

# Dell financial statement analysis of profitability ratios



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## **Introduction**

Dell is a transnational corporation that develops, manufactures, sells and supports personal computers and other computer products. It came into success during the 1980s and 1990s and became the largest seller of personal computers and servers. The main difference between Dell and its competitors is that Dell sells its products directly to customers. They do so in order to better understand customers' needs and provide the most effective computing solutions to meet those needs and this makes Dell so unique. Furthermore, Dell uses "configure to order" approach which means that they deliver computers configured to special customer specifications. To minimize cost, just-in-time approach is implemented. Dell maintains a negative cash conversion cycle (CCC) because it uses a direct-sales model via the internet and the telephone network and receives payments for the products before it has to pay for the materials. Other very important aspect is that Dell uses "pull" system by building computers only after customers place orders and by requesting materials from suppliers as needed and so they avoid overproduction.

Dell's major competitors are Apple, Hewlett-Packard, Samsung, Sun Microsystems, Gateway, Lenovo, Sony, Acer, Toshiba and Asus.

Dell stocks are trading on the NASDAQ stock market and Dell belongs to Information Technology Industry (Computer Hardware).

## **Financial statement analysis**

### **Profitability ratios**

Comparing Dell's and industry's operating margin, Dell's is relatively larger. That means that Dell earns more per dollar of sales than industry. Same is with the 5 year average. Net profit margin is higher as well during the 2009 and 5 year average. That means that Dell generates more profit for every dollar it generates in revenue or sales and of course it is a good signal for the investor as well.

Dell has higher gross profit margin comparing to the industry both in recent year and 5 year average. That means that Dell is financially healthy and has a bigger proportion of money left.

Return on assets is higher as well comparing both recent year and 5 year average, indicating that Dell has an efficient management and that company is able to generate more profit with its assets.

To sum up all indicators shows that Dell performs better comparing to the industry, same in the short-time and in the long-time.

### **Financial strength**

Dell's current ratio comparing to the industry ratio is 0.28 less but still company's current ratio is larger than 1 and that means that company can easily meet short-term debt obligations. So Dell is in relatively good short-term financing standing.

Since we could not find the industry's total debt to equity ratio we took Apple Company which is Dell's competitor and belongs to the same industry to  
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compare it to the Dell's ratio. Dell's total debt to equity ratio is 5.2 while Apple's is only 0.95. It's a huge difference and it is obviously seen that company's have different management approach. Talking about Dell this kind of total debt to equity ratio can be a little bit frustrating because company with a higher debt/equity ratio may be riskier, especially in times of rising interest rates due to the additional interest that has to be paid out for the debt. But since now interest rates are at all time low, there is not a big issue, of course we need to have in mind that sooner or later interest rates will be changed and it will affect company's performance if it don't manage its debts or increase shareholders equity.

We couldn't find industry's quick ratio as well, so we used Apple's ratio to compare with. Apples quick ratio is 1.59 which is considerably higher than Dell's 1.05. That means that Dell has less ability to use its near cash or quick assets to immediately extinguish its current liabilities

To sum up Dell in financial strength didn't perform as good as in the profitability. Of course we should take into account that both companies' are following different strategies and overall Dell's figures are not bad but should be improved to attract more investors.

## **Growth rates**

Since we couldn't find industry's earnings per share average we used Apple's EPS as the measure to compare with our company. Dell's EPS is 1.27 while Apple's 0.69. That indicates that Dell's stockholders retains more earnings than Apple's and it's a good signal for the investor.

Dell has a higher positive beta comparing to the industry. That means that stocks generally follows the market and has higher response to the market change. We think that in this time it's generally good, because after credit crunch market will eventually stabilize and return to its previous positions.

Dell pays no dividends because company are buying backing its stocks.

Generally it's a good signal for the investors because it's a signal of confidence. Buy backs also increase demand for stocks driving up prices and by taking shares out of the public's hands, buybacks make earnings-per-share look better, since there are fewer shares among which to divide profits.

To sum up Dell in growth rates performs well and has all attractive ratios for the investor.

Fundamental analysis shows that Dell performs very well in profitability and growth rates. On the other hand it should increase its financial strength.

Overall Dell seems to be good investment. Now we should examine when it's the right time to buy dell's stocks both for the short and long times. We will ground it by technical analysis.

### **DuPont analysis**

ROE had the biggest return in 2006 and decreased sharply in 2007 because of the financial crisis. The average ROE during the 5 year period is 0.66 and Dell probably will seek to increase its REO to attract more investors.

## **Technical analysis**

To analyze Dell as the investment opportunity it's not enough just to rely on the fundamental analysis, so we decided to do some technical analysis to determine is it the right time to buy stocks of the company.

Graph below shows the trend of the Dell's stocks:

Source: Nasdaq

As you see now it is not the right time to buy Dell's stocks. Price of the stocks break through the lower support line and decreased. We don't think that it's due to company's financial stability or other major factors related to the company. For short-term investment we could recommend to wait until trend will reverse. Furthermore Dell predicts higher demand for the next year due to stabilization of the world economy, and that of course will increase shareholders equity.

We think that if the world economy will stabilize and we already have indicators showing that and there will be no W shape recession Dell stock as the long-term investment is considered as good investment.

## **Individual case analysis**

### **Capital Structure**

There are some possible ways how to use Debt and Equity data to get an informative info about capital structure, so to be more informative will show three charts in which there several possible ways to check how capital structure are placed.

As is seen from chart Debt / Equity, debt is higher than equity and this leads to: company is aggressive in financing growth with debt. This growth expansion by issuing debt may effect on future profitability - high interest expense. Debt / Equity ratio is falling down in 2009 it is good information, cause in 2008 economical turndown, debt has in proportion to equity decreased which means in more difficult times Dell have reduced risk of default.

Interesting information could be taken from Debt / Market Capitalization proportion changes. As can be seen from graphs that comparing market value of a company and equity value from balance sheet, market valued company many times more than it actually is in balance sheet. This could be a signal to be more careful on investing in Dell, because it seems that Dell market price is overvalued. And in 2009 market capitalization of a company has been less then debt is - it is very bad signal, but on the other hand market capitalization is going by the trend to get closer to equity value.

Dell currently have long term debt by issuing bonds in the bond market, all of which are rated in A, it is in category of investment level. Longest bond maturity date is 2038-04-15. Coupon differs from 3.38% till 7.1% correlates to maturity date.

Weighted Average Cost of Capital for Dell is extremely high - 38%, the biggest impact of high WACC value is made by very high cost of equity which is based on calculation of ROE.  $ROE = 65\%$ . High WACC shows high risk probability, increases risk of insolvency. From WACC point of view there must be issuing new debts to repurchase equity, cause by now equity requires big

interests expenses. In today situation there is other sources for lower prices of debts than equity holders supplying.

## **Payout policy**

### **One-way oriented payout policy**

Payouts are often called dividends. But not only dividends could be a form of companies payout, companies can repurchase its shares, and it will be called payout. As data showed Dells board of directors made a decision not to pay dividends. Company is only repurchasing its shares. It could be a signal for investors that shares are undervalued.

### **Retained earnings and payout.**

From 2005 to 2009 Dell's retained earnings more than doubled, from 9174 millions to 20677millions. but payout sum haven't changed, and for all these 5years it was above 3000millions only in 2005 it skyrocketed to 6000millions. (See Dell balance sheet)

### **Shares repurchases**

As one of the Dell corporation officers argues, Dell uses only shares repurchase as payout because of business climate. Company is located in climate which requires permanent growth. So Dell needs to invest in order to be competitive in laptops market. Shares repurchases also has same advantages over a dividends.

Firstly repurchase of shares helps to reduce opportunity of dilution, or even eliminate it.



Secondly it is easier for Dell to balance return for shareholders with other business objectives.

And finally it gives more flexibility for shareholders to make a decision then they want to withdraw their investment.

Also where some disadvantages of shares repurchases as:

There could be some agency conflicts inside the company, if managers have same inside information which is unknown for other share holders they could repurchase shares for less value than intrinsic value of the shares.

Shares repurchases can negatively affect liquidity of firm's stock, because the will be decrease in shares outstanding.

Shares repurchases can also be a result of penalties, because government or other responsible organizations can view shares repurchases as way to help shareholders to avoid taxes.

It can also be a negative signal of firms future growth.

## **Key competitors payout policies**

### **IBM**

IBM is one of two key competitors for Dell. It's payout policy differs from Dell, IBM pays dividends for shareholders and also repurchases shares. One of the main reasons why IBM pays dividends could be its revenues which are almost twice as big as Dells. (see table1a, table1b)

## HPQ

HPQ second of Dells key competitor. HPQ also as IBM pays dividends to its shareholders, but amount paid in dividends is two times smaller than IBM. So companies' payout policy is the middle compared with IBM and Dell payout policies. (See table2)

Dell Company has long term debt. Long term debt is at the moment much bigger than in recent years. In 2009 April, Dell sold 500 million notes, later in June they sold 1 billion worth of bonds. This explains why Dell long term debt is much bigger than in recent years . In comparison Apple had no long term debt in recent years. Apple company has a lot of cash so they do not need to release new bonds and increase long term debt. Dell is an American company which as many other companies hold their part of cash outside the US. Dell chose to access capital markets in order to supplement liquidity ratio in the United States. By accessing the capital markets Dell needs to raise its long term debt. Dell also believes that its share repurchasing is good for the company, that increases operating leverage and this keeps shareholders happy to, so they spend a big part of long term debt for share repurchasing. As we see from the graph in period from 2005-2008 long term debt was not changing dramatically. In 2008 long term debt was smaller than in last 3 years. One of the main reasons why it was lower is, that Dell was suffering from interest expenses, so they decided to repay their loans and buy back some of bonds in order to decrease interest payments.

Company released coupon bonds as well. There are 7 types of bonds, all of them have A - rating, and that means that these bonds are high quality.

Bonds differ by coupon worth, price and maturity. Dell . GH has the longest  
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maturity (until 2038). All bonds are callable, and that means that the issuer can redeem the bond before the maturity. These bonds most time have higher coupon rate.

## **Short term financing**

Net working capital during 2005 – 2008 didn't change a lot, with the average NWC of 1971 million dollars, but in 2009 NWC increased dramatically nearly four-fold comparing to net working capital of 2008. To understand why Dell had such a huge increase in net working capital we need deeper investigation of its Balance Sheet.

During 2007 – 2009 Total Current Assets increased only by 212 million dollars, so it's not the driving factor which led to such huge increase in Net Working Capital, but on the Current Liabilities side a situation is different.

Accounts payable decreased by 3183 millions dollars to 8309 millions by 2009 and it was the main factor which led to decreased current liabilities and furthermore an increase in Net Working Capital. Other factors like accrued expenses, notes payable, and other current liabilities decreased as well, but they played only a minor role due to a small amount of decrease.

Looking at Net Working Capital, we could strongly say that Dell NWC increased due to decrease in accounts payable, which is a good signal to the investors.

Dell maintains a negative cash conversion cycle(CCC) because it uses a direct-sales model via the internet and the telephone network and receives payments for the products before it has to pay for the materials.

Looking at the last two years Dell improved its accounts payable and decreased to 60 days. Accounts receivable has improved as well to 28 days. Due to its improvements CCC has decreased.

If we exclude years 2007 and 2008 as the abnormal receivables and payables due to the financial crisis, average accounts receivable will be 27 days, and accounts payable - 73 days. From these calculations we can strongly say that Dell improved and that company will try to keep these figures stable, or improve even more.

Industries receivable turnover is 6. 17 (source: <http://www.reuters.com/finance/stocks/financialHighlights?symbol=DELL.O>) while Dell's 9. 48 in 2009. This implies that Dell's collection of accounts receivable is more efficient comparing to the industry average.

Industries inventory turnover is 10. 26

(source: <http://www.reuters.com/finance/stocks/financialHighlights?symbol=DELL.O>) while Dell's 57. 84 in 2009. Comparing to the industry level, Dell's inventory turnover is five-fold bigger. That may mean that company is not keeping enough inventories to meet demand. This could equate to loss of sales. But because Dell proceeds its orders only after customers place orders and by requesting materials from suppliers as needed they avoid overproduction, so high measure of inventory turnover doesn't mean that Dell is in trouble unless other companies which supply Dell with materials will struggle to meet Dell's demand But that is another case.

To sum it up, I think that Dell manages its working capital well, and performs in most of the cases better than the industry average. Furthermore Dell uses “configure to order” approach which really helped them during the crisis to avoid overproduction. Dell Net Working Capital increased dramatically and Cash Conversion Cycle decreased almost by the half. All these figures are good signals for the investors.

### **Following the company as financial analyst**

Since 2005 Dell's prices slightly started to fall. Even though there were periods when it lifted, the whole trend was shifting down until it plummeted during end of 2008 and the beginning of 2009. From this period company slowly recovered. However at the end of November prices dropped again. In this article stock values during September-November 2009 and major factors affecting it are described. There are also comparison of Dell with other companies, future prospects and solutions for investors included. Using a weekly review of prices following findings were made.

Graph above was made by using weekly prices (in dollars)

At the beginning of September stock prices started to rise quite significantly till it reached 16.6 in day 8. Then the growth became smaller and from 16.69 in day 14 it dropped to 15.04 at the end of the month. October hadn't been too promising either. At the beginning there was a rise to 15.81 then followed by slight fluctuation stock value dropped from 15.48 in day 19 to 14.45 seven days later. November seemed to be inspiring at first when the trend started rising, but then it dropped from 15.4 at day 9 to 14.29 at day 16. Towards the end of the month trend was pretty much stable, however

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still slightly decreasing and reached the point of 14.12 at November 30. The graphic shows some fluctuations during these three months. However after each major rise in stock price there is a lot bigger fall which determines the decreasing trend in the whole period. Stock value due to given time span lessened by 1.57. By looking from a bigger scope (the whole 2009 year) stock prices were reaching a peak during these three months which was at September 14th. However an eight month climb in stock prices slackened and continues to head down.

There are few main events affecting the trend of stock prices shown in the graph. One of them is acquisition of Perot Systems the other is Dell's lost position in worldwide sales from 2nd place to 3rd and the last one is sharp drop in PC sales.

The agreement of Perot Systems acquisition on September 21 shows Dell's willingness to expand in business and get some market share from IT services was a good sign to investors. It was a move made against Hewlett-Packard (HP) which also used this kind of expanding strategy by acquiring another service company, Electronic Data Systems Corp. This reflects that hardware industry is not as profitable as services. However Dell expects to gain earnings from this deal only at fiscal year 2012. This event hadn't boosted the price of shares significantly but at least helped keeping it from dropping even more. Dell gave its position in worldwide sales and production of PC's to Acer and it made the company lose some of its market share. This was due to strategy not to lower the prices too much even though its market share can suffer. That's how company wanted to increase profitability. It's worth mentioning that Dell had increased sales internationally. In China, <https://assignbuster.com/dell-financial-statement-analysis-of-profitability-ratios/>

India, Brazil and Russia it was up 18 percent. China is Dell's second-largest country in terms of revenue, sales there increased 20 percent. However this did not help much in keeping companies position in worldwide sales. At the end of November a big decline in PC sales appeared. This made Dell's stock prices plummet.

Dell has been hit by economic crisis just like other brands in computer industry. The only difference is that this particular brand has problems getting back its wellbeing even at the recovering of the IT sector. Companies like Hewlett-Packard, Apple, Acer and some others start to feel the improvement of market conditions and during November had bigger than expected profits. This was influenced by boosting their presence in retail stores and also by the popularity of so called "netbook" computers that mostly supplemented Acer's wallet. The reason why Dell recovers so slowly is its target market. Company focused on corporations and large government agencies that had tightened their spending even at economic recovery and the demand for PC's isn't as robust as hoped. Since these customers made up to 80% of Dell's revenue, loss in earnings was substantial. This benefitted Dell's rivals and shaped the market by making HP top seller of PC's worldwide. Acer advanced to the second place and pushed Dell to third. Now Michael Dell CEO of company is starting to put some effort to expand Dell's presence in consumer PCs sold in stores to improve its condition. When comparing Dell with its competitors big difference in their stock price can be seen. For example when looking at share price of HP during September-November there had been an increasing trend that rose by 3.96 at the end of period when looking at weakly closing prices. Apple had also boosted

stock value that lifted from 170.31 to 199.91 during these three months. There are more examples of increasing value of companies in IT sector unfortunately Dell is not joining them.

In future Dell market position should start recovering. Firstly the acquisition of Perot Systems should lead to an expansion not only in hardware but also in IT service niches. Also company announces to increase its earnings in short future, but mainly they are hoping to boost sales in holidays which might lead just to a seasonal uplift. Company started to change the ways of making and selling PC's by focusing on contracting the retailers and manufacturers instead of doing everything themselves. Expanding acquisitions is also the goal towards reaching more profitable markets. The release of a new operating system Windows 7 according to Dell CEO Michael Dell will hopefully also increase the sales due to positive views towards it. There seems to be many changes and factors that could help Dell to recover its wealth again.

According to the trend of historical stock prices, taking into account the position of Dell's competitors and considering changes that have been and will be made in the future the following solutions for the investors have been made:

The stocks should not be acquired by investors that seek to gain earnings in short term and who want to invest lets say for 6-8 months and then sell their basket (a proposition also made by Jayson Noland, a senior analyst at investment firm Robert W. Baird), because there is a possibility for them to lose earnings due to down sloping trend in share price. However there can

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be boost in sales of PC's during holidays that can increase earnings, but this would only be a seasonal uplift.

Long term investors can benefit from buying Dell's shares. The price is relatively cheap comparing to other hardware producers and sooner or later the company is going to recover and bringing profit to shareholders. The only question is how long will it take for it to recover completely.

Existing investors that already bought Dell's shares should not panic, keep the stocks to themselves and wait for Dell's recovering. By selling shares now most of them will definitely lose money and the opportunity to retrieve their accumulated earnings.

There is another possibility. Investors could focus on companies in PC industry that are more successful and stable than Dell. For example HP. The price of shares is bigger, but so is the opportunity to gain wealth.

In conclusion Dell's financial situation comparing to other companies in IT and hardware industry does not look very good. High expectations didn't come true, but there is still a possibility to recover. By expanding to other fields and restructuring operations Dell will be able to stand on its feet however this might take several years to happen.