HM Payson

Microsoft: Left in the Dust – and Brimming with Value

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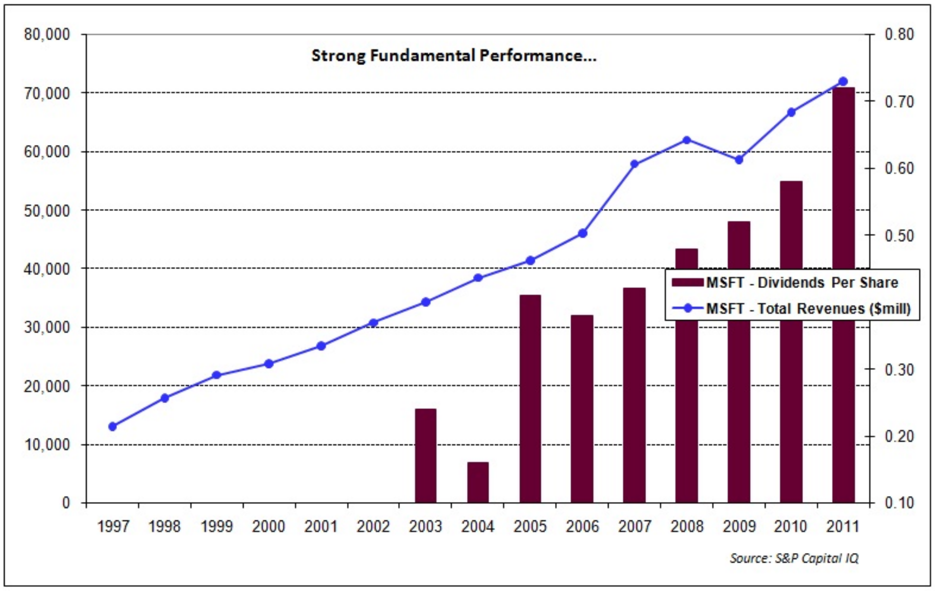
As we watch the Facebook saga unfold in somewhat predictable fashion (see HM Payson Research Note: *"Facebook: Buyer Beware,"* May 17, 2012), we cannot help but notice some compelling values at the other end of the large-cap technology pond. Although widely perceived as a boring – or even dying – destroyer of shareholder value, Microsoft strikes us as one of the more compelling investment propositions in any market sector today.

Microsoft Windows is the dominant operating system in the personal computing market, with a 92% global share. This has been both a blessing and a curse for shareholders as the proliferation of mobile computing platforms (tablets and phones) has caused PC growth to slow dramatically and fueled the popular perception that Microsoft will become irrelevant. The company's fundamental performance tells a very different story, however. For example,

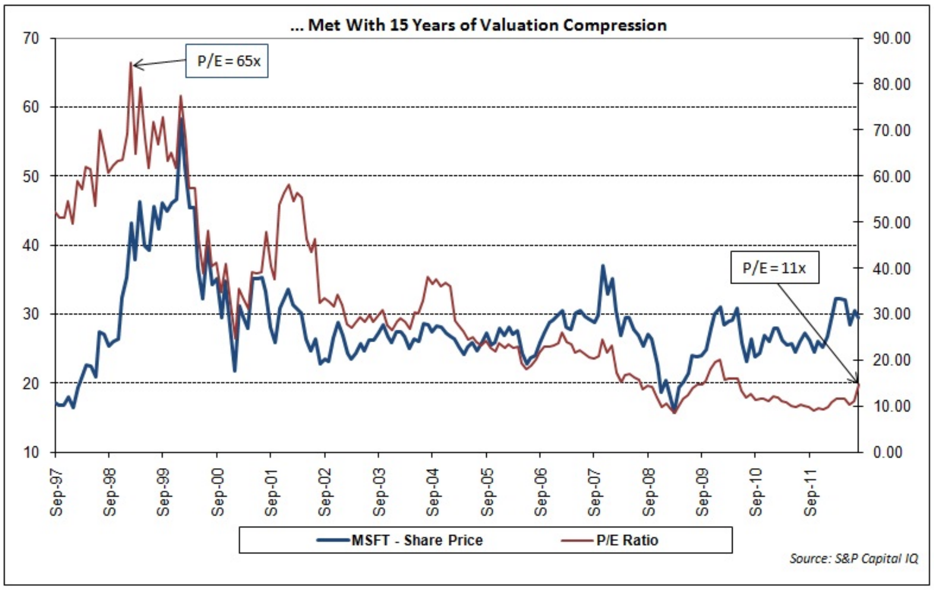


over the last five years, Microsoft's revenues have increased by 44%, equating to an 8% compounded annual rate – an impressive feat for any company during this challenging economic period. Even in the fiscal year ended June 2012, in the face of a product cycle lull and Apple's meteoric success, Microsoft's revenues rose by almost 6%. Meanwhile, both net profit margins and returns on capital presently exceed 30%; hardly symptomatic of a dying company!

Underpinning this strong fundamental performance is the reality that Microsoft is much more than just Windows. Its end-markets extend well beyond consumers and the PC. The company has a very strong presence in the corporate environment, including business applications and other related software running workstations, servers and "the cloud". The Business division (the Office application suite) and the Server and Tools division (corporate servers and cloud installations) comprise nearly 60% of total revenue, are growing at healthy rates and are very profitable. Meanwhile, the Windows 8 launch due in October is expected to give the PC business – both consumer and corporate – a significant boost.

Despite this strong performance, Microsoft shares have been moribund for more than a decade. In fact, the stock today languishes in the $30 range, 40% below its all-time peak in late 1999. Of course, technology valuations generally were irrational in 1999, but the end result is that today Microsoft represents an impressive investment proposition. The P/E ratio stands at a mere nine times the estimate of the coming year's earnings per share, and the price-to-sales ratio of 3.5 is very reasonable for such a profitable franchise. Using the methodology described in our earlier communication on healthcare stocks (See "Healthcare Stocks: Attractively Valued No Matter What Happens in Washington" July 10, 2012), our conclusion is that the current price implies a growth rate of *negative* 6%. Granted, Microsoft's growth rate has slowed, and will likely continue to moderate, but this strikes us as overly pessimistic.

What we like most about Microsoft is its balance sheet quality and potential to produce a growing stream of income for our clients. The company holds more than $60 billion in cash and equivalents, and carries very modest levels of debt. The dividend yield today stands at 2.6%, and has grown by an average annual rate of 15% for the last five years. Yet, with a 9% free cash flow yield, the company is capable of committing to a much larger dividend and/or stepped-up share repurchases. In fact, we estimate that a yield of 7% on today's price



(combined dividends and stock repurchase) is well within reach, if management is willing. Though the pace of such actions has been frustratingly slow, we suspect Cisco's recent actions (a 75% dividend hike, causing an immediate 10% jump in its share price) have not gone unnoticed in the Redmond, Washington executive suites.

Investors are both skeptical about Microsoft's future growth and justifiably impatient with a management team whose acumen for mapping and executing on a strategic direction has been rightly questioned. Failed efforts to organically develop new growth businesses, as well as some ill-advised and expensive acquisitions, have drawn the ire of many critics and caused the stock to fall out of favor with growth-oriented investors. But once again, uncertainty and unpopularity represent the source(s) of many outstanding investment opportunities. For those seeking income, a healthy total return, and quality in an otherwise uncertain, low return environment, Microsoft stands out.

Market Log- August 20, 2012

S&P 500: 1,418.13
10 year T-Note: 1.81%
Crude Oil: $95.97
Gold: $1,620.10

If you have questions or comments regarding this or any other Research Note, please email the H.M. Payson & Co. Research Department at **hmpresearch@hmpayson.com.**