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Investment Review by
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Microsoft

The King of Cash

When searching for suitable investments for our clients, Sire Line Capital looks for high-quality businesses that 1) are simple to understand, 2) have a consistent operating history and favorable long-term prospects, 3) are managed by honest and able managers whose interests are aligned with ours and 4) can be purchased at a significant discount to intrinsic value. In other words, we want to pay a reasonable price for predictability and quality. We believe we have found that in Microsoft (MSFT).

1. Simple to Understand

Founded in 1975, MSFT is the world's largest software company. The company generates revenue by developing, manufacturing and licensing a wide range of software products and services for many different types of computing devices. Software products and services include 1) operating systems for personal computers, servers, and intelligent devices; 2) server applications for distributed computing environments; 3) information worker productivity applications; 4) business solutions applications; 5) high-performance computing applications; 6) software development tools and 7) video games. MSFT earns revenues primarily from customers paying a fee to license its software.

The company has five operating segments, with three accounting for 83% of total revenues:

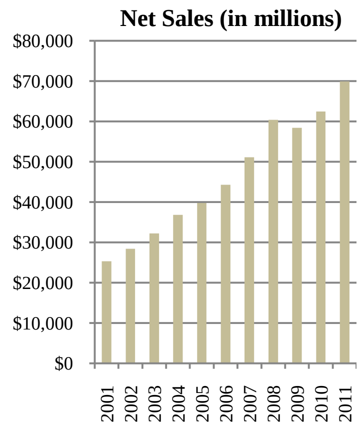
% of Total Revenue	FY2011
Microsoft Business	32%
Windows & Windows Live	27%
Server and Tools	24%
Entertainment and Devices	13%
Online Services	4%
Total	100%

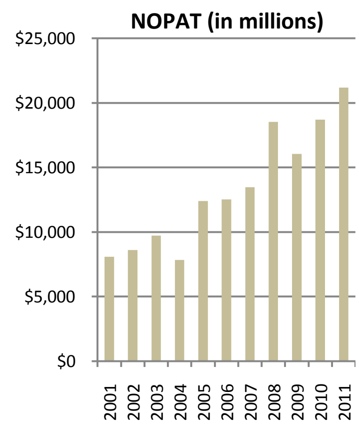
Source: Company reports, SLC analysis

Millions of people around the world use MSFT products and services on a daily basis.

2. Consistent Operating History and Favorable Long-term Prospects

MSFT has consistently generated above-average growth and returns on invested capital. During the last ten years the company's compounded annual growth rate for sales and net operating profit after tax (NOPAT) was over 10%, while its average return on invested capital was 29%:





	5-Year Avg.	10-Year Avg.
Return on Invested Capital	41%	29%
Return on Tangible Capital	60%	38%

Source: Company reports, SLC analysis

And the company's returns look even better if you adjust for the significant amount of cash that the company keeps on the balance sheet. Interestingly, over the last ten years the company only had to invest an additional $18.4 billion in capital to generate nearly $16 billion in additional operating income (EBIT):

	2001-2011
Increase in cash EBIT	$15,891
Increase in Invested Capital (1)	$18,402
Incremental Pre-tax Return on Capital	86%

Source: Company reports, SLC analysis
(1) Assumes cash equals 40% of sales in all years.

There are only a select few companies in the world that have achieved these types of returns.

Given the company's dominant market position in important product categories, the company's future remains bright. Recent product launches (Windows 7; Office 2010) have been huge hits and the company is positioned extremely well to compete in the new world of cloud computing. In addition, we believe Windows Phone has great potential and should be a meaningful contributor to earnings within the next few years.

3. Managed by Honest and Able Managers Whose Interests are Aligned with Ours

When analyzing a management team the first thing we look for is significant stock ownership by insiders. Insiders at MSFT own over 12% of the company. This is a well above ownership levels for most companies. Steve Ballmer, the co-founder and CEO of MSFT, is a large shareholder and knows the company better than anyone. The company's spiritual leader, Bill Gates, retired from day-to-day corporate activities a few years ago, but remains Chairman of the Board and continues to have significant input into the future direction of the company. Mr. Gates also continues to own a significant amount of stock.

The next thing we look for in a management team is value creation and the amount of value being returned to shareholders. The most important job a management team has is capital allocation. Real shareholder value can only be created through the efficient allocation of capital and resources. This can be analyzed by looking at the statement of cash flows in the company's financial statements.

The table below is a cumulative summary of the company's cash flow statement for the last five years. As you can see, the company's operating activities have generated nearly $110 billion of cash flow since 2006 (line 1). Of that, management reinvested approximately $23 billion back into the business in the form of capital expenditures (line 2) and acquisitions (line 4). After adding roughly $6 billion worth of debt to the capital structure (line 6 & 7), management had nearly $92 billion of free cash available for equity shareholders (line 8). All told, MSFT's management returned over $78 billion to shareholders over the last five years in the form of dividends and share repurchases (lines 9-11). This equates to nearly a third of the company's equity market value at the beginning of 2006.

(in millions)

	Cumulative Cash Flows: 2006-2011	Total	Line
	Funds from Operating Activities	109,512	1
-	Capital Expenditures	12,897	2
=	**FCF**	**96,615**	**3**
-	Net Assets from Acquisitions	10,387	4
=	**FCF, net**	**86,228**	**5**
+	Change in Current Debt	-	6
+	Change in Long-Term Debt	5,749	7
=	**FCF available for div. & repurchases**	**91,978**	**8**
	Cash Dividends Paid - Total	22,046	9
-	Stock Repurchases	56,635	10
=	**Total Returned to Shareholders**	**78,681**	**11**

Source: Company Reports, SLC analysis

Not only is the company able to generate a significant amount of value from its operations, but MSFT's management has returned most of it to shareholders. This is exactly what we want to see from a management team. They are thinking and acting like shareholders.

4. Can it be Purchased at a Significant Discount to Intrinsic Value?

MSFT's stock was recently trading at a price of $24 per share, which is the same level it traded at in 1998. This flat stock performance contrasts sharply with the attractive revenue and earnings growth that the company has generated over the same period. When a company's business economics outperform its stock price over a long period of time, we get interested.

At $24 per share and with 8.5 billion shares outstanding, MSFT had an equity market value of $204 billion (8.5 billion shares x $24 per share = $204 billion). Normalized annual free cash flow is approximately $23 billion, which results in a free cash yield of roughly 11% ($23/$204 = 11%). If you adjust the equity market value for the cash and investments on the balance sheet, the free cash flow yield improves to nearly 16%. This is a huge premium to the recent risk-free rate of return for the 10-year Treasury bond of around 3.10%. However, given the company's potential for continued above-average growth, an investor in MSFT is likely to experience a return well above 16%. If we assume long-term volume growth of 2%-3% and inflation of 2%-3%, the total expected forward rate of return for an investment in MSFT increases to 20% (16%+2%+2%=20%), assuming shares trade at a similar multiple of cash flow in the future. This rate of return from such a high-quality business is extremely attractive to us, especially in the current environment.

The calculation of intrinsic value is a little more difficult. Value comes from three main sources: assets, earnings power and growth. When we value a business we always start with the most reliable information. For a business, the most reliable data is always found on the balance sheet. At the end of the most recent quarter MSFT had just over $57 billion ($6.70 per share) in total stockholders' equity. This is well below the company's recent equity market value of $204 billion. Even after we make certain adjustments to the balance sheet to better reflect current replacement values, the closest we can get to is around $125 billion ($14.70 per share). This would be an appropriate measure of MSFT's worth if it had no competitive advantages and competed on a level playing field. However, we know that is not the case given the dominant market position in key product categories and the above-average returns on capital that they are generating. A better way to measure the worth of a company with inherent competitive advantages is to look at the cash earnings power that the assets are generating. For that, we need to go to the company's income statement.

In the company's just completed 2011 fiscal year, MSFT generated over $21 billion in net operating profit after tax

(NOPAT). However, this number includes growth-related expenditures. Remember, if we want a more reliable result, we have to separate the more reliable information from the less reliable information. So before we try to value the company using often unreliable expectations about the future, we want to know how much the company's current earnings power is worth. To do this we need to make certain adjustments to NOPAT to get a better sense of the company's earnings power in a no-growth scenario. If we assume a certain amount of the company's operating expenses are growth-related (i.e. research & development expenses, marketing expenses, plant, property & equipment expenses), we can add a portion of these expenses back to income to better reflect the company's current earnings power. After making this adjustment, MSFT's current earnings power is closer to $22 billion. When we capitalize this number at an appropriate discount rate and add back net cash (cash minus debt), the equity value of MSFT's current earnings power is close to $330 billion ($38.80 per share). In other words, if MSFT earns the same amount every year in the future as they did last year, the company should be worth somewhere around $330 billion today. At a current equity market value of $204 billion, either the market believes that MSFT's earnings will decline in the future, or its stock is significantly undervalued.

To complete this analysis, we need to go one step further and try to value the future growth of the company. If we assume the company is able to grow at least at the rate of GDP, the company is worth well over $500 billion ($59 per share). Again, this final calculation relies on the most unreliable and least tangible information—future growth expectations.

So what is the correct value of MSFT? We believe the truth is usually somewhere in between. Meaning, the intrinsic value of the company is somewhere between its earnings power value of $330 billion, which assumes no growth, and the value assuming GDP-type growth in earnings ($500+ billion). Because we can buy the stock now at a price that is substantially less than the company's current earnings power value, we don't really care if the future growth rate is 3%, 5% or 7%. If we buy the stock today, the growth rate only needs to be positive for us to make an adequate return on our investment.

To conclude, MSFT is simple to understand, has generated consistent growth and profitability over time, owns a difficult-to-replicate franchise with significant barriers to entry, and is being managed by an experienced and capable team of executives whose interests are aligned with ours. Most importantly, the price is right!