Educated Investing

Finding Value in the Dell

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The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. In each issue of the Stern Opportunity, MPSIF will share a stock recommendation based on the recent work of a current MPSIF Analyst.

This edition features the research of MPSIF Value Fund Analyst Ward Jones. He recommends the purchase of Dell, Inc shares (NASDAQ: DELL) at its current price of $19.78 (as of 2/19/2007). Based on Ward’s Discounted Cash Flow valuation of $34.24/share, he places a conservative 12 month target price for Dell at $28.50. This represents upside potential near 45%. MPSIF currently holds 892 shares of Dell.

Dude, $40 billion Companies Don’t Turnaround on a Dime

2007 was a volatile year for many technology stocks, and Dell was no exception. As quickly as investors piled into DELL shares after Michael Dell resumed control of operations as CEO in the first half of the year, they exited in the second half due to a slower-than-expected turnaround in bottom line profits. Dell has been losing market share to a more nimble field of competitors, including Hewlett-Packard (HPQ) and Lenovo, which purchased IBM’s computer business in December 2004.

Dell has felt the pain of an inferior market position, missing the boat on international growth and consumer notebook trends over the last 18-24 months. However, the company has recognized the limitations of its direct sales model and has begun to rapidly roll-out a retail presence. Within nine months, the company has established relationships with several key retailers, including Wal-Mart, Best Buy and Staples in the US, as well as Tesco in Europe and Gome in China. Furthermore, DELL has quickly ramped the program and shipped product to 10,000 stores by the end of CY07. Over the next several months the company will work with its channel partners to improve supply chain efficiencies and tailor in-store merchandise to meet customer’s needs. These key retail partnerships will likely help recapture market share lost to HPQ and improve profitability in Dell’s ailing consumer segment. The initial signs are promising.
With the launch of the XPS line of notebooks, the company has refreshed what consumers perceived to be an outdated product line. In so doing, the company hopes to garner additional market share in this faster-growing segment of the PC market, which IDC estimates will growth at a 20+% CAGR over the next 3-4 years vs. just 8-10% for desktops. Industry experts claim that consumers will account for almost 50% of notebooks purchased by the year 2011. Dell is making the necessary upgrades to its product and service capabilities to position itself more competitively going forward. It will be necessary to closely watch the accompanying marketing campaign as the company attempt to reinvigorate its image to US consumers.

**Key Investment Points**

*International Growth Opportunities*
Dell’s biggest growth opportunity exists in its international expansion. Over the past 10 years, Dell has gained market share in nearly every product category and geographic region. In particular, Dell has more than doubled its market share in the Asia/Pacific region over the past five years (exceeding Lenovo’s growth rate). In 2006, revenue from outside the U.S. contributed a record 46% to firm revenue and, for the first time in its history, Dell shipped more units internationally than it did domestically. Dell recently announced a partnership with Gome Group, the largest electronics retailer in China, which operates approximately 1,000 stores in 168 cities in China. This partnership helps should enable Dell to take advantage of gaining market share in the Chinese market that is expected to grow at over 25% annually over the next 3-5 years.

*PC Upgrade Cycle*
Component and PC manufacturers have turned in lackluster performance in 2007 as a Vista-inspired upgrade cycle has largely failed to materialize. Enterprise adoption, which typically lags consumers by 1-2 years, should drive results over the next 12-18 months. Dell has a dominant market share among Enterprise customers and is positioned well to reap the benefits of this upgrade cycle.

*Strong Balance Sheet*
As anticipated, with the accounting investigation behind them, DELL announced a $10 billion share repurchase program. At current levels, that represents nearly 20% of the total market capitalization. Assuming execution at an average price of $22 over the next twelve months, it could be $.08-.10 or 6% accretive to FY09 results.

*Corporate Restructuring*
Dell has announced that it will be eliminating approximately 10% of its 84,000 employee headcount over the next twelve months. Analysts estimate that this alone could save Dell upwards of $750MM per year, or nearly $0.25 in annual EPS, by the end of 2008.
**Low Historical Valuation**

Backing out the more than $6 in cash per share on the balance sheet, DELL is trading at the very bottom of its historical trading range, at 10x forward earnings. Over the past five years, Dell’s P/E has ranged between 10x and 30x forward earnings, with a mean of 22x. While it will take several quarters to regain confidence in Michael Dell’s new strategy and execution, much of the potentially bad news is already priced into the stock at these levels. This presents investors with an opportune entry point for this stock.

**Profitability Improvements Target $2 Earnings Power by CY10**

On stable revenue growth over the next several years in the mid-single digits, it is likely that initiatives aimed to improve operating margins could drive EPS run-rate north of $2 exiting CY09. Earning comparable operating margins to competitor HPQ in the consumer business could deliver more than $300M in operating profit and $.15-20 of incremental EPS. Furthermore, the company spent more than $134M in the first nine months of FY08 related to the accounting investigation, which will roll off in FY09 and return approximately $.06-.07 in EPS.

Conservatively, 15 times 2009 EPS of $1.90 would suggest a $28.50 stock price over the next 12-24 months, or 45% return from here. Despite a roundtrip ticket aboard a pretty volatile stock, Dell has several levers left to pull to drive profitable growth for the next several years. As such, I recommend BUYING DELL.

**Risks to Rating**

**Increased Competition Will Continue to Pressure Prices and Margins**

The industry in which Dell participates is extremely competitive. Competition has come from all angles including Hewlett-Packard, IBM and Sun with servers and Lenovo and Acer with PCs. The large number of competitors on all fronts has led to eroding margins due to price pressures.

**Economic Sensitivity**

Increasing pressures on consumer confidence and spending, particularly in the US, could limit Dell’s ability to grow the top line and improve profitability. While market share is relatively nascent in higher growth emerging markets, a broader global slowdown could likewise encumber Dell’s growth progress.

**Retail Strategy Execution**

Dell has conceded the limitations of its build-to-order or direct sales model over the phone/internet. To the extent that a transition to a two-pronged approach, including a substantial retail presence, does not go smoothly and incurs significant costs in supply chain disruption could compromise Dell’s ability to compete effectively on price in that channel.
About MPSIF

The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. The fund, part of the overall NYU endowment, was established in 1999 through a generous gift from Michael Price, managing partner, MFP Investors, LLC and former chairman of Franklin Mutual Series funds.

With roughly $1.9 million currently under management, MPSIF provides Stern MBA students interested in pursuing a career in asset management with hands on experience managing a real fund with significant assets.

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