October 15, 2013

Jefferies

EQUITY RESEARCH AMERICAS

Microsoft (MSFT)

Upgrade to Buy: Pocketing the Change

BUY
(from HOLD)
Price target $42.00
(from $33.00)
Price $34.45

Key Takeaway

We upgrade the stock based on: 1) A new operating structure with greater transparency on the best assets; 2) Increased conviction around the transition to the cloud with Office 365/ Azure; 3) Optionality on Intel's improving competitiveness, which could drive upside to Windows; 4) Increasing value of IP related to Android; 5) The potential for portfolio focus/ better capital allocation under a new CEO.

Pocketing the change: The last year has been one of accelerating change at Microsoft. While uncertainty remains around some major decisions (including the new CEO), we think the stage is set for a series of value creating events to unfold over the next 18 months.

A new operating structure: We think the Commercial "BestCo" vs. Devices and Consumer "OtherCo" provides better transparency on key assets and lays out a framework for further potential portfolio streamlining.

Increased conviction around the transition to the cloud with Office 365/ Azure: Our deep-dive into O365 (Page 14) suggests a powerful opportunity in SMB/ consumer to drive higher value per customer which raises our conviction in the value of Office. While early days for Azure, we think it is fast becoming the #2 in infrastructure/ platform as a service.

Intel's increasing competitiveness could drive upside to Windows: Our base case is that Windows remains in decline, but Intel's improved position in low power/ price MPUs could provide upside to our assumptions.

Increasing value of IP related to Android: Microsoft gets royalties on around 50% of Android devices sold worldwide (Page 26) and given growth in the ecosystem, we think this could be worth $3-4/ share (effectively offsetting losses in Bing).

The potential for portfolio focus/ better capital allocation under a new CEO: While there is risk related to choice of candidate, we think the right individual could drive incremental value for shareholders.

Valuation/Risks

Our $42 is based on a sum of the parts, which equates to 14X FY15 EV/ NOPAT for "BestCo" and 8X FY15 EV/ NOPAT for "OtherCo." Risks include the commitment to first party hardware (including handsets); Windows OEM revenue could continue to drag on earnings growth; and the shift to the cloud creates some uncertainty on operating margin/ capital intensity.

USD	*Prev.*	2012A	*Prev.*	2013A	*Prev.*	2014E	*Prev.*	2015E
Rev. (MM)	--	73,723.0	--	77,849.0	*81,373.0*	81,909.0	*84,932.0*	86,360.0
EV/Rev		3.0x		2.8x		2.7x		2.5x
Consensus	--	--	*2.75*	2.58	*3.05*	2.69	--	2.96
EPS								
Sep	--	0.68	--	0.53	*0.59*	0.53	*0.64*	0.63
Dec	--	0.78	--	0.76	--	0.78	*0.78*	0.77
Mar	--	0.60	--	0.72	*0.66*	0.69	*0.72*	0.74
Jun	--	(0.06)	--	0.59	*0.68*	0.72	*0.76*	0.80
FY Jun	--	2.00	--	2.58	*2.71*	2.72	*2.90*	2.95
FY P/E		17.2x		13.4x		12.7x		11.7x

Financial Summary

Book Value/Share:	9.35
Net Debt (MM):	(72,266.0)
Operating Margin:	34.4%
Net Cash/Share:	$8.56
Gross Margin:	74.0%

Market Data

52 Week Range:	$36.43 - $26.26
Total Entprs. Value (MM):	218,629.8
Market Cap. (MM):	290,895.8
Shares Out. (MM):	8,444.0
Float (MM):	7,608.1
Avg. Daily Vol.:	53,784,440

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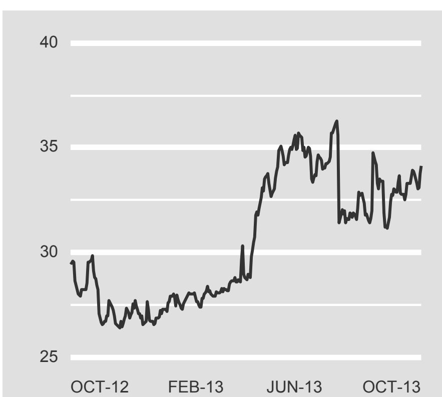
Price Performance



Microsoft

Buy: $42 Price Target

Scenarios

Target Investment Thesis

- We assume FY14 revenue growth of +5% Y/Y and are modelling revenue CAGR of +5% between FY12 and FY15.
- We believe that the transition to Office 365/ Azure is successful and increases the co's recurring revenue base.
- We model a 40 bps contraction in OM in FY14, with slight OM expansion in FY15.
- FY15 NG EPS: $3.23; Target Multiple: 13X; Target Price $42

Upside Scenario

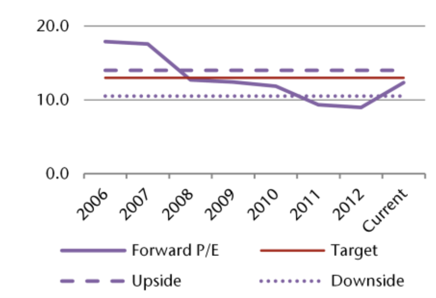
- Assumes a rev CAGR of +7% between FY12 and FY15; PC market improves and Windows gains share in tablet and smartphone market.
- Potential disposal of loss-making assets such as Bing; Office 365/ Azure momentum continues
- Better operating leverage due to top-line growth.
- FY15 NG EPS $3.43; Target multiple 14X; Target Price $48

Downside Scenario

- Assumes low single digit rev decline as Windows 8 adoption is worse than expected. Surface fails to gain tablet market share in a post-PC world.
- Mgmt focus on cloud services fails to pay off with Azure unable to get traction.
- OM declines given negative leverage due to rev decline. CF declines due to investments in first-party hardware
- FY15 NG EPS $2.84; Target Multiple 11X; Target Price $30

Long Term Analysis

1 Year Forward P/E



Source: Capital IQ, Jefferies estimates

Long Term Financial Model Drivers

LT Earnings CAGR	**7%**
Organic Revenue Growth	**6%**
Acquisition Contribution	**0%**
Operating Margin Expansion	**0 pp**

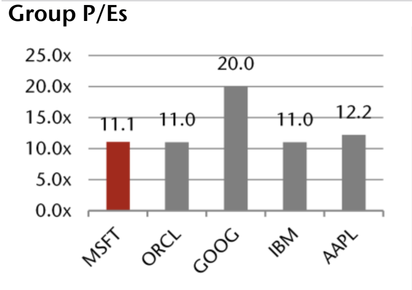
Other Considerations

MS Office continues to be one of the stickiest apps in the market and serves as the personal productivity standard for enterprises and consumers. Office on iOS will drive further adopton.

Azure is MSFT's IaaS and PaaS offering and is widely viewed as #2 in the public cloud, behind Amazon Web Services.

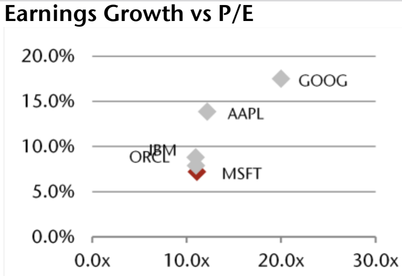
Peer Group

Group P/Es



Source: Capital IQ, Jefferies estimates

Earnings Growth vs P/E



Source: Capital IQ, Jefferies estimates

Recommendation / Price Target

Ticker	Rec.	PT
MSFT	Hold	$42
ORCL	Hold	$34
GOOG	Buy	$1000
AAPL	Buy	$600
IBM	Hold	$210

Catalysts

- Widespread adoption of Office 365 by Enterprise and SMBs leading to higher recurring revenue.
- MSFT Azure adoption increases on account of its expanded system support.
- PC market improves and MSFT gains share in tablet/ smartphone market.
- Hidden value unlocked through Android patents

Company Description

Microsoft Corporation is the leading provider of operating systems for PCs and the world's largest software maker by revenue. It is engaged in developing, licensing and supporting a range of software products and services. The Company operates in two segments: Devices & Consumer and Commercial. The company was founded in 1975 and is headquartered in Redmond, Washington.

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Upgrade to Buy: Pocketing the Change

We upgrade Microsoft to Buy and set a $42PT. We think change at Microsoft (and there has been a lot of it in the last 18 months) adds up to a good thing:

- The new operating structure highlights a "BestCo" vs. "OtherCo" structure;
- Microsoft is embracing a transition to the cloud aggressively with its most valuable commercial assets (Office and Server products); and
- A new CEO (TBA) and an activist on the board provide further potential for value creation.

What are the value creating events?

- Transparency on "BestCo," which should grow faster and has superior gross and operating margin characteristics;
- Transparency on the key cloud assets of Office 365 and Azure;
- The potential for higher value in Windows than our base case, especially if Intel's competitiveness in low price/ low power devices improves;
- Value in IP related to the android ecosystem; and
- The opportunity from improved capital allocation.

What are the risks?

- The commitment to first party hardware (including handsets);
- Windows OEM revenue could continue to drag on earnings growth; and
- The shift to the cloud creates some uncertainty on operating margin/ capital intensity.

Our view on valuation

- Our $42 is based on a sum of the parts, which equates to 14X FY15 EV/ NOPAT for "BestCo" and 8X FY15 EV/ NOPAT for "OtherCo";
- Our $42 is based on the Office business being worth $20 a share; Server and Cloud Platform $12 a share; Windows $5 a share plus net cash (adjusted for overseas repatriation).

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Valuation Framework

We think the new operating structure creates much greater transparency on the best assets (especially Office, Server and Cloud) vs. the other assets (OEM Windows, first party hardware and consumer internet). In particular, the new operating structure will cast a stronger light on the cloud assets, especially Office 365 and Azure.

We split the value of Microsoft into four segments: 1) Clear drivers of upside value; 2) Hidden drivers of upside value; 3) Uncertain drivers of upside value; and 4) Zero to negative value.
In our valuation work we make no assumptions around disposals or radical changes to capital structure.

Different paths to value
We break our sum of the parts analysis into different components:

- **Clear paths to Value: Office and Cloud.** We believe the commercial cloud assets of Office 365 and Azure can drive shareholder value. Our analysis of Office 365 suggests there is significant revenue opportunity in the model transition, especially within the SMB and consumer segments. With Azure, while we ascribe low value to this asset today, we are incrementally confident that it is becoming the #2 provider of PaaS/ IaaS by leveraging the market share gains the company has enjoyed in its core enterprise server business.

- **Hidden path to value: IP over Android.** Microsoft has broad agreements in place with over 20 partners regarding patents that cover a broad range of areas in the Android operating system. We expect growth in Android volumes to drive higher royalties for Microsoft over the next few years.

- **Uncertain path to value: Windows.** Our core thesis remains cautious on OEM Windows licensing and we assume ongoing declines. However, with the advent of lower price/ lower power devices based on Intel's new MPUs coming to market and with signs that certain parts of the market are starting to refresh PCs (such as US enterprise) we think there is positive optionality to this business.

- **Zero to negative value: Windows Phone, First party hardware, Xbox and Consumer Internet.** We frame the valuation for these segments as higher risk. The historic EDD segment was break even over the last 9 years, while the Internet assets (Bing and MSN) have been loss making.

Our valuation framework is based on a sum of the parts analysis (which we detail further in the segments of this note). It also equates to what we view as fair multiple for the best assets in the Commercial segment of the business and a low multiple for the other assets in the Devices and Consumer segment.

Chart 1: Most of the value sits within the Commercial segment

	'BestCo' Commercial	'OtherCo' Devices and Consumer	% of our EV
Office	~ 85%	~15%	55%
Server and Cloud	100%	0%	33%
Windows	~25%*	~75%	14%
IP/ Patents	0%	100%	6%
Surface/ Devices	0%	100%	0%
Bing/ MSN	0%	100%	-8%

Source: Jefferies

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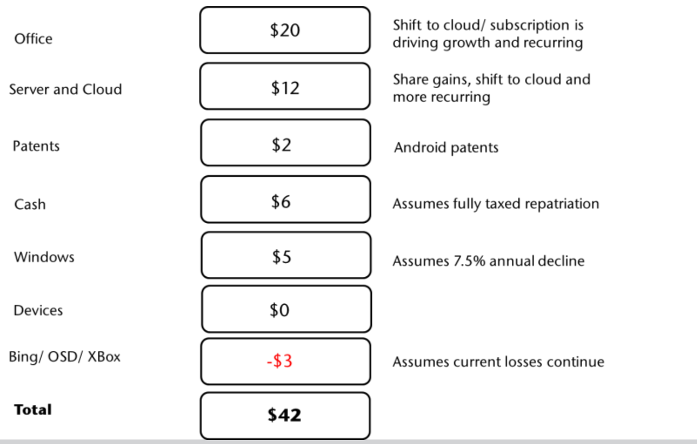
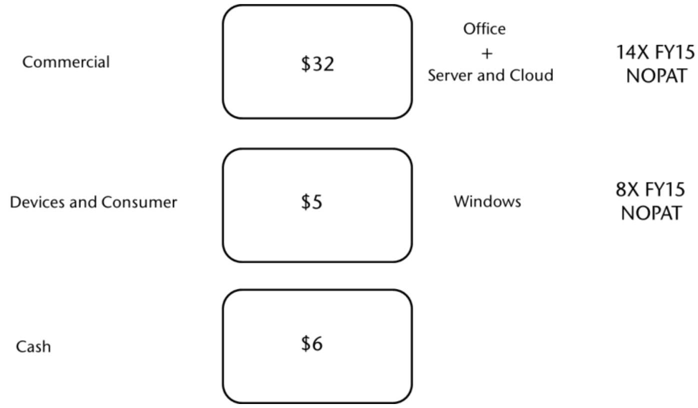
Chart 2: Sum of the parts valuation



Source: Jefferies

Chart 3: Operating segment valuation



Source: Jefferies

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"BestCo" vs. "OtherCo"

"BestCo" is the commercial segment that contains the key assets that are transitioning to the cloud. "OtherCo" is the Devices and Consumer segment that carries less clear value.

The new operating structure highlights the best assets in the Commercial Segment (that we call "BestCo") and the Devices and Consumer Segment ("OtherCo"). The Commercial Segment is characterized by faster growth, higher gross and operating margins and the majority of the enterprise cloud assets. Devices and Consumer, on the other hand, is characterized by lower growth, lower gross and operating margins, and currently loss making first party hardware and consumer cloud assets.

We think it more likely that the market will assign a higher value to the "BestCo" Commercial Segment than it would otherwise have done were those assets reported under the previous reporting structure that mixed hardware with software, and commercial with consumer and licenses and services.

Chart 4: New segments create clear distinction

'BestCo'	'OtherCo'
Commercial	**Devices and Consumer**
Commercial Windows (Volume Licensing)	Consumer Windows (OEM and Retail)
Commercial Office	Office for Consumer
Server Products	First Party Hardware e.g. Surface
Dynamics Applications	Xbox consoles, subs and games
Cloud: Azure, O365, Dynamics and Skype	Search and Display Advertising
Attributes in FY13	**Attributes in FY13**
Revenue – Grew 9%	Revenue – Declined 4%
Gross margins – Fell 200bps	Gross margins – Fell 500bps
High Recurring Revenue	Low Recurring Revenue

Source: Jefferies, company data

Majority of profits are in Commercial

The Commercial Segment is larger and more profitable than The Devices and Consumer Segment. Given our expectations around growth, gross margin and operating margin for the respective segments, we would expect this gap to increase over time. The Devices and Consumer Segment includes first party hardware (such as Surface) and will likely include the majority of Nokia revenue once that business is consolidated.

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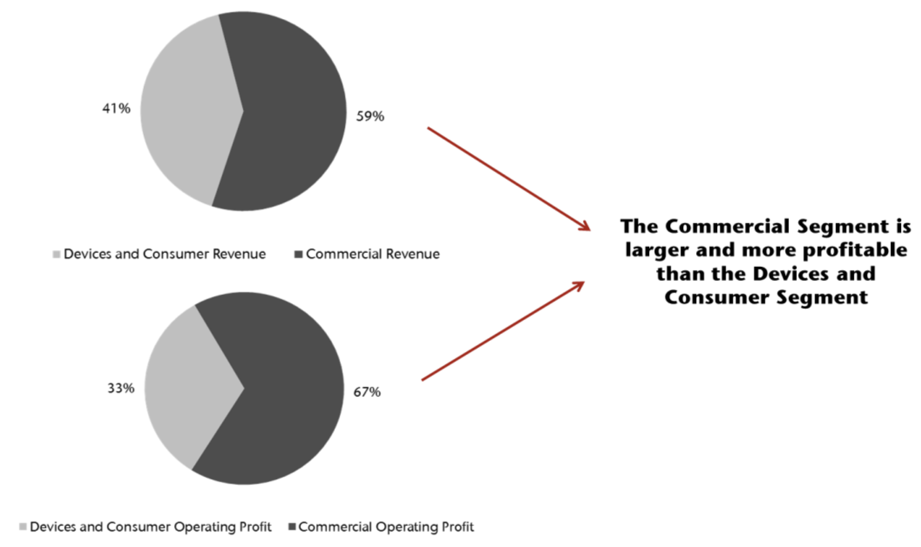
Chart 5: Most Profits Are in the Commercial Segment "BestCo"

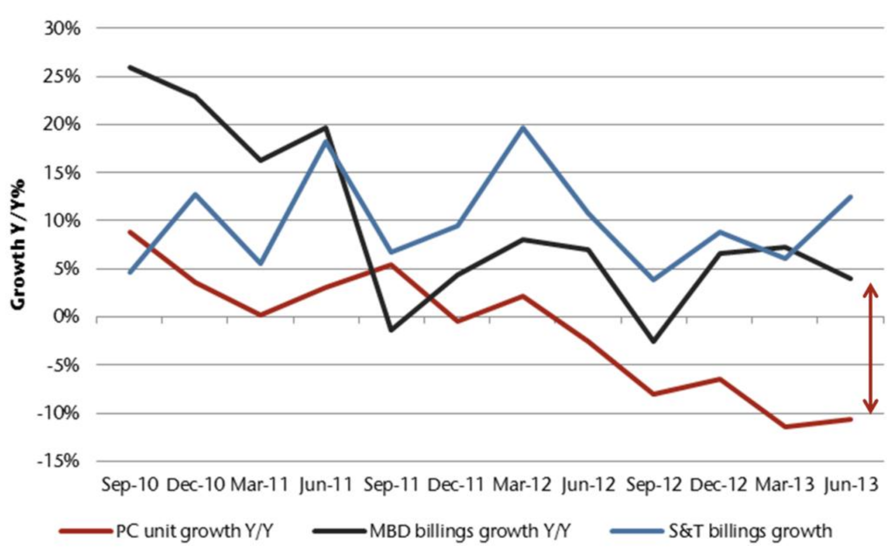


Source: Jefferies, Company Data

Commercial is independent of PCs

The Commercial Segment consists of assets that are independent of PCs. We don't have sufficient historical data to demonstrate this based on new segment reporting, but a good proxy is the performance of the prior Server and Tools and Microsoft Business Division segments. While we discuss the potential for a change in fortune in the Windows OEM segment driven by new low cost devices that are hitting the market in 2H13, our base assumption is that Windows OEM revenue will continue to decline.

Chart 6: Commercial segment independent of PCs

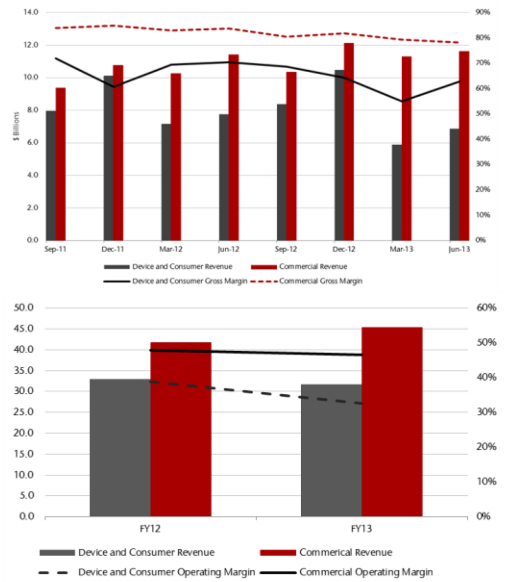


Source: Jefferies, company data

Fundamentals weaker in Devices and Consumer

Devices and Consumer segment revenue has been declining due to weak Windows OEM revenue over the last year. In addition, increased revenue contribution from first party hardware (and lower Windows margins due to high levels of Windows 8 marketing spend) has resulted in declining gross and operating margins in this segment.

Chart 7: "OtherCo" fundamentals have been weak and declining



Device and Consumer revenue has been declining due to weak Windows OEM revenue

As a result GMs and OM's in the Device and Consumer segment have been declining

Source: Jefferies, company data

Commercial has more recurring revenue

We calculate that more than 50% of the Commercial Segment is recurring in nature. This compares with less than 20% in the Devices and Consumer segment. Given the growth in cloud services within the Commercial segment (O365 and Azure), we expect this gap to widen.

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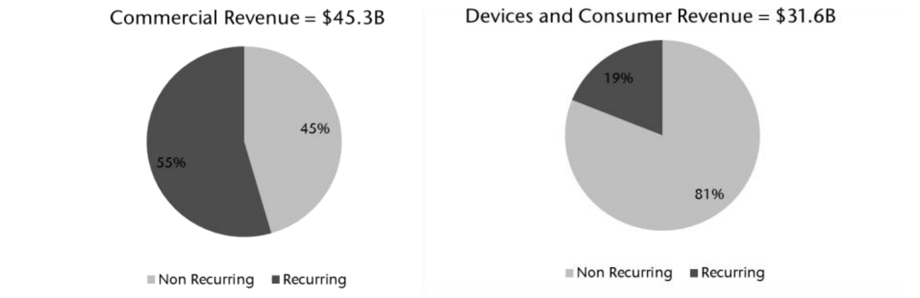
Chart 8: Estimate of recurring revenue by segment

($B)	F4Q13 Total Revenue	F4Q13 Recurring Revenue	F4Q13 Recurring %	Comment
Devices and Consumer				
Hardware	1.2	0.3	21%	Xbox Live Subscriptions
Licensing	4.1	0.2	5%	Phone/ IP Licensing
Other	1.6	0.9	53%	Bing and MSN
Total	**6.9**	**1.3**	**19%**	
Commercial				Windows volume licenses, 60% of Office,
Licensing	10.0	5.8	58%	60% of Dynamics and 50% of Server Products
Other	1.6	0.5	33%	O365, Dynamics CRM and Azure
Total	**11.7**	**6.4**	**55%**	



Source: Jefferies, Company Data

Shift to Cloud in Commercial is a driver of value

We think the shift of Office toward O365 subscriptions and the shift from Server Products toward Azure is value creating for Microsoft. This is happening within the Commercial segment, while O365 for consumers is a very small proportion of the overall Devices and Consumer mix.

Chart 9: The major cloud shifts are occurring in the Commercial Segment

Source: Jefferies, Company Data

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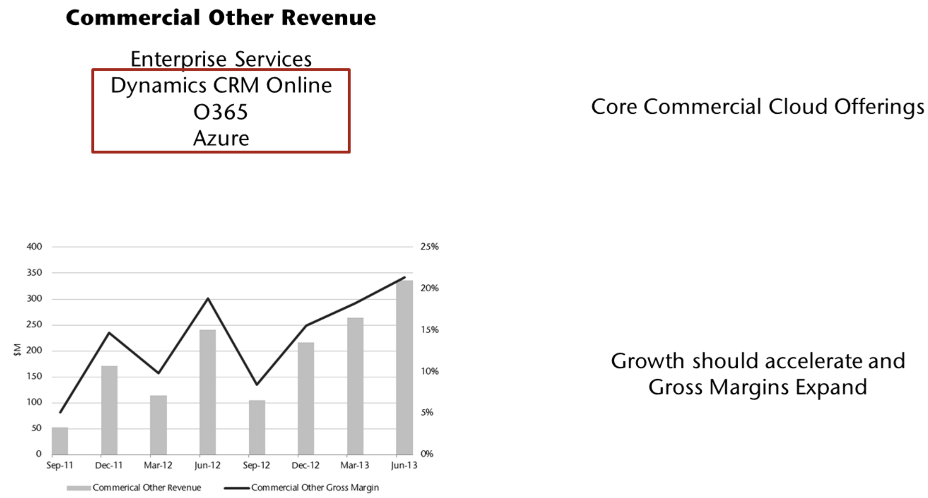
Chart 10: Azure, O365 and SaaS will become more transparent over time



Source: Jefferies, company data

Our thoughts on the new CEO

We don't know who the next CEO of Microsoft will be, but we do have our views on the type of individual we would prefer. We would like an outsider that casts new eyes on the company's core assets. We would like an individual that brings a strong operational track record and the ability to decide what Microsoft assets should remain as core and what could be viewed as non-core. Finally, we would like an individual that sees recurring cash flows that provide the opportunity for a more optimal capital structure. With the views of ValueAct and major shareholders taken into consideration, we are confident that the board will find the right individual to lead the company.

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Clear Paths to Value: 1) Office; 2) Server and Cloud

We think the most valuable assets in the Microsoft franchise are Office and the Server and Cloud platform businesses. In this section, we lay out our view on these businesses and the value of the transition to the cloud. We conclude that the Office business is worth $20-22 a share and the Server and Cloud Platform business $10-12 a share. Within this, we ascribe relatively low value to Azure today.

We think Office 365 can be a material driver of value as it increases wallet share for Microsoft and lowers total cost for customers.

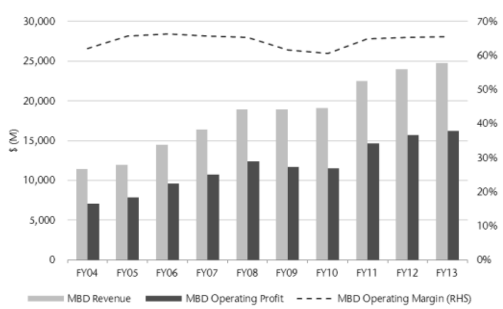
Office and Office 365

We think the transition of Office business toward a cloud business through Office 365 is a powerful driver of value for Microsoft as it:

- Drives higher revenue for Microsoft and lower costs for customers
- Increases attach of the number of products used per customer
- Increases stickiness and pushes back on the biggest competitor, Google

The Office business is the largest and most profitable business within Microsoft.

Chart 11: Summary details on Microsoft Office



Office has grown to be c.30% of revenue and c.45% of profits

>90% of MBD segment was Office

>85% was Enterprise/ SMB

>60% was recurring revenue

It is already very enterprise/ SMB centric and highly recurring due to multi-year licensing

Source: Jefferies, company data

What Is Office?

Office is more than the personal productivity tools that you and I are familiar with. Office includes a number of enterprise server products focused around communication and collaboration.

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Chart 12: Office is personal productivity + communication and collaboration

Office is personal productivity applications:
Word
PowerPoint
Outlook
OneNote

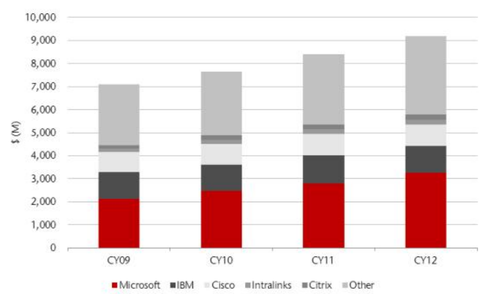
Office is server products:
Exchange (Mail)
SharePoint (Collaboration)
Lync (Unified Communication)

Source: Jefferies estimates

Office has been a share gainer

According to IDC, Microsoft share in the enterprise collaboration segment has increased over recent years. This is further supported by the size of some of the server products. For example, SharePoint for collaboration is now more than $2B in run rate revenue, while Lync for Unified Communications is more than $1B in run rate revenue.

Chart 13: Share gains in collaboration



Market share has increased from 30% to 35% over the last 4 years

SharePoint >$2B run rate revenue[1]
Lync >$1B run rate revenue[2]

Source: IDC; [1]Microsoft press release, Nov. 12, 2012; [2]Microsoft prepared remarks for F4Q13 earnings.

Office is undergoing a shift to the Cloud

Office 365 is a subscription-based cloud service that provides access to software services based on the Office platform. Office 365 was launched in 2011, but only with the release of Office 2013 did Microsoft begin to offer broader plans to address all segments of the market (enterprise, SMB and consumer) with the service.

Chart 14: Key attributes of the shift to Office 365

Office → Office 365

- Shift from single user-based licenses to multiple device-based subscriptions
- Shift to hosted versions of the server products
- Drive more transactional revenue to subscription revenue
- Drive down costs for customers
- Drive up revenues for Microsoft

Source: Jefferies, Company Data

We think Office 365 is having an impact on the key competitive threat, especially in the SMB segment of the market.

Office 365 is pushing back on Google

Microsoft has highlighted some of the revenue momentum with Office 365 and recent survey work suggests real momentum relative to Google Docs. Our own checks with vendors that sell to the MSP/ SMB space suggest strong momentum with Office 365 versus Google. Additionally, Microsoft also highlighted a number of customer wins at its recent financial analyst meeting, with the company claiming 440+ customers were won back from Google in FY13, including Burger King, Campbell's Soup, Kemet, Smithfield and Kindred Healthcare amongst others.

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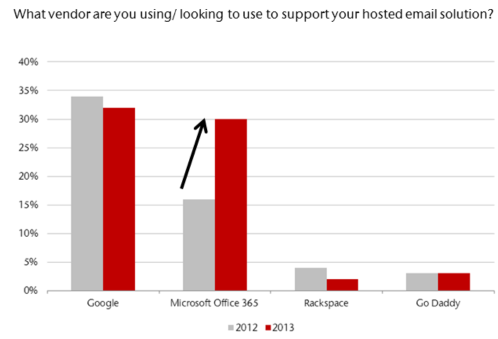
Chart 15: Office 365 has momentum



Office 365 is pushing back against the key threat from Google

- F3Q13 $1B annual run-rate
- F4Q13 $1.5B annual run-rate

The revenue momentum with Office 365 is very strong

Source: Spiceworks, Catching Up to the Cloud Report, June 2013, Jefferies, company data

Office 365 Value Scenarios

Office 365 is offered as a service across enterprise customers, SMB customers and consumer customers. Our analysis across the three difference categories suggests that the biggest opportunity is in the SMB segment (where both the customer and Microsoft have the most to gain), followed by the consumer segment and finally the Enterprise segment. All our analysis is based on a 9-year lifetime use scenario.

Big Benefit under SMB scenario

Our SMB analysis is based on a company with 150 employees and, where under the traditional Office model, the customer used Office Professional (upgraded every 5 years), no Subscription Advantage, a hosted exchange server, and no SharePoint or Lync usage. We assume the SMB moves to Office 365 Midsize at $15/ month/ user, which include Office 365 Desktop Apps, Exchange, SharePoint, and Lync. Under this scenario, there are significant cost advantages for the customer (around IT personnel and hosting costs) and value advantages through access to SharePoint and Lync. For Microsoft, there is significant revenue uplift by moving the customer to Office 365 subscription.

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Our analysis of the SMB opportunity suggests Office 365 provides significant TCO for customers and significantly higher revenue for Microsoft over the customer life.

Chart 16: Big Benefit under the SMB Scenario

Customer Costs under Office 365

	9-Year Total
Implementation	$16,833
Hardware	$21,200
Office 365 Subscription	$243,000
Training	$12,500
Ongoing administration	$438,750
Total	$732,283

Customer Savings under Office 365

	9-Year Total
Hardware	$91,650
Third-party software	$16,200
Web conferencing savings	$85,000
Microsoft licenses	$120,000
Hosted Exchange costs (Non-MSFT provider)	$145,800
Avoided implementation	$70,626
Reduced IT support effort	$663,750
Total	$1,193,026

	Traditional	Office 365	% diff
Microsoft Revenue	$120,000	$243,000	103%
Customer Expense Reduc	$1,193,026	$732,283	-39%

Assumes

- 150 employees SMB

- Office Professional (upgraded every 5 years)

- No Subscription Advantage

- Uses hosted Exchange through a third party

- Does not license Sharepoint or Lync today

- SMB switches to Office 365 Midsize at $15/month/user, which includes Office365 Desktop apps, Exchange, Sharepoint and Lync

- IT Support decrease to 0.75 FTE from 1.75 FTE

Big benefit to Microsoft and the SMB Customer!

Source: Jefferies, Forrester, an anonymous certified Microsoft Reseller and an anonymous certified Microsoft Hosting partner

Big benefit under Consumer scenario

Our analysis of the shift of a consumer to Office 365 Home Premium also suggests significant value opportunity. One of the big hurdles Microsoft would need to cross is the relatively low historical rate of Office attach to consumer PCs (around 20%). However, with the introduction of 5-device support under a single subscription, we think the company has taken an important step toward improving attach. We think the next step will be to offer Office optimized for touch usage on tablets and native device support for non-Windows platforms, especially the iPad. We believe consumer attach would increase significantly if this were to occur and recent management commentary at the annual financial analyst meeting suggests we are getting closer.

Chart 17: Big Benefit under Consumer Scenario

	9-Year Total	Delta
Office 365	$900	
Office Home & Student[1]		
Upgrades every edition	$834	8%
Upgrades every second edition	$556	62%
Upgrades every third edition	$278	224%
Simple Average		**98%**

Assumes

- Perpetual equivalent is Home & Student Edition

- We conservatively assume under historical licensing that a consumer would have bought 2 licenses to achieve device parity.

- We note that Office 2013 licenses now only support 1 device vs. 3 with Office 2010 and earlier.

- We believe Office 365 would be incrementally more attractive if Office was supported natively on iOS

Big benefit to Microsoft if it can convince consumers

Source: Jefferies, Company Data

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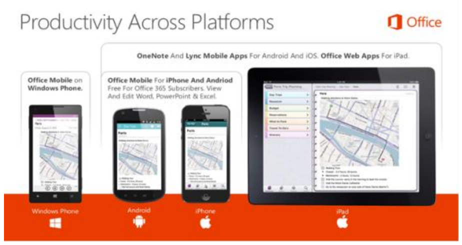
Microsoft continues to indicate Office for iPad is coming: "iPad will be picked up . . . when there is a touch first user interface" -- Steve Ballmer, Gartner CIO Symposium, October 2013.

Chart 18: Native Office on iPad/ Android would help consumer attach



Microsoft has not exposed Office to iPad/ Android tablets natively . . .yet

'We are working on touch-first versions for our core apps in the Office suite and we will bring these apps to Windows devices, and also to other devices'. Qi Lu, FAM, September 19 2013

'We're going to integrate our services with our devices. We'll also make our services available on other people's devices, both to the consumer and to the enterprise. . . we're going to embrace your iPads and your iPhones . . . we know how to do that'. Steve Ballmer, FAM, September 19 2013

Source: Jefferies, Company Data

More modest benefit under Enterprise scenario

Our Enterprise analysis is based on a company with 5000 employees and where under the traditional Office model the customer used Office Professional, Exchange, SharePoint, Lync under subscription advantage. We assume the Enterprise switches to the Office 365 E3 plan at $18.20 / month/ user, which includes Office 365 Desktop Apps, Exchange, SharePoint and Lync. Under this scenario, there are more modest cost advantages for the customer. For Microsoft, there is small revenue uplift by moving the customer to Office 365 subscription.

Chart 19: Modest benefit under enterprise scenario

Customer Costs under Office 365	9-Year Total
Implementation	$150,000
Hardware	$204,000
Office 365 Subscription	$9,828,000
Training	$100,000
Ongoing administration	$900,000
Total	$11,182,000

Customer Savings under Office 365	9-Year Total
Hardware	$1,081,150
Third-party software	$270,000
Microsoft CALs and Subscription Advantage	$8,765,000
Microsoft Server Licenses	$609,135
Avoided implementation	$400,000
Reduced IT support effort	$1,800,000
Total	$12,925,285

	Traditional	Office 365	% diff
MSFT Revenue	$9,374,135	$9,828,000	5%
Customer Expense Reduc	$12,925,285	$11,182,000	-13%

Modest benefit to Microsoft and the Enterprise Customer

Assumes

- 5000 employee Enterprise
- Office Professional, Exchange, Sharepoint and Lync Servers and Enterprise CAL Suite
- Subscription Advantage
- Enterprise customer switches to Office 365 E3 plan at $18.20/month/user, which includes Office365 Desktop apps, Exchange, Sharepoint and Lync
- IT Support needs decrease to 1 FTE from 3 FTE

Source: Jefferies, Forrester, an anonymous certified Microsoft Reseller and an anonymous certified Microsoft Hosting partner

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Pulling it all together

Our view is that with 50% consumer penetration and 100% SMB penetration, Office 365 could add around 3% CAGR to the growth rate of Office or around $10B of incremental revenue over the next nine years. We think it produces a path to sustainable growth in the mid to higher single digits.

We think Office 365 could provide as much as ~$10B of incremental cumulative revenue over nine years (assumed customer lifetime).

Chart 20: Office 365 meaningful to increased value for the Office franchise

	% of Office
Consumer	15%
SMB	20%
Enterprise	65%
Total Office	100%

Consumer and SMB constitute around 35% of Office revenue

Incremental Growth from Office 365

	% O365 penetration	CAGR
Consumer	50%	11%
SMB	100%	11%
Enterprise	100%	0%
Incremental O365		**3%**
Base growth	100%	3%
Total Office		**6%**

Over 9 years, we think Office 365 could add around 3% CAGR to Office revenue growth or just under $10B incremental revenue

Source: Jefferies, Company Data

Chart 21: Our central case is that Office is worth around $20 a share

	Annual Revenue Growth				
WACC	2.0%	4.0%	6.0%	8.0%	10.0%
7.0%	$22.4	$26.0	$30.3	$34.7	$40.1
8.0%	$18.7	$21.5	$24.8	$28.6	$32.9
9.0%	$16.0	$18.4	$21.1	$24.2	$27.7
10.0%	$14.0	$16.0	$18.3	$20.9	$23.9
11.0%	$12.5	$14.2	$16.3	$18.4	$20.9

$20 equates to 13X our FY15 prior MBD NOPAT estimate

Source: Jefferies. Please see appendix for full DCFs.

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Server and Cloud Platform

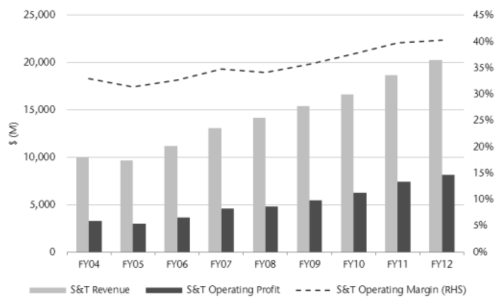
Microsoft has been a share gainer in its Server and Tools Products business, growing billings by an average of 10% over the last 3 years. In addition, the company is emerging a meaningful player in the market for public and hybrid cloud services through Azure, which has the advantage of a large install base of common server products and common development environment.

We think the opportunities for growth in this segment reflects:

- Share gains in markets such as database
- Introduction of new products (such as Power BI) that leverage Server products
- A Public and hybrid cloud gaining momentum

The Office business is the largest and most profitable business within Microsoft.

Chart 22: Summary details on server and cloud platform



Server Products have grown to be c.25% of revenue and c.25% of profits

Grew billings by 10% CAGR in last 3 years

c.50% of S&T is recurring revenue

Taking share in database and virtualization

Strong set of assets that are taking share in major categories

Source: Jefferies, Company Data

What is the Server and Cloud platform?

These products are data center infrastructure products (such as server operating system, database, Systems Management, etc.) as well as cloud platform infrastructure services (such as virtualized server infrastructure, block storage and other services such as web sites, media services, etc.).

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Chart 23: Server and cloud platform

Windows Server 2012

SQL Server 2014

Windows Intune

Visual Studio

Infrastructure products:
Server operating systems
Database
Systems Management
Development tools

Windows Azure

Infrastructure as a Service:
Virtual Machines/ Network
SQL Database
Storage
Web sites
Mobile services
HDInsight
Media Services

Source: Jefferies, Company Data

Server products have been share gainers

We think many of Microsoft's server products have gained share over recent years. We highlight two examples below with database and server virtualization. We think a combination of aggressive pricing and incrementally improving competitive position has driven increased adoption.

An increasing amount of Server products are consumed under a recurring consumption model. In fact, around 50% of the old Server and Tools division was annuity volume licensing.

We think the combination of increased adoption of Microsoft's server products in the data center as well as a significant amount of recurring consumption positions Microsoft well as a provider of cloud infrastructure to existing customers.

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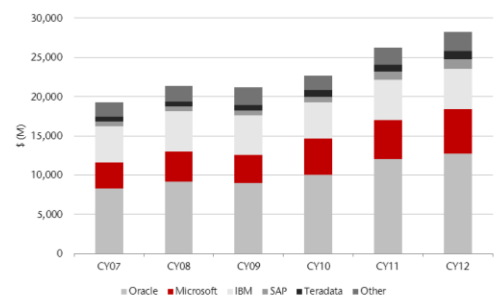
Chart 24: Share gains example: Database



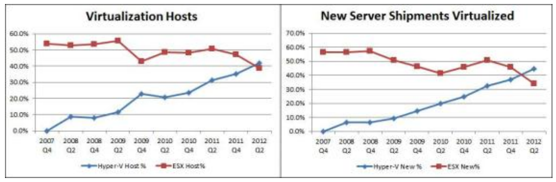
Market share has increased from 17% to 20% over the last 5 years

Strong recent growth

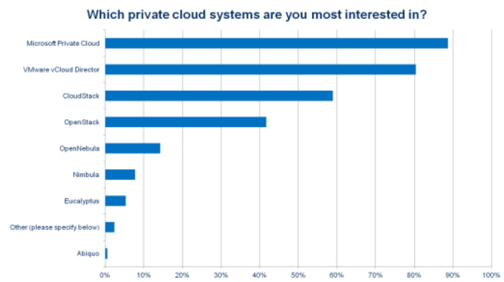
	F3Q12	F4Q12	F1Q13	F2Q13	F3Q13	F4Q13
SQL Revenue Growth	High teens	c.20%	Double digit	c.16%	c.16%	c.16%

Source: IDC, Jefferies, Company Data

Chart 25: Share gains example: Server Virtualization



Microsoft Hyper-V taken share within Windows Server 2012



Windows Server/ System Center helping Microsoft's position in private cloud

Source: IDC worldwide server virtualization tracker; IDC Worldwide Cloud and Virtualization System Software Report 2012

Transition to the Azure Cloud platform

Microsoft introduced Azure as a Platform as a Service offering in 2010, but it has evolved significantly since then, becoming a more fully fledged Infrastructure as a Service platform, offering support for non-Microsoft products (both proprietary and open source) and competing on similar economic terms as the leader, Amazon Web Services.

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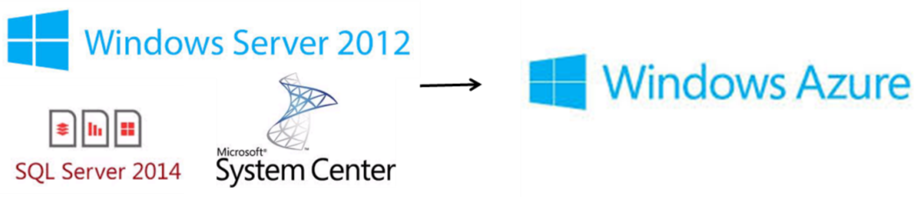
Chart 26: Shift to the cloud



- Shift toward pay-as-you-go compute, storage and networking
- Compete with new cloud compute competitors including Amazon and Google
- Play in private, public and hybrid cloud
- Drive down costs for customers
- Drive up revenues for Microsoft

Source: Jefferies, Company Data

Chart 27: What is Azure?

Windows Azure	**Open and flexible cloud platform to quickly build, deploy and manage applications across a global network of Microsoft-managed datacenters.**
Open and Flexible	**Languages:** ASP.NET, PHP, Node.js, Python, etc **Database:** SQL Server, MySQL, noSQL, etc **Operating Systems:** Windows, Linux
Transparent	Pricing on per minute usage Same price worldwide
Enterprise Ready	99.95% monthly SLA Hybrid cloud enabled Many common infrastructure technologies

Source: Jefferies, Company Data

We think Azure has some key competitive advantages including incumbency of server products and development tools shared with the on-premise environment.

Azure has some competitive advantages

We think Microsoft's cloud platform has some key advantages. First, it enjoys incumbency because it is based on many of the same underlying infrastructure components to those already deployed in the corporate data center. Second, there is a common development environment across the underlying infrastructure. Third, Microsoft can manage one of the biggest headaches of the cloud (user access and security) by leveraging the existing Active Directory technology that is widely deployed in customers' on-premise environments.

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Chart 28: We think Azure has some competitive advantages

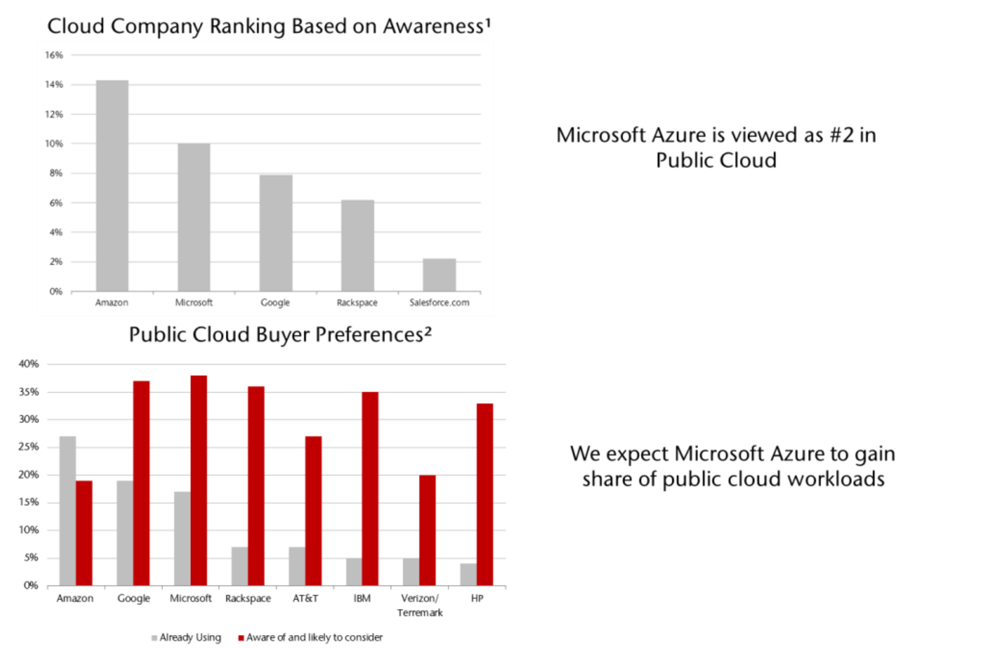
Source: Jefferies, Company Data

Azure is seeing positive momentum with external surveys of IT professionals suggesting more wide-spread use.

Already No. 2 and gaining share

As we track third party surveys and speak to IT professionals, our sense is that Azure has started to gain more momentum in the last year. Based on two recent surveys, we note that Azure is already viewed by IT professionals as the second most important public cloud platform. More importantly, it is viewed (alongside Google and Rackspace) as one of the platforms most likely to gain share.

Chart 29: Industry surveys increasingly bullish on Azure

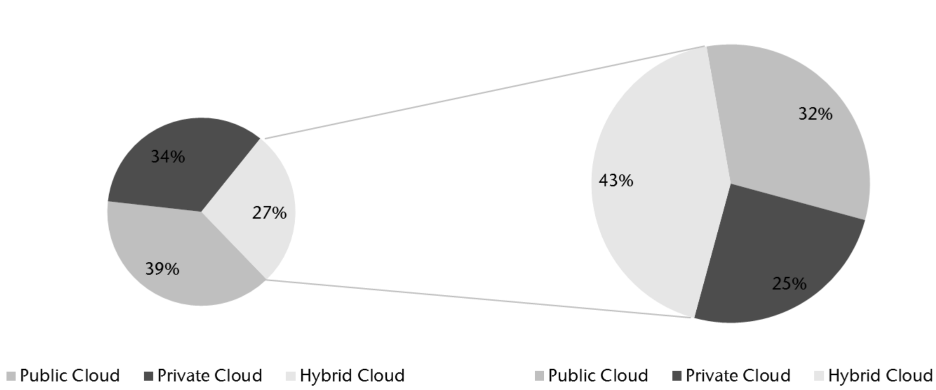


Source: ¹ GigaOM Future of Cloud Computing – 3rd Annual Study 2013 (N=855); ²Everest Group/ Cloud Connect, Enterprise Cloud Adoption Survey 2013 (N=101

A strong play on hybrid cloud

Due to Microsoft's incumbency, we think it is well positioned to play in hybrid cloud where the on-premise infrastructure is mirrored in the public cloud to provide the ultimate flexibility and scalability for where and how workloads run. We expect the hybrid model to become the most commonly adopted model by enterprises over coming years. While there is ample competition from leaders (such as Amazon Virtual Private Cloud) and open source alternatives (OpenStack), we believe Microsoft has a good opportunity in this emerging, high growth market.

Chart 30: Hybrid Cloud expected to increase as a percentage of the mix



Source: GigaOM Future of Cloud Computing – 3rd Annual Study 2013 (N=855); Pie sizes illustrative of market growth

Good customer momentum

Microsoft highlighted a vast array of tier customers that are using Azure to some degree at its recent financial analyst meeting. The key question remains as to how deep usage of the platform is. However, there are an increasing set of customer use cases that suggest large companies are doing more with the platform.

Chart 31: Strong customer roster

Source: Jefferies, Company Data

We note that Microsoft:

- Has over 250K customers using Azure
- Has over 50% of the F500 as customers
- ~Is adding 1K customers a day
- Is seeing Azure compute and storage double every 6-9 months
- Has over 4 Trillion database objects in Azure

Push for adoption

Recent moves from Microsoft reinforce our view that the company is serious about driving adoption. We note price matching with market leader AWS for basic services, more credits and incentives for the Microsoft development community and new options for specific workloads.

Chart 32: MSFT serious on price and other factors to drive adoption

- Commitment to match Amazon Web Services prices for compute, storage and bandwidth
- Azure credits and discounts for MSDN members to develop on Azure
- Pricing has been moved to per minute v per hour/ minimums by others
- 8 data centers and new data centers being added in China, Japan and Australia
- New high memory VM instances for demanding workloads

Source: Jefferies, Company data

Most of the value we ascribe today is for the traditional server products, but we expect that to shift toward Azure over time.

Valuation

Based on a DCF, we ascribe most of the value ($10) to the server products today and only a small part ($2) to the Azure part of the business. Our assumption of $12 of value for the entire business equates to 11X our FY15 NOPAT estimate (adjusted for corporate cost load) for our prior S&T division estimate.

Chart 33: Server & Tools + Azure is worth around $12 per share

S&T Infrastructure Products

	Annual Revenue Growth				
WACC	2.0%	3.5%	5.0%	6.5%	8.0%
7.0%	$10.9	$12.5	$14.4	$16.5	$19.0
8.0%	$9.1	$10.4	$11.8	$13.5	$15.5
9.0%	$7.8	$8.8	$10.0	$11.4	$14.1
10.0%	$6.8	$7.7	$8.7	$9.8	$11.2
11.0%	$6.0	$6.8	$7.7	$8.6	$9.7

Azure

	Terminal Operating Margin				
WACC	15%	20%	25%	30%	35%
7.0%	$1.4	$3.6	$5.7	$7.8	$9.8
8.0%	$0.8	$2.2	$3.5	$4.8	$6.0
9.0%	$0.6	$1.5	$2.4	$3.3	$4.2
10.0%	$0.4	$1.1	$1.8	$2.5	$3.1
11.0%	$0.3	$0.9	$1.4	$1.9	$2.4

$12 equates to 11X our FY15 prior S&T NOPAT estimate

Source: Jefferies, Company Data. Please see appendix for full DCFs.

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Hidden Path to Value: IP

We believe there is some value associated with Microsoft's enforcement of IP over OEMs that license the Android operating system. We think that ultimately could be worth $3-4 a share, but today we ascribe a $2 value per share.

Microsoft is an indirect play on Android

Microsoft claims that Android infringes more than a dozen Microsoft patents and filed a complaint with the ITC in October 2010 as the starting point for enforcement. Since then, Microsoft has been successful in signing agreements with at least 20 OEMs that license the Android operating system.

Chart 34: Microsoft has moved to enforce patents

Microsoft claims that Android infringes more than a dozen patents

Microsoft filed a complaint with the ITC in October 2010 against Motorola

Microsoft now has agreements in place with at least 20 partners

Patents cover a broad range of areas including:

File names/ file system
Flash memory monitoring
APIs around mobile devices and cellular technology
online and offline data synchronization

Patent numbers that we know of:

5,579,517	1996	6,578,054	2003
5,758,352	1996	6,370,566	2002
6,621,746	2003	5,778,372	1998
6,826,762	2004	6,339,780	2002
6,909,910	2005	5,889,522	1999
7,644,376	2010	6,891,551	2005
5,664,133	1997	6,957,233	2005

Design patents are typically enforceable for 14 years and utility/ software patents for 20 years. We believe many of Microsoft's patents will be enforceable for some time.

Source: Jefferies, Company data

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Chart 35: Announced Android patent deals

April 27 2010	HTC	Apr 25 2012	Pegatron
June 27 2011	General Dynamics Itronix	Apr 30 2012	Barnes and Noble
June 29 2011	Velocity Micro	July 9 2012	Aluratek
June 30 2011	Onkyo	July 9 2012	Coby Electronics
July 5 2011	Wistron	Nov 7 2012	Sharp (and related)
Sept 8 2011	Acer	Dec 11 2012	EINS
Sept 8 2011	ViewSonic	Dec 11 2012	Hoeft and Wessel
Sept 8 2011	Samsung	Feb 21 2013	Nikon
Oct 23 2011	Compal	Apr 16 2013	Foxconn/ Hon Hai
Jan 12 2012	LG	Apr 23 2013	ZTE

'With ZTE and other licensees, Microsoft gets royalties from 80% of the Android smartphones sold in the US and more than 50% of those sold Worldwide' Horacio Gutierrez, Deputy General Council, Microsoft

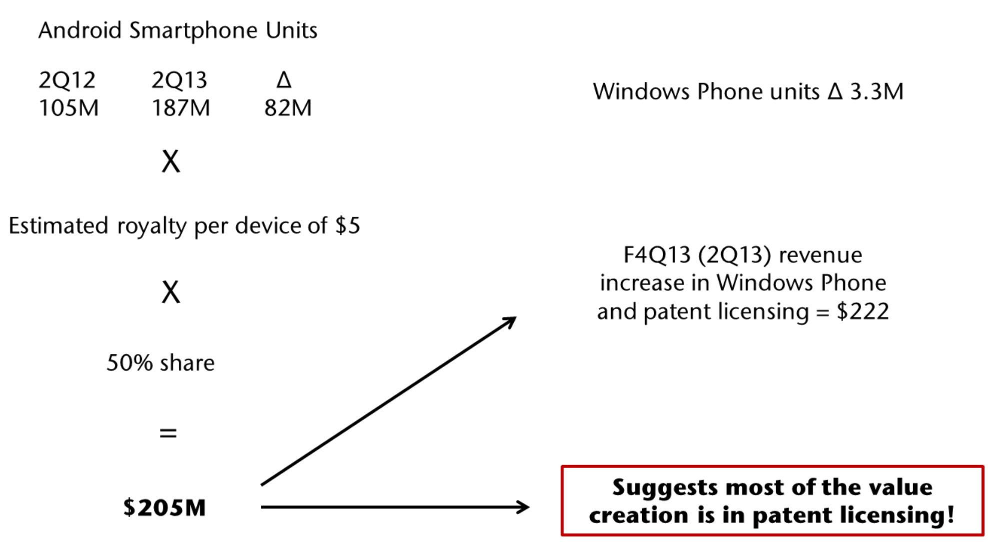
Source: Jefferies, Company Data

Our analysis of "Windows Phone and IP" suggests almost all the value is being created by Microsoft's royalty arrangements with Android OEMs rather than Windows Phone.

Microsoft is generating royalties on 50% of Android smartphones!

Our analysis of Windows Phone revenues for F4Q13 suggests that most of the value creation from Microsoft's efforts around phone thus far have been from Android rather than Windows!

Chart 36: Analysis of F4Q13 Phone and IP revenues



Source: Jefferies, Company Data

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What could this be worth?

Using industry forecasts for Android smartphone units and estimated royalty per devices based on what we think is a reasonable analysis of 4Q13, we think this could be worth as much as $3-4 a share by 2017.

$3-4 of value per share isn't that material in the context of overall enterprise value, but it could be sufficient, for example, to offset the ongoing losses associated with Bing!

Chart 37: Estimate of future royalty value

Android Smartphone Unit Forecasts

CY13	CY14	CY15	CY16	CY17
652M	743M	830M	908M	987M

X

Estimated royalty per device of $5

X

75% share[1]

=

>$2.5B earnings → **Worth $3-4 a share**

Source: IDC, Jefferies
Note 1: Assumes MSFT wins more licensees (eg. Huawei, Motorola Mobility); we assume 90% gross margin and 20% corporate tax rate.

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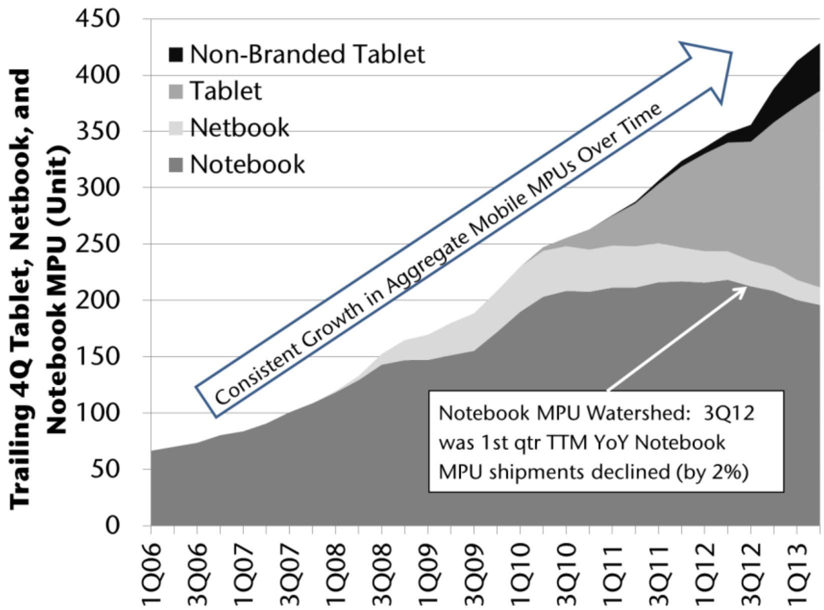
Uncertain Path to Value: Windows

We remain uncertain about the value of Windows. So far Microsoft has suffered from a lack of relevance in the growth segments of the personal computing landscape (i.e., Smartphones and Tablets). As a result, Windows OEM revenue has declined as it remains tied predominantly to traditional PC form factors.

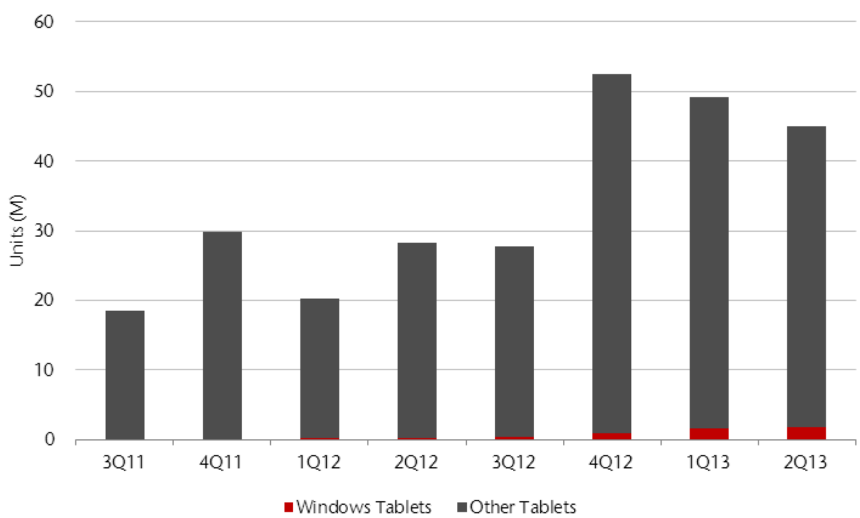
Chart 38: Tablets have been taking share from PCs



Source: Jefferies, Mercury Research

Windows share of the tablet market thus far has been almost non-existent.

Chart 39: Windows has so far garnered only 4% share of the tablet market



Source: Jefferies, IDC

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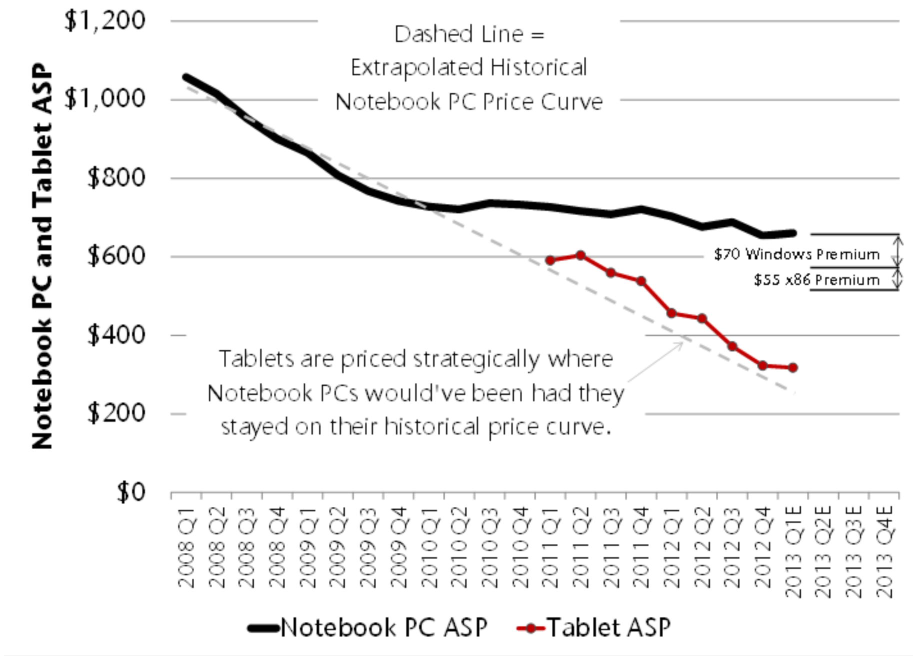
Price has been a part of Wintel's failure in tablets

Perhaps as important, if not more important than the innovative form factor of the tablet, is that notebook PCs have just been too expensive. Neither Microsoft nor Intel were willing to concede on price and Intel had to deliver next generation products that allowed the introduction of devices at the right price point and with the right performance and power characteristics. We were encouraged when we saw changes being made earlier this year – see our note co-authored with Mark Lipacis: Wintel Resurrection? from June 2013.

Chart 40: The elimination of the $125 Wintel premium would go a long way to making the notebook PC more competitive in pricing



Source: IDC, Gartner, Jefferies

An analysis of PC shipments by price bucket reinforces this view. Over the past four years, PCs priced between $300 and $500 have become a larger part of the PC mix.

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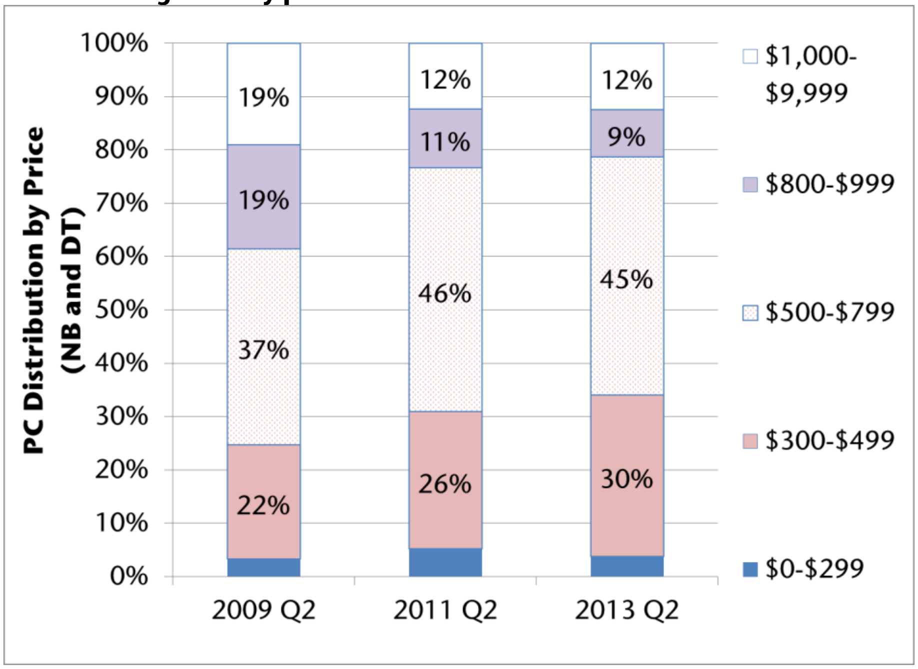
Chart 41: PC growth by price bucket

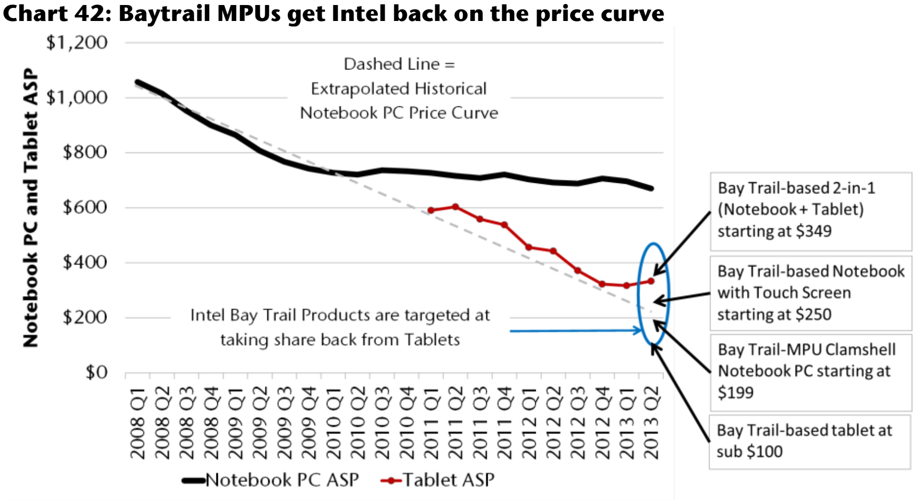


Source: Gartner, Jefferies

With the advent of improved low cost/ low power devices powered by Intel's next generation Baytrail and Haswell MPUs, Wintel devices could get back on the cost curve.

Our lead semi-conductor analyst, Mark Lipacis, recently upgraded Intel to Buy (Intel Upgrade to Buy: 60 Billion Reasons to Buy INTC). His primary thesis is that the company has a new focus on manufacturing leadership to make MPUs that are lower power, higher performance and cheaper than competitive solutions, which should translate into share gains in sub $500 tablets, 2-in-1 PCs and handsets.

Chart 42: Baytrail MPUs get Intel back on the price curve



Source: Gartner, Intel IDF Press Release, Jefferies estimates

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A number of low price Wintel devices are coming to market this holiday season.

Could we be surprised this holiday season?

While it is not part of our core thesis, it is possible that we could be positively surprised by adoption of Wintel based devices this holiday season.

Chart 43: Could we be surprised this holiday season?

	Dell Venue Pro	Intel Atom Baytrail MPU 10.8 inch screen 1.65lbs 9 hours battery	$149-499
	Asus Transformer Book Trio T100	Intel Atom Baytrail MPU 10.1 inch screen 2.2lbs 12 hours battery	$329*
	Toshiba Encore	Intel Atom Baytrail MPU 8 inch screen 1lb 6 hours battery	$329*
	Lenovo Miix 2	Intel Atom Baytrail MPU 10.1 inch screen 1.3lbs 8 hours battery	$449*

Source: Jefferies, www.winsupersite.com,* estimated prices

Our base case valuation does not assume upside from Windows OEM revenues, which we expect to continue to decline upper -single digits.

For now, we assume weak Windows environment

For now our core thesis remains cautious on OEM Windows licensing. Our view is based on the following:

- We expect tablets to continue to cannibalize traditional consumer PCs – although we think Microsoft's participation in the tablet market could improve modestly
- We think Microsoft will participate at lower license ASPs
- We expect Windows in the Enterprise to be relatively resilient given around $4B is tied to volume licensing

Our assumption is Windows revenues decline in perpetuity by around 5-10% per year.

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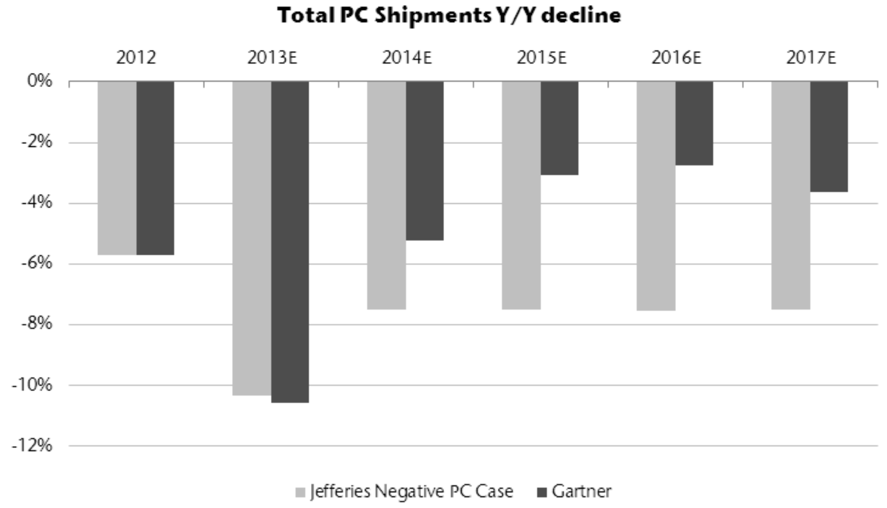
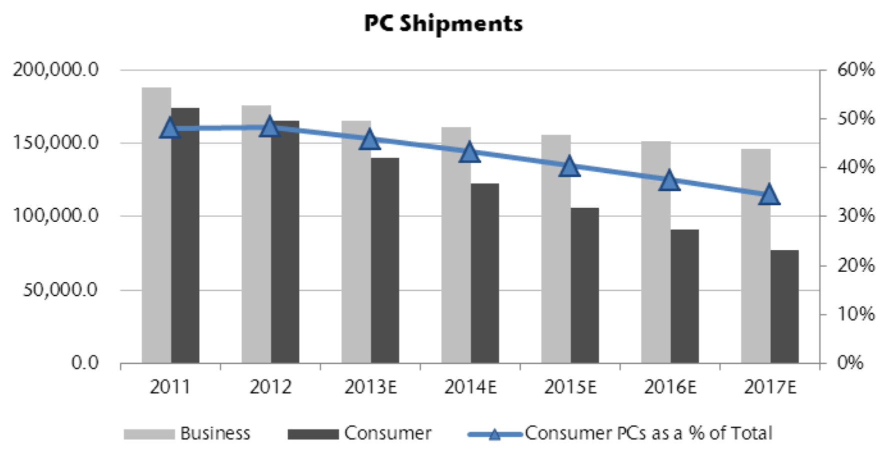
Chart 44: We assume ongoing declines for the Windows business



Source: Gartner, Jefferies

Chart 45: Consumer declines faster than Enterprise



Source: Gartner, Jefferies

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Valuation

Chart 46: Windows is worth around $5 a share

	Annual revenue decline				
WACC	2.5%	5.0%	7.5%	10.0%	12.5%
7.0%	$8.1	$6.7	$5.5	$4.6	$3.9
8.0%	$7.3	$6.1	$5.1	$4.3	$3.6
9.0%	$6.6	$5.5	$4.7	$4.0	$3.4
10.0%	$6.1	$5.1	$4.4	$3.7	$3.2
11.0%	$5.6	$4.8	$4.1	$3.5	$3.0

$5 equates to 7X our FY15 prior Windows NOPAT estimate

Source: Jefferies

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Zero to Negative Value Assumption: 1) Windows Phone, 2) First Party Hardware, 3)Xbox and 4) Consumer Internet

Windows Phone and Nokia

We assume zero value for Windows Phone. We note for example that in F4Q13 (2Q13), Windows Phone saw growth of 3.3M units Y/Y. At a <$10 royalty rate per unit (as disclosed in MSFT's Nokia acquisition presentation), that would equate to approximately $33M of incremental revenue. We believe Windows Phone constituted less than $250M in revenue on a TTM basis. Assuming 90% gross and 50% operating margin on these sales would only have delivered only $0.01 of EPS.

The acquisition of Nokia provides the option for Microsoft to remain in the smartphone business.

What does the purchase of Nokia mean?

We think Microsoft decided to buy Nokia for four reasons:

- **A defensive move:** Nokia is c.80% of Windows Phone units. Nokia had evaluated moving away from the Microsoft commercial relationship and had already established a group internally to look at the cost and risk associated with an alternative platform. Buying Nokia ensures Microsoft has the option of remaining in the Smartphone business.
- **Not an excessive use of cash:** €3.79B for the Devices and Services business and €1.65B for IP licensing. We estimate this to be around 10% of Microsoft's offshore cash balance.
- **Dilutive, but cost synergies will help:** Based on current ASP mix and current group corporate rate , if Windows Phone can get to 6% market share by 2016 (4% today) then we estimate the business could generate $800-1.2B of post-tax EP.
- **Path to break-even:** Microsoft expects EBIT break-even at 50M units.

If the strategy does not work (or if the new CEO decides that it is not a business Microsoft should be in), we think there is a path to exit, even though it won't be without cost.

What if new CEO doesn't want to be in Phones/ the strategy doesn't work?

We think it would cost Microsoft about $6B to exit the business base on:

- **32K employees,** but we believe around 1/2 are employed without recourse for severance. Assume severance and redundancy costs is a full year of fully loaded operating expense = $1.5B.
- **We estimate warranty/ returns on 50% of devices sold.** Warranty/ returns on 30M annualized smartphone units at $175 ASP would be $2.5B and warranty and returns on 200M mobile phones would be $2B. In total, $4.5B.
- **Total estimate = $6B**

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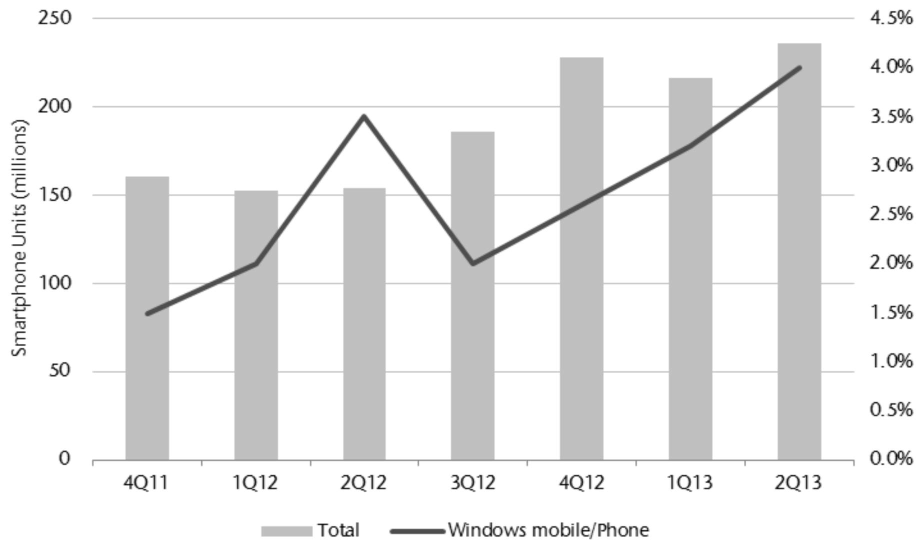
Windows Phone is taking share

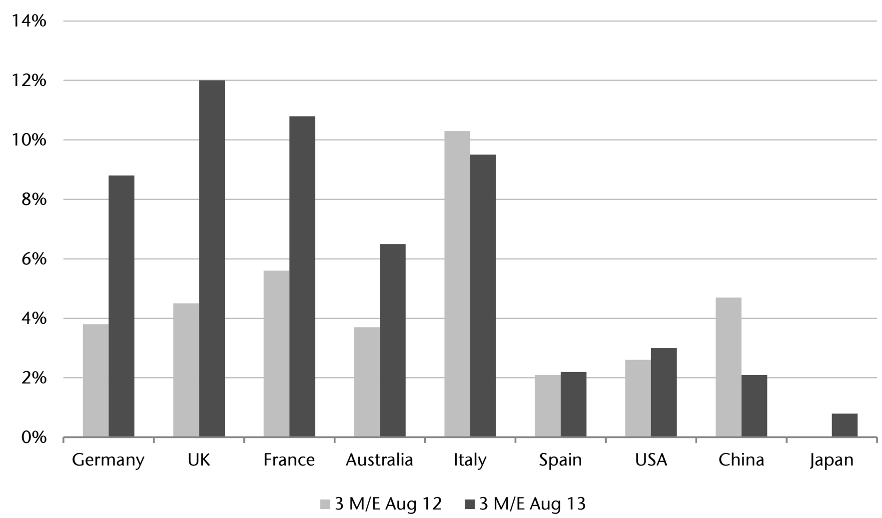
Data from IDC suggests Windows Phone is taking share from a low base. Windows Phone stood at 4% market share (35M units annualized) as of 2Q13. In addition, we note that data from Kantar Worldwide suggests

Chart 47: From a low base, Windows Phone has taken share



Source: Jefferies, IDC

Chart 48: Windows Phone is taking share in Europe



Source: Jefferies, IDC

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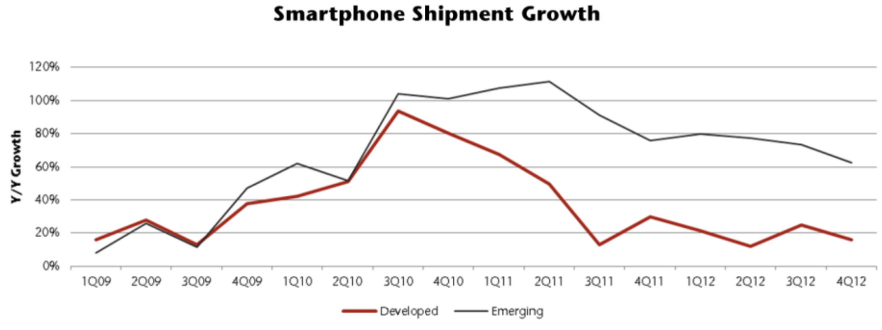
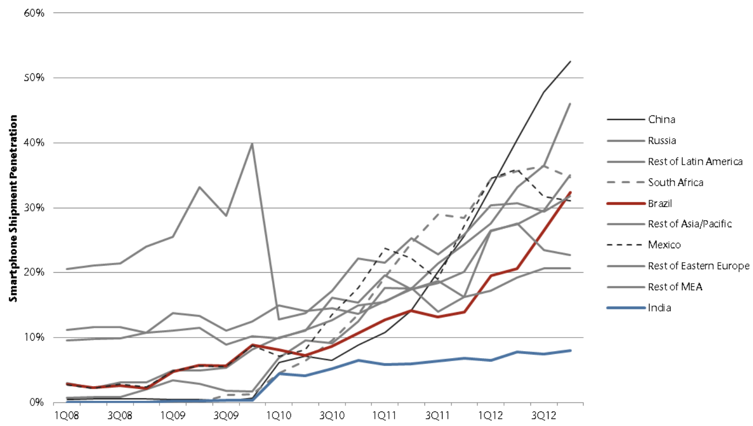
But the Backdrop for Handsets Is Tough

Chart 49: Smartphone shipments are decelerating in developed markets…



Source: Jefferies

Chart 50: …while emerging markets have low ASP



	Tranche #1	Tranche #2	Tranche #3
Nominal GDP Per Capita	$43K	$9K	$4K
Smartphone Shipment Penetration	>50%	33%-50%	<33%
Estimated Smartphone ASP	$429	$187	$84

Source: Jefferies, Gartner, CIA Worldbook

First Party Hardware/ Xbox

We assume zero value to First party hardware and Xbox at Microsoft.

The prior EDD segment (which included Xbox console, accessories, first party video games, Xbox Live subscriptions, Kinect, Skype, and Windows Phone) was effectively a break-even business over the last decade.

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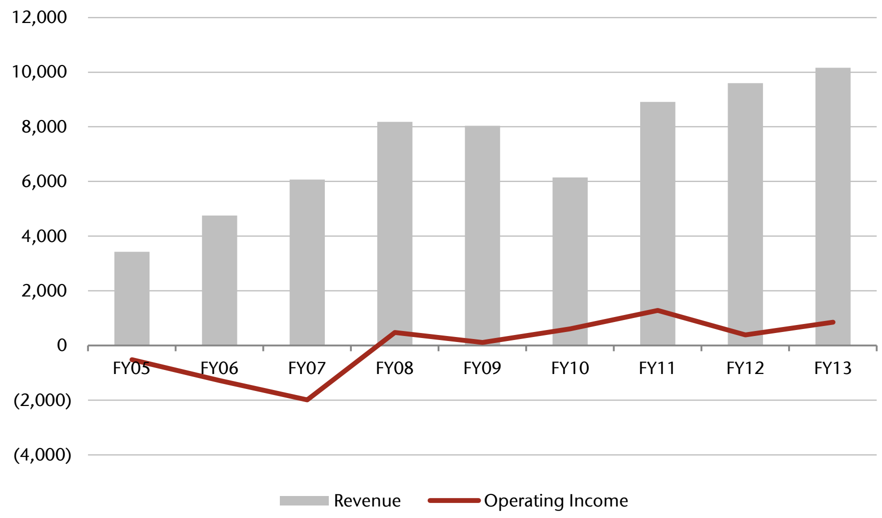
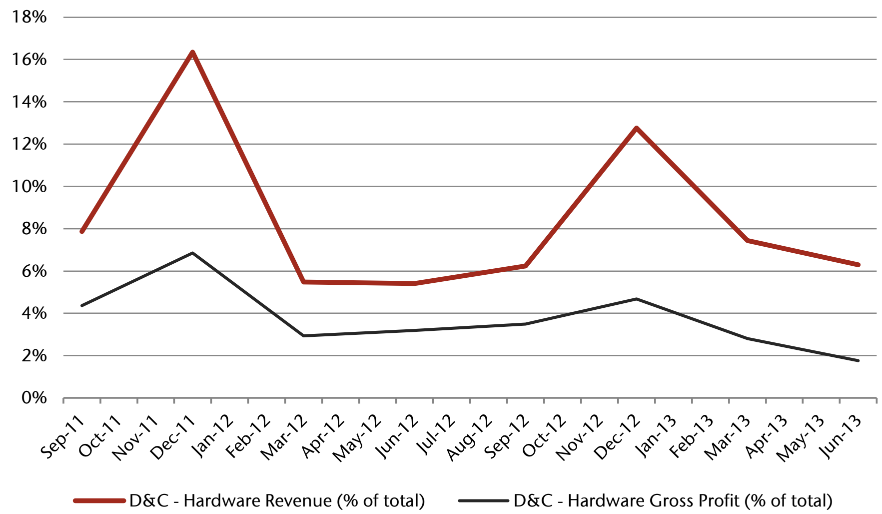
Chart 51: Cumulative GAAP profit from EED is approximately zero



Source: Jefferies, Company Data

The new disclose data for hardware (in the Devices and Consumer segment) suggests that (excluding the write down on Surface in F4Q13) the business is generating gross margins in the 30-40% range. More importantly, gross profit contribution to the total is in the 2-4% range.

Chart 52: Hardware is a tiny contributor to total gross profits



Source: Jefferies, Company Data

Xbox One provides pathway to a product cycle

Microsoft will ship its third generation console, Xbox One, on November 22 2013. This is the first major console refresh since November 2005. Given the 78M unit install base of the Xbox 360 and notwithstanding what is viewed as the relatively high price point of the

Xbox One ($499 including Kinect versus PS4 at $399), demand thus far seems to be good with sales of Day One pre-orders sold out across most Internet retailers.

Microsoft is positioning Xbox One as much more than just a game console. Much more of the focus is on Entertainment (e.g., natural language control, unique experience such as NFL on Xbox One and Xbox Live subscriptions for access to content). Microsoft is also attempting to converge the user experience with Windows and other consumer services across PC, Tablet, Smartphone and the living room. For example, with Xbox One, Windows Phone can be used as a remote. Similarly, Skype on Xbox One will include group video calls.

We conservatively model growth of 25% Y/Y for Devices and Consumer Hardware revenue growth over the next four quarters, which compares with an average of almost 70% in the four quarters post the launch of Xbox 360. We think our estimates are conservative.

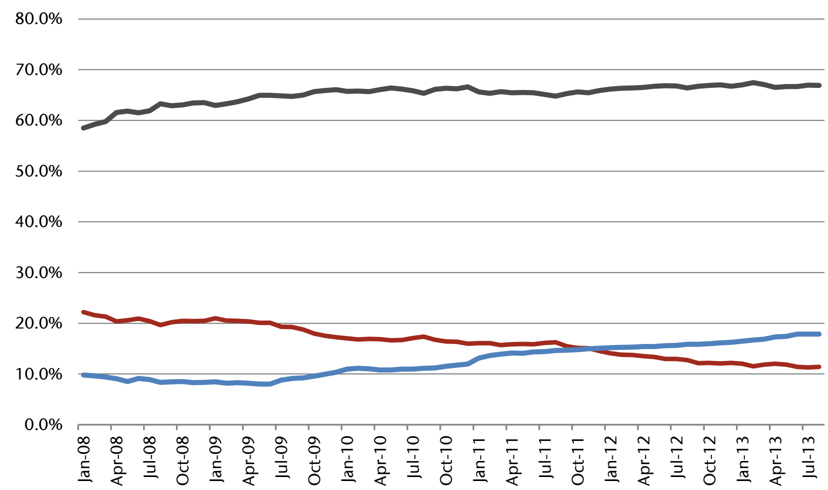
Consumer Internet: Bing and MSN

The consumer internet assets (primarily Bing and MSN) generate revenue through the sale of search and display advertising. The economic model of these business are predicted on scale such that profitability is only achieved at certain level of revenue per search/ impressions.

Despite efforts to increase search share (including the Yahoo! Search agreement that was signed in 2009), Microsoft has so far failed to achieved sufficient scale to drive this business to profitability and has extended the relationship with Yahoo for at least another year (while still guaranteeing some level of minimum revenue pre search to Yahoo).

Given the modest improvement in market share and the risk that Yahoo! could eventually seek to shift its search engine provider away from Microsoft, we assume that losses in this business will continue. In addition, we think this remains one of the most capital intensive parts of Microsoft's business.

Chart 53: U.S. Explicit Search Market Share



Source: Jefferies

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Chart 54: We assume Bing/ MSN remain loss making

	Terminal Operating Margin				
WACC	-25%	-20%	-15%	-10%	-5%
7.0%	-$4.5	-$3.8	-$3.2	-$2.5	-$1.7
8.0%	-$3.8	-$3.2	-$2.7	-$2.1	-$1.4
9.0%	-$3.2	-$2.7	-$2.3	-$1.8	-$1.2
10.0%	-$2.9	-$2.4	-$2.0	-$1.6	-$1.1
11.0%	-$2.6	-$2.2	-$1.8	-$1.4	-$1.0

-$3 equates to 14X our FY15 prior Windows NOPAT estimate

Source: Jefferies

Capital Allocation

- Microsoft has net cash of $8.56/ share (or $6 if we tax-adjust for offshore cash). $18.3B of cash is domestic and $69.6B is held offshore
- Microsoft is under-levered compared to large-tech peers
- Microsoft could double its current debt load and still have Debt/ EBITDA in line or below Cisco, IBM and Oracle
- At 2x debt and a $33 share price, Microsoft can repurchase approximately 6% of shares outstanding
- We estimate MSFT generates approx. $10-12B in FCF in the U.S.
- With dividend raise of 22% in FY14, we estimate MSFT will pay out approximately $9.5B in FCF as dividends
- At $33 price and mid-point of our FCF estimate, MSFT can repurchase 1% of shares outstanding without raising additional debt or tapping foreign cash

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Chart 55: Microsoft is under-levered relative to its peers
$ in millions except per share data

	MSFT	AAPL	CSCO	IBM	ORCL
Cash	87,866	146,620	50,610	10,357	39,104
Debt	15,600	16,958	16,211	34,122	24,108
Net Cash	72,266	129,662	34,399	(23,765)	14,996
Net Cash / Share	$8.56	$141.98	$6.33	($21.42)	$3.21
Assets	142,431	199,856	101,191	115,153	86,406
Equity	78,944	123,354	59,128	17,883	43,986
LTM EBITDA	31,614	55,868	15,974	27,511	18,333
Shares	8,442	913	5,437	1,109	4,674
Share Price	$33.01	$480.94	$25.59	$196.61	$32.48
Dividend	$1.12	$12.20	$0.68	$3.80	$0.48
Market Cap	278,670	439,226	139,133	218,119	151,812
Net Cash as % of Mkt Cap	26%	30%	25%	NM	10%
Debt to Assets	0.11	0.08	0.16	0.30	0.28
Debt to Equity	0.20	0.14	0.27	1.91	0.55
Debt to LTM EBITDA	0.49	0.30	1.01	1.24	1.32
Dividend Yield	3.4%	2.5%	2.7%	1.9%	1.5%

Source: Jefferies, company data

Chart 56: U.S. based FCF
$ in millions

	FY11	FY12	FY13
Increase in U.S. cash	3,595	179	(550)
Acquisitions	71	1,612	1,584
Dividends paid	5,180	6,385	7,455
Share repurchases	11,555	5,029	5,360
Net proceeds from debt	(6,146)	0	(3,537)
Estimated U.S. cash flow	**14,255**	**13,205**	**10,312**

	FY11	FY12	FY13
Pre-tax profit	28,071	22,267	27,052
U.S. as % of total revenue	54%	53%	52%
U.S. net income (at 35% tax)	9,915	7,626	9,183
Working capital and capex, net	2,229	9,889	5,477
U.S. as % of total revenue	54%	53%	52%
U.S. working capital and capex	1,211	5,211	2,860
Estimated U.S. cash flow	**11,126**	**12,837**	**12,044**

Source: Jefferies, company data

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APPENDIX

Chart 57: MSFT Estimate Changes

	F1Q14E					FY14E					FY15E				
	New	**Prev**	**Change**	**% Change**	**Consensus**	**New**	**Prev**	**Change**	**% Change**	**Consensus**	**New**	**Prev**	**Change**	**% Change**	**Consensus**
D&C - Hardware	909	-	-	-		8,474	-	-	-		8,924	-	-	-	
D&C - Licensing	4,756	-	-	-		16,578	-	-	-		15,468	-	-	-	
D&C - Other	1,484	-	-	-		7,402	-	-	-		7,869	-	-	-	
Commercial - Licensing	9,178	-	-	-		42,382	-	-	-		45,219	-	-	-	
Commercial - Other	1,523	-	-	-		7,073	-	-	-		8,880	-	-	-	
Total Revenues ($Ms)	**17,850**	**17,924**	**-74**	**0%**	**17,828**	**81,909**	**81,373**	**536**	**1%**	**83,061**	**86,360**	**84,932**	**1,428**	**2%**	**89,964**
Y/Y	12%	12%				5%	5%				5%	4%			
Q/Q	-10%	-10%													
Operating Profit	**5,501**	**5,516**	**-16**	**0%**		**27,856**	**27,668**	**188**	**1%**		**29,549**	**29,064**	**485**	**2%**	
Operating Margin	31%	31%				34%	34%				34%	34%			
EPS	**$0.53**	**$0.54**	**0.00**	**0%**	**$0.55**	**$2.72**	**$2.71**	**0.02**	**1%**	**$2.69**	**$2.95**	**$2.90**	**0.05**	**2%**	**$2.96**
Y/Y	2%	2%				6%	5%				8%	7%			
EPS (Operating)	**$0.59**	**$0.59**	**0.00**	**0%**		**$2.99**	**$2.97**	**0.02**	**1%**		**$3.23**	**$3.18**	**0.05**	**2%**	
Y/Y	2%	2%				6%	6%				8%	7%			

Source: Jefferies estimates, FactSet

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Chart 58: Microsoft Business Division DCF
($ in millions, except per-share items)

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	CAGR: 2013-2025
Total Revenue	24,727	26,211	27,783	29,450	31,217	33,090	35,076	37,180	39,411	41,776	42,611	43,463	44,333	5%
Y/Y Growth		*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*2%*	*2%*	*2%*	
NG Operating Income	16,190	17,037	18,059	19,143	20,291	21,509	22,799	24,167	25,617	27,154	27,697	28,251	28,816	5%
NG Op Margin	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	*65%*	
Tax rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	
CFO	11,333	11,926	12,641	13,400	14,204	15,056	15,959	16,917	17,932	19,008	19,388	19,776	20,171	
Y/Y Growth	*NM*	*5%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*2%*	*2%*	*2%*	
Capex	1,978	2,097	2,223	2,356	2,497	2,647	2,806	2,974	3,153	3,342	3,409	3,477	3,547	
% of rev	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	
uFCF	9,355	9,829	10,419	11,044	11,706	12,409	13,153	13,943	14,779	15,666	15,979	16,299	16,625	5%
Y/Y Growth	*NM*	*5%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*	*2%*	*2%*	*2%*	
PV of uFCF		9,017	8,769	8,528	8,293	8,065	7,843	7,627	7,417	7,213	6,750	6,316	5,911	
Terminal Value	86,127												242,247	

Present Value of Equity		*($ in Ms)*
PV of FCF	91,750	52%
PV of Terminal Value	86,127	48%
Enterprise Value	177,877	100%
Less: Debt	0	
Add: Cash	0	$0.00
Equity Value	177,877	
FDS	8,442	
Equity Value/ Share	**$21.07**	

DCF Assumptions	
WACC	9.0%
Perpetual Growth Rate	2.0%
Tax Rate	25%

Source: Jefferies, company data

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Chart 59: Server & Tools DCF
($ in millions, except per-share items)

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	CAGR: 2013-2025
Legacy S&T Revenue	19,587	20,566	21,594	22,674	23,808	24,998	26,248	27,561	28,939	30,385	31,905	33,500	35,175	*5%*
Y/Y Growth		*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	
Legacy S&T Operating Income	8,228	8,226	8,638	9,070	9,523	9,999	10,499	11,024	11,575	12,154	12,762	13,400	14,070	*5%*
NG Op Margin	*42%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	
Tax rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	
CFO	5,760	5,759	6,046	6,349	6,666	6,999	7,349	7,717	8,103	8,508	8,933	9,380	9,849	
Y/Y Growth	*NM*	*0%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	
Capex	979	1,028	1,080	1,134	1,190	1,250	1,312	1,378	1,447	1,519	1,595	1,675	1,759	
% of rev	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	
uFCF	4,781	4,730	4,967	5,215	5,476	5,750	6,037	6,339	6,656	6,989	7,338	7,705	8,090	*4%*
Y/Y Growth	*NM*	*-1%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	*5%*	
PV of uFCF		4,340	4,180	4,027	3,879	3,737	3,600	3,468	3,340	3,218	3,100	2,986	2,876	
Terminal Value	41,913												117,886	

Present Value of Equity		*($ in Ms)*
PV of FCF	42,750	50%
PV of Terminal Value	41,913	50%
Enterprise Value	84,663	100%
Less: Debt	0	
Add: Cash	0	$0.00
Equity Value	84,663	
FDS	8,442	
Equity Value/ Share	**$10.03**	

DCF Assumptions	
WACC	9.0%
Perpetual Growth Rate	2.0%
Tax Rate	25%

Source: Jefferies, company data

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Chart 60: Azure DCF

($ in millions, except per-share items)

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	CAGR: 2013-2025
PaaS Market	1,206	1,582	2,020	2,508	3,056	3,462	3,808	4,151	4,483	4,797	5,085	5,339	5,606	*14%*
Y/Y Growth		*31%*	*28%*	*24%*	*22%*	*13%*	*10%*	*9%*	*8%*	*7%*	*6%*	*5%*	*5%*	
Azure PaaS Revenue	60	158	303	502	764	1039	1142	1245	1345	1439	1525	1602	1682	*32%*
Market Share	*5%*	*10%*	*15%*	*20%*	*25%*	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*	
IaaS Market	6,319	9,193	13,184	18,291	24,303	30,939	37,126	42,695	46,965	51,192	54,775	58,061	60,964	*21%*
Y/Y Growth		*45%*	*43%*	*39%*	*33%*	*27%*	*20%*	*15%*	*10%*	*9%*	*7%*	*6%*	*5%*	
Azure IaaS Revenue	442	1,379	2,637	4,024	6,076	8,353	11,138	12,809	14,089	15,357	16,432	17,418	18,289	*36%*
Market Share	*7%*	*15%*	*20%*	*22%*	*25%*	*27%*	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*	*30%*	
Total Azure Revenue	503	1,537	2,940	4,526	6,840	9,392	12,280	14,054	15,434	16,796	17,958	19,020	19,971	*36%*
Y/Y Growth		*206%*	*91%*	*54%*	*51%*	*37%*	*31%*	*14%*	*10%*	*9%*	*7%*	*6%*	*5%*	
Azure Operating Income	-40	-61	29	226	479	845	1474	2108	3087	4199	4489	4755	4993	
NG Op Margin	*-8%*	*-4%*	*1%*	*5%*	*7%*	*9%*	*12%*	*15%*	*20%*	*25%*	*25%*	*25%*	*25%*	
Tax rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	
CFO	(40)	(61)	29	158	335	592	1,032	1,476	2,161	2,939	3,143	3,329	3,495	
Y/Y Growth	*NM*	*53%*	*-148%*	*439%*	*112%*	*77%*	*74%*	*43%*	*46%*	*36%*	*7%*	*6%*	*5%*	
Capex	75	231	441	543	684	751	982	1,124	1,235	1,344	1,437	1,522	1,598	
% of rev	15%	15%	15%	12%	10%	8%	8%	8%	8%	8%	8%	8%	8%	
uFCF	(116)	(292)	(412)	(385)	(349)	(160)	49	351	926	1,596	1,706	1,807	1,897	
Y/Y Growth	*NM*	*153%*	*41%*	*-7%*	*-9%*	*-54%*	*-131%*	*615%*	*164%*	*72%*	*7%*	*6%*	*5%*	
PV of uFCF		(268)	(346)	(297)	(247)	(104)	29	192	465	735	721	700	675	
Terminal Value	17,707												49,803	

Present Value of Equity		*($ in Ms)*
PV of FCF	2,254	11%
PV of Terminal Value	17,707	89%
Enterprise Value	19,961	100%
Less: Debt	0	
Add: Cash	0	$0.00
Equity Value	19,961	
FDS	8,442	
Equity Value/ Share	**$2.36**	

DCF Assumptions	
WACC	9.0%
Perpeutal Growth Rate	5.0%
Tax Rate	25%

Source: Jefferies, company data

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Chart 61: Windows Division DCF
($ in millions, except per-share items)

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	CAGR: 2013-2025
Total Revenue	16,990	15,716	14,537	13,447	12,438	11,505	10,642	9,844	9,106	8,423	7,791	7,207	6,666	-8%
Y/Y Growth		-8%	-8%	-8%	-8%	-8%	-8%	-8%	-8%	-8%	-8%	-8%	-8%	
NG Operating Income	10,024	9,272	8,577	7,934	7,338	6,788	6,279	5,808	5,372	4,970	4,597	4,252	3,933	-8%
NG Op Margin	59%	59%	59%	59%	59%	59%	59%	59%	59%	59%	59%	59%	59%	
Tax rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	
CFO	7017	6491	6004	5553	5137	4752	4395	4066	3761	3479	3218	2976	2753	
		-8%	-7%	-8%	-8%	-7%	-8%	-8%	-8%	-7%	-8%	-8%	-8%	
Capex	510	471	436	403	373	345	319	295	273	253	234	216	200	
% of revenue	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%	
uFCF	6,507	6,019	5,568	5,150	4,764	4,407	4,076	3,770	3,488	3,226	2,984	2,760	2,553	-8%
Y/Y Growth	NM	-7%	-7%	-8%	-7%	-8%	-8%	-8%	-8%	-7%	-8%	-8%	-8%	
PV of uFCF		5,522	4,686	3,977	3,375	2,864	2,430	2,062	1,750	1,485	1,260	1,070	908	
Terminal Value	8,087												22,747	

Present Value of Equity		*($ in Ms)*
PV of FCF	31,390	80%
PV of Terminal Value	8,087	20%
Enterprise Value	39,478	100%
Less: Debt	0	
Add: Cash	0	$0.00
Equity Value	39,478	
FDS	8,442	
Equity Value/ Share	**$4.68**	

DCF Assumptions	
WACC	9.0%
Perpetual Growth Rate	-2.0%
Tax Rate	25%

Source: Jefferies, company data

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Chart 62: Online Services Division DCF
($ in millions, except per-share items)

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	CAGR: 2013-2025
OSD Revenue	3,202	3,554	3,910	4,262	4,645	5,017	5,368	5,636	5,918	6,155	6,401	6,593	6,791	*6%*
Y/Y Growth		*11%*	*10%*	*9%*	*9%*	*8%*	*7%*	*5%*	*5%*	*4%*	*4%*	*3%*	*3%*	
OSD Operating Income	-1,281	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	-1,200	*-1%*
NG Op Margin	*-40%*	*-34%*	*-31%*	*-28%*	*-26%*	*-24%*	*-22%*	*-21%*	*-20%*	*-19%*	*-19%*	*-18%*	*-18%*	
Tax rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	
CFO	(1,281)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)	
Y/Y Growth	*NM*	*-6%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	*0%*	
Capex	480	533	586	511	465	401	429	451	473	492	512	527	543	
% of rev	15%	15%	15%	12%	10%	8%	8%	8%	8%	8%	8%	8%	8%	
uFCF	(1,761)	(1,733)	(1,786)	(1,711)	(1,665)	(1,601)	(1,629)	(1,651)	(1,673)	(1,692)	(1,712)	(1,727)	(1,743)	*0%*
Y/Y Growth	*NM*	*-2%*	*3%*	*-4%*	*-3%*	*-4%*	*2%*	*1%*	*1%*	*1%*	*1%*	*1%*	*1%*	
PV of uFCF		(1,590)	(1,504)	(1,322)	(1,179)	(1,041)	(972)	(903)	(840)	(779)	(723)	(669)	(620)	
Terminal Value	(9,031)												(25,402)	

Present Value of Equity		*($ in Ms)*
PV of FCF	(12,141)	57%
PV of Terminal Value	(9,031)	43%
Enterprise Value	(21,172)	100%
Less: Debt	0	
Add: Cash	0	$0.00
Equity Value	(21,172)	
FDS	8,442	
Equity Value/ Share	**-$2.51**	

DCF Assumptions	
WACC	9.0%
Perpetual Growth Rate	2.0%
Tax Rate	30%

Source: Jefferies, company data

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Chart 63: Income Statement
($ in millions, except per-share items)

	FY12					FY13					FY14E					FY15E				
	Sep-11	Dec-11	Mar-12	Jun-12	FY12	Sep-12	Dec-12	Mar-13	Jun-13	FY13	Sep-13E	Dec-13E	Mar-14E	Jun-14E	FY14E	Sep-14E	Dec-14E	Mar-15E	Jun-15E	FY15E
D&C - Hardware	1,366	3,415	953	1,006	6,740	1,084	2,808	1,402	1,167	6,461	909	3,433	2,127	2,005	8,474	1,359	3,433	2,127	2,005	8,924
D&C - Licensing	5,093	4,956	4,763	4,683	19,495	4,678	5,703	4,352	4,288	19,021	4,756	4,701	3,193	3,928	16,578	4,269	4,068	3,072	4,058	15,468
D&C - Other	1,515	1,738	1,437	1,513	6,203	1,400	1,999	1,656	1,563	6,618	1,484	2,329	1,838	1,751	7,402	1,648	2,310	1,950	1,961	7,869
Commercial - Licensing	8,332	9,585	9,090	10,119	37,126	8,945	10,135	9,979	10,627	39,686	9,178	11,048	11,213	10,944	42,382	9,912	11,821	11,886	11,601	45,219
Commercial - Other	1,039	1,166	1,157	1,282	4,644	1,248	1,389	1,449	1,574	5,660	1,523	1,683	1,794	2,072	7,073	1,872	2,054	2,234	2,720	8,880
Other	27	25	7	(544)	(485)	(1,347)	(578)	1,651	677	403	-	-	-	-	-	-	-	-	-	-
Revenue	**17,372**	**20,885**	**17,407**	**18,059**	**73,723**	**16,008**	**21,456**	**20,489**	**19,896**	**77,849**	**17,850**	**23,194**	**20,165**	**20,700**	**81,909**	**19,060**	**23,687**	**21,269**	**22,344**	**86,360**
Y.Y	*7%*	*5%*	*6%*	*4%*	*5%*	*-8%*	*3%*	*18%*	*10%*	*6%*	*12%*	*8%*	*-2%*	*4%*	*5%*	*7%*	*2%*	*5%*	*8%*	*5%*
Q.Q	*0%*	*20%*	*-17%*	*4%*		*-11%*	*34%*	*-5%*	*-3%*		*-10%*	*30%*	*-13%*	*3%*		*-8%*	*24%*	*-10%*	*5%*	
Cost of Revenue	3,777	5,638	3,952	4,163	17,530	4,168	5,692	4,787	5,602	20,249	4,972	6,073	5,854	5,824	22,723	5,648	6,526	6,334	6,687	25,195
Y.Y	20%	17%	1%	12%	13%	10%	1%	21%	35%	16%	19%	7%	22%	4%	12%	14%	7%	8%	15%	11%
Gross Profit	13,595	15,247	13,455	13,896	56,193	11,840	15,764	15,702	14,294	57,600	12,878	17,121	14,311	14,876	59,186	13,411	17,161	14,936	15,657	61,165
Gross Margin	*78.3%*	*73.0%*	*77.3%*	*76.9%*	*76.2%*	*74.0%*	*73.5%*	*76.6%*	*71.8%*	*74.0%*	*72.1%*	*73.8%*	*71.0%*	*71.9%*	*72.3%*	*70.4%*	*72.4%*	*70.2%*	*70.1%*	*70.8%*
Operating Expenses																				
Research and Development	2,329	2,371	2,517	2,594	9,811	2,460	2,528	2,640	2,783	10,411	2,499	2,737	2,823	2,898	10,957	2,668	2,961	2,871	3,016	11,517
Sales and Marketing	2,900	3,762	3,414	3,781	13,857	2,945	4,309	3,794	4,228	15,276	3,570	4,824	4,033	4,451	16,878	3,335	5,093	3,935	4,022	16,385
General and Administrative	1,163	1,120	1,150	1,136	4,569	1,127	1,156	1,656	1,210	5,149	1,309	1,522	430	235	3,496	1,002	1,342	688	682	3,714
Total Operating Expenses	6,392	7,253	7,081	13,704	34,430	6,532	7,993	8,090	8,221	30,836	7,378	9,083	7,287	7,584	31,331	7,006	9,396	7,494	7,720	31,616
Operating Income	**7,203**	**7,994**	**6,374**	**192**	**21,763**	**5,308**	**7,771**	**7,612**	**6,073**	**26,764**	**5,501**	**8,038**	**7,024**	**7,292**	**27,856**	**6,405**	**7,765**	**7,442**	**7,937**	**29,549**
Operating Margin	*41.5%*	*38.3%*	*36.6%*	*1.1%*	*29.5%*	*33.2%*	*36.2%*	*37.2%*	*30.5%*	*34.4%*	*30.8%*	*34.7%*	*34.8%*	*35.2%*	*34.0%*	*33.6%*	*32.8%*	*35.0%*	*35.5%*	*34.2%*
Other Income/ (Expense)	103	245	(11)	167	504	226	(1)	(9)	72	288	51	60	59	71	241	78	86	89	100	352
Income Before Taxes	7,306	8,239	6,363	359	22,267	5,534	7,770	7,603	6,145	27,052	5,552	8,098	7,083	7,364	28,097	6,483	7,851	7,530	8,037	29,901
Taxes	1,568	1,615	1,255	851	5,289	1,068	1,393	1,548	1,180	5,189	1,055	1,539	1,346	1,399	5,338	1,232	1,492	1,431	1,527	5,681
Tax Rate	*21.5%*	*19.6%*	*19.7%*	*19.7%*	*23.8%*	*19.3%*	*17.9%*	*20.4%*	*19.2%*	*19.2%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*
Net Income	5,738	6,624	5,108	(492)	16,978	4,466	6,377	6,055	4,965	21,863	4,497	6,559	5,738	5,965	22,758	5,251	6,359	6,099	6,510	24,220
EPS (Reported)	**$0.68**	**$0.78**	**$0.60**	**($0.06)**	**$2.00**	**$0.53**	**$0.76**	**$0.72**	**$0.59**	**$2.58**	**$0.53**	**$0.78**	**$0.69**	**$0.72**	**$2.72**	**$0.63**	**$0.77**	**$0.74**	**$0.80**	**$2.95**
Y.Y	9%	1%	-2%	-109%	-26%	-22%	-3%	20%	N/A	29%	2%	4%	-4%	22%	6%	19%	-1%	8%	11%	8%
Fully Diluted Shares Outstanding	8,490	8,465	8,498	8,388	8,506	8,494	8,444	8,429	8,442	8,470	8,409	8,375	8,342	8,309	8,359	8,275	8,242	8,209	8,175	8,225
EPS (Operating) - Jefco	**0.68**	**0.78**	**0.60**	**0.73**	**2.78**	**$0.58**	**$0.81**	**$0.77**	**$0.65**	**$2.82**	**$0.59**	**$0.86**	**$0.75**	**$0.79**	**$2.99**	**$0.70**	**$0.85**	**$0.81**	**$0.87**	**$3.23**
Y.Y	9%	1%	6%	6%	5%	-14%	4%	29%	-12%	2%	2%	6%	-3%	22%	6%	18%	-1%	8%	11%	8%
Dividend Per Share	**$0.20**	**$0.20**	**$0.20**	**$0.20**	**$0.80**	**$0.23**	**$0.23**	**$0.23**	**$0.23**	**$0.92**	**$0.28**	**$0.28**	**$0.28**	**$0.28**	**$1.12**	**$0.32**	**$0.32**	**$0.32**	**$0.32**	**$1.29**
Dividend Yield (at $35 share price)					*2.3%*					*2.6%*					*3.2%*					*3.7%*
Y.Y	*25.0%*	*25.0%*	*25.0%*	*25.0%*	*25.0%*					*15.0%*					*21.7%*					*15.0%*

Source: Jefferies, company data

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Chart 64: Income Statement Analysis

	FY12					FY13					FY14E					FY15E				
	Sep-11	Dec-11	Mar-12	Jun-12	FY12	Sep-12	Dec-12	Mar-13	Jun-13	FY13	Sep-13E	Dec-13E	Mar-14E	Jun-14E	FY14E	Sep-14E	Dec-14E	Mar-15E	Jun-15E	FY15E
Y/Y Growth																				
Windows	-71.5%	-32.5%	-78.6%	-78.8%	-64.6%	-20.6%	-17.8%	47.1%	16.0%	-4.1%	-16.1%	22.3%	51.7%	71.8%	31.2%	49.5%	0.0%	0.0%	0.0%	5.3%
Server and Tools	31.9%	15.6%	18.9%	3.5%	16.9%	-8.1%	15.1%	-8.6%	-8.4%	-2.4%	1.7%	-17.6%	-26.6%	-8.4%	-12.8%	-10.2%	-13.5%	-3.8%	3.3%	-6.7%
OSB	177.0%	143.8%	115.4%	122.5%	137.9%	-7.6%	15.0%	15.2%	3.3%	6.7%	6.0%	16.5%	11.0%	12.0%	11.8%	11.1%	-0.8%	6.1%	12.0%	6.3%
MBD	60.2%	56.9%	70.6%	72.3%	64.9%	7.4%	5.7%	9.8%	5.0%	6.9%	2.6%	9.0%	12.4%	3.0%	6.8%	8.0%	7.0%	6.0%	6.0%	6.7%
EDD	-42.1%	-68.5%	-40.2%	-13.8%	-47.9%	20.1%	19.1%	25.2%	22.8%	21.9%	22.1%	21.2%	23.8%	31.7%	25.0%	22.9%	22.0%	24.5%	31.2%	25.5%
Revenue	7.3%	4.7%	6.0%	4.0%	5.4%	-7.9%	2.7%	17.7%	10.2%	5.6%	11.5%	8.1%	-1.6%	4.0%	5.2%	6.8%	2.1%	5.5%	7.9%	5.4%
Operating income	1.2%	-2.1%	11.6%	-96.9%	-19.9%	-26.3%	-2.8%	19.4%	3063.0%	23.0%	3.6%	3.4%	-7.7%	20.1%	4.1%	16.4%	-3.4%	5.9%	8.8%	6.1%
Net income	6.1%	-0.2%	-2.4%	-108.4%	-26.7%	-22.2%	-3.7%	18.5%	-1109.1%	28.8%	0.7%	2.9%	-5.2%	20.1%	4.1%	16.8%	-3.1%	6.3%	9.1%	6.4%
Cost of Revenues	20%	17%	1%	12%	13%	10%	1%	21%	35%	16%	19%	7%	22%	4%	12%	14%	7%	8%	15%	11%
R&D	6%	9%	11%	8%	8%	6%	7%	5%	7%	6%	2%	8%	7%	4%	5%	7%	8%	2%	4%	5%
S&M	3%	-2%	1%	-3%	-1%	2%	15%	11%	12%	10%	21%	12%	6%	5%	10%	-7%	6%	-2%	-10%	-3%
G&A	24%	19%	-1%	-4%	8%	-3%	3%	44%	7%	13%	16%	32%	-74%	-81%	-32%	-23%	-12%	60%	190%	6%
Operating Expenses	8%	4%	4%	83%	27%	2%	10%	14%	-40%	-10%	13%	14%	-10%	-8%	2%	-5%	3%	3%	2%	1%
EPS - Diluted (Non-GAAP)	9%	1%	-2%	-109%	-26%	-22%	-3%	20%	-1103%	29%	2%	4%	-4%	22%	6%	19%	-1%	8%	11%	8%
Q/Q Growth																				
Windows	-71.2%	150.0%	-72.1%	5.6%		7.8%	159.0%	-50.1%	-16.8%		-22.1%	277.7%	-38.0%	-5.7%		-32.2%	152.6%	-38.0%	-5.7%	
Server and Tools	12.6%	-2.7%	-3.9%	-1.7%		-0.1%	21.9%	-23.7%	-1.5%		10.9%	-1.2%	-32.1%	23.0%		8.7%	-4.7%	-24.5%	32.1%	
OSB	122.8%	14.7%	-17.3%	5.3%		-7.5%	42.8%	-17.2%	-5.6%		-5.1%	57.0%	-21.1%	-4.8%		-5.9%	40.2%	-15.6%	0.5%	
MBD	41.9%	15.0%	-5.2%	11.3%		-11.6%	13.3%	-1.5%	6.5%		-13.6%	20.4%	1.5%	-2.4%		-9.4%	19.3%	0.5%	-2.4%	
EDD	-30.1%	12.2%	-0.8%	10.8%		-2.7%	11.3%	4.3%	8.6%		-3.2%	10.5%	6.6%	15.5%		-9.7%	9.7%	8.8%	21.7%	
Revenue	0.0%	20.2%	-16.7%	3.7%		-11.4%	34.0%	-4.5%	-2.9%		-10.3%	29.9%	-13.1%	2.7%		-7.9%	24.3%	-10.2%	5.1%	
Net income																				
Cost of Revenues	2%	49%	-30%	5%		0%	37%	-16%	17%		-11%	22%	-4%	-1%		-3%	16%	-3%	6%	
R&D	-3%	2%	6%	3%		-5%	3%	4%	5%		-10%	10%	3%	3%		-8%	11%	-3%	5%	
S&M	-26%	30%	-9%	11%		-22%	46%	-12%	11%		-16%	35%	-16%	10%		-25%	53%	-23%	2%	
G&A	-1%	-4%	3%	-1%		-1%	3%	43%	-27%		8%	16%	-72%	-45%		326%	34%	-49%	-1%	
Operating Expenses	-15%	13%	-2%	94%		-52%	22%	1%	2%		-10%	23%	-20%	4%		-8%	34%	-20%	3%	
EPS - Diluted (Non-GAAP)	-2%	16%	-23%	-110%		-996%	44%	-5%	-18%		-9%	46%	-12%	4%		-12%	22%	-4%	7%	
Revenue Contribution																				
Windows	9%	23%	6%	7%		7%	19%	9%	8%		6%	23%	14%	13%		9%	23%	14%	13%	
Server and Tools	29%	24%	27%	26%		29%	27%	21%	22%		27%	20%	16%	19%		22%	17%	14%	18%	
OSB	9%	8%	8%	8%		9%	9%	8%	8%		8%	10%	9%	8%		9%	10%	9%	9%	
MBD	48%	46%	52%	56%		56%	47%	49%	53%		51%	48%	56%	53%		52%	50%	56%	52%	
EDD	6%	6%	7%	7%		8%	6%	7%	8%		9%	7%	9%	10%		10%	9%	11%	12%	
Cost of Revenues	22%	27%	23%	23%		26%	27%	23%	28%		28%	26%	29%	28%		30%	28%	30%	30%	
R&D	13%	11%	14%	14%		15%	12%	13%	14%		14%	12%	14%	14%		14%	13%	14%	14%	
S&M	17%	18%	20%	21%		18%	20%	19%	21%		20%	21%	20%	22%		18%	22%	19%	18%	
G&A	7%	5%	7%	6%		7%	5%	8%	6%		7%	7%	2%	1%		5%	6%	3%	3%	
Gross Margin	78%	73%	77%	77%		74%	73%	77%	72%		72%	74%	71%	72%		70%	72%	70%	70%	
Operating Margin	41%	38%	37%	1%		33%	36%	37%	31%		31%	35%	35%	35%		34%	33%	35%	36%	
Net Margin	33%	32%	29%	-3%		28%	30%	30%	25%		25%	28%	28%	29%		28%	27%	29%	29%	

Source: Jefferies, company data

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Chart 65: Balance Sheet
($ in millions, except per-share items)

	FY12					FY13					FY14E					FY15E				
	Sep-11	Dec-11	Mar-12	Jun-12	FY12	Sep-12	Dec-12	Mar-13	Jun-13	FY13	Sep-13E	Dec-13E	Mar-14E	Jun-14E	FY14E	Sep-14E	Dec-14E	Mar-15E	Jun-15E	FY15E
Current Assets																				
Cash and Equivalents	12,881	10,610	6,388	6,938	6,938	5,036	6,017	5,240	3,804	3,804	8,257	7,845	14,063	17,213	17,213	21,195	22,590	28,126	31,078	31,078
ST Investments	44,522	41,126	53,141	56,102	56,102	61,608	62,295	69,243	73,218	73,218	73,218	73,218	73,218	73,218	73,218	73,218	73,218	73,218	73,218	73,218
Accounts Receivable, net	10,153	13,643	10,961	15,780	15,780	9,871	14,317	11,991	17,486	17,486	10,512	14,947	12,771	17,710	17,710	11,224	15,265	13,471	19,117	19,117
Inventories, net	2,270	1,351	1,412	1,137	1,137	1,624	1,661	2,133	1,938	1,938	3,213	1,856	1,613	1,242	1,242	2,287	1,184	1,702	1,341	1,341
Deferred Income Taxes	2,190	2,169	2,350	2,035	2,035	2,052	1,983	1,676	1,632	1,632	1,632	1,632	1,632	1,632	1,632	1,632	1,632	1,632	1,632	1,632
Other	3,255	3,614	2,608	3,092	3,092	3,860	3,301	3,241	3,388	3,388	3,213	4,175	3,630	3,726	3,726	3,431	4,264	3,828	4,022	4,022
Total Current Assets	**75,271**	**72,513**	**76,860**	**85,084**	**85,084**	**84,051**	**89,574**	**93,524**	**101,466**	**101,466**	**100,045**	**103,673**	**106,927**	**114,741**	**114,741**	**112,988**	**118,152**	**121,976**	**130,408**	**130,408**
Non-Current Assets																				
PP&E, net	8,033	8,010	8,225	8,269	8,269	8,329	8,698	9,204	9,991	9,991	10,848	12,007	12,975	13,969	13,969	14,884	16,068	17,089	18,162	18,162
Equity & Other Investments	8,576	7,550	9,068	9,776	9,776	10,038	10,707	11,193	10,844	10,844	10,844	10,844	10,844	10,844	10,844	10,844	10,844	10,844	10,844	10,844
Goodwill	12,537	19,670	19,698	13,452	13,452	14,466	14,727	14,682	14,655	14,655	14,655	14,655	14,655	14,655	14,655	14,655	14,655	14,655	14,655	14,655
Intangible Assets	1,026	2,581	2,756	3,170	3,170	3,423	3,341	3,240	3,083	3,083	2,857	2,739	2,573	2,416	2,416	2,195	2,070	1,903	1,754	1,754
Deferred Income Taxes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other	1,972	1,919	1,403	1,520	1,520	1,569	1,636	2,262	2,392	2,392	1,606	1,856	1,613	1,656	1,656	1,715	1,895	1,702	1,788	1,788
Long-Term Assets	**32,144**	**39,730**	**41,150**	**36,187**	**36,187**	**37,825**	**39,109**	**40,581**	**40,965**	**40,965**	**40,811**	**42,101**	**42,661**	**43,540**	**43,540**	**44,293**	**45,532**	**46,193**	**47,203**	**47,203**
Total Assets	**107,415**	**112,243**	**118,010**	**121,271**	**121,271**	**121,876**	**128,683**	**134,105**	**142,431**	**142,431**	**140,855**	**145,774**	**149,588**	**158,282**	**158,282**	**157,281**	**163,684**	**168,169**	**177,610**	**177,610**
Current Liabilities																				
Accounts payable	3,719	3,884	3,790	4,175	4,175	3,631	4,356	4,532	4,828	4,828	4,391	5,389	4,672	4,767	4,767	4,499	5,661	4,917	5,123	5,123
Short-term debt	-	-	-	1,231	1,231	2,236	2,241	2,246	2,999	2,999	2,999	2,999	2,999	2,999	2,999	2,999	2,999	2,999	2,999	2,999
Accrued compensation	2,388	2,677	3,272	3,875	3,875	2,666	2,942	3,474	4,117	4,117	2,840	3,183	3,942	4,291	4,291	2,911	3,344	4,148	4,610	4,610
Income taxes	705	921	958	789	789	847	630	689	592	592	592	592	592	592	592	592	592	592	592	592
Short-term unearned revenue	14,345	13,985	13,929	18,653	18,653	18,295	18,354	16,511	20,639	20,639	19,102	19,108	18,825	24,100	24,100	22,005	23,374	23,577	28,767	28,767
Securities lending payable	1,141	849	1,210	814	814	415	21	564	645	645	645	645	645	645	645	645	645	645	645	645
Other	3,245	3,057	3,011	3,151	3,151	3,312	3,366	3,913	3,597	3,597	3,705	3,789	3,548	3,620	3,620	3,796	3,980	3,733	3,890	3,890
Total Current Liabilities	**25,543**	**25,373**	**26,170**	**32,688**	**32,688**	**31,402**	**31,910**	**31,929**	**37,417**	**37,417**	**34,274**	**35,704**	**35,223**	**41,014**	**41,014**	**37,448**	**40,595**	**40,611**	**46,625**	**46,625**
Long term debt	11,927	11,932	11,938	10,713	10,713	9,714	11,947	11,949	12,601	12,601	12,601	12,601	12,601	12,601	12,601	12,601	12,601	12,601	12,601	12,601
Long-term deferred revenue	1,313	1,349	1,262	1,406	1,406	1,292	1,459	1,394	1,760	1,760	1,760	1,760	1,760	1,760	1,760	1,760	1,760	1,760	1,760	1,760
Other	9,241	9,468	9,981	10,101	10,101	10,632	10,791	12,145	11,709	11,709	11,114	10,609	11,826	11,397	11,397	11,389	11,145	12,445	12,246	12,246
Total liabilities	**48,024**	**48,122**	**49,351**	**54,908**	**54,908**	**53,040**	**56,107**	**57,417**	**63,487**	**63,487**	**59,749**	**60,674**	**61,410**	**66,771**	**66,771**	**63,198**	**66,101**	**67,417**	**73,233**	**73,233**
Total shareholders' equity	**59,391**	**64,121**	**68,659**	**66,363**	**66,363**	**68,836**	**72,576**	**76,688**	**78,944**	**78,944**	**81,106**	**85,100**	**88,178**	**91,510**	**91,510**	**94,083**	**97,583**	**100,752**	**104,378**	**104,378**
Total Liabilities and SE	**107,415**	**112,243**	**118,010**	**121,271**	**121,271**	**121,876**	**128,683**	**134,105**	**142,431**	**142,431**	**140,855**	**145,774**	**149,588**	**158,282**	**158,282**	**157,281**	**163,684**	**168,169**	**177,610**	**177,610**

Source: Jefferies, company data

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Chart 66: Cash Flow Statement
($ in millions, except per-share items)

	FY12					FY13					FY14E					FY15E				
	Sep-11	Dec-11	Mar-12	Jun-12	FY12	Sep-12	Dec-12	Mar-13	Jun-13	FY13	Sep-13E	Dec-13E	Mar-14E	Jun-14E	FY14E	Sep-14E	Dec-14E	Mar-15E	Jun-15E	FY15E
Net Income	**5,738**	**12,362**	**17,470**	**16,978**	**16,978**	**4,466**	**10,843**	**16,898**	**21,863**	**21,863**	**4,497**	**11,056**	**16,794**	**22,758**	**22,758**	**5,251**	**11,610**	**17,710**	**24,220**	**24,220**
Depreciation & Amortization	726	1,404	2,170	2,967	2,967	710	1,719	2,772	3,755	3,755	797	1,611	2,422	3,241	3,241	831	1,667	2,514	3,378	3,378
Stock-Based Comp.	558	1,133	1,724	2,244	2,244	603	1,206	1,805	2,406	2,406	607	1,395	2,081	2,785	2,785	648	1,453	2,177	2,936	2,936
Net Gains on Investments	(30)	(142)	(74)	(200)	(200)	11	33	(19)	80	80	-	-	-	-	-	-	-	-	-	-
Excess Tax Benefits from ESOs	(70)	(74)	(84)	(93)	(93)	(177)	(186)	(192)	(209)	(209)	-	-	-	-	-	-	-	-	-	-
Deferred Income Taxes	402	416	282	7,147	7,147	38	178	404	(19)	(19)	-	-	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Unearned Revenue	6,139	13,683	21,825	36,104	36,104	8,209	18,946	28,632	44,253	44,253	-	-	-	-	-	-	-	-	-	-
Recognition of Unearned Revenue	(7,653)	(15,710)	(23,993)	(33,347)	(33,347)	(8,770)	(19,253)	(30,852)	(41,921)	(41,921)	-	-	-	-	-	-	-	-	-	-
Unearned Revenue	(1,514)	(2,027)	(2,168)	2,757	2,757	(561)	(307)	(2,220)	2,332	2,332	(1,537)	(1,531)	(1,814)	3,461	3,461	(2,095)	(726)	(523)	4,667	4,667
Accounts Receivable	4,733	1,081	3,851	(1,156)	(1,156)	6,156	1,668	3,859	(1,807)	(1,807)	6,974	2,539	4,715	(224)	(224)	6,486	2,445	4,240	(1,407)	(1,407)
Change in Current Assets	(1,102)	394	344	162	162	(1,425)	(1,308)	(1,652)	(1,498)	(1,498)	(1,100)	(704)	83	358	358	(750)	(480)	(562)	(395)	(395)
Change in Long-Term Assets	(75)	(45)	37	(175)	(175)	(233)	(313)	(326)	(478)	(478)	786	536	779	736	736	(59)	(239)	(46)	(132)	(132)
Change in Assets	(1,177)	349	381	(13)	(13)	(1,658)	(1,621)	(1,978)	(1,976)	(1,976)	(314)	(168)	862	1,094	1,094	(809)	(719)	(608)	(526)	(526)
Change in Current Liabilities	(993)	(423)	(537)	329	329	(1,287)	(434)	737	1,250	1,250	(1,606)	(182)	(380)	136	136	(1,471)	307	120	945	945
Change in Long-Term Liabilities	120	276	934	666	666	183	165	864	1,158	1,158	(595)	(1,100)	117	(312)	(312)	(7)	(252)	1,048	849	849
Change in Liabilities	(873)	(147)	397	995	995	(1,104)	(269)	1,601	2,408	2,408	(2,201)	(1,282)	(262)	(177)	(177)	(1,479)	55	1,169	1,794	1,794
Cash Flow from Operating Activities	**8,493**	**14,355**	**23,949**	**31,626**	**31,626**	**8,484**	**13,264**	**22,930**	**28,833**	**28,833**	**8,823**	**13,621**	**24,797**	**32,939**	**32,939**	**8,834**	**15,788**	**26,679**	**35,063**	**35,063**
Proceeds from ST Debt	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Proceeds from New Debt (mat>90 days)	-	-	-	-	-	-	2,232	2,232	4,883	4,883	-	-	-	-	-	-	-	-	-	-
Repayments of >90 Day Debt	-	-	-	-	-	-	-	-	(1,346)	(1,346)	-	-	-	-	-	-	-	-	-	-
Stock Repurchased	(1,934)	(2,976)	(3,999)	(5,029)	(5,029)	(1,632)	(3,290)	(4,318)	(5,360)	(5,360)	(1,000)	(2,000)	(3,000)	(4,000)	(4,000)	(1,000)	(2,000)	(3,000)	(4,000)	(4,000)
Dividends Paid	(1,341)	(3,024)	(4,707)	(6,385)	(6,385)	(1,676)	(3,609)	(5,534)	(7,455)	(7,455)	(1,942)	(4,296)	(6,641)	(8,977)	(8,977)	(2,326)	(4,991)	(7,645)	(10,288)	(10,288)
Stock Issued	336	544	1,635	1,913	1,913	417	562	765	931	931	-	-	-	-	-	-	-	-	-	-
Excess Tax Benefits from ESOs	70	74	84	93	93	177	186	192	209	209	-	-	-	-	-	-	-	-	-	-
Other	-	-	-	-	-															
Cash Flow from Financing Activities	**(2,869)**	**(5,382)**	**(6,987)**	**(9,408)**	**(9,408)**	**(2,714)**	**(3,935)**	**(6,679)**	**(8,148)**	**(8,148)**	**(2,942)**	**(6,296)**	**(9,641)**	**(12,977)**	**(12,977)**	**(3,326)**	**(6,991)**	**(10,645)**	**(14,288)**	**(14,288)**
CapEx	(436)	(934)	(1,683)	(2,305)	(2,305)	(603)	(1,533)	(2,463)	(4,257)	(4,257)	(1,428)	(3,284)	(4,897)	(6,553)	(6,553)	(1,525)	(3,420)	(5,121)	(6,909)	(6,909)
Cash for Acquisitions	(875)	(9,502)	(9,586)	(10,112)	(10,112)	(1,145)	(1,456)	(1,564)	(1,584)	(1,584)	-	-	-	-	-	-	-	-	-	-
Purchases of Investments	(11,299)	(21,346)	(45,297)	(57,250)	(57,250)	(20,138)	(30,212)	(48,372)	(75,396)	(75,396)	-	-	-	-	-	-	-	-	-	-
Maturities of Investments	2,825	8,886	13,122	15,575	15,575	1,259	3,248	4,513	5,130	5,130	-	-	-	-	-	-	-	-	-	-
Sales of Investments	7,536	15,371	23,317	29,700	29,700	13,307	20,433	30,163	52,464	52,464	-	-	-	-	-	-	-	-	-	-
Securities Lending Payable	(66)	(358)	3	(394)	(394)	(399)	(792)	(249)	(168)	(168)	-	-	-	-	-	-	-	-	-	-
Cash Flow from Investing Activities	**(2,315)**	**(7,883)**	**(20,124)**	**(24,786)**	**(24,786)**	**(7,719)**	**(10,312)**	**(17,972)**	**(23,811)**	**(23,811)**	**(1,428)**	**(3,284)**	**(4,897)**	**(6,553)**	**(6,553)**	**(1,525)**	**(3,420)**	**(5,121)**	**(6,909)**	**(6,909)**
Effect of exchange rates	(38)	(90)	(60)	(104)	(104)	47	62	23	(8)	(8)	-	-	-	-	-	-	-	-	-	-
Change in cash	3,271	1,000	(3,222)	(2,672)	(2,672)	(1,902)	(921)	(1,698)	(3,134)	(3,134)	4,453	4,041	10,259	13,409	13,409	3,982	5,377	10,913	13,866	13,866
Beginning of Period Cash	**9,610**	**9,610**	**9,610**	**9,610**	**9,610**	**6,938**	**6,938**	**6,938**	**6,938**	**6938**	**3,804**	**3,804**	**3,804**	**3,804**	**3804**	**17,213**	**17,213**	**17,213**	**17,213**	**17212.93**
End of Period Cash	**12,881**	**10,610**	**6,388**	**6,938**	**6,938**	**5,036**	**6,017**	**5,240**	**3,804**	**3,804**	**8,257**	**7,845**	**14,063**	**17,213**	**17,213**	**21,195**	**22,590**	**28,126**	**31,078**	**31,078**

Source: Jefferies, company data

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Company Description

Founded in 1975, Microsoft develops, licenses, and supports a wide range of software products and services, designs and sells hardware, and delivers online advertising to a global customer audience.

The company's solutions include operating systems for personal computers, servers, phones, and other intelligent devices; server applications for distributed computing environments; productivity applications; business solution applications; desktop and server management tools; software development tools; video games; and online advertising. Microsoft also provides consulting and product/ solution support services and trains and certifies computer system integrators and developers. The company has 94K+ employees and is headquartered in Redmond, Washington.

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I, Ross MacMillan, certify that all of the views expressed in this research report accurately reflect my personal views about the subject security(ies) and subject company(ies). I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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Company Specific Disclosures

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Buy - Describes stocks that we expect to provide a total return (price appreciation plus yield) of 15% or more within a 12-month period.

Hold - Describes stocks that we expect to provide a total return (price appreciation plus yield) of plus 15% or minus 10% within a 12-month period.

Underperform - Describes stocks that we expect to provide a total negative return (price appreciation plus yield) of 10% or more within a 12-month period.

The expected total return (price appreciation plus yield) for Buy rated stocks with an average stock price consistently below $10 is 20% or more within a 12-month period as these companies are typically more volatile than the overall stock market. For Hold rated stocks with an average stock price consistently below $10, the expected total return (price appreciation plus yield) is plus or minus 20% within a 12-month period. For Underperform rated stocks with an average stock price consistently below $10, the expected total return (price appreciation plus yield) is minus 20% within a 12-month period.

NR - The investment rating and price target have been temporarily suspended. Such suspensions are in compliance with applicable regulations and/or Jefferies policies.

CS - Coverage Suspended. Jefferies has suspended coverage of this company.

NC - Not covered. Jefferies does not cover this company.

Restricted - Describes issuers where, in conjunction with Jefferies engagement in certain transactions, company policy or applicable securities regulations prohibit certain types of communications, including investment recommendations.

Monitor - Describes stocks whose company fundamentals and financials are being monitored, and for which no financial projections or opinions on the investment merits of the company are provided.

Valuation Methodology

Jefferies' methodology for assigning ratings may include the following: market capitalization, maturity, growth/value, volatility and expected total return over the next 12 months. The price targets are based on several methodologies, which may include, but are not restricted to, analyses of market risk, growth rate, revenue stream, discounted cash flow (DCF), EBITDA, EPS, cash flow (CF), free cash flow (FCF), EV/EBITDA, P/E, PE/growth, P/CF, P/FCF, premium (discount)/average group EV/EBITDA, premium (discount)/average group P/E, sum of the parts, net asset value, dividend returns, and return on equity (ROE) over the next 12 months.

Conviction List Methodology

1. The aim of the conviction list is to publicise the best individual stock ideas from Jefferies Global Research
2. Only stocks with a Buy or Underperform rating are allowed to be included in the recommended list.

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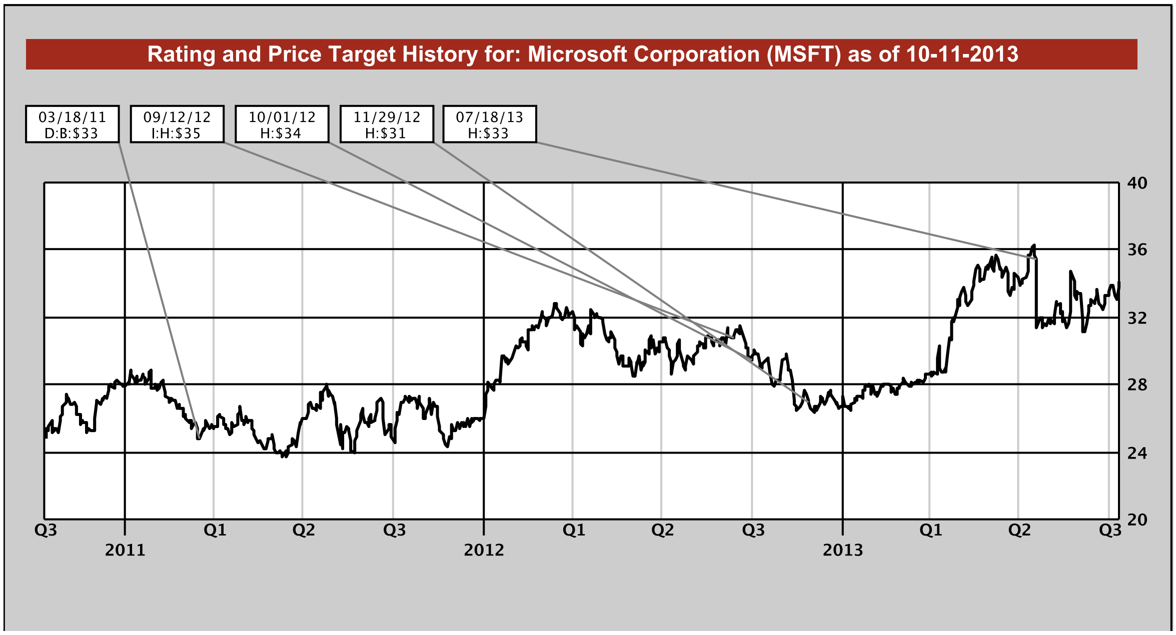
3. Stocks are screened for minimum market capitalisation and adequate daily turnover. Furthermore, a valuation, correlation and style screen is used to ensure a well-diversified portfolio.
4. Stocks are sorted to a maximum of 30 stocks with the maximum country exposure at around 50%. Limits are also imposed on a sector basis.
5. Once a month, analysts are invited to recommend their best ideas. Analysts' stock selection can be based on one or more of the following: non-Consensus investment view, difference in earnings relative to Consensus, valuation methodology, target upside/downside % relative to the current stock price. These are then assessed against existing holdings to ensure consistency. Stocks that have either reached their target price, been downgraded over the course of the month or where a more suitable candidate has been found are removed.
6. All stocks are inserted at the last closing price and removed at the last closing price. There are no changes to the conviction list during the month.
7. Performance is calculated in US dollars on an equally weighted basis and is compared to MSCI World AC US$.
8. The conviction list is published once a month whilst global equity markets are closed.
9. Transaction fees are not included.
10. All corporate actions are taken into account.

Risk which may impede the achievement of our Price Target

This report was prepared for general circulation and does not provide investment recommendations specific to individual investors. As such, the financial instruments discussed in this report may not be suitable for all investors and investors must make their own investment decisions based upon their specific investment objectives and financial situation utilizing their own financial advisors as they deem necessary. Past performance of the financial instruments recommended in this report should not be taken as an indication or guarantee of future results. The price, value of, and income from, any of the financial instruments mentioned in this report can rise as well as fall and may be affected by changes in economic, financial and political factors. If a financial instrument is denominated in a currency other than the investor's home currency, a change in exchange rates may adversely affect the price of, value of, or income derived from the financial instrument described in this report. In addition, investors in securities such as ADRs, whose values are affected by the currency of the underlying security, effectively assume currency risk.

Other Companies Mentioned in This Report

- Apple Inc. (AAPL: $496.04, BUY)
- Google, Inc. (GOOG: $876.11, BUY)
- Intel Corporation (INTC: $23.45, BUY)
- International Business Machines (IBM: $186.97, HOLD)
- Oracle Corporation (ORCL: $33.28, HOLD)



Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos. Count	IB Serv./Past 12 Mos. Percent
BUY	844	48.06%	178	21.09%
HOLD	767	43.68%	122	15.91%
UNDERPERFORM	145	8.26%	1	0.69%

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