

CASE 32

Dell Inc.:

CHANGING THE BUSINESS MODEL (MINI CASE)

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DELL INC. was founded in 1984 by Michael Dell at age 19 while he was a student living in a dormitory at the University of Texas. As a college freshman, he bought personal computers (PCs) from the excess inventory of local retailers, added features such as more memory and disk drives, and sold them out of the trunk of his car. He withdrew US\$1000 in personal savings, used his car as collateral for a bank loan, hired a few friends, and placed ads in the local newspaper offering computers at 10%–15% below retail price. Soon he was selling US\$50,000 worth of PCs a month to local businesses. Sales during the first year reached US\$600,000 and doubled almost every year thereafter. After his freshman year, Dell left school to run the business full time.

Michael Dell began assembling his own computers in 1985 and marketed them through ads in computer trade publications. Two years later, his company witnessed tremendous change: It launched its first catalog, initiated a field sales force to reach large corporate accounts, went public, changed its name from PCs Limited to Dell Computer Corporation, and established its first international subsidiary in Britain. Michael Dell was selected “Entrepreneur of the Year” by *Inc.* in 1989, “Man of the Year” by *PC Magazine* in 1992, and “CEO of the Year” by *Financial World* in 1993. In 1992, the company was included for the first time among the *Fortune 500* roster of the world’s largest companies.

By 1995, with sales of nearly US\$3.5 billion, the company was the world’s leading direct marketer of personal computers and one of the top five PC vendors in the world. In 1996, Dell supplemented its direct mail and telephone sales by offering its PCs via the Internet at dell.com. By 2001, Dell ranked first in global market share and number one in the United States for shipments of standard Intel architecture servers. The company changed its name to Dell Inc. in 2003 as a way of reflecting the evolution of the company into a diverse supplier

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of technology products and services. In 2005, Dell topped *Fortune*'s list of "Most Admired Companies." Fiscal year 2005 (Dell's fiscal year ended in early February or late January of the same calendar year) was an outstanding year in which the company earned US\$3.6 billion in net income on US\$55.8 billion in net revenue.

Soon, however, increasing competition and cost pressures began to erode Dell's margins. Even though the company's net revenue continued to increase to US\$57.4 billion in fiscal year 2007 and US\$61.1 billion during fiscal year 2008, its net income dropped to US\$2.6 billion in 2007, with a slight increase to US\$2.9 billion in 2008. The "great recession" of 2008–2009 took its toll on both Dell and the computer industry. Dell's fiscal 2010 (ending January 29, 2010) net income fell further to US\$1.4 billion on US\$52.9 billion in net revenue. Sales improved during calendar year 2010 as the global economy showed signs of recovery. Net revenue for February through July 2010 increased to US\$30.4 billion compared to only US\$25.1 billion during the first half of 2009, while first half net income rose to US\$886 million in 2010 compared to US\$762 million during the same period in 2009. Nevertheless, Dell's net income was only 2.91% of net revenue during the first half of 2010, compared to a much rosier 6.45% during 2006. (Note: Dell's financial reports are available via the company's website at www.dell.com.)

Problems of Early Growth

The company's early rapid growth resulted in disorganization. Sales jumped from US\$546 million in fiscal 1991 to US\$3.4 billion in 1995. Growth had been pursued to the exclusion of all else, but no one seemed to know how the numbers really added up. When Michael Dell saw that the wheels were beginning to fly off his nine-year-old entrepreneurial venture, he sought older, outside management help. He temporarily slowed the corporation's growth strategy while he worked to assemble and integrate a team of experienced executives from companies like Motorola, Hewlett-Packard, and Apple.

The new executive team worked to get Dell's house in order so that the company could continue its phenomenal sales growth. Management decided in 1995 to abandon distribution of Dell's products through U.S. retail stores and return solely to direct distribution. This enabled the company to refocus Dell's efforts in areas that matched its philosophy of high emphasis on customer support and service. In July 2004, Kevin Rollins replaced Michael Dell as Chief Executive Officer, allowing the founder to focus on being Chairman of the Board. This situation did not last long, however. Rising sales coupled with rapidly falling net income caused Michael Dell to rethink his retirement and resume his role as CEO in January 2007. Although Michael Dell in 2010 owned only 11.7% of the corporation's stock, at age 45 he owned the largest block of stock and continued to be the "heart and soul" of the firm. The rest of the directors and executive officers owned less than 1% of the stock.

Business Model

Dell's original business model was very simple: Dell machines were made to order and delivered directly to the customer. The company had no distributors or retail stores. Dell PCs had consistently been listed among the best PCs on the market by *PCWorld* and *PC Magazine*. Cash flow was never a problem because Dell was paid by customers long before Dell paid its suppliers. The company held virtually no parts inventory. As a result, Dell made computers more quickly and cheaply than any other company.

Dell became the master of process engineering and supply chain management. It spent less on R&D than did Apple or Hewlett-Packard, but focused its spending on improving its manufacturing process. (Dell spent 1% of sales on R&D versus the 5% typically invested by

other large computer firms.) Instead of spending its money on new computer technology, Dell waited until a new technology became a standard. Michael Dell explained that soon after a technology product arrived on the market, it was a high-priced, high-margin item made differently by each company. Over time, the technology standardized—the way PCs standardized around Intel microprocessors and Microsoft operating systems. At a certain point between the development of the standard and its becoming a commodity, that technology became ripe for Dell. When the leaders were earning 40% or 50% profit margins, they were vulnerable to Dell making a profit on far smaller margins. Dell drove down costs further by perfecting its manufacturing processes and using its buying power to obtain cheaper parts. Its reduction of overhead expenses to only 9.6% of revenue meant that Dell earned nearly US\$1 million in revenue per employee—three times the revenue per employee at IBM and almost twice HP's rate.

Although the company outsourced some operations, such as component production and express shipping, it had its own assembly lines in the United States, Malaysia, China, Brazil, India, and Poland. A North Carolina plant had been opened in 2005 as Dell's third American desktop plant. Cost pressures had, however, caused management to rethink its manufacturing strategy. They closed the company's desktop plants in Texas and Tennessee in 2008 and 2009, respectively, and were planning to close the firm's last desktop assembly plant in North Carolina in January 2011. From then on, desktop assembly for the North American market would take place in Dell's factories in other countries and by contract manufacturers in Asia and Mexico. In Europe, the company closed its Ireland plant and sold its plant in Poland to Foxconn Technology, a unit of Hon Hai, the world's largest contract manufacturer. They then contracted with Foxconn for manufacturing services. In contrast to its global desktop manufacturing strategy, 95% of Dell's notebook computers were assembled in Dell's plants in Malaysia and China.

After its failed experiment with distribution through U.S. retail stores in the 1990s, management again changed its mind regarding its reliance on direct marketing. Over time, Dell's competitors had imitated Dell's direct marketing model, but were also successfully selling through retail outlets. A presence in retail was becoming especially important in countries outside North America. Sales in these countries were often based on the advice of sales staff, putting Dell's "direct only" business model at a disadvantage. In response, Dell began shipping its products in 2007 to major U.S. and Canadian retailers, such as Wal-Mart, Sam's Club, Staples, and Best Buy. This was soon followed by sales elsewhere in the world through DSGI, GOME, and Carrefour, among others, to number over 56,000 outlets worldwide.

Product Line and Structure

Over the years, Dell Inc. has broadened its product line to include not only desktop and laptop (listed under mobility) computers, but also servers, storage systems, printers, software, peripherals, and services, such as infrastructure services. By 2010, net revenue by product line was composed of desktop PCs (25%), mobility (31%), software and peripherals (18%), servers and networking (11%), services (11%), and storage (4%). Desktop PCs' net revenue dropped from 38% in 2006, with each of the other product lines (especially mobility) increasing as a percentage of total revenue. Although the 2010 gross margin for all Dell products was only 14.1% of sales, due to a lower average selling price, the gross margin for services, including software, was a much fatter 33.7%.

Dell's corporate headquarters was located in Round Rock, Texas, near Austin. In 2009, the company was reorganized from a geographic structure into four global business units based on customers: *Large Enterprise*, *Public*, *Small & Medium Business*, and *Consumer*. Its 2010 revenue by segment was 27% from Large Enterprise, 27% from Public, 23% from Small & Medium Business, and 23% from the Consumer unit. Interestingly, operating income as a percentage of total revenue totaled 9% for both Public and Small & Medium Business units,

6% from Large Enterprise, and only 1% from the Consumer unit. Commercial customers accounted for 77% of total revenue. Dell was dependent upon the U.S. market for 53% of its total 2010 revenues.

The Industry Matures

By 2006, the once torrid growth in PC sales had slowed to about 5% a year. Sales fell significantly during the “great recession” of 2008–09 as companies and consumers deferred computer purchases. With the economy improving, the output of U.S. computer manufacturers was forecast to grow at an annual compounded rate of 7% between 2010 and 2015. Nevertheless, margins were getting progressively smaller for the desktop PC, Dell’s flagship product. Competitors were becoming increasingly competitive in both desktop and mobile computers.

Gateway, for example, found ways to reduce its costs and fight its way back to profitability. The same was true for Hewlett-Packard (HP) once it had digested its acquisition of Compaq. Asian manufacturers, such as Acer, Toshiba, and Lenovo, with strengths in laptops were becoming major global competitors. Ironically, by driving down supplier costs, Dell also reduced its rivals’ costs. In addition, the sales growth in the computer industry was in the consumer market and in emerging countries rather than in the corporate market and developed countries in which Dell sold most of its products. Between 2006 and 2010, HP replaced Dell as the company with the largest global market share in personal computers. Using price reductions, Dell was now battling with Acer for second place in global PC market share.

As the personal computer became more like a commodity, consumers were no longer interested in paying top dollar for a computer unless it was “unique.” Wal-Mart and Best Buy were selling basic laptop computers for less than US\$300 in 2010 and intended to maintain this pricing so long as manufacturers continued to supply low-cost products. PC notebook sales had been falling during 2010, primarily due to the introduction of Apple’s highly featured iPad and the consequent rise in “tablet” PC sales. According to Morgan Stanley, Apple’s iPad cannibalized about 25% of PC notebook sales since its introduction in April through August, 2010. Dell countered the iPad with a tablet computer called Streak in May 2010, but failed to generate much enthusiasm or sales for this product.

As corporate buyers increasingly purchased their computer equipment as part of a package of services to address specific problems, service-oriented rivals like IBM, HP, and Oracle had an advantage over Dell. All of these competitors had made large commitments to servers, software, and consulting—all having higher margins than personal computers. IBM had sold its laptop, hard drive, and printer businesses to focus on building its services business. Hewlett-Packard acquired Electronic Data Systems in 2008 to boost its expertise in services. By offering customers a package of servers, software, and storage, HP dominated the server business with 32% market share, with IBM closely following with a 28% share of the market. Oracle’s acquisition of Sun Microsystems gave it 8% of the server market. IBM and Oracle offered proprietary server platforms in enterprise accounts. In contrast, Dell (along with HP) offered x86 open-system servers. In order to better compete in the large enterprise market segment, Dell purchased Perot Systems, an IT services company, in 2009. Even after this acquisition, however, services accounted for only 13% of Dell’s sales. In 2010, Dell attempted to acquire 2PAR, a data storage firm, but was outbid by HP.

Issues and Strategy

Since 2007, when Michael Dell resumed being the company’s CEO, Dell has made more than 10 acquisitions, cut about 10,000 jobs, and hired executives from Motorola and Nike to add more excitement to its product line. Its US\$3.6 billion purchase of Perot Systems allowed it to

expand into higher-margin computing services. Nevertheless, Dell's stock fell 42% following January 2007, during a period when Hewlett-Packard's stock gained 11% and IBM gained 31%.

The industry's focus shifted from desktop PCs to mobile computing, software, and technology services—areas of relative weakness at Dell. Due to a changing industry, the company's original business model based on direct sales and value chain efficiencies had been abandoned. It was now using the same distribution channels, component providers, and assembly contractors as its competitors. Unfortunately, Dell's emphasis on cost reduction and competitive pricing meant that it was no longer perceived as providing high-quality personal computers or the quality service to go with them. Previously a strength of the company, its customer service rating in 2005 fell to a score of 74 (average for the industry) in a survey by the University of Michigan. Complaints about Dell's service more than doubled in 2005 to 1,533. Although the company successfully worked to improve customer satisfaction by adding more service people, more people meant increased costs and smaller margins.

In order to improve the company's competitive position, Dell's management initiated a three-pronged strategy:

- *Improve the core business* by profitably growing the desktop and mobile computer business and enhancing the online experience for customers. This involved cost-savings initiatives and simplifying product offerings.
- *Shift the portfolio to higher-margin and recurring revenue offerings* by expanding the customer solutions business in servers, storage, services, and software. This involved growing organically as well as through acquisitions.
- *Balance liquidity, profitability, and growth* by maintaining a strong balance sheet with sufficient liquidity to respond to the changing industry. This provided the capability to develop and acquire more capabilities in enterprise products and solutions.

Future Prospects

A number of industry analysts felt that Dell was not well positioned either for a future of low-priced, commodity-like personal computers or one of highly featured innovative digital products like the iPad and iPod. To continue as a major player in the industry, they argued that Dell needed an acquisition similar to HP's US\$13.2 billion purchase of EDS in order to compete in business information services. Overall, analysts were ambivalent about the firm's prospects in a changing industry. Should Dell continue with its current strategy of following the consumer market down in price and adjusting its costs accordingly or, like IBM, should it change its focus to more profitable business services, or, like HP, should it try to do both?