Microsoft Corp. (MSFT)

Updated May 2nd, 2020 by Eli Inkrot

Key Metrics

Current Price:	$175	**5 Year CAGR Estimate:**	2.7%	**Market Cap:**	$1.34 T
Fair Value Price:	$121	**5 Year Growth Estimate:**	9.0%	**Ex-Dividend Date:**	05/20/20
% Fair Value:	144%	**5 Year Valuation Multiple Estimate:**	-7.1%	**Dividend Payment Date:**	06/11/20
Dividend Yield:	1.2%	**5 Year Price Target**	$186	**Years Of Dividend Growth:**	18
Dividend Risk Score:	B	**Retirement Suitability Score:**	D	**Last Dividend Increase:**	10.9%

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. Microsoft's market capitalization is now $1.3 trillion, compared to annual underlying earnings power of ~$40 billion.

On April 29th, 2020 Microsoft reported Q3 fiscal year 2020 results for the period ending March 31st, 2020. (Microsoft's fiscal year ends June 30th.) For the quarter, the company generated revenue of $35.0 billion, representing a 14.6% increase compared to Q3 fiscal year 2019. The growth was across the board, with Productivity and Business Processes, Intelligent Cloud and Personal Computing growing 15%, 27% and 3% respectively. Azure, Microsoft's high-growth cloud platform, grew by 59% year-over-year, showcasing Microsoft's strong position in this ever-growing market. Operating income came in at $13.0 billion, representing a 25% increase. Net income totaled $10.8 billion, a 22% gain and earnings-per-share equaled $1.40, a 23% improvement. Microsoft CEO Satya Nadella said that Microsoft has seen "two years' worth of digital transformation in two months" with minimal impact from the ongoing COVID-19 crisis.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$2.10	$2.69	$2.72	$2.65	$2.63	$2.65	$2.79	$3.08	$3.88	$4.75	***$5.50***	***$8.46***
DPS	$0.52	$0.64	$0.80	$0.89	$1.12	$1.24	$1.44	$1.56	$1.68	$1.80	***$2.04***	***$3.20***
Shares[1]	8,668	8,376	8,381	8,328	8,239	8,027	7,808	7,708	7,677	7,643	***7,690***	***7,500***

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 have been compelling during recent years.

Microsoft's cloud business is growing at a 20%+ pace thanks to Azure, which has been growing tremendously for a few years. 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 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.

Longer-term, from 2008 through 2019, Microsoft was able to grow its earnings-per-share by 8.8% annually. This is in-line with our anticipation, even taking into consideration the current crisis.

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[1] In millions.

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	13.1	9.6	10.4	11.2	14.0	17.0	18.1	20.2	22.1	23.7	***31.7***	***22.0***
Avg. Yld.	1.9%	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	2.0%	1.6%	***1.2%***	***1.7%***

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-times 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. From this point we are forecasting a meaningful headwind on the valuation front, using 22x as fair value.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	25%	24%	29%	34%	43%	47%	52%	51%	43%	38%	***37%***	***38%***

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.

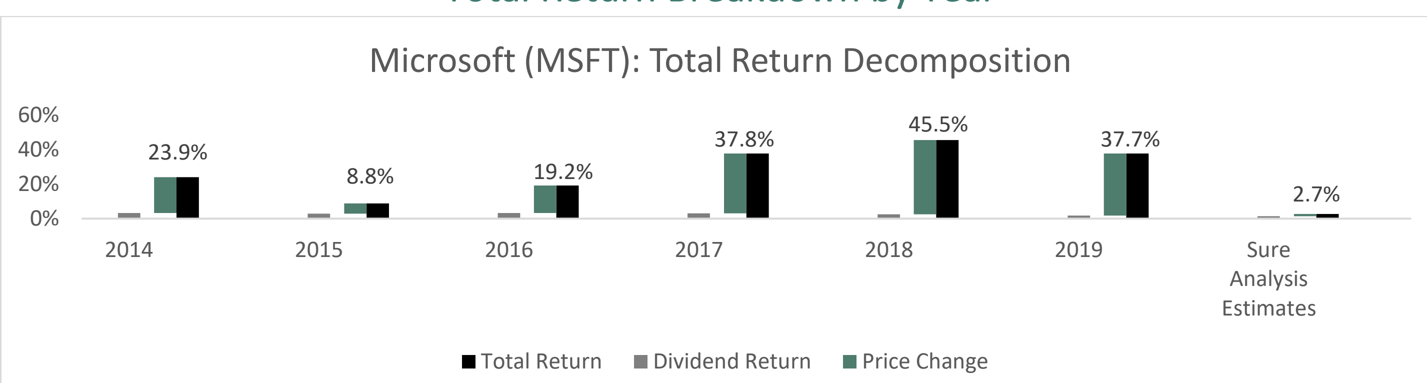
Microsoft has a great moat in the operating system & Office business units and a strong market position in cloud computing. It is unlikely that the company will lose market share with its older, established products, whereas cloud computing is such a high-growth industry that there is enough room for 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 $137.6 billion in cash and securities, $170.5 billion in current assets and $285.4 billion in total assets against $58.7 billion in current liabilities and $170.9 billion in total liabilities.

Final Thoughts & Recommendation

Shares are up 3% since our last report. Microsoft had 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 intermediate total return potential, 2.7% annually, is limited as the 9.0% anticipated growth rate and 1.2% starting dividend yield could be largely offset by the potential for a significant annual valuation headwind. Even though Microsoft the business looks strong, we are not compelled by the valuation and continue to rate shares as a hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	62484	69943	73723	77849	86833	93580	91154	96571	110360	125843
Gross Profit	50089	54366	56193	57464	59755	60542	58374	62310	72007	82933
Gross Margin	80.2%	77.7%	76.2%	73.8%	68.8%	64.7%	64.0%	64.5%	65.2%	65.9%
SG&A Exp.	17277	18162	18426	20289	20488	20324	19198	19942	22223	23098
D&A Exp.	2673	2766	2967	3755	5212	5957	6622	8778	10261	11682
Operating Profit	24098	27161	27956	26764	27886	28172	27188	29331	35058	42959
Op. Margin	38.6%	38.8%	37.9%	34.4%	32.1%	30.1%	29.8%	30.4%	31.8%	34.1%
Net Profit	18760	23150	16978	21863	22074	12193	20539	25489	16571	39240
Net Margin	30.0%	33.1%	23.0%	28.1%	25.4%	13.0%	22.5%	26.4%	15.0%	31.2%
Free Cash Flow	22096	24639	29321	24576	27017	23724	24982	31378	32252	38260
Income Tax	6253	4921	5289	5189	5746	6314	5100	4412	19903	4448

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets ($B)	86	108	121	142	172	174	193	250	259	287
Cash & Equivalents ($B)	6	10	7	4	9	6	7	8	12	11
Acc. Receivable ($B)	13	15	16	15	20	18	18	22	26	30
Inventories ($B)	1	1	1	2	3	3	2	2	3	2
Goodwill & Int. ($B)	14	13	17	18	27	22	22	45	44	50
Total Liab. ($B)	40	52	55	63	83	94	121	163	176	184
Accounts Payable ($B)	4	4	4	5	7	7	7	7	9	9
Long-Term Debt ($B)	6	12	12	16	23	35	53	86	76	72
Total Equity ($B)	46	57	66	79	90	80	72	88	83	102
D/E Ratio	0.13	0.21	0.18	0.20	0.25	0.44	0.74	0.98	0.92	0.71

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	22.9%	23.8%	14.8%	16.6%	14.0%	7.0%	11.2%	11.5%	6.5%	14.4%
Return on Equity	43.8%	44.8%	27.5%	30.1%	26.2%	14.4%	27.0%	31.9%	19.4%	42.4%
ROIC	38.5%	38.2%	23.1%	25.3%	21.3%	10.7%	17.1%	17.0%	10.0%	23.5%
Shares Out.	8,668	8,376	8,381	8,328	8,239	8,027	7,808	7,708	7,677	7,753
Revenue/Share	7.00	8.14	8.67	9.19	10.34	11.34	11.38	12.33	14.16	16.23
FCF/Share	2.48	2.87	3.45	2.90	3.22	2.87	3.12	4.01	4.14	4.93

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