

VMware Inc. (VMW)

Attractive

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Dell Reverse Merger Would Be a Nightmare for VMware Shareholders; Thoughts on Brewing Dell/VMW Situation

With media reports (CNBC) swirling that Michael Dell and its Board are continuing to head down the rocky road of constructing a reverse merger with VMware, the Street continues to have growing frustration and angst around this deal which we believe would be a “head scratching strategic move”. Taking a step back, when Dell went private five years and again when they purchased EMC in a controversial 2016 acquisition, tech investors have continued to be perplexed at some of these Michael Dell led major strategic deals which have left shareholders on the wrong side of these “value creating events”. That said, in our opinion Michael Dell & Co. have done a commendable job of transforming Dell, a long time PC driven consumer based company with clear headwinds, into an enterprise behemoth through the combination of the EMC/VMware acquisition and a host of organic initiatives around storage, cloud, and networking over the past few years and thus changed the company’s growth path. Ultimately, the going private transaction that Dell led in 2013 put the company in a position of strength to consummate the EMC acquisition and take on roughly \$50 billion of debt to fund this game changing deal. Since consummating the EMC deal in 2016 and its 82% ownership of VMware, the biggest success story has been VMware, which has seen a renaissance of growth through its software defined strategy and vSAN and NSX product footprint that has translated into robust FCF generation, improved execution, and double-digit top-line and bookings growth with strong 4Q results last week, another data point supporting this cloud growth story for 2018 and beyond. However, the potential Dell reverse merger being discussed would be a major gut punch and value destructor to the VMware growth story and bull thesis that we believe could potentially cut the multiple by 25%-30% if this deal gets the green light. **While we maintain our Attractive rating and \$135 price target on VMware** based on its standalone fundamental value, in a Dell reverse merger deal scenario we would

see significant downside risk to shares and revisit our rating as this deal would be a tough pill to swallow for shareholders and be a major overhang on the name for years to come.

Overview of Potential Dell/VMware Reverse Merger

With Dell and its board exploring strategic options which appears to have a stock-for-stock reverse merger with Dell at the top of the list on the near-term horizon, its time to take a step back as to how we got here and analyzing the next possible steps. As part of the Dell/EMC acquisition in 2016, Dell gained ownership of 82% of VMware, but essentially left the company untouched fundamentally and from a leadership position to continue its strategic build-out of its dominant position on the cloud/server virtualization space. At the time of the acquisition, Dell issued a tracking stock (DVMT), which tracks VMware's fundamental performance and Dell's ownership stake, which currently trades at a steep discount to VMware's shares (35%+ discount). To fund this massive \$67 billion EMC acquisition, Dell originally took on \$48.8 billion of debt and has since paid this debt load down to roughly \$40 billion through FCF generation and divestiture proceeds on the services/software front. However, with the recently implemented tax changes and interest shield/deductibility impact, Dell now faces additional taxes of between \$300 million to \$400 million in 2018 and ~\$200 million of additional taxes on a go-forward basis which has catalyzed Dell to revisit its current capital structure and look for strategic alternatives to alter its current debt laden trajectory.

Access to the VMware cash flow generating machine. With VMware's \$8 billion of cash in the coffer and annual FCF generation north of \$3 billion, Dell through a reverse merger would have access to this cash flow generating machine and thus enable them to pay down debt and restructure the company's capital

structure, while consolidating the whole Dell/EMC/VMware franchise into one mammoth entity. However, this would all come at the expense of VMware shareholders which would go from owning a pure play cloud, virtualization story growing double digits with \$3 billion+ of annual FCF to owning a complex enterprise/consumer albatross with a myriad of products and businesses in mature, cash cow areas while taking on \$40 billion+ of debt on the balance sheet. We continue to believe an IPO of Dell standalone back in the public markets and/or sale of the Pivotal assets (we estimate valuation is between \$6 billion to \$8.5 billion) is the smartest move for Michael Dell & Co. to make at this juncture at least as an interim step to restructure the portfolio of assets and help Dell pay further down its current debt load. We also believe a buy-in of the rest of VMware (18%) is still an option on the table as this would ultimately give Dell access to VMware's business and cash board/cash flow capabilities, however this option would roughly cost Dell another ~\$15 billion to acquire this piece at a premium in our estimation, so it's a less likely scenario but still possible.

Summary thoughts; a reverse merger would be a “major strategic misstep”.

Fundamentally speaking, VMware shares have significant upside if a Dell reverse merger deal does not get green lighted and ultimately approved by shareholders (which also remains a roadblock on this deal). We believe on a pure play valuation basis, given its FCF and EPS power and current growth trajectory in 2018/2019, VMware shares are worth in the \$140-\$150 range in a bull case scenario and \$135 in a base case. However, if Michael Dell and Silver Lake decide to go down the reverse merger path, the game plan for tech investors in our opinion would be to own the tracker stock (DVMT) which would see the spread narrow significantly and unfortunately would make the VMware asset untouchable to own in the near-term unless the valuation was in the \$90-\$100 range. Now all eyes are on Michael Dell and the Board to see the next strategic steps in this game of high stakes poker

and try to read the tea leaves coming out of the company (and VMware) over the coming weeks as this is a “fork in the road” situation for Dell, VMware, and all the stakeholders involved to see which move Dell & Co. makes next in this saga.