Microsoft Corp. (MSFT)

Updated July 23rd, 2020 by Eli Inkrot

Key Metrics

Current Price:	$203	**5 Year CAGR Estimate:**	1.9%	**Market Cap:**	$1.57 T
Fair Value Price:	$136	**5 Year Growth Estimate:**	9.0%	**Ex-Dividend Date:**	08/19/20
% Fair Value:	149%	**5 Year Valuation Multiple Estimate:**	-7.7%	**Dividend Payment Date:**	09/10/20
Dividend Yield:	1.0%	**5 Year Price Target**	$210	**Years Of Dividend Growth:**	18
Dividend Risk Score:	A	**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 $1.6 trillion, compared to annual underlying earnings power of $44+ billion.

On July 22nd, 2020 Microsoft reported Q4 and full year fiscal 2020 results for the period ending June 30th, 2020. For the quarter, the company generated revenue of $38.0 billion, representing a 12.8% increase compared to Q4 2019. The growth was across the board with Productivity and Business Processes, Intelligent Cloud and Personal Computing growing 6%, 17% and 14% respectively. Azure, Microsoft's high-growth cloud platform, grew by 47% year-over-year, showcasing Microsoft's strong position in this ever-growing market. Operating income came in at $13.4 billion, representing an 8.1% increase. Net income totaled $11.2 billion, a -15% decline, while earnings-per-share equaled $1.46 compared to $1.71 previously.

For the year Microsoft generated revenue of $143.0 billion, a 13.6% increase compared to fiscal year 2019. Operating income equaled $53.0 billion, a 23.3% increase. Net income totaled $44.3 billion, a 12.8% improvement, while earnings-per-share equaled $5.76 versus an adjusted $4.75 in the prior year.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	$2.69	$2.72	$2.65	$2.63	$2.65	$2.79	$3.08	$3.88	$4.75	$5.76	***$6.20***	***$9.54***
DPS	$0.64	$0.80	$0.89	$1.12	$1.24	$1.44	$1.56	$1.68	$1.80	$1.99	***$2.04***	***$3.14***
Shares[1]	8,376	8,381	8,328	8,239	8,027	7,808	7,708	7,677	7,643	7,683	***7,700***	***7,550***

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 strong pace thanks to Azure, which has been growing tremendously for a few years. Microsoft's Office product range, which had 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. 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 COVID-19 pandemic.

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[1] In millions.

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Valuation Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	9.6	10.4	11.2	14.0	17.0	18.1	20.2	22.1	23.7	28.1	***32.8***	***22.0***
Avg. Yld.	2.5%	2.8%	3.0%	3.0%	2.7%	2.9%	2.5%	2.0%	1.6%	1.2%	***1.0%***	***1.5%***

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	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	24%	29%	34%	43%	47%	52%	51%	43%	38%	35%	***33%***	***33%***

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.

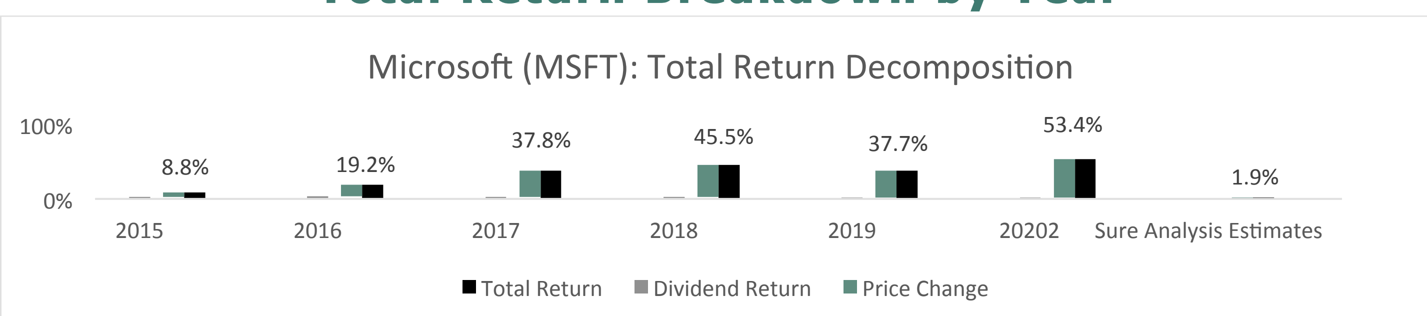
Microsoft has a great moat in the operating system & Office business units and a strong market position in cloud computing. It is unlikely that the company will lose market share with its older, established products, whereas cloud computing is such a high-growth industry that there is enough room for 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 $136.5 billion in cash and securities, $181.9 billion in current assets and $301.3 billion in total assets against $72.3 billion in current liabilities and $183.0 billion in total liabilities.

Final Thoughts & Recommendation

Shares are up 16% 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, 1.9% annually, is limited as the 9.0% anticipated growth rate and 1.0% 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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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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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	69943	73723	77849	86833	93580	91154	96571	110360	125843	
Gross Profit	54366	56193	57464	59755	60542	58374	62310	72007	82933	
Gross Margin	77.7%	76.2%	73.8%	68.8%	64.7%	64.0%	64.5%	65.2%	65.9%	
SG&A Exp.	18162	18426	20289	20488	20324	19198	19942	22223	23098	
D&A Exp.	2766	2967	3755	5212	5957	6622	8778	10261	11682	
Operating Profit	27161	27956	26764	27886	28172	27188	29331	35058	42959	
Op. Margin	38.8%	37.9%	34.4%	32.1%	30.1%	29.8%	30.4%	31.8%	34.1%	
Net Profit	23150	16978	21863	22074	12193	20539	25489	16571	39240	
Net Margin	33.1%	23.0%	28.1%	25.4%	13.0%	22.5%	26.4%	15.0%	31.2%	
Free Cash Flow	24639	29321	24576	27017	23724	24982	31378	32252	38260	
Income Tax	4921	5289	5189	5746	6314	5100	4412	19903	4448	

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets ($B)	108	121	142	172	174	193	250	259	287	
Cash & Equivalents ($B)	10	7	4	9	6	7	8	12	11	
Acc. Receivable ($B)	15	16	15	20	18	18	22	26	30	
Inventories ($B)	1	1	2	3	3	2	2	3	2	
Goodwill & Int. ($B)	13	17	18	27	22	22	45	44	50	
Total Liab. ($B)	52	55	63	83	94	121	163	176	184	
Accounts Payable ($B)	4	4	5	7	7	7	7	9	9	
Long-Term Debt ($B)	12	12	16	23	35	53	86	76	72	
Total Equity ($B)	57	66	79	90	80	72	88	83	102	
D/E Ratio	0.21	0.18	0.20	0.25	0.44	0.74	0.98	0.92	0.71	

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	23.8%	14.8%	16.6%	14.0%	7.0%	11.2%	11.5%	6.5%	14.4%	
Return on Equity	44.8%	27.5%	30.1%	26.2%	14.4%	27.0%	31.9%	19.4%	42.4%	
ROIC	38.2%	23.1%	25.3%	21.3%	10.7%	17.1%	17.0%	10.0%	23.5%	
Shares Out.	8,376	8,381	8,328	8,239	8,027	7,808	7,708	7,677	7,643	7,683
Revenue/Share	8.14	8.67	9.19	10.34	11.34	11.38	12.33	14.16	16.23	
FCF/Share	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.