



# Microsoft Corp. (MSFT)

Updated April 25<sup>th</sup>, 2019 by Eli Inkrot

## Key Metrics

<b>Current Price:</b>	\$130	<b>5 Year CAGR Estimate:</b>	3.0%	<b>Volatility Percentile:</b>	10.3%
<b>Fair Value Price:</b>	\$94	<b>5 Year Growth Estimate:</b>	8.0%	<b>Momentum Percentile:</b>	94.3%
<b>% Fair Value:</b>	139%	<b>5 Year Valuation Multiple Estimate:</b>	-6.4%	<b>Growth Percentile:</b>	75.4%
<b>Dividend Yield:</b>	1.4%	<b>5 Year Price Target</b>	\$138	<b>Valuation Percentile:</b>	11.4%
<b>Dividend Risk Score:</b>	B	<b>Retirement Suitability Score:</b>	D	<b>Total Return Percentile:</b>	15.3%

## Overview & Current Events

Microsoft Corporation, founded in 1975 and headquartered in Redmond, WA, 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. After the latest earnings report the Microsoft hit a market capitalization of \$1 trillion, compared to annual underlying earnings power of about \$33 billion. On April 24<sup>th</sup>, 2019 Microsoft reported Q3 fiscal year 2019 results for the period ending March 31<sup>st</sup>, 2019. The company generated revenue of \$30.6 billion, representing an increase of 14% compared to the Q3 fiscal year 2018. The growth was across the board, with Productivity and Business Processes, Intelligent Cloud and Personal Computing making up 33.5%, 31.6% and 34.9% of revenue and each growing 14%, 22% and 8% respectively. Azure, Microsoft's high-growth cloud platform, grew by 73% year over year, showcasing Microsoft's strong position in this ever-growing market. Net income came in at \$8.8 billion, a 19% year-over-year increase, and earnings-per-share equaled \$1.14, representing a 20% increase. Separately Microsoft said that revenue for Q4 fiscal year 2019 would come in between \$32.2 billion and \$32.9 billion, with an effective tax rate of approximately 17%.

## Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
<b>EPS</b>	\$1.62	\$2.10	\$2.69	\$2.72	\$2.65	\$2.63	\$2.65	\$2.79	\$3.08	\$3.88	<b>\$4.25</b>	<b>\$6.25</b>
<b>DPS</b>	\$0.52	\$0.52	\$0.64	\$0.80	\$0.89	\$1.12	\$1.24	\$1.44	\$1.56	\$1.68	<b>\$1.88</b>	<b>\$2.80</b>
<b>Shares</b>	8,908	8,668	8,376	8,381	8,328	8,239	8,027	7,808	7,708	7,677	<b>7,600</b>	<b>7,400</b>

After years of solid growth, Microsoft had a hard time growing its profits during the 2011 through 2015 timeframe. 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, although this form of capital allocation becomes less attractive with an elevated valuation.

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. Thanks to rising margins and a declining share count Microsoft's growth outlook over the coming years looks quite compelling, although not quite as robust as the company's last couple of years.

Looking longer-term, from 2008 through 2018, Microsoft was able to grow its earnings-per-share by nearly 8% annually. This is in-line with our anticipation, taking into consideration new growth prospects against a very large starting base.

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



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## 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	22.1	30.6	22.0
Avg. Yld.	2.4%	1.9%	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	2.0%	1.4%	2.0%

Microsoft is marked by a number of very distinct valuation periods. In the 1990's and early 2000's, it was not uncommon to see shares trade north of 30 or 40 time earnings. From 2003 through 2008 shares regularly traded in the 20 to 25 times earnings range. From 2009 through 2014 a 10 to 15 multiple was typical. And lately, 20 times earnings and above has once again become the norm as growth has picked up extensively. Our view is that an above average multiple is warranted for the business, especially considering the strong balance sheet, but not something that approaches 30 times earnings. Indeed, from this point we are forecasting a meaningful headwind on the valuation front.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	32%	25%	24%	29%	34%	43%	47%	52%	51%	43%	44%	45%

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. However, the below-average yield makes Microsoft less suitable as an income stock today.

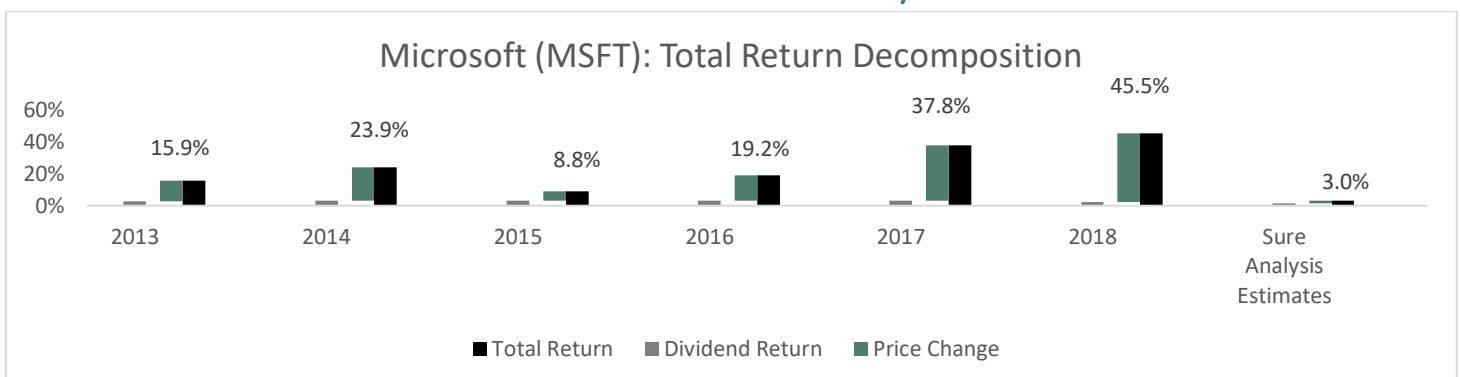
Microsoft has a great moat in the operating system & Office business units and a strong market position in cloud computing. It is unlikely that the company will lose market share with its older, established products, whereas cloud computing is such a high-growth industry that there is enough room for growth for multiple companies. Microsoft has a renowned brand and a global presence, which provides competitive advantages. The company is relatively resilient against recessions, and its AAA-rated balance sheet makes it a low-risk business.

As of the most recent quarterly report Microsoft held \$131.6 billion in cash and securities, \$159.9 billion in current assets and \$263.2 billion in total assets against \$53.9 billion in current liabilities and \$168.4 billion in total liabilities.

## Final Thoughts & Recommendation

Shares are up 23% since our last report. 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. However, we believe total return potential, 3.0% annually, is limited as the 8.0% anticipated growth rate and 1.4% starting dividend yield are largely offset by the potential for a 6.4% annual valuation headwind. Even though Microsoft looks strong fundamentally, we are not compelled in the least by the valuation and rate shares as a hold.

## Total Return Breakdown by Year



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## Income Statement Metrics

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

## Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
<b>Total Assets (\$B)</b>	77.89	86.11	108.70	121.27	142.43	172.38	174.47	193.47	250.31	258.85
<b>Cash &amp; Equivalents</b>	6076	5505	9610	6938	3804	8669	5595	6510	7663	11946
<b>Acc. Receivable</b>	11192	13014	14987	15780	17486	19544	17908	18277	22431	26481
<b>Inventories</b>	717	740	1372	1137	1938	2660	2902	2251	2181	2662
<b>Goodwill &amp; Int.</b>	14262	13552	13325	16622	17738	27108	21774	21605	45228	43736
<b>Total Liab. (\$B)</b>	38.33	39.94	51.62	54.91	63.49	82.60	94.39	121.47	162.60	176.13
<b>Accounts Payable</b>	3324	4025	4197	4175	4828	7432	6591	6898	7390	8617
<b>Long-Term Debt</b>	5746	5939	11921	11944	15600	22645	35292	53461	86194	76240
<b>Total Equity</b>	39558	46175	57083	66363	78944	89784	80083	71997	87711	82718
<b>D/E Ratio</b>	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
<b>Return on Assets</b>	19.3%	22.9%	23.8%	14.8%	16.6%	14.0%	7.0%	11.2%	11.5%	6.5%
<b>Return on Equity</b>	38.4%	43.8%	44.8%	27.5%	30.1%	26.2%	14.4%	27.0%	31.9%	19.4%
<b>ROIC</b>	35.7%	38.5%	38.2%	23.1%	25.3%	21.3%	10.7%	17.1%	17.0%	10.0%
<b>Shares Out.</b>	8.90	8.67	8.38	8.38	8.33	8.24	8.03	7.81	7.71	7.68
<b>Revenue/Share</b>	6.50	7.00	8.14	8.67	9.19	10.34	11.34	11.38	12.33	14.16
<b>FCF/Share</b>	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.

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