

Microsoft struggles to regain former growth

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A quarter-century into its career as a publicly traded company, Microsoft finds itself a prisoner of its own past success.

The company continues to grow top-line revenue, but at a slower pace than in the glory days of the late 1980s and 1990s. Its profitability would be the envy of most other companies, but operating margins have gradually declined for most of the past decade.

Investors worry that Microsoft's missed opportunities in smartphones and late entry to the [tablet market](#) threaten its core [Windows](#) and Office businesses - the sources of most of the company's value. And any new business lines, no matter how successful, almost inevitably would be less profitable than Windows and Office.

The result: a stock that has been so persistently undervalued for the past decade that it looks more like a bond - no longer a stock young people buy to get rich but one retirees buy to stay afloat.

"It's certainly not valued as a growth company," said Sid Parakh, an analyst who follows Microsoft for Seattle's McAdams Wright Ragen brokerage. "Could they become a growth company at some point in the future? The potential is there, but for them to deliver on it they really need to execute."

The company has high hopes for its smartphone partnership with Nokia, tablets running the future Windows 8 operating system, and the hosted software and services business that goes by the moniker "cloud computing."

In the wake of several recent high-profile announcements of corporate split-ups ([Abbott Laboratories](#), McGraw-Hill, Sara Lee, Tyco), some investors may renew calls for Microsoft to spin off one or more business lines or split itself up entirely.

But while a split-up might unlock some value - in the server-software and tools segment, for instance, or the Microsoft Dynamics business-software operation - [company management](#) insists that its various product lines support one another.

Nor would a breakup address the fundamental force holding back Microsoft's share price: doubts that Windows and Office will be able to continue generating cash at their historical rates, or that the company will find any similarly big, high-margin successor.

"What some investors are saying is, 'Hey, you're so reliant on two businesses to drive your operating profitability, and in one of those businesses you're falling behind,' " Parakh said.

With a few brief exceptions, Microsoft's shares have traded in the mid-\$20s for most of the past decade - a price that almost certainly undervalues the company.

The Seattle Times used standard valuation metrics to put a price tag on the company and estimate how much each of Microsoft's five operating segments contributes to its overall value. The resulting estimate was an overall enterprise value of \$399.3 billion, which implies a fair-value share price of about \$47 - well above Tuesday's \$26.74 close.

Microsoft's Business Division, which includes Office and Dynamics, accounts for more than half the company's total enterprise value in our analysis. The Windows unit accounts for more than a quarter, while the Server and Tools segment adds 14 percent. Everything else - the Xbox gaming platform, the Bing search engine, MSN, Windows Phone - contributes negligibly to Microsoft's value.

The Seattle Times' analysis likely overstates Microsoft's value because it is based on revenue and operating income for the past four quarters, while professional analysts and investors use projected future financial results. Still, most outside analyses peg the stock's fair value in the low \$30s.

And there's no doubt that most of the earning power, and hence the value, of Microsoft remains with the Windows and Business divisions. In the past 12 months, for example, the Business Division generated \$14.4 billion in operating income and Windows kicked in another \$12.2 billion. Together, they accounted for nearly all the company's operating earnings, as smaller profits in the Server and Tools and Xbox units were mostly offset by losses in online services and general corporate expenses.

The operating margins in Windows and Office both exceed 63 percent - a phenomenally high level of profitability that has been sustained over

time, and which makes even Microsoft's other profit-making businesses look small in comparison.

For example, Server and Tools (whose products are used to develop and maintain corporate networks) posted an operating profit of \$6.6 billion over the past four quarters on \$17.4 billion in revenues, for an operating margin of almost 38 percent. The Seattle Times' analysis estimates the stand-alone value of Server and Tools at \$49.6 billion.

"I think there's a huge amount of value in Server and Tools," said Brendan Barnicle, an analyst at Portland, Ore.-based Pacific Crest Securities who has followed Microsoft for 11 years. "If Microsoft were to run Server and Tools as a stand-alone business, it would be one of the most attractive software companies out there."

But Microsoft CEO Steve Ballmer has dismissed previous suggestions to either break up the company or break out any of its businesses. As Ballmer said during a recent analysts' conference, from servers to smartphones to tablets, "Windows is at the center of our go-forward strategy."

"With the new Windows 8 release, they're starting to show why it makes more sense to leave all the different pieces under the same roof," said Parakh, the analyst. "They're tying in the smartphone interface, which has the same look and feel as the desktop. The Office products tie in with the server business and will run on the phone or your PC or your tablet."

For now, though, several of other Microsoft's business lines - notably Xbox and Bing - have more strategic than financial value.

"The games business and the search business are fundamentally defensive businesses," said Rob Helm, managing vice president for

research at Kirkland, Wash.-based Directions on Microsoft. "The defensive businesses help prop up the core businesses."

Microsoft originally developed the Xbox at a time when video-game consoles looked like they might challenge PCs as general-purpose media-consumption devices, Helm said. And Bing's main job, especially since its link-up with Yahoo, is to take as much market share in online search and ad revenue as it can away from Google - which Microsoft sees as threatening its Windows and Office franchises.

"Microsoft hopes that in the long term both games and online advertising will develop into interesting businesses in their own right," Helm said. But for now, he added, "they're about cutting off competitors at the pass."

Still, with two such powerful cash engines strapped to its wings, why is Microsoft valued by shareholders at so much less than comparable firms? The main reason seems to be skepticism that those two engines will continue to pump out cash at the rates they have been - combined with dismay at management's apparent slowness in responding to new competitive threats.

Take smartphones, which more and more people are using to surf the Web, check email, play games and do other things they once needed a PC to do. Early on Microsoft was one of the leading vendors of smartphone operating systems, but it has lost much of that ground to Apple's iPhone and Google's Android system. Research firm Gartner estimates that Microsoft captured less than 2 percent of global smartphone sales in the second quarter.

But the company, and some analysts, have high hopes that situation can be turned around, especially with the release of Windows Phone 7.5 (code name: "Mango") and Nokia's decision to base all its new

smartphones on Microsoft's system. Research firm IDC predicts Windows Phone will capture 20 percent of the smartphone market by 2015.

"They're late, but there's still time for them to get back in the game," Parakh said. "There's still a lot of growth potential in smartphone."

Tablets and e-readers, from Apple's iPod to Amazon's Kindle, are the other threat to the PC-based Windows-Office duopoly - and another instance of Microsoft seeming to fumble the ball.

CNET reported recently that Microsoft last year killed a dual-screen tablet, code-named Courier, it had in development because "the product didn't clearly align with the company's Windows and Office franchises." The Courier would have used a heavily modified version of Windows; instead, Microsoft chose to develop tablets based on the upcoming Windows 8.

But that, Helm and other analysts say, means Microsoft won't have a meaningful entry in the tablet market for at least another year - by which time, Gartner estimates, Apple will have sold 130.4 million iPads. Gartner estimates that by 2015, Microsoft will have 10.6 percent of the tablet market versus Apple's 45.6 percent.

"Microsoft has always counted on being a fast follower on technology - not on getting there first but on getting there in time to catch the mass market," Helm said. "But the speed at which markets go mass has outstripped not just their ability but anyone's ability to be a fast follower."

Even as Microsoft searches for ways to regain its reputation as a growth stock, analyst Barnicle said, it caters to value investors in finding ways to return cash to shareholders. At around 3 percent, the current dividend

yield is just below that of 30-year Treasury bonds; in fiscal 2011, Microsoft spent more than \$11.5 billion to buy back stock.

For most companies, there's a trade-off between size, growth and profit. When it was smaller and its businesses had more room to run, [Microsoft](#) could combine sizzling growth and rich profit margins. Now, that sweet spot may be out of reach.

"There are not really many \$75 billion companies that grow at 20 percent," Barnicle said. "In fact, I'm not sure there are any."

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