NASDAQ **MSFT**

MICROSOFT CORP

SOFTWARE INDUSTRY

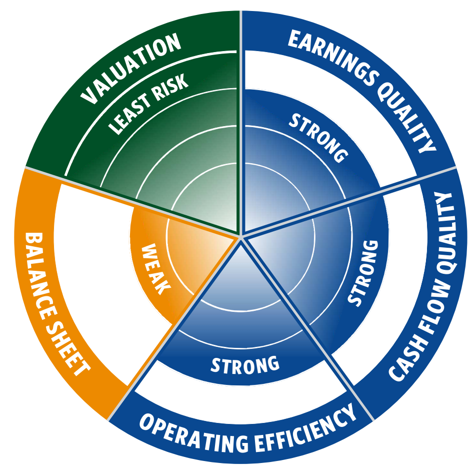
OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

OUR EVALUATION OF MSFT

MICROSOFT CORP is showing strong Earnings Quality, Cash Flow Quality and Operating Efficiency, and Valuation suggests a lower amount of price risk, but Balance Sheet Quality is weak. When combined, MSFT deserves a HOLD rating.

The Balance Sheet rating improved on the strength of better liquidity. Though this dimension and all of the others were either stronger or unchanged at worst, it was not sufficient to raise the overall rating.

FINANCIAL SONAR™ FOR MSFT 1ST QUARTER 2015



HISTORICAL RATINGS

	Q2 2014	Q3 2014	Q4 2014	**Q1 2015**
OVERALL RATING	BUY	BUY	HOLD	HOLD
EARNINGS QUALITY	STRONGEST	STRONGEST	STRONG	STRONG
CASH FLOW QUALITY	STRONG	STRONG	STRONG	STRONG
OPERATING EFFICIENCY	STRONG	STRONG	STRONG	STRONG
BALANCE SHEET	WEAKEST	STRONG	WEAKEST	WEAK
VALUATION	LEAST RISK	LEAST RISK	LEAST RISK	LEAST RISK

PRICE TRENDS AND VALUATION

Price (AS OF 01/08/15)	**$47.60**	MARKET CAP.	**$392.3 BILLION**	PRICE/SALES	**4.2**
PRICE/EARNINGS	**18.4**	PRICE/EARNINGS GROWTH	**NA**	PRICE/CASH FLOW	**14.2**
PRICE/ADJUSTED EARNINGS	**18.0**	PRICE/ADJUSTED EARNINGS GROWTH	**-716.7**	PRICE/ADJUSTED CASH FLOW	**16.8**

NASDAQ **MSFT** **MICROSOFT CORP**

SOFTWARE INDUSTRY OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

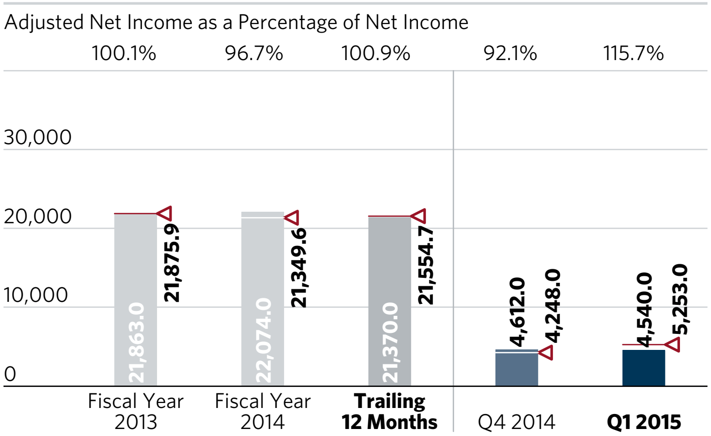
EARNINGS QUALITY: STRONG

Earnings quality has long been analyzed and used by investors as a measure of the fundamental quality of the company and its future prospects. Companies may be including certain items that increase reported earnings and often the amount of cash flow supporting the earnings may be weak. Jefferson adjusts for these kinds of items and other anomalies to produce an adjusted earnings number that more accurately reflects ongoing business fundamentals at MICROSOFT CORP. Reported earnings are compared to the Jefferson adjusted earnings as a means to gauge earnings quality. Also measured is the amount of cash flow that underpins earnings.

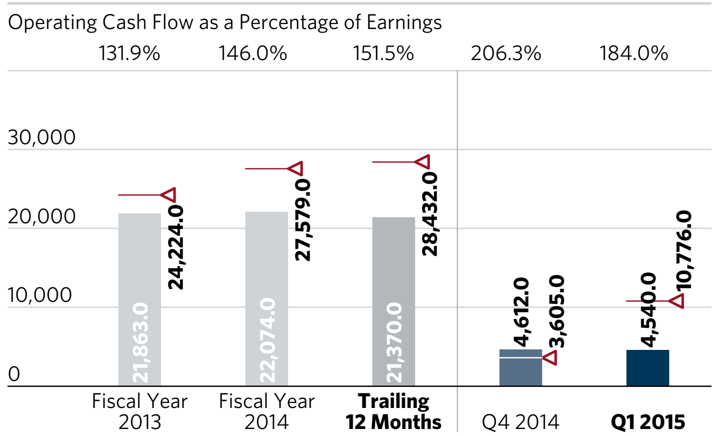
The earnings quality for MSFT remains STRONG.

With an adjusted net income of $5,253M in the last quarter that was greater than the reported number, MSFT's quality of net income earnings is extremely high. However, operating cash flow decreased during the last quarter to $8,354M from $9,514M, and the ratio of operating cash flow to earnings has also declined. Though both Earnings Quality measures declined, the changes were not sufficient to lower the overall rating.

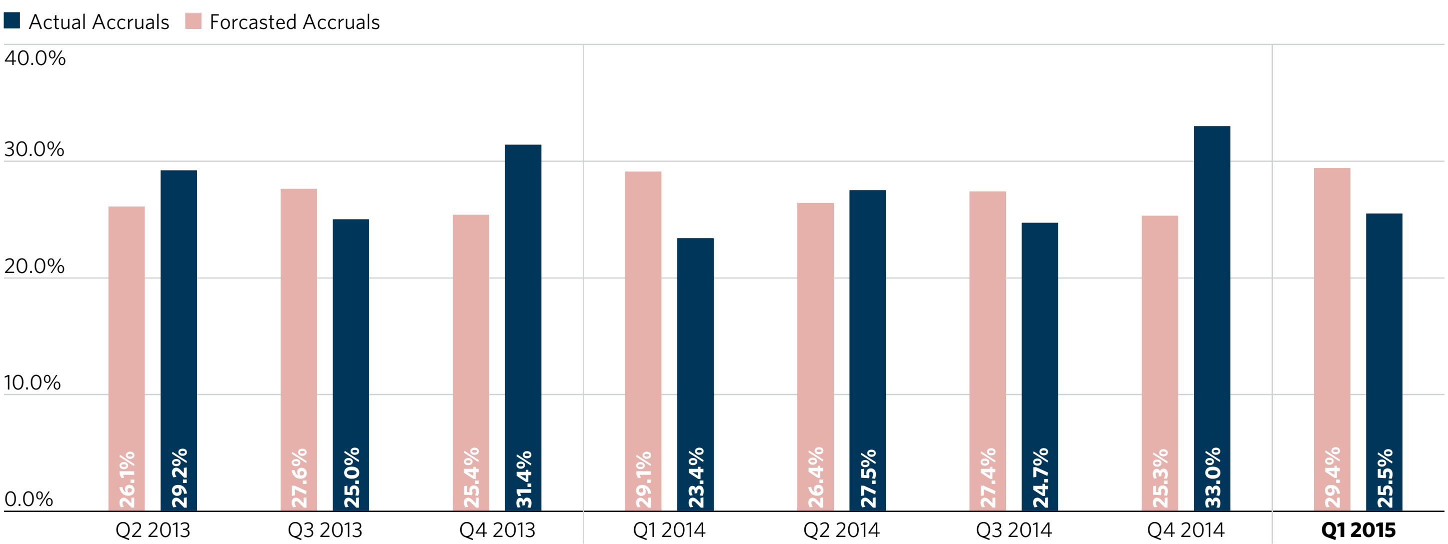
NET INCOME VS. ADJUSTED NET INCOME



EARNINGS VS. OPERATING CASH FLOW



ACCRUALS



NASDAQ **MSFT** **MICROSOFT CORP**

SOFTWARE INDUSTRY OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

CASH FLOW QUALITY: STRONG

Cash flow is considered by many investors to be the ultimate measure of company performance and more reliable than reported earnings. The Jefferson measurement eliminates items that are not part of recurring cash flow or the result of actual operations for MICROSOFT CORP. These adjustments to cash flow provide a truer measure of cash flow and the resultant cash flow quality rating.

The cash flow quality rating for MSFT remains STRONG Meanwhile the operating cash flow quality year over year weakened.

Even though the quarterly operating cash flow quality improved with a reported number of $8,354M and an adjusted number that was 129.0% of reported, the decline in the annual operating cash flow quality offset this with a reported number of $32,231M and an adjusted number that was 85.6% of reported. This represents deterioration from the previous period when the reported number was closer to the adjusted number.

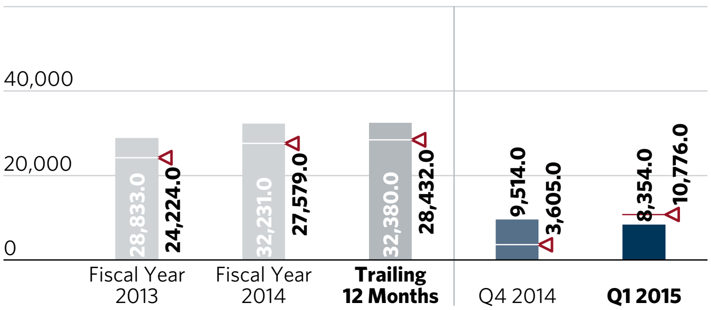
OPERATING CASH FLOW

$ IN MILLIONS

△ Adjusted Operating Cash Flow

Adjusted Operating Cash Flow as a Percentage of Operating Cash Flow

Fiscal Year 2013	Fiscal Year 2014	Trailing 12 Months	Q4 2014	Q1 2015
84.0%	85.6%	87.8%	37.9%	129.0%



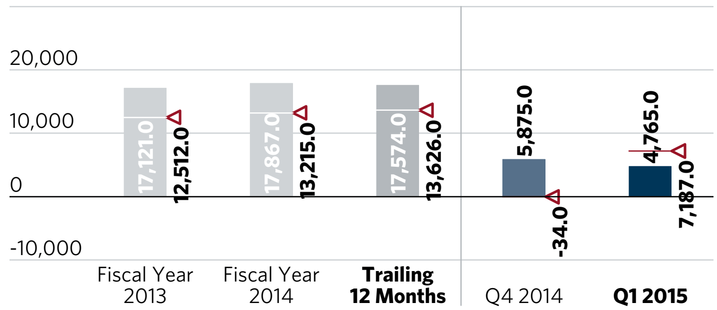
FREE CASH FLOW

$ IN MILLIONS

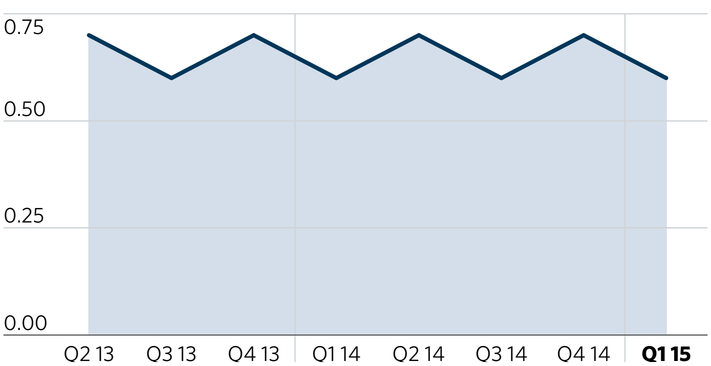
△ Adjusted Free Cash Flow

Adjusted Free Cash Flow as a Percentage of Free Cash Flow

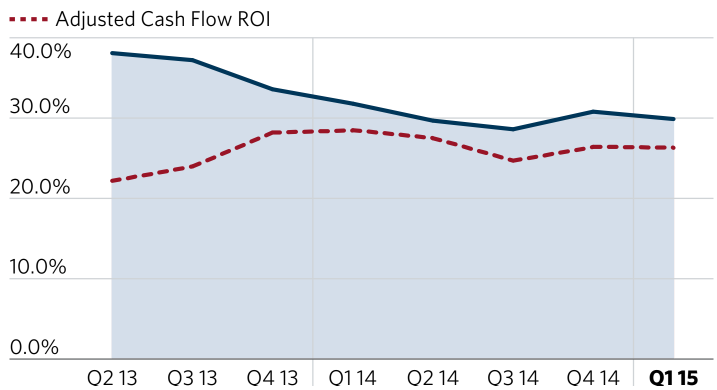
Fiscal Year 2013	Fiscal Year 2014	Trailing 12 Months	Q4 2014	Q1 2015
73.1%	74.0%	77.5%	-0.6%	150.8%



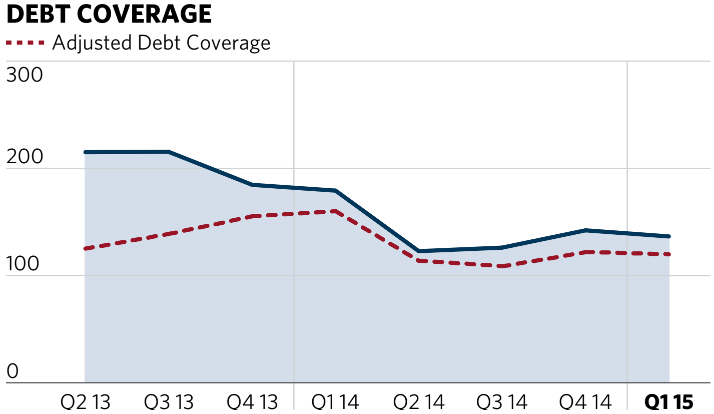
FLOW RATIO



CASH FLOW ROI



DEBT COVERAGE



OPERATING EFFICIENCY: STRONG

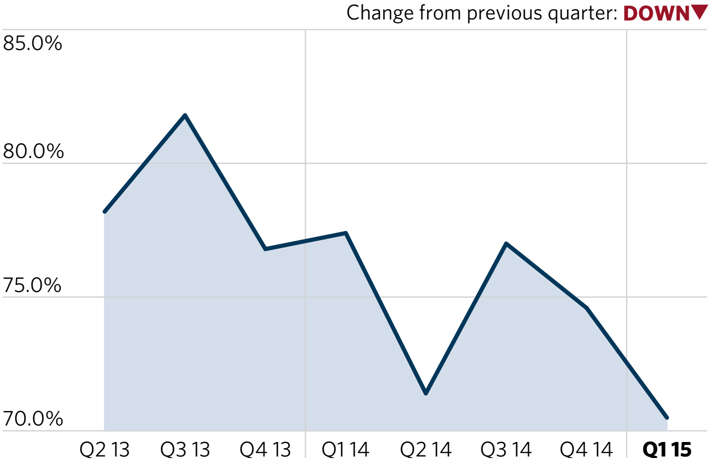
The ability of MICROSOFT CORP to earn a profit is in part the result of how rapidly it converts its collection of assets into revenues and the resulting earnings and cash flow margins available. Operating Efficiency is measured by a combination of factors including: return on invested capital (ROIC), gross margin, EBIT margin, asset turnover, equity turnover, and lastly Staff, General, and Administrative costs as a percentage of sales (SGA).

The operating efficiency rating for MSFT remains STRONG as the SGA costs and EBIT margin strengthened over the last quarter, while at the same time the ROIC, gross margin and net margin weakened.

Even though the SGA costs improved from 39.9% to 34.2% of sales, the decline in ROIC offset this, deteriorating from 21.6%to 20.1%. The lower ROIC indicates that MSFT is producing less profit per dollar of capital invested in the business.

GROSS MARGIN

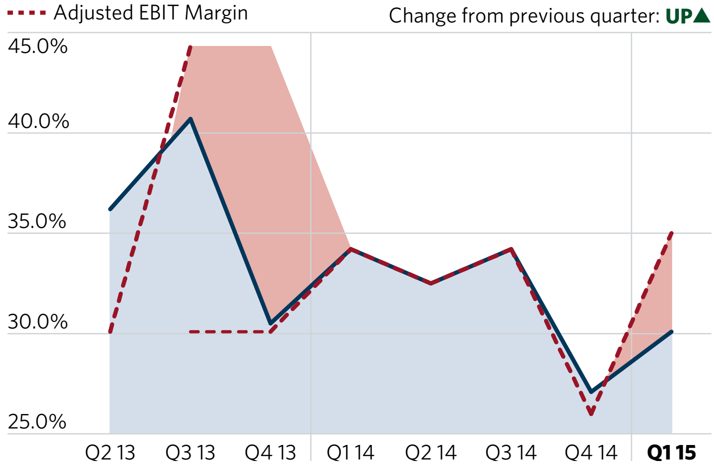
Change from previous quarter: **DOWN▼**



EBIT MARGIN

Adjusted EBIT Margin

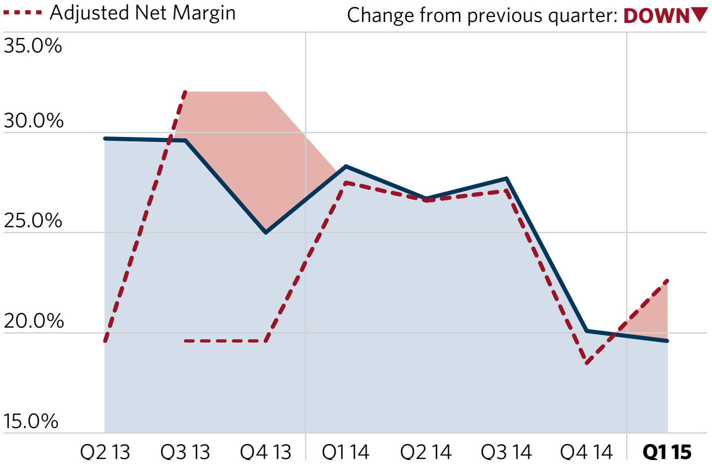
Change from previous quarter: **UP▲**



NET MARGIN

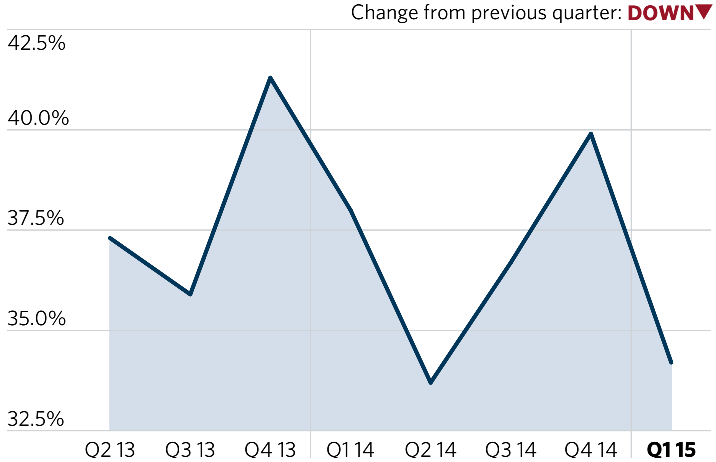
Adjusted Net Margin

Change from previous quarter: **DOWN▼**



SG&A AS A PERCENTAGE OF SALES

Change from previous quarter: **DOWN▼**



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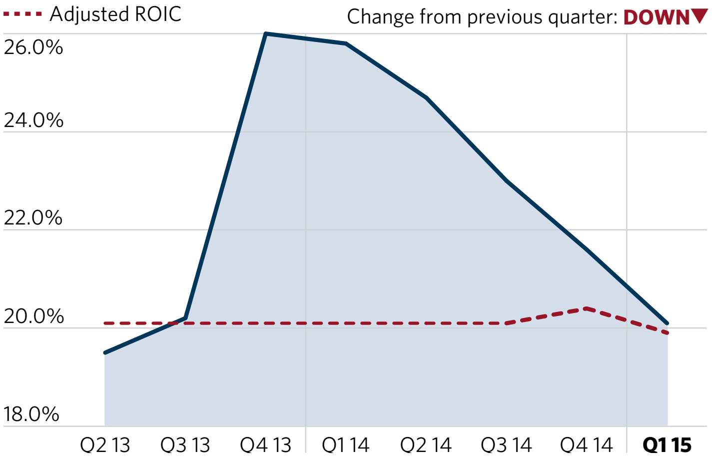
OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

OPERATING EFFICIENCY: STRONG

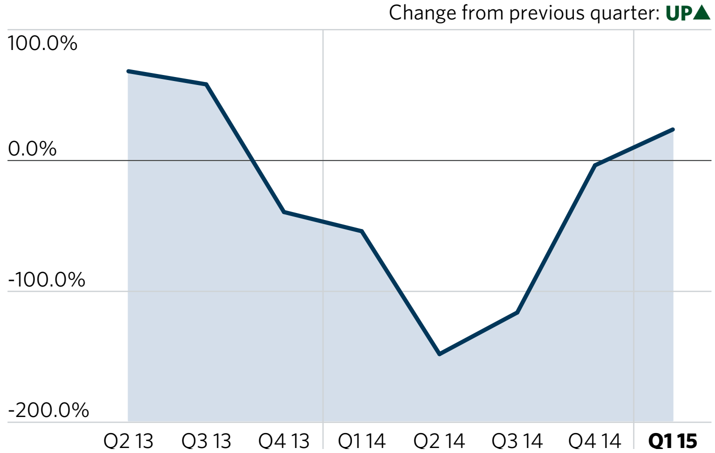
ROIC

Change from previous quarter: **DOWN▼**

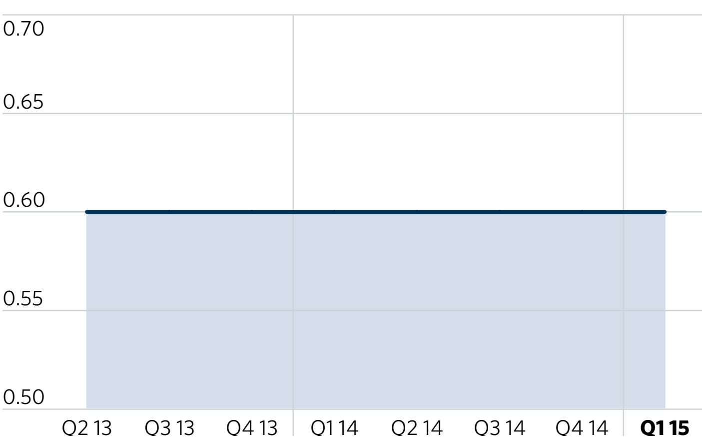


RETURN ON INCREMENTAL INVESTED CAPITAL

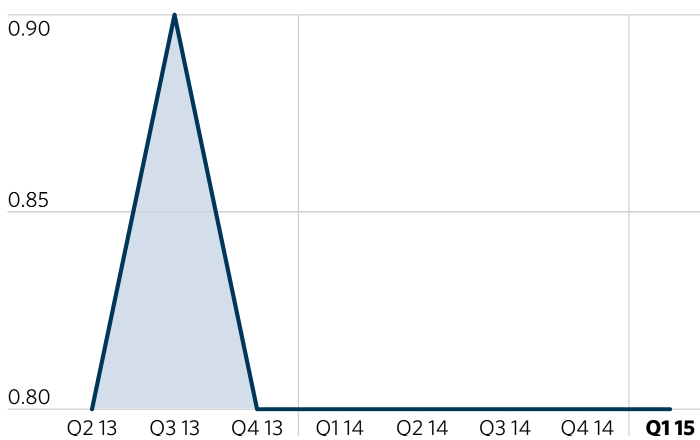
Change from previous quarter: **UP▲**



ASSET TURNOVER



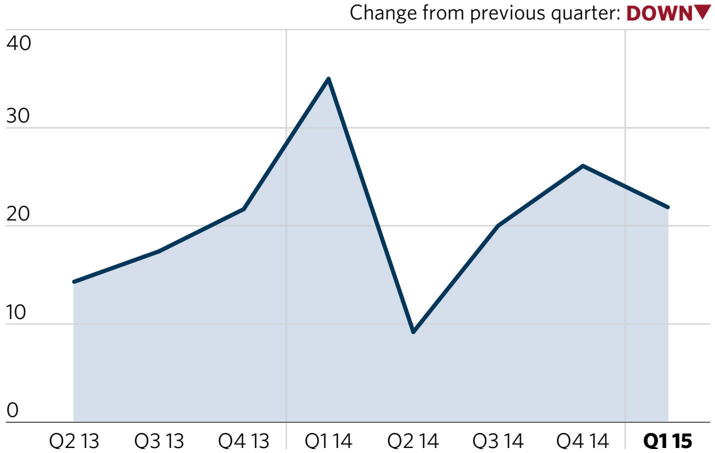
EQUITY TURNOVER



CASH CONVERSION CYCLE

IN DAYS

Change from previous quarter: **DOWN▼**



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OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

BALANCE SHEET QUALITY: WEAK

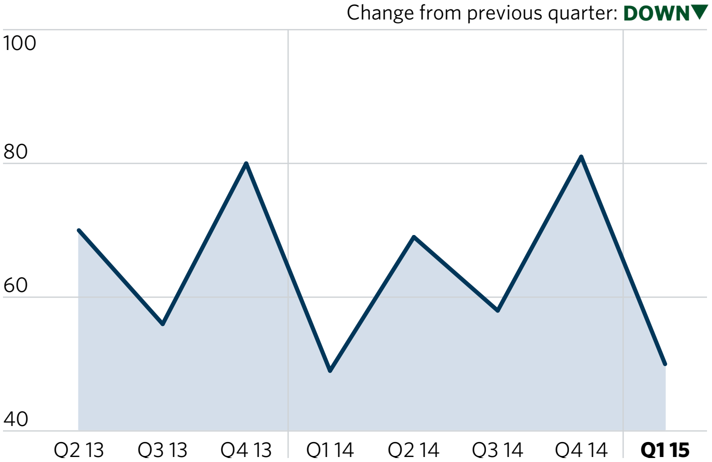
The balance sheet shows the ability of MICROSOFT CORP to pay its bills and fund future growth. It also provides clues to aggressive accounting since reported earnings that do not generate cash flow generally end up somewhere on the balance sheet. The following are analyzed in determining balance sheet quality: quick ratio, current ratio, cash position, accounts receivable days sales outstanding (AR DSOs), and number of days inventory is held prior to sale to customers (Inv Days).

The balance sheet rating for MSFT strengthened from WEAKEST to WEAK as the AR DSOs and cash position improved over the last quarter.

AR DSOs decreased from 81 to 50 days, indicating that MSFT has shortened the time it takes on average to receive payment from its customers, thereby increasing liquidity. In addition, the cash position improved from $85,709M to $89,193M. The higher amount of cash on hand indicates that MSFT will be better able to meet financial obligations.

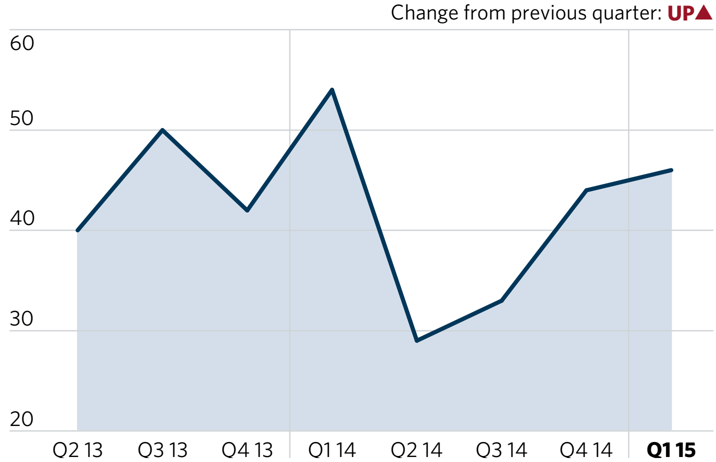
RECEIVABLES DAYS OUT

Change from previous quarter: **DOWN▼**

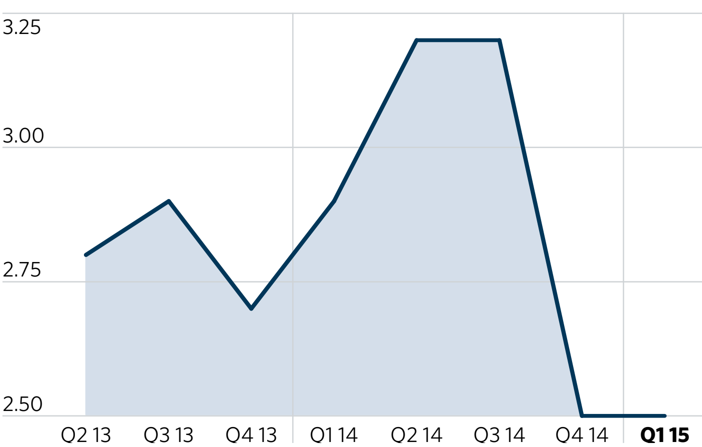


INVENTORY DAYS OUT

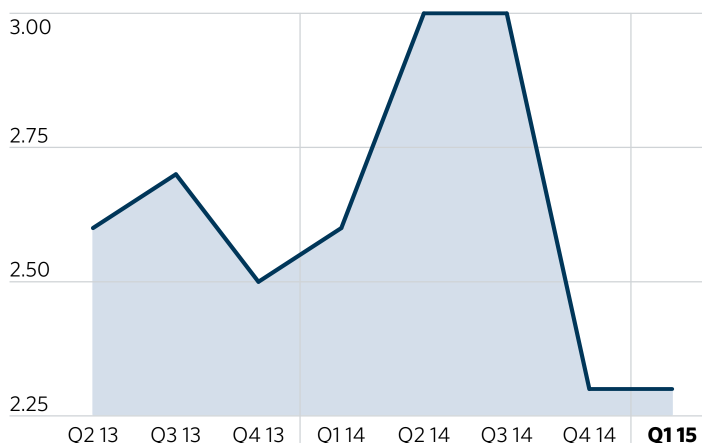
Change from previous quarter: **UP▲**



CURRENT RATIO



QUICK RATIO

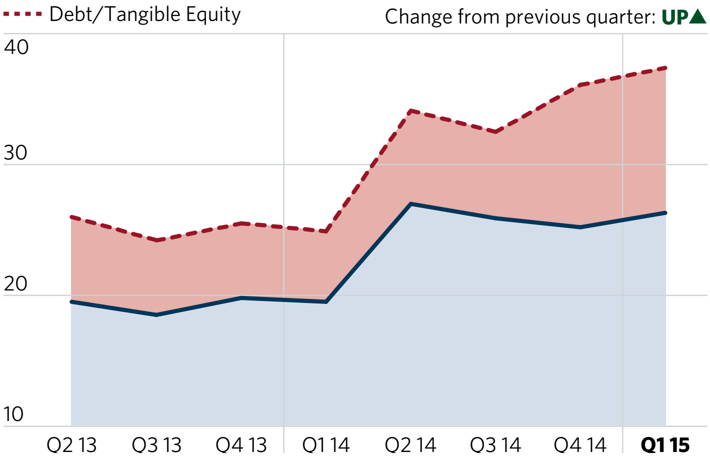


NASDAQ **MSFT** **MICROSOFT CORP**

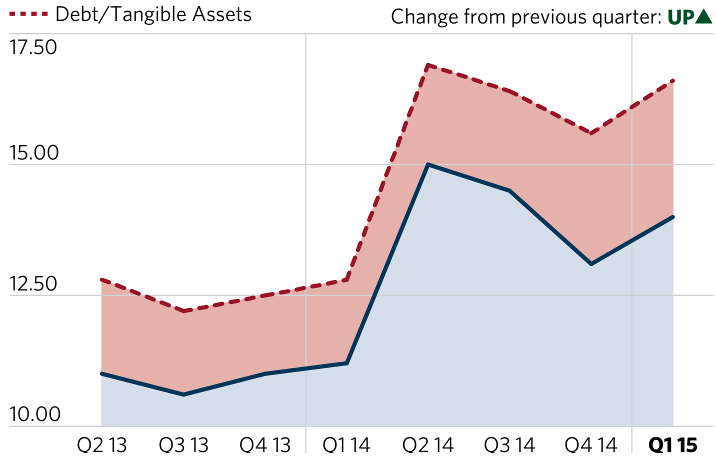
SOFTWARE INDUSTRY OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

BALANCE SHEET QUALITY: WEAK

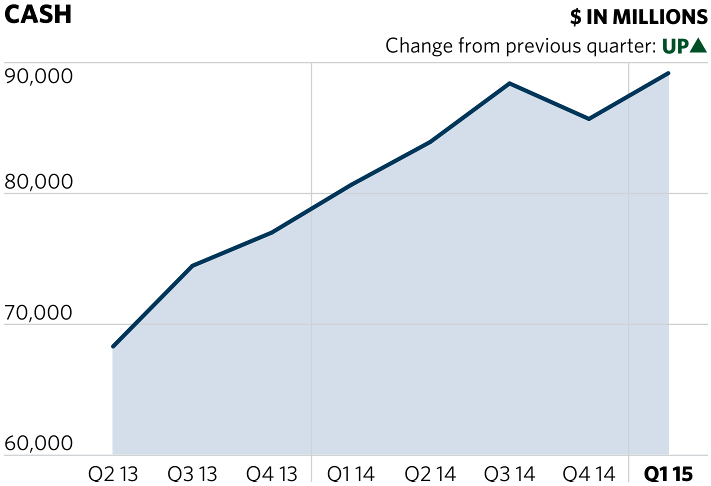
DEBT/EQUITY



DEBT/ASSETS



CASH



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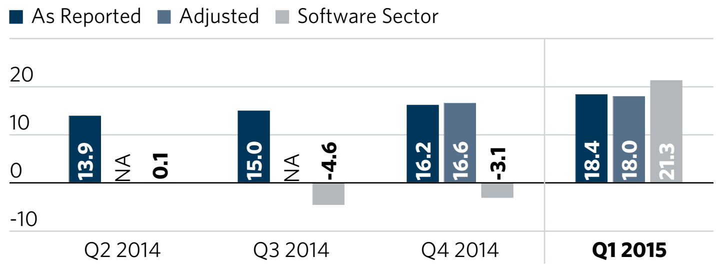
VALUATION: LEAST RISK

A favorable valuation (a LEAST RISK or LOW RISK rating) implies lower potential downward price risk that is evidenced by a company price multiple that is lower than the corresponding sector average. The valuation rating is based on both absolute and relative levels at MICROSOFT CORP compared to its peers within its sector based on price to earnings (PE), price to earnings growth (PEG), price to sales (PS), and price to cash flow (PCF).

The valuation rating for MSFT remains a LEAST RISK.

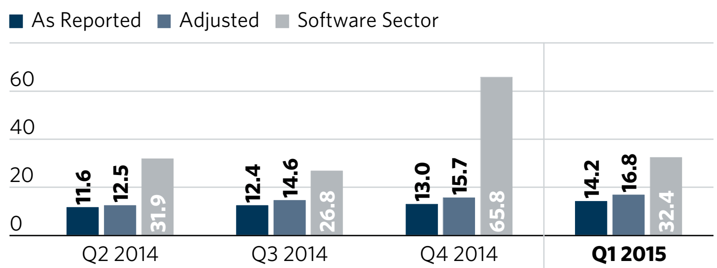
PRICE/EARNINGS

	RANGE		
LAST 2 YEARS	LOW	HIGH	AVERAGE
Reported Price/Earnings	**12.20**	**18.40**	**15.08**
Adjusted Price/Earnings	**16.60**	**18.00**	**17.30**
Sector Price/Earnings	**18.10**	**43.90**	**23.98**



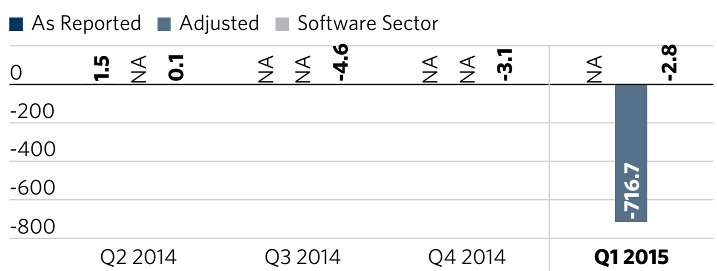
PRICE/CASH FLOW

	RANGE		
LAST 2 YEARS	LOW	HIGH	AVERAGE
Reported Price/Cash Flow	**10.40**	**14.20**	**12.35**
Adjusted Price/Cash Flow	**12.50**	**38.40**	**19.19**
Sector Price/Cash Flow	**-7.40**	**90.30**	**33.08**



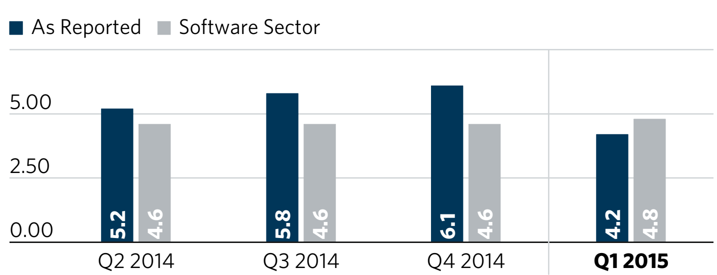
PRICE/EARNINGS GROWTH

	RANGE		
LAST 2 YEARS	LOW	HIGH	AVERAGE
Reported Price/Earnings Growth	**1.50**	**1.90**	**1.70**
Adjusted Price/Earnings Growth	**-716.70**	**-716.70**	**-716.70**
Sector Price/Earnings Growth	**-4.60**	**0.30**	**-1.39**



PRICE/SALES

	RANGE		
LAST 2 YEARS	LOW	HIGH	AVERAGE
Reported Price/Sales	**4.20**	**6.60**	**5.76**
Sector Price/Sales	**3.90**	**4.80**	**4.35**



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OVERALL RATING FOR **1ST QUARTER 2015** **HOLD**

PEER VALUATION COMPARISON

TICKER	COMPANY	MARKET CAP.	PRICE ON 01/08/15	PRICE/ EARNINGS	PRICE/ SALES	PRICE/ CASH FLOW	PRICE/ EARNINGS GROWTH	VALUATION RATING
MSFT	**MICROSOFT CORP**	**$392.3 B**	**$47.60**	**18.4**	**4.2**	**14.2**	**NA**	**LEAST RISK**
ORCL	ORACLE CORP	$190.6 B	$43.40	17.8	5.1	14.4	4.2	**LEAST RISK**
SAP	SAP SE -ADR	$81.2 B	$66.10	0.0	3.7	14.8	0.0	**LEAST RISK**
CRM	SALESFORCE.COM INC	$37.0 B	$58.60	-112.7	7.4	307.1	-5.3	**MEDIUM RISK**
ADBE	ADOBE SYSTEMS INC	$36.4 B	$73.00	149.0	8.9	65.3	NA	**MOST RISK**
INTU	INTUIT INC	$25.7 B	$89.90	30.7	5.8	25.4	6.0	**MEDIUM RISK**
SYMC	SYMANTEC CORP	$17.6 B	$25.50	18.1	2.6	12.4	1.2	**LOW RISK**
SOFTWARE SECTOR		**$11.9 B**	—	**21.3**	**4.8**	**32.4**	**-2.8**	—

PEER OPERATING COMPARISON

TICKER	COMPANY	MARKET CAP.	GROSS MARGIN (%)	EBIT MARGIN (%)	NET MARGIN (%)	ROIC (%)	CASH CONVERSION CYCLE (DAYS)	OPERATING EFFICIENCY RATING
MSFT	**MICROSOFT CORP**	**$392.3 B**	**70.5**	**30.1**	**19.6**	**20.1**	**21.0**	**LOW RISK**
ORCL	ORACLE CORP	$190.6 B	81.9	37.4	26.1	14.9	NA	**LOW RISK**
SAP	SAP SE -ADR	$81.2 B	76.1	29.7	21.9	16.0	0.0	**MEDIUM RISK**
CRM	SALESFORCE.COM INC	$37.0 B	82.8	-1.6	-2.8	-6.8	0.0	**MEDIUM RISK**
ADBE	ADOBE SYSTEMS INC	$36.4 B	91.0	7.4	4.4	3.1	0.0	**LOW RISK**
INTU	INTUIT INC	$25.7 B	81.1	-17.0	-12.5	25.4	0.0	**MOST RISK**
SYMC	SYMANTEC CORP	$17.6 B	88.0	23.4	15.1	12.5	-33.0	**LOW RISK**

DEFINITIONS

Adjusted Net Income: Adjusted Net Income is a company's reported net income less adjustments for one-time and non-operating items yielding a more realistic picture of a company's ongoing earnings.

Accruals – Forecasted and Actual: The comparison of forecasted and actual accruals identifies a discretionary build not attributable to a company's sales growth, and could be a sign of poor earnings quality. For our purposes, the forecasted accrual component is an aggregate measurement of total accruals (short-term balance sheet accounts) that distinguishes between "normalized" and "extraordinary" accruals. The normalized accruals are based on historical relationships between sales and accruals and are dynamically adjusted over time to account for changes in the ratio between these two variables. Normally, short term accruals will grow as sales grow – i.e., the "normalized" measure. Discretionary accruals are the portion of accruals that are in excess of the base factor and therefore exceed the normal and are "extraordinary".

Adjusted Operating Cash Flow: Adjusted Operating Cash Flow is reported operating cash flow less adjustments for one-time and non-operating items yielding a more realistic picture of a company's ongoing cash flow from operations.

Adjusted Free Cash Flow: Adjusted Free Cash Flow is reported operating cash flow less adjustments for one-time, non-operating items and capital expenditures. This provides a more realistic picture of a company's ongoing cash generation from operations after capital investments.

Flow Ratio: The Flow Ratio is a measurement of management's effectiveness in managing its working capital to maximize the company's cash flows. The measure is a ratio of a company's non-cash current assets to its non-interest bearing short-term liabilities.– These non-cash assets include items such as accounts receivable (which are essentially interest-free loans to customers) and inventory (which is subject to obsolescence or spoilage). The non-interest bearing liabilities are essentially interest-free loans to the company. A lower ratio implies tighter cash management for a company as it has less cash tied up in non-cash current assets and is able to utilize interest free loans from suppliers.

Cash Flow Return on Investment: Cash Flow ROI is a measure of a company's ability to generate operating cash flow from its invested capital. Many analysts consider this measure preferable to an earnings return measure such as ROE since cash flow is considered a more reliable measure.

Adjusted Cash Flow Return on Investment: Adjusted Cash Flow ROI is a measure of the ability to generate operating cash flow from its investment in capital calculated using a company's adjusted cash flow.

Debt Coverage: Debt Coverage is a measure of a company's ability to cover its debt obligations with cash flow it generated from continuing operations.

Adjusted Debt Coverage: Adjusted Debt Coverage is a measure of a company's ability to cover its debt obligations with cash flow it generated from continuing operations, calculated using a company's adjusted cash flow.

Adjusted Return on Invested Capital: Adjusted ROIC assesses a company's efficiency at allocating the capital to profitable investments using a company's adjusted net income (see above) yielding a measure of how well a company is using its capital to generate returns.

Adjusted EBIT Margin: Adjusted EBIT Margin is a measure of a company's earnings before interest and income taxes less adjustments for one-time and non-operating items divided by a company's sales.

Adjusted Net Margin: Adjusted Net Margin is a measure of a company's net income less adjustments for one-time and non-operating items divided by a company's sales.

Return on Incremental Invested Capital: ROIIC measures the relationship between incremental investment and incremental net operating profit after tax. This provides a measure of the returns a company is earning on recent investments rather than all investments as measured by ROIC.

Cash Conversion Cycle: The Cash Conversion Cycle measures the number of days working capital is tied up from the date of purchase of raw materials until the collection of cash from the sale of the product.

Debt to Tangible Equity: Debt to Tangible Equity is a ratio of a company's debt to equity less adjustments for goodwill and other intangible assets yielding tangible equity.

Debt to Tangible Assets: Debt to Tangible Assets is a ratio of a company's debt to total assets less adjustments for goodwill and other intangible assets.

Price/Adjusted Earnings: Adjusted Price/Earnings is a relative valuation measure comparing a company's share price to its adjusted net income.

Price/Adjusted Cash Flow: Adjusted Price/Cash Flow is a relative valuation measure comparing a company's share price to its adjusted cash flow.

Price/Adjusted Earnings Growth: Adjusted Price/Earnings Growth is a relative valuation measure comparing a company's share price to its growth in adjusted earnings.

ABOUT THE FINANCIAL SONAR™ REPORT & METHODOLOGY

The Jefferson Financial Sonar™ ratings system classifies companies into three categories: Buy, Hold and Sell. The Financial Sonar rating is the result of a point scoring system derived from the five main criteria. The more negative the rating, the more likely the overall rating will be a Sell. More positive criteria will support an Overall Rating of Buy.

Jefferson Research & Management has developed the Financial Sonar™ Rating System which is based upon five analytical criteria: Earnings Quality, Cash Flow, Operating Efficiency, Balance Sheet, and Valuation. The first four criteria are rated in one of four categories (best to worst): Strongest, Strong, Weak, Weakest. Valuation is also rated in one of four categories (best to worst): Least Risk, Low Risk, Medium Risk, Most Risk.

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Jefferson Research & Management is an independent investment research and advisory firm founded in 1989 and based in Portland, Oregon. The firm has been providing fundamental research to institutional and individual clients for more than 20 years. Financial Sonar™ ratings are based on a proprietary rating system developed by Jefferson Research & Management that measures the changes in company fundamentals using information from financial statements.

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