

### Microsoft — Some cracks in the windows, but Microsoft may surprise

#### Basic company Information and overview:

Microsoft engages in the development, manufacture, licensing and support of software products for various computing devices worldwide. The company was founded as a partnership in 1975 and incorporated in 1981. Its common stock is traded on the NASDAQ Stock Market under the symbol MSFT. Revenue is generated by developing, manufacturing, licensing and supporting a wide range of software products and services for many different types of computing devices. Its software products and services include operating systems for servers, personal computers and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solutions applications; high-performance computing applications; software development tools; and video games. The company provides consulting and product support services and trains and certifies computer system integrators and developers. Microsoft also designs and sells hardware including the Xbox 360 video game console, the Zune digital music and entertainment device and peripherals.

#### Microsoft's metrics are as follows:

Spot (\$)	26.55
Mkt Cap (\$mn)	223457
12M Fwd P/E	8.74
10 Average P/E	18.6
10 Average DY	2.17
FYE	30-Jun-13
P/Book ratio	3.25
12M trailing DY	3.13
12M Fwd DY	3.39

Source: Bloomberg, Anchor Capital

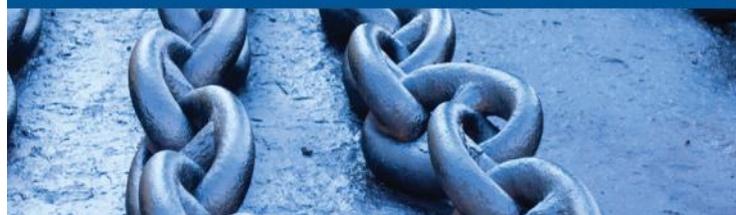
Online offerings and information are delivered through Live Search, Windows Live, Office Live, its MSN portals and channels and the Microsoft Online Services platform which includes offerings for businesses such as Microsoft Dynamics CRM Online, Exchange Hosted Services, Exchange Online, and SharePoint Online. The company enables the delivery of online advertising across its broad range of digital media properties and on Live Search through its proprietary adCenter® platform. Microsoft also researches and develops advanced technologies for future software products and services and it believes that delivering breakthrough innovation and high-value solutions through its integrated software platform is the key to meeting its customers' needs and to its future growth.

Microsoft believes it will continue to lay the foundation for long-term growth by delivering new products and services, creating new opportunities for partners, improving customer satisfaction and improving its internal processes.



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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.



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Its focus is to build on this foundation through ongoing innovation in its integrated software platforms; by delivering compelling value propositions to customers; by responding effectively to customer and partner needs; and by continuing to emphasise the importance of product excellence, business efficacy, and accountability.

**Notable dates (ignoring Server and Office):**

1975	Founded by Paul Allen and Bill Gates
To Aug 1995	Windows 1, 2, 3 and 3.1, Windows NT, Windows 95
FY98	Windows 98 launch
FY00	Windows 2000 launch Steve Ballmer becomes CEO
FY01	Windows XP launch
FY02	Xbox launch
FY03	Tablet PC launch – FAILURE (big, bulky and too early)
FY04	Large special dividend
FY06	Windows Live launch (internet based Windows) Xbox 360 launch
FY07	Windows Vista launch aQuantive acquisition (online advertising) for \$6bn - FAILURE
FY08	Bill Gates goes part-time
FY09	Bing search engine launch AAA credit rating awarded
FY10	Windows 7 launch
FY11	Office 365 (where Office meets the cloud) Partnership with Nokia Skype acquisition for \$8.5bn (biggest ever deal for Microsoft)
FY13	Windows 8 launch Surface tablet launch ('ultimate stage for Windows 8')

**Current state of the company:**

Year-end	MktCap	P/E	EPS	Net cash
June	\$225bn @	9.8x to June 2013	FY14 - \$3.24 (+11%)	\$5.1bn
	\$26.55 per share	(historical)	FY13 - \$2.92 (+7%)	
			FY12 - \$2.72 (+5%)	
			FY11 - \$2.59 (historical, or \$2.02 including goodwill write-off)	

Bill Gates and Paul Allen had a dream when they launched Microsoft in 1975 – to have a personal computer on every desk and in every home. Now there are more than 1bn Windows users around the world. Microsoft's operating system runs more than 90% of the computers out there.

However, the PC market is no longer growing like it did in the past and there are now more exciting computing devices for sale that offer mobility for users and other features like touchscreens, not just keyboards and mouse pads.

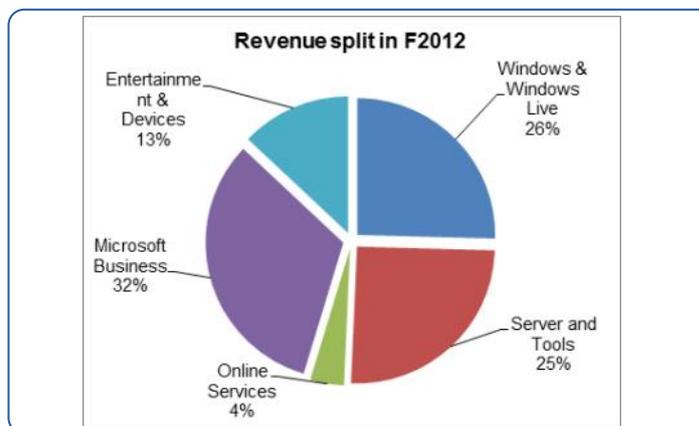
Microsoft has been too slow and probably too bureaucratic in responding to these changes in the market. They may have over 90% of the PC operating system (OS) market but they only have 4% of the smartphone OS market and 0% of the tablet market. If you combine all of these computing devices, Microsoft OS only runs 30% of software, and this number is declining. Some people even refer to Microsoft as a dying company.

Hence the launch of Windows 8, the biggest product launch in 17 years for Microsoft. Windows 8 is an operating system that will work on PCs, tablets and smartphones, although it will work best on a tablet. This is unlike Apple which has one operating system for PCs (OS X) and another one for tablets and smartphones (iOS – mobile version of OS X). The Windows 8 launch is described as a big gamble by many experts. The screen looks very different - there is no Start button and the user interface is very different with colourful tiles. This may feel great on a tablet with a touchscreen, but on a traditional PC with a mouse or touchpad, it can be confusing. Most analysts seem to be nervous about this launch and the press coverage is also 'touch and go.'

So this is Microsoft's attempt to move beyond the PC. The take-up will be slow for corporates because they are still upgrading to the PC friendly, Windows 7. The tablet has good potential, but unfortunately it may cannibalise their PC market. The smartphone opportunity may be tougher to pull off – they could come in at a distant third force in this market after Google (Android) and Apple. The dream scenario for Microsoft is that users see a real benefit in having virtually the same operating system for devices in the office, on the road and at home on the couch.

53% of revenue and around 75% of Microsoft's profits come from Windows and Office. The PC is important to both of these, although more so for Windows. Microsoft also sells a range of corporate products that are often underappreciated by investors (e.g. Servers and Tools and parts of Microsoft Business) and the outlook for these looks good.

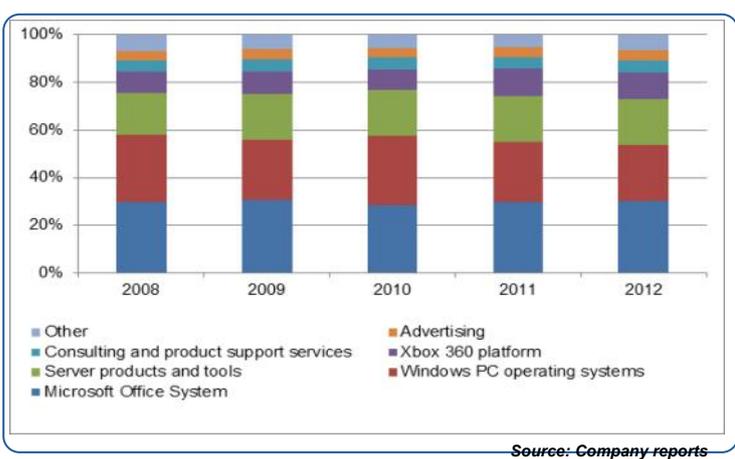
**Revenue split**



Source: Company reports

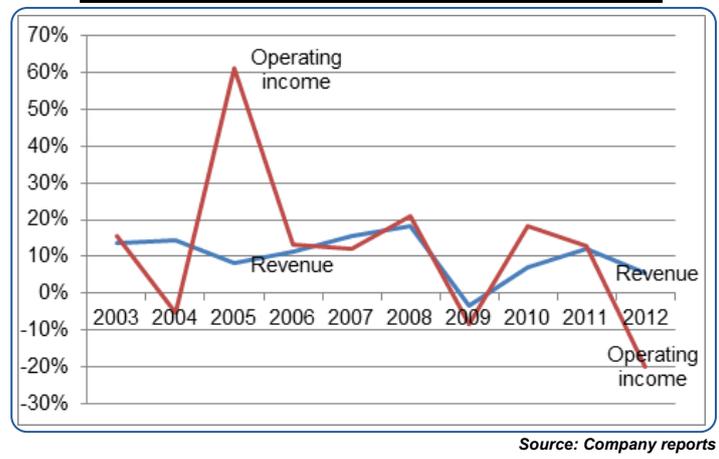
Microsoft Business and Servers and Tools have been the key growing categories making up 57% of revenue in FY12. These two areas are less dependent on PC sales, while the other major driver – Windows and Windows Live – is primarily dependent on PC sales. With the boom in the smartphone industry, PC sales have been under major pressure and much of the company's future will depend on how they are able to adapt to this.

**Revenue drivers:**



Take note of Windows PC operating system. For the reasons given above, this has declined from 28% of revenue in 2008 to 23% in 2012. This division has the highest operating margins along with Microsoft Office – both having margins above 60%.

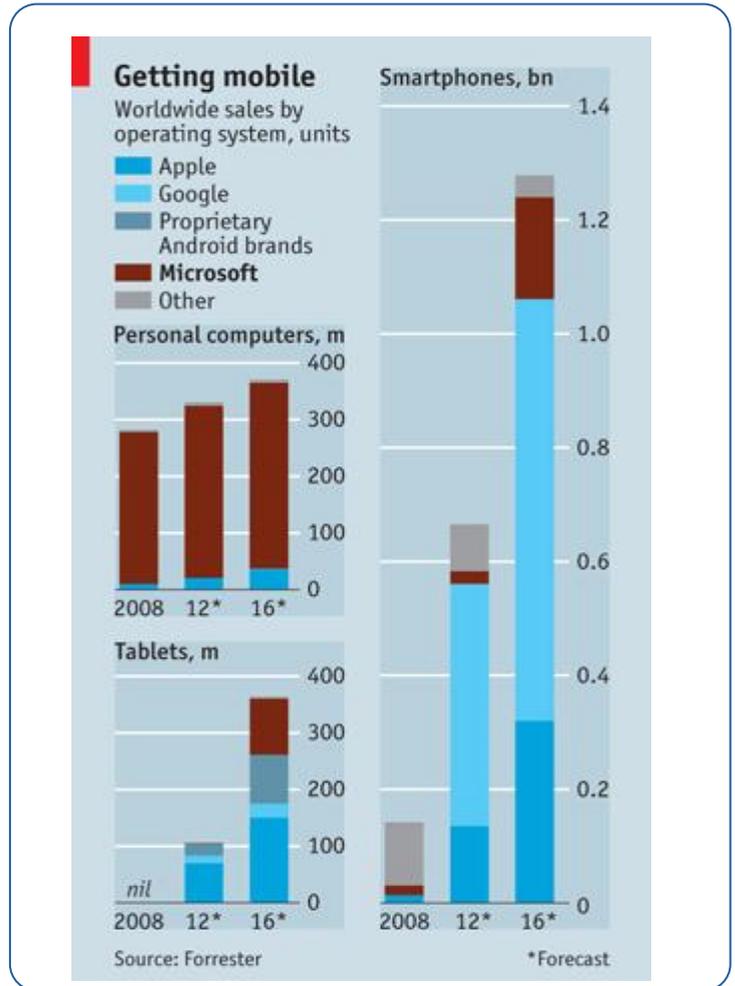
**YoY % change: Revenue and operating profit:**



Operating income in FY12 would have been up slightly vs the prior year if you exclude a \$6.2bn goodwill write-off for the aQuantive deal of 2007.

Revenue growth has slowed over the past two years with no growth in Windows due to the low growth in PC sales. Operating margins have been steady in the 35-39% range.

Note that Windows and Office are the biggest contributors to the company's operating profit.



Source: The Economist 25 Oct 2012

**Revenue sources per the five divisions:**

- Windows and Windows Live**  
 75% comes from Windows operating system software purchased by OEMs (i.e. PC companies). So the major driver is growth in PC sales. With Windows 8, Microsoft will be trying to add phone and tablet areas to this. To date it has been almost completely PC driven.

The three charts above show this opportunity. If you add PCs, tablets and smartphones, Microsoft's share of personal computing devices is only 30%. In PCs they have more than 90% of the operating system market, but this market has slowed in the past two years (decline expected in 2012), hurt by slightly lower sales to consumers and modest growth to businesses. The weak economy and the launch of Windows 8 would have had some impact here, as well as the competition from other computing devices like tablets.

There is some risk that business PC customers won't take to Windows 8, feeling that it is too gimmicky and they could wait for the next upgrade and possibly lose some faith in the company for trying to cover too many computing devices with one operating system. Either way, with Windows 7 still in the upgrade cycle we are likely to see a slower than usual pickup of Windows 8 by PC corporate customers, because of the reliance on a touch screen and new hardware to bring it to life fully.

In tablets, Microsoft is invisible even though they were premature in launching a tablet product way back in 2003. They launched the Surface on 25 October 2012 which is regarded as the 'ultimate stage for Windows 8.' If the Surface series of products therefore perform as expected, we could expect at least a 25% market share of this relatively new market by 2016 (total industry unit sales of 126mn expected in 2012). Using the chart above, this would imply roughly 100mn in sales of Microsoft-related tablets in 2016. Forecasts may be too conservative in this new category (April 2010 was the launch date of the previous iPad), but 100mn tablets would compare with say 400-450mn Microsoft driven PCs in 2016. This forecast for PC sales may be too optimistic if these tablets cannibalise the PC market for Microsoft. Competitors are obviously also aiming to replace PCs with tablets and PC hardware companies are annoyed with their old software ally – Microsoft – for going into the tablet hardware market.

Smartphones are the biggest category of all and Microsoft currently has a very small share of operating systems – about 4%. With Windows 8, Microsoft has the opportunity to take third place from RIM (Blackberry) but remain well behind the dominant Google and Apple operating systems. With the idea behind Windows 8 being a universal platform to allow for effortless transition for users between PCs, tablets and smartphones, we probably need the PC and tablet to lead the process of pushing Windows 8 into the market. Only then can the Windows smartphone become a key product.

Nokia, being reliant on Windows for smartphone software and potentially facing some cash flow problems, doesn't have too much time to wait. So they will push the product hard, with some help from telecom operators who are also keen to boost other smartphone providers. But for now it will be difficult to draw customers away from Google and Apple phones. Microsoft's share of smartphones should improve from such a low base, but it is difficult to project a substantial market share in the medium term. Microsoft is more likely to do better in tablets than smartphones.

- **Server and Tools**

55% of revenue comes from primarily multi-year volume licencing agreements. This division offers several different products that are driven by the corporate market. Revenue has grown nicely over the past two years – double-digits – and will likely continue to do so.

- **Online services**

The search engine Bing appears to be the main contributor

to revenue here. Market share is 16% in the US and growing slightly, but if you include their related Yahoo properties, market share has declined slightly. The problem here is that the division makes losses and management admit that their expectations for future growth and profitability are lower than their previous estimates. Don't expect much from this division.

- **Microsoft Business**

Like Servers and Tools, this division includes several products that are sold to businesses. 80% of sales are to businesses and depends on the number of information workers in a licenced enterprise and it is therefore less dependent than Windows on the number of PCs sold in a given year.

Microsoft Office is the key product category – 90% of total sales. This is the largest contributor to group sales and profits and continues to grow steadily.

The new Microsoft Office 2013 will launch in March and will reflect the major changes of Windows 8. This will be the most comprehensive Office product release ever.

- **Entertainment and devices**

Xbox is the largest contributor here. The competition is tough with Nintendo and Sony. Profitability is not that important to the company.



Source: Bloomberg, Company reports

**Valuation:**

The valuation multiples on Microsoft are very modest at around 10 times for both historic and forward earnings. The historic dividend yield is 2.8%. Forecast earnings growth is 11% in FY14 after a relatively flat year in FY13 (up around 5%). So the market is not expecting much growth. The expectations for Microsoft seem to be low.

The company has slowly but surely increased their dividend yielding to a decent 3.4% and is expected to remain in that region. On a DCF valuation, Microsoft could be worth \$60 i.e. double the current share price. This assumes modest single-digit revenue growth and margins settling at the 28% level - recently the range has been 35-39%. The long term hasn't applied to many tech companies yet except for IBM, so long-term projections can't be relied on. What is likely to drive the share price is better revenue growth on the back of Windows 8. The expectation of this happening is quite low. So there is a good opportunity in Microsoft if this product launch turns out to be successful. If it doesn't work then Microsoft will probably continue to grind down.

This looks like a value play. The problem with technology stocks is that value plays seldom work out, because these companies have a shorter life cycle than most other companies. There are many examples like Dell, Sun Microsystems, Yahoo and HP. Thus, when there is deep value it normally means the company is already on the way out. Apple was a rare exception when Steve Jobs was rehired to run the company and IBM moved strongly into services which is far more resilient.

It may be time for Steve Ballmer to leave the company. Microsoft's demise has happened on his watch. He has said NO to many innovations that would have taken Microsoft into new areas. His leaving could be positive for the company.

Fortunately the innovation cycle appears to be slowing for tech again after the flurry from Apple over the past five years. New product releases are just evolutionary and not revolutionary. This is good for an evolutionary company like the modern day Microsoft. It can just copy for a while. With expectations so low, it can be a very good time to buy into the company.

***FJ Veldman***



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