CAIRN INVESTMENT GROUP

COMPANY SPOTLIGHT:

Microsoft Corporation

COMPANY DESCRIPTION

Headquartered in Redmond, WA, Microsoft is the world's largest independent software developer. Microsoft develops, licenses and supports software services via its Windows and Azure cloud services. The company is also involved in the design and sales of hardware products via gaming systems, tables, phones, and laptops.

Satya Nadella took over as CEO on 2/4/14 for Steve Ballmer. Mr. Nadella joined Microsoft in 1992.

KEY POINTS

- Global leader in software development and sales.
- High switching costs for customers give the company a strong competitive advantage in software solutions
- Consistently in the top 10 R&D spenders worldwide according to Fortune
- Above average financial health with low debt levels (Net Debt -$50 billion and LT Debt/Cap of 33%) and high cash flow generation
- Compelling upside as valuations and growth remain attractive

COMPANY HIGHLIGHTS AND FINANCIALS

As a global leader in software development and services, Microsoft enjoys a strong competitive advantage due to high costs for customers to change to a competitor. The company's customer base is well diversified across numerous private companies and public entities. The firm's revenue breakdown is 55% Devices and Consumer (Licensing, hardware, gaming) and 45% Commercial (Licensing, server products, cloud services via Azure) with a continued migration towards services via cloud offerings. The firm also generates over 50% of its revenues outside the US. A potentially softer dollar could provide a nice tailwind to reported sales and profits.

The firm spends over $11 billion per year on R&D which equates to roughly 13% of sales. This shows the company has the financial resources to maintain competitive. Microsoft has a shareholder friendly capital allocation strategy since they started paying a dividend in 2003. Over the last three years they have also repurchased over $26 billion in stock at prices that were very beneficial to existing shareholders.

Since its initial launch in 2012, the Microsoft Surface lineup has grown to generate $1.35 billion in sales as of last quarter which is up 29% YOY. Microsoft continues to grow its server products and cloud services with revenues growing in the triple digits from the previous year. Microsoft continues to gain market share in the public cloud space with 9% total market share with estimates growing to 17% market share ($6.2 billion in revenue) by the end of 2017 (Gartner). The continued success of Microsoft's hardware products (Surface and Xbox) and growth in their cloud computing business should support continued growth in profitability.

The company's operating performance has been very strong over time. The firm generates high operating margins, averaging 30% over the previous five years. The firm also generates over $24 billion in FCF and has historically had a return on capital above their cost of capital (ROIC of 18%). This combined with the company's focus of returning cash to shareholders via dividends, and strategic buybacks, shows how focused and shareholder friendly the management team has been over time. Microsoft also has over $100 billion in cash and equivalents which gives them a strong financial position to fund future growth initiatives.

VALUATION AND RISKS

Microsoft is trading right in line with historical valuations and below fair value based on scenario analysis of free cash flow growth. MSFT has a dividend yield of 2.6% and generates over $24 billion in free cash flow to give them the flexibility to continue to raise their dividend over time. On a free cash flow basis, we expect the company to grow free cash flow on average at 2.0% over the next decade, below its current growth rate of 6.70% over the previous 10 years, due to a higher competition in cloud services and lower demand for traditional hardware and PCs which could slow software growth. Modeling our conservative assumption places a price of $62.00 on shares which is almost a 14% premium based on current price. If our conservative assumptions turn out to still be overly optimistic, we still feel there is a margin of safety built into the current price based on the company's high returns on capital and strong cash flow generation.

The company has an uneven track record in previous acquisitions. We would like to see more disciplined capital spending under the new CEO. Continued customer adoption of Windows 10 combined with growth in hardware and cloud will continued to be a focus as we monitor company performance.

—Patrick Mason, Investment Analyst, Cairn Investment Group

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ABOUT CAIRN INVESTMENT GROUP Cairn Investment Group is an independent fee only Registered Investment Advisor based in Portland, Oregon. Cairn staff has the experience and capabilities to serve our investors with a level of personal attention that only a smaller, independent company can provide. We pride ourselves on working in close contact with our investors.

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