

Investment Research

Microsoft (MSFT)

Buy

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The Undervaluation

The bridge between the consumer and the commercial market segments defines the undervaluation of Microsoft. The organization has established a defensible position in both market segments. In fact, Microsoft has established a dominant position in the commercial market segment, which typically changes at a slower rate than the consumer market segment.

This market dynamic creates value for Microsoft because it provides Microsoft with more time to respond to the competitive threats from Google and Apple.

Google has been giving away their operating system for years. This strategy has been very effective in the market. Recently, Apple started giving away their operating system too. When is Microsoft going to respond to the collective, competitive threat?

Steve Ballmer did a great job maximizing the profitability of Microsoft over the years. But his managerial style actually extracted shareholder value from the organization, which appears counterintuitive given the level of profitability at Microsoft.

The market appreciates profitability – but only to a degree. Eventually, a profit-maximizing, managerial strategy leads to a point of diminishing return. Examine the cost-cutting, profit-maximization managerial style of Mark Hurd at Hewlett Packard. It's the same dynamic at Microsoft. Only Steve Ballmer inherited a much stronger position.

On 12/31/1999, Microsoft (MSFT) had a market capitalization of approximately \$601 billion. On 12/31/1999, Apple (AAPL) had a market capitalization of \$17 billion. Google (GOOG) had a market capitalization of ZERO. Compare these values to the current market capitalizations: MSFT \$316 billion, AAPL \$472 billion and GOOG \$345 billion.

In other words, Microsoft lost \$285 billion in market capitalization since 12/31/1999. But Apple gained \$455 billion in market capitalization, and Google gained \$345 billion during the same time period.

Talk about an opportunity cost to the Microsoft shareholder! How did Microsoft miss the opportunity?

Profit maximization frequently overlooks the value of creation. It's having the ability to read the market – altruistically – and create solutions which satisfy needs in the market. The quality of the solution generates the value for the shareholder.

Unless Microsoft plans on giving away its operating system, the organization better respond to the competitive threat of Google and Apple. Giving away the operating system directly attacks the Windows franchise.

Why doesn't Microsoft directly attack the Google franchise? It can essentially give away search related advertising through Bing? Such a strategy would significantly increase its share of the search market, especially if advertisers passed through savings to the consumer, and effectively create a cost advantage, which would pull the consumer into the market.

This pricing strategy attacks the very core of Google, because Google generates approximately 85% of its business through search related advertising and services, making it vulnerable in the market.

It's amazing what can be accomplished with a genuine, altruistic invitation to build something for the greater good of mankind. Just ask Google!

Microsoft has to develop the ability to read the market and create solutions which satisfy needs in the market.

This creates the shareholder value!