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Leveraged Buyout of Dell Inc.

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Overview

One of the most talked about items of financial news at the moment is the likely future of Dell Inc. On January 11, 2013, news first circulated that a purchase of Dell was being considered by two private equity firms. This led to a two-day jump in the stock price of over 20%. Since then, a number of parties have emerged as potential Dell purchasers. At this point, a special committee was formed by Dell's board of directors with the purpose of ensuring that shareholder value was maximized through the transaction process. The first potential bidder is the combination of Michael Dell, the current CEO at Dell and a holder of 15% of outstanding shares, and Silver Lake, a technology oriented private equity firm. On February 5th, a special committee formed by Dell's board formally accepted the offer from Mr. Dell and Silver Lake which valued Dell at $13.65 per share. At this point, activist investor Carl Icahn stepped in and announced that he had accumulated a substantial share in Dell. He has made a number of proposals, including an outright bid for 54% of Dell's equity as well as a $9 dividend per share and a recapitalization of Dell. Additionally, Blackstone, one of the biggest American private equity firms, has stepped in and has made an offer of $14.25 per share. However, Blackstone is yet to secure the required financing for the deal or found a CEO to potentially replace Michael Dell if he were to resign. Thus, many believe that Blackstone's bid would not be followed through on and that Dell's special committee is simply using the Blackstone offer as leverage in order to obtain a better offer from Mr. Dell and Silver Lake.

Regardless of which of these bids end up being accepted, Dell could end up representing one of the biggest leveraged buyouts in history. At the $13.65 per share that Mr. Dell and Silver Lake are currently offering, the buyout will cost the bidder a total of over 24 billion dollars. One of the biggest challenges for the acquirer will be finding the financing for this deal. Further, the structure of the financing for this deal could greatly impact the returns for the acquirer. Through a strong fundamental analysis of Dell as well as the utilization of a leveraged buyout model, this optimal capital structure and the associated potential returns will be explored.

Conflicts of Interest

One of the most interesting aspects of the potential acquisition of Dell is the inherent conflicts of interest involved should Mr. Dell be part of the acquiring group. Many shareholders feel that much of Dell's poor performance over the past few years can be blamed on the acquisitions that Mr. Dell has orchestrated as the CEO of Dell. The five year chart below reflects how Dell has largely been flat since coming out of the financial crisis and actually dropped significantly in the past year, prior to the possibility of an acquisition being raised.

Given that much of the drop in the stock price can be attributed to the decisions of Mr. Dell, many feel that by being part of the acquiring group he is benefiting from his own mistakes at the expense of shareholders. Further, a company's board of directors would typically be responsible for approving or rejecting non-hostile acquiring bids. However, given that Mr. Dell is the CEO and Chairman, Dell's board has an obvious conflict of interest in trying to ensure that the interests of shareholders are put first. As a result, a special committee, which excludes Mr. Dell, has been assembled in order to evaluate acquiring bids. Regardless, there is still great concern over the independence of this committee. As a result, many of Dell's largest shareholders such as Southeastern Asset Management, who owns 8.5% of Dell shares, have actively campaigned against the proposed buyout by Mr. Dell. Overall, it seems that no matter how this acquisition ends up getting done, there will be certain parties which are unsatisfied.

Current Position

Dell has struggled to evolve from a pure seller of PC's to a provider of information technology services. Dell's original operations gave consumers the ability to customize desktop PC's online, which would be delivered to their door. However, given the consumer trend away from desktop and even laptops to mobile technology, overall PC sales have suffered.

Dell is a struggling company at the moment. In fiscal 2013, ending February 1, 2013, the companies sales dropped to just under $57B from over $62B the year before despite spending $5B on acquisitions over the course of the year. Further, their consumer segment, which used to be the cornerstone of their business, achieved an operating loss despite $11B in sales.

As can be seen below, certain segments of Dell, such as their servers and networking and their services business are growing. However, a large portion of Dell's revenue still comes from its mobility and desktop PC segments. Again, while these may have been what Dell used to be known for, it seems as though Dell may have lost its competitive advantage while facing extremely tough competition such as Apple, HP, Acer, Samsung, and others.

	Fiscal Year Ended		
	February 1, 2013	February 3, 2012	January 28, 2011
		(in millions)	
Net revenue:			
Enterprise Solutions and Services:			
Enterprise Solutions:			
Servers and networking	$ 9,294	$ 8,336	$ 7,609
Storage	1,699	1,943	2,295
Services	8,396	8,322	7,673
Third-party software and peripherals	9,257	10,222	10,261
Client:			
Mobility	15,303	19,104	18,971
Desktop PCs	12,991	14,144	14,685
Net revenue	$ 56,940	$ 62,071	$ 61,494

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In order to be successful in the longer term, Dell will need to become much more of a service based company which sells to businesses rather than consumers. One company that has managed to achieve this is IBM. IBM was able to successfully divest their PC segment and most of their hardware business and has turned into a successful provider of business services and information technology solutions. While it may not be necessary for Dell to fully get rid of its consumer facing segments, how Dell manages its ongoing transition from a consumer-facing hardware company to a business-facing services company will be crucial.

Projections

In projecting out Dell's financial results, one must take a stand on whether they expect the past years almost 10% drop in sales to be a trend going forward, or if they expect Dell's growth rates to return to what they were in the few years before that. It seems as though the most reasonable approach to projecting Dell's growth is to apply a weighted average of the past three year's revenue growth rate for each segment for the next five years and then have revenues trend towards ~2% afterwards. Based on the current segment revenue mix and their past growth rates, it seems as though Dell will likely be able to grow its revenues at approximately 0-2% per year over the next 5 years (See exhibit 1). Further, using a three year weighted average of Dell's operating margin, it can be expected that their operating income will grow at 1-2% over the next

5 years, with the exception of the next fiscal year when we may see a big jump due to the extremely weak comparables of fiscal 2013.

On top of our own projections, we looked at several others, including Aswath Domodaran, Goldman Sachs and Morgan Stanley. As well, an average of the 3 was taken, which were in line with our projections.

Opportunity for Buyers

Dell appears to represent a viable and potentially highly profitable buyout opportunity for Mr. Dell and Silver Lake or any other potential bidder. Dell's stock price had dropped very significantly prior to the first rumours of a potential buyout. As a result, the company was trading at historically cheap multiples. Further, Dell currently does not carry nearly as much leverage as it could in order to maximize shareholder returns. If a Dell acquirer can stabilize the company's revenues and take on significant amounts of debt, they can achieve strong risk adjusted returns. Assuming an entry price of 13.65, a 1% revenue growth rate for the next five years, and that the acquirer can exit at the same EV/EBITDA multiple at which they purchase Dell, a potential bidder could achieve an IRR of around 28%. Given the high risk involved in a leverage buyout, a return of around 20% is typically desired. In order to meet this return, Dell cannot pay more than $15.50 under the current assumptions. Up until a price per share of $15.50, Dell seems like a very profitable leveraged buyout opportunity; however, given the variability and risk surrounding the projections, a price of $13.65 does not look so far off from what is fair.

Best Option for Shareholders

For shareholders, the bid from Mr. Dell and Silver Lake represents the chance to get rid of a likely underwater investment position. While the currently offered price of $13.65 likely still leaves most investors with a loss, it would at least limit the loss and save investors from having to go through Dell's likely volatile transformation. Further, the 35% premium to the unaffected stock price implied by the bid is a substantial premium and is larger than both the mean and median premiums received on takeovers over $1B since 2009[1].

On the other hand, if a substantial return can be achieved through a LBO, shareholders may want to achieve these returns themselves by changing Dell's capital structure. Even after the cost of repatriating foreign cash, Dell has nearly $7B in cash that it can pay out to shareholders while still having $3B in cash for operations. If Dell were to use this cash and possibly additional debt to pay out a one-time dividend it could provide immediate returns to shareholders without affecting Dell's operations. The one question that this option raises is whether Dell can successfully complete the transformation that it is anticipating while being a public company. Many of the changes that are likely needed to fully right the company are risky and will lead to volatile and unpredictable financial results. Thus, simply recapitalizing the company may not be as effective as an LBO which takes the company private.

Another option would be for Dell to maintain its capital structure but to attempt to sell off different parts of its business. At the moment, Dell is comprised of a number of parts which feature very different business characteristics and very different growth rates. Investors often prefer simpler businesses without so many moving parts. If Dell were to divest some of their segments or potentially split up the company, it could unlock shareholder value. Companies in the past such as Kraft, which split into Kraft Foods Group and Mondelez International, have done this and seen it lead to a great increase in shareholder value.

[1] http://www.sec.gov/Archives/edgar/data/826083/000119312513134593/d505474dex99c5.htm

It seems like the best option for Dell's shareholders is to accept a takeover offer. Ideally, Dell's special committee will be able to solicit more bids and obtain an offer greater than the current $13.65 being offered. However, even at a price of $13.65, it seems as though accepting the bid may be the best option for shareholders as it presents them with a significant premium and does not force them to take on the risk of Dell's upcoming transformation.

In conclusion, this takeover bid by Mr. Dell and Silver Lake represents a compelling option for both the acquirers and Dell shareholders.

Exhibit 1- Dell Projections

	2013 Revenue	Past Year Growth	2012-2011 growth	2011-2010 Growth	**Weighted Average 3 Year Growth**
Enterprise Solutions:					
Servers and Networking	9294	11%	10%	12%	**10.83%**
Storage Services	1699	-13%	-15%	4%	**-10.83%**
Services	8396	1%	8%	12%	**5.17%**
Software and Peripherals	9257	-9%	0%	17%	**-1.67%**
Client:					
Mobility	15303	-20%	1%	31%	**-4.50%**
Desktop PC's	12991	-8%	-4%	24%	**-1.33%**

	2013	2012	2011	**3 year weighted average**
Dell Operating Margin	5.29%	7.14%	5.58%	**5.95%**

	Revenue 2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Enterprise Solutions											
Servers and Networking	9,294	10,301	11,417	12,654	14,024	15,544	16,619	17,551	18,422	19,263	20,092
Storage Services	1,699	1,515	1,351	1,204	1,074	958	920	905	901	903	910
Services	8,396	8,830	9,286	9,766	10,270	10,801	11,242	11,660	12,073	12,488	12,908
Software and Peripherals	9,257	9,103	8,951	8,802	8,655	8,511	8,568	8,691	8,851	9,034	9,234
Client:											
Mobility	15,303	14,614	13,957	13,329	12,729	12,156	12,065	12,125	12,262	12,446	12,663
Desktop PC's	12,991	12,818	12,647	12,478	12,312	12,148	12,249	12,439	12,678	12,948	13,243
Total	56,940	57,180	57,608	58,233	59,065	60,117	61,662	63,373	65,186	67,082	69,050
Annual Growth		0.42%	0.75%	1.08%	1.43%	1.78%	2.57%	2.77%	2.86%	2.91%	2.94%
Operating Income	**3,012**	**3,405**	**3,430**	**3,468**	**3,517**	**3,580**	**3,672**	**3,774**	**3,882**	**3,995**	**4,112**
Annual Growth		13.05%	0.75%	1.08%	1.43%	1.78%	2.57%	2.77%	2.86%	2.91%	2.94%