How much is being driven by pure mix in client and how much is being driven by a shift in the enterprise platforms?

Stacy Smith

Well, I don't think I can separate out the branding from the mix within client. I think those things are synonymous. I think that we've spent a lot of energy to be able to articulate differentiated features and performance at different price points. That's a tool that we hadn't historically used, and that in conjunction with having a great product like Sandy Bridge and the kind of performance that brings has led to the richer mix within the client segment. I think that in general, that's the bigger driver, and then the fact that the Enterprise market has been relatively stronger than the consumer market is a secondary driver to ASP good news that we've seen.

Daniel Berenbaum - MKM Partners LLC

And then you talked a lot about emerging markets, and I just want to make sure, emerging markets versus enterprise. How much of emerging markets is enterprise? Or do you have more or less visibility into what the split is between, say, consumer and small, medium business in emerging markets?

Paul Otellini

We'll get to that level of detail in this call. In general, the business segment in emerging markets is a larger percentage of the total. But as the affordability of technology comes down like we showed at the investor meeting. We actually expect a lot of the growth to come in the Consumer segment of those markets. It's going to be a faster part of the growth equation.

Operator

Our next question comes from the line of Doug Freedman with Gleacher & Company.

Doug Freedman - Gleacher & Company, Inc.

Stacy, if I could dig in a little bit on the CapEx plan and if the little bit of pull in that you're showing. Should I characterize these slight increase in CapEx this year as a pull in from next year given the slide that you put up at the Analyst Day? Can you help offer some color there?

Stacy Smith

Some of it is a pull in. Some of it is we're growing faster. So this is really construction-related spending. Some of it is we're going a little faster on the 40-nanometer factories. The larger portion of it, and keep in mind, we're talking about a relatively small increment. But the larger portion of it is an increase in the scope of those factories. As we guide into the planning, we saw some opportunities to do some things in the infrastructure that we're putting in place that make it easier for those factories to support multiple generations behind 40-nanometer. So kind of putting in place the capability for 10 and 7-nanometer, and when it gets kind of high ROI to do that now versus having to retrofit those factories later. So it's a combination of those 2 things, but if I was ordering, the capability is driving a little bit more and the speed is driving a little bit less.

Doug Freedman - Gleacher & Company, Inc.

If I could look at what's going on near term with the OpEx number, this one of the few times I think I've seen you guys grow spending faster than you're forecasting revenue growth from that perspective. How should we think about revenue growth and the fall through to EPS if we were to just be modeling your revenue. What should we -- is there a ratio we should think about that you're targeting to drop through or anything you can offer as color as far as understanding those 2 numbers?

Stacy Smith

Yes, I mean, the simple answer there is what I said at the Investor Meeting, which is Paul and I are still committed to drive spending as a percent of revenue at or below 30% is our long term goal. And so I do think we will, over the long term, get some leverage in that line item. But we have a couple of things going on now. We see very fast growth in revenues. So some of this is revenue dependent. When I just step back and look, we grew from 2009 to 2010, we grew the business $8.5 billion. From 2010 to 2011, we're on track to grow the business in excess of $10 billion again. And so that revenue and profit dependent spending is a piece of this. But I think more importantly, we're making some important investments in our business that we believe give us even better position as we go forward. And we talked at the investor meeting about redefining the PC category with Ultrabooks.

We're making investments there. We're making investments in our Server business to continue and accelerate the growth rate in that business. And we're making investments in our Tablet and Phone business in order to improve the offering that we can offer to customers there. And Paul can talk a bit about that. And so it's a combination of those things, but right now, those investments are important. They don't change our long term view of the business, but they're important investments for us to make.

Operator

Our next question comes from the line of Craig Berger with FBR.

Craig Berger - FBR Capital Markets & Co.

Can you just, on the CapEx, help us understand how much of that is sort of 4-year equipment versus how much of that is longer-term halls and walls? And how long are your halls and walls depreciated over?

Stacy Smith

Of the increment, it's almost all construction, and that's -- you can have varying depreciation schedules but think of that as depreciating over a long period of time. We tend to use buildings for a decade. That's part of the reason that we build in the capabilities to support multiple generations in a factory. Equipment tends to depreciate on a much shorter period of time. Again, it can vary, but think of that over a handful of years.

Craig Berger - FBR Capital Markets & Co.

Can you talk about CapEx spending like that for the year not the increment, but the total?

Stacy Smith

Probably not at the level of detail that you'd want. But if you look at the CapEx that we're doing this year, we said at the investor meeting more of that, much more of that is being driven by building factories than what is normal for us. Andy talked about that in his investor meeting presentation. I'd refer you back to that. It's been a long time since we've had to build incremental shelves, but the growth in our business now requires it. So we're putting in place some clean room space that we haven't had to do over the last couple of generations. So it's a larger percent, but I'm not going to break out the exact percent between the 2.

Craig Berger - FBR Capital Markets & Co.

And then just a follow-up, gross margin Q2 to Q3, I know you've gone through it a little bit. But can you just help us understand again why there's greater than 100% revenue fall-through?

Stacy Smith

Yes, when I walk you through kind of the gross margin -- the short answer to your question is we're getting -- we're starting to get benefit of the tapering off of other cost of sales. And so that tends to give us higher than normal fall through. But if I step back and we use a reconciliation of Q2 to Q3 and talk a little bit about what I expect for the year, as we go from the second to third quarter, gross margin is going to be up around about 3.5 points. So that takes us up to 64%. The 3.5 points comes from -- we expect it to be a higher volume quarter. We've talked about that. We start to see -- as consistent with our historical patterns, we start to see the falling off of startup costs, so that adds about 1 point. We get about 1 point because we're now projecting to be finished with the impact of the Cougar Point reserves, so we don't have to repeat that in the third quarter, and then there's about 0.5 point as we continue up the ramp of the various 32 nanometer factories, our costs start to improve. We've talked about that on prior calls. So that's what gives us the benefit into the third quarter. And then as I think about the fourth quarter, and you can kind of get the math when you look at our annual forecast. I expect that we'll get little bit of benefit in terms of startup costs. You tend to see that come down over a couple of quarters. And so they think about the fourth quarter gross margin. I put it in the range of a bit higher than the 64%, probably based on what I know today, below the 65% that we've articulated as the high end of our range. So kind of in that zone.

Operator

Our next question comes from the line of Michael McConnell with Pacific Crest Securities.

Michael McConnell - Pacific Crest Securities, Inc.

Stacy, I had a question just looking at the segmented revenues here on fleet PC Client. Looks like you had growth in this business of about 11% year-over-year, yet operating profits were down about 1% year-over-year. Could you talk about the disconnect there with ASPs being as firm as they are?

Stacy Smith

It's startup cost, Michael. So if you think about our trend, you're on a two-year cadence. So during this year-over-year comparison from Q2 '11 to Q2 '10, what you're doing is you're comparing our lowest point in startup costs to our highest point in startup cost, because they start coming down here and if you think about that on a company-wide basis, some of that is DCG as well, but if you think about that on a company-wide basis, that's kind of 3.5 points of gross margin on a year-over-year comparison. So it's pretty significant.

Michael McConnell - Pacific Crest Securities, Inc.

And then I wanted to ask, looks like the upside driver relative to your expectations was in the other group or the Intel architecture group. And I think Infineon was about 90 million upside versus your expectation. So I understand that point and the driver there. What was the other areas, I guess, that were considerably strong and what's the outlook for that particular segment as we move into the back half of the year?

Stacy Smith

I apologize, I'm not sure I understand your question. If I look at what was different from the expectations when we started the quarter, Infineon actually came in kind of right where we expected it. At a good quarter, but in line with the expectations. The other elements in there were pretty much in line. The difference from expectations was our ASP was a little bit higher, our mix was a little bit better. And so -- and that was more of a PC and server comment than other Intel architecture group comment.

Operator

Our next question comes from the line of Shawn Webster with Macquarie.

Shawn Webster - Macquarie Research

A simple one, and then a more complicated one on CapEx. So on the simple question, what did your units do sequentially for processors? Where they down 3%, down 1%, flat?

Stacy Smith

Yes, on a sequential basis, it's a little bit complex, Shawn, because remember we had the 14th week in Q1. If I strip out the 14th week, I'd articulate it as units were seasonal. And you normally see a Q2 that's just little bit down from the first quarter.

Shawn Webster - Macquarie Research

And then on capital expenditures, high-level question is, if your outlook for PCs is coming down, I'm wondering why we didn't see CapEx be flat or maybe down some? And then maybe you could share with us your expectation for capital intensity. Do you expect it to get back to a historical, kind of 35% rate next year?

Stacy Smith

Remember the capital forecast that we put in place is in support of multiple generations. We don't buy capital in Q2 to support what we're doing in 2011. The capital we're buying is 22-nanometer peak. It's 14-nanometer factories. You'll soon see us moving into the cycle of 40-nanometer equipment. So it's a longer-term view. In terms of capital intensity, it's the same data that we shared with you at the investor meeting.

Operator

Our next question comes from the line of Uche Orji with UBS.

Uche Orji - UBS Investment Bank

Let me just ask you about Ultrabooks. Sean was quoted at the Computex as saying that this should be about 40% of the consumer mix by the end of next year. If one were to go back and compare this to CULV from a couple of years ago, what makes you more confident that this will achieve this level of success? Do you enjoy the form factor? I think CULV also had performance issues. So if you can talk about the level of confidence you have with Ultrabooks, and how you see that ramping from now until next year to get to that 40%?

Paul Otellini

Well, as I look at this, I don't think that the Ultrabook strategy is anywhere near equal to the CULV strategy as you call it. That was really a kind of a point product. It was focused on form factor. We didn't really put a lot of engineering into it with our customers, and we didn't look at other features. If you will, it's kind of a trial run in hindsight is the way I would look at it. The Ultrabook project is much more akin to Centrino. It's a very holistic approach to moving the entire market to a different kind of form factor, not just in terms of its thinness, but in terms of the feature set. I talked about always on, always connected. So the machine is always aware of the networks around it. I talk about instant on, instant boot capability. We talked about building in integral touch into it, another feature set. So this is as much about the features around the skin, or inside the skin, as the shape of the skin. And as we look at this with our customers, we also see that there's a great deal of engineering that has to be done. Because one thing we know is that today, these feature sets cost more money. But we don't think that PC prices are going to go up over time. So what we have to do is work with the ecosystem to cost engineer these features for high-volume price point displacement. And that's the only way you can achieve sort of a 40% number as Shawn predicted in that timeframe is by doing price point replacements. And then looking forward a year later, into the next generation, silicon, it gets cheaper to do it so we could penetrate more of the market.

Uche Orji - UBS Investment Bank

Another way to look at ASP resilience we've seen in your CPU business on the client side, how much of that is beyond just mix? How much of that is also, I believe, you can take more build up material share? And specifically, I just want to know if the things like graphic attach rates have changed within the configurations here, seeing and therefore, you're capturing all that value. Or is it a case of Intel taking advantage of the fact that components like memory are a lot softer and therefore there isn't much pressure to take CPU pricing down by your customer?

Paul Otellini

Well, it's really demand driven, that's the way I look at it. End customers are demanding a higher mix of product, which gets into the branding and feature set questions that came up earlier. In terms of bill of materials, we had a very strong position to integrate graphics prior to Sandy Bridge. That just got stronger for Sandy Bridge. It satisfies more and more of the market and customers are using it, particularly in smaller form factor machines because of the power advantage. So there's no compromise on pixels, as you get a significant advantage on battery life. And as a result, we're seeing a very strong utilization, both in desktops and notebooks for Sandy Bridge graphics.

Operator

Our next question comes from the line of Christopher Danely with JPMorgan.

Christopher Danely - JP Morgan Chase & Co

Paul, I was wondering if you can just kind of take a step back and give us your latest thoughts on tablets, and ultimately what you think it will be and do to the PC market, what it means to Intel, and what sort of share goals do you have in tablets?

Paul Otellini

Chris, my thoughts really haven't changed from April. Even after I saw the numbers yesterday from Apple and we get engaged in lots of Win8 and Android tablet design activity across the board. I believe this category is additive to computing. I don't think it's going to replace any one category. I think it may replace some discretionary sales at any point in time. And I think that's one of the reasons that netbooks down year-on-year is this tablet's strength to some extent. The netbooks are probably also down because of the very good value if you can get in low-end notebooks nowadays as compared to, say, a netbook. So there's a number of pressures on that particular segment. Going forward, I really don't see that. I think it's a device that some people will use as a standalone device, but many people use it as a companion device, and that's good for us, and that seems to be the model even if you look at the Apple numbers, it seems to be the model that's consistent with their base.

Christopher Danely - JP Morgan Chase & Co

And then as my follow-up, just some quick modeling questions. Going forward, what should we be thinking about share count and McAfee Flash and Infineon revenue?

Stacy Smith

So from a share count standpoint, I think you know that something we're not going to comment on. I can kind of tieback our philosophy to our actions in Q2 if you think that's helpful to you. We articulated the philosophy in the May Investor Meeting, first investing in our business, no change there. Dividends, second, and we articulated that we wanted to allocate more of our free cash flow to the dividend, making that approximately 40% of our free cash flow, and then using the remainder of cash generation, one of the things we look at there is the buyback. I think you can see that play out nicely in the second quarter. We kept our cash balances relatively flat. We increased the dividend 16%, we made significant investments in our business including the CapEx numbers. And we bought back $2 billion worth of stock with the free cash flow that we generated that was in excess of what we needed for those other uses. I think that's a nice model for us, and that's very consistent with our philosophy. In terms of McAfee and Infineon, what was your specific question there?

Christopher Danely - JP Morgan Chase & Co

I guess, what you guys think or what should we be thinking on the revenue going forward if there's any sort of seasonality there?

Stacy Smith

It doesn't change the seasonality for the company as far as I can tell. So I haven't seen anything there. If you look back -- I commented on this earlier, if you look back across the last decade, we see in every environment that second half revenue is 2 points higher than the first half revenue. And McAfee and Infineon don't change that pattern for us.

Operator

Our next question comes from the line Vivek Arya with Bank of America.

Vivek Arya - BofA Merrill Lynch

Paul, I'm curious, how will Intel be impacted by the launch of Windows 8? Is that a net positive or do you think that changes competitive landscape? Like what are the puts and takes that we should think about?

Paul Otellini

Well, we talked about this an awful lot at our Investor Meeting. So I'm not going to give you a lot more color than we gave there, except to say, in general, I think it's good. I mean, whenever Microsoft has a new operating system, that's good for us. We've been working with Microsoft for several years now on the feature set of Win 8 and optimizing our silicon around it in PC space. I think the jury is out on how that will be received by the public in tablets, and we expect to be hypercompetitive for Win8 tablets. We're involved in the program as aggressively as any of the silicon vendors. And our job is to make sure that we can outperform, out battery, and out compatibility the ARM guys in Win8 tablets.

Vivek Arya - BofA Merrill Lynch

And just as a follow up on the near term, I think you mentioned 8% to 10% unit forecast. Slightly different than before. Could you talk about the fact that I think you mentioned the netbooks. But those have been weak for some time. Are there any other dynamics that plays at a macro issue, are there other factors we should think about?

Paul Otellini

The principal change is the netbook. As I said earlier, our core, mainstream PC and Notebook and Desktop business is still forecasted for us at double digits. And we're very comfortable with that part of the product line. The biggest change from 6 months ago is a slower growth rate on netbooks. So still showing growth in netbooks, just at a slower rate. And that has impacts on ASP. It also has impacts on our overall volume.

Operator

Our next question comes from the line of Jim Covello with Goldman Sachs.

James Covello - Goldman Sachs Group Inc.

The question I would have is, is there a way to quantify the impact of unit growth next year on the capacity side? How much will unit capacity be up in 2012 as a result of the CapEx in 2011?

Stacy Smith

I'm thinking about how to answer that question, Jim. As we've said, we're putting in capacity that's pretty consistent with the kind of TAM growth we've seen for the last several years. And we have some ability to flex up. So we're making sure we're putting in some factory space to go a little bit higher than that. And we have the ability that if things end up being softer than that as you saw us in 2009 to respond pretty quickly and bring down the CapEx number and just upgrade and bring in more capital at the leading edge node. So think of it as pretty consistent with historical unit growth rates with some ability to go higher than that and some flexibility to respond if things end up being a little softer than that. And I think Andy did a great job of articulating that in the investor meeting. If you want to refresh on that, we can take you through it.

James Covello - Goldman Sachs Group Inc.

Yes, I remember he talked about how you can kind of shut it down pretty quickly. So to that end, if I can use my follow up on the same topic, if the PC unit forecast that you guys see keeps coming down, is there a number that we could think about that we could then expect you to kind of go more on the slower side on the CapEx as we head into next year? If it came down to 5, which is where the third parties are, maybe the third parties aren't right. But if your forecast kept coming down, is the market number, the third-party number a number where we would expect the CapEx to slow a little bit?

Stacy Smith

Well, it would certainly be much less than what it would be if the market growth is '12. But I realize that's not entirely helpful answer to you. But at this point in the year, that's as far as I'm going to go in terms of forecasting CapEx for next year. I mean, Andy also articulated, when we're building factories, and we're equipping those factories there tends to be a couple years cycle. So I gave you a strong hint to expect elevated CapEx next year relative to the historical trend line. If the unit growth is significantly less than we're anticipating, that number would be less than what we're anticipating. If it's more, it's more. But that doesn't help you because we haven't told you the baseline.

Paul Otellini

There's a third factor, Jim, I'd throw into here, which is that, increasingly our product line is more and more modular. And as we move from Sandy Bridge to Ivy Bridge next year, we have the ability to mix and match cores, and mix and match graphics engines, much more so than we've ever done before. So if we end up in a quarter [ph] case that you're describing where the markets short-term is much smaller than our ability to supply it, we can up crank our products pretty substantially at very little marginal cost. And really have a much more across-the-board competitive offering than even we have today.

Stacy Smith

There's lots of tools. It's interesting. There's lots of tools here at our disposal that we haven't historically had. The forward use of our capacity gives us the ability to move capacity quickly to the leading edge. 5 years ago, it isn't a capability we had. As Paul said, the modularity of our architecture now gives us a lot of flexibility just kind of mix-and-match the capacity to the growth of the market.

Operator

Our final question comes from the line of David Wong with Wells Fargo.

David Wong - Wells Fargo Securities, LLC

Stacy, can you go through the gross margin puts and takes as we go from the September to the December quarter, please?

Stacy Smith

Sure. I won't do it at a level of detail any more than I said in terms of I expect to be kind of a bit higher than where we are and under the upper range of 65% that we put out there. When I think about the fourth quarter, I think we would benefit from startup costs coming down. A strong fourth quarter gives us a couple of other benefits. And then I think the big variable for us there is we have a lot of product qualifications that are kind of teed up across the end of this year and the beginning of next year. And where are those product qualifications fall could dictate where the gross margin ends up. So in terms of variability, I think that's probably the biggest variable for Q4.

David Wong - Wells Fargo Securities, LLC

For my follow-up, Software and Services, it looks to me like the operating margin is still negative despite the full quarter of McAfee. Is that a normalized level of profitability, or are there special accounting effect that are still there that will go away over the next few quarters? And if so, can you give us some idea of the underlying operating margin you've got in this division at the moment?

Stacy Smith

Well, the revenue related accounting impact is in that segment. So you see that in the Software and Services Group segment. The amortization of acquisition-related intangibles is outside of that segment. So it's a little bit of a mix. That's sitting in the corporate line. I think what you're really seeing there -- so part of this will improve as we get the deferred revenue back from the accounting impact, that should be sometime next year. And you can see us already building up that deferred revenue balance on our balance sheet. So it increases just kind of watch that line item, it's not something you'd typically had to do with Intel. And then the other pieces, remember, there's still a lot of investment inside that Software and Services Group that's in support of tablets and in support of phones and things like that. So there's a lot of investment in there that causes the overall segment results to be, as you say. McAfee, if you just isolated that, looks quite good.

R. Sellers

Thanks, David, and thank you all for joining our conference call today. As a reminder, our third quarter earnings conference call is scheduled for Tuesday, October 18, 2011. Thanks, and have a good night.