

KEYSTONE'S

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Independent Equity Advisors

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Focus BUY Portfolio	Initial Coverage: Microsoft Corporation
	Price: \$105.08
	Symbol: MSFT: NASDAQ
	Near Term: ▲ BUY
	Long Term: ▲ BUY

Summary

Microsoft develops and licenses consumer and enterprise software. It is known for its Windows operating systems and Office productivity suite. The company is organized into three overarching segments: productivity and business processes (legacy Microsoft Office, cloud-based Office 365, Exchange, SharePoint, Skype, LinkedIn, Dynamics), intelligence cloud (infrastructure- and platform-as-a-service offerings Azure, Windows Server OS, SQL Server), and more personal computing (Windows Client, Xbox, Bing search, display advertising, and Surface laptops, tablets, and desktops). Through acquisitions, Microsoft owns Xamarin, LinkedIn, and GitHub. It reports revenue in product and service and other revenue on its income statement. (Source: www.tmxmoney.com).

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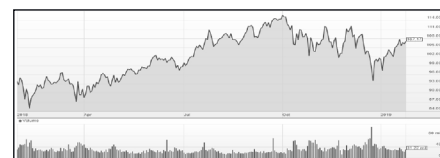


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Microsoft Corporation (MSFT: NASDAQ)**Recommendation: BUY****Focus BUY Portfolio**

Current Price (January 28, 2019).....\$105.08

**COMPANY DESCRIPTION**

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INVESTMENT HIGHLIGHTS

- Utility-style software company with growing recurring revenues.
- Second largest player with expanding market share in high-growth cloud computing space.
- Solid financial momentum in all three operating segments.
- Strong balance sheet consisting of \$6.94 per share in net cash.
- Reasonable valuation relative to software peer group.

RECENT FINANCIALS**First Quarter 2019 Performance:**

- Revenue increased 19% to \$29.1 billion.
- Operating income increased 29% to \$9.9 billion.
- Earnings per share increased 36% to \$1.14.

Revenue in the **Productivity and Business Processes** segment increased 19% (up 18% in constant currency) to \$9.8 billion. Within the segment, Office commercial products and cloud services revenue increased 17% and Office consumer products and cloud services revenue increased 16%, both of which were driven by continued growth in Office 365. LinkedIn revenue increased 33% with record levels of engagement highlighted by LinkedIn sessions growth of 34%. Dynamics products and cloud services revenue increased 20% driven by Dynamics 365 revenue growth of 51%.

Revenue in **Intelligent Cloud** increased 24% to \$8.6 billion and increased 24%. Within the segment, server products and cloud services revenue increased 28% driven by Azure revenue growth of 76%. Enterprise Services revenue increased 6%.

Revenue in **More Personal Computing** increased 15% to \$10.7 billion. Within the segment, Windows OEM revenue increased 3%, Windows commercial products and cloud services increased 12%, Gaming revenue increased 44%, with Xbox software and services revenue growth of 36%.

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TABLE 2: QUARTERLY FINANCIAL DATA

(millions)	Q1 2019	Q1 2018	Change
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Operating Income	\$9,955	\$7,708	29.2%
Non-GAAP Net Income	\$8,824	\$6,576	34.2%
Non-GAAP EPS	\$1.14	\$0.84	35.7%
Net Cash	\$53,998	\$47,228	14.3%
Shareholder's Equity	\$85,967	\$89,647	-4.1%

TABLE 3: ANNUAL FINANCIAL DATA

(millions)	2018	2017	Change
Revenues	\$110,360	\$96,571	14.3%
Operating Income	\$35,058	\$29,025	20.8%
Non-GAAP Net Income	\$30,267	\$25,489	18.7%
Non-GAAP EPS	\$3.88	\$3.25	19.4%

TABLE 4: FINANCIAL RATIOS

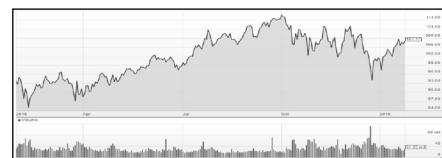
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Price-to-Earnings	25.0
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Operating Margin	32.4%
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search advertising revenue increased 17%, and Surface revenue increased 14%.

2018 Full Year Performance:

- Revenue increased 14% to \$110.4 billion.
- Operating income increased 21% to \$35.1 billion.
- Earnings per share increased 19% to \$3.88.

Strong financial performance for the 2018 fiscal year was driven largely by the same factors which drove the Q1 fiscal 2019 results. These include double-digit revenue growth across all three of the companies operating segments and particular strength in Intelligent Cloud, Office 365, LinkedIn, and Gaming.

BALANCE SHEET

MSFT has a strong financial position with net cash of \$54.0 billion which is equivalent to \$6.94 per share or 6% of the company's market capitalization. The company's balance sheet consists of cash and equivalents of \$135.9 billion and total debt of \$81.9 million.

OUTLOOK

The near-term outlook for MSFT is generally strong with momentum in each of the three operating segments. The company's guidance for Q2 fiscal 2019 is revenue of \$31.9 to \$32.7 billion and operating income of \$9.9 to \$10.4 billion. This guidance (at the midpoints) implies year-over-year growth of 11.7% for revenue and 16.9% for operating income.

HISTORICAL FINANCIALS

The following charts illustrate MSFT's financial over the last 15 years.

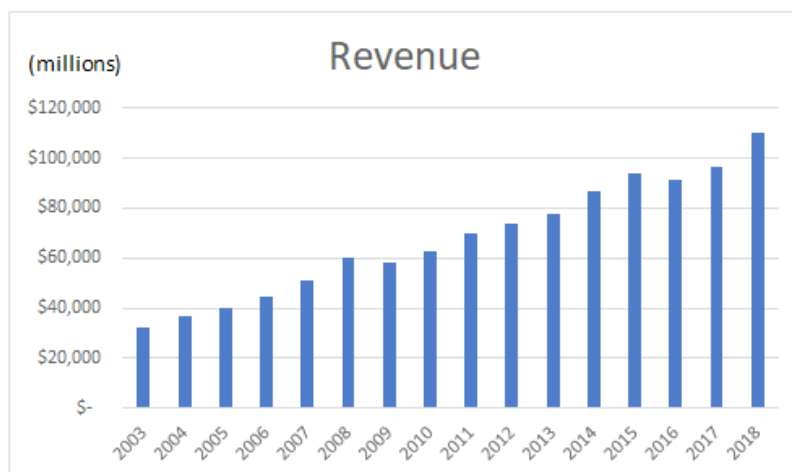


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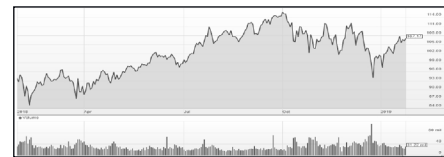
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MSFT has produced near consistent revenue growth over the 15-year period from 2003 to 2018 with average compound growth of 8.6%. Revenue growth accelerated in the last full year increasing 14.3%.



Operating income has consistently trended upwards over the 15-year period with growth in 11 out of 15 years. On average, operating income has increased at a compound rate of 9.1% per year over this period. Growth accelerated in the last full year increasing 19.5%.



EPS has trended upwards over the 15-year period with growth in 12 out of 15 years. On average, EPS has increased at a compound rate of 13.6% per year over this period. Growth accelerated in the last full year increasing 16.4%.

OPERATIONS

MSFT divides its business operations into three key segments: 1) Productivity and Business Processes; 2) Intelligent Cloud; and 3) More

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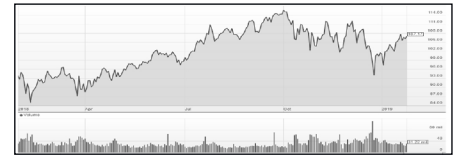
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Personal Computing.

1. Productivity and Business Processes: Consists of products and services used for productivity, communication, and information services.

This segment primarily comprises:

- Office Commercial, including Microsoft Office 365 subscriptions and Office licensed on-premises, comprising Office, Exchange, SharePoint, Skype for Business, and Microsoft Teams, and related Client Access Licenses (“CALs”).
- Office Consumer, including Office 365 subscriptions and Office licensed on-premises, and Office Consumer Services, including Skype, Outlook.com, and OneDrive.
- LinkedIn, including Talent Solutions, Marketing Solutions, and Premium Subscriptions.
- Microsoft Dynamics business solutions, including Dynamics ERP on-premises, Dynamics CRM on-premises, and Dynamics 365, a set of cloud-based applications across ERP and CRM.

2. Intelligent Cloud: Consists of public, private, and hybrid server products and cloud services that can power modern business.

This segment primarily comprises:

- Server products and cloud services, including Microsoft SQL Server, Windows Server, Visual Studio, System Center, and related CALs, and Microsoft Azure.
- Enterprise Services, including Premier Support Services and Microsoft Consulting Services.

3. More Personal Computing: Consists of products and services geared towards harmonizing the interests of end users, developers, and IT professionals across all devices.

This segment primarily comprises:

- Windows, including Windows original equipment manufacturer (“OEM”) licensing and other non-volume licensing of the Windows operating system; Windows Commercial, comprising volume licensing of the Windows operating system, Windows cloud services, and other Windows commercial offerings; patent licensing; Windows Internet of Things (“IoT”); and MSN advertising.
- Devices, including Microsoft Surface, PC accessories, and other intelligent devices.
- Gaming, including Xbox hardware and Xbox software and services, comprising Xbox Live transactions, subscriptions, and advertising (“Xbox Live”), video games, and third-party video game royalties.

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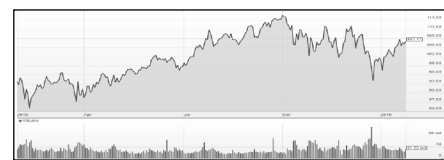
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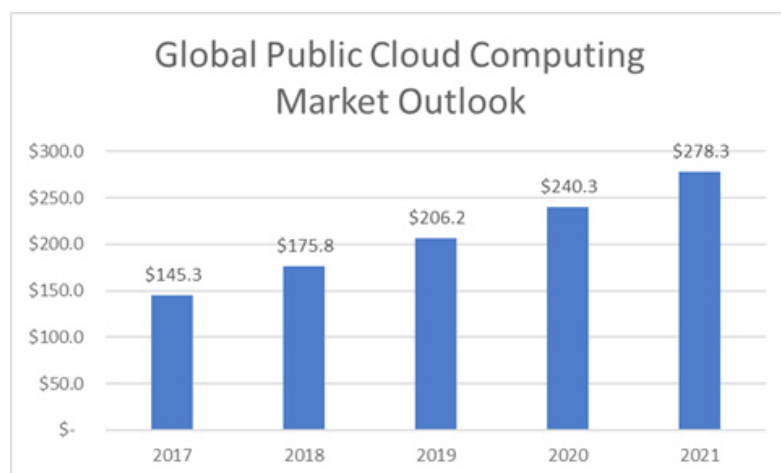


4. Search.

KEY AREAS OF GROWTH

MSFT has established strong operating momentum in each of its three operating segments, all of which have posted double-digit revenue growth over the last year. A key strategy of the company in recent years has been to shift revenue streams from the sale of prepackaged software to recurring revenue. This is being accomplished largely through a focus on growing the company's cloud computing operations and Office 365 which provides the core MS Office products, as well as additional services, for an ongoing subscription fee, as opposed to the traditional one-time payment license.

Accelerating cloud adoption is an important IT trend with large and small organizations opting to outsource IT infrastructure to centralized cloud providers. The market is expected to continue to experience strong growth over the next several years. Gartner is estimating that the global public cloud market will grow to \$278.3 billion by 2021 which reflects an annual growth rate of over 16% per year from 2018.



Source: Gartner (September 2018)

Microsoft has focused on growing its cloud-based service offerings (which include Microsoft Azure) and is now the 2nd largest player in the cloud computing space behind Amazon AWS. The chart below illustrates the cloud infrastructure top players by market share as of Q3 2018. MSFT remains well below Amazon but it has the fastest growth rate of the group with a 2.5% gain in market share over the previous 4 quarters (more than twice the gain of any other company).

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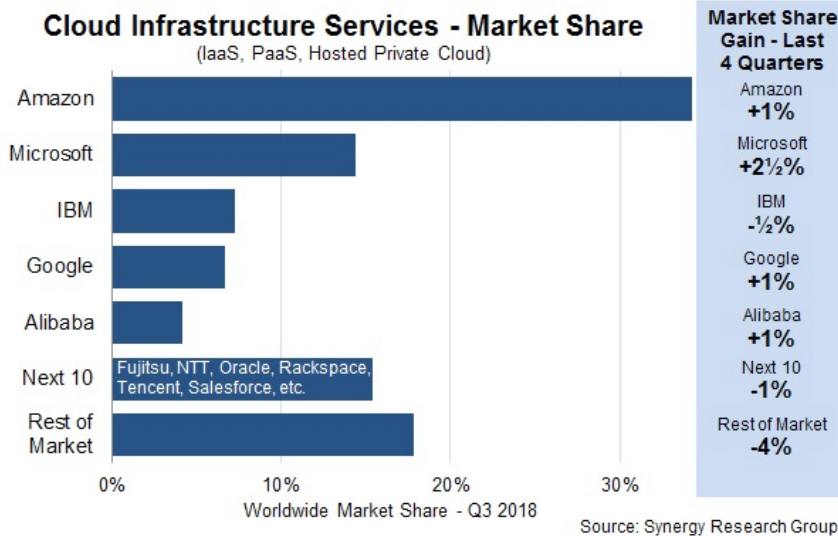
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MSFT has expanded well beyond its core software services such as with its \$26.2 billion acquisition of LinkedIn in December 2016, which is the world's largest social media platform for professionals, its ownership of Xbox, which is the second largest gaming console in the world by market share, and the recent \$7.5 billion acquisition of GitHub, which is the world's largest software development platform. In the last 3 years alone, MSFT has completed 31 acquisitions in a wide range of areas including artificial intelligence, gaming, social media and cybersecurity, to name a few.

VALUATION

MSFT reported earnings per share of \$4.18 over the last 12 months which equates to a price-to-earnings valuation of 25 times (23 times on a cash-out basis).

MSFT trades at a premium to the overall market and to its own average valuation multiple over the past 5 years. Financial performance and growth have accelerated in the last 2 years, and given the strong track record and outlook for the company, we still believe that this represents growth at a "reasonable price."

Within the software technology space specifically, companies with track records and outlooks of double-digit revenue and earnings growth and strong balance sheets, generally trade at price-to-earnings multiples ranging from 30 to 50+ times. Considering the comparable companies, we believe that MSFT's valuation can continue to expand from the current level as the company executes successfully on its growth strategy.

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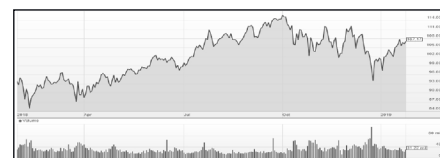
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	2014	2015	2016	2017	2018	Current
Average Share Price	\$36.88	\$45.72	\$57.11	\$67.00	\$92.36	\$105.08
Earnings Per Share	\$2.63	\$2.65	\$2.76	\$3.18	\$3.70	\$4.18
Price-to-Earnings	14.0	17.3	20.7	21.1	25.0	25.2

CONCLUSION

MSFT is a behemoth in the technology sector and in many ways operates like a software utility. The company's core suite of products, including the Windows operating system and MS Office, maintain dominant market shares within their respective categories and continue to be protected from competitors by substantial barriers entry.

Historically, MSFT has maintained a consistent trend of improving performance although growth has fluctuated and flatten over certain periods. More recently, we have seen growth accelerate as the company has expanded into new markets and invested in innovation. Over the last year, all three of the company's operating segments have produced strong financial momentum and double-digit growth. Cloud computing in particular has been an important trend in the IT sector and a major driver of growth for the company. MSFT has positioned itself as the second largest player in the space and has increased its share in a market that is expected to continue to grow at a double-digit rate over the next several years.

MSFT is a more defensive play in the software technology space. The wide spread use of its core products and shift to more recurring revenue streams provides greater stability in the financial performance. The numerous growth opportunities, including cloud, also provide a catalyst for investor returns over the next several years and we consider the stock to be reasonably valued (at 25 times trailing earnings) relative to its market peers.

We view MSFT as an attractive long-term opportunity and are initiating coverage with a rating of BUY.

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2008a; 2009e

The term (a) refers to the actually results that a company has posted on its financial statements. The term (e) refers to analyst estimates of future results.

Book value (BV)

The total value of a company's assets, on its Balance Sheet, less any liabilities. Also referred to as Shareholder Equity. (The value of a company's assets, on its Balance Sheet, does not necessarily reflect the true value of assets).

Cash Flow from Operations (CFO; Operating Cash Flow)

The cash inflow that a company receives during a period, resulting from operating activities (does not include Cash Flow from Investing or Financing).

Current ratio

One of many ratios designed to evaluate short-term liquidity of a company. Calculated as current assets divided by current liabilities, this ratio gauges the level of cash resources relative to current liabilities as a measure of cash obligations (the ratio should be greater than 1).

D/E: Debt-to-equity ratio

A measure of a company's financial leverage calculated by dividing long term debt by shareholders equity. It indicates what proportion of equity and debt the company is using to finance its assets (a lower ratio indicates lower relative debt ratios).

EBITDA

Earnings before interest, taxes, depreciation, and amortization. EBITDA is calculated as revenue minus expenses (excluding tax, interest, depreciation, and amortization).

EPS: Earnings per share

A company's earnings available to common shareholders, also known as net income or net profit, divided by the number of shares outstanding.

Fair Value

The price at which an analyst believes a company's stock should be priced. Although this value is based on intelligent analysis, it in no way is a representation of what the company's share price will be trading at given any period of time. The analysis used to determine Fair Value is based on numerous assumptions and uncertainties. Fair Value should be used only as a general guide to investing and should not be depended upon.

FCFE: Free cash flow to equity

Cash flow from operations less working capital requirements, sustaining capital expenditures and scheduled debt repayments. FCFE consists of cash inflows that are available to the shareholders of the company.

Net working capital surplus (deficiency)

A measure of the company's ability to carry on its normal business comfortably and without financial stringency, to expand its operations without the need of new financing, and to meet emergencies and losses. Calculated by deducting current liabilities from the current assets (as positive figure is a surplus, whereas a negative figure is a deficiency).

P/B: Price-to-book ratio

Calculated as a stock's market value (current closing price) divided by its latest quarter's book value. While a lower P/B ratio could mean that the stock is undervalued, it could also serve as a sign of weak fundamentals, and as with most ratios, this varies a fair amount by industry.

P/CF: Price-to-cash flow ratio

Calculated as a company's current share price divided by its cash flow per share (i.e., free cash flow divided by the number of company's shares outstanding) over the last four quarters (called "TTM," or "trailing 12 months" calculation). It is a measure of the market's expectations regarding a firm's future financial health.

P/S: Price-to-sales ratio

It is calculated as a stock's current market price divided by its sales (revenue) per share. When calculating this ratio, we use the company's revenue from its latest four quarters, or on a TTM basis.

ROE: Return on equity

A measure of a corporation's profitability, calculated as net income divided by shareholder's equity. ROE is often useful in comparing the profitability of a company to other firms in the same industry.

Tangible Book Value (TBV)

The total value of a company's assets, on its Balance Sheet, less any liabilities and intangible assets such as goodwill. Also referred to as Shareholder Equity. (Also true asset values likely differ from Balance Sheet Values, Tangible Book Value is generally considered a more accurate representation of value).

Times Interest Earned

The multiple of Net Income (before interest and taxes) to interest payments during the period. This assesses a company's ability and margin of safety, with respect to meeting its interest obligations (a higher number is more attractive).

Yield

The investment return resulting from income distributions. Calculated as the annual or annualized interest or dividend distribution, divided by the cost of the original investment.

Disclosure					
Stock Holding				Other	
Companies	KeyStone	KeyStone Employees	Related Companies	Investment Banking Client	Related Company Business Relationship
Microsoft Corporation	NO	NO	NO	NO	NO

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