Corporate Dealmaker: Dead or alive: Unwanted

by **Suzanne Miller** | Published March 14, 2013 at 3:31 PM ET

Is Dell Inc. worth more dead than alive? That seems to be the unspoken question as Dell tackles a growing pack of angry shareholders who don't quite share management's vision for their future. While Michael Dell was clearly hoping for a long shareholder vacation -- a few peaceful years in an LBO spa -- instead he has managed to trigger a rebellion.

Scorning Dell's $13.65 a share offer, some investors are clamoring for proposals for an offer twice that size or a huge cash dividend. It's not clear that Dell can afford to fork over a lot more money to satisfy dissenters. Equally unclear is what happens if it actually does. Will the resulting entity have the resources to do what is necessary to survive in a rapidly evolving technology market?

Of course, a successful leveraged buyout would also entail a substantial drawdown of cash and an increase in debt, so a private Dell may be equally hobbled. The company might survive, but might be unable to thrive as an integrated hardware-to-software provider. Hence the unpalatable choice that may be shaping up for Dell's investors: Kill the company now and take as big a dividend as they can or sell into the LBO and hope to cash in as the company disintegrates into a death spiral.

Southeastern Asset Management, the next biggest shareholder after Michael Dell, says management should consider among other options paying a special dividend of $12 a share, which would represent some 85% of the buying group's offer. Late last week, activist Carl Icahn chimed in with his own demand for a special dividend of $9 per share. Both investors have suggested Dell empty its overseas cash coffers to pay them, rather than use that money to finance management's planned LBO with Silver Lake. Repatriation would mean dealing with a 35% U.S. corporate tax charge on the foreign cash, which would chew up a chunk of the roughly $7 billion the company would bring back home. Investors argue that if Dell management is happy to pay that tax for its own benefit, then it should be happy to do that for the enrichment of shareholders.

The LBO premise, of course, is that Michael Dell -- with the help of Silver Lake and Microsoft Corp., another investor in the deal -- will have more time to spend in the performance recovery room. Nobody knows for sure what will happen in recovery and Dell offered few details. The presumption is that the PC maker will continue to migrate toward being a bigger end-to-end provider of enterprise software and services. It's not clear what this will mean for its PC business, although Microsoft's involvement in the deal suggests there's a commitment to stay the course for now in PCs, which make up roughly 50% of revenues. At this point, Dell officials apparently still see the company as an integrated business that just needs time away from meddlesome shareholders to transform itself.

Investors, in contrast, are looking at Dell through the reverse end of the profit telescope -- what's in the future and how that might translate into instant lottery winnings. In its February letter to Dell's board, Southeastern provided a detailed inventory of what it thought the parts of Dell were worth. In one interesting instance, it said the $13.65 offer price doesn't take into account Dell's strong product distribution capability, especially in the small to medium-size business space. This strength, built on the company's history of selling directly to end customers, is something that competitors like Hewlett-Packard Co., IBM Corp., Oracle Corp. and Cisco Systems Inc. don't do nearly as well, Southeastern notes. That's important because Southeastern also concedes that Dell has done a decent job with acquisitions the past few years. Most of these deals -- which cost some $13.7 billion -- were done under David Johnson, who spearheaded the company's acquisition strategy when he jumped ship from IBM in 2009. In January, just before the LBO news broke, Johnson was hired away by Blackstone Group.

Southeastern noted that during Dell's June 2012 analyst day, management said that in aggregate the acquisitions "had delivered a 15% internal rate of return" and that it looks like "the acquisitions are worth a minimum of their cost." Translation: the deals have been accretive. During his tenure, Johnson consistently made the point that the secret sauce in his acquisition strategy was buying midsized targets that could quickly thrive by hooking them up to this global distribution network. In other words, the distribution value story and the acquisition strategy are closely aligned as a leverage key for growth.

This fact raises a question: What happens to Dell's acquisition strategy if it burns up all its cash and leverages its balance sheet through the roof? Will Dell survive to realize its brighter future, or will it be forced to break itself up? Clearly, M&A is essential for any big tech company to survive and grow in today's ever-changing market. If anything, Dell has been criticized in some quarters for sticking too strictly to smaller deals. In a recent research note, Barclays plc analysts said that Dell's strategy the past several years has been to leverage the cash thrown off by its PC division to fund expansions into higher-value hardware and to use its balance sheet capacity for M&A to diversify its revenue. "If the company goes private, we think it would have limited capacity for further M&A," the analysts noted, adding that in the large-cap tech world, companies must constantly engage in M&A.

Greg Milano, co-founder and CEO of Fortuna Advisors LLC, a value-based strategic advisory firm, suggests Michael Dell has nobody but himself to blame for the company's current conundrum. He notes in an interview that the $28 billion capital deployment to buy back stock "is more than Dell invested in R&D, capital expenditures and acquisitions combined" for the 10 years ended in 2012. "Dell deployed more to do buybacks during this period than 95% of the S&P 500. So the dismal total return to shareholders Dell experienced is no surprise to us."

Milano notes that for the 10-year period through 2012, Dell's buyback return on investment was -16.2% per year on repurchases of almost $28 billion worth of their own stock. Buyback ROI is an annualized IRR-like return, he explained, based on how much a company pays to repurchase shares and what the shares are worth now. "Dell keeps buying back shares that go down in value ... and their timing is bad too. This buyback ROI is 7% per year worse than it otherwise would be due the timing of their buybacks. Again, it is understandable that investors are upset. How would they feel if Dell made an acquisition for $28 billion that went down in value 16.2% per year?"

In other words, Dell has a credibility problem in the market after years of underperforming. That's one of the reasons Michael Dell has few allies. If he couldn't pull off a turnaround by now, why will an LBO help? Typically, companies that do LBOs have cost inefficiencies and are turnaround candidates, meaning they have locked-up value in assets that can be spun off. While Dell has insisted on preserving the integrated nature of its overall business, its eagerness to go private suggests management may in fact be open to a breakup down the line. Certainly at this point, it's unclear how Dell will grow fast enough organically if it blows all its money on an LBO or forks over all its cash, padded with wads of debt, to shareholders. The question ultimately comes down to whether Dell is worth more dead than alive. If shareholders insist on a massive pay-down now, the future may be short. If Dell management holds sway, it will still be faced with an uphill battle as it borrows against a deficit of patience in the market.