# Dell Inc DELL [XNAS] | ★★★

| Last Price | Fair Value | Consider Buy | Consider Sell | Uncertainty | Economic Moat™ | Stewardship | Morningstar Credit Rating | Industry |
|---|---|---|---|---|---|---|---|---|
| 13.63 USD | 14.00 USD | 8.40 USD | 21.70 USD | High | None | Standard | UR- | Computer Systems |

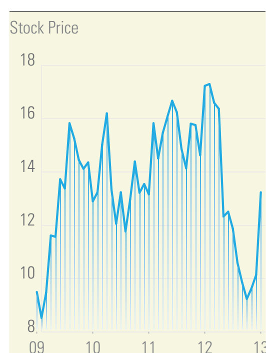
## Dell Going Private in $24.4 Billion Deal

by Carr Lanphier

Analyst covering this company do not own its stock.

Pricing as of Feb 08, 2013.
Rating as of Feb 08, 2013.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.




**Analyst Note** Feb. 05, 2013

Dell DELL announced that it will go private after being acquired by a consortium of investors for $24.4 billion dollars, or $13.65 per share, which is a 25% premium relative to where shares were trading prior to rumors of a potential buyout. While the negotiated price is slightly below our $14 fair value estimate for the firm, we think the deal provides an attractive short-term exit for shareholders and potential long-term benefits for the consortium of investors.

Rumors of a potential Dell acquisition by a buyout group led by Michael Dell and Silver Lake Partners were first leaked to the media on Jan. 12. But it appears that this deal has been in the works since Michael Dell approached the company's board of directors in August 2012. Dell's board formed a special committee, led by lead director Alex Mandl, to evaluate and negotiate terms of the acquisition.

According to the company's announcement, the buyout will be financed through a combination of cash on hand from Dell's balance sheet; cash and equity from Michael Dell--who owns approximately 14% of outstanding Dell shares; cash investments from Silver Lake and MSD Capital; debt financing from Bank of America Merrill Lynch BAC, Barclays BCS, Credit Suisse CS, and RBC Capital Markets; and a $2 billion loan from Microsoft MSFT. The agreement includes a 45-day period during which the special committee will solicit alternative bids.

We think this deal makes sense for all parties involved. From the perspective of the buyout team, this seems like a good time to take Dell private; the firm's shares lost nearly half their value between February and November 2012, and Dell was trading near 10-year lows and below its enterprise value. Dell, whose performance has suffered due to deteriorating conditions in the PC industry, just released its first product line of tablets and tablet-laptop convertibles in the last few months, which provides exposure to the fast-growing mobility market. Dell also has spent about $10 billion since 2007 to acquire companies with high-margin revenues that complement its portfolio of products. We expect Dell's new mobility products could improve top-line performance in the near term, while merging the acquired products and services into an integrated suite of solutions for the enterprise customer base could grow Dell's sales and profitability in the longer term.

From Microsoft's perspective, the $2 billion loan appears to be a solid investment--likely at an attractive interest rate--that provides critical financing for a key business partner. On the consumer side, Dell represents a key conduit to Microsoft's end markets. Hewlett-Packard HPQ and Lenovo both command a larger portion of PC market share, but consolidation in the PC hardware space might adversely affect Microsoft's bargaining power for its Windows 8 operating system. Microsoft also has a history of working closely with its partners, and it may have an interest in leveraging Dell's global manufacturing and retail presence in order to build upon its recent foray into hardware manufacturing with the Surface tablet. On the enterprise side, Dell represents about 22% of Microsoft's installed enterprise servers and, as Dell is gaining share in the server market, it could be a key partner for Microsoft's success in the enterprise space. Additionally, several of the companies Dell acquired provide supplemental management software for Microsoft's platform, and a closer relationship could be symbiotic for both Microsoft and Dell.

From Dell's perspective, a buyout is helpful in several ways. First, it alleviates public scrutiny and allows the company to consider long-term opportunities while the relationship dynamics between PCs and mobile devices matures. We don't think PCs will become defunct, despite the recent sales declines. The PC's role in business is evolving, and hardware--be it PCs, smartphones, or tablets--will remain a vital portal between businesses and consumers. We believe it would be a mistake for Dell to shed a business that provides the critical touch point between consumers and technology because investors are displeased with short-term

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| Close Competitors | Currency (Mil) | Market Cap | TTM Sales | Oper Income | Net Income |
|---|---|---|---|---|---|
| **International Business Machines Corp** | USD | 227,885 | 104,689 | 19,868 | 16,261 |
| **Hewlett-Packard Co** | USD | 32,865 | 120,357 | -11,057 | -12,650 |

hardware margins. Dell also gains a strategic business partner in Microsoft from the buyout. In the short term, Dell could benefit from early releases of Microsoft software or services, which would differentiate Dell hardware from the competition. Microsoft may also use Dell's new mobility manufacturing capacity to produce future tablets. In the longer term, Dell and Microsoft may benefit from melding hardware and operating-system designs to improve security, functionality, or performance.

In all, we think the buyout proposal is beneficial for all parties, and we would be surprised if another party could counter the offer from Michael Dell and Silver Lake Partners, given the size and liquidity demands of the deal. We are optimistic that a private Dell could be a successful company and continue to generate quality products for enterprise and consumer markets.

**Thesis** Dec. 10, 2012

DELL DELL, well known as one of the world's largest computer suppliers, is developing a high-margin suite of end-to-end solutions for enterprise businesses by acquiring businesses that complement its existing lines. However, we believe that DELL has overpaid for many of its acquisitions, and we fear this trend may continue, with negative implications for its investment prospects.

Chairman Michael Dell retired as CEO in 2004, 20 years after founding DELL, only to return in 2007 to try to stem declines in sales growth, PC market share, and profitability. The industry dynamics of PCs and printers, traditionally DELL's bread and butter, were deteriorating. Growing international competition had turned computer hardware into a commodity, and alternative devices such as smartphones, laptops, and tablets were cannibalizing the PC market.

Dell was forced to re-evaluate the hardware-centric strategy he had promoted since the company's founding, and, upon returning to his role as CEO, set about diversifying into higher-margin software and services. The new growth strategy was straightforward: DELL needed to become an end-to-end IT solutions provider by buying IT companies that would run on DELL's legacy hardware business. From 2007 to 2012, DELL invested $9.6 billion to acquire competencies in areas like IT management software, storage, software security and cloud services and integrated them into a new suite of solutions. As a result, DELL's Servers and Networking and Enhanced Services sales grew 35% in the last five years, offsetting a $2 billion decline in PC and mobility sales--which includes laptops, PCs, and tablets--due to the cutthroat competition in the industry. More, these new businesses have led to higher profitability. DELL's gross margins have jumped by 5% since 2007, operating margins have increased 2% despite the aggressive investments in acquisitions, and operating profits have grown by 44%. The operating improvements from the new businesses validate Dell's strategy of moving away from the PC business, and we expect DELL's revenue mix will skew more toward its new services businesses over the next five years.

DELL's evolution into an end-to-end solutions provider is aided by existing businesses; DELL can leverage its enterprise server install base to grow solutions sale, while the consumer hardware business generates operating cash flows that are fueling DELL's acquisition strategy. Many businesses today, including existing DELL customers, are unsure of the best way to upgrade their current IT infrastructure. DELL is well positioned meet these customers' needs by supplementing its server and hardware portfolio, with which many companies are familiar, with leading IT solution brands DELL has acquired. These include Perot Systems, Compellent, and Quest Software, to offer a suite of virtual solutions that the business can keep onsite or move to a DELL hosted cloud. We anticipate that DELL's virtual solutions will increase the stickiness of its businesses, particularly if acquisitions can develop integrated and

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complementary offerings, which could lead defensible barriers to entry and meaningful traction if DELL's solutions are widely adopted.

DELL's improving business model is no guarantee of success, however, due to a number of variables. First, IBM IBM and HP HPQ were quicker to transition from hardware to virtual solutions and have already established customer relationships. IBM is a well-entrenched consultant for businesses looking to migrate to the cloud, while HP is also using a hardware-software combination to target companies that want onsite or internal cloud services, which will make it difficult for DELL to differentiate its own hybrid solutions. Next, customers may not use DELL consulting services that push DELL's own hardware and services, and instead consult unbiased IT consultants that would not recommend unproven DELL solutions. Rather, these consultants are more likely to suggest established providers--like BMC BMC, Rackspace RAX, or Google GOOG--that have more experience and proven track records. Third, if the hardware industry dynamics continue to deteriorate, DELL's profitability could suffer materially. The convergence of smartphones, tablets, and laptops is limiting hardware differentiation, and software is becoming the primary product differentiator and the determining factor in customer purchase decisions. Adding to this, Microsoft's Surface tablet is made in house, and if that continues, DELL and other device-makers will be boxed out of the fastest-growing electronics segment, intensifying the competition over desktop PCs, laptops, and servers. Also, DELL has paid premium prices for many of its acquisitions, which indicates desperation, weighs on returns, and encourages other acquisition targets to raise their price. In all, we think DELL's transition will be costly, slow, and the firm's acquisition tactics may ultimately destroy more shareholder value than it creates.

**Valuation, Growth and Profitability**

Our fair value estimate for DELL is $14 per share. This fair value estimate implies fiscal 2013 (ended September) price/earnings of 5.7 times, an enterprise value/EBITDA of 2.3 times, and a free cash flow yield of 12.1%. After revenue growth of 90 basis points in fiscal 2012, we project a 9% decline in fiscal 2013, as a tough pricing in the PC market and lower IT spending impedes growth. In the longer term, we anticipate DELL's revenue growth will average 2.9% between fiscal 2014 and fiscal 2017 as strong demand for virtual services is offset by tablets cutting into the PC market-increasing the competition between PC makers--and the commoditization of the server and storage markets. On a product line basis between fiscal 2013 to fiscal 2017, we expect growth to average 6% in Mobility, half a percent in Desktop PCs, negative 4% in Software and Peripherals, 3% in Servers and Networking, 2% in Enhanced Services, and 16% in Storage. We expect the PC desktop market to be cannibalized by demand for laptop PCs, and both laptop and desktop PCs to lose market share to tablets, which could have an adverse effect on demand for peripherals like speakers and webcams. Finally, storage services are becoming increasingly necessary for businesses and consumers alike, and we expect DELL's acquisitions of EqualLogic, PowerVault, and Compellent will give it needed scale and competencies to grow its storage sales faster than the market.

DELL's gross margins spiked to 22% in fiscal 2012, having spent the previous decade in a range of 16%-19%, as the company spent the previous five years acquiring and developing higher-margin businesses. We expect challenging economic conditions and an unfavorably PC heavy product mix to push gross margins slightly under 22% in fiscal 2013, and drop below 21% by fiscal 2017 as PCs continue to become more commoditized. DELL is likely to continue trying

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to offset PC commoditization by focusing on acquisitions and incurring high operating costs. We anticipate DELL's fiscal 2013 operating margins will contract to 5.2% from 7.1% in the previous year, ultimately falling under 5% by fiscal 2017. While DELL's transition is a necessary risk for the company, it is evolving into end-to-end solutions provider on the fly and that constitutes a "high" fair value uncertainty rating, in our opinion.

### Risk

DELL's pivot from a computer hardware manufacturer to a cloud services provider pose a number of significant risks for the company. In the near term, DELL's primary risk is further price degradation in PCs from increased competition, as well as higher cannibalization rates from tablets and smartphones. Next, DELL's rapid acquisition fueled transformation creates risks that DELL could get into a bidding war for target companies, be unable to retain key talent of the acquired companies, or find that the acquired technology benefits do not meet expectations. More, DELL is attempting to develop a consulting service and push its virtual services at the same time, which could be perceived as a conflict of interests by customers and harm its credibility. Finally, DELL's strategy is predicated on business dynamics coalescing around the company's existing technology, like remote servers, over the long term. However, competitors like Amazon AMZN and Google are established service providers that possess scale advantages over DELL and are pushing the industry toward an entirely cloud-based platform. If the incumbents, or even an acquired startup, develop disruptive cloud technologies that are substantially more efficient than alternative computing solutions, DELL's newly constructed services could be rendered obsolete.

### Bulls Say

- DELL is expanding its presence in enterprise solutions that provide stickier business and recurring revenue relative to the hardware industry.
- Despite the challenging economics of the PC business, an efficient operational model allows the firm to churn out billions in free cash flow.
- Many of DELL's acquisition targets are smaller companies with small customer bases. Unrolling the acquired solutions to DELL's large, established customer base is an easy way to grow high-margin sales and improve DELL's profitability.

### Bears Say

- The tablet market is the fastest-growing segment in computer electronics, but DELL may not be able to participate if Microsoft manufactures tablets in house like it did with the Surface.
- DELL has overpaid for acquisitions in the past and is likely to do so again in the future.
- We expect PC pricing to decline as competitors adjust pricing to reflect improvements in supply chain efficiency and favorable component pricing.

### Financial Overview

Financial Health:We think DELL's financial health is solid. As of November, the firm's balance sheet reflected $11 billion of cash and investments, $9 billion in debt, and employs a business model that allowed DELL to churn out $5 billion in free cash flow in fiscal 2012, despite the challenging economics of the PC business.

### Company Overview

Profile: Nearly two thirds of DELL's revenue is derived from endpoint devices (PCs and related peripherals) for consumer and enterprise use. DELL provides notebook computers, desktop computers, software and other peripheral equipment, servers and networking equipment, storage, and

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services. Historically, DELL was a direct distributor, but it has been building its retail presence in an effort to boost sales growth.

Management: DELL is led by founder, chairman, and CEO Michael Dell. Dell temporarily retired from the CEO position in 2004, handing the reins to Kevin Rollins, but returned to the post in 2007. Dell remained an active chairman during his retirement, but the firm missed out on several key trends, including smartphones, tablets, and cloud computing. Dell prevented Rollins from pursuing substantial acquisitions that would have diversified the company away from a hardware-centric company. The company's performance slipped as a result, and when Dell returned he immediately began transitioning the company to become a virtualized end-to-end solutions provider, effectively copying the same transformation IBM and HP had already started. While we like new direction of the company, we think DELL is late to the game in this transition and has paid a premium price for acquisitions. For example, in 2009, DELL purchased Perot for $30 per share, or $3.9 billion, after Perot declined offers of $17, $19, and $26.50. We think this is a good example of management's willingness to play any price to acquire higher-margin revenue, which is destroying shareholder capital in the process.

That said, we like Dell's decision to bring in the industry's top management talent to help in the difficult transition. For example, John Swainson, president of software, served as CEO of CA Technologies and led IBM's global software sales before joining DELL in 2012. Next, Marius Haas, president of Enterprise Solutions, joined DELL in 2012 from the Private Equity titan Kohlberg Kravis Roberts, where he had been responsible for identifying technology investment opportunities, and previously held senior operations roles at HP, Compaq, and Intel. Also, Dave Johnson, senior vice president of corporate strategy, had spent 27 years with IBM as a member of the senior leadership team before joining DELL in 2009. We think this team of industry veterans has been an average steward of shareholder capital thus far, which is still an accomplishment given the challenging task of transforming one of the world's largest computer companies into a virtual solutions company. DELL, which initiated a quarterly cash dividend of $0.08 in June, likes to return an attractive 20%-35% of free cash flow to shareholders through buybacks and dividends, which is more than offset by DELL's poor acquisition record.

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## Analyst Notes

**A Tale of Two Dells: PC Sales Plummet While Enterprise Hardware Surges in 2Q Results** Aug. 21, 2012

Dell DELL reported second-quarter results in line with our expectations, but the firm's outlook for the second half of fiscal 2013 suggests that there is no end in sight to the weak demand that is dragging on Dell's PC business. We are lowering our full-year non-GAAP EPS estimates to $1.78. We do not expect to change our $18 fair value estimate, but if our outlook for the PC market deteriorates further, we will consider a downward adjustment to our fair value estimate. We believe the recent decline in the firm's operating margin is a return to a sustainable level and that the growing enterprise-focused business will largely offset the secular decline of Dell's PC sales over time.

Total revenue was $14.5 billion, down 8% year over year, as collapsing PC revenues were only partially offset by a healthy showing from enterprise solutions. Dell's PC-centric businesses declined 14% year over year, while the enterprise-focused segments (servers, networking, storage, and services) combined to deliver 6% growth over the prior year. Soft consumer demand was clearly a key component of the disappointing decline in PCs, with revenue from Dell's consumer business unit falling 22% year over year. Despite the steep fall in revenue, a combination of cost cutting and the product mix-shift from PCs to enterprise technologies helped to stabilize Dell's operating margin at 6.2%, down 110 basis points year over year, but up 50 basis points sequentially.

Dell is facing several key headwinds in the PC market. First and foremost, tablets and smartphones are cannibalizing some of the purchasing spend that traditionally might have gone to mobile and desktop PCs. Second, there are few compelling reasons to upgrade a consumer PC just months before the launch of Windows 8. Third, the areas of PC unit shipment growth, typically emerging markets, are the areas where the most price-sensitive consumers reside and the most aggressive PC competitors are focusing their efforts.

Nonetheless, demand for the traditional PC form factors (desktop and mobile) is not dead. We believe that much of the demand for alternative devices is additive, rather than destructive of PC demand. A large proportion of tablets and smartphones are the second or third compute device in a household. In developing markets where many households are still adding their first compute device, we believe the traditional form factor will be the typical choice. Furthermore, while there has been some adoption of tablets in the workplace, the vast majority of usage is still by consumers. Desktops and laptops are still king for content creation, and while the corporate refresh cycle may elongate, it will still drive a base level of PC unit shipments during the next several years.

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**Dell Under Review** Oct. 04, 2012

We are placing Dell DELL under review as we transfer coverage to a new analyst.

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**Dell Shares Spike on Buyout Rumors** Jan. 15, 2013

Dell DELL shares were up 13% Monday on unconfirmed reports that two private equity firms were in negotiations to take the company private. Since we consider the shares to be attractively valued today, and the company generates consistent cash flows that could attract private equity firms, we recognize that Dell could be a target. We anticipate that any buyout price above our fair value estimate would be a good deal for shareholders.

We believe that any potential buyer would be attracted to Dell's higher-margin services business. Traditionally a

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**Analyst Notes** (continued)

hardware purist, Dell has spent $9.6 billion since 2007 to acquire software and service providers and build out end-to-end solutions for enterprise customers that generate higher-margin sales. With such acquisition rates, it is no surprise that Dell has seen substantial traction in the past two years; its software and services sales have jumped 43% since 2010 and constituted more than 25% of annual revenue in 2012. These higher-margin sales have led to improvements in the bottom line, with operating margins jumping from 4.1% in 2010 to 7.1% in 2012, despite acute weakness in the PC industry that has weighed on Dell's performance. We think Dell's existing enterprise customer base provides a promising runway for the company's new service offerings and could help drive robust sales growth in the future.

Additionally, last week Dell confirmed that David Johnson, senior vice president of corporate strategy, was leaving for Blackstone Group BX. Johnson joined Dell in May 2009 to loud protests from IBM IBM, where he had been head of mergers and acquisitions, and ramped up Dell's acquisition pace from 7 buyouts in 2006-09 to 20 acquisitions over the next three years. His presence coincided with substantial growth from Dell's higher-margin business, and while he has positioned the company to continue increasing revenue organically, we do not think Dell has sufficient capabilities on hand to be a successful end-to-end solutions provider. Dell's $11 billion cash reserve provides a sizable war chest for future actions, but the firm may need another visionary leader in this role who can find necessary competencies at attractive prices.

Our fair value estimate is $14 per share, and we expect shareholders would benefit from any offer above that. Private equity firms may be lured by the strong operating cash flows Dell generates, which could be used to pay down the additional debt that the company would take on if it were taken private. Dell's performance has been depressed by cyclical weakness in the PC industry, but the company could generate high-margin sales growth and stronger operating cash flows if it can create a compelling end-to-end solution in the enterprise market, thus allowing a private equity firm to profit from its investment.

**Addressing Microsoft's Possible Investment in Dell**

Jan. 22, 2013

Microsoft MSFT could be adding its voice, and, more important, its wallet to the buyout discussions surrounding Dell DELL, according to CNBC and Wall Street Journal reports. The reports speculate that Microsoft may invest between $1 billion and $3 billion of mezzanine financing in the buyout, alongside Silver Lake Partners, Evercore Partners, and Michael Dell. We believe Microsoft's involvement would lend credibility to the investor group, increasing the chances that a buyout will occur.

Dell's shares have responded positively to today's news, as it is still unclear whether the investment group would be able to raise the necessary capital to finance an estimated $21 billion-$25 billion buyout without Microsoft's involvement. The possible $1 billion-$3 billion investment by Microsoft would provide additional liquidity and demonstrate a commitment by Microsoft to Dell's viability.

The rationale for Microsoft's interest in an investment in Dell is unclear, but could be due to a variety factors. First, Microsoft might have a desire to see a key strategic business partner remain viable. Microsoft has a history of working closely with its partners, and it may have an interest in leveraging Dell's global manufacturing and retail presence in order to build upon its recent foray into hardware manufacturing with the Surface tablet. Also, Dell has acquired a number of management software providers in

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recent years, such as Quest Software, that supplement the capabilities of Microsoft's enterprise management tools.

At the rumored size, the investment would represent less than two months of free cash flow for Microsoft, or less than 5% of current cash and equivalents, making this investment one with minimal downside. Nevertheless, if such an investment were made without a compelling strategic rationale, we would have to question the company's capital allocation strategy.

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In all, we think the buyout proposal is beneficial for all parties, and we would be surprised if another party could counter the offer from Michael Dell and Silver Lake Partners, given the size and liquidity demands of the deal. We are optimistic that a private Dell could be a successful company and continue to generate quality products for enterprise and consumer markets.

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# Dell Inc(USD) DELL

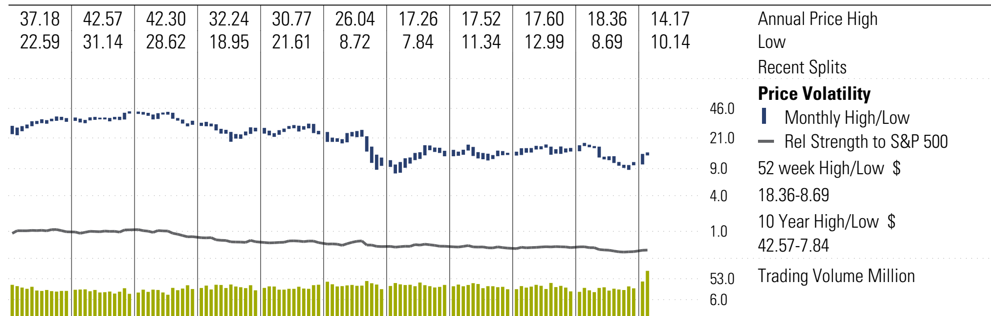
| Last Close $ | Sales $Mil | Mkt Cap $Mil | Industry | Currency |
|---|---|---|---|---|
| $13.52 | $58,657 | $23,488 | Computer Systems | USD |

Dell Inc is a technology company, which offers a range of technology solutions, including servers and networking products, storage products, services, software and peripherals, mobility products, and desktop PCs.

| Morningstar Rating | Fair Value Uncertainty | Fair Value | Economic Moat | Style | Sector |
|---|---|---|---|---|---|
| ★★★ As of 02-06-2013 | High | $14.00 | None | Large Value | Technology |

One Dell Way
Phone: +1 512 338-4400
Website: http://www.dell.com

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | YTD | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 37.18 | 42.57 | 42.30 | 32.24 | 30.77 | 26.04 | 17.26 | 17.52 | 17.60 | 18.36 | 14.17 | Annual Price High |
| 22.59 | 31.14 | 28.62 | 18.95 | 21.61 | 8.72 | 7.84 | 11.34 | 12.99 | 8.69 | 10.14 | Low |
| | | | | | | | | | | | Recent Splits |




| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | YTD | Stock Performance |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 27.1 | 24.0 | -28.9 | -16.2 | -2.3 | -58.2 | 40.2 | -5.6 | 8.0 | -29.6 | 33.3 | Total Return % |
| -1.6 | 13.1 | -33.8 | -32.0 | -7.8 | -21.2 | 13.8 | -20.7 | 5.9 | -45.6 | 27.1 | +/- Market |
| 0.2 | 10.7 | -28.2 | -34.2 | -36.8 | -19.0 | -33.8 | -26.4 | -6.9 | -45.0 | 39.4 | +/- Industry |
| — | — | — | — | — | — | — | — | — | 1.6 | 1.2 | Dividend Yield % |
| 87003 | 104689 | 70488 | 56098 | 54927 | 19911 | 28098 | 26155 | 26283 | 17616 | 23488 | Market Cap $Mil |

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | TTM | Financials (USD) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 35404 | 41444 | 49121 | 55788 | 57420 | 61133 | 61101 | 52902 | 61494 | 62071 | 58657 | Revenue $Mil |
| 17.9 | 18.2 | 18.4 | 17.7 | 16.6 | 19.1 | 17.9 | 17.5 | 18.5 | 22.3 | 21.3 | Gross Margin % |
| 2844 | 3544 | 4206 | 4382 | 3070 | 3440 | 3190 | 2172 | 3433 | 4431 | 3245 | Oper Income $Mil |
| 8.0 | 8.6 | 8.6 | 7.9 | 5.4 | 5.6 | 5.2 | 4.1 | 5.6 | 7.1 | 5.5 | Operating Margin % |
| 2122 | 2645 | 3018 | 3602 | 2583 | 2947 | 2478 | 1433 | 2635 | 3492 | 2606 | Net Income $Mil |
| 0.80 | 1.01 | 1.18 | 1.46 | 1.14 | 1.31 | 1.25 | 0.73 | 1.35 | 1.88 | 1.48 | Earnings Per Share $ |
| — | — | — | — | — | — | — | — | — | — | 0.08 | Dividends $ |
| 2644 | 2619 | 2568 | 2449 | 2271 | 2247 | 1986 | 1962 | 1955 | 1853 | 1765 | Shares Mil |
| 2.30 | 2.37 | 2.05 | 1.52 | 3.05 | 2.14 | 2.57 | 3.53 | 4.82 | 5.86 | 5.86 | Book Value Per Share $ |
| 3538 | 3670 | 5821 | 4751 | 3969 | 3949 | 1894 | 3906 | 3969 | 5527 | 3679 | Oper Cash Flow $Mil |
| -305 | -329 | -515 | -747 | -896 | -831 | -440 | -367 | -444 | -675 | -548 | Cap Spending $Mil |
| 3233 | 3341 | 5306 | 4004 | 3073 | 3118 | 1454 | 3539 | 3525 | 4852 | 3131 | Free Cash Flow $Mil |

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | TTM | Profitability |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 14.6 | 15.2 | 14.2 | 15.5 | 10.6 | 11.1 | 9.2 | 4.8 | 7.3 | 8.4 | 6.0 | Return on Assets % |
| 44.4 | 47.4 | 47.3 | 68.4 | 61.7 | 73.1 | 61.9 | 28.9 | 39.3 | 41.9 | 27.7 | Return on Equity % |
| 2.44 | 2.38 | 2.31 | 2.40 | 2.35 | 2.30 | 2.26 | 1.76 | 1.70 | 1.49 | 1.34 | Asset Turnover |
| 6.0 | 6.4 | 6.1 | 6.5 | 4.5 | 4.8 | 4.1 | 2.7 | 4.3 | 5.6 | 4.4 | Net Margin % |
| 3.2 | 3.1 | 3.6 | 5.7 | 5.9 | 7.4 | 6.2 | 6.0 | 5.0 | 5.0 | 4.5 | Financial Leverage |

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 10-12 | Financial Health (USD) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 506 | 505 | 505 | 625 | 569 | 362 | 1898 | 3417 | 5146 | 6387 | 5310 | Long-Term Debt $Mil |
| 4873 | 6280 | 6485 | 4047 | 4328 | 3735 | 4271 | 5641 | 7766 | 8917 | 10177 | Total Equity $Mil |
| 0.10 | 0.08 | 0.08 | 0.15 | 0.13 | 0.10 | 0.44 | 0.61 | 0.66 | 0.72 | 0.52 | Debt/Equity |
| -9 | -263 | 2761 | 1621 | 2148 | 1354 | 5292 | 5285 | 9538 | 7447 | 3851 | Working Capital $Mil |

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | TTM | Valuation |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 35.6 | 34.8 | 23.1 | 19.9 | 18.5 | 7.5 | 19.4 | 13.0 | 7.6 | 6.9 | 9.2 | Price/Earnings |
| 0.0 | 0.0 | — | — | 0.0 | 0.0 | 0.0 | 0.0 | — | 0.0 | 0.6 | P/E vs. Market |
| 2.2 | 2.3 | 1.4 | 1.0 | 0.9 | 0.3 | 0.5 | 0.4 | 0.4 | 0.3 | 0.4 | Price/Sales |
| 14.8 | 17.8 | 14.6 | 16.5 | 8.0 | 4.8 | 5.6 | 3.8 | 3.0 | 1.7 | 2.3 | Price/Book |
| 23.8 | 23.9 | 14.7 | 13.3 | 13.9 | 8.9 | 8.3 | 7.1 | 5.3 | 4.9 | 6.5 | Price/Cash Flow |

## Growth Rates Compound Annual

| Grade: C | 1 Yr | 3 Yr | 5 Yr | 10 Yr |
|---|---|---|---|---|
| Revenue % | 0.9 | 0.5 | 1.6 | 7.1 |
| Operating Income % | 29.1 | 11.6 | 7.6 | 9.5 |
| Earnings/Share % | 39.3 | 14.6 | 10.5 | 15.1 |
| Dividends % | — | — | — | — |
| Book Value/Share % | 25.1 | 32.1 | 21.2 | 10.9 |
| Stock Total Return | -22.5 | 1.1 | -6.4 | -5.5 |
| +/- Industry | -19.6 | -16.2 | -21.4 | -19.5 |
| +/- Market | -37.5 | -13.7 | -11.4 | -13.7 |

## Profitability Analysis

| Grade: D | Current | 5 Yr Avg | Ind | Mkt |
|---|---|---|---|---|
| Return on Equity % | 27.7 | 49.0 | 38.8 | 20.4 |
| Return on Assets % | 6.0 | 8.1 | 14.4 | 8.3 |
| Revenue/Employee $K | 536.2 | 636.3 | — | 1077.3 |
| Fixed Asset Turns | 27.4 | 26.5 | 11.9 | 6.9 |
| Inventory Turns | 33.5 | 45.3* | 21.2 | 11.5 |
| Gross Margin % | 21.3 | 19.1 | 34.9 | 43.8 |
| Operating Margin % | 5.5 | 5.5 | 11.5 | 19.0 |
| Net Margin % | 4.4 | 4.3 | 13.6 | 13.3 |
| Free Cash Flow/Rev % | 5.3 | 5.5 | 15.0 | 12.1 |
| R&D/Rev % | 1.4 | 1.1 | 3.3 | — |

## Financial Position (USD)

| Grade: C | 01-12 $Mil | 10-12 $Mil |
|---|---|---|
| Cash | 13852 | 10991 |
| Inventories | 1404 | 1364 |
| Receivables | 9803 | 9338 |
| Current Assets | 29448 | 25662 |
| Fixed Assets | 2124 | 2156 |
| Intangibles | 7695 | 12702 |
| Total Assets | 44533 | 45446 |
| Payables | 12088 | 10556 |
| Short-Term Debt | 2867 | 3724 |
| Current Liabilities | 22001 | 21811 |
| Long-Term Debt | 6387 | 5310 |
| Total Liabilities | 35616 | 35269 |
| Total Equity | 8917 | 10177 |

## Valuation Analysis

| | Current | 5 Yr Avg | Ind | Mkt |
|---|---|---|---|---|
| Price/Earnings | 9.2 | 10.9 | 15.1 | 15.6 |
| Forward P/E | 6.9 | — | — | 11.2 |
| Price/Cash Flow | 6.5 | 6.9 | 7.8 | 9.5 |
| Price/Free Cash Flow | 7.6 | 8.2 | 9.9 | 76.3 |
| Dividend Yield % | 1.2 | — | 1.4 | 2.1 |
| Price/Book | 2.3 | 3.8 | 3.9 | 2.2 |
| Price/Sales | 0.4 | 0.4 | 1.6 | 2.6 |
| PEG Ratio | 3.0 | — | — | 2.1 |

*3Yr Avg data is displayed in place of 5 Yr Avg

## Quarterly Results (USD)

| Revenue $Mil | Jan | Apr | Jul | Oct |
|---|---|---|---|---|
| Most Recent | 16031.0 | 14422.0 | 14483.0 | 13721.0 |
| Previous | 15692.0 | 15017.0 | 15658.0 | 15365.0 |
| **Rev Growth %** | **Jan** | **Apr** | **Jul** | **Oct** |
| Most Recent | 2.2 | -4.0 | -7.5 | -10.7 |
| Previous | 5.3 | 1.0 | 0.8 | -0.2 |
| **Earnings Per Share $** | **Jan** | **Apr** | **Jul** | **Oct** |
| Most Recent | 0.42 | 0.36 | 0.42 | 0.27 |
| Previous | 0.48 | 0.49 | 0.48 | 0.49 |

## Close Competitors

| | Mkt Cap $Mil | Rev $Mil | P/E | ROE% |
|---|---|---|---|---|
| International Business Machines Corp | 227139 | 104689 | 14.5 | 74.2 |
| Hewlett-Packard Co | 32515 | 120357 | -2.6 | -41.4 |

## Major Fund Holders

| | % of shares |
|---|---|
| Longleaf Partners | 1.78 |
| Vanguard Total Stock Mkt Idx | 1.10 |
| PowerShares QQQ | 0.99 |

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MORNINGSTAR®

## Morningstar's Approach to Rating Stocks

**Our Key Investing Concepts**

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

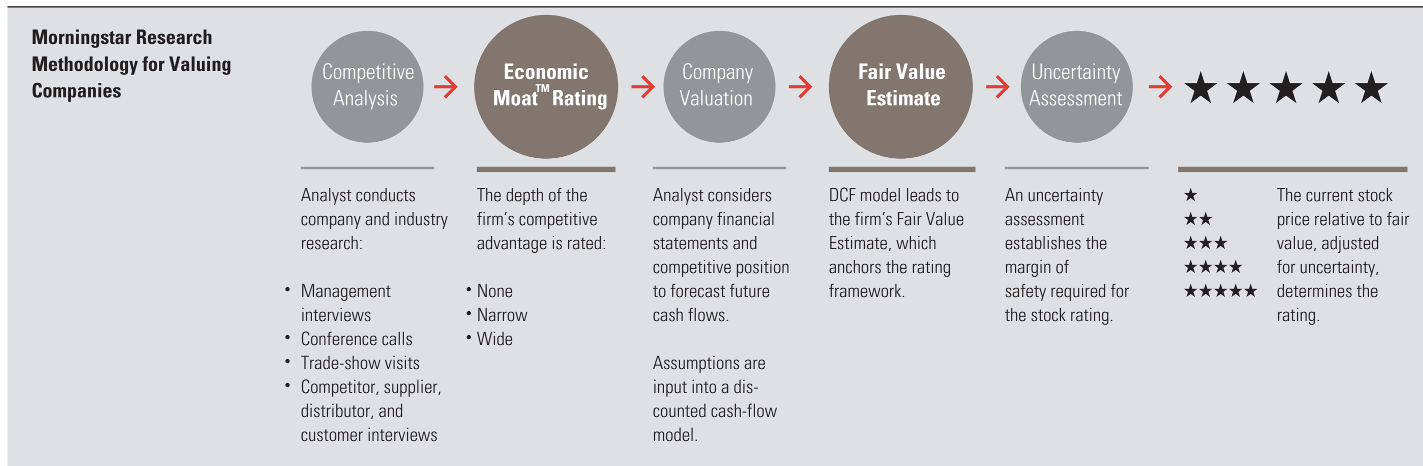
Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

### Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

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economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

**Discounted Cash Flow**

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

**Discount Rate**

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

**Fair Value**

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

**Uncertainty**

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

**Margin of Safety**

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

**Consider Buying/Consider Selling**

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

**Stewardship Grades**

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

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