

Microsoft Poised for a Knockout Quarter

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After two bang-up earnings reports from Microsoft for fiscal 2008, investors are looking for Microsoft to make it three for three when it reports third-quarter earnings after the close of trading on Thursday.

The Redmond, Wash. company raised full-year revenue guidance by as much as \$1 billion in its last quarterly report on the strength of its first fiscal half.

The company also continues its dogged pursuit of Yahoo!. After a less-than-impressive earnings report from Yahoo!, analysts say the buyout can be pulled off at or close to the offer price of \$31 a share. Microsoft shares were trading up 3.4% Wednesday, while Yahoo!'s were down 2%.

Jane Snorek, a portfolio manager at First American Funds, which holds Microsoft shares, expects the software company to beat its own revenue projections of \$14.3 billion to \$14.6 billion and report growth of 16%, for a top line of \$14.7 billion. "They're going to have at least a couple hundred million upside," she predicted.

The consensus estimate of sell-side analysts is for revenue of \$14.5 billion and EPS, excluding items, of 44 cents on a bottom line of \$4.3 billion, according to Thomson Financial.

"We have increased confidence in Microsoft's ability to beat third-quarter expectations," which could prompt the company to guide higher for 2009, Pacific Crest analyst Brendan Barnicle wrote in a note Monday. Currency conversion alone could add \$200 million to \$575 million to revenue, he added. The firm makes a market in shares of Microsoft.

Looking for Growth

"What we're looking for is long-term growth in double digits," said Dan Davidowitz, portfolio manager at Polen Capital Management, which has held Microsoft shares for 14 years. "We're looking to see consistency of top-line growth. We're real long-term investors." The firm owns 1.2 million shares, about 6% of its portfolio.

Davidowitz hopes to see increasing adoption of the Windows Vista operating system, now that Vista's Service Pack 1 has been released to the market.

Sales of Vista are probably in line with projections, said Davidowitz, noting, "It's growing nicely." He dismissed conjecture that businesses will hold out for the subsequent version of Windows, not due out until 2010.

"I think it's much ado about nothing as to whether Vista is great or not great," he said, adding businesses will ultimately upgrade to Vista because of its market dominance.

"I don't understand any of this negativity on Vista," said Snorek, noting that corporate software upgrades aren't usually immediate.

"Vista is very successful, and Microsoft managed to get a price increase out of it," said Snorek, referring to its higher average selling price compared to Windows XP.

Microsoft can probably expect an extra two to three percentage points of growth above reported PC industry shipment growth of 13%, due to the headway the company has made against piracy abroad, Snorek said.

While PC shipment growth is skewed toward emerging markets, where software piracy rates are higher, Davidowitz said, "we've got some nice growth additions from fighting piracy over the last two quarters."

Vista, Microsoft Office and other business applications are probably benefiting from the economic downturn because their average selling prices are comparatively lower than big-ticket software licenses from companies like SAP and Oracle, says Snorek.

"You could also get a lot of upside from Server 2008," which was released during the quarter, Snorek said.

In the entertainment and devices division, the continuing healthy sales of the Xbox gaming platform into the new calendar year has been encouraging. "That could easily surprise," especially given Microsoft's revenue share from game titles in the market, Snorek said.

While the online division continues to struggle, investors are hoping for further signals on its intentions as it pursues Yahoo!. In March, Microsoft made a hostile offer of \$31 for its search and advertising competitor, which Yahoo! has repeatedly rejected as being too low. Microsoft says the acquisition will put it in a better position to compete in search and advertising with Google.

Strategic Acquisition

"We like the idea of Microsoft using strategic acquisitions to grow" the online division, "as long as they don't overpay," said Davidowitz. Strategically, the acquisition of aQuantive in 2007 and the proposed buyout of Yahoo! make a lot of sense because of online advertising's huge growth potential. "We understand why they want to go after Yahoo!," Davidowitz said.

"We also own Google, so we understand why Microsoft wants to make a big splash there."

"We love it at the price they offered. We don't want them bidding against themselves," Davidowitz said Tuesday before Yahoo! reported earnings. "I don't see a reason to raise

the price. At the original price of \$31, it looked like Microsoft could get a good return on investment.

If Microsoft can get \$1 billion in synergies from a merger with Yahoo!, the company can get a low- to mid-teens return on investment, Davidowitz estimated. "We think that's pretty good."

Synergies below \$1 billion would render the deal unattractive. "We hope the return on investment would stay in double digits." Otherwise, Polen might object to the purchase price, Davidowitz said.

Snorek predicted that Microsoft would offer \$31.50 to \$32, "just to make Yahoo! happy and make it be friendly."

Like many Microsoft investors, Snorek doesn't like the distraction that a merger with Yahoo! would bring. The best resolution would be if "the deal was called off, and Microsoft gave up and walked away," she said.