Leveraged Buyout Case Study: Silver Lake’s $24 Billion Leveraged Buyout of Dell – Part 2 – Channel Checks for Revenue and Expenses

In Part 2 of this case study, you’ll create revenue and expense scenarios for Dell.

In investment banking, typically you just rely on equity research or use whatever numbers the client wants to see; on the buy-side, you need to use your brain and come up with your own view on the market and potential growth and margins in each segment.

As part of that process, you’ll conduct “channel checks” where you visit and speak with key distributors, suppliers, retailers, and customers in an attempt to understand the granular drivers at a deeper level than everyone else.

In this case study, you have limited time so you can’t do in-depth checks across all of Dell’s segments.

However, you have found the time to contact a few key vendors via LinkedIn. Here are the comments you’ve collected from them:

Comments on Overall Market Size / Growth:

- You heard from several IT department managers at large companies that indicated they expect modest growth for desktops and laptops in the next 1-2 years because of the Windows 8 release, but they think spending will be relatively flat after that, at least until the next major operating system release from Microsoft.
- You spoke with the data center manager at a Fortune 500 company who indicated that they plan to increase spending aggressively on servers in the next several years as “big data” becomes more and more important.
- You did not speak with any consumer end-users of Dell’s products, but market expectations are currently for modest to flat growth in laptop and desktop sales, driven by the migration to smartphones and tablets.

Comments on the Servers/Networking Segment:

- You spoke with one IT manager at a Fortune 500 company (the same one as above) and pointed out that Dell’s market share in Servers/Networking increased from 12% to 17% in the past 4 years. You asked his views on Dell’s products vs. those of the competition:
  - He indicates that while he doesn’t think Dell has much pricing power, his company and others appreciate the integrated solutions and the level of add-on services and support that Dell provides, which is a major factor behind their purchasing decisions.
  - From his conversations with other vendors and peer companies, he expects Dell’s market share to increase as they expand their sales force to market these products.
He can’t put an exact number on the potential increase, but he would not be surprised to see Dell’s market share approach 20% in the next several years; anecdotally, around 1 in 5 other IT managers he’s spoken with already use or are planning to use at least some of Dell’s products.

An IT manager at a much smaller company made the following comment to you:

“In the past, we’ve outsourced a lot of our data needs, but we’re starting to move more of this in-house and purchase our own servers because our business is becoming increasingly data-driven. We’d rather keep the most important parts internal and stored on our own servers.”

Comments on the Desktop and Laptop (Mobility) Segment:

Since Dell sells many of its desktops and laptops direct to consumers, you were not able to conduct a traditional “retail” channel check where you go in and speak with suppliers and large retailers on the ground.

However, Wall Street consensus is that Dell’s market share will decline in both of these markets by at least several percentage points over the next 5 years.

You spoke with one IT manager at a Fortune 500 company who had a different view on these products – here’s a quote from your conversation with him:

“We don’t expect to increase or decrease spending on laptops and desktops much, but we don’t have a strong reason to switch away from Dell at this stage. Especially with the value-added services they provide after the sale, we’re reluctant to switch away and possibly end up with a vendor that doesn’t provide much after-market support.”

Another IT manager at a much smaller company made the following points:

“Dell offers solid solutions, but they’re not sharply differentiated from the competition as you see with some of the software products and services we use. Price-wise, they’re competitive and are always willing to compete to offer a better deal, but we don’t expect our spending to increase or decrease by much. We’re buying tablets for some of our staff, but still plan to equip everyone with desktops and laptops as well.”

You spoke with a key competitor in this segment, who offered the following comments:

“Dell doesn’t have much pricing power competitively because their machines have been commoditized over time… they tend to use their value-added services and other products to win desktop/mobility deals. The products are solid, but we typically split evenly all deals where we compete against Dell.”

Comments on the Services Segment:

This has been one of Dell’s fastest-growing segments historically, in part due to its efforts to promote its outsourcing services as well as its bundling and cross-promotion of its services with its server, desktop, and laptop products.

http://breakingintowallstreet.com
http://www.mergersandinquisitions.com
• You spoke with one IT manager at a Fortune 1000 company based in Asia that offered the following comments:
  o “Dell has been expanding aggressively overseas, and we expect to spend more on their IT services in the next few years. There are plenty of local vendors also offering these services, sometimes at lower rates, but Dell’s professionalism is top-notch and they’ve delivered better results than other vendors we’ve worked with in the past.”
• Another IT manager at a local medium-sized business based in the US made the following comments:
  o “The big thing with Dell is that they do a better job of selling warranties and value-added services even after the initial purchase… we’re planning to buy a higher percentage of systems with warranties because, for us, it has proven more cost-effective than fixing problems internally or hiring external consultants to do the same.”
• You also read an interview with several executives at Dell indicating that expanding their services segment will be one of the top business priorities over the next several years. All their investor presentations point to aggressive growth in this segment as well.

Comments on the Software & Peripherals Segment:

• Dell has been placing a greater emphasis on software due to a number of large-scale acquisitions and its stated intention to shift to a software company. However, analysis of these numbers is more difficult than it should be because they lump together software revenue and peripheral (e.g. computer accessory) revenue.
• Recent, significant acquisitions include Quest Software (systems management and virtualization), SonicWALL (network security and data protection), and Wyse Technology (desktop virtualization). In the prior year, Dell also acquired Compellent (virtual storage), SecureWorks (information security), and Force10 Networks (datacenter networking).
• Another IT manager contact at a Fortune 500 company offered the following commentary:
  o “Dell’s software is about on-par with what we see from other vendors, but it hasn’t even begun to fully integrate it with its server and other hardware offerings yet… we haven’t bought more or less due to the software necessarily, but it’s a nice add-on.”
• Another IT manager at a smaller company gave the following comments about Dell’s software:
  o “There are a ton of virtualization solutions out there on the market… VMware was the first and biggest, and in many ways they have the most robust software. For our purposes, however, we don’t necessarily need all their bells and whistles and we’ve been looking at offerings from other vendors, including Dell.”
• Finally, another IT manager at a large European telecom company offered the following comments:
  o “I’m not too aware of Dell’s current software offerings because we’ve mostly purchased their servers and desktops before. I would have to speak with some of my staff members about that and get back to you on what they think.”
Comments on the Storage Segment:

- You ran out of time to do any channel checks for this segment. It is also much smaller than the other segments of Dell’s business, so you’re going to use simple percentage growth assumptions here instead.

Comments on the Tablets / Potential Tablets Segment:

- As desktops and laptops have stagnated, tablets and smartphones have taken off and the market has completely shifted in that direction. You noticed that Dell earned a small amount of revenue from tablets, so you decided to ask around and find out more about their current offerings in this market.
- All the IT managers and other vendors you spoke with indicated that they have no plans to purchase Dell tablets, nor are they even aware of the available options. Apple, Google, and Samsung seem to be the most popular tablet vendors among those you spoke with.
- Additionally, Dell has not indicated firm plans for this segment, nor has it indicated how much it plans to focus on tablets vs. growing its software and services segments.

Comments on the Expenses and Margins:

- It’s very difficult to conduct channel checks on the expense side because customers and suppliers don’t necessarily know what Dell’s internal cost structure looks like.
- However, most people you’ve spoken with seem to think that margins on hardware can only fall over time as it becomes increasingly commoditized and prices decrease, making it more difficult for Dell to maintain its current markup percentages.
- On the software and services side, opinions are mixed because the costs are less well-known. The consensus seems to be that while Dell doesn’t have much pricing power or ability to increase ASPs (average selling prices), these are also higher-margin businesses and Dell’s margins are likely to increase substantially over time as more revenue comes from these segments. Also, many vendors note that while Dell doesn’t have much pricing power, there is also less price competition and less undercutting than in the hardware business.