

Breaking Analysis: Here are Five Strategic Options for Dell and VMware

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1. Buy the remaining ~19% of VMware shares and take full control of the company.
2. Sell VMware to a strategic company or private equity firm.
3. Spin off VMware by transferring Dell's ~81% VMware ownership to Dell shareholders.
4. Make no change in structure.
5. Sell ~20% of VMware ownership, raise cash, pay down debt and maintain control.

In this Breaking Analysis we'll assess these five options and what it means for Dell, VMware, customers and partners. As always, we'll bring in the [spending data from ETR](#) to add the customer perspective.

What Happened?

On June 23rd, the [Wall Street Journal reported](#) that Dell is exploring strategic options for its approximately 81 percent share in VMware. Both Dell and VMware stocks popped on the news. We believe that Dell is floating this trial balloon to gauge investor, customer and partner sentiment and perhaps send a signal to short sellers that Michael Dell has other arrows in his quiver to unlock value in his companies- i.e. squeeze me and I will squeeze you back.

The Hard News

The WSJ story said Dell was considering spinning off VMware or buying the remaining 19% of VMware stock that it doesn't own.

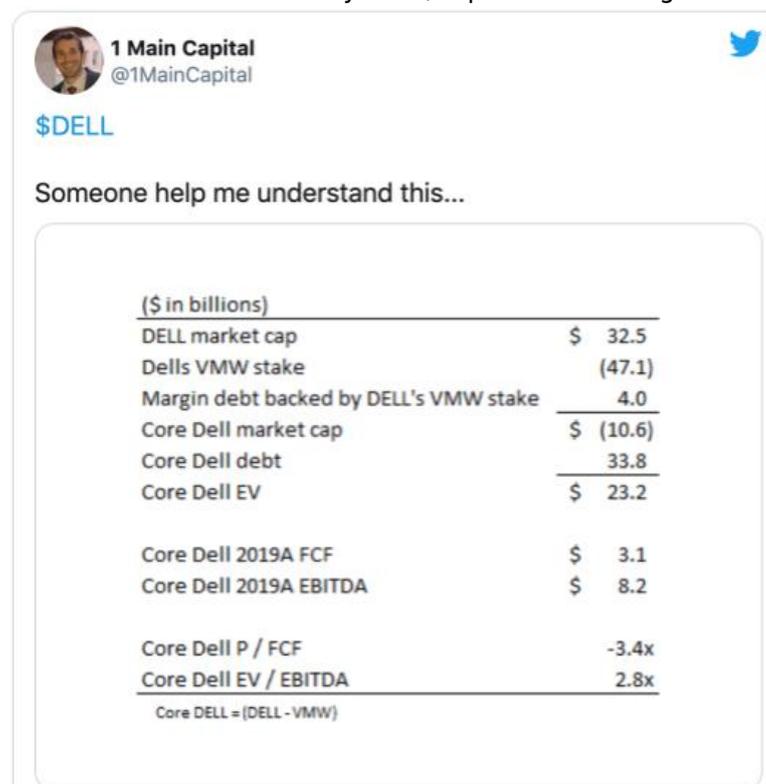
The article cited unnamed sources and said that a spin off would not likely happen until September 2021 for tax reasons. That would mark the five year anniversary of Dell acquiring EMC and would allow for a tax free transaction.

The Story

- June 23: WSJ reports Dell is exploring strategic options for its ~81% stake in VMware
- WSJ story said Dell was considering spinning off VMware or buying the remaining 19% of VMware stock that it doesn't own
- Spin off wouldn't happen until September 2021
- What options does Dell really have & what does it mean?

Why Would Dell Make a Move?

This tweet from Yaron Naymark, a portfolio manager at 1 Main Capital sort of sums it up.



Key Takeaways

- Investors put negative value on core Dell
 - Debt, conglomerate structure, low margin, low growth
 - Leaves many investors on the sidelines
- Owning Dell is a cheap way to own VMware - assuming the value gets unlocked at some point
- Leaking the options freezes the shorts for a year

He laid out this chart which shows Dell's market cap prior to the stock pop - it's ~\$38B today. And the value of its VMware ownership - which is over \$50B since the news leaked. Let's cut to the chase and right through all the EBITDA & FCF data.

Investors value the core assets of Dell somewhere south of minus \$11B.

Folks who follow Dell know this story. But those who don't may be surprised to know that Dell, without VMware has revenue of more than \$80B but the street puts a negative value on the stock.

Why? Because Dell is carrying more than \$30B of core debt. It owns and controls the vast majority of VMware shares- Michael Dell has something like 97% voting control — and the street puts a conglomerate penalty on the stock. Moreover, core Dell is a low margin, low growth business with exposure to hardware. Further, people complain that Michael uses VMware as his funding machine and many investors just won't touch the stock. So \$DELL has underperformed the broader tech sector.

As we've often said - even going back to EMC days - owning the stock of VMware's owner is a cheap way to buy VMware...assuming that value gets unlocked at some point.

So Dell is perhaps signaling that it has some options and other levers to pull in order to juice its value. And as we said - maybe Michael is trying to give pause to any big shorts trying to profit on the downside over the next twelve months.

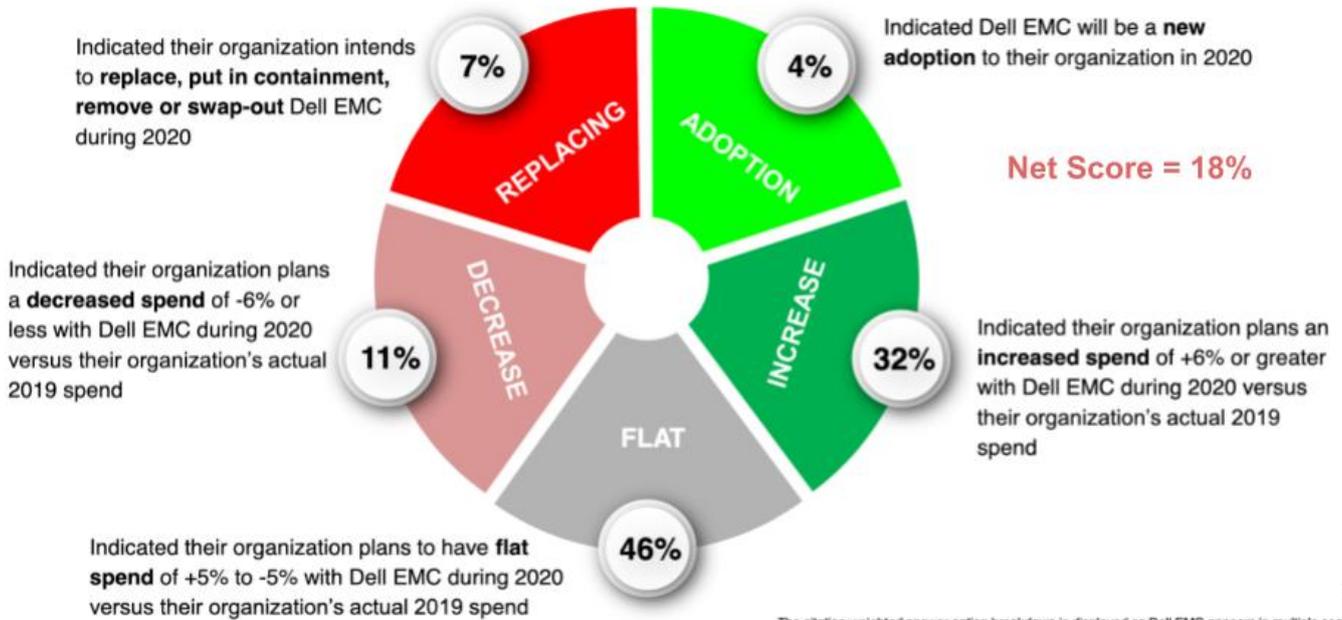
What's the ETR Spending Data Say?

Before we dig into the five scenarios, let's look at the spending climate. We'll assess selected ETR data for Dell and VMware and evaluate the respective positions of a combined Dell/VMware relative to the competition.

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This chart uses the core ETR methodology that we've shared many times. For those not familiar, we use the concept of Net Score. Net Score is a simple metric like Net Promoter Score (NPS).

DELL EMC 2020 TSIS ANSWER OPTION BREAKDOWN



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OPINIONS ONLY EXIST DUE TO A LACK OF DATA

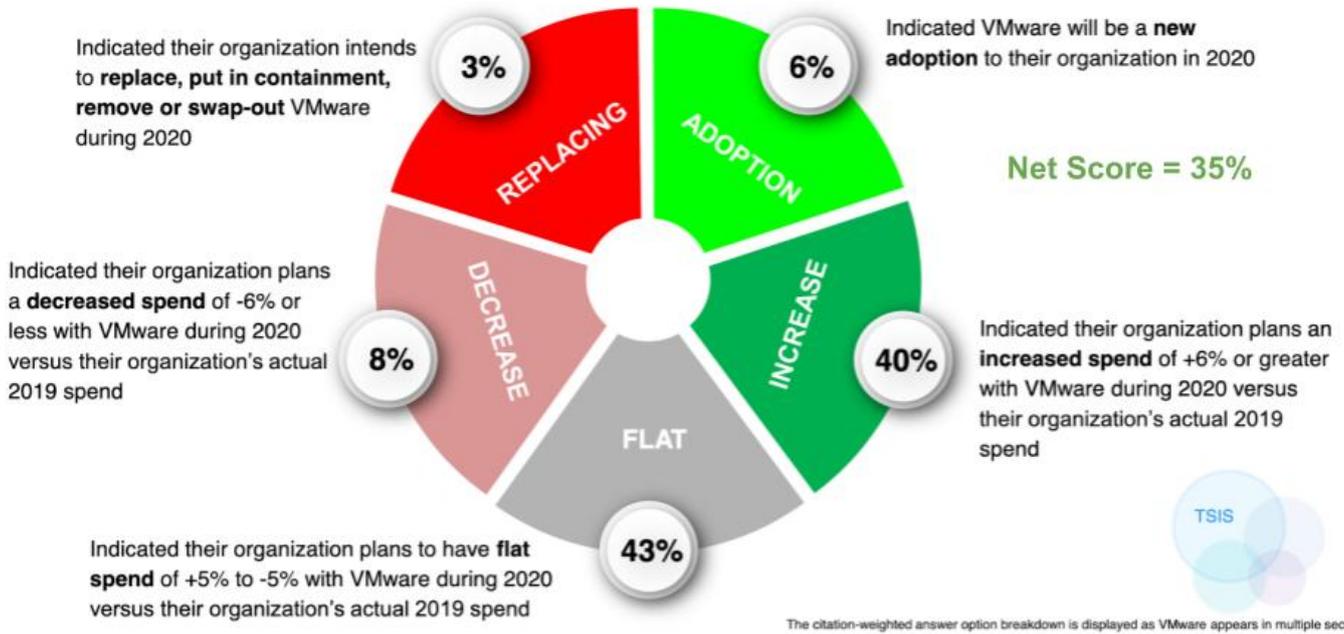
The chart above shows the five elements of Dell's Net Score. Each quarter, ETR asks customers do you plan to adopt the vendor new - that's the lime green at 4%, spend more relative to last year - i.e. more than 6% - that's the forest green at 32%. Flat spend is the gray - meaning plus 5% to minus 5%. Decrease spend by 6% or greater - that's the pink at 11% - or are you replacing the platform - bright red at 7%.

Net Score a measure of spending momentum and is derived by adding the greens and subtracting the reds. You can see Dell in the last survey - which was taken at the height of the pandemic - has a Net Score of 18%. We make that soft red - its not terrible but its not great either. Of course this is across Dell's entire portfolio from client to data center and it excludes VMware.

What about VMware's Spending Momentum?

This next graphic applies the exact same methodology to VMware.

VMWARE 2020 TSIS ANSWER OPTION BREAKDOWN



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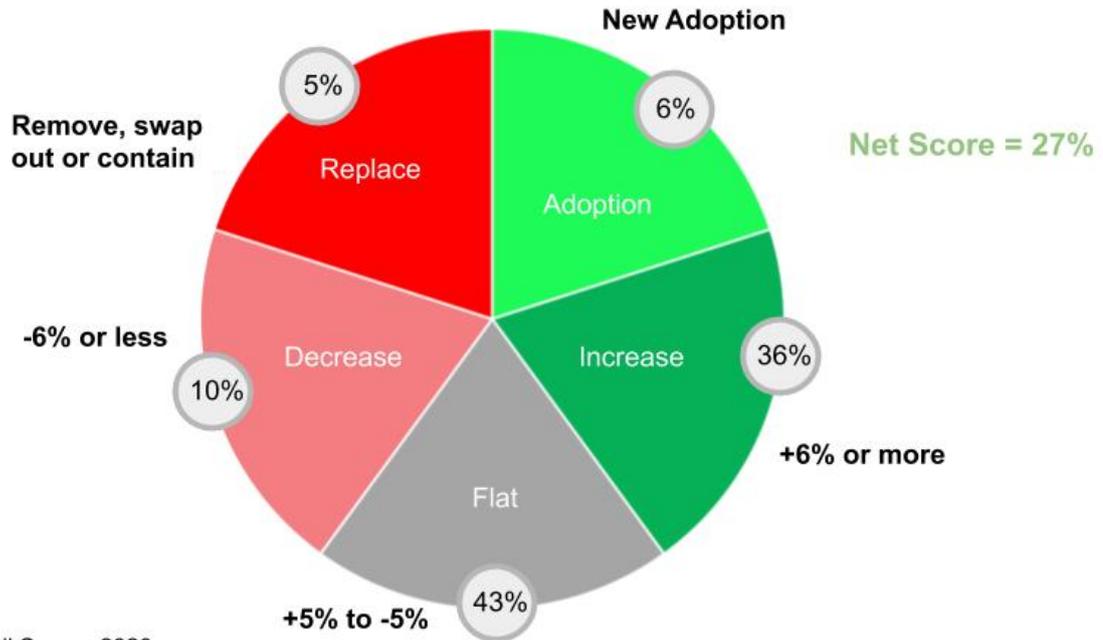
As you can see above, VMware has a much higher Net Score at 35% which is not surprising for a higher growth company. 46% of VMware customers planning to spend more in 2020 relative to 2019.

Combining Dell and VMware

One of the scenarios put forth in the WSJ article was Dell acquiring the remaining shares of VMware. It's something we'll analyze later in this post but what would that look like from an ETR spending perspective. The chart below does that.

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Combined Dell VMware Net Score: N = 975



Source: ETR April Survey 2020

There are 975 combined Dell VMware respondents in the last ETR survey . You can see above the combined company Net Score is 27% with 42% of respondents planning to spend more than they did last year.

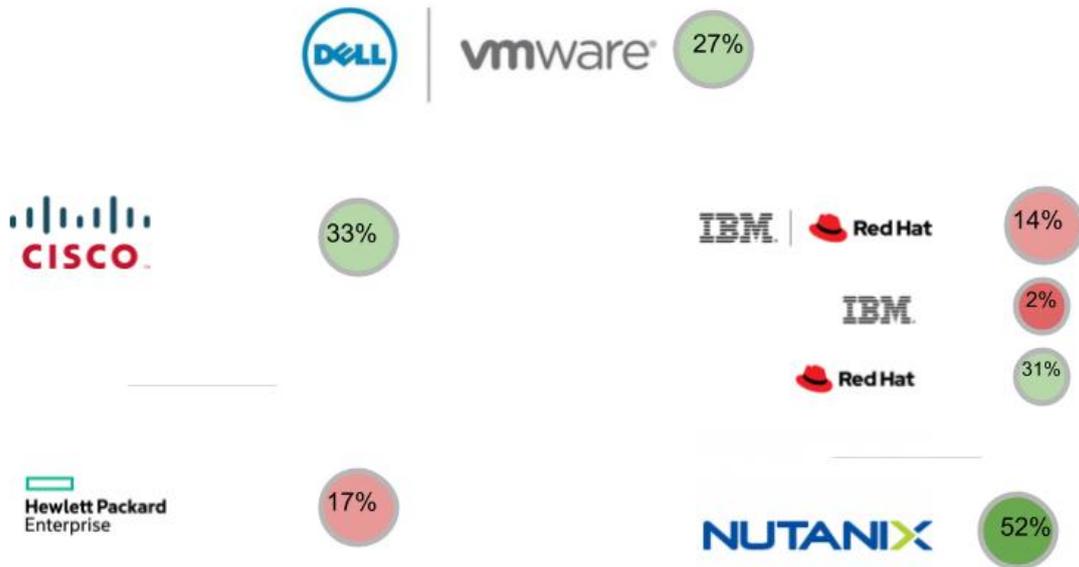
So you may be asking - is this good? How does this compare to Dell and VMware competitors?

Comparing the Combined Dell VMware Net Scores to the Competition

In the chart below we show the Net Score compares.

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Net Score Comparisons



Source: ETR April Survey 2020

In the above graphic, we see the combined Dell VMware at 27%. Cisco as we have often reported consistently shows strength relative to other enterprise data center players. You can see HPE is a tepid 17% so it has some work to do to live up to the promises of the HP / HPE split. We also show IBM Red Hat at 14% and the granular scores for each company. There's some room for improvement from IBM Red Hat. You can see IBM in the danger zone and Red Hat much stronger but it has softened somewhat in the surveys since last year. So we would like to see better momentum from IBM Red Hat. It's unfortunate that COVID hit when it did as IBM began ramping up its Red Hat go to market.

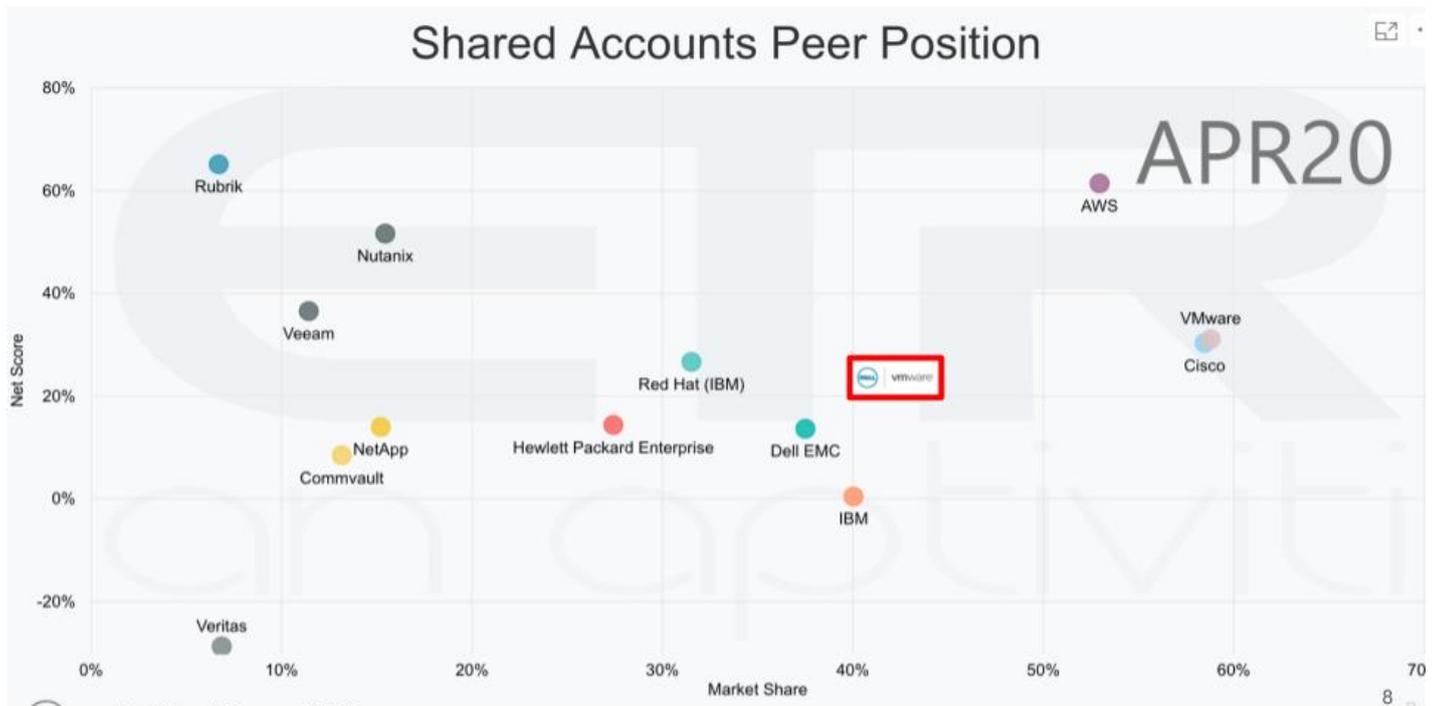
For further comparison purposes we include Nutanix in the chart. Nutanix is a much smaller company but one that is still fairly mature. But you can see at 52% its Net Score is much higher than the big enterprise whales. As a final comparison, we've been reporting for months on high-flying companies like [Automation Anywhere](#), [CrowdStrike](#), [Okta](#), [Zscaler](#), [Rubrik](#), [Snowflake](#) and [UiPath](#)...these emerging companies have Net Scores north of 60% and even in the 70% percent range. But they're growing from a much smaller base.

Visualizing the Horses on the Track

As you know, in addition to the Net Score metric we like to use another ETR measure called Marketshare. It's a measure of pervasiveness or marketshare within the survey and is a proxy for real marketshare. It's calculated by dividing the number of mentions of a vendor by the total number of mentions within a sector.

The chart below plots several companies with their Net Score on the Y-Axis and Marketshare on the X-Axis.

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Source: ETR April Survey 2020

We combined Dell and VMware together and plotted them in the Red Box for comparison purposes.

What does this tell you about the competitive landscape? Well first - everyone would love to be AWS. Microsoft too - we didn't plot Microsoft because they're so dominant they skew the chart somewhat. But they would be way out to the right on the X-Axis because they have such a huge number of products and mentions in the data set.

You can see VMware and Cisco right on top of each other which is ironic because they increasingly overlap in offerings. And you can see the other companies and for context we've added a few more competitors like Veeam and Commvault. And you can see the combination of Dell and VMware is pretty strong.

Perhaps this gives some credibility to the scenario calling for Dell to acquire the remaining VMware shares. So let's start there in unpacking Dell's options.

Assessing Five Options for Dell VMware

Option #1 - Acquire the Outstanding VMware Stock

Stifel analyst Brad Reback was quoted in [MarketWatch](#) as saying the following:

We have long believed Dell would ultimately buy-in the ~19% (~\$12.5B) of VMware that it does not own in order to gain full control over VMware's substantial [free cash flow] of about \$4B annually and still expect this to be the ultimate outcome.

-Stifel analyst Brad Reback

This declaration surprised us. On the one hand you can see from the previous chart this would be a better outcome for Dell from a competitive standpoint. It pulls Dell up and to the right. But perhaps not so much for VMware as it went down and to the left. And Dell would have to raise more cash to do the deal and take on even more debt. Maybe it could get Silver Lake Partners, Dell's long time investment ally, to finance the

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deal. Dell would then become the Oracle of infrastructure. It certainly would make Dell even more strategic to CIOs.

Would this move be good for customers? Well on the one hand we feel it would bring better integration between Dell and VMware. We wonder though if that is the critical issue for customers. Rather we think the VMware ecosystem of partners who for years have integrated through VMware APIs gives customers choice and adequate if not excellent integration already.

Rather we think this approach would stifle VMware's innovation engine which is already squeezed with the way [Dell has used VMware's cash](#). We also wonder what would happen to VMware leadership. Our guess is CEO Pat Gelsinger would call it a day. And what about Sanjay Poonen who is the obvious next in line for the CEO job at VMware? Would he become the President of Dell's software division? And what about the rest of the team at VMware - a Silicon Valley stalwart would slowly morph into Austin-based Dell.

Post "spin in," with the debt burden growing it means more of VMware's cash would go to paying down the debt meaning less money for R&D or even stock buybacks. We're not a huge fan of this scenario and for sure the technology partner ecosystem (who are admittedly Dell's competitors) would be ice cold on such a deal. Although one could argue they already are less than lukewarm.

Bottom line: Positive for core Dell. Negative for competitors and ecosystem partners. Neutral to negative for customers. Positive near term for shareholders...Unclear longer term.

Option #2 - Dell Sells its Stake in VMware

Dell could sell VMware to a strategic company or a private equity firm? It would wipe out Dell's debt and they'd have some cash left over to sail into the sunset on a boat with a bunch of hardware in the cargo hold.

This would be a big pill to swallow for a buyer. Even though Michael Dell has something like 97% voting power we think there's fine print somewhere that says he has a responsibility to protect the interests of the minority shareholders. So to get approval it would have to sell at a premium. Could be as high as \$70B at today's prices.

Microsoft has the cash - but they don't need VMware. Amazon could pull it off but that certainly is not likely even if Google - who also has the cash - were interested in buying VMware. Google would be the most likely candidate. It would give Google Cloud instant access to the coveted enterprise. But hard to conceive as it would unwind the relationship between AWS and VMware which is quite productive at the moment.

For a PE firm, they'd have to come up with \$65 - \$70B and it would take 15-20 years to get their money back through cash flows. If we recall, to finance the EMC acquisition Michael Dell (through MSD Capital, his family office), Silver Lake and some other PE investors only had to put up about \$4B of hard cash to acquire EMC at ~\$67B. That was the PE deal of the century as Silver Lake now owns about 29% of Dell, which includes about 23.5% of VMware.

Bottom Line: Unlikely

Option #3 - Spin out VMware

In such a transaction, Dell shareholders would get VMware stock. There may be some financial wizardry that Tom Sweet, Dell's CFO, and his band of financial geniuses could swing to actually take some cash out of this deal to chip away at the debt. But we're not qualified to speculate on some magic move that they could make to create liquidity in such a transaction.

Nonetheless, this would unlock the value of both Dell and VMware by removing the conglomerate hangover for Dell and it would undoubtedly attract more sideline investors into VMware's stock. Michael Dell personally and Silver Lake would still own a boatload of VMware stock so there's an ongoing incentive

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there. But it would leave Dell untethered from VMware.

So this is interesting and we think remotely possible if there's a way for Dell to create liquidity. It would be good for VMware customers. VMware gets full autonomy and control over its destiny without Dell bogarting its cash. So it could freely innovate. VMware's Technology ecosystem partners AKA Dell's competitors (e.g. HPE, IBM, NetApp, etc.) would like it although they are already well down the path of looking to optimize VMware alternatives (think Cisco).

However, Dell would become less strategic for customers so we don't like that for Dell's installed base.

Bottom Line: Positive for investors. Positive for VMware and VMware customers. Negative for Dell's core customers.

Option #4 - Do Nothing

We think this is as possible as any outcome. Dell can keep chipping away at its debt with its cash flow. It can use VMware as a strategic lynchpin with customers. Sure they continue to pay the [liquidity overhang](#) tax and frustrate some shareholders - but that's been the pattern anyway.

The problem with this scenario is core Dell is currently worth minus ~\$12B which is frustrating for Dell, Silver Lake and Dell shareholders. And it doesn't unlock any near term value.

Bottom Line: Negative for investors. Neutral for Dell, VMware, customers, partners/competitors.

Option #5 - Dell Sells Some of its VMware Stock, Retains Majority Ownership

The more we think about it, the more we like this scenario. What if Dell sold 20% of its VMware stake and raised \$10B in cash that it could use to really eat into its debt burden. A move like this combined with some additional debt pay down from cash flow could cut Dell's core debt close to \$20B by the end of 2021. This would make the balance sheet more attractive and could get the company back to an investment grade credit rating, which would drop hundreds of millions if not a billion dollars to the bottom line. It would allow Dell to continue to control VMware with improved cash flow and earnings.

What we don't know is if there are nuances to this scenario - in other words does dropping ownership from roughly 80% to about 60% trigger some loss of control or some other reporting issue. We've been scanning SEC filings but at the time of this publication we haven't found a definitive answer. Dell declined to comment.

This move doesn't radically alter relationships with customers or partners. VMware maintains its existing autonomy...it somewhat lessens Dell's perceived control over VMware and it attacks Dell's debt burden. Yes its still a bit of a halfway house but a more attractive and stable option for the near term in our view. And it would, we think, unlock more value for shareholders - at least VMware shareholders.

Bottom Line: Positive for Dell, positive for VMware, positive for investors, neutral for customers, neutral for partners/competitors.

Looking Ahead to the Post-Isolation Spending Climate

It looks like the stock market is coming to the reality that we are in a recession although much of the downward pressure in the market at the end of last week was related to the prospects of a Biden presidency.

We will see what the economic shutdown will mean for tech companies this earnings season. ETRs next survey is in the field and they will have fresh data on the impact of COVID going into the dog days of summer.

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For now, here's our current thinking. Tech spending is going to be soft broadly. Our current forecast remains at -4% to -5% for IT spending in 2020 relative to 2019. We think the softness is going to be especially notable for legacy on-prem infrastructure and we expect traditional enterprise businesses to deteriorate in the second half of 2020.

There will be bright spots in tech, particularly the ones we've reported on. Cloud. Automation (e.g. Automation Anywhere and UiPath), and other names we've highlighted like Snowflake, CrowdStrike, Okta and Zscaler will continue to do well in a post-COVID environment. We also expect Microsoft to continue to show staying power although because of their size they are exposed to pockets of soft demand.

For Dell, we think the data center business will continue to be tough despite some new product cycles in storage. But we think Dell will continue to benefit from the remote worker pivot as we believe there was/is still some unmet demand in laptops that will show up in Dell's income statements in the form of client revenue.

What do you think?

Tweet @dvellante or email david.vellante@siliconangle.com. Or comment on our [LinkedIn posts](#). We post weekly on [SiliconANGLE](#) and [Wikibon](#) so check out those properties. And [go to ETR](#) for all the survey action.

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Watch the full video analysis:

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David Vellante is co-CEO of SiliconANGLE Media, as well as co-founder and Chief Analyst at The Wikibon Project, the world's leading open source technology research community. Dave is a long-time tech industry analyst, entrepreneur, writer and speaker. As co-host of theCUBE - "The ESPN of Tech," Vellante has interviewed over 5,000 experts since 2010. He is also a co-founder of CrowdChat, an angel funded startup based in Palo Alto using big data techniques to extract business value from social data. Prior to these exploits, Dave founded a CIO consultancy and spent a decade growing and managing IDC's largest business unit. He lives in Massachusetts with his wife and four children where he is active in town activities including serving as the president of his town's local "Kiddie Sports" association. Dave holds a B.S. in Applied Mathematics from Union College.



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