

Microsoft (MSFT)

Earnings Update

Hold | Market Perform

William Errett | February 1, 2024



Overview

Summary

Microsoft is a very large and very wide moat business. They benefit from all 4 types of moats: Switching Costs, Cost Advantages, Network Effects, and Intangible Assets regarding their Office Software Suite. They also have access to great growth opportunities that only serve to widen and strengthen their moat over time. Additionally, they have a great balance sheet with cash assets totaling \$144 Bn which is 5.9% of their \$2.44 Tr current market capitalization.

Microsoft printed solid results for their second quarter of FY23. However, it is important to note that there are some numbers here that are impacted by the recent acquisition of Activision Blizzard, so actual underlying results are a bit lower than the reported metrics. Microsoft beat on Revenue by 1.5% and beat on Earnings Per Share (EPS) by 6%. Revenue for the quarter came in at \$62.0 Bn, up 18% from the previous Q2. Operating Income was \$27.0 Bn up 33%, and Net income was \$21.0 Bn up 33%. Earnings Per Share for the quarter finished at \$2.93, a 33% increase from the year before.

Their Productivity and Business Processes segment printed revenue results of \$19.2 Bn which is up 13% from a year prior. This was based on a 15% increase in Office Commercial products and cloud services driven by Office 365 Commercial revenue growth of 17%. Office Consumer products and cloud services revenue have increased 5%. Microsoft 365 Consumer subscribers grew to 78.4 million. Revenue from LinkedIn increased by 9% during the quarter. And finally, Dynamics products and cloud services revenue have increased 21%.

Revenue in Intelligent Cloud was \$25.9 Bn, which was up 20%. This was primarily driven by a 22% increase in revenue from server products and cloud services. This was impacted by a 30% increase in their Azure revenues.

The Revenue from Personal Computing came in at \$16.9 Bn up 19%. This came from a 9% increase in Windows revenue, partially offset by a 9% decline in revenue from devices. Microsoft is currently phasing out some devices that are low margin for the business, so until they complete that process this segment is expected to decline slightly. Xbox Content revenue increased 61% (55% was contributed from Activision) and search and news advertising increased 8%.

Microsoft provided future guidance for their segments for Q3 this year. They expect Productivity and Business processes to grow by about 11%. In Intelligent Cloud they expect growth of between 18% and 19% for the next quarter. And for More Personal Computing they expect growth between 11 and 14%.

This brings their expectations for revenue to roughly \$60 Bn, up by 13% from Q3 FY22. They expect Operating income finish at roughly \$26.2 Billion net of amortization from the Activision acquisition, up by about 17%. And finally, with a tax rate expected to be 18% this leaves Net Income at an estimated \$21.0 Bn which would be up by about 14%.

Microsoft is a great business and has an attractive market ahead of them. Due to the large number of unique products that benefit from many different market forces it can be hard to predict this business. Based on my analysis of a combination of value bands and the fair value at an 11% growth rate, I recommend to HOLD our shares.

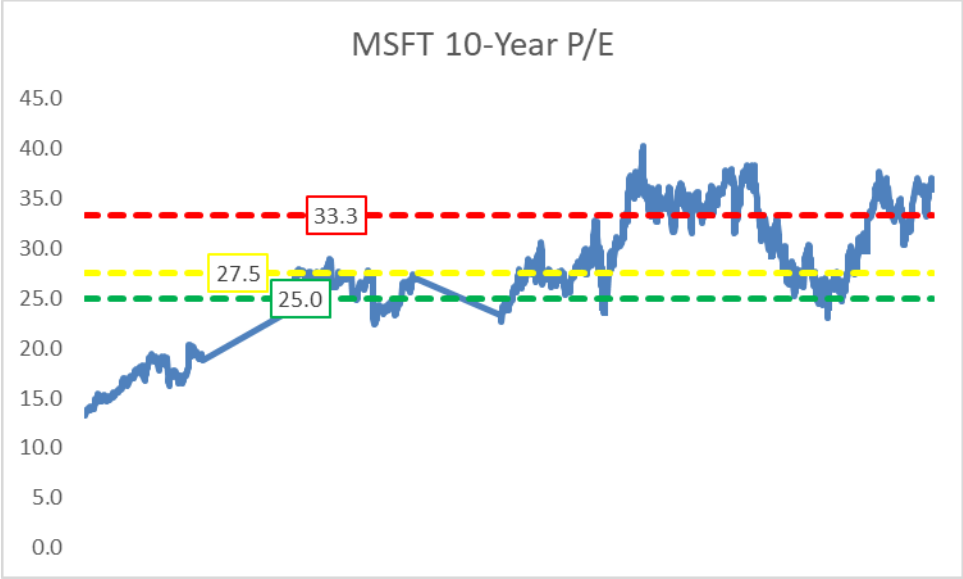
IOFS

Microsoft is an excellent company when it comes to Interpretation of Financial Statements (IOFS) analysis. The currently pass all our metrics except for Capital Expenditures as a percentage of Net Income, which is 42.6%. However, in all other metrics Microsoft exceeds our thresholds by a large margin.

	2014-06	2015-06	2016-06	2017-06	2018-06	2019-06	2020-06	2021-06	2022-06	2023-06	TTM
IOFS											
Revenue	\$ 86,833	\$ 93,580	\$ 91,154	\$ 96,571	\$ 110,360	\$ 125,843	\$ 143,015	\$ 168,088	\$ 198,270	\$ 211,915	\$ 227,583
Gross profit	\$ 59,755	\$ 60,542	\$ 58,374	\$ 62,310	\$ 72,007	\$ 82,933	\$ 96,937	\$ 115,856	\$ 135,620	\$ 146,052	\$ 158,735
Operating Income	\$ 27,886	\$ 28,172	\$ 27,188	\$ 29,331	\$ 35,058	\$ 42,959	\$ 52,959	\$ 69,916	\$ 83,383	\$ 88,523	\$ 100,533
Net Income	\$ 22,074	\$ 12,193	\$ 20,539	\$ 25,489	\$ 16,571	\$ 39,240	\$ 44,281	\$ 61,271	\$ 72,738	\$ 72,361	\$ 82,541
Free Cash Flow	\$ 27,017	\$ 23,724	\$ 24,982	\$ 31,378	\$ 32,252	\$ 38,260	\$ 45,234	\$ 56,118	\$ 65,149	\$ 59,475	\$ 67,445
EBIT	\$ 28,417	\$ 19,288	\$ 26,882	\$ 32,123	\$ 39,207	\$ 46,374	\$ 55,627	\$ 73,448	\$ 85,779	\$ 91,279	\$ 103,622
EBITDA	\$ 33,629	\$ 25,245	\$ 33,504	\$ 40,901	\$ 49,468	\$ 58,056	\$ 68,423	\$ 85,134	\$ 100,239	\$ 105,140	\$ 120,925
Dividend Yield %	2.57	2.74	2.72	2.22	1.67	1.34	0.98	0.81	0.94	0.78	0.69
Gross Margin	68.8%	64.7%	64.0%	64.5%	65.2%	65.9%	67.8%	68.9%	68.4%	68.9%	69.7%
Operating Margin	32.1%	30.1%	29.8%	30.4%	31.8%	34.1%	37.0%	41.6%	42.1%	41.8%	44.2%
Net Margin	25.4%	13.0%	22.5%	26.4%	15.0%	31.2%	31.0%	36.5%	36.7%	34.1%	36.3%
FCF Margin	31.1%	25.4%	27.4%	32.5%	29.2%	30.4%	31.6%	33.4%	32.9%	28.1%	29.6%
D&A/ Gross Profit	8.7%	9.8%	11.3%	14.1%	14.3%	14.1%	13.2%	10.1%	10.7%	9.5%	10.9%
Capex/ Net Income	24.8%	48.7%	40.6%	31.9%	70.2%	35.5%	34.9%	33.7%	32.8%	38.8%	42.6%
Dividend Payout ratio	245.8%	122.3%	54.3%	47.1%	77.5%	35.6%	34.5%	27.2%	25.1%	27.5%	25.2%
Shares Outstanding	8399.0	8254.0	8013.0	7832.0	7794.0	7753.0	7683.0	7608.0	7540.0	7472.0	7468.0
Returns %											
ROE	26.2	14.4	27.0	31.9	19.4	42.4	40.1	47.1	47.2	38.8	39.6
ROTE	35.6	20.2	37.8	54.9	40.7	85.7	73.5	80.4	84.5	66.8	39.6
ROIC	26.5	19.6	21.8	20.8	11.7	25.5	25.8	30.3	29.7	24.9	39.6
ROCE	24.5	15.3	20.8	19.5	19.9	22.2	24.9	31.0	33.3	31.6	39.6
ROA	14.0	7.0	11.2	11.5	6.5	14.4	15.1	19.3	20.8	18.6	39.6
ROC	247.1	139.1	162.5	132.1	118.0	115.9	115.0	118.8	108.3	92.4	39.6
Leverage & Liquidity											
LT Debt	20645	27808	40557	81445	77810	72850	67249	59703	58521	54718	59083
ST Debt	2000	7484	12904	10121	3998	5516	3749	8072	2749	5247	29291
PF Stock	0	0	0	0	0	0	0	0	0	0	0
Leases*7	0	0	0	0	0	0	0	0	0	0	0
Pension SF											
Cash	\$ 8,669	\$ 5,595	\$ 6,510	\$ 7,663	\$ 11,946	\$ 11,356	\$ 13,576	\$ 14,224	\$ 13,931	\$ 34,704	\$ 17,305
Obligation Ratio ⁽¹⁾	0.6x	2.4x	2.3x	3.3x	4.2x	1.7x	1.3x	0.9x	0.7x	0.3x	0.9x
Cash/ Revenue	10.0%	6.0%	7.1%	7.9%	10.8%	9.0%	9.5%	8.5%	7.0%	16.4%	7.6%
Per Share Data											
Owners Earnings	\$ 8.28	\$ 7.57	\$ 3.27	\$ 4.24	\$ 4.60	\$ 5.23	\$ 6.04	\$ 7.99	\$ 9.05	\$ 8.11	\$ 9.77
Earnings	\$ 2.63	\$ 1.48	\$ 2.56	\$ 3.25	\$ 2.13	\$ 5.06	\$ 5.76	\$ 8.05	\$ 9.65	\$ 9.68	\$ 11.06
Operating Cash Flow	\$ 3.87	\$ 3.59	\$ 4.16	\$ 5.04	\$ 5.63	\$ 6.73	\$ 7.90	\$ 10.09	\$ 11.81	\$ 11.72	\$ 13.75
Free Cash Flow	\$ 3.22	\$ 2.87	\$ 3.12	\$ 4.01	\$ 4.14	\$ 4.94	\$ 5.89	\$ 7.38	\$ 8.64	\$ 7.96	\$ 9.04
Dividends	\$ 1.07	\$ 1.21	\$ 1.39	\$ 1.53	\$ 1.65	\$ 1.80	\$ 1.99	\$ 2.19	\$ 2.42	\$ 2.66	\$ 2.79
Book Value	\$ 10.90	\$ 9.98	\$ 9.22	\$ 11.38	\$ 10.78	\$ 13.39	\$ 15.63	\$ 18.88	\$ 22.31	\$ 27.75	\$ 32.06
Tangible Book Value	\$ 7.61	\$ 7.26	\$ 6.45	\$ 5.51	\$ 5.08	\$ 6.88	\$ 8.97	\$ 11.24	\$ 11.75	\$ 17.35	\$ 12.03

Due to the cost advantages surrounding software, the larger that Microsoft grows the more margin expansion they can realize because of operating leverage. Return on Equity for the last 12 months was 39.4% and even adding debt to get Return on Invested Capital it only drops to 26.1%. When it comes to the obligation ratio their current obligation ratio is 0.1x which is slightly higher than normal due to a larger cash balance. However, the highest they their obligation ratio has been in the last 5 years was 1.7x.

Valuation



Microsoft’s multiple has continued to increase over the last 10 years. This makes them considered overvalued at this current multiple of 36.5x earnings. Due to an exit multiple averaging 25x in the model, earnings per share would have to grow at exceptional rates for the next 5 years to afford a positive margin of safety.

5 Year Discounted Cash Flow											
Ticker: MSFT											
Price: \$403.80											
								Total Return			
								P/E	Price	PV	Annual
										5 YR Return	Return
Bear	EPS	Current	2024	2025	2026	2027	2028	25.0x	\$ 443.47	\$ 277.61	9.8%
		\$ 11.06	\$ 12.06	\$ 13.14	\$ 14.32	\$ 15.61	\$ 17.02	27.0x	\$ 477.50	\$ 298.74	18.3%
			9.0%	9.0%	9.0%	9.0%	9.0%	29.0x	\$ 511.54	\$ 319.88	26.7%
											4.8%
Base	EPS	Current	2024	2025	2026	2027	2028	25.0x	\$ 485.03	\$ 303.51	20.1%
		\$ 11.06	\$ 12.28	\$ 13.63	\$ 15.13	\$ 16.79	\$ 18.64	27.0x	\$ 522.31	\$ 326.65	29.3%
			11.0%	11.0%	11.0%	11.0%	11.0%	29.0x	\$ 559.58	\$ 349.79	38.6%
											6.7%
Bull	EPS	Current	2024	2025	2026	2027	2028	25.0x	\$ 529.68	\$ 331.32	31.2%
		\$ 11.06	\$ 12.50	\$ 14.12	\$ 15.96	\$ 18.03	\$ 20.38	27.0x	\$ 570.44	\$ 356.62	41.3%
			13.0%	13.0%	13.0%	13.0%	13.0%	29.0x	\$ 611.19	\$ 381.93	51.4%
											8.6%

