

Recommendation: BUY

Target Price until (06/30/2016): \$48.21

1. Reasons for the Recommendation

Reasons for BUY

We have decided to give this stock a recommendation of buy, for we believe that the stock price will be going up in the next year. Our first reason that we give this recommendation is that the acquisition of Nokia has been expected to be a positive source of revenue for the company after an initial stage. So far Nokia has been a negative source of revenue for the company, but the sales of Nokia phones have increased by 5.6% compared to last year. This means that Microsoft was successful in keeping up with the positive trend that Nokia had, and even improve it. This also is a positive sign signaling that the company is on the right path in recovering the cost of the acquisition. The purchase of Nokia is expected to have a positive net investment after 3 years. Microsoft has made phones part of their business model and has included them in the devices and consumer sector of their operations. In the entirety of FY2014, phone hardware made up sales of just over \$1.9 billion. In the first quarter of FY 2015, phone hardware made sales of \$2.6 billion. This shows a very significant improvement in the sales from Nokia.

Our second reason for the buy recommendation is that the cloud and internet services that they have designed are being pushed by the company, and they have been moving more towards subscription services. Subscription services have been increasing greatly in the software publishing industry. We believe that moving from the old system of selling a piece of software once and then not being able to receive revenues from it any further is becoming a thing of the past, and that subscription services are going to be the future of software publishing. The margins for the new system are lower but the expected quantity of agreements that could be sold will be higher, bringing more revenue to the company.

Microsoft was also successful with the Microsoft Surface, which takes a new form of innovation by mixing a tablet and a computer and having an all-in-one device. The major way that the surface is innovative is that it is the first tablet device to work and behave exactly like a computer, and comes with Microsoft's Windows 8 Operating System. When the surface pro came out, it had difficulty selling due to the high price and the lack of a community following like the Apple iPad has. This led the company to follow a stronger advertising campaign to promote the surface pro 3; putting ads up on YouTube videos, television commercials, even buying entire stadiums full of advertising in order to push their product into the market. The success of their ad campaign is shown when looking at their financials: Microsoft's surface pro sales have increased over 126% over the last year. This means that the idea of mixing a tablet and a laptop fit the consumer trend and that Microsoft is still able to innovate. We believe that the increased brand awareness and hardware capability of Microsoft will end up carrying them higher in this segment of the market.

Risks / Reasons not to buy:

One of the major concerns from customers across the board has been a topic for software publishing for a long time: innovation. Microsoft has always built very sturdy products that have stood up against the test of time, but their innovation is severely lacking in comparison with some of their other competitors such as Apple. They have been increasing their ability to innovate and have been pushing some very drastic changes to their product lines with the reinvention of Windows Operating System and also with products from branches they previously were not involved in (tablets). The new Windows OS and also the tablets lagged behind their competitors for a long time, but may end up picking up traction as they learn from their mistakes and reinvent their brand. In response to the lackluster performance from

Company name MSFT

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Windows 8, Microsoft is due to release Windows 10 in late 2015 and is said to fix most of the problems caused by Windows 8.

2. Company Analysis

Strengths:

The first strength of Microsoft is its brand reputation. Microsoft is one of the most popular companies in the world and any person who grew up using a computer has certainly been in touch with Windows, its operating system. Another strong point for the company is the huge amount of cash it holds. Another strength of the company is the diversity of the segments that it operates in. This is important because the company is not relying on one source of revenue. Microsoft products range from hardware and software to internet services. The positive last quarter results are another strength of the company. In fact, Microsoft has shown a strong performance in the last 4 months with an increase in the sales of its new line of products.

Weaknesses:

The first weakness of the company is the fact that it is lagging behind the leaders of the market Apple and Google. The Sales of the company are not close to what the competitors are doing. In fact, the iOS and Android operating systems remain more widely used among tablets and phone producers, which leads us to the second weakness of the company, namely slow innovations. In fact, Microsoft has a huge R&D budget and works with the best engineers, but fails to offer innovative products to the market. Additionally, the new products released are usually out in a time where the technology lost its value to the eyes of the consumers, putting the company behind with competition. Another weakness of the company is the lack of success and negative feedback that Windows 8 encountered, both from the users and app developers, especially in the mobile version of the OS. Consumers complained about the complexity of the platform and few apps were developed. The final weakness that will be discussed concerns the questionable acquisitions that the company has been known for. The company has spent huge amounts of money to expand or improve its services. However, a lot of the acquisitions were unsuccessful and did not contribute to the company's operations. Recently, Microsoft acquired Mojang, the company behind Minecraft, for \$ 2B and many questions are still to be answered regarding how the purchase will be capitalized.

Opportunities:

One of Microsoft's tremendous opportunities consists on the potential market that the company can have in emerging countries. Microsoft has huge worldwide channels of distribution and an important reputation in emerging markets. Additionally, the brand reputation of both Nokia and Microsoft is a great asset that could be used to attract customers with the release of the new products. A second opportunity for Microsoft is capitalizing on its huge market share for computer operating systems. About 90% of the world's computers use Windows and PCs constitute 95% of the computers sold worldwide. If Microsoft finds a formula to incite customers to switch to Windows 10, there is a chance to generate important revenue from the OS. Another opportunity for Microsoft consists on the mobile and cloud industries. More and more customers feel the need to use the cloud services to save their data. The ability to access your data everywhere and be able to stock it in a secure environment is the main driver for consumers. The Windows Lumia could also represent an important opportunity for Microsoft. In fact, the smartphone market is expanding subsequently worldwide. Another opportunity for Microsoft is the growth through acquisitions. The huge reserve of cash that the company owns can be used to acquire companies that can bring new technologies and skills to the business. Microsoft could use that as a shortcut to position itself as an important competitor in the market.

Threats:

The first threat that faces the company is the intense competition it has from the different actors in the technology industry. The barriers to entry to the market are not difficult to overcome and main competitors have established high standards for innovation. In order for Microsoft to remain attractive the company should sustain its product line and be able to remain at the top of the innovation level. A second threat for the company is cybercrime. The recent years have witnessed an increase in cyber attacks and the Windows unit has suffered from different breaches. The efforts of the company to build a trusted brand could be compromised if hackers succeed on penetrating the security system of its software and hardware. Another threat for Microsoft is the continuous change and the need to adapt to consumer trends. The lifecycle of a product has shortened across time and the demand for new technologies has become the center for success for any technology company. For instance, the tablets market sales have decreased and consumers are now turning toward wearable devices. Finally, Microsoft face the threat of potential lawsuits. It has already inherited all the litigations from the Nokia acquisition and will probably face more lawsuits given its monopolistic position in the operating system market. Lawsuits constitutes an important threat because of the amount of money and time they require to be settled.

3. Industry Analysis

Industry - Technology

Microsoft belongs to the technology industry. Technology is one of the largest industries in the market. The different products, produced under this category, aim to provide customers with tools that can help them increase productivity and simplify professional and personal tasks. The industry has different subcategories including semiconductors, software and programming, networks and internet computer services, hardware, scientific and technical instruments and communication equipment. Microsoft operates primarily under the software and programming category with products like Windows and Office. The use of technology products has become essential in the daily life of humans worldwide and there is an increasing demand for new products by consumers. The main characteristic of the industry is the reliance on innovation as a main indicator of the performance of a company. The more innovative a company is, the more customers it can attract. The technology industry is also one of the most active, given the number of mergers and acquisitions that take place.

The major players of the technology industry are Microsoft, Apple, and IBM, who all together own roughly 40% of the market share. This industry has quite a few competitors but it is not likely for new competitors in the market to grab a lot of the market share; the current market owners have created barriers to entry that are difficult to overcome when attempting to get a large share of the market. IBM has been a part of the technology industry since Microsoft has been in business, and is one of the leaders in the technology industry despite having different products than those that are in line with Microsoft and Apple. The primary competitor for Microsoft is Apple, who has a very different way of designing products; designing them with the intent of innovation and presentation rather than overall utility. Many of Apple's products have strong performance, but are still outperformed by Microsoft instruments in most of the key areas as well as Samsung. There is a strong emotional brand loyalty from the consumers of Apple, however, which Microsoft has been trying to take business from. Apple recently has outperformed Microsoft in the phone hardware and tablet sales, although Microsoft's sales in each respectively has increased a tremendous amount in the past year. In the technology industry, there are regularly acquisitions by larger firms taking control of smaller firms in order to get control of a patent or technology that would make their business better. Most of these acquisitions are done by the larger

companies in the industry and there are two notable ones from Microsoft in recent years: Nokia and aQuantive. The Nokia phone business was a recent purchase by Microsoft in order to facilitate their break into the phone hardware segment of the technology industry, and is currently on the fence as to how profitable it is. Earlier, Microsoft purchased the company aQuantive in order to boost the advertising business of Microsoft, but ended up taking a cost charge of over 96% of their purchase to their goodwill. This is suggesting that the company they paid \$6.3 billion for was in fact nearly worthless to them.

The expected growth of the industry for the next 5 years is supposed to average about 2.8% and this has already been reflected in our analysis of the future of the company. The expected growth of the industry has an exponential growth above the historic trend, although we also believe that the expected future growth may be above this level. Overall we feel that the outlook for this industry is strong and may be undervalued as a sector for the market, and Microsoft is in a good position to take advantage of it from all ends of the spectrum

Appendix: Inputs into valuation using multiples

| | 2008A | 2009A | 2010A | 2011A | 2012A | 2013A | 2014A | 2015F | 2016F |
|---------------------------|----------|----------|----------|----------|----------|----------|----------|----------|-----------|
| Stock Price | \$27.51 | \$23.77 | \$23.01 | \$26.00 | \$30.59 | \$34.54 | \$41.70 | \$40.64 | \$48.21 |
| Diluted EPS | \$1.87 | \$1.62 | \$2.10 | \$2.69 | \$2.00 | \$2.58 | \$2.63 | \$2.87 | \$3.21 |
| Sales | \$60,420 | \$58,437 | \$62,484 | \$69,943 | \$73,723 | \$77,849 | \$86,833 | \$95,516 | \$105,068 |
| Sales per share (Diluted) | \$6.38 | \$6.50 | \$7.00 | \$8.14 | \$8.67 | \$9.19 | \$10.43 | \$11.46 | \$12.70 |
| P/E | \$14.73 | \$14.68 | \$10.95 | \$9.65 | \$15.33 | \$13.38 | \$15.86 | \$14.15 | \$15.00 |
| P/S | \$4.31 | \$3.66 | \$3.29 | \$3.19 | \$3.53 | \$3.76 | \$4.00 | \$3.67 | \$3.84 |

** Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*