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Research Update:

Dell Inc. Corporate Credit Rating Lowered To 'BB-' From 'BBB' On Proposed LBO; Outlook Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

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Overview

- U.S. computer systems provider Dell Inc. expects to complete its approximately \$25 billion acquisition by Michael Dell and Silver Lake Partners in October 2013.
- We are lowering our corporate credit rating to 'BB-' from 'BBB', our commercial paper rating to 'B' from 'A-2', and our issue-level ratings on Dell's senior unsecured debt to 'B+' from 'BBB', and assigning a '5' recovery rating. We are removing all ratings from CreditWatch.
- We are also assigning our 'BB+' issue rating to Dell's proposed first-lien secured debt totaling \$7.5 billion, with a recovery rating of '1', and our 'BB' issue rating to the company's proposed \$1.25 billion second-lien notes due 2021 (with recovery rating of '2').
- The stable outlook incorporates our expectation that Dell will use cash balances and cash generation to reduce debt, and that ongoing cost reduction initiatives will largely offset pricing pressures across Dell's primary business segments.

Rating Action

On Sept. 11, 2013, Standard & Poor's Ratings Services lowered the corporate credit rating on Round Rock, Tex.-based Dell Inc. to 'BB-' from 'BBB', and the commercial paper rating to 'B' from 'A-2'. We removed all ratings from CreditWatch, where we had placed them with negative implications on Feb. 5, 2013. The outlook is stable.

We also lowered our issue-level ratings on Dell's senior unsecured debt to 'B+' from 'BBB', and assigned a '5' recovery rating, indicating our expectations for modest (10% to 30%) recovery of principal in the event of a payment default.

At the same time, we assigned our 'BB+' issue rating to Dell's proposed first-lien secured debt (which includes a \$4 billion term loan B due 2020, \$1.5 billion term loan C due 2018, and \$2 billion first-lien notes due 2020) with a recovery rating of '1', indicating our expectation for very high (90% to 100%) recovery of principal in the event of a payment default. We also assigned our 'BB' issue rating to the company's proposed \$1.25 billion second-lien notes due 2021 with recovery rating of '2', indicating our expectation for substantial (70% to 90%) recovery of principal in the event of a payment default.

Rationale

The downgrade incorporates our revision of Dell's business risk profile to "fair" from "satisfactory", reflecting ongoing pricing pressures and volume declines in PCs, which is still Dell's largest business by revenue, and also our revision of its financial risk profile to "aggressive" from "modest", pro forma for the significantly higher leverage resulting from the proposed LBO.

Dell's fair business risk profile reflects:

- 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 60% of Dell's revenues).
- The acceleration of Dell's strategy to capture market share, which materially lowered profitability in the first half of fiscal 2014 in Dell's end user segment.
- A modest but improving revenue mix of higher-margin services and software.

Dell's aggressive financial risk profile reflects:

- Our expectation that cost reduction and restructuring actions will sustain Dell's competitive cost position post-LBO, albeit at lower-than-historical levels.
- Adequate liquidity, including substantial post-closing cash balances.
- Pro forma adjusted debt to EBITDA at about 5x as of Aug. 31, 2013.
- Dell's commitment to use some of its cash portfolio and the majority of free operating cash flow to reduce debt by \$2 billion by January 2014, with further reductions over time.

The current rating reflects our expectation that highly competitive market conditions and declining demand for PCs will continue to suppress revenue growth and EBITDA 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.

We expect adjusted EBITDA margins to be in the 5% area in the near term, down from 7.2% in fiscal 2013. Although Dell expects to reduce costs by more than \$3.5 billion, full realization of the benefit of those actions is not expected before the end of fiscal 2016. We also 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.

We revised our assessment of Dell's management and governance to "fair" from "satisfactory", reflecting the company's post-LBO reliance on Michael Dell's position as controlling shareholder.

Dell's "aggressive" financial profile reflects initial pro forma adjusted leverage in the 5x area as of Aug. 31, 2013, and our expectation that Dell will maintain leverage below 5x as of fiscal year-end Jan. 31, 2014 and beyond. The current rating incorporates Dell's commitment to use some cash on hand and the majority of free operating cash flow to reduce debt over the near-to-intermediate term. R&D spending is less than 2%, and capital expenditures are expected to remain about 1% of revenues, which should enable the company to generate pro forma annual free operating cash flow in excess of \$1.5 billion.

Liquidity

Dell has "adequate" liquidity, with sources of cash expected to exceed uses for the next 12 months. We expect post recapitalization cash balances (expected to be in excess of \$6 billion) will be a material source of liquidity and also fund a portion of the expected near-term debt reduction.

Relevant aspects of Dell's liquidity, in our view, are as follows:

- We see coverage of uses to be in excess of 1.2x for the next 12 months, including moderate near-term debt maturities.
- We expect that net sources would be positive in the near term, even with a 15% decline in EBITDA from fiscal 2013 levels.
- Material, debt-financed acquisitions are not incorporated in the current rating.
- Additional liquidity is provided by availability under Dell's \$2 billion asset-backed revolving credit facility maturing 2018 (unrated), expected to be partially drawn at closing.

The proposed term loans and notes are not expected to contain financial maintenance covenants.

Recovery analysis

For the complete recovery analysis, see the recovery report on Dell to be published on RatingsDirect shortly following this report.

Outlook

The stable outlook reflects our expectation that Dell will use cash on the balance sheet and free operating cash flow to repay debt on an ongoing basis. Specifically, we expect Dell to repay about \$2 billion of debt following the LBO transaction close, such that adjusted total debt to EBITDA is below 5x as of Jan. 31, 2014. In addition, we expect the benefits from ongoing cost reduction and restructuring initiatives will largely offset pricing pressure across Dell's primary business segments.

The potential for higher ratings is currently constrained by Dell's aggressive financial risk profile, weak demand and profitability conditions in Dell's end user and enterprise solutions segments, and lack of revenue and operating

performance visibility. Although not likely in the near term, we could lower ratings if a material shortfall in expected revenue and EBITDA levels, or insufficient debt repayments, results in adjusted leverage in excess of 5x.

Related Criteria And Research

- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- 2008 Corporate Criteria: Commercial Paper, April 15, 2008
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009
- Companies Owned By Financial Sponsors: Rating Methodology, Mar. 21, 2013

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Dell Inc.		
Corporate Credit Rating	BB-/Stable/B	BBB/Watch Neg/A-2
Commercial Paper	B	A-2

New Rating

Dell International LLC

Senior Secured

US\$4 bil term B bank ln due 2020 BB+

Recovery Rating 1

US\$1.5 bil term C bank ln due 2018 BB+

Recovery Rating 1

US\$1.25 bil 2nd lien notes nts due 2021 BB

Recovery Rating 2

US\$2 bil 1st lien bridge bank ln due 2020 BB+

Recovery Rating 1

Downgraded; CreditWatch Action; Recovery Rating Assigned

	To	From
Dell Inc.		
Senior Unsecured	B+	BBB /Watch Neg
Recovery Rating	5	

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