DELL INC: THE LEVERAGED BUYOUT

INTRODUCTION

In September 2013, Thomas Muller, an associate at Silver Lake, sat at his desk to prepare for the week ahead. It had been a grueling few months, but the deal to purchase Dell Inc. (Dell) was finally closed. Muller was scheduled to meet with one of the partners on the deal team to review Dell's financial targets for the upcoming year. Muller cracked open his laptop, took a sip of his coffee, and started looking over Dell's financials.

COMPUTER HARDWARE MANUFACTURING INDUSTRY[1]

The global computer hardware manufacturing industry consisted of companies that manufactured products in four main categories: computers, storage devices, peripherals, and terminals. Computers included personal computers (PCs), supercomputers, mainframes, and special-use computers designed for specific purposes. These products comprised approximately 60% of sales in the computer hardware manufacturing industry in 2012. Storage devices consisted of personal storage devices, such as external hard drives and server-based storage for large volumes of data. Storage products comprised approximately 10% of industry sales in 2012. Peripherals was a broad category that covered products from printers and scanners to graphics cards, and made up approximately 20% of industry sales. Terminals were monitors and screens sold separately from personal computers. These products comprised about 10% of 2012 industry sales.

The computer hardware manufacturing industry was highly competitive and fragmented, with many companies of various sizes competing for the same sales. Hewlett-Packard was the largest competitor, with a market share of 16.1% in 2012, followed closely by Lenovo with 14.9%. Dell was the third largest player with 10.7% share, while Acer trailed behind with 10.2%.[2] Size was an important factor for companies' success, as it allowed for economies of scale in both manufacturing and distribution.

Industry Trends

Two important trends were rapidly developing in the computer industry at the beginning of 2013. Traditional PCs were under intense price pressure as consumers and businesses were faced with seemingly endless options for purchase. Additionally, new technologies were redefining the way people used computers. Smaller, faster laptop computers were being produced, tablet sales were growing quickly, and smartphones were gaining capabilities that overlapped significantly with the functions of traditional PCs. Competitors

---

[1] Unless otherwise referenced all information for this section was sourced from: Ulama, Darryle. "Global Computer Hardware Manufacturing." IBIS World (2012). Web.

[2] Jones, Chuck. "PC Market Consolidating Around Top 3 Vendors." Forbes. Forbes Magazine, 10 Oct. 2010. Web. 25 Mar. 2016.

faced difficult decisions about where to allocate research and development budgets because they needed to innovate as well as decrease overall costs. In corporate client segments, including servers and storage, clients were also moving towards lower cost solutions, such as cloud-based networking and storage. These types of solutions reduced customers' upfront infrastructure costs.

The industry was expected to grow into 2017 based on three major factors: economic recovery in developed nations, sales in emerging markets, and the expansion of the internet. The composition of the industry was predicted to change significantly as portable products were showing impressive growth. Desktop PC sales were expected to decline at a rate of 5% annually, portable PCs were projected to grow at a rate of 19.3%, and smartphones were projected to grow at a rate of 110%. The most rapid transition was happening within tablet sales, which were expected to grow at a rate of 175% up to 2017. Tablet and smartphone sales were dominated by Apple and Samsung, who held a collective 51% share in the tablet market and 46% share in the smartphone market.

DELL INC.[3]

History

Michael Dell, a 19 year-old University of Texas student, started Dell Computer Corporation (Dell) in 1984. Under its original name, PCs Limited, the business focused on selling IBM-compatible personal computers (PCs) to other University of Texas students. Demand for custom-built PCs grew rapidly and Dell soon began selling to customers outside of the school. Shortly after founding the company, Michael Dell used a $1,000 loan from his family to drop out of school and focus on the business full-time. In its first full year of operation, Dell generated over $73 million in sales.

Dell's early success was driven by the company's unique business model. By avoiding distribution to retail outlets, the company eliminated many costs that were borne by other competitors in the industry. This cost advantage allowed Dell to offer custom-built computers to consumers at lower prices than competitors. Dell also had an operational focus on improving margins through cost reduction and streamlined processes. With this focus, Dell became a leader in computer manufacturing efficiency. In 1988, Dell underwent an initial public offering (IPO), selling 3.5 million shares to the public at a share price of $8.50. Following the IPO, the company operated at a total market capitalization of $80 million.

In the 1990's, Dell faced a number of decisions that would affect the long-term strategy of the company. The most important of these decisions came in 1993, when Dell considered a movement into big-box retail stores. This movement was set to capitalize on Dell's recent growth and newfound brand awareness among consumers. Dell hired Bain & Company to

[3] Unless otherwise referenced all information for this section was sourced from: "About Dell." Dell Official Site - The Power To Do More. Web. 25 Mar. 2016.

evaluate this strategic alternative and provide a recommendation for the direction of the business. Bain consultant Kevin Rollins advised against the change, arguing that Dell's margins would be significantly eroded as a result of paying retailers for shelf space. Rollins thought that this reduction of margins would offset any benefits associated with volume growth. Dell acted on Bain's recommendations and continued to avoid retail distribution. To increase its presence in the home-use market without utilizing retail stores, the company moved towards a consumer-friendly product portfolio that included more individual desktop models. Rollins was hired by Dell in 1996 to take on the role of Chief Operating Officer.

Tensions began to grow at Dell in the early 2000's. Rollins sensed a shift in the market and wanted the company to diversify its product offerings outside of PCs. Michael Dell did not agree with Rollins' proposed changes and rejected the majority of his suggestions. Despite Michael Dell's views on diversification, in 2003, Dell changed its name from Dell Computer Corporation to Dell Incorporated to reflect the company's foray into other markets. Michael Dell stepped down as CEO in 2004 to focus on new technology development, leaving the day-to-day management of the business to Rollins. In the late 2000's, competitors began to catch up to Dell's manufacturing advantages, quickly eroding the cost leadership position that had propelled Dell to the top of the industry. These competitors also invested heavily in research and development, allowing them to create more advanced technologies than Dell. 2006 marked the end of Dell's dominance in the PC market, as it was the first year that the company grew at a slower rate than the industry. This was the same year that Hewlett-Packard overtook Dell as the largest global PC manufacturer.

In an attempt to regain market leadership, Dell undertook a restructuring in 2007. Under Rollins' leadership, the company had missed four of its last five quarterly earnings targets. Michael Dell reassumed the position of CEO and developed a plan called "Dell 2.0", which would change the operations of the business to be more efficient and in-line with consumer demands. This plan involved shifting the company's focus to small and medium sized customers, shortening design cycles, and expanding the server business through $13 billion in acquisitions. As part of the Dell 2.0 rebranding strategy, Dell's mobile division launched the Dell Streak, a smartphone-tablet combination, in 2010. The Streak was met with poor reviews, as critics cited an outdated operating system and multiple faulty features. Overall, the Dell 2.0 rebranding effort proved to be ineffective and in 2011 Dell dropped to number three in the industry, with Lenovo surpassing the company in PC units sold globally.

FINANCIAL PERFORMANCE & OPERATING SEGMENTS[4]

In fiscal 2013, Dell generated $56.9 billion in revenue, which represented a decline of 8.3% from the previous year. The company was starting to struggle financially and had missed its revenue targets for six consecutive quarters. Management forecasted that the business

[4] Unless otherwise referenced all information for this section was sourced from: "Dell Annual Report 2013." Web. 25 Mar. 2016.

would grow by 4.3% annually from fiscal 2014 to 2017 due to strong growth in emerging markets. Dell also hired the Boston Consulting Group (BCG) to provide a third party opinion on forecasted growth and strategic direction for the business. BCG forecasted annual growth of (1.1%) from 2014-2017, citing difficulties in the PC market as well as diminished manufacturing advantages over competitors.

In 2013, Dell consisted of five operating segments: End-user Computing, Enterprise Solutions Group, Software & Peripherals, Dell Services and Dell Software Group.

End-user Computing (EUC)

The EUC segment included notebooks, desktop PCs, thin client products, tablets, and third party software. EUC was Dell's largest operating segment and contributed $28.7 billion of revenue in fiscal 2013. Since much of the products in this segment were personal computers, the segment was subject to the declining consumer demand that was affecting the entire industry. Revenue shrank 13.8% from 2012 to 2013, reflecting Dell's difficulties in creating desirable products for end consumers. Despite this difficulty, management forecasted annual growth of 3% for the EUC segment up to fiscal 2016.

Enterprise Solutions Group (ESG)

ESG was comprised of servers, networking products and storage products. Customers within this segment were small to large companies seeking hardware and software that would allow them to store and transfer files across their business.

Servers & Networking
From 2007 to 2011, Dell's Servers and Networking segment grew at a compound annual growth rate of 6.3% and generated $8.3 billion in 2011 revenue. Industry analysts expected server industry sales to grow by 1.7-3.0% up to 2016. Estimates for networking industry sales growth varied widely, with some estimates as low as 2.9% and some as high as 7.3%. Management forecasted compound annual server growth of 4.4% and networking growth of 32.1% up to 2016. The significant growth in networking was to be generated by Dell's recent acquisition of Force10, a developer of computer networking products for corporate clients.

Storage
Dell's Storage sales declined at a compound annual rate of 5.7% from 2007 to 2011. In 2011, these products accounted for $1.9 billion of revenue. Although this segment of Dell's business had recently seen large declines, management was projecting a CAGR of 10.2% up to 2016, based on the company's increased focus on corporate clients following the Dell 2.0 restructuring effort.

Software & Peripherals (S&P)

When customers purchased a product from the EUC or ESG segments, they often purchased additional software or accessories produced by Dell's S&P segment. These products included printers, scanners, and device drivers, among many others. S&P delivered $9.2 billion in revenue in fiscal 2013, which was 9.9% lower than in 2012 due to a decline in EUC sales. Industry analysts predicted sales in this segment to grow at a CAGR of 4.3-6.6% up to 2016. Dell's management forecasted 2.1% annual growth for the same period, incorporating expectations that its EUC segment would continue to have difficulties.

Dell Services

Dell Services included services sold to businesses in a variety of areas such as IT, business, support and deployment, infrastructure, cloud computing, security, and application services. This segment generated revenue of $8.5 billion in fiscal 2013, 2.3% higher than in 2012. Management projected this segment to grow in line with industry estimates – management forecasted 5.1% growth annually to 2016, while industry analysts forecasted 4.7%.

Dell Software Group

Dell Software Group focused on systems management, security, and information management for corporate clients. The software sold helped clients securely manage internal information stored on a company intranet by performing functions such as data encryption. This segment generated approximately $600 million in revenue in fiscal 2013 and management expected this segment to grow at a CAGR of 23.5% up to 2016. This forecast far exceeded industry estimates of 7.3-7.7% and was based on assumptions that Dell's new focus on corporate clients would be a success.

STRATEGIC OPTIONS

In 2013 Dell Inc. was competing in four different segments of the global computer manufacturing industry: End-user Computing (EUC), Enterprise Solutions (ESG), Dell Services, Dell Software[5,6]. Amidst consistent loss of market share and revenue growth far below the industry, changes to the Company's leadership personnel and ownership structure were explored to revive Dell.

Michael Dell, CEO, was approached about his thoughts on Dell once again becoming a private company by a number of private equity firms. In August 2012, Michael Dell met with representatives from KKR and Silver Lake. Both firms were in agreement that if the firm were to be taken private, Michael Dell should retain his position at the helm.

---

[5] Dell's Enterprise solutions Group includes servers, networking and storage systems manufacturing and sales

[6] http://www.sec.gov/Archives/edgar/data/826083/000082608313000005/dellfy1310k.htm#sA9C2D60527E2933CEAAEB25618AC04F7, date accessed, February 21, 2015

Following the initial buy-out meetings, Michael Dell met with the Board of Directors to discuss strategic options available to the company. The Board created a special committee to review offers and negotiate with potential purchasers. The committee reached a consensus that going private was the best available option to re-build the company, but nevertheless enlisted JP Morgan and Goldman Sachs to report on other alternatives available to Dell Inc.

In September 2012, JP Morgan submitted its initial report to the board. The report provided a number of options for the company including: a leveraged recapitalization, a separation of the End User Computer (EUC) business, a transformative acquisition and a sale to a strategic buyer.[7]

Goldman Sachs provided their recommendations shortly after JP Morgan's. The firm believed that Dell's turnaround strategy was too dependent on the declining PC market and that the company was not doing enough to gain traction in emerging markets. Goldman Sachs had some similar recommendations as JP Morgan, with strategic alternatives including: leveraged buy-out, separation of the Enterprise Storage Server (ESS) and EUC businesses, sale of the distributed file system (DFS), spin-merger transaction involving EUC, seeking a strategic buyer, share repurchase, and issuing a cash dividend.[8]

Both advisors recommended prioritizing buy-out opportunities as the first course of action. With a high level of expertise in the computer hardware manufacturer industry, Silver Lake and KKR were both seen as attractive buyers. Even though the price received from a strategic buyer would likely yield a higher price, neither advisor believed that Dell Inc. could successfully find a buyer. Further, news that Dell was seeking a buyer threatened to damage its reputation and cause further depreciation of the stock price.

In October 2012, the first round of preliminary buy-out bids from Silver Lake and KKR were received by the special committee. Silver Lake offered a price between $11.22 and $12.16 per share for all outstanding shares, other than Michael Dell's, as those shares would be rolled over. KKR offered a higher range of $12-$13 per share, purchasing all shares with the exception of both Michael Dell's and the Southeastern Asset management's shares.[9] The Special Committee felt the initial offers were too low and contained too many contingencies to demand a sale. On December 2, 2012 KKR decided to drop out of the bidding and Silver Lake revised their bid to $12.70 per share, with less conditions.[10] This offer was still not enough to motivate the Special Committee to recommend a sale.

[7] http://www.sec.gov/Archives/edgar/data/826083/000119312513134593/d505474dex99c11.htm, date accessed, February 21, 2015
[8] http://www.sec.gov/Archives/edgar/data/826083/000119312513134621/d505474dex99c24.htm, date accessed, February 21, 2015
[9] http://www.sec.gov/Archives/edgar/data/826083/000119312513242115/d505470ddefm14a.htm, date accessed, February 21, 2015
[10] http://www.sec.gov/Archives/edgar/data/826083/000119312513242115/d505470ddefm14a.htm, date accessed: February 21, 2015

Given the lack of support for the initial offers, Dell's Special Committee enlisted Boston Consulting Group (BCG) to gain another perspective on the strategic options available to the firm. On December 5, 2012 the BCG report was received which indicated that a drastic change in strategy was needed by Dell Inc. to regain market share. The EUC business was down because of declining laptop and desktop sales and a shift towards low-cost alternatives. To compete, BCG recommended that Dell to abandon its made-to-order strategy in favor of a build-to-stock model. This recommendation re-affirmed Michael Dell's suspicion that a buy-out was the only feasible option, as all other alternatives possessed too high a likelihood of short-term losses which would damage the value of the company.

In January 2013, the advisors to the Special Committee were changed, with Evercore hired to replace JP Morgan.

SILVER LAKE

Silver Lake was founded in 1999 in Menlo Park, California by Jim Davidson, David Roux, Roger McNamee and Glenn Hutchins and grew to be a global leader in technology investing with over $23 Billion in assets under management. The firm operated three primary businesses: Silver Lake Partners focused to large cap tech investments; Silver Lake Sumeru focused on middle-market tech investments; and Silver Lake Financial, which specialized in distressed debt securities issued by tech companies. Some of Silver Lake's more recent investments include Skype, Avaya, Go Daddy, Seagate Technology, and Alibaba. [11]

INTEREST FROM PE FIRMS[12]

Given the alternatives presented by the three advisors, Dell Inc.'s Special Committee decided to continue to pursue buyout opportunities. In mid-January 2013 Bloomberg News reported that Dell Inc. was considering going private. The market showed support for the move and Dell Inc.'s stock price rose 13% the same day. To help expedite the buy-out process Dell Inc. signed confidentiality agreements with potential sources of financing including RBC Capital Markets, Credit Suisse, Barclays, and Bank of America Merrill Lynch.

Silver Lake continued to pursue Dell and in order to table a better offer asked Dell Inc.'s permission to partner with Microsoft to help finance the deal. Dell Inc. was willing to entertain this structure, and on January 16, 2013 Silver Lake submitted an adjusted bid of

---

[11] http://www.silverlake.com/, date accessed: February 21, 2015

[12] Unless otherwise stated, all information from this section was taken from this source http://www.reuters.com/article/2013/09/12/us-dell-buyout-timeline-idUSBRE98B0XF20130912, date accessed: February 21, 2015

$12.90 per share, with financing from RBC, Barclays, BAML, and Credit Suisse, in addition to $2 billion from Microsoft. The Special Committee, was however fast to reject the offer. Silver Lake responded by immediately increasing their offer to $13.50, but refused to go any higher when the Special Committee was still unsatisfied. Wanting to complete the deal, Michael Dell agreed to take $13.36 for his shares, raising the price for the remaining shares to $13.60. These adjustments were still not enough to convince the Special Committee to accept.

In February 2013 Silver Lake finally reached an agreement with the Special Committee, by increasing their offer price to $13.65 per share, with a substantial "go-shop" [13] provision included in the purchase agreement. The go-shop period was 45 days, with the option for an extension if other bids were received. Michael Dell and Silver Lake only got one chance to match any superior offer received during this go-shop period, and the termination fee was fairly low, at $180 Million.[14] JP Morgan and Evercore both deemed the Silver Lake offer to be fair from a financial point of view and recommended that the Special Committee accept the offer. On February 5, 2013 the Company executed the merger agreement and announced the transaction.[15]

There was strong interest from a number of parties during the go-shop period. Evercore contacted 67 parties and 4 more firms indicated unsolicited interest. Of the 71 firms involved, 11 showed significant interest in purchasing Dell Inc. A few of these offers received are discussed below:

Blackstone signed a confidentiality agreement and began due-diligence shortly after the commencement of the go-shop period. Blackstone, however, did not want to do a deal alone and instead wished to form a consortium to purchase the company. Francisco Partners III, Strategic Party E and Sponsor B all joined Blackstone shortly after the commencement of the due-diligence process. On March 22, Insight Venture Management joined the Blackstone consortium and the group submitted an offer. The non-binding proposal was a full cash offer with an option for shareholders to roll over equity up to a certain unspecified limit. The consortium would offer more than $14.25 per share for the Company, but keep Dell public. However, Blackstone stated that it would only continue if it were reimbursed for its out-of-pocket expenses related to evaluating the transaction.[16]

Icahn Enterprises also expressed interest and met with JP Morgan to discuss the deal and sign a confidentiality agreement. In early March, only a month into the go-shop period, Icahn Enterprises sent a letter to the board expressing the opinion that the Michael Dell and

---

[13] A go-shop period is a provision that allows a public company which is being sold to seek out competing offers after a firm offer has already been received

[14] http://www.sec.gov/Archives/edgar/data/826083/000119312513242115/d505470ddefm14a.htm, date accessed: February 21, 2015

[15] http://www.sec.gov/Archives/edgar/data/826083/000119312513134593/d505474dex99c4.htm, date accessed: February 21, 2015

[16] http://www.sec.gov/Archives/edgar/data/826083/000119312513242115/d505470ddefm14a.htm, date accessed: February 21, 2015

Silver Lake offer was not in the best interest of the shareholders. Icahn Enterprises proposed a leveraged recapitalization and special dividend, threatening a proxy fight. On March 22, 2013 Icahn Enterprises submitted its non-binding proposal to purchase the Company. This offer gave shareholders the option to either take a cash offer of $15 per share or roll over their shares one-to-one. This offer was for 58% of equity resulting in Dell Inc. remaining a public company.

In May, a month after criticizing Dell Inc.'s proxy statement claiming it made no strong argument for the Company to go private, Southeastern joined forces with Icahn to propose a special dividend of $12 per share and leveraged recapitalization, as well as proposing new Board members. In June, Southeastern sold $1 billion of its Dell Inc. stock to Icahn at $13.52 per share, resulting in Icahn being Dell Inc.'s largest shareholder. Icahn offered to buy another 1.1 billion shares at $14 per share, but saw their hopes of a deal diminish as Michael Dell stated he was strongly opposed to any leveraged recapitalization.[17]

In July, many major proxy firms recommended that shareholders accept the Dell and Silver Lake offer. Icahn combated this set-back by recommending that shareholders pursue their legal right to an appraisal of the fair value of their shares, raising its own offer by including a warrant. The revised offer valued shares between $15.50 and $18 a share. After the July shareholder meeting, Michael Dell and Silver Lake raised its bid to $13.75 and requested that a majority of shareholders approve the transaction. The Special Committee rejected this request, but expedited the voting process.

Upon realizing that a deal looked unlikely, in August Icahn filed a lawsuit against Dell Inc., unsuccessfully petitioning the court to fast track the case. In early September, Icahn gave up on the attempt to acquire Dell. On September 12, 2013 Silver Lake and Michael Dell received approval from shareholders to take the company private.[18]

CONCLUSION

Thomas sat back and sipped his coffee. He knew it was going to be an uphill battle to return Dell to its former success. The most pressing issue for Thomas was to determine what level of growth would Dell need to make the purchase a success for Silverlake.

[17] http://www.sec.gov/Archives/edgar/data/826083/000119312513242115/d505470ddefm14a.htm, date accessed: February 21, 2015

[18] http://www.sec.gov/Archives/edgar/data/826083/000119312513242115/d505470ddefm14a.htm, date accessed: February 21, 2015

EXHIBIT 1

LEVERAGED BUYOUT ANALYSIS

A leveraged buyout (LBO) occurs when an acquiring firm, typically a private equity firm, infuses the target with a high amount of debt (typically 65-80% of the capital structure) and uses the target's free cash flow to pay down the debt over time. As the debt is paid down, equity grows to a larger proportion of the capital structure, driving returns for the equity holders. These returns can be measured by the LBO model. Private equity firms typically purchase companies, which they believe can provide an IRR within a specified range, usually around 20%. LBO models are also used to determine the optimal capital structure for a given company. This means balancing returns with the level of debt (risk) that a firm can take on. Doing this implies that private equity firms can reach their Internal Rate of Return (IRR) goals while ensuring that interest and principal payments on debt are made.

There are three main steps to building an LBO model:

1. Building a 3-Statement Operating Model
2. Determining Sources and Uses of Capital
3. Performing Returns Analysis

STEP 1: BUILDING A 3-STATEMENT OPERATING MODEL

The operating model is an analyst's best prediction of a company's financial performance. However, it is common for analysts to create various operating scenarios to analyze how the company performs under different conditions.

Operating Scenarios

Operating scenarios provide sensitivity analysis to the outputs of the model. Looking at various operating scenarios allows the user of the model to make a fully educated decision. In this example, the operating scenario's section provides four different sets of projections: Management, Sponsor, Analyst, and Downside. These are all manually entered into the model as assumptions and provide the user with the ability to test the sensitivity of returns in a variety of scenarios. This allows the user to balance the IRR returns with the likelihood of defaulting on debt, should future performance be less than is expected.

Forecasted Financial Statements

After determining various operating scenarios, the analyst can create financial statements for the company. Operating models typically include three or more years of historical financial data. Having these actuals allow analysts to use a company's historical performance to better project future financial outcomes. Analysts typically project financials out around 5-7 years, which is the typical holding period for a financial sponsor.

The overarching goal of creating the three-statement model is to determine what the capital structure of the company will be at the end of the holding period. In order to do so, it is necessary to project the company's future operating performance with an income statement, track the company's financial position with a balance sheet, and forecast its cash position with a cash flow statement. The section of the operating model that differentiates an LBO from other models is the debt schedule.

Debt Schedule

The debt schedule is the most important part of the LBO model, as it determines the pay down of debt, which drives the IRR. The debt schedule tracks the outstanding principal for each tranche of debt throughout the projection period. To do this, the model finds the cash that is available for debt repayment. This is calculated by first subtracting Cash Flow from Investing Activities (mostly capex) from Cash Flow from Operations. Next, one must subtract other planned cash flows such as mandatory paydowns of debt and planned dividends. The remaining balance is Cash Available for Optional Debt Repayment. In the LBO it is assumed that all of this cash will be used to pay down debt. The debt will be paid down from highest to lowest seniority, meaning that highest yielding, lowest seniority debt will be paid down last.

STEP 2: PURCHASE PRICE ASSUMPTIONS

The Purchase Price Assumptions portion of the model highlights key assumptions that the analyst must make about the transaction. These assumptions, such as the purchase price of the business, have large implications on the IRR of the transaction. Similarly to Operating Scenarios, analysts typically have Financing Scenarios that show what the IRR will be given various financing outcomes.

Financing Scenarios

The purpose of the financing scenario section is to rotate among the different scenarios to understand how the IRR of the investment changes with different financing options. This typically helps private equity companies better understand the financing options available. Different assumptions that can be made about financing include:

Sources & Uses

The Sources and Uses section is one of the most important parts of the LBO model, as it summarizes the capital infusions (Sources) and the purpose of the capital (Uses). Hence, a Sources and Uses section must always balance. Some examples of sources of funds include existing cash, different tranches of debt, and equity from various investors (in this case Silver Lake Partners and Michael Dell). Some examples of uses of funds include paying existing equity investors for their shares, paying banks and other creditors to replace existing debt with new debt, and paying financial and legal advisors for various transaction fees.

Categorization of Debt Instruments

Due to the high levels of debt required for an LBO, there are often multiple creditors and thus multiple types of debt issued in an LBO. It is important to categorize these different types of debts (and their balances) in order to appropriately model out their unique interest and principal obligations.

Fixed/Floating Interest Rate and Pricing

Debt instruments with fixed interest rates do not depend on market interest rates. Conversely, the interest rate of a debt issue can also be pegged to a market-based interest rate, such as LIBOR. It is important for the analyst to apply the appropriate interest rates to different tranches of debt.

PIK (Payment-In-Kind) %

Companies sometimes issue PIK debt, particularly for higher-yielding bonds. PIK interest debt differs from traditional cash interest debt because interest payments are not made out in cash, but are instead added onto the existing debt balance. This figure tells you the proportion of the interest expenses that will paid through PIK instead of cash.

Tenor

The tenor represents the number of years until the debt must be repaid in full.

OID (Original Issue Discount)

OID is a type of interest that is not payable as it accrues. OID is normally created when a debt, usually a bond, is issued at a discount. In effect, selling a bond at a discount converts stated principal into a return on investment, or interest.

Revolving Commitments

A revolving commitment is essentially a line of credit that is granted by a bank to the borrowing corporation, with a fee charged for using the funds in addition to the interest.

Revolver Commitment Fees - % (Spread to LIBOR)

Banks will charge commitment fees for the funds that they commit to a company's revolver – these fees are often based on the going LIBOR.

Purchase Price Assumption Window

The purchase price assumptions section is made up of five different sub-sections.

1. The sources section draws from the financing scenarios, and shows the adjustments that will be made to the liabilities and equity side of the balance sheet in the deal.
2. The uses section, which also draws account balances from the financing scenarios, shows how much of the capital is going towards the equity purchase price, the payment of various fees and the assumption of existing debt.
3. The offer price is used to determine which tranches will be "in the money" and therefore exercised, giving fully diluted shares outstanding. The number of tranches and exercise price are entered as assumptions.
4. The purchase price section takes the historical price per share and adds the assumed premium paid in the acquisition. The model uses the fully diluted shares outstanding value to determine the fully equity value paid.
5. This total equity price is then used to determine enterprise value, by adding net debt and non-controlling interests, both taken from the most recent balance sheet.

STEP 3: RETURNS ANALYSIS

The Returns Analysis calculates the output of the LBO model: the target company's implied internal rate of return. To calculate return, the equity value of the investment at the end of the holding period is calculated. This is done by multiplying the company's terminal EBITDA by the assumed exit multiple. Terminal Net Debt is then subtracted, resulting in the company's implied equity value. The IRR and Money over Invested Capital can then be calculated using their respective formulas; these are measures of return that investors will use the gauge the attractiveness of the investment.