

Title:

On Microsoft

Word Count:

1635

Summary:

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The moat in the first two are wide. The Windows moat is huge.

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Keywords:

MSFT, GOOG, Microsoft, Google, windows, search, games, video, value, investing, investor, stock

Article Body:

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There are three core businesses that are already well developed: Windows, Office, and Servers.

The moat in the first two are wide. The Windows moat is huge.

The business model in operating systems is great. You keep upgrading every few years; the hardware needn't progress for you to find things to tweak and get people to buy the next step up. It's insanely profitable.

I think the new launch (Vista) will be bigger than people expect (eventually) in how it allows for cross selling other Microsoft products (but we'll see about that). I expect the press to be very negative at least until well after the launch, because there will always be some bugs and delays.

## Games

Eventually, video games will be a big business for Microsoft. I hate the economics of the console business, but love the economics of the publishing (and development) side of things.

I'm sorry to see that Microsoft didn't use its cash pile to buy up an established business here (publishers were cheap in the market a few years ago; an all cash deal would have worked well. Now, everyone thinks video games will be the next big thing).

The console wars are going well for Microsoft. The two keys to establishing a dominant console are launching first and getting good games on your platform. We'll see how Sony (SNE) does this round, but I expect them to be the big loser.

Nintendo may surprise here. I think the Xbox 360 and Nintendo's new console (Wii) will do very well. It'll be interesting to see the breakdown of the consoles in both the domestic and foreign markets. I think Sony may still be strong overseas, but could be in a much poorer position at the end of this round than they were with the PS2.

## Search

Long-term I am optimistic about search. I think Google's position is much weaker than most people think. I don't think Microsoft will be the only one to benefit here.

Search is a very natural cross sell with Windows. That's the direction everything seems to be headed in (combining online and desktop search). For future growth in terms of market share I think Microsoft is in a better position than either Yahoo (YHOO) or Google (GOOG).

I also think we might see a couple other (largely unknown) search engines gain some share.

I think Google's strength is its brand. Its dominance helps with advertisers more than users. I don't think it has a lock on users. Also, I think Google has been poorly positioned for doing much of anything outside of keyword search.

I expect to see a lot more in the way of intelligent, social search inspired stuff. Years from now, much of search will have to be helping you find what you didn't know you wanted to find.

Google is dominant in a different business: helping you find what you know you want to find (but don't know the name / location). The two types of search are very different. Both will be important, but the growth in other forms of search will be coming off a smaller base and will likely integrate with keyword search. Google has the most to lose here.

#### Other Devices

Microsoft wants to perform well on mobile devices and on your TV. Compared to competitors it is very strong in these respects.

The strategy seems to be the one I would favor - to control the point of initial contact wherever software is used and then to only venture into the actual application or content side of the business where it is highly profitable to do so. In video games it will be highly profitable. In other areas it is less likely to be very profitable.

I expect to see more generic, web-based applications. These will be less profitable for everyone. Office should hold up well, but not as well as Windows. Basically, Microsoft needs to take what it has in PCs and import that to TVs, Handheld Devices, Consoles, and the Web.

That should be the strategy. I think that is the strategy. These aren't unrelated businesses that need to be broken up to unlock creativity (as some have suggested). Rather, the profit potential for each is greatly enhanced by being part of Microsoft. If you take these pieces apart they are worth very little. There would only be the three businesses I started off talking about and the console / games business.

Internationally, there is going to be natural growth for Microsoft's dominant businesses. It won't be a tremendous growth rate, but it will be strong and will require virtually no additional investment to secure.

#### Obsolescence Issues

Overall, I like the future for software a lot more than hardware, because the marginal gains in the quality of hardware will slow greatly in the years ahead.

The question isn't what can be done mathematically in terms of increasing specs; it's what that translates to for the user. We are reaching a point where the individual user will not directly see the benefits of increased hardware performance as clearly as he did in the past.

Much of the research that goes in to this area will only serve to bring down prices and benefit memory intensive businesses - it will not provide as much of a "wow" factor for the user anymore.

This is especially true in games. The situation in desktop applications is already such that improving the software design is where most gains will come from.

Computing power is simply not a scarce resource for most individuals sitting at home or in a cubicle. Advances will benefit some users a lot and will trickle down to the end user (often via the web) through fast responses and cheap services. But, that's a barely noticeable change.

You'll see something here akin to the kind of thing you see in the brokerage business. It won't be obvious, because price competition will never be as great in software.

Generally, you'll just see the prices for doing anything electronically come down. That's very different from what we've seen over the last few decades, where you also had advancements that attracted new users, because they allowed developers to do something differently, not just more cheaply.

This is a very long-term trend I'm worried about. It could weigh heavily on a business like Dell (DELL), because PCs are actually quite durable; once the rate of obsolescence slows, sales will have to slow as the cycle lengthens.

## Management

I think Microsoft's management is absolutely the best in the business. In fact, I think it's one of the best in any business.

It would be hard for me to find more than a handful of people I'd rather have managing a business I was part owner of. I also think the current arrangement is a good one.

There is enough of a line between current operations and future investments in the Chairman / CEO split that investors will probably get the greatest benefit from the brilliance of the Chairman this way.

Everyone underestimates Bill Gates. It's easy, because his great triumph came some time ago now. But, he's interested in building something lasting. I trust him more than anyone in tech without a question. He always impresses me whether

he's talking about his own industry or some other topic. He has exactly the right kind of mind for someone running a business where the long-run is such a concern.

Qualitatively, I think Microsoft scores close to perfectly. I could cite the profitability stats, but I won't, because you know they're better than almost any other business on the planet - and that's with a huge siphoning off of resources to investments in the future that aren't required to maintain the cash cow, wide-moat Windows franchise.

### Valuation

Valuation is a bit more troubling. Microsoft is not at the point on an EV/EBIT basis where I'd be buying the stock if there was a risk of no extraordinarily profitable growth in the future. In other words, at the current price, it clearly makes for a bad bond.

The key is earnings growth. I think you have to believe MSFT will have a real future in search, games, and non-PC devices that will fuel future, highly profitable growth.

I think that future is there. As far as a truly large cap stock (say \$10 billion or more) it's about as attractive as anything on the planet right now - and certainly it's the most attractive stock of any very large U.S. business. Even though Intel (INTC) and Dell are cheap looking, I don't like them nearly as much. Dell is an interesting situation, but I don't understand the business well enough.

I have a better idea of where MSFT is headed - and I like it.

### Conclusion

I don't own shares of MSFT. I won't be buying any either. I don't normally own such large stocks. I prefer much smaller businesses, because the mispricings tend to get more out of whack. You aren't going to see MSFT trade at an EV/EBIT of 7.5 or something like that, but you do sometimes get those chances in small (high quality) businesses.

There are a lot of chances to find wild mispricings without much of the future being a concern. Those are the situations I prefer to invest in, because businesses like MSFT have an awfully large anchor with the amount of capital they've got - plus, they tend to be less likely to be wildly mispriced.

However, if I had to own one business with a market cap of more than \$10 billion

and hold it for a lifetime I would buy Microsoft here without hesitation.