Microsoft Corporation (MSFT)

Updated July 20th, 2018 by Jonathan Weber

Key Metrics

Current Price:	$104	**5 Year CAGR Estimate:**	8.3%	**Volatility Percentile:**	24.4%
Fair Value Price:	$79	**5 Year Growth Estimate:**	12.1%	**Momentum Percentile:**	91.4%
% Fair Value:	132%	**5 Year Valuation Multiple Estimate:**	-5.4%	**Valuation Percentile:**	11.6%
Dividend Yield:	1.6%	**5 Year Price Target**	$140	**Total Return Percentile:**	48.0%

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 $804 billion.

Microsoft announced its most recent quarterly results on July 19. The company earned $1.13 per share during the quarter, for a 7% increase year over year. Revenues totaled $30.1 billion, a hefty 17% increase over the prior year's quarter. Microsoft's cash position totaled $134 billion at the end of the quarter. Fiscal 2018 has ended with the June quarter. During those twelve months, Microsoft earned $3.88 per share.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$1.62	$2.10	$2.69	$2.72	$2.65	$2.63	$2.65	$2.79	$3.29	$3.88	***$4.05***	***$7.17***
DPS	$0.52	$0.52	$0.64	$0.80	$0.89	$1.12	$1.24	$1.44	$1.56	$1.68	***$1.80***	***$3.22***

After years of solid growth, Microsoft had a hard time growing its profits during the 2011-2015 time frame. After some change-up in its management and a strategic shift (towards cloud computing and mobile) Microsoft's growth has been 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 80%+ rate for 11 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 software-as-a-service (SaaS) system. Office 365 revenues grew by 38% last quarter.

Microsoft's EPS grew by 18% during fiscal 2018, a higher growth rate than the revenue increase of 14% over the same time fame. Due to low variable costs, the impact of operating leverage will allow Microsoft to maintain an earnings growth rate that is higher than the revenue growth rate for the foreseeable future. Buybacks are an additional factor for Microsoft's earnings per share growth.

The markets Microsoft addresses continue to grow, with cloud computing being the most compelling. This 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 earnings per share growth rate will drop to the low-double digits range going forward.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	13.4	13.1	9.6	10.4	11.2	14.0	17.0	18.1	20.2	25.4	***25.7***	***19.5***
Avg. Yld.	2.4%	1.9%	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	1.7%	***1.6%***	***2.3%***

Disclosure: This analyst has no position in the security discussed in this article, and no plans to initiate one in the next 72 hours.

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 during the last decade (as Microsoft was highly profitable but wasn't able to generate growth several years in a row). We believe that Microsoft's shares will trade at a high-teens earnings multiple in the years that follow, which will result in significant multiple compression.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
GP/A	59.4%	58.2%	50.0%	46.3%	40.4%	34.7%	34.6%	27.2%	23.1%	27.8%	***28.0%***	***29.0%***
Debt/A	49.2%	46.3%	47.4%	45.3%	44.6%	47.9%	54.1%	62.7%	70.1%	67.9%	***66.0%***	***60.0%***
Int. Cov.	-	166.6	96.2	59.6	64.1	47.6	25.7	16.9	11.4	12.0	***13.6***	***15.0***
Payout	32.1%	24.8%	23.8%	29.4%	33.6%	42.6%	46.8%	51.6%	50.6%	43.3%	***44.4%***	***44.1%***
Std. Dev.	29.0%	23.4%	19.1%	20.0%	20.7%	13.7%	28.2%	18.4%	10.6%	15.0%	***17.0%***	***18.0%***

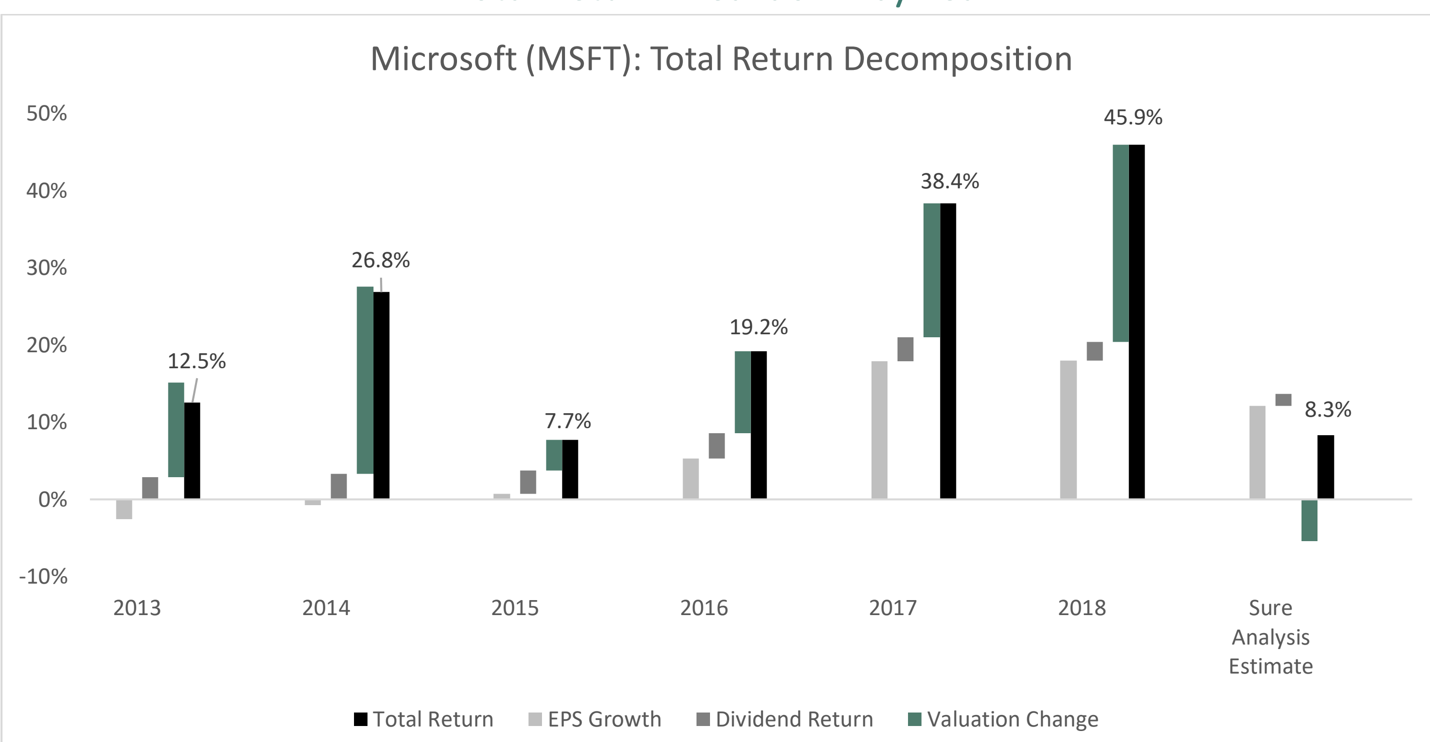
In the above table there are two clear trends. Gross profits to assets have been declining from an extremely high level to a still very solid level, and the debt to assets ratio has risen significantly as well. As cash has been building up Microsoft's asset base has widened dramatically, which is the 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. Due to its sizeable net cash position Microsoft rightfully holds an AAA rating. Microsoft thus is a very low-risk investment with a fortress balance sheet.

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. Due to its strong balance sheet and wide moat Microsoft is a low-risk investment. It is a hold for now, though this may change when or if it returns to a more reasonable valuation.

Total Return Breakdown by Year



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