Daiwa Securities

Microsoft Corporation (MSFT US)

Global Credit Research GCRE018

FICC Research Dept.

63m or 630m users?

- FY19 Q3 revenues up 14% y/y driven by commercial cloud, Office 365; LinkedIn; Azure revenues grew 73% y/y
- EBITDA up 21% y/y with EBITDA margins improving 2.4pp y/y to 43.4% with margin improvements in LinkedIn and Office 365
- Strong credit profile supported by high capabilities to generate cash flows, a diversified product portfolio and excellent liquidity; commercial cloud and LinkedIn offer further growth opportunities

Credit Analyst
Stefan Tudor, CFA
(81) 3 5555-8754
stefan.tudor@daiwa.co.jp

Daiwa Securities Co. Ltd.

Credit Opinion

Q3 results confirm Microsoft's strong credit profile supported by high capabilities to generate cash flows, a diversified product portfolio, excellent liquidity and strong market position in growing markets. Microsoft's ecosystem is expanding across all business segments benefiting from "favorable secular trends and IT spending conditions". Total revenues increased 14% y/y to $30.6bn driven by growth across all the business segments. Azure revenue grew 73% y/y with improving gross margins. FOCF increased 19% y/y to $11bn due to strong revenue growth and lower capital expenditures in the quarter.

We also notice the high number of users across a wide range of services. Both 63m and 630m are the right numbers to represent Microsoft's strong ecosystem. Xbox Live community amounted to 63m monthly active users and it has further growth opportunities as Microsoft is planning to launch a new game streaming service later this year. LinkedIn's members grew about 3% q/q to 630m. If we take into consideration that Facebook has approximately 2.4bn users, we believe LinkedIn presents further growth opportunities.

With commercial unearned revenues increasing 19% y/y and commercial bookings showing a strong growth of 30% y/y, we expect cloud market to support revenue growth going forward. Microsoft is well positioned in the market with growing partnerships with leading companies and differentiated innovation across product portfolio.

Microsoft has an excellent liquidity supported by growing FOCF and $59bn of adjusted net cash positions. We expect Microsoft to use its cash to finance the required CapEx, to make acquisitions to expand its business ecosystem and get access to new technologies and to return capital to shareholders. However shareholders' capital return programs and investments should be moderate and we don't expect a significant deterioration in the credit metrics, given its rich cash buffer and conservative financial policy.

The main risk factors are the aggressive competition in the IT industry and security threats. Technology sector evolves rapidly with changing and disruptive technologies, shifting user needs and frequent introductions of new products and services. To remain competitive, Microsoft needs to keep on making innovative products and services that match the needs of businesses and consumers.
Cyberattacks and security vulnerabilities could lead to reduced revenue, increased costs, liability claims or harm to Microsoft brand image. As cyberthreats are constantly evolving, there is a risk Microsoft finds it difficult to detect and successfully defend against them.

FY19 Q3 Results Highlights

Microsoft announced FY19 Q3 results on April 24th.
Total revenues increased 14% y/y to $30.6bn driven by growth across all the business segments.
Commercial cloud revenue grew 41% y/y to $9.6bn driven by growth in the US and Western Europe. Commercial cloud revenue includes Office 365 commercial, Azure, the commercial portion of LinkedIn, Dynamics 365. Azure revenue increased 73% y/y.
Commercial unearned revenue increased 19% y/y to $25.1bn and commercial bookings increased 30% benefiting from solid renewal execution and an increase in the number of long-term Azure contracts.

Microsoft ecosystem is expanding with a growing number of users across a wide range of services. Office 365 commercial reached 180m users, Enterprise Mobility and Security installed base reached 100m, Outlook apps on iOS and Android surpassed more than 100m users for the first time this quarter. Windows 10 is active on more than 800m devices. LinkedIn reached nearly 630m members. Git hubs surpassed 36m registered users. Xbox Live community amounted to 63m monthly active users.

EBITDA increased 21% y/y to $13.3 bn with EBITDA margin improving 2.4pp to 43.4%.
Gross margin improved 1.3pp y/y to 66.7% driven by significant improvement in commercial cloud margin and a sales mix shift in More Personal Computing. Commercial cloud gross margin percentage increased 5 points y/y to 63% driven by significant improvement in Azure gross margin.
Operating expenses grew 9% y/y to $10.1bn.

FOCF increased 19% y/y to $11bn reflecting the timing of lower cash payments for property, plant and equipment.
Cash from operations increased 11% to $13.5bn mainly due to strong cloud billings and collections.
CapEx (cash paid for property, plant and equipment) decreased 13% y/y to $2.6bn mainly due to the timing of cloud infrastructure build out. However Microsoft expects a sequential increase in capital expenditure in Q4 to meet growing customer demand.

Microsoft has an excellent liquidity position with an adjusted net cash position of $58.5bn.
Cash, cash equivalents & short-term investments amounted to $131.6bn and make up for about a half of total assets.
Total debt amounted to $73.1bn. There is no commercial paper issued or outstanding.

Microsoft returned $7.4bn to shareholders in Q3.
Microsoft repurchased $3.9bn worth of common stock and declared $3.5bn of dividends. On September 20, 2016, the Board of Directors approved a $40.0 bn share repurchase program. This program started on December 22, 2016, has no expiration date and may be suspended or discontinued at any time without notice. As of March 31, 2019, $15.6bn remained of this repurchase program.

Segment Results

More Personal Computing

More Personal Computing revenues increased 8% to $10.7bn driven by performance in Windows and Surface.
Windows revenue increased 7% y/y to $4.9bn driven by .growth in Windows OEM and Windows Commercial. Windows OEM Pro revenue increased 15% while Windows OEM non-Pro revenue declined 1%, still ahead of the consumer PC market. The strong performance of Windows OEM was driven by improved chip supply for premium devices that met both unfulfilled second quarter and third quarter demand.

Devices revenue increased 17% y/y to $1.4bn. Surface revenue increased 21% with strong growth across both commercial and consumer.
Search advertising revenue increased 7% y/y to $1.9bn. Excluding traffic acquisition costs, search advertising revenue increased 12% driven by growth in Bing, due to higher revenue per search.
Gaming revenue increased 5% y/y to $2.4bn driven by Xbox software and services growth, partially offset by a decline in Xbox hardware. Xbox software and services increased 12% y/y, primarily due to third-party title strength and subscription growth, while Xbox hardware revenues declined 33% y/y primarily due to a decrease in volume of consoles sold.
Xbox Live community had 63m monthly active users.

More Personal Computing operating income increased 25% y/y to $3.2bn with operating margins improving 4.1pp to 29.5%.
Gross profit increased 13% and gross margin increased 2pp due to sales mix to higher-margin products and Windows and gaming businesses.
Operating expenses increased 1%.

Productivity and Business Processes

Productivity and Business Processes revenues increased 14% y/y to $10.2bn driven by performance in Japan and LinkedIn.
Office Commercial revenue increased 12% y/y driven by Office 365 Commercial growth. Office 365 Commercial revenue increased 30% y/y due to growth both in subscribers and average revenue per user (ARPU), offset in part by lower revenue from products licensed on-premises, reflecting a continued shift to Office 365 Commercial. Office 365 commercial seats grew 27% y/y, benefiting from the strong performance of Microsoft 365 academic offers. ARPU growth is due to continued customer migration to higher-value E3 and E5 offerings.
Office consumer revenue increased 8% y/y with 4pp of growth coming from transactional sales in Japan. Office 365 consumer subscribers grew to 34.2m.
LinkedIn revenue increased 27% to $1.7bn fueled by record levels of engagement in the feed and content shared across the platform. There was growth across each line of business and Marketing Solutions increased 46% y/y. LinkedIn’s members grew about 3% q/q to 630m.
Dynamics revenue increased 13% driven by Dynamics 365 revenue growth of 43% y/y.

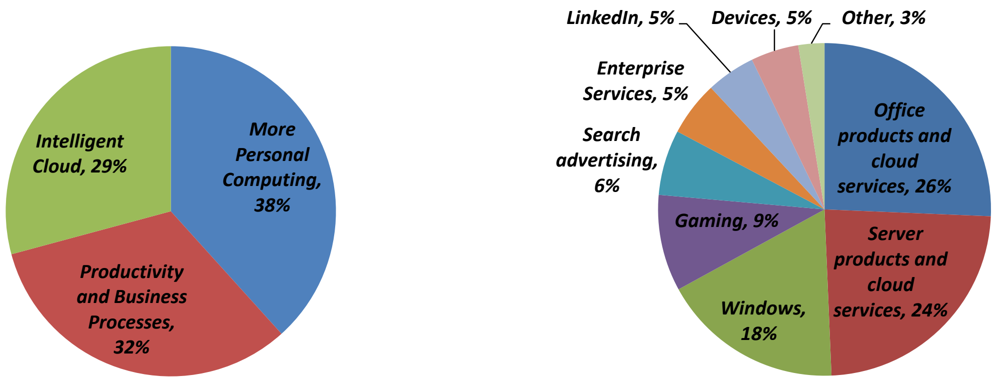
Productivity and Business Processes operating income increased 28% to $4bn with operating margins improving 4.3pp y/y to 38.8%.
Gross profit increased 15% y/y and gross margin increased 1pp y/y due to improvements in LinkedIn and Office 365 margins, partially offset by an increased mix of cloud offerings.
Operating expenses increased 4% y/y driven by continued investment in LinkedIn and cloud engineering.

Intelligent Cloud

Intelligent Cloud revenues increased 22% to $9.7bn driven by continued customer demand for server products and cloud services.
Server products and cloud services revenue increased 27% to $8.1bn. Azure revenue increased 73% driven by strong growth in consumption based business across all customer segments, partially offset by tempering growth in per user business. Enterprise mobility installed base grew 53% to over 100m seats and server products revenue grew 7% due to continued demand for premium versions and hybrid solutions.
Enterprise services revenue increased 4% to $1.5 bn driven by growth in Premier Support Services.

Intelligent Cloud operating income increased 21% to $3.2bn with operating margins declining 0.4pp to 33.2%.
Gross profit increased 21% driven by revenue growth and economies of scale of cloud services. Gross margin slightly decreased due to an increased mix of cloud offerings, partially offset by material improvement in Azure gross margin.
Operating expenses increased 22% driven by investments in cloud, AI engineering, GitHub and commercial sales capacity.

Chart 1: Annual Revenue breakdown by segment/ product (end of FY18)



Source: Company materials, Bloomberg; compiled by Daiwa.

Company's guidance for Q4 FY19

Microsoft expects total revenues to increase between 7%-9.4% y/y driven by Intelligent Cloud and Productivity and Businesses Processes segments (see Chart 2 for more details).
COGS should be between $10.65bn- $10.85bn and operating expenses should be between $10.7bn- $10.8bn.
Commercial gross margins should improve y/y driven by improvement in Azure gross margin, partially offset by the continued change in revenue mix from SaaS towards Azure IaaS and PaaS services.
CapEx is expected to increase q/q to support growing demand for cloud services.

Chart 2: Company Guidance

($m)	Q4 2018	Q4 2019 Guidance Range		YOY	
Total Revenues	**30,085**	**32,200**	**32,900**	**7.0%**	**9.4%**
More Personal Computing (MPC)	10,811	10,800	11,100	-0.1%	2.7%
Productivity and Business Processes (PBP)	9,668	10,550	10,750	9.1%	11.2%
Intelligent Cloud (IC)	9,606	10,850	11,050	13.0%	15.0%

Source: Company materials, Bloomberg; compiled by Daiwa.

Regarding FY20, Microsoft expects double-digit revenue and operating income growth with stable operating margins.

Chart 3: Financial Results

($m) Period End		Q3 2018 2018/3/31	Q4 2018 2018/6/30	Q1 2019 2018/9/30	Q2 2019 2018/12/31	Q3 2019 2019/3/31	YOY	QOQ
■P/L								
Revenues		26,819	30,085	29,084	32,471	30,571	14.0%	-5.9%
EBITDA		11,002	12,895	12,792	13,253	13,267	20.6%	0.1%
	EBITDA margin	*41.0%*	*42.9%*	*44.0%*	*40.8%*	*43.4%*	*2.4*	*2.6*
Operating Income		8,292	10,379	9,955	10,258	10,341	24.7%	0.8%
Pretax Income		8,641	10,680	10,221	10,385	10,486	21.4%	1.0%
Net Income		7,424	8,873	8,824	8,420	8,809	18.7%	4.6%
■C/F								
Cash from operations		12,151	11,418	13,657	8,900	13,520	11.3%	51.9%
	Depreciation & Amortization	2,710	2,516	2,837	2,995	2,926	8.0%	-2.3%
Cash from investing		3,844	▲2,670	▲2,953	▲4,200	▲1,363	---	-67.5%
	CapEx	▲2,934	▲3,980	▲3,602	▲3,707	▲2,565	-12.6%	-30.8%
Free cash flow (FCF)		15,995	8,748	10,704	4,700	12,157	-24.0%	158.7%
Free operating cash flow (FOCF)		9,217	7,438	10,055	5,193	10,955	18.9%	111.0%
Cash from financing		▲19,658	▲6,039	▲7,384	▲13,216	▲7,601	-61.3%	-42.5%
Net cash flow		▲3,663	2,709	3,320	▲8,516	4,556	---	---
■B/S								
Assets		242,679	256,986	257,619	258,859	263,281	8.5%	1.7%
	Current assets	156,659	169,662	164,195	156,874	159,887	2.1%	1.9%
	Cash&Marketables	132,270	133,768	135,880	127,662	131,618	-0.5%	3.1%
Liabilities		160,507	170,562	171,652	166,731	168,417	4.9%	1.0%
	Current liabilities	46,133	58,488	56,277	50,318	53,861	16.8%	7.0%
	Total Debt	76,927	76,240	76,230	73,169	73,100	-5.0%	-0.1%
	Adjusted Net Debt (*)	▲ 55,343	▲ 57,528	▲ 59,650	▲ 54,493	▲ 58,518	5.7%	7.4%
Equity		79,239	82,718	85,967	92,128	94,864	19.7%	3.0%
■Financial Ratios								
Equity Ratio		32.7%	32.2%	33.4%	35.6%	36.0%	3.4	0.4
Adjusted NetD/E		▲0.70	▲0.70	▲0.69	▲0.59	▲0.62	0.1	▲ 0.0
Adjusted NetD/EBITDA		▲1.30	▲1.27	▲1.25	▲1.09	▲1.12	0.2	▲ 0.0
ROA		6.4%	6.6%	7.3%	13.0%	13.4%	7.0	0.4
ROE		20.0%	20.5%	22.3%	37.7%	37.4%	17.3	▲ 0.3

Source: Company materials, Bloomberg; compiled by Daiwa.
(*)Adjusted net debt = total debt- cash- marketables
FCF (free cash flow) = CFO (cash flow from operating activities)- CFI (cash flow from investing activities)
FOCF (free operating cash flow) = CFO (cash flow from operating activities)- CapEx (Capital Expenditure)
We are using last twelve months net income for ROA and ROE calculations.

Chart 4: Revenues breakdown by business segment

($m) Period End	Q3 2018 2018/3/31	Q4 2018 2018/6/30	Q1 2019 2018/9/30	Q2 2019 2018/12/31	Q3 2019 2019/3/31	YOY
Total Revenues	**26,819**	**30,085**	**29,084**	**32,471**	**30,571**	**14%**
More Personal Computing (MPC)	9,917	10,811	10,746	12,993	10,680	8%
Productivity and Business Processes (PBP)	9,006	9,668	9,771	10,100	10,242	14%
Intelligent Cloud (IC)	7,896	9,606	8,567	9,378	9,649	22%
Corporate and Other	-	-	-	-	—	-
Total Operating Income	8,292	10,379	9,955	10,258	10,341	25%
More Personal Computing	2,523	3,012	3,143	2,964	3,154	25%
Productivity and Business Processes	3,115	3,466	3,881	4,015	3,979	28%
Intelligent Cloud	2,654	3,901	2,931	3,279	3,208	21%
Corporate and Other	-	0	-	-	-	-
Operating Margins	30.9%	34.5%	34.2%	31.6%	33.8%	2.9
More Personal Computing	25.4%	27.9%	29.2%	22.8%	29.5%	4.1
Productivity and Business Processes	34.6%	35.9%	39.7%	39.8%	38.8%	4.3
Intelligent Cloud	33.6%	40.6%	34.2%	35.0%	33.2%	▲ 0.4

Source: Company materials, Bloomberg; compiled by Daiwa.

Chart 5: Revenues breakdown by product

($m) Period End	Segment	Q3 2018 2018/3/31	Q4 2018 2018/6/30	Q1 2019 2018/9/30	Q2 2019 2018/12/31	Q3 2019 2019/3/31	YOY
Total Revenues		**26,819**	**30,085**	**29,084**	**32,471**	**30,571**	14%
Office products and cloud services	PBP	7,088	7,578	7,622	7,747	7,889	11%
Server products and cloud services	IC	6,343	7,991	7,058	7,791	8,053	27%
Windows	MPC	4,612	5,424	4,901	4,758	4,944	7%
Gaming	MPC	2,251	2,286	2,738	4,232	2,363	5%
Search advertising	MPC	1,784	1,769	1,788	1,976	1,911	7%
Enterprise Services	IC	1,489	1,551	1,450	1,521	1,542	4%
LinkedIn	PBP	1,335	1,464	1,530	1,693	1,696	27%
Devices	MPC	1,219	1,283	1,261	1,948	1,423	17%
Other		698	739	736	805	750	7%

Source: Company materials, Bloomberg; compiled by Daiwa.
MPC= More Personal Computing
PBP= Productivity and Business Processes
IC= Intelligent Cloud

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
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■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

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The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

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Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association