Microsoft (MSFT)

Updated October 24th, 2018 by Jonathan Weber

Key Metrics

Current Price:	$102	**5 Year CAGR Estimate:**	9.8%	**Volatility Percentile:**	13.3%
Fair Value Price:	$83	**5 Year Growth Estimate:**	12.1 %	**Momentum Percentile:**	93.3%
% Fair Value:	123%	**5 Year Valuation Multiple Estimate:**	-4.1%	**Growth Percentile:**	96.4%
Dividend Yield:	1.8%	**5 Year Price Target**	$140	**Valuation Percentile:**	10.6%
Dividend Risk Score:	B	**Retirement Suitability Score:**	C	**Total Return Percentile:**	42.5%

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 $786 billion.

Microsoft reported its first quarter (fiscal 2019) results on October 24. The company generated revenues of $29.1 billion during Q1, an increase of 18.6% year over year. The company benefited from broad sales growth. Office commercial products revenues rose 16%, LinkedIn grew by 33%, Microsoft's Azure cloud offering grew by 76%, gaming revenues rose by 45%, and even Microsoft's Search ad revenues rose by 17% year over year. Operating leverage and lower taxes allowed for a very strong net income growth rate of 34% compared to Q1 2018. Microsoft's earnings-per-share rose by 36%, impacted by a slightly lower share count, to $1.14.

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	***$4.25***	***$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***
Shares	8.90	8.67	8.38	8.38	8.33	8.24	8.03	7.81	7.71	7.68	***7.55***	***7.10***

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.

Microsoft's cloud business is growing at a mid-teens range thanks to Azure, which combines IaaS, PaaS & SaaS offerings and which has been growing at a 70%+ rate for 12 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 36% during Q1. 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. Microsoft's strong cash flows will allow the company to shrink its share count further.

The markets Microsoft addresses continue to grow, with cloud computing being the most compelling one of these markets. This means that even without any market share gains Microsoft would be able to grow its top line. Thanks to rising margins and a declining share count Microsoft's growth outlook over the coming years looks quite compelling, although the earnings-per-share growth rate will not remain at 20%+ over the coming years.

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	***24.0***	***19.5***
Avg. Yld.	2.4%	1.9%	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	1.7%	***1.8%***	***2.3%***

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Microsoft trades at a relatively high valuation of 24 times this year's earnings. Its valuation has come down slightly over the last year, but shares continue to trade well above our fair value estimate. Multiple contraction will, therefore, be a headwind for Microsoft's total returns over the coming years. The company's shares offer a dividend yield of 1.8%, which is a nice addition for total return seekers, but which is likely too low for most income focused investors.

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%***

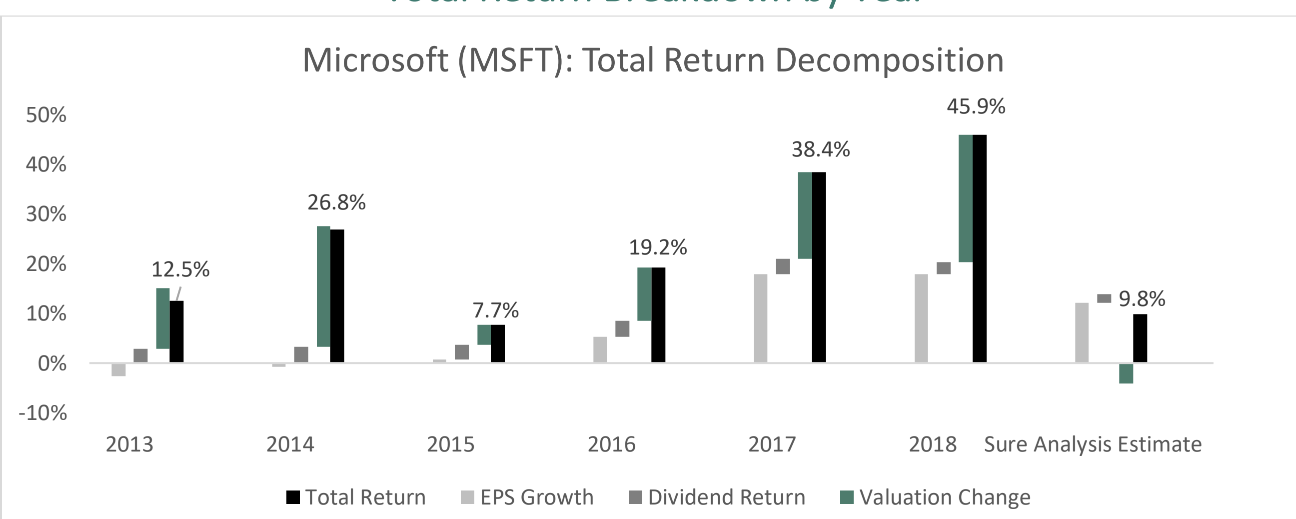
In the above table there are two clear trends. Gross profits to assets have been declining from an extremely high level to a still very solid level, and the debt to assets ratio has risen significantly as well. As cash has been building up Microsoft's asset base has widened dramatically, which is the 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 is a software giant with a dominant market position in several key markets. On top of that Microsoft is a major player in the high-growth cloud computing industry, which drives its earnings growth rate. Microsoft is, at the same time, a relatively low-risk business, due to its fortress balance sheet and solid recession performance. Microsoft should continue to deliver attractive earnings-per-share growth rates, but its relatively high valuation will be a headwind for Microsoft's total returns going forward. Due to its high valuation we rate Microsoft a hold at the current price.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	58437	62484	69943	73723	77849	86833	93580	91154	96571	110B
Gross Profit	46282	50089	54366	56193	57464	59755	60542	58374	62310	72007
Gross Margin	79.2%	80.2%	77.7%	76.2%	73.8%	68.8%	64.7%	64.0%	64.5%	65.2%
SG&A Exp.	16909	17277	18162	18426	20289	20488	20324	19198	19942	22223
D&A Exp.	2562	2673	2766	2967	3755	5212	5957	6622	8778	10261
Operating Profit	20363	24098	27161	27956	26764	27886	28172	27188	29331	35058
Op. Margin	34.8%	38.6%	38.8%	37.9%	34.4%	32.1%	30.1%	29.8%	30.4%	31.8%
Net Profit	14569	18760	23150	16978	21863	22074	12193	20539	25489	16571
Net Margin	24.9%	30.0%	33.1%	23.0%	28.1%	25.4%	13.0%	22.5%	26.4%	15.0%
Free Cash Flow	15918	22096	24639	29321	24576	27017	23724	24982	31378	32252
Income Tax	5252	6253	4921	5289	5189	5746	6314	5100	4412	19903

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets ($B)	77.89	86.11	108.70	121.27	142.43	172.38	174.47	193.47	250.31	258.85
Cash & Equivalents	6076	5505	9610	6938	3804	8669	5595	6510	7663	11946
Acc. Receivable	11192	13014	14987	15780	17486	19544	17908	18277	22431	26481
Inventories	717	740	1372	1137	1938	2660	2902	2251	2181	2662
Goodwill & Int.	14262	13552	13325	16622	17738	27108	21774	21605	45228	43736
Total Liab. ($B)	38.33	39.94	51.62	54.91	63.49	82.60	94.39	121.47	162.60	176.13
Accounts Payable	3324	4025	4197	4175	4828	7432	6591	6898	7390	8617
Long-Term Debt	5746	5939	11921	11944	15600	22645	35292	53461	86194	76240
Total Equity	39558	46175	57083	66363	78944	89784	80083	71997	87711	82718
D/E Ratio	0.15	0.13	0.21	0.18	0.20	0.25	0.44	0.74	0.98	0.92

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	19.3%	22.9%	23.8%	14.8%	16.6%	14.0%	7.0%	11.2%	11.5%	6.5%
Return on Equity	38.4%	43.8%	44.8%	27.5%	30.1%	26.2%	14.4%	27.0%	31.9%	19.4%
ROIC	35.7%	38.5%	38.2%	23.1%	25.3%	21.3%	10.7%	17.1%	17.0%	10.0%
Shares Out.	8.90	8.67	8.38	8.38	8.33	8.24	8.03	7.81	7.71	7.68
Revenue/Share	6.50	7.00	8.14	8.67	9.19	10.34	11.34	11.38	12.33	14.16
FCF/Share	1.77	2.48	2.87	3.45	2.90	3.22	2.87	3.12	4.01	4.14

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.