Rating Action: Moody's assigns Ba3 CFR to Dell; rates new secured debt at Ba2 and Ba3; outlook stable

Global Credit Research - 11 Sep 2013

Over $12.5 billion of rated debt affected

New York, September 11, 2013 -- Moody's Investors Service assigned Ba3 Corporate Family (CFR) and Ba3-PD Probability of Default ratings to Dell Inc., the parent company of Dell International LLC. In addition, Moody's assigned Ba2 ratings to Dell International LLC's senior secured term loans and first lien notes, and a Ba3 rating to the second lien notes. The Prime-2 short-term commercial paper rating was withdrawn. Upon closing of the debt financing, the existing unsecured notes held at Dell Inc. will be downgraded to B1 from Baa1. For the unsecured notes that are paid off in connection with the financing, the ratings will be withdrawn. The rating outlook is stable.

These rating actions will conclude the review for downgrade initiated on February 5, 2013 following the announcement of a definitive agreement with founder Michael Dell (75% owner) and Silver Lake (25% owner) to acquire Dell in a leveraged buyout (LBO) with the equity valued at over $24 billion.

RATINGS RATIONALE

The Ba3 CFR reflects the high initial debt (gross reported debt of over $18 billion; 6 times debt to EBITDA) arising from the LBO debt combined with the challenges of the declining personal computer (PC) industry, which still accounts for nearly half of Dell's revenues. Moody's expects Dell's PC revenues to continue eroding in 2014 in the low single digits as the decrease in mobility products is partly offset by slight growth of commercial desktops.

The increased debt burden will limit Dell's financial flexibility, potentially hindering the company's ability to transition more of its business to the faster growing and potentially more profitable enterprise solutions from its core hardware business. While Moody's believes that Dell is building sufficient sales, product, and R&D scale in its enterprise segments following a series of acquisitions ($11.8 billion on acquisitions since January 2010), Dell will have to complete the transition mostly organically. The risk exists that additional funding will be required for Dell to expand its technology footprint to remain competitive against peers with superior liquidity and credit profile.

The Ba3 rating incorporates our expectation of significant debt pay down over the next several years which will likely limit annual M&A spending to the $500 million to $1 billion range. Moody's anticipates significant cost savings (more than $2.5 billion), although those savings will likely be reinvested in the business through R&D or marketing incentives, so margins are expected to remain relatively flat. Moody's expects Dell to reduce debt, which should arise from solid free cash flow ($2 billion annually, adjusted for non-recurring items) along with cash now on hand. Without share buybacks or dividends (which has averaged about $1.4 billion per year since the beginning of fiscal 2009) and a more tempered approach to M&A activity, Dell will have ample cash flow that can be used for debt service. Moody's anticipates gross reported debt being less than $16 billion by January 31, 2015 (less than 5 times gross debt to EBITDA; or mid 3 times including the adjustment for the finance operations).

There is considerable key man risk associated with Michael Dell's majority stake, including relatively little ability of the board of directors to exert effective oversight over the controlling owner and to make strategic course corrections if necessary. Further, if Mr. Dell is unable to serve as CEO for an extended period, this could have a substantial effect on the company's strategic direction. Moody's does expect, however, that Silver Lake Partners will have certain consent rights for significant cash outlays.

Moody's could upgrade Dell's ratings if the company were to show sustained revenue growth in the low single digits, operating margins greater than 6%, free cash flow in excess of $2.5 billion, and gross debt to EBITDA below 3.5 times. The rating could be lowered with sustained erosion of market share, reported operating profit margins lower than 2.5%, or contraction of the PC market faster than anticipated. Also, any indications of any change from Dell's intent to use the majority of free cash flow to reduce debt, or that gross debt to EBITDA remains above 5 times beyond fiscal 2015 could also pressure the rating down.

Ratings assigned:

Dell Inc.
Corporate Family Rating of Ba3
Probability of Default Rating of Ba3-PD
Rating to be downgraded (upon close):
Senior unsecured rating to B1 (LGD5, 73%) from Baa1
Rating withdrawn:
Commercial Paper short-term rating, Prime-2
The rating outlook is stable.
Dell International LLC
Term Loans at Ba2 (LGD2, 27%)
First lien notes at Ba2 (LGD2, 27%)
Second lien notes at Ba3 (LGD3, 44%)

The principal methodology used in this rating was the Global Technology Hardware Industry Methodology published in October 2010. Other methodologies used include Loss Given Default for Speculative-Grade Non-Financial Companies in the U.S., Canada and EMEA published in June 2009. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Dell Inc. is one of the world's leading providers of personal computers, servers, and related devices.

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