Microsoft Corporation (MSFT)

Updated May 11th, 2018 by Jonathan Weber

Key Metrics

Current Price:	$97	**5 Year CAGR Estimate:**	8.7%	**Quality Percentile:**	N/A
Fair Value Price:	$74	**5 Year Growth Estimate:**	12.1%	**Momentum Percentile:**	N/A
% Fair Value:	130%	**5 Year Valuation Multiple Estimate:**	-5.1%	**Total Return Percentile:**	N/A
Dividend Yield:	1.7%	**5 Year Price Target**	$132	**Valuation Percentile:**	

Overview & Current Events

Microsoft develops, manufactures and sells both software and hardware to businesses and consumers. Its offerings include operating systems, business software, software development tools, video games and gaming hardware, and cloud services. Microsoft was founded in 1975, is headquartered in Redmond, WA and is currently trading at a market capitalization of $752 billion.

Microsoft's most recent quarterly results were announced on April 26. The company's Q3 results included EPS of $0.95 (up 36% year over year) and revenues of $26.8 billion, up 16% year over year. Another highlight from Microsoft's most recent earnings call include operating cash flows of $12.2 billion and cash holdings of $132 billion.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.87	$1.62	$2.10	$2.69	$2.72	$2.65	$2.63	$2.65	$2.79	$3.08	***$3.82***	***$6.75***
DPS	$0.44	$0.52	$0.52	$0.64	$0.80	$0.89	$1.12	$1.24	$1.44	$1.56	***$1.68***	***$2.98***

After years of solid growth Microsoft was having a hard time growing its profits further during the 2011-2015 time frame, but after some change-up in its management and a strategic shift (towards cloud computing and mobile) Microsoft's growth was reinvigorated. Growth rates for revenues and especially for profits are at a very high level, thanks to several factors which are discussed below.

Microsoft's cloud business is growing at a mid-teen range thanks to Azure, which combines IaaS, PaaS & SaaS offerings and which has been growing at a 90%+ rate for ten quarters in a row. Microsoft's Office product range, which has been a low-growth cash cow for many years, is showing strong growth rates as well after Microsoft has changed its business model towards the Office 365 system (commercial Office revenues grew by 40% during the last quarter). Microsoft is also a key player in the gaming industry (with hardware as well as software offerings) and benefits from strong market growth in that industry.

Microsoft's EPS are growing at a significantly faster pace than revenues due to three key elements: Rising margins, as software offerings come with high fixed but low variable costs, lower taxes (tax reform impact) and last but not least a shrinking share count. Due to its strong cash generation Microsoft can repurchase shares steadily (buybacks during the most recent quarter alone totaled $3.8 billion), which means that each remaining share's portion of Microsoft's net earnings rises.

The markets Microsoft addresses continue to grow (with cloud computing being the most compelling market Microsoft addresses), which means that even without any market share gains Microsoft would be able to grow its top line. With the factors that grow earnings even further in place Microsoft's growth outlook over the coming years looks quite compelling, although the company will not be able to maintain a 30%+ EPS growth rate.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	16.3	13.4	13.1	9.6	10.4	11.2	14.0	17.0	18.1	20.2	***25.4***	***19.5***
Avg. Yld.	1.4%	2.4%	1.9%	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	***1.7%***	***2.3%***

Microsoft's P/E ratio averaged 15.2 over the last decade. Shares are significantly more expensive right now. This is not surprising, though. Microsoft's growth outlook is a lot better than it was over during the last decade (as Microsoft was highly profitable but wasn't able to generate growth several years in a row). On top of that the market as a whole got more expensive. Multiple expansion for Microsoft is thus not a surprise. Going forward Microsoft will likely not see its valuation drop back to the mid-teens, as its strong position in growth markets such as cloud computing will allow for higher valuations going forward.

Microsoft has been a solid income investment a couple of years ago when its shares yielded up to three percent, right now the income generation potential is relatively small, as Microsoft has turned from a value to a growth investment.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	67.0%	59.4%	58.2%	50.0%	46.3%	40.4%	34.7%	34.6%	27.2%	23.1%	***25.0%***	***29.0%***
Debt/A	50.1%	49.2%	46.3%	47.4%	45.3%	44.6%	47.9%	54.1%	62.7%	70.1%	***65.0%***	***60.0%***
Int. Cov.	225.7	-	166.6	96.2	59.6	64.1	47.6	25.7	16.9	11.4	***12.0***	***15.0***
Payout	23.5%	32.1%	24.8%	23.8%	29.4%	33.6%	42.6%	46.8%	51.6%	50.6%	***44.0%***	***44.1%***
Std. Dev.	26.2%	29.0%	23.4%	19.1%	20.0%	20.7%	13.7%	28.2%	18.4%	10.6%	***15.0%***	***18.0%***

In the above table there are two clear trends. Gross profits to assets have been declining from an extremely high level to a still very solid level, and the debt to assets ratio has risen significantly as well. Both trends are not a reason to worry, but can be explained by Microsoft's cash-rich balance sheet. As cash has been building up its asset base has widened dramatically, which is the reason for the declining gross profits to assets ratio. Since offshore cash has not been accessible for Microsoft in the past, the company has raised debt to finance acquisitions, buybacks & dividends, which is the explanation for the rising debt to assets ratio.

Since Microsoft holds more than $130 billion in cash on its balance sheet its net cash (cash minus short term & long term debt) position is still sizeable (about $50 billion) and the company rightfully is rewarded with a AAA rating (one of just two publicly traded companies with this rating, Johnson & Johnson being the other one). Microsoft thus is a very low-risk investment with a fortress balance sheet. Due to tax legislation changes Microsoft can now access offshore cash, and will therefore likely start utilizing it (and stop borrowing money at the same time).

Microsoft has a great moat in the operating system & Office business units and a strong market position in cloud computing. It is unlikely that the company will lose market share with its older, established products, whereas cloud computing is such a high-growth industry that there is enough room for growth for multiple companies.

Final Thoughts & Recommendation

Microsoft has turned from a value & income stock into a growth investment. Microsoft should be able to deliver attractive growth rates going forward. It is a hold for now, until it returns to a more reasonable valuation.

Total Return Breakdown by Year