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Dell's Transformation Won't Mirror IBM

By Marty Wolf

Dell's announcement that Michael Dell and Silver Lake Partners are buying the company and taking it private paves the way for an acceleration of Dell's (DELL) transition from products to solutions.

As Dell seeks to develop higher margin businesses with a future, the company may even eventually make a complete exit from PC hardware – a shrinking, low-margin business that still accounts for 70 percent of Dell's revenue.

From Dell's perspective, the desire to make this move is understandable. It's hard for a $55 billion public company to execute a bold and complicated strategy while meeting Wall Street's unrelenting expectations for growth every 90 days. Going private will allow the company to work on its business in, well, private.

Welcome to the Post-PC Era

From a financial perspective, the specifics of the transaction are encouraging. First, it's huge. Dell and Silver Lake were able to raise $24.4 billion to finance the deal, including a $2 billion loan from Microsoft. If it's completed – and personally I can't imagine that it won't be – it will be the largest leveraged buyout in the last five years and one of the largest tech LBOs ever. The latter distinction is especially important because it disproves conventional wisdom that you can't get large tech deals done.

Second, Dell shareholders will receive a cash payment of $13.65 a share – a 25 percent premium over Dell's closing share price of $10.88 on January 11, 2013, which was the last trading day before buyout rumors began. Not bad for a company whose most recent quarter-over-quarter report was a downer: Revenue down 11 percent, net income down 47 percent and earnings per share down 45 percent.
Of course, when a large public company is taken out at a premium, it means the company is worth more to the acquirers going forward than it is to shareholders.

Still, both the size of the transaction and the premium being paid should give all companies in all industries a renewed sense of optimism about what is possible to capitalize. This is welcome news as we emerge from a prolonged global recession.

Most of all, though, the Dell deal sends a clear message to the IT industry: Welcome to the post-PC era – exclamation point.

A New Mission

Think about it. With this transaction, the world's third largest PC company is saying it needs to sell solutions to survive. It's not about technology, it's not about products and it's not about distribution. It's about solving business problems.

In that regard, IBM (IBM) could be considered a role model for Dell.

When Lou Gerstner became CEO in 1993, IBM was literally on the brink of death. It had squandered an early lead in the PC business by failing to recognize that the real long-term value in PCs was software, not boxes. And despite its history of technology leadership and sales acumen, the company lacked a cohesive strategy, a sense of urgency and was losing billions of dollars.

First things first, Gerstner shed the low-margin commodity businesses that were weighing the company down. Then he began re-focusing the company on higher margin, higher value opportunities such as

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software and technology integration services.

I met Gerstner in 1994 when I was president of Computerland, the large chain of retail computer stores, and we were doing about a billion dollars in year in business with IBM. At the time, as the former CEO of RJR Nabisco and not a technologist, Gerstner was widely criticized and even ridiculed for his ideas about what IBM could become. But I could tell right away that he “got it.”

Just about a year after Gerstner joined IBM the company was making money again.

The extreme makeover to a global consulting and services powerhouse took longer. It culminated in IBM selling a majority stake in its PC business – including its well-respected ThinkPad brand – to Lenovo in 2004.

It's Not 1993 Anymore

But if IBM and ThinkPad are what come to mind when you think about Dell, think again. IT in 2013 is not like IT in 1993. And what a difference 20 years can make.

In 1993, PCs were in their heyday. Microsoft (MSFT) and Intel (INTC) ruled the world, creating billions of dollars of value for the partners in its ecosystem – including IBM and Dell. The Internet was in its commercial infancy. There were no smartphones, no cloud computing and no Facebook (FB).

Fast forward to 2013. With smartphones, tablets and the cloud replacing desktops and laptops with remarkable speed, it's a brand new dynamic and exciting world. But for years, PC companies have been delivering products that are unremarkable and uninspired.

In Microsoft's Interest

In retrospect, it’s not surprising that last year Microsoft felt compelled to enter the tablets business with Surface. What is surprising is Microsoft sells Surface direct to customers through its retail stores, at least in the United States. This means the company now openly competes for customers with its longtime OEM hardware partners, including Dell, Lenovo, Acer and HP. Further, Microsoft is moving to displace its distributors and resellers whose low-value, low-margin services the company can easily duplicate.

As I wrote in a piece for *Yahoo Finance* on January 27th, Microsoft’s possible financial interest in Dell was not a signal that Microsoft wanted to stay in the PC business, but rather further proof that Microsoft is moving away from it. The company’s participation will ensure that Microsoft continues to benefit from Dell’s enterprise PC business as long as it lasts. At the same time, it reinforces Microsoft’s desire to take its enterprise business in the same direction as Dell: to solutions and the cloud.

I have no doubt that Microsoft’s recent strategy shifts played a large part in Dell’s decision to accelerate its business transformation. Still, in choosing to go private, Dell is also acknowledging the reality that this transition cannot and will not happen overnight. Since 2008, Dell has spent $13 billion on acquisitions designed to acquire expertise in cloud computing, datacenter infrastructure, management software and managed services – 10 of them in 2012 alone – including Quest Software, AppAssure and SonicWall.

It just wasn’t enough.

What Are the Next Steps?

So once the transaction is complete – and Dell is freed from the quarterly reporting wrath of Wall Street – what would be the most sensible actions for the company to take?

- First, Dell will have luxury of being able to de-emphasize low-margin products in favor of higher value solutions. This was not possible before because the only shot Dell had at meeting revenue expectations every quarter was to sell as much product as possible.With the shift to solutions will come a move to a recurring revenue model. In the old days, Dell could make a sale and recognize revenue right away. Under a recurring revenue model, revenue recognition occurs over one, two or even three years.

Both of these actions will reduce top line growth in the short term. Margins, however, will increase.

- Second, I expect that Dell will move quickly to become much less transaction oriented and much more relationship oriented, solving customer's problems and providing topnotch service. In the old Dell, everything depended on cost reduction. Now Dell is moving into businesses where the assets get up and go home every night.

This will be a sea change for the company and it will require a cultural transformation in addition to a massive business strategy shift.

- Three, watch for Dell to work diligently to integrate the acquisitions it has already made as effectively and rapidly as possible. At the rate the company has been making acquisitions in the last year, the company is probably right now more a collection of assets rather than a cohesive whole.
- Fourth, despite Michael Dell's assertion that Dell has made all the acquisitions it needs to make, Dell will find this is not true. To be successful, Dell will have to continually look for companies to buy that deliver new customers, have deep, established relationships with CEOs, CFOs and CIOs, provide IP and talent, and bring scale so Dell can continue to grow.

It's also important to note that as with any major change in the competitive landscape of an industry, there will be winners and losers. Among the winners will be technology service providers such as CDW and Insight, whose established solutions and customer relationships – especially in the midmarket and enterprise segments – will become even more valuable to their OEM partners. Losers will include large mainline distributors that can easily be displaced from the supply chain.

A New Challenge for Dell

As for Dell, even with these actions, the company's success is far from assured. This is a company that was at one time *the* leader in the PC business. Then it became *a* leader in the PC business.

It is about to enter a space where it is not even in the top quadrant, let alone one of the top three.
This is why 2013 is not 1993. When IBM moved into services it was a green field of opportunity. IBM was a leader and it would soon be a leader again. For Dell to succeed similarly, it must be nimble and find its value-add in a crowded market.

Of course Michael Dell did that once before when he created the best custom supply chain system in the PC industry – a differentiation that propelled the company to number one in its time.

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