ZACKS INVESTMENT RESEARCH

January 24, 2014

Microsoft Corp. (MSFT-NASDAQ)

Current Recommendation	NEUTRAL
Prior Recommendation	Underperform
Date of Last Change	12/18/2013
Current Price (01/23/14)	$36.06
Target Price	**$38.00**

SUMMARY

Microsoft is one of the largest software companies in the world. Its operating systems are installed on the majority of computers anywhere in the world. Fiscal second quarter 2014 earnings exceeded the Zacks Consensus Estimate. The reorganization of the business and "devices and services" model are encouraging, but execution risks are considerable. The departure of CEO Ballmer at this juncture may be a good thing, but does not alleviate near-term uncertainties. Additionally, competition remains stiff and Microsoft's dominant position in the PC market continues to be challenged by new-age devices. However, considering the fact that the promising new products, enterprise refresh cycle and cost reduction initiatives will continue to generate sizeable cash flows, we are reiterating our Neutral recommendation on Microsoft shares.

SUMMARY DATA

52-Week High	$38.94
52-Week Low	$27.15
One-Year Return (%)	33.60
Beta	0.95
Average Daily Volume (sh)	32,079,574
Shares Outstanding (mil)	8,348
Market Capitalization ($mil)	$300,986
Short Interest Ratio (days)	1.94
Institutional Ownership (%)	68
Insider Ownership (%)	9
Annual Cash Dividend	$1.12
Dividend Yield (%)	3.11
5-Yr. Historical Growth Rates	
Sales (%)	6.9
Earnings Per Share (%)	12.0
Dividend (%)	18.1
P/E using TTM EPS	13.3
P/E using 2014 Estimate	13.7
P/E using 2015 Estimate	12.5
Zacks Rank *: Short Term 1 – 3 months outlook	4 - Sell

* Definition / Disclosure on last page

Risk Level *	Below Avg.,
Type of Stock	Large-Growth
Industry	Comp-Software
Zacks Industry Rank *	170 out of 267

ZACKS CONSENSUS ESTIMATES

Revenue Estimates

(In millions of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2012	17,372 A	20,885 A	17,407 A	18,059 A	73,723 A
2013	16,008 A	21,456 A	20,489 A	19,896 A	77,849 A
2014	18,529 A	24,519 A	20,647 E	20,345 E	84,040 E
2015	20,193 E	25,108 E			89,766 E

Earnings Per Share Estimates

(EPS is operating earnings before non-recurring items, but including employee stock options expenses)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2012	$0.68 A	$0.78 A	$0.60 A	$0.73 A	$2.79 A
2013	$0.53 A	$0.81 A	$0.72 A	$0.59 A	$2.65 A
2014	$0.62 A	$0.78 A	$0.65 E	$0.59 E	$2.64 E
2015	$0.65 E	$0.77 E			$2.88 E

Projected EPS Growth - Next 5 Years % 8.5

RECENT NEWS

Microsoft Corporation's fiscal second-quarter earnings of 78 cents beat the Zacks Consensus Estimate by 10 cents, or 14.7%. Shares were up 3.5% in extended trading.

Revenue

Revenue of $24.52 billion was up 32.3% sequentially and 14.3% from last year, beating our estimates by 4.4%.

Devices & Consumer segment

Management changed the operating structure at the beginning of fiscal year 2014. Accordingly, the company now has two main segments: Devices & Consumer (D&C) and Commercial.

Licensing, hardware and other revenue made up 22%, 19% and 7% of quarterly revenue taking the contribution of the Devices & Consumer segment to 48%.

The licensing side of the business was mixed, with revenue increasing 24.0% sequentially but declining 5.6% year over year. Large enterprises and developed markets in general led to increased demand for Pro shipments, which helped offset significant weakness in non-Pro sales. Non Pro revenue in China was particularly weak. The consumer side of the business was extremely weak, with Office for consumer devices down 24% year over year.

Hardware revenue on the other hand strengthened considerably in the last quarter, increasing 218.5% sequentially and 68.4% year over year. The strength was driven by strong holiday sales of both gaming and tablet platforms. Xbox units touched 7.4 million for the quarter, of which 3.9 million units were Xbox One, so momentum was strong despite the fact that Sony also launched the PS4 during the quarter. Surface shipments also doubled sequentially, indicating that Microsoft is gaining ground despite strong offerings from Apple, Samsung and other Android manufacturers.

Other revenue increased 9.7% sequentially and dropped 10.3% year over year. Management said that the launch of Halo 4 in the year-ago quarter impacted that comparison. However, the quarter was very strong for the segment in other respects with Office 365 Home premium subscribers up to 3.5 million, search advertising revenue up 34% and Xbox Live transactional revenue up more than 25%.

Commercial Segment

Commercial licensing revenues increased 13.5% sequentially and 7.4% year over year. Server and Office commercial revenues were up 12% and 10%, respectively. System Center and SQL Server Premium grew double-digits, Hyper-V picked up 5 points of share and Windows volume licensing grew 10%.

Commercial other revenues increased 11.0% sequentially and 28.1% year over year. Cloud services are becoming more popular, with commercial cloud revenue growing 107% year over year. Office 365 and Azure and Dynamics CRM seats all grew triple digits.

Operating Results

Microsoft's gross margin of 66.2% was down 619 basis points (bps) sequentially and 726 bps below the year-ago quarter, due to the much higher mix of hardware products and Xbox One launch costs. The 545 bp contraction in the D&C Hardware gross margin more than offset the expansion in other D&C

categories. The commercial segment on the other hand, saw gross margin expansion across both licensing and other segments.

Operating expenses of $8.27 billion were up 16.7% sequentially and up 3.4% from last year. On a sequential basis, R&D, S&M and G&A increased 373 bps, 36 bps and 41 bps, respectively. Their increases from the year-ago quarter were 57 bps, 261 bps and 35 bps, respectively. As a result, the operating margin expanded 168 bps sequentially and 372 bps year over year to 32.5%.

The company generated a net income of $6.56 billion, or 26.7% net income margin compared to $5.24 billion, or 28.3% in the previous quarter and $6.38 billion, or 29.7% in the year-ago quarter. Since there were no one-time items in any of the quarters, the pro forma and GAAP earnings were same at 78 cents a share compared to 62 cents in the previous quarter and 76 cents in the year-ago quarter.

Balance Sheet

Inventories were down 39.0%, as the inventories built up for the holiday season were sold off during the quarter. As a result, inventory turns went from 7.8X to 20.8X. Days sales outstanding (DSOs) dropped from 54 to 59.

Microsoft ended with a cash and short term investments balance of $83.94 billion, up $3.27 billion during the quarter. The net cash position was around $60.97 billion, up from $64.74 billion at the beginning of the quarter. In the last quarter, the company generated $4.41 billion in cash flow from operations, spent $588 million to repurchase its debt, $2.11 billion to repurchase shares, $2.33 billion to pay dividends, and $1.73 billion to purchase capital assets.

Guidance

Microsoft provided guidance for both the third quarter and fiscal year 2014.

For the third quarter, the company expects D&C licensing revenue of $4.1-4.3 billion, D&C hardware revenue of $1.9-2.0 billion, D&C other revenue of $1.8 billion, Commercial licensing revenue of $10.4-10.6 billion and Commercial other revenue of $1.8 billion. Microsoft expects COGS of $6.1-6.3 billion (down significantly from the Dec quarter because of the hardware mix) and opex of $7.7-7.8 billion.

For 2014, it expects opex of $31.2-31.5 billion (previous $31.3-31.9 billion), a tax rate of 18-20% (reiterated) and capex of $6.0 billion (previous $6.5 billion).

Our Take

Microsoft reported another solid quarter, with strong results across most segments. The consumer side of the business was notably weaker (as expected), but it’s heartening to see the growth in tablets. This is strategically a very important segment for Microsoft, since tablets continue to eat into its core computing business. Also, consumer purchases, particularly in emerging markets continue to get more mobile.

Microsoft has been late to enter the market that is now dominated by iOS or Android. The company has made straight for the high end, despite criticism regarding the products and doubts about its ability to execute. The strong growth in the last quarter indicates that Microsoft is on the right track.

The company is still not making money on its surface devices however and management did not say when the business was expected to break even. But in the meantime, it is sparing no expense to succeed. Of course, a higher percentage of hardware in the mix is going to tell on margins and this should be expected. The addition of Nokia’s business will add to the pressure on margins.

Management did assure that the PC business was better than expected and that there were signs of stabilization. This is similar to what **Intel** said earlier and in line with Gartner IDC estimates.

Add to this its success in the cloud and new partnerships, such as GoDaddy, which give it a foothold in the SMB market and its plain to see its focus.

VALUATION

Microsoft shares are currently trading at 13.3X its trailing twelve months earnings compared to 52.3X for the peer group and 18.6X for the S&P 500 and roughly in the middle of the historical range.

The current 74% discount to the peer group based on forward earnings for 2014 is slightly above the 72% average discount in the historical period, indicating the possibility of upside. However, the shares are expected to earn just 8.5% in the next 5 years, which is below the 18.2% expected of the peer group.

We are therefore r reiterating the shares to Neutral and setting a target price of $38 (14.4X P/E).

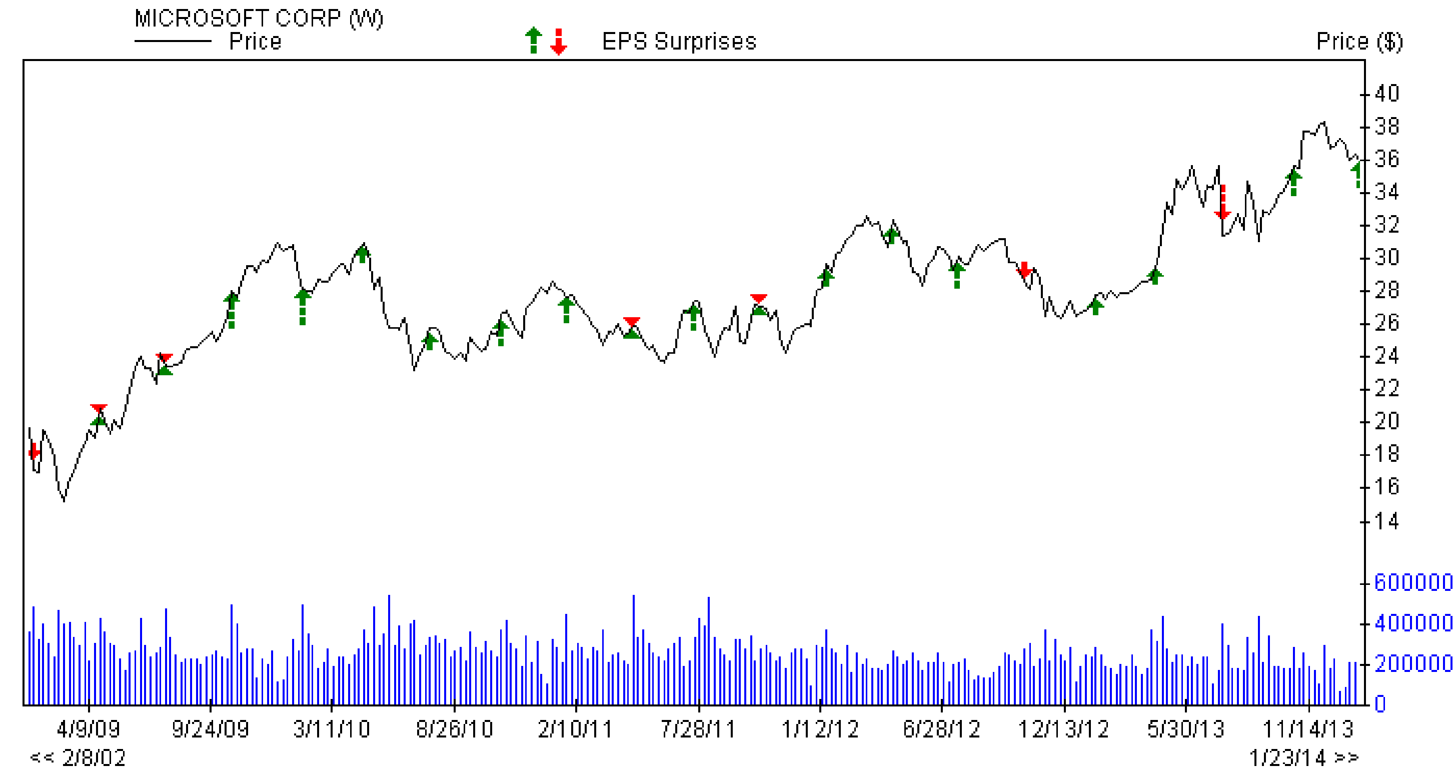
Key Indicators

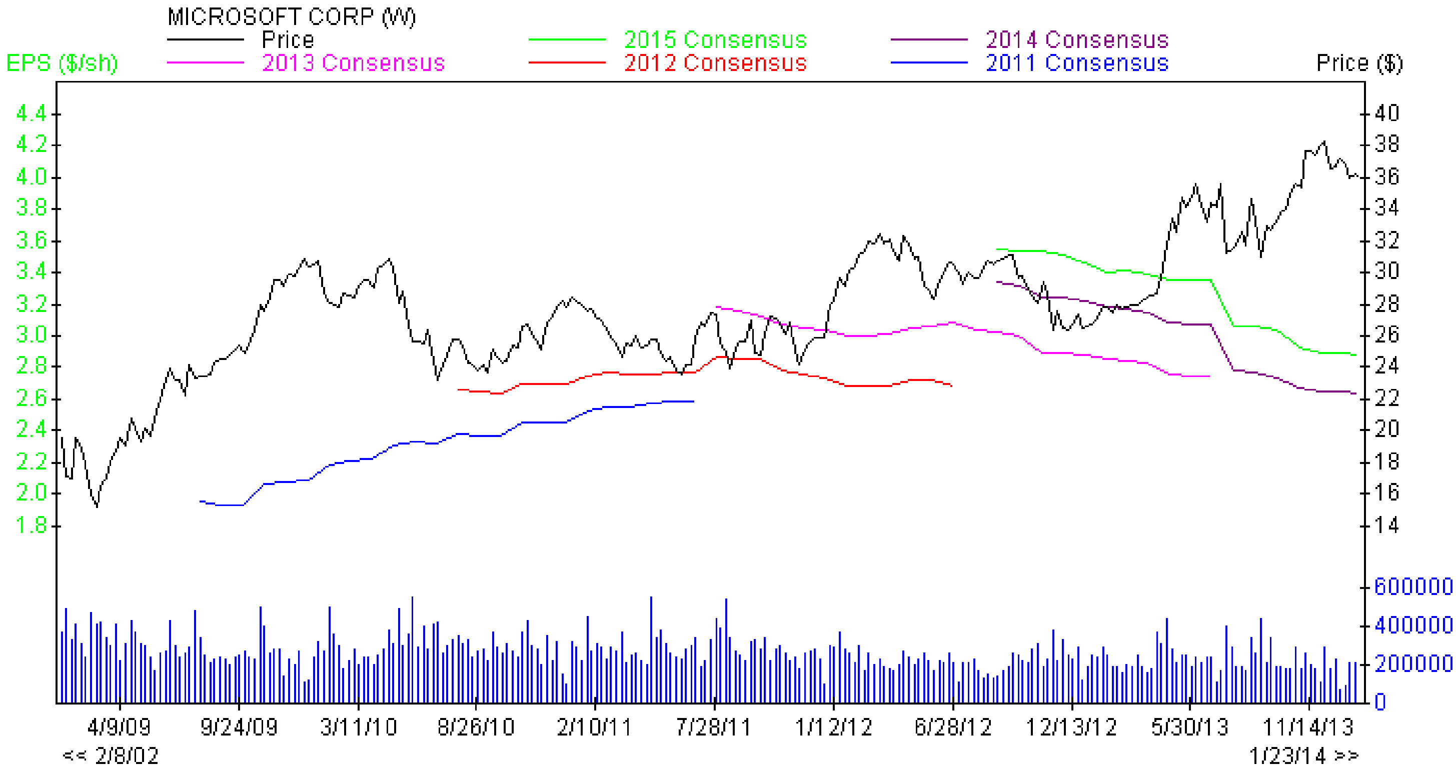
	P/E F1	P/E F2	Est. 5-Yr EPS Gr%	P/CF (TTM)	P/E (TTM)	P/E 5-Yr High (TTM)	P/E 5-Yr Low (TTM)
Microsoft Corp (MSFT)	**13.7**	**12.5**	**8.5**	**11.5**	**13.3**	**18.2**	**8.6**
Industry Average	51.8	55.4	18.2	92.0	52.3	257.9	17.9
S&P 500	15.8	15.1	10.7	19.4	18.6	27.7	12.0
Textmunication Holdings, Inc (TXHD)							
ENTERCONNECT INC. (ECNI)							
Oracle Corp (ORCL)	13.6	12.5	11.5	11.7	14.1	18.3	10.9
SAP AG ADR (SAP)	16.8		12.0	16.6	18.6	24.8	12.2

TTM is trailing 12 months; F1 is 2014 and F2 is 2015, CF is operating cash flow

	P/B Last Qtr.	P/B 5-Yr High	P/B 5-Yr Low	ROE (TTM)	D/E Last Qtr.	Div Yield Last Qtr.	EV/EBITDA (TTM)
Microsoft Corp (MSFT)	**3.8**	**6.4**	**3.1**	**29.8**	**0.2**	**3.0**	**7.5**
Industry Average	9.8	9.8	9.8	-95.6	0.5	0.4	-7.4
S&P 500	5.2	9.8	2.9	24.2		2.1	

Earnings Surprise and Estimate Revision History

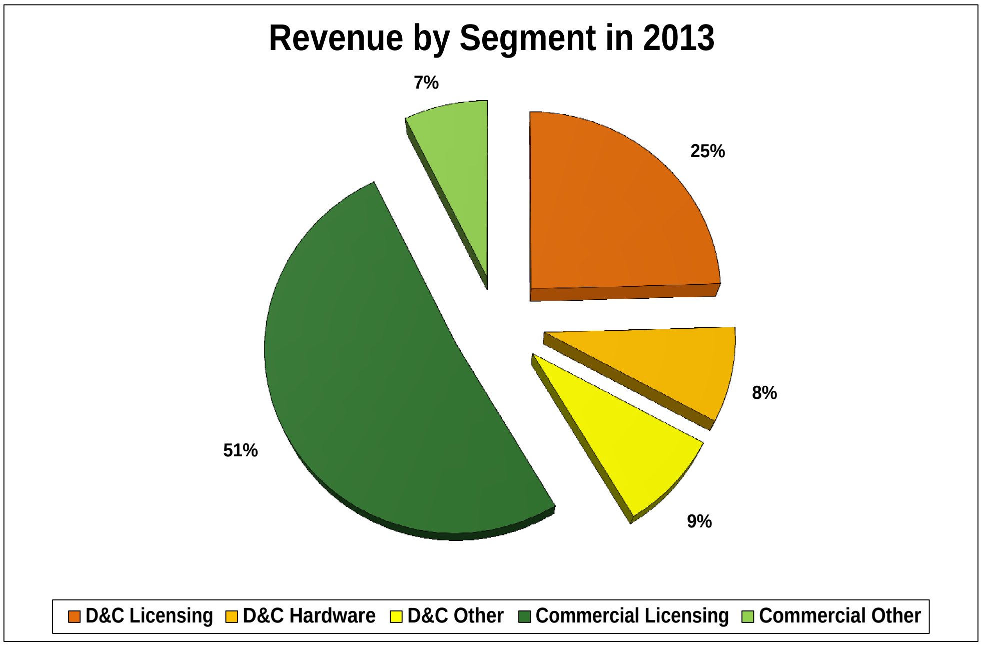




NOTE – THIS IS A NEWS-ONLY UPDATE; THE REST OF THIS REPORT HAS NOT BEEN UPDATED YET.

OVERVIEW

Redmond, Washington-based Microsoft Corporation is one of the largest broad-based technology providers in the world today. Although software is the most important revenue source, the company's offerings also include hardware and online services. Additionally, Microsoft offers support services in the form of consultation, training and certification of system integrators and developers. The company reports revenue in five separate segments, each of which targets a specific user group.



The operating structure was changed in the first quarter of fiscal 2014. Accordingly, the company now has two main segments: Devices & Consumer and Commercial. Historical data has been presented according to the new segments in the above chart.

Devices & Consumer includes **licensing** (non-volume licensing of the Windows OS and related software; non-volume licensing of Microsoft Office for consumers; Windows Phone, including related patent licensing; and certain other patent licensing), **hardware** (entire Xbox platform, Surface and Microsoft PC accessories) and **other** (resale, including Windows Store, Xbox LIVE transactions and the Windows Phone Marketplace; search advertising; display advertising; Subscription, comprising Office 365 Home Premium; Studios, comprising first-party video games; retail stores; and other consumer products and services not included elsewhere).

Commercial includes commercial **licensing** (server products, volume licensing of the Windows OS and Office for business) and **other** (Enterprise Services, including Premier product support services and Microsoft Consulting Services; Online Services, comprising Office 365 other than Office 365 Home Premium, other Microsoft Office online offerings, and Dynamics CRM Online; Windows Azure; and other commercial products and online services not included elsewhere).

Products are sold through OEMs, through distributors, large account resellers (LARs), value added resellers (VARs) and online. Important OEM customers include Acer, ASUSTek, Dell, Fujitsu, Hewlett-

Packard, Lenovo, NEC, Samsung, Sony and Toshiba. Low-volume, customized PC vendors operating in local markets also generate a significant portion of sales. Retail sales generally come through Best Buy, Target and Wal-Mart.

REASONS TO BUY

- Microsoft has a **dominant position in the PC market**, with its operating systems being used in the majority of PCs worldwide. The company launched its Windows 8 operating system last year and is introducing a newer version this year based on popular demand. Still, adoption on mobile platforms is likely to be stronger than on desktops. Since mobile is growing while PCs are declining, this is probably not so bad for the company. The PC market has been slowing down over the last two years due to natural disasters, supply chain issues, the drive to transfer computing operations to the cloud, iPad and other tablets that continue to pick up a share of PC spend, as well as weak macro conditions. As a result, PC shipment growth is expected to remain sluggish. Therefore, Microsoft's gains are likely to come from its position in the mobile segment, upgrades to the existing installed base and success in emerging markets. The company launched Windows 8 with a mobile focus, which we consider positive because that is where future growth will come from. On the enterprise front, Windows 7 adoption is steady, with two-thirds of the existing base having migrated thus far. It is worth noting that despite the many pressures, Microsoft's dominant position in the traditional PC market and successive iterations of the Windows platforms continue to generate solid revenues and cash flows for the company.

- Given the growing importance of mobile platforms, Microsoft has been taking steps to build a position in the **mobile computing** segment. We think that **Windows 8** adoption rates will continue growing through 2013, helped by its **Surface** tablet, which was launched last year. Microsoft is bundling other benefits, such as Office 365 for students for a full four-year period, which should help adoption. The **agreement with Barnes & Noble** indicates that the company is probably looking for other hardware partnerships that could help to further build its position in the fast-growing tablet market. Although neither company said that future Nooks would be powered by Microsoft's OS (it currently runs on Android), it seems very likely since Microsoft's investment would be disproportionate if the intention was to simply create a Nook app for Windows 8. Barnes & Noble's education business will also help Microsoft create a viable alternative to Apple devices, since it enables the digital publishing of college text books. Just recently, Microsoft loaned **$2 billion to Dell** to help it go private. This could be another attempt by the company to build a loyal partnership.

- Microsoft's **server business** is one of the major beneficiaries of the move to cloud computing. While the segment continues to benefit from enterprise refresh rates, cloud computing is driving demand for many of its products (Windows Server, System Center, Azure). Microsoft offers a hybrid cloud solution that enables the integration of existing IT infrastructure with the public cloud. The company's continued innovation in the segment has driven double-digit revenue growth in fiscal years 2010, 2011 and 2012, which dropped off only slightly in 2013. We think that growth prospects here are extremely bright, as organizations increasingly rely on private, public or hybrid clouds.

- Microsoft is one of the three largest providers of **gaming** hardware. Its Xbox console was one of the first gaming devices of its kind. Microsoft supplemented the hardware with a number of popular video game titles. It also introduced the Xbox Live online gaming service, which enabled subscribers to play online Xbox games with each other and download new games directly onto the device. Non-gaming applications, such as Facebook, Twitter, Netflix, Last.fm, Sky, Canal and Zune were also made available through Xbox Live. The Live experience is popular, judging from the growth in the subscriber base to 40 million since its launch in 2002. The installed base of Xbox 360 game consoles continues to grow every quarter, driven by enhancements to the platform, making Xbox one of the leading gaming platforms. The launch of the new Xbox was well-timed, although the very radical changes and very strong competition could have an impact on growth.

- Microsoft has launched **Windows Phone 8**, better known as Windows Phone Apollo. Samsung, Huawei, HTC and Nokia have partnered with Microsoft to introduce devices based on the OS. Earlier versions of WinMo had compatibility issues that were detrimental to user experience. Given the very short life cycles of cell phones and their essentially consumer nature, it was very easy for consumers to switch to alternatives, thus eroding the company's market share. The market has seen dramatic changes over the last few years, with new Asian players in the form of Samsung, HTC and others that are using Google's Android becoming dominant players. Microsoft has found a solid hardware partner in Nokia. Nokia dominates the emerging markets, particularly in Asia. Microsoft's superior OS could help the company tap the growth potential in Asia, while stemming Nokia's market share losses. Microsoft stands to gain because Nokia will incur the hardware costs, leaving Microsoft to enjoy the higher margins typical of a software business. At the same time, the licensing is the result of a close relationship (rather than previous licensing of the OS to all and sundry), so compatibility issues can be minimized. IDC expects the Windows Phone OS to be the second largest OS with a 19% global share of the smartphone market in 2016, following Android and preceding iOS and Blackberry (IDC Worldwide Smartphone 2012-2016 Forecast and Analysis dated June 2012). Data for 2017 is not yet publicly available.

- Microsoft's **Bing search engine is taking market share**. While most of the recent gains have been at the expense of Yahoo, there is reason to believe that the company is also chipping away at Google in specific verticals. Moreover, share gains are not restricted to the U.S. alone; some strong Google markets, such as the U.K. are also showing a slight movement in preferences. Strategic actions, such as the agreement with HP to put Bing as the default search engine on most of its PCs have helped. Also, Apple and Google are increasingly competing with each other in the mobile segment, which could prove to be of strategic importance to Microsoft. Apple currently maintains Google search as the default, helping Google to become the leader in the mobile segment. But there are indications that Apple is moving toward Bing, so Google's search market share could be compromised. Facebook has also chosen Bing to support its "Graph Search" so Microsoft is making headway. The main obstacles for Apple appear to be Google's user experience and mindshare. If Bing can provide similar or better experience, Microsoft has a fighting chance to make it really big in the mobile segment. Particularly so, since it is already in partnership with Nokia, which remains one of the largest players in the smartphone segment after Samsung and Apple. Therefore, we think that the segment's losses are not as significant as the potential and we expect Microsoft to continue investment to improve Bing.

- Microsoft remains very active on the **merger and acquisition** front. The company completed nine acquisitions in fiscal year 2009 and added two more in fiscal year 2010. It also purchased certain assets of a Chinese company in fiscal 2011. These entities were quickly absorbed and their technologies integrated within existing or new product lines. Part of the acquisition strategy is also concerned with the killing off of competing technologies and rival products. Fiscal 2012 was very significant, since the company closed the Skype acquisition and also picked up enterprise social networking company Yammer. Both these acquisitions were a diversion from management's usual strategy of picking up much smaller targets that are purchased outright for cash. They were instead key technologies intended to enhance its cloud offerings. This was followed by 11 smaller acquisitions in 2013.

- **Management execution** has been good in recent times. This has helped Microsoft build a net cash and short term investments balance of $64.7 billion ($7.76 per share). The significant amount of cash provides the flexibility required to pursue any growth strategy, whether by way of acquisitions or otherwise. Additionally, while the mix of hardware sales in any given quarter results in gross margin fluctuations, the focus on cost reduction has increased, which is a positive. Of course, Microsoft has made quite a few acquisitions and is spending resources to improve the distribution of its surface products, which are adding to its costs.

REASONS TO SELL

- Our immediate concern about Microsoft is regarding the **softness in the core computing market**. The company is dependent on this market for the largest chunk of its revenue. Although enterprise refresh rates have not been too bad, Microsoft continues be impacted by the weakness in notebooks and netbooks as consumers move to tablets. Additionally, the cannibalization of the core desktop market by mobile computing devices is a secular negative for the company and its future growth in the Windows segment is greatly dependent on its ability to build position in mobile devices, particularly tablets. In this respect, it should be borne in mind that although Microsoft's Surface is a good product and seeing decent uptake (albeit below expectations), the company clearly needs to work on the distribution side, since its stores are still limited in number. We think that aggressive pricing is required to gain ground in the segment, especially since it is a late entrant into a market with several strong players. So the inventory correction in the last quarter is not surprising. Emerging markets remain a positive, although they are essentially price sensitive, so Microsoft is likely to see stiff competition from Android. Microsoft's first mover advantage will help however.

- Another negative for Microsoft (which is also a negative for other software companies) is the transition to a **multi-year licensing model**. This may be considered a negative, since the company will be recognizing revenue over time instead of at the outset. However, there is a positive side, first, because it allows customers to spend on software upgrades that wouldn't otherwise be viable in the current economic environment and second, because it improves the visibility of its revenues and cash flows. In the near term however, there will naturally be a negative impact on results. It appears that this negative coupled with the PC market decline is going negatively impact results in the next few quarters, which is why we are taking down our estimates.

- Microsoft is the dominant provider of operating systems into the PC market. So any new player, or any technology advancement in the space, unless by Microsoft itself, results in **market share erosion**. Although Windows 8.1 will remove some of the issue associated with Windows 8, and attach rates for the Windows 7 OS remain decent, Google Chrome and Apple Macintosh are splitting the market. This will naturally be lost opportunity for the company.

- The company's **cell phone operating systems** have not been too successful. The already struggling segment received a death blow from Google's Android operating system. Android is a practically free operating system that the phone manufacturer offers preinstalled with the phone. Google is very active in developing new versions of Android, which continue to improve user experience. While Microsoft has managed to extract some cash from Android-based phone makers as patent infringement claims, Google's Motorola has avoided payment thus far. Apple's iPhone is also its hottest selling product and the company has pushed Research In Motion's Blackberry out of the market. Microsoft launched **Apollo**, which should further improve the user experience. However, the devices based on the earlier OS didn't really do well and Nokia Lumia uptake has been slow. Microsoft has now done everything right but the marketing of the OS is probably falling short, especially since it is up against very strong players that are virtually dominating the smartphone market and pushing out everyone else. The addition of Samsung, HTC and Huawei as hardware partners is a positive.

- Microsoft is seeing increased **competition** from all quarters. Particularly, Google seems to be present in all its markets. Although Google's focus is on search and online advertising, while Microsoft's is on selling its software, the two companies are increasingly pitted against each other because of the conditions in the market. Google is forced to sell Android to ensure the predominance of Google search, while Microsoft must target online advertising if it is to make good some of the losses resulting from the emergence of Android and Chrome. Google is seeing tremendous success, with its Android OS emerging as the leading platform for smartphones and seeing strong growth in tablets. We are particularly concerned since the PC market in developed nations is mature, while that in developing nations is cost-sensitive. Microsoft could lose out due to lack of market growth in developed nations and the cost of its OS in developing nations. Moreover, Apple's Macintosh has a loyal customer base, which is an additional pressure. The gaming console market is also very competitive, since Sony and Nintendo are equally strong. Microsoft has done very well with Kinect and remains the leading console in the U.S. However, there is severe price competition in this market and successful gaming titles are a must in order to push sales.

- Microsoft is still a very small player in the **search** market, which is currently dominated by Google. Although recent statistics show some market share gains, it is apparent that most of the gains are coming from Yahoo rather than Google. On the other hand, Google has taken a dominant position in the mobile segment on the strength of its Android OS and is also set to use Chrome to challenge it in the PC OS area. Microsoft's online advertising hasn't really gained critical mass yet. The company has been spending heavily in the area. Further, technology investments will have to continue, since success depends on the company's ability to wrest share from Google.

DISCLOSURES & DEFINITIONS

Our recommendation for each stock is closely linked to the **Zacks Rank**, which results from a proprietary quantitative model using trends in earnings estimate revisions. This model is proven most effective for judging the timeliness of a stock over the next 1 to 3 months. The model assigns each stock a rank from 1 through 5. Zacks Rank 1 = Strong Buy. Zacks Rank 2 = Buy. Zacks Rank 3 = Hold. Zacks Rank 4 = Sell. Zacks Rank 5 = Strong Sell. We also provide a **Zacks Industry Rank** for each company which provides an idea of the near-term attractiveness of a company's industry group. We have 264 industry groups in total. Thus, the Zacks Industry Rank is a number between 1 and 264. In terms of investment attractiveness, the higher the rank the better. Historically, the top half of the industries has outperformed the general market. In determining **Risk Level**, we rely on a proprietary quantitative model that divides the entire universe of stocks into five groups, based on each stock's historical price volatility. The first group has stocks with the lowest values and are deemed **Low Risk**, while the 5th group has the highest values and are designated **High Risk**. Designations of **Below-Average Risk**, **Average Risk**, and **Above-Average Risk** correspond to the second, third, and fourth groups of stocks, respectively.