

Microsoft: A Growth Story

Cheap, Cheap, and Cheap

Microsoft's share price is currently trading at a discount due to concerns about open-source architecture and future growth prospects. While these concerns are valid, the market appears to have over reacted. The stock is currently trading at an adjusted forward P/E of 17.* This is in line with the S&P 500 forward P/E of 16-17 despite the fact that Microsoft has significantly higher ROI and better growth prospects than the average S&P 500 company.**

Given its portfolio of initiatives and a clear strategy on execution, Microsoft should continue to profitably grow at a long-term rate of 5-6%. At current EBITA margins of 44%, the implied valuation is 25-30% higher than current market value. At a more sustainable EBITA margin of 38-40% the implied valuation is 20-25% higher.

It's All in the Growth....

Microsoft has a very clear plan to grow through innovation. The company plans on increasing revenue through three initiatives: *Growth of anchor businesses* (core businesses), *expansion of portfolio*, and *growth in services*. The company is in a strong strategic position to execute all three of these areas and yet continue to earn high profit margins.

I. *Growth of anchor businesses*: Overall growth rate for the anchor businesses are expected to be around 4-5% over the long-term (see Exhibit 1). The primary drivers of growth in these businesses will be sales of new PCs (IDC expects this to be 8% over the next four years), refresh cycles, shift toward higher-premium product mix, new customer segments, and continued market share gain from UNIX in the server business.

The anchor businesses also enjoy favorable long-term growth opportunities in rapidly growing emerging markets such as China and India. As these markets continue to develop, they will increasingly enforce intellectual property rights. With current piracy rates exceeding 95% in China, Microsoft has significant opportunity to capture value. Furthermore, in the short-run piracy has allowed Microsoft to compete against Linux and capture network effects.

II. *Expansion of Portfolio*: Microsoft is working on expanding its core portfolio to include more products than just Windows and Office. The company has products in its pipeline that allow document management, collaboration, and Internet telephony, among others. While the exact market opportunity of this is difficult to measure, recent product launches such as sharing point (the fastest-growing product in Microsoft's history), as well as Microsoft Project and Visio (which combined have achieved over \$1 billion in revenue in just a few years), indicate that Microsoft has the potential to capture even a bigger share of the pie in the software market.

III. *Growth in Services*: Microsoft views services as the next frontier for its growth. The services strategy focuses on expanding current software and platform offerings to annuity-type revenue generating services. These include the X-box live website (play and download games) and MSN services (search, e-mail, music). While Microsoft has fallen behind Google and Yahoo in the search market, the company is investing heavily to reestablish itself as the market leader in this fast growing segment. According to Standard & Poor's, the Internet advertising market exceeded \$12 billion in 2004 of which search advertising generated over \$5 billion. IDC forecasts this market to grow at a rate of 20% over the next five years. With a track-record of being able to play catch-up and then lead (as it did with Netscape and the Server market), Microsoft could gain significant share in this market. As a matter of fact, recent user surveys are already beginning to show a sharp increase in the MSN experience

The Numbers Say it!

I. *Multiplies-Based Valuation*: Microsoft is currently trading at an adjusted forward P/E of 17 and Forward EV/EBITA of 12. When compared to peers, the fair weighted average operating EV/EBITA for Microsoft is 15 (see Exhibit 2). This implies a valuation of approximately \$340 billion or 20% above the \$280 billion market cap as of 9/16/2005.

II. *DCF-Based Valuation*: A bottom-up sum-of-parts valuation for Microsoft leads to a value of \$336 billion (see Exhibit 1). A decline in margins is forecasted to account for growing product sales from developing markets and the possibility of increased competition. Margins in MSN are expected to improve as the low-profit margin ISP business continues to decline and Internet-based services contributes higher portion of the value.

Valuation can benefit significantly from minor increases in growth. Exhibit 3 shows that a 2% increase in growth can lead to a 30% increase in share price while a similar increase in margins leads to only a 4% increase in share price.

The Future Says

Short-term catalysts: Microsoft will be launching several new products in the coming years. The release of Windows Vista, Office 12, and X-box 360 should lead to strong growth results and renewed interest in the stock.

Long-term catalysts: Microsoft is working on launching the largest marketing campaign in its history to inform users about the benefits of Windows over Linux and why the total cost of ownership is higher for Linux compared to Windows. The company is also working with China and India to address piracy issues.

* P/E adjusted for cash & equivalents. **2001-04 Growth CAGR for S&P: 5.9% , MSFT: 12%. Adjusted median 2004 ROI for S&P: 14% , MSFT: >30%

Exhibit 1: Discounted Cash Flow Analysis Assumptions

	Growth CAGR 2002-05	Growth CAGR 2006-20	EBITA Margins 2005	EBITA Margins 2006-20	Operating Value	WACC Calculation	
Client	9.2%	4.5%	79.9%	67.0%	122,360	Risk Free Rate	4.2%
Information Worker	10.0%	4.9%	76.1%	65.0%	122,419	Risk Premium	5.3%
Server Platforms	20.7%	5.7%	33.5%	33.5%	63,742	Levered Beta	0.94
MSN	5.6%	15.1%	18%	30.0%	23,229	Cost of Equity	9.2%
Corporate & Other*					4,713	Weight of Equity	100%
Consolidated	11.9%	5.7%	43.0%	39.1%	336,463	WACC	9.2%

Note: Growth in perpetuity kept at 4.5%.

*Includes Mobile, Home & Entertainment, Business Solutions, R&D expenses and excess cash

Exhibit 2: Multiples Based Valuation

Microsoft Operating Enterprise Value / EBITA		Calculation of Peer Median EV/EBITA		Valuation Based on Peers Average EV/EBITA	
MV of common equity	279,280	Client	12	Est. 2006 EBITA	20,498
Options, pfd stock & other	1,880	Information Worker	13	Net EV at peers multiple	305,580
Debt, leases & pensions	2,356	Server	12	Add: Cash	36,955
Total Gross Enterprise Value	283,516	Business Solutions	13	Gross Enterprise Value	342,535
Less: Excess Cash	(36,955)	MSN	24	Less: Debt & other equity	(4,236)
Net Enterprise Value	246,561	Other	18		
Consensus 2006 EBITA	20,498				
Microsoft Net EV/EBITA	12.0	Weighted EV/EBITA	15.0	Implied Fair MV	338,299

Exhibit 3: Stock Price Sensitivity

