

Running head: THE MICROSOFT CORPORATION – COMPANY ANALYSIS

The Microsoft Corporation – Company Analysis

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Abstract

A group of investors has approached us for advice on an investment in the Microsoft Corporation. The investors want detailed research on the company, including its financial strengths and weaknesses, position in the market, and potential for growth. They want us to analyze the data we collect and make recommendations as to whether they should invest in the company. We will provide sound analysis and data to support our recommendation.

Introduction

Microsoft Corporation's headquarter is in Redmond, Washington and started mainly as a software development company creating operating systems for personal computers (PCs) and office productivity software for PCs. Today this company is developing and supporting many software products for various computing devices worldwide. MSFT (2006) identified seven major product segments within the Microsoft Corporation: 1) Clients, 2) Servers and Tools, 3) Information Worker, 4) Microsoft Business Solutions, 5) MSN, 6) Mobile and Embedded Devices, 7) Home and Entertainment.

The Microsoft technical innovations and its leadership in consumer markets and corporate markets make them a redoubtable competitor in this information age. In this paper, a financial analysis of the Microsoft Corporation is conducted based on the publicly available financial data for the last five years and a recommendation will be made for an investment strategy based on Microsoft's track record. The reader should not judge the future gain or loss based on the past performance, since it is impossible to predict the future. Thus, please use your common sense to adjust the financial decision based on market conditions and other factors beyond the control of this study.

Company Profile

Index Membership

This company is member of New York Stock Exchange (NYSE).

Sector of activity and Industry

Based on MSFT (2006), the Microsoft Corporation is operating in the technology sector and is active in application software industry.

Number of divisions and employees

The Microsoft (2006) has seven divisions and 61,000 employees. There are 39,000 employees in the United States and 22,000 all over the world. There are 24,000 individuals in research and development, 18,000 in sales and marketing, 12,000 in product support and consulting services, 2,000 in manufacturing and distribution, and 5,000 in general and administration.

Business Summary

Segment Revenue

The following table 1 shows the segment revenue for the MSFT (2006) for last 3 years.

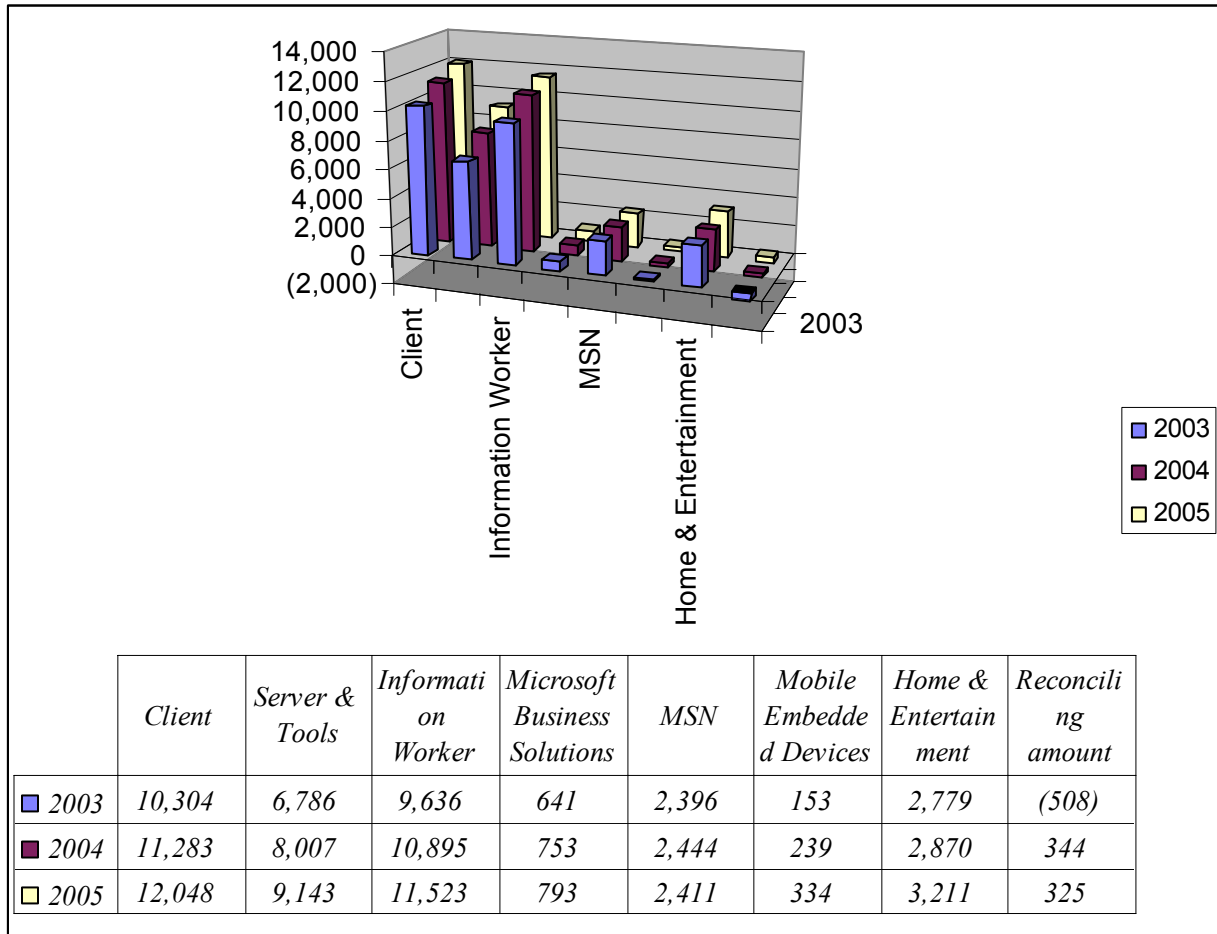
Table 1 – Microsoft’s Segment Revenue ((In millions)

Segment Revenue	2003	2004	% 2004 vs. 2003	2005	% 2005 vs. 2004
Client	10,304	11,283	10%	12,048	7%
Server & Tools	6,786	8,007	18%	9,143	14%
Information Worker	9,636	10,895	13%	11,523	6%
MS Business Solutions	641	753	17%	793	5%
MSN	2,396	2,444	2%	2,411	-1%
Mobile Embedded Devices	153	239	56%	334	40%
Home & Entertainment	2,779	2,870	3%	3,211	12%
Reconciling amount	(508)	344		325	
Consolidated	32,187	36,835	14%	39,788	8%

The consolidated revenue was up by 14% in 2004, but the growth was a bit slower at 8% in 2005. As far as the revenue by segment of activity is concerned, there were remarkable

revenue growths for the mobile and embedded devices with 40% increase, the server and tools with an increase of 14%, and the home and entertainment segment with 12% increase compare to 2004. In opposite side, the Internet service provider MSN lost some revenue in 2005 by 1%.

Graph 1 – Plot of Microsoft’s Segment Revenue



	<i>Client</i>	<i>Server & Tools</i>	<i>Information Worker</i>	<i>Microsoft Business Solutions</i>	<i>MSN</i>	<i>Mobile Embedded Devices</i>	<i>Home & Entertainment</i>	<i>Reconciling amount</i>
■ 2003	10,304	6,786	9,636	641	2,396	153	2,779	(508)
■ 2004	11,283	8,007	10,895	753	2,444	239	2,870	344
■ 2005	12,048	9,143	11,523	793	2,411	334	3,211	325

Finally, in 2005 over all consolidated revenue is increasing by 8% compare to 2004, but still lower compare the 2004’s revenue increase of 14%.

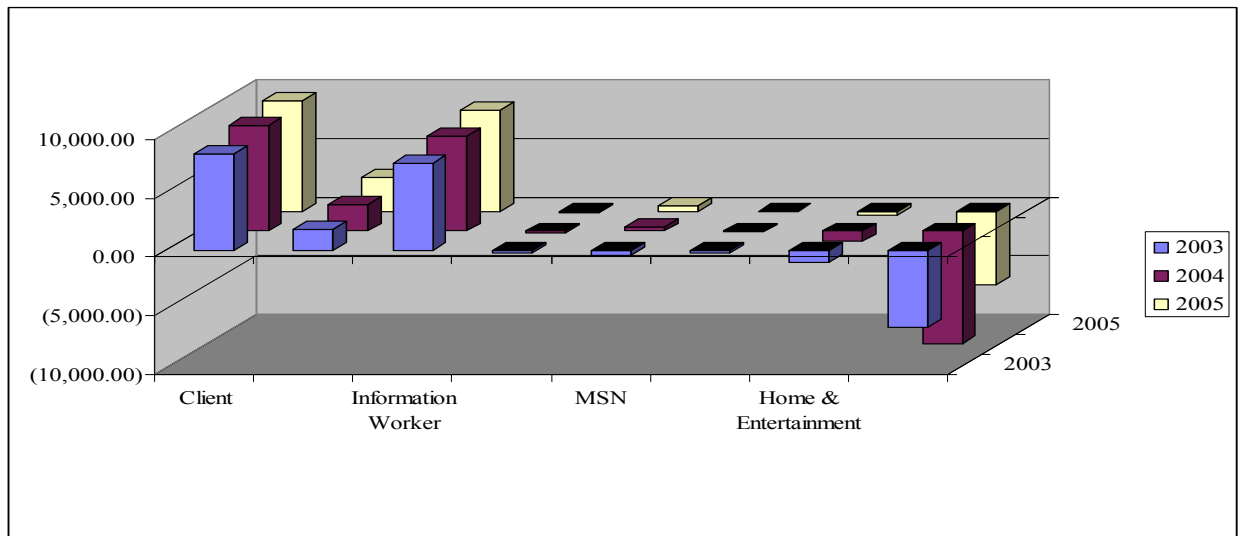
Net Operating Income/Loss

The net operating income or loss for last 3 years is shown in the following table 2:

Table 2 – Microsoft’s Net Operation Income/Loss (In millions)

	2003	2004	% 2004 vs. 2003	2005	% 2005 vs. 2004
Client	8,306.00	8,975.00	8%	9,396.00	5%
Server & Tools	1,879.00	2,302.00	23%	2,888.00	25%
Information Worker	7,500.00	8,112.00	8%	8,616.00	6%
MS Business Solutions	(143.00)	(115.00)	20%	(163.00)	-42%
MSN	(384.00)	383.00	200%	469.00	22%
Mobile Embedded Devices	(162.00)	(98.00)	40%	(19.00)	81%
Home & Entertainment	(938.00)	(894.00)	5%	(359.00)	60%
Reconciling amount	(6,513.00)	(9,631.00)		(6,267.00)	
Consolidated	9,545.00	9,034.00	-5%	14,561.00	61%

Graph 2 – Microsoft’s Net Operation Income/Loss



In term of net operation income or loss, there are mixed results. The client and Information Worker segments are strong and the net operation income is increasing each year at

average rate of 7%. The server and tool segment is strong with 24% average growth. The MSN segment is strongest with 200% increase in 2004 and 22% in 2005. In the negative side, one can observe the net operating losses continues from 2003, 2004 to 2005 in Microsoft Business Solution, Mobile Embedded Devices, and Home and Entertainment.

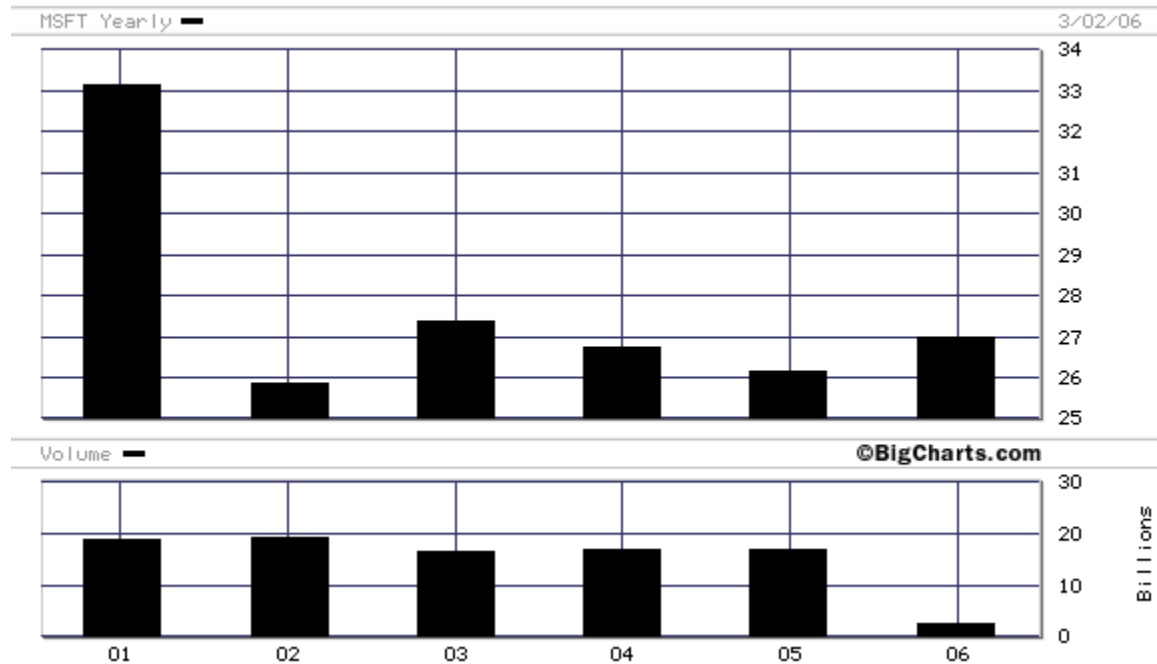
Stock price movements

The table 3 shows the snapshot of MSFT as of March 2nd, 2006. (Big Charts, 2006).

Table 3 – Microsoft’s Stock Price Movements

Last:	Change:	Open:	High:	Low:	Volume:
26.97	▼ -0.17	27.02	27.1001	26.90	41,856,388
	Percent Change:	Yield:	P/E Ratio:	52 Week Range:	
	-0.63%	1.33	22.48	23.82 to 28.38	

Graph 3 – MSFT’s stock price movements for last five years.



You can observe a dramatic stock devaluation of Microsoft in 2002. This corresponds with the overall US economic slowdown, the aftermath of September 11th, 2001 terrorist attacks and the loss of investors' confidence in the high technology sectors and the dot com companies.

Dividend payments

Based on statement of cash flows (Exhibit 6), the Microsoft Corporation didn't pay any dividends for 2001 and 2002. But they paid the amount of \$857 million, \$1,729 million, and \$36,112 million respectively for 2003, 2004, and 2005.

Financial Statements

Income Statement

Exhibit 1 provides the Microsoft Corporation's income statements from 2001 to 2005. Revenues are shown at the top of income statement, after which operating expenses, interest costs, and taxes are subtracted to obtain the net income available to common shareholders, which are referred to as net income. The revenue growth has been accelerating at a rate of 13% per year on average. This seems to be a normative growth rate based on five years of data. This growth is significantly lower than the 10 year average growth of 23% (Yahoo, 2006). However, it is still solid growth.

Earning per share (EPS) or "the bottom line" shows \$1.13 per share in 2005, up from \$0.76 in 2004, and it is up from \$0.70 in 2003.

Dividends per share (DPS) indicate that in 2001 and 2002, Microsoft didn't pay any dividends to shareholders. In year 2003 the DPS was \$0.08. It doubled in 2004 to \$0.16 and jump to \$3.33 for 2005.

Book value per share (BVPS) for the year 2001 was \$4.43 and the average market value per share was \$33.20. Therefore the market value per share versus book value per share ratio was around 7.50 times. This ratio was 5.25 times in 2002, 4.54 times in 2003, 3.82 times in 2004,

and 5.87 times in 2005. This indicates that Microsoft achieved high rates of return on their assets causing their market values to be well above of their book values.

For the past five years, research and development expenses are around 17% of revenue in 2001, 15% in 2002, 20% in 2003, 21% in 2004, and 16% in 2005.

General and administrative expenses are growing from 3% of revenue in 2001 to 5% in 2002, 8% in 2003, 14% in 2004, and 10% in 2005. The large increase in 2004 is attributable to legal expenses of \$1.92 billion to settle the Sun Microsystems case, a \$605 million fine imposed by the European Commission, and \$280 million of stock-based compensation.

The cost of revenue was 14% of revenue in 2001, 18% in 2002, 19% in 2003, 18% in 2004, and 16% in 2005.

The sales and marketing was 19% of revenue in 2001, 19% in 2002, 23% in 2003, 23% in 2004, and 22% in 2005.

The most current growth rates per percent of Microsoft compared to the industry and the S&P 500 (MSN Money Central, 2006) is shown in the table 4.

Table 4. Growth Rates %

Growth Rates %	Company	Industry	S&P 500
Sales (Qtr vs year ago qtr)	9.40	1.80	10.70
Net Income (YTD vs YTD)	13.40	36.90	17.70
Net Income (Qtr vs year ago qtr)	5.50	-8.90	20.00
Sales (5-Year Annual Avg.)	11.07	2.77	5.12
Net Income (5-Year Annual Avg.)	7.99	12.25	15.23
Dividends (5-Year Annual Avg.)	NA	NA	7.96

Balance Sheet

The balance sheet statement is presented in Exhibit 3 which shows the Microsoft Corporation's assets from 2001 to 2005. The assets are listed in order of their liquidity.

1. Cash versus other assets. The cash and short term investments were \$31.6 billion in 2001, \$38.6 billion in 2002, \$49 billion in 2003, \$60.5 billion in 2004, and \$37.7 billion in 2005. There is a general trend of growing cash from 2001 up to 2004. In 2001, the cash and short term investments represented 53.7% of total current assets, 57.1% in 2002, 60% in 2003, and 64.2% in 2004. But, this trend came to a decline in 2005 with cash representing 53.3% of total current assets. The net total receivables were \$3.6 billion in 2001, \$5.129 billion in 2002, \$5.196 billion in 2003, \$5.89 billion in 2004, and \$7.18 billion in 2005. The percentage of total receivables compare to the total current assets is 6.2% in 2001, 7.6% in 2002, 6.4% in 2003, 6.2% in 2004, and 10.1% in 2005.

2. Liabilities versus stockholder's equity. The claims against the total current assets are represented by the total liabilities providing the net worth as indicated in table 5.

Table 5 – Microsoft's Net Worth

Year	2001	2002	2003	2004	2005
Total current assets	\$39,210	\$48,576	\$58,973	\$70,566	\$48,737
Minus Total Liabilities	\$11,541	\$15,466	\$16,820	\$19,543	\$22,700
Net Worth	\$27,699	\$33,110	\$42,153	\$51,023	\$26,037

Cash Flow

The cash flow statement is presented in Exhibit6. Cash flow from operations increased from \$14.626 billion in 2004 to \$16.605 billion in 2005.

Cash flow from financing is negative and went up by \$39 billion in 2005. This due primary to \$36.112 paid dividends to the shareholders.

Cash flow from investing was very positive in 2005. It went from (\$3.345) billion to \$15,027 billion. The increase in cash flow from financing is attributable to a shift in duration of investment held. Long-term maturities were exchanged for more liquid investments.

Financial Ratios Analysis

The purpose of this section is to evaluate and interpret the results, especially with respect to the financial statements.

Liquidity Ratios

Brigham & Houston (2004) argue that liquidity shows how a firm can meet its short-term obligations using assets that could be converted into cash in a short period of time. These liquid assets are listed in the balance sheet as current assets. They are used to meet current liabilities. Now, the question is how much liquidity a firm must have? To answer this question, one has to consider the role of the operating cycle. This is the time it takes to invest in firm's products and services to the time when investment generates cash. The net operating cycle is the duration of time it takes to convert an investment of cash in inventory and back into cash. So, the number of days a firm holds its fund in inventory is calculated by the following formula:

The inventory turnover ratio of the Microsoft Corporation for last five years is shown in the table 6. There is a remarkable improvement from 2001 to 2002 going from 41.63 days to 7.71 days. In 2004, the inventory turnover increased to 15.95 days, but the trend reverses itself in 2005 and stayed at 12.63 days. The industry's inventory turnover ratio is 28.4 and 8.4 for S&P 500. So, Microsoft is performing well compare to the industry, but still could improve even better compared to S&P 500.

Table 6 – Microsoft's Inventory Turnover Ratio

Inventory Turnover	2001	2002	2003	2004	2005	Industry	S&P 500
Number of day	41.63	7.71	9.47	15.95	12.63	28.4	8.4

The same kind of logic could be applied to the account receivables to determine the number of days between sales to the time it is collected in cash. The longer the operating cycle, the more current assets are needed to cover current liabilities. Thus, it is important to know how long it takes to convert inventories and account receivables into cash. The following table 7 shows the Microsoft's number of days it takes to collect account receivables. One can notice that in 2001 it took Microsoft 52.97 days to collect receivables and in 2002 it went up to 66 days. By 2003, there is an improvement of 7 days staying at 58.92 days. In 2004, there isn't any significant change, but by the year 2005, it went up by 7 days and stayed at 65.87 days.

Table 7 – Microsoft's Average Collection Period

Number of Days receivables	2001	2002	2003	2004	2005
Number of days	52.97	66.00	58.92	58.36	65.87

Measures of liquidity

Brigham & Houston (2004) explained that liquidity ratios provide a measure of firm's ability to generate cash to meet its immediate needs. There are three liquidity ratios:

1. The current ratio is the ratio of current assets to current liabilities indicating a firm's ability to satisfy its current liabilities with its current assets. The latest Microsoft's current ratio is 2.89. The industry's current ratio is 2.3, and S&P500 is 1.4. This is well beyond the Industry and S&P 500.

Table 8 – Microsoft's Current Ratio

	2001	2002	2003	2004	2005	Industry	S&P 500
Current Ratio	4.24	3.81	4.22	4.71	2.89	2.3	1.4

2. The quick ratio is the ratio of quick assets to current liabilities indicating a firm's ability to satisfy its current liabilities with its current assets. The quick ratio is 2.86 and above the Industry of 2.1 and S&P 500 of 1.0.

Table 9 – Microsoft's Quick Ratio

	2001	2002	2003	2004	2005	Industry	S&P 500
Quick Ratio	4.23	3.76	4.17	4.69	2.86	2.1	1.0

3. The net working capital to sales ratio is the ratio of net working capital to sales indicating a firm's liquid assets relative to its need for liquidity.

Table 10 – Microsoft's Net Working Capital to Sales Ratio

	2001	2002	2003	2004	2005
Net Working Capital to Sales	1.18	1.26	1.40	1.51	0.80

The larger the liquidity ratios are, the better the firm's position to meet its immediate financial obligations. The Microsoft's liquidity ratios are showing increasing liquidity from 2001 to 2004, but it is weakening in 2005.

Profitability Ratios

Brigham & Houston (2004) defined that the profitability ratios compare components of income with sales. There are three ratios to consider: 1) gross profit margin, 2) operating profit margin, 3) net profit margin, 4) return on total assets, 5) return on common equity.

1. The gross profit margin is the ratio of gross income to sales. This ratio shows how much of every dollar of sales is left after costs of good sold.

2. The operating profit margin is the ratio of operating profit to sales. This is a ratio that represents how much of each dollar of sales is left over operating expenses.

3. The net profit margin is the ratio of net income to sales and indicates how much of each dollar of sales is left over after all expenses.

4. The ratio of net income to total assets measures the return on total assets (ROA) after interest and taxes.

5. The “bottom line” accounting ratio is the ratio of net income to common equity, which measures the return on common equity (ROE).

Table 11 – Microsoft’s Profitability Ratios

Profitability Ratios	2001	2002	2003	2004	2005	Industry	S&P 500
Gross profit	86.34%	81.70%	81.18%	81.77%	84.42%	82.6%	47.3%
Operating profit margin	46.33%	41.99%	29.65%	24.53%	36.60%	32.5%	12.4%
Net profit margin	29.04%	27.60%	23.40%	22.17%	30.80%	23.5%	8.5%
ROA	12.49%	11.57%	9.21%	8.66%	17.30%	13.9%	2.9%
ROE	15.53%	15.00%	11.60%	10.92%	25.47%	22.6%	16.3%

Table 11 shows the Microsoft’s profitability ratios compared to the Industry and the S&P 500.

Indeed, the Microsoft Corporation is profitable and leads not only the rivals, but also S&P 500.

Activity Ratios

Brigham & Houston (2004) showed that the activity ratios are measures of how well assets are used.

1. Accounts receivable turnover is the ratio of net credit sales to account receivable. This ratio indicates how many times in the period credit sales have been created and collected on.

2. Total asset turnover is the ratio of sales to total assets. This ratio indicates the extent that the investment in total assets results in sales. There is some room for improvement in term of account receivable turnover. In year 2005, this ratio was at 5.54 for Microsoft compare to the industry rate of 5.2. In other hand, the total asset turnover is better than the industry but above the S&P 500.

Table 12 – Microsoft’s Activity Ratios

Activity Ratios	2001	2002	2003	2004	2005	Industry	S&P 500
Account receivable turnover	6.89	5.53	6.19	6.25	5.54	5.2	7.5
Total Asset Turnover	0.43	0.42	0.39	0.39	0.56	0.6	0.3

Financial Leverage Ratios

A firm uses equity or debt to finance its assets. If the firm decides to use debt, then this introduces the financial risk to its operations, since the firm is legally obligated to pay interest and to repay the principal as promised. If the firm decides to use equity financing, then it doesn’t legally obligate the firm to pay anything except it might have to pay the dividends which are at the discretion of the board of directors. Brigham & Houston (2004) argue that financial leverage ratios are used to assess how much financial risk the company has taken on. There are two types of financial leverage ratios: component percentages and coverage ratios.

Component-percentage financial leverage ratios

1. The total debt to assets ratio indicates the proportion of assets that are financed with debt.
2. The long-term debt to assets ratio shows the proportion of the firm’s assets that are financed with long-term debt. Microsoft doesn’t have long term debt.

3. The debt to equity ratio indicates the relative uses of debt and equity as sources of capital to finance the firm's assets, evaluated using book values of the capital sources.

Table 13 – Microsoft's Financial Leverage Ratios

	2001	2002	2003	2004	2005
Total debt to assets ratio	19.62%	22.86%	20.58%	20.71%	32.06%
Total debt to equity ratio	24.41%	29.64%	25.91%	26.12%	47.18%

Coverage financial leverage ratios

Brigham & Houston (2004) defined that the times-interest-coverage ratio compares the earnings available to meet the interest obligation with the interest obligation.

Table 14 – Microsoft's Coverage Financial Leverage Ratios

	2001	2002	2003	2004	2005
Coverage financial leverage					
Times-interest-coverage	-60.10	-30.00	6.33	2.86	7.04

Shareholder Ratios

Brigham & Houston (2004) argued that shareholder ratios demonstrate the overall results of business operations so they can be compared in terms of a share of stock. There are two numbers of earnings per share reported by companies: basic and diluted. Basic earnings per share are calculated using reported earnings and the average number of share outstanding. Diluted earnings per share are computed assuming that all potentially dilutive securities are issued. The table 15 shows both the basic and diluted earnings per share ratio.

Table 15 – Microsoft's EPS

Earnings Per Share	2001	2002	2003	2004	2005

Basic	\$0.69	\$0.72	\$0.70	\$0.76	\$1.13
Diluted	\$0.66	\$0.70	\$0.69	\$0.75	\$1.12

The difference between the basic and diluted earnings per share could be attributed to the use of stock options in compensation programs.

Price-earnings ratio

Brigham & Houston (2004) stated that the price-earnings ratio (P/E or PE ratio) is the ratio of the price per share of common stock to the earnings per share of common stock.

Table 16 – Microsoft's P/E Ratio

	2001	2002	2003	2004	2005	Industry	S&P 500
Price/Earnings Ratio	97	71	40	36	23	27.3	18.4

P/E is used to analyze the company's ability to generate cash flows in the future. The following table (MSFT, 2006) is a snapshot of top application software companies by market cap as of March 4th, 2006.

Table 17 – Snapshot of top application software companies

Company	Symbol	Price	Change	Market Cap	P/E
Microsoft Corp.	MSFT	26.9	-0.15%	278.28B	22.26
Oracle Corp.	ORCL	12.8	-0.08%	66.02B	23.25
SAP AG	SAP	52.1	0.85%	64.54B	35.93
Adobe Systems Inc.	ADBE	39.1	0.62%	23.42B	32.9
CA INC.	CA	27	0.07%	15.59B	76.27
Intuit Inc.	INTU	48.6	0.35%	8.60B	21.31

Financial Analysis and Benchmarking

Based on the income statement analysis from Exhibit 2, the Microsoft's revenue has been growing at a rate of 13% on average every year. In this highly competitive market segment, this growth rate is solid.

In fiscal year 2005, the Microsoft Corporation invested 16% of its revenue in research and development (Exhibit 3). This amount was 21% in 2004, 20% in 2003, 15% in 2002, and 17% in 2001.

General and Administrative expenses show a steady increase from 3% in 2001, 5% in 2002, 8% in 2003, and all of sudden 14% in 2004! This is due to legal expenses of \$1.92 billion to settle the Sun Microsystems case, a \$605 million fine imposed by the European Commission, and \$280 million of stock-based compensation (CNN, 2006). In 2005, General and Administrative expenses were reduced to 10%.

Based on Microsoft's Balance Sheet (Exhibit 4), the company has \$37.751 billion in cash and short-term investments. Microsoft doesn't have long term debt, but they do have short-term loans and liabilities. The fiscal year 2005, the value of Microsoft's current liabilities was \$22.7 billion. Although, there is an increase in short-term liabilities in 2005, Microsoft's has 1.66 times the cash necessary to payoff its short-term debt without tapping to its account receivables and other assets.

The working capital can be known by subtracting the current assets of \$48,737 billion from the current liabilities at \$22,700 billion. Therefore, the working capital is \$26,037 billion. Based in Balance Sheet (Exhibit 4) there are 10,710 billion shares outstanding in 2005. So, the working capital per share is \$2.41. MSN Money Central (2006) lists the Microsoft stock around \$27.00.

In fiscal year 2005, the current ratio was 2.89 compare to 4.71 in 2004. One can see continual improvement efficiency. Specially, the Microsoft using its cash to launch new operation system named Vista and planned to be released for consumer market in 2007.

In term of quick ratio as of year 2005, Microsoft has \$2.86 in current assets for every \$1 in liabilities. This is a good financial position. But, the quick ratio has deteriorated in year 2004 from 4.69 to 2.86 in year 2005.

Direct Competition Comparison

Microsoft is in direct competition with many high technology companies. This is due to the vast products and services that Microsoft is developing for many segments of activities.

MSFT (2006) indicated in table 18 some of the major direct competitors of Microsoft.

Table 18 – Microsoft’s Direct Competition

	Microsoft	Google	IBM	Oracle
Market Cap:	289.43B	137.80B	131.37B	64.58B
Employees:	61,000	3,021	348,052	49,872
Quarterly Revenue Growth:	6.00%	95.90%	-7.80%	19.40%
Revenue:	40.34B	5.25B	94.38B	12.89B
Gross Margin:	85.01%	57.15%	39.17%	76.83%
EBITDA:	17.95B	2.24B	18.48B	5.01B
Operational Margins:	42.19%	33.93%	14.14%	33.62%
Net Income:	12.87B	1.30B	8.57B	2.88B
EPS:	1.184	4.514	5.160	0.550
P/E:	22.96	103.29	16.12	22.75
PEG (5 yr expected):	1.67	2.67	1.48	1.38

P/S:	7.16	26.10	1.40	5.01
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Microsoft is ranked number one in term of sales and its net income is the highest. The future financial growth seems to be strong. Microsoft is subject to fierce competition not only from its arch commercial rivals such as IBM, Oracle, Sun Microsystems, but also from non-commercial software developers. These companies are developing open source software at nominal cost and earn their revenue by providing software customization or service support. A good example of this open source software is the operating system Linux. Another example is Open Office which can be used to replace Microsoft Office Productivity Suites.

Microsoft's own success has become a handicap, since many hackers are focusing their attentions to break into Microsoft software products causing security issues.

Microsoft is using its intellectual capital as a competitive advantage to respond to these threats. The introduction of new generation of 64 bits operating system called Windows Vista is scheduled to be offered to the public for the fiscal year 2007 (Microsoft 2006). Foley (2006) reported that on February 2006, Microsoft has invited hundreds of Technology Adoption Partners to come to the Redmond for the beta testing of Windows Vista.

Microsoft is releasing in 2006 major updates of several products including new version of its database management system called SQL Server, an integrated software development environment called Visual Studio, and a middle ware called Biz Talk Server. Microsoft is preparing to introduce new wave of products, code named Office 12, to be released during the first half of fiscal year 2007 (Microsoft 2006).

Microsoft Business Solutions has already released a major product upgrade for Microsoft CRM version 3.0 to address the needs of small and mid-size firms to manage their customers'

relationship and marketing efforts. Other enhancements include products such as Microsoft Axapta, Microsoft Great Plains, Microsoft Navision and Microsoft Solomon (Microsoft 2006).

In 2006, Microsoft Mobile and Embedded Devices division “expects to release added functionality to the Windows Mobile 5.0 platform through the Microsoft Enterprise Feature Pack and the Extended Service Pack 2”. (Microsoft, 2006, p.10)

Microsoft Xbox went through a major upgrade in May 2005 and it will be introduced in the first half of 2006 in European Market (Microsoft 2006).

Recommendations

Microsoft’s current stock pricing levels appears slightly undervalued compare to its peers. It is recommended, based on current data and future expectations for growth, to buy this stock or at least to hold for future upside. But, it is important to notice that Microsoft is no longer the prototypical growth stock. The shares are 47% below their all-time-high reached in the year 1999. This year stock price is around \$27 and profits are continuing to grow. The year-ahead earnings are \$1.43 per share. The balance sheet includes \$4 per share in cash. There is expectation of 13% earnings growth this year. In term of new products offering, Microsoft is marketing its Xbox 360 game player in US and Europe, the Windows Vista and new Microsoft Office products are in beta release and will be ready for mass market in 2007. Business Week (2005) listed the Microsoft Corporation brand as number two in its top 100 brands just behind Coca Cola. This brand recognition is due to the Microsoft Corporation’ management philosophy which is centered on the innovation and forward looking business strategy by designing new products and services using their strong market position on Windows platforms. Their competitive advantage is a source of litigation by other software development companies and ongoing governments’ scrutiny in United States and European Union. But, Microsoft is fighting back and tried to settle most of these litigations out of the court. This has a direct impact on their

net income and profitability. With the anticipated release of Windows Vista in 2007, we could expect higher earnings momentum.

Conclusion

Microsoft carries a positive rating. Based on ratio analysis and benchmarking with its competitors, the current valuation of stock seems undervalued. There is a potential for future growth, thus holding on Microsoft stock is very attractive in any portfolio. A target price of \$29 per share is reasonable and we highly recommend buying it.

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Exhibit 1- Microsoft Corporation Income Statement (In million except per share data)

INCOME STATEMENT	2001	2002	2003	2004	2005
Revenue	\$25,296	\$28,365	\$32,187	\$36,835	\$39,788
Operating Expenses:					
Cost of revenue	\$3,455	\$5,191	\$6,059	\$6,716	\$6,200
Research & development	\$4,379	\$4,307	\$6,595	\$7,779	\$6,184
Sales & marketing	\$4,885	\$5,407	\$7,562	\$8,309	\$8,677
General & administrative	\$857	\$1,550	\$2,426	\$4,997	\$4,166
Total Operating Expenses	\$13,576	\$16,455	\$22,642	\$27,801	\$25,227
Operating Income	\$11,720	\$11,910	\$9,545	\$9,034	\$14,561
Investment income/ (loss) and other	(\$195)	(\$397)	\$1,509	\$3,162	\$2,067
Income before income and taxes	\$11,525	\$11,513	\$11,054	\$12,196	\$16,628
Provision for income taxes	\$3,804	\$3,684	\$3,523	\$4,028	\$4,374
Income before accounting change	\$7,721	\$7,829	\$7,531	\$8,168	\$12,254
Effect of accounting change	(\$375)	\$0	\$0	\$0	\$0
Net Income	\$7,346	\$7,829	\$7,531	\$8,168	\$12,254
Earning per share:					
Basic	\$0.69	\$0.72	\$0.70	\$0.76	\$1.13
Diluted	\$0.66	\$0.70	\$0.69	\$0.75	\$1.12
Weighted average shares outstanding:					
Basic	10,683	10,811	10,723	10,803	10,839
Diluted	11,148	11,106	10,882	10,894	10,906
Dividends per share	\$0	\$0	\$0.08	\$0.16	\$3.33
Book value per share	\$4.43	\$4.83	\$6.05	\$6.93	\$4.44
Cash flow per share	\$0.83	\$0.82	\$0.83	\$0.87	\$1.21

Exhibit 2 – Microsoft Corporation Income Statement – Percentage of Change

INCOME STATEMENT	From 2001 to 2002	From 2002 to 2003	From 2003 to 2004	From 2004 to 2005	Average
Revenue	10.82%	11.87%	12.62%	7.42%	10.68%
Operating Expenses:					
Cost of revenue	33.44%	14.33%	9.78%	-8.32%	12.31%
Research & development	-1.67%	34.69%	15.22%	-25.79%	5.61%
Sales & marketing	9.65%	28.50%	8.99%	4.24%	12.85%
General & administrative	44.71%	36.11%	51.45%	-19.95%	28.08%
Total Operating Expenses	17.50%	27.33%	18.56%	-10.20%	13.29%
Operating Income	1.60%	-24.78%	-5.66%	37.96%	2.28%
Investment income/ (loss) and other	50.88%	126.31%	52.28%	-52.98%	44.12%
Income before income and taxes	-0.10%	-4.15%	9.36%	26.65%	7.94%
Provision for income taxes	-3.26%	-4.57%	12.54%	7.91%	3.16%
Income before accounting change	1.38%	-3.96%	7.80%	33.34%	9.64%
Effect of accounting change					
Net Income	6.17%	-3.96%	7.80%	33.34%	10.84%
Earning per share:					
Basic	4.17%	-2.86%	7.89%	32.74%	10.49%
Diluted	5.71%	-1.45%	8.00%	33.04%	11.33%
Weighted average shares outstanding:					
Basic	1.18%	-0.82%	0.74%	0.33%	0.36%
Diluted	-0.38%	-2.06%	0.11%	0.11%	-0.55%

Exhibit 3 – Microsoft Corporation Common Size Income Statement

INCOME STATEMENT	2001	2002	2003	2004	2005
Revenue	100%	100%	100%	100%	100%
Operating Expenses:					
Cost of revenue	14%	18%	19%	18%	16%
Research and development	17%	15%	20%	21%	16%
Sales & marketing	19%	19%	23%	23%	22%
General & administrative	3%	5%	8%	14%	10%
Total Operating Expenses	54%	58%	70%	75%	63%
Operating Income	46%	42%	30%	25%	37%
Investment income /(loss) and other	-1%	-1%	5%	9%	5%
Income before income and taxes	46%	41%	34%	33%	42%
Provision for income taxes	15%	13%	11%	11%	11%
Income before accounting change	31%	28%	23%	22%	31%
Effect of accounting change	-1%	0%	0%	0%	0%
Net Income	29%	28%	23%	22%	31%

Exhibit 4 – Microsoft Corporation Balance Sheet (In millions)

BALANCE SHEET	2001	2002	2003	2004	2005
Current Assets:					
Cash and Short Term Investments	\$31,600	\$38,652	\$49,048	\$60,592	\$37,751
Total Receivables, Net	\$3,671	\$5,129	\$5,196	\$5,890	\$7,180
Total Inventory	\$83	\$673	\$640	\$421	\$491
Other Current Assets, Total	\$3,856	\$4,122	\$4,089	\$3,663	\$3,315
Total Current Assets	\$39,210	\$48,576	\$58,973	\$70,566	\$48,737
Property/Plant/Equipment, Total - Net	\$2,309	\$2,268	\$2,223	\$2,326	\$2,346
Goodwill, Net	\$1,511	\$1,426	\$3,128	\$3,115	\$3,309
Intangibles, Net	\$401	\$243	\$384	\$569	\$499
Long Term Investments	\$14,361	\$14,191	\$13,692	\$12,210	\$11,004
Other Long Term Assets, Total	\$1,038	\$942	\$3,332	\$5,582	\$4,920
Total Assets	\$58,830	\$67,646	\$81,732	\$94,368	\$70,815
Current Liabilities:					
Accounts Payable	\$1,188	\$1,208	\$1,573	\$1,717	\$2,086
Accrued Expenses	\$742	\$1,145	\$1,416	\$1,339	\$1,662
Other Current Liabilities	\$7,324	\$10,391	\$10,985	\$11,913	\$13,129
Total Current Liabilities	\$9,254	\$12,744	\$13,974	\$14,969	\$16,877
Deferred Expenses	\$409	\$398	N/A	N/A	N/A
Other Liabilities, Total	\$1,878	\$2,324	\$2,846	\$4,574	\$5,823
Total Liabilities	\$11,541	\$15,466	\$16,820	\$19,543	\$22,700
Common Stock, Total	\$28,390	\$31,647	\$49,234	\$56,396	\$60,413
Retained Earnings (Accumulated Deficit)	\$18,899	\$20,533	\$15,678	\$18,429	(\$12,298)
Total Equity	\$47,289	\$52,180	\$64,912	\$74,825	\$48,115
Total Liabs. & Stockholders' Equity	\$58,830	\$67,646	\$81,732	\$94,368	\$70,815
Total common Share Outstanding	10,766	10,718	10,771	10,862	10,710

Exhibit 5 – Microsoft Corporation Balance Sheet (Percent of Assets)

BALANCE SHEET	2001	2002	2003	2004	2005
Current Assets:					
Cash and Short Term					
Investments	53.7%	57.1%	60.0%	64.2%	53.3%
Total Receivables, Net	6.2%	7.6%	6.4%	6.2%	10.1%
Total Inventory	0.1%	1.0%	0.8%	0.4%	0.7%
Other Current Assets, Total	6.6%	6.1%	5.0%	3.9%	4.7%
Total Current Assets	66.6%	71.8%	72.2%	74.8%	68.8%
Property/Plant/Equipment					
Total - Net	3.9%	3.4%	2.7%	2.5%	3.3%
Goodwill, Net	2.6%	2.1%	3.8%	3.3%	4.7%
Intangibles, Net	0.7%	0.4%	0.5%	0.6%	0.7%
Long Term Investments	24.4%	21.0%	16.8%	12.9%	15.5%
Other Long Term Assets,					
Total	1.8%	1.4%	4.1%	5.9%	6.9%
Total Assets	100.0%	100.0%	100.0%	100.0%	100.0%
Current Liabilities:					
Accounts Payable	2.0%	1.8%	1.9%	1.8%	2.9%
Accrued Expenses	1.3%	1.7%	1.7%	1.4%	2.3%
Other Current Liabilities	12.4%	15.4%	13.4%	12.6%	18.5%
Total Current Liabilities	15.7%	18.8%	17.1%	15.9%	23.8%
Deferred Expenses	0.7%	0.6%	N/A	N/A	N/A
Other Liabilities, Total	3.2%	3.4%	3.5%	4.8%	8.2%
Total Liabilities	19.6%	22.9%	20.6%	20.7%	32.1%
Common Stock, Total	48.3%	46.8%	60.2%	59.8%	85.3%
Retained Earnings					
(Accumulated Deficit)	32.1%	30.4%	19.2%	19.5%	-17.4%
Total Equity	80.4%	77.1%	79.4%	79.3%	67.9%
Total Liabs. & Stockholders' Equity	100.0%	100.0%	100.0%	100.0%	100.0%

Exhibit 6 – Microsoft Corporation Statement of Cash Flows (In millions)

CASH FLOW FROM OPERATING ACTIVITIES	2001	2002	2003	2004	2005
Net Profit After Taxes	\$7,346	\$7,829	\$7,531	\$8,168	\$12,254
Cumulative effect of accounting change, net of tax	\$375	\$0	\$0	\$0	\$0
Depreciation	\$1,536	\$1,084	\$1,393	\$1,186	\$855
Stock-based compensation	\$0	\$2,424	\$3,749	\$5,734	\$2,448
Net recognized (gains)/losses on investments	\$2,221	\$1,596	\$380	(\$1,296)	(\$527)
Stock option income tax benefits	\$2,066	(\$416)	\$1,365	\$1,100	\$668
Deferred income taxes	(\$420)	\$11,152	(\$894)	(\$1,479)	(\$179)
Unearned revenue	\$6,970	(\$8,929)	\$12,519	\$11,777	\$13,831
Recognition of unearned revenue	(\$6,369)	(\$1,623)	(\$11,292)	(\$12,527)	(\$12,919)
Account receivable	(\$418)	(\$264)	\$187	(\$687)	(\$1,243)
Other current assets	(\$482)	(\$9)	\$412	\$478	(\$245)
Other long-term assets	(\$330)	\$1,449	(\$28)	\$34	\$21
Other current liabilities	\$774	\$216	\$35	\$2,063	\$396
Other long-term liabilities	\$153		\$440	\$75	\$1,245
Net Cash Flow from Operations	\$13,422	\$14,509	\$15,797	\$14,626	\$16,605
Financing					
Common stock issued	1,620	1,497	2,120	2,748	3,109
Common stock repurchased	(\$6,074)	(\$6,069)	(\$6,486)	(\$3,383)	(\$8,057)
Repurchase of put warrants	(\$1,367)	\$0	\$0	\$0	\$0
Common stock cash dividends	\$0	\$0	(\$857)	(\$1,729)	(\$36,112)
Other	\$235	\$0	0	0	(\$18)
Net cash used for financing	(\$5,586)	(\$4,572)	(\$5,223)	(\$2,364)	(\$41,078)
Investing					
Additions to property and equipment	(\$1,103)	(\$770)	(\$891)	(\$1,109)	(\$812)
Acquisitions of companies, net of cash required	\$0	\$0	(\$1,063)	(\$4)	(\$207)
Purchase of investments	(\$66,346)	(\$89,386)	(\$91,869)	(\$95,005)	(\$68,045)
Maturities of investments	\$5,867	\$8,654	\$9,205	\$5,561	\$29,153
Sales of investments	\$52,848	\$70,657	\$77,123	\$87,215	\$54,938
Net cash used for investing	(\$8,734)	(\$10,845)	(\$7,495)	(\$3,342)	\$15,027
Net change in cash and equivalents	(\$898)	(\$908)	\$3,079	\$8,920	(\$9,446)

Effect of exchange rates on cash and equivalents	(\$26)	\$2	\$61	\$27	(\$7)
Cash and equivalents, beginning of period	4846	3922	2217	5357	14304
Cash and equivalents, end of period	\$3,922	\$3,016	\$5,357	\$14,304	\$4,851

Exhibit 7 – Microsoft Corporation Ratio Analysis

	2001	2002	2003	2004	2005
Current Ratio	4.24	3.81	4.22	4.71	2.89
Quick Ratio	4.23	3.76	4.17	4.69	2.86
Inventory Turnover	41.63	7.71	9.47	15.95	12.63
Average Collection Period	52.97	66.00	58.92	58.36	65.87
Total Asset Turnover	0.43	0.42	0.39	0.39	0.56
Debt Ratio	0.20	0.23	0.21	0.21	0.32
Debt-to-Equity	0.04	0.04	0.04	0.06	0.12
Times Interest Earned	-60.10	-30.00	6.33	2.86	7.04
Gross Profit Margin	86.34%	81.70%	81.18%	81.77%	84.42%
Operating Profit Margin	46.33%	41.99%	29.65%	24.53%	36.60%
Net Profit Margin	29.04%	27.60%	23.40%	22.17%	30.80%
Return on Total Assets (ROA)	12.49%	11.57%	9.21%	8.66%	17.30%
Return on Equity (ROE)	15.53%	15.00%	11.60%	10.92%	25.47%
Earnings Per Share	\$0.68	\$0.73	\$0.70	\$0.75	\$1.14
Price/Earnings Ratio	6.21	5.22	6.04	6.27	2.52