

DELTA OUTCOMES GLOBAL LEADERS / INVESTMENT STORY

Why We Own Microsoft

An employee can leave a Teams meeting with a transcript, action list and draft follow-up already prepared. A developer can ask GitHub Copilot to write or review code. A finance team can interrogate a spreadsheet in natural language. To the user, these look like new software features. To Microsoft, they are another layer of intelligence sold through products and relationships already embedded in how organisations work.

That is the starting point for the investment case. Artificial intelligence is not a separate business sitting beside Office and Azure. It is becoming a new source of demand across an installed base Microsoft has spent decades building. The question is whether the company can convert that demand into durable earnings at a return high enough to justify the capital now being spent on data centres, chips, power and networks.

Structural demand, with a very large bill attached

Companies are moving more computing into the cloud, digitising workflows and adding AI to software employees already use. This creates demand for three things Microsoft can sell together: infrastructure through Azure, applications through Microsoft 365 and Dynamics, and the data, developer and security tools connecting them.

The adoption evidence is meaningful. In Microsoft's fourth quarter of fiscal 2026, Azure and other cloud-services revenue grew 43% year on year. Azure revenue exceeded \$100 billion for the full year for the first time, while Microsoft 365 Copilot passed 30 million paid seats. Microsoft Cloud revenue reached \$214.4 billion for the year, up 27%, and commercial remaining performance obligations - contracted revenue not yet recognised - ended the year at \$678 billion.

That last number needs discipline. The headline backlog rose 84%, partly because of very large OpenAI commitments. Excluding OpenAI, it still grew 25%, and management said all sequential growth in the quarter came from customers outside frontier-model companies. Demand is therefore broader than one relationship, but investors should not treat the headline backlog as a simple measure of diversified demand.

The advantage is distribution and integration

Microsoft's advantage is not that it invented every important technology it sells. It is that Azure, Microsoft 365, GitHub, Dynamics, security and enterprise data tools increasingly reinforce one another.

For existing customers, Copilot adds AI to software licensed, governed and connected to company data. GitHub can feed workloads into Azure, while identity, cybersecurity and data governance sit in the same ecosystem.

That integration reduces friction and creates switching costs. It also gives Microsoft several routes to monetise the same structural trend: cloud consumption, premium software seats, security products, developer services and data workloads.

The advantage is not permanent. AWS and Google remain formidable, open-source models can lower costs, and customers increasingly want flexibility across clouds and model providers. Microsoft must prove integration creates better economics, not simply greater dependence.

Where Microsoft fits

Microsoft sits primarily within Delta's Climate Action theme. That is less obvious than for an electrification or insulation company, so it needs careful explanation.

AI and cloud computing are becoming material sources of electricity demand. If they continue to scale, the sector will require enormous additions of generation, grids, cooling, water systems and lower-carbon building materials. Microsoft's size means the way it buys power and designs data centres can influence those markets.

That does not make every AI workload environmentally beneficial, and it is not, on its own, why we own the shares. Climate Action identifies a structural constraint Microsoft must help solve if its cloud and AI platform is to keep growing. Human Advancement and Nature Innovation also appear through productivity, water and materials, but the investment case still has to stand on Microsoft's economics and on the people running the business.

How adoption becomes earnings

Fiscal 2026 revenue reached \$331.8 billion, up 18%, while operating income rose 21% to \$155.2 billion - an operating margin of roughly 47%. Cash from operations reached \$182.9 billion.

Microsoft Cloud revenue grew 27% for the year. In the fourth quarter, Intelligent Cloud revenue rose 32%, with Azure up 43%, while Microsoft 365 and Dynamics add recurring subscription economics around that infrastructure base.

But AI is changing the cost structure too. Microsoft Cloud gross margin fell from 69% in fiscal 2025 to 66% in fiscal 2026 as Azure became a larger part of the mix and AI infrastructure costs increased. Additions to property and equipment jumped from \$64.6 billion to \$115.9 billion in one year - roughly 63% of fiscal 2026 operating cash flow. Net property and equipment

reached \$313.1 billion at June 2026, with another \$34.6 billion committed to buildings and improvements, primarily data centres.

This is the causal chain we test: enterprise adoption drives cloud and software revenue; Microsoft's installed base supports recurring demand and pricing; scale produces exceptional profit and cash flow; but more of that cash must now be reinvested in physical infrastructure. The investment works only if the new capacity earns attractive incremental returns, and valuation discipline determines whether those economics justify ownership.

A financially strong business, not just a good story

A compelling theme only matters if the company behind it can pay for what the theme demands. For Microsoft that question is unusually concrete: the AI build-out now requires more than \$100 billion of capital spending a year, and only a genuinely profitable business can fund that without eroding what shareholders own. So before getting carried away with the story, we ask a simpler question: is this a genuinely well-run, profitable company? On the historical record, clearly yes - though that record now has to be read alongside a capital programme that is changing the shape of the business.

Profitability. Microsoft earns exceptional profits on the money invested in it. Its return on shareholders' equity - essentially, how much profit it generates for every dollar shareholders have invested - has held at around 30% or above in each of the past three fiscal years, at roughly 33% in fiscal 2024 and 30% in both fiscal 2025 and fiscal 2026, even as the equity base grew by around two-thirds. Its operating margin has risen every year over the same period, from around 42% in fiscal 2023 to almost 47% in fiscal 2026 - a level very few companies of any size achieve. The broader picture is more nuanced: gross margin has eased from around 70% to 68% over the past three years as lower-margin AI infrastructure becomes a larger share of the mix. Microsoft has so far offset that pressure through cost discipline, with headcount 2% lower over the year to June 2026, but gross margin is where the cost of the build-out shows first.

Earnings growth. Profit has grown faster than sales. Over the three years to fiscal 2026, revenue grew at around 16% a year, while operating income compounded at around 21% a year and earnings per share at around 23% - the clearest marker that the business is becoming more profitable as it grows, not just bigger. The fiscal 2026 bottom line needs one caveat: reported earnings were lifted by gains on Microsoft's AI investments, including a \$3.2 billion gain in the fourth quarter alone, so operating income growth of 21% is the cleaner measure of the underlying business. Momentum carried into the final quarter, when revenue rose 18% to \$90.0 billion and operating income 18% to \$40.6 billion. Management guidance for fiscal 2027 points to double-digit growth in both revenue and operating income, with the operating margin expected to decline by less than a point - a forecast rather than a result, but one that indicates

heavier depreciation from the build-out is expected to be absorbed rather than to overwhelm profit growth.

Shareholder returns. Ultimately, none of this matters to an investor unless it shows up in the share price. Over the five years to the end of 2025, Microsoft's shares delivered a total shareholder return - share price growth plus dividends - that compounded at around 18% a year. That average was not a smooth ride: the shares fell by more than a quarter in 2022, and by almost a fifth again in the first seven months of 2026 as investors questioned whether AI spending would earn its keep, before recovering by around a quarter from their late-July level in the weeks after the fiscal fourth-quarter results. Microsoft's returns have tracked its improving profitability over time, but the market is now pricing the capital programme as a genuine risk, and is likely to keep doing so.

None of this is guaranteed to continue, and the scale of capital spending is a real test of it - but it gives us real confidence that Microsoft has both the profitability and the financial discipline to fund the infrastructure its investment case now depends on.

Leadership we can trust

A good business also needs to be well led, and Microsoft has the structural protections we look for. Every director stands for election each year under a majority-voting standard, giving shareholders a regular and meaningful say over who governs the company. There is only one class of listed share, so voting control stays aligned with economic ownership. The board's own effectiveness is reviewed annually with an independent facilitator, and the themes arising from that review are disclosed publicly rather than kept behind closed doors. The board draws on a broad mix of financial, industrial, technology and public-policy experience, with a steady cadence of new appointments. Executive pay is weighted heavily towards multi-year performance: the large majority of the Chief Executive's target pay is performance-based and delivered in shares, with payouts adjusted for total shareholder return relative to the wider US market, and more than 91% of votes cast supported the pay programme at the most recent advisory vote.

Capital allocation is a clear strength. Return on invested capital has stayed well above our 9% hurdle throughout the period we assess; it has eased from its fiscal 2021 peak as the asset base expands, but at around 24% in fiscal 2025 it remains more than two and a half times that hurdle, and Microsoft returned more than \$43 billion of cash to shareholders in fiscal 2026 while funding the largest investment programme in its history. Our engagement priorities centre on independence at the top of the house. The Chief Executive also chairs the board - a combination balanced by a well-defined Lead Independent Director role covering executive sessions, the Chief Executive's evaluation and succession planning - and several long-serving directors are reaching the tenure at which we no longer treat them as independent. Continued board refreshment, and in time a separation of the Chair and Chief Executive roles, would

strengthen an already sound structure. Taken together, this gives us confidence that Microsoft is led by a management team that allocates capital with discipline and acts in the long-term interests of shareholders and other stakeholders.

Outcome evidence - and the contradiction we should not hide

Microsoft's environmental evidence is useful because it shows both progress and pressure.

In its 2026 Environmental Sustainability Report, covering fiscal 2025, Microsoft reported that it matched 100% of annual global electricity consumption with renewable energy and replenished more than 14.2 million cubic metres of water - more than it withdrew globally for the first time. It also reported a 23% year-on-year improvement in water usage effectiveness at its Phoenix data centres after cooling-system changes.

But total Scope 1, 2 and 3 emissions increased 25% year on year. Microsoft attributes that mainly to rapid data-centre expansion and its decision to stop relying on certain non-additional, unbundled renewable-energy certificates in its reported accounting.

Those facts belong together. Annual renewable matching is not the same as operating every data centre on carbon-free electricity every hour, and water replenishment does not eliminate local water impacts. Rising absolute emissions show that AI growth is making Microsoft's 2030 commitments harder.

For us, the climate case should be judged by whether Microsoft can reduce the resource intensity of computing, bring genuinely additional clean power onto grids and ultimately bend absolute emissions down while the business grows. These are company-reported figures, and we hold them to the same evidentiary standard we apply to the financial and governance claims above.

Value, decision, and tension

We own Microsoft because three things line up: a durable, structural source of demand in cloud computing and AI, met through one of the strongest distribution systems in enterprise technology and tied to a climate constraint Microsoft must help solve to keep growing; a genuinely high-quality business behind it, with returns on equity around 30%, operating margins that have risen for three years and earnings growing faster than sales; and a leadership team whose capital discipline and accountability to shareholders we trust, with clear priorities for strengthening board independence further.

We do not own it on the assumption that every AI workload is socially or environmentally beneficial, that today's cloud margins are permanent, or that capital spending on this scale will automatically earn attractive returns. The central tension is that Microsoft is no longer only

a capital-light software compounder; it is becoming one of the world's largest builders of physical digital infrastructure. Capital expenditure almost doubled in fiscal 2026, cloud gross margins are already showing the effect, and a meaningful part of the headline backlog rests on commitments from a small number of frontier-model companies.

In mid-September 2026, Microsoft's shares traded at \$490.30, around 24.8 times current-year consensus earnings, with the consensus price target of \$571.38 sitting around 16% above the share price. That is not an undemanding valuation for a business in the middle of its heaviest-ever investment cycle, and it assumes that Azure and AI keep compounding strongly on a much larger capital base. A great business can still be a poor investment if the price assumes flawless execution. Valuation discipline, not enthusiasm for AI, is what ultimately governs position sizing.

What could break the chain

A number of things could weaken this thesis, and we watch for all of them:

- Demand could slow while spending does not. Azure growth could decelerate as capacity constraints ease or enterprise AI budgets tighten, Copilot adoption could stall below the level that justifies premium pricing, and backlog tied to frontier-model customers could convert more slowly or less reliably than the broader customer base.
- The build-out could prove harder or costlier than planned. Access to power, grid connections, water, chips and community consent could delay capacity or raise its cost, while regulatory, copyright and competition scrutiny could alter the economics of AI services and distribution.
- The financial strength we describe above is a track record, not a guarantee. Gross margins could keep falling without offsetting operating leverage; the extension of data-centre useful lives from 15 to 25 years flatters near-term depreciation rather than reflecting a genuine efficiency gain; fourth-quarter free cash flow fell 23% as capital spending rose; and return on invested capital, already below its peak, needs to stay well above the cost of capital as the asset base grows.
- Competition could erode pricing power. AWS and Google remain formidable, and cheaper open-source models or multi-cloud strategies could commoditise parts of the AI stack faster than integration protects Microsoft's margins.
- The impact case can also fail on its own terms. Total emissions rose 25% in the latest reported year, annual renewable matching is not hourly carbon-free power, and efficiency gains per unit of computing can be overwhelmed by growth in total demand.

The thesis would weaken materially if Azure growth slowed sharply while capital spending stayed elevated, if returns on the new capacity drifted towards the cost of capital, if cloud

margins kept falling without future operating leverage, or if absolute emissions kept rising with no credible path back towards Microsoft's 2030 commitments. It would also weaken if valuation left no margin of safety for those risks.

Microsoft is compelling because it owns one of the strongest distribution systems in enterprise technology and is converting AI from an experiment into a paid product inside existing workflows - and because the company doing it is, by the numbers, one of the most profitable large businesses we cover, overseen by leadership whose capital discipline we trust. The next phase of the investment case will not be proved by more AI announcements. It will be proved by whether Microsoft can turn enterprise necessity into durable cash flows: whether the enormous capital being deployed earns strong incremental returns, funded by real financial strength, and whether that infrastructure can grow without transferring unacceptable costs to shareholders, customers, communities or the environment.

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