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## Research Update:

# Dell Inc. Corporate Credit Rating Affirmed; Outlook Revised To Positive On Debt Reduction Expectations

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## Research Update:

# Dell Inc. Corporate Credit Rating Affirmed; Outlook Revised To Positive On Debt Reduction Expectations

## Overview

- We expect U.S. computer systems provider Dell Inc. to reduce leverage over the near term.
- We are revising our outlook to positive from stable, and affirming our 'BB-' corporate credit rating and all issue-level ratings.
- The positive outlook incorporates our expectation that Dell will use cash balances and cash generation to reduce debt and improve its financial risk profile in the near term.

## Rating Action

On April 29, 2014, Standard & Poor's Ratings Services affirmed its 'BB-' corporate credit and all issue-level ratings on Round Rock, Tex.-based Dell Inc. We also revised our outlook to positive from stable.

## Rationale

The outlook revision to positive from stable reflects our expectation that Dell will achieve stable revenues and modest operating performance improvement in fiscal 2015. In addition we expect debt reductions will result in improvement to Dell's financial profile, such that the company will reduce adjusted leverage and sustain it below 4x within the next 12 months. Our ratings reflect Dell's "fair" business risk profile and "aggressive" financial risk profile.

Dell's "fair" business risk profile incorporates:

- The company's strong brand name and good market position across its hardware product portfolio.
- A geographically diverse and broad customer base.
- Highly competitive market conditions and weak demand for personal computers (which comprise more than half of Dell's revenues).
- Dell's strategy to capture market share, while successful, had a significant impact on profitability.
- A modest but improving revenue mix of higher-margin services and software.
- Our business risk assessment also incorporates our view of Dell's "low" country risk and "moderately high" industry risk for the technology hardware industry. Our assessment of Dell's management and governance is "fair."

The rating reflects our expectation that highly competitive market conditions and declining demand for PCs will continue to suppress revenue growth over the rating horizon. In addition, a more leveraged capital structure and diminished free operating cash flow could impede Dell's ability to invest in growth businesses and successfully adapt to evolving technologies and market conditions. Based on total revenues, Dell is the third-largest U.S. computer systems company.

Adjusted EBITDA margins were somewhat below our expectations prior to the company's LBO transaction. Although Dell is in the midst of a large cost-cutting initiative, we do not expect full realization of the benefit of those actions before the end of fiscal 2016. We believe that much of the potential cost saving benefits will be reinvested in the businesses and help to offset pricing pressures, which we expect to be ongoing. Those factors are partially offset by an improving revenue mix of higher margin services and software solutions, which, in combination with cost savings, should enable Dell to achieve moderate adjusted EBITDA improvement in fiscal 2015. We view Dell's EBITDA margins and return on capital levels to be "below average" for the technology hardware sector, and the company's volatility of profitability to be "fair".

Dell's "aggressive" financial risk profile reflects adjusted leverage (including our captive finance and surplus cash adjustment) of 4.2x as of Jan. 31, 2014. The rating incorporates Dell's commitment to use the majority of free operating cash flow to reduce debt over the near-to-intermediate term. Moderate research and development (R&D) spending and capital expenditures should enable the company to generate significantly positive annual free operating cash flow.

Our base-case scenario includes the following assumptions:

- U.S. GDP growth of 3.0% and 3.3% in 2014 and 2015, respectively.
- Global GDP growth of 3.7% in 2014 and 4.0% in 2015.
- Global information technology (IT) spending growth in the low-to-mid single digits in 2014.
- Ongoing cost reduction and restructuring actions will sustain Dell's competitive cost position.
- We expect revenue mix dynamics and seasonality to result in some variability of EBITDA margins quarter to quarter.
- Potential acquisitions will be modest in size and will not materially weaken Dell's financial profile.

Based on these assumptions, we arrive at the following credit measures:

- Flat revenues in the near term.
- Modest EBITDA margin improvement, albeit still below historical levels.
- The ratio of adjusted debt to EBITDA sustainably below 4x exiting fiscal 2015.

## **Liquidity**

In our view, Dell has "strong" liquidity, a revision from our prior assessment of "adequate." We expect net sources would be positive in the near term even with a 30% decline in EBITDA from fiscal 2014 levels, and that coverage of uses will be in excess of 1.5x for the next 12 months.

## **Principal Liquidity Sources**

- Cash and short-term investment balances along with free operating cash flow.
- Availability under Dell's \$2 billion asset-backed revolving credit facility maturing 2018 (unrated).

## **Principal Liquidity Uses**

- Moderate debt maturities.
- Settlement of outstanding appraisal proceedings for Dell shareholders that did not vote in favor of the October 2013 LBO transaction.
- Potential acquisitions will be modest in size.

## **Outlook**

The positive outlook reflects our expectation that Dell will achieve stable revenues and modest operating performance improvement in fiscal 2015. We expect the benefits from ongoing cost reduction and restructuring initiatives will largely offset pricing pressure across Dell's primary business segments. In addition we expect Dell will use the majority of free operating cash flow to repay debt on an ongoing basis.

## **Upside Scenario**

We could raise the rating if Dell achieves stable revenues and modest operating performance improvement in fiscal 2015, and leverage is sustainably reduced below 4x within the next 12 months.

## **Downside Scenario**

We could revise the outlook to stable if weak demand and profitability conditions in Dell's end user and enterprise solutions segments, and lack of operating performance stability result in adjusted leverage sustained at or above 4x.

## **Ratings Score Snapshot**

Corporate Credit Rating: BB-/Positive/--

Business risk: Fair

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive
- Anchor: bb-
- Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
  - Capital structure: Neutral (no impact)
  - Liquidity: Strong (no impact)
  - Financial policy: Neutral (no impact)
  - Management and governance: Fair (no impact)
  - Comparable rating analysis: Neutral (no impact)

## Recovery Analysis

Standard & Poor's recovery rating on the company's first-lien secured debt is '1', indicating our expectation for very high (90% to 100%) recovery of principal in the event of a payment default, and we rate this debt 'BB+', two notches above the corporate credit rating. Our recovery rating on Dell's senior unsecured debt is '5', indicating a modest (10% to 30%) expectation of recovery in the event of a payment default, and we rate these notes 'B+', one notch below the corporate credit rating.

## Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Technology Hardware And Semiconductors Industry , Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Recovery: Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

## Ratings List

Ratings Affirmed; Outlook Action; Not Rated Action

	To	From
Dell Inc. Corporate Credit Rating	BB-/Positive/NR	BB-/Stable/B

Not Rated Action

	To	From
Dell Inc. Commercial Paper	NR	B

Ratings Affirmed; Recovery Rating Unchanged

Dell Inc.

*Research Update: Dell Inc. Corporate Credit Rating Affirmed; Outlook Revised To Positive On Debt Reduction Expectations*

Senior Unsecured	B+
Recovery Rating	5

Dell International LLC

Senior Secured	BB+
Recovery Rating	1

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