Stock Market Review

Was this a lost decade for Microsoft shareholders?

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Microsoft Corporation	2008	2009	2010	2011
Year End – 30 June	$million	$million	$million	$million
Revenue	60,420	58,437	62,484	69,943
EBITDA	24,548	22,925	26,771	29,927
Profit after tax	17,681	14,569	18,760	23,150
Cash flow from operations	21,612	19,037	24,073	26,994
Shareholders' Funds	36,286	39,558	46,175	57,083
Net Margin *(%)*	29.26	24.93	30.02	33.10
Return on Equity *(%)*	48.73	36.83	40.63	40.55
Dividends per share	$0.440	$0.520	$0.520	$0.640
Value of Share Buy-Backs	12,424	8,200	10,836	11,458

Over recent years, there has been a growing debate among investors on whether one should focus on Apple Inc as a core technology holding in an investment portfolio or whether Microsoft Corporation offers a more rewarding investment. Microsoft is often seen as the fading star compared to Apple not only from a product roll-out perspective but also in the investment world given the staggering difference in their share price performances over the past years.

In fact, a 10-year comparison of the share price movements of Microsoft versus Apple shows a 22 per cent drop in Microsoft's share price which is in sharp contrast to the extraordinary upturn of 3,740 per cent for Apple. In December 2001, shortly after Apple introduced the iPod, its share price was at $11 per share and this has since surged to circa $400 per share! Taking a more recent trend gives similar results with a flat share price for Microsoft over the past six years and a 450 per cent growth in the share price of Apple.

This naturally impacted the overall value of both businesses with Apple briefly becoming the most valuable company in the world shortly before the demise of Steve Jobs a few months ago. Apple currently has an overall value of circa $380 billion while the market capitalisation of Microsoft has remained languishing in the region of $220 billion.

Apple shareholders who have held shares for the past few years are naturally thrilled by the substantial gains accumulated, whereas Microsoft shareholders are undoubtedly disappointed with their investment performance. So can the turn of the century be regarded as a lost decade for Microsoft shareholders?

Although the share price shows one side of the picture, the financial performance of Microsoft provides a different scenario. Microsoft managed to double its profitability in the past five years despite the significant competition that emerged and the criticism leveled on the company for failing to innovate more rapidly and entering into other growth areas such as mobile telephony where Apple became so successful.

While the share price traded sideways for most of this time, the recent financial performance has been excellent and this should be one of the key elements when analysing the investment rationale for Microsoft. Rising profitability levels and a stable share price bring a lower price to earnings multiple, which is normally a clear buying signal for the market.

In the 1990s, Microsoft's price earnings ratio peaked at an extraordinary level of 50 times. This dropped to circa 21 times in 1996 and decreased further to circa 10 times at current share price levels. The high profitability growth (and subsequent drop in the price to earnings multiple) resulted from the average revenue growth of circa 12.5 per cent per annum over the last five years. Concurrently, Microsoft maintained a net profit margin of an average of circa 29 per cent per annum over recent years and an average return on equity of approximately 40 per cent every year.

Moreover, although dividend payments to shareholders have grown over the years, the company's cash generation remains very strong (over $20 billion per annum) and the balance sheet is robust on many counts. As at September 30, 2011, Microsoft held cash and short-term investments totalling $57 billion with "only" $12 billion in borrowings.

> **“Although dividend payments to shareholders have grown over the years, the company's cash generation remains very strong”**

These strong fundamentals indicate a compelling investment case. However, it is surprising that the market continues to price Microsoft at such a low multiple. Does this indicate concerns on increased competition and below-average growth in future years?

In the 1980s and 1990s, Microsoft was regarded as the most successful IT company at a time when Apple Inc was struggling for survival and few other companies really offered stiff competition. However, some critics argue that as Microsoft grew so rapidly it became over-confident, it lacked creativity and it also made bad acquisitions.

The former CEO of Apple, the late Steve Jobs, offered his fair share of criticism towards Microsoft. In fact, in his biography published recently he says Microsoft have "become mostly irrelevant" and will continue "to lag in the post-PC world". Apple's former CEO claimed that Microsoft "were never as ambitious product-wise as they should have been".

Apple and more recently Google (with its Android operating system) competed successfully with Microsoft's Windows solution. In fact, Apple's extraordinary success with the iPhone and iPad were the main causes for the recent decline in the sales of Windows for the first time ever.

However, analysts who support Microsoft's investment case are of the view that the upcoming launch of Windows 8 could provide a boost to Microsoft in 2012 by offering stiffer competition to Apple and Google since this new operating system is tailored for tablets. Moreover, Microsoft is also planning a different Windows version for mobile phones. Additionally, sales of Windows are also likely to accelerate in the coming years since Microsoft will discontinue support for the Windows XP in 2014, thereby forcing the business segment to upgrade to the new Windows system.

A differentiating factor between the two tech giants in recent years was that while Apple concentrated on both the software and the hardware of the product chain, Microsoft focused solely on software and only entered the hardware area with the Xbox. This is where the recent partnership with Nokia could contribute to market share gains in 2012 and beyond. In contrast to Microsoft, Nokia's core strength was hardware rather than software.

In September 2010, Nokia hired ex-Microsoft employee Stephen Elop as its new CEO. The new CEO ditched Nokia's development of its own Symbian operating system and instead signed a deal with Microsoft in which Nokia committed to produce mobile phones that would run exclusively on the Windows operating system. Although Nokia's share of the global smart phone market has nearly halved within the last few years, some analysts claim that Microsoft will benefit from Nokia's still strong brand name and its wide global distribution network. Additionally, the Nokia-Microsoft alliance could extend beyond mobile phones to tablets providing Microsoft with an opportunity to compete more aggressively with Apple and Google in the tablet market.

Some of Microsoft's key strengths were highlighted by the international credit rating agency Fitch when last week it maintained the company's rating at AA+ with a stable outlook. In its report, Fitch indicated that although volumes of personal computers are expected to decline and lead to lower revenue from Windows, this decline is expected to be offset by continued strong revenue growth from businesses reflecting robust enterprise demand. The rating agency also expects Microsoft to continue to produce strong cash flows in excess of $15 billion per year, which will support dividend payments and the ongoing share buy-back programme. Microsoft has another $11.2 billion remaining under its current share repurchase programme expiring in September 2013.

Notwithstanding the fundamental strengths evident in Microsoft's financial statements and its recurring business potential, the stock market continues to view the company in a pessimistic method as evidenced by the depressed share price and the low price to earnings ratio. However, the low valuation could provide an opportunity for long-term investors to benefit from a potential re-rating of the company in the future if it can prove to compete more aggressively with Apple and Google and if it can continue to generate equally strong cash flows as it has done in recent years. Over the longer-term, price and value normally converge on the stock market and this value investing philosophy lies behind the famous statement of Benjamin Graham and Warren Buffet "price is what you pay and value is what you get".