Microsoft Corp. (MSFT)

Updated January 31st, 2019 by Jonathan Weber

Key Metrics

Current Price:	$106	**5 Year CAGR Estimate:**	9.7%	**Volatility Percentile:**	10.6%
Fair Value Price:	$86	**5 Year Growth Estimate:**	12.1%	**Momentum Percentile:**	87.8%
% Fair Value:	123%	**5 Year Valuation Multiple Estimate:**	-4.1%	**Growth Percentile:**	96.8%
Dividend Yield:	1.7%	**5 Year Price Target**	$140	**Valuation Percentile:**	19.8%
Dividend Risk Score:	B	**Retirement Suitability Score:**	D	**Total Return Percentile:**	53.2%

Overview & Current Events

Microsoft Corporation 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 $817 billion.

Microsoft reported its second quarter (fiscal 2019) earnings results on January 30. The company generated revenues of $32.5 billion during the second quarter, which represents a revenue growth rate of 12.4% compared to the prior year's quarter. Microsoft grew across its segment, with productivity and business process revenues rising 13% year over year to $10.1 billion, while Office Commercial revenues rose 11% year over year. Office Consumer revenues rose by a below-average rate of 2%. The largest growth driver was, once again, Microsoft's cloud segment, with Intelligent Cloud revenues rising 21% year over year to $9.4 billion. Azure, Microsoft's high-growth cloud platform, grew by another 76% year over year, showcasing Microsoft's strong position in this ever-growing market. Microsoft also generated solid revenue growth with its hardware products, including Surface revenues that rose by 41% year over year and Gaming revenues that rose 9% compared to the prior year's quarter.

Microsoft generated earnings-per-share of $1.10 during the second quarter, which beat the analyst consensus and which represents a growth rate of 15% compared to the prior year's period. Microsoft guides for revenues of $29.8 billion during the third quarter of fiscal 2019, which is in-line with the analyst consensus.

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 were highly compelling during recent quarters.

Microsoft's cloud business is growing at a ~20% pace 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. 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 will most likely be able to grow its top line.

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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 15%+ 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	***24.9***	***19.5***
Avg. Yld.	2.4%	1.9%	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	1.7%	***1.7%***	***2.3%***

Microsoft's growth has accelerated over the last couple of years, driven by rising cloud revenues primarily. This has resulted in a rising valuation for Microsoft's shares, as the market treats Microsoft as a growth stock right now. It makes sense that Microsoft trades for more than the low-teens earnings multiple that it has traded at ten years ago, but a price to earnings ratio of well above 20 does not seem sustainable, as growth rates will likely slow down to some extent.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
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%***

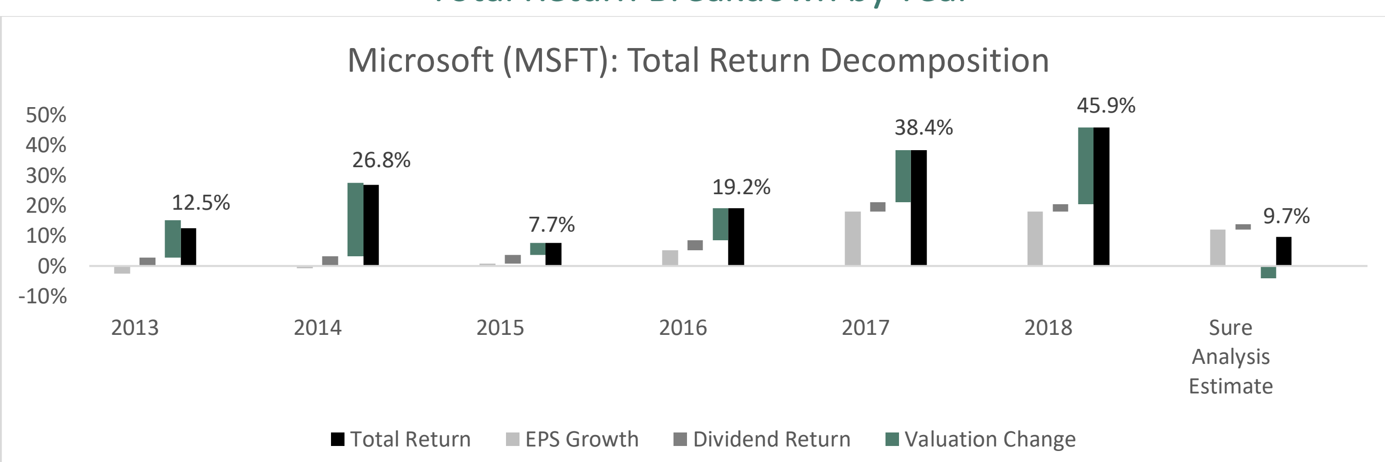
Microsoft has been a solid income investment throughout the last decade. The dividend payout ratio has never risen substantially above 50%, and the fact that Microsoft owns one of the strongest balance sheets in the world means that the dividend is very safe. The below-average yield makes Microsoft less suitable as an income stock right here, though.

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. Microsoft has a renowned brand and a global presence, which provides competitive advantages. The company is relatively resilient versus recessions, and its AAA-rated balance sheet makes it a relatively low-risk investment.

Final Thoughts & Recommendation

Microsoft has been a low-growth cash cow throughout the majority of the last decade, but a focus on cloud computing and mobile has reinvigorated Microsoft's growth. We believe that the growth outlook remains solid, but the above-average valuation will be a headwind for Microsoft's total returns going forward. Even though Microsoft looks strong fundamentally we rate shares a hold at current prices due to valuation concerns.

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.