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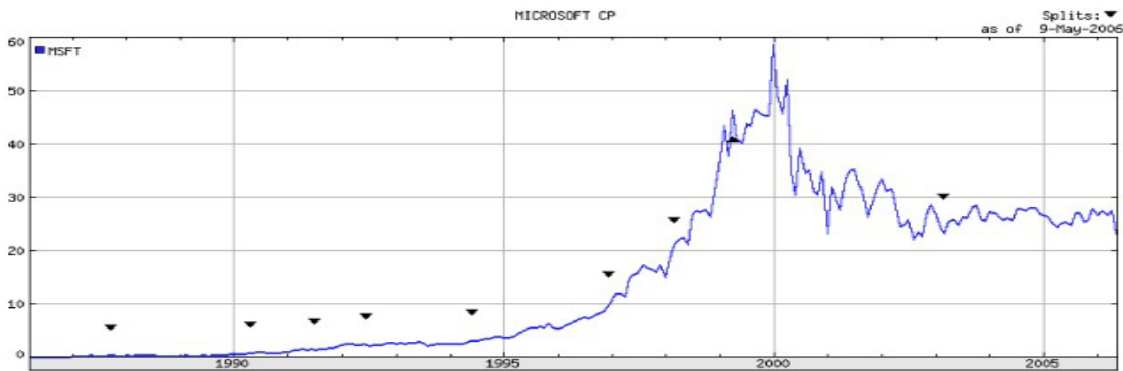
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MICROSOFT (ticker: MSFT) - TIME TO OWN A MONOPOLY?

Bill Gates gets it. He is good friends with Warren Buffett and Charlie Munger. He has absorbed a great deal of their wisdom on how to run a company for the long-term. He now sits on Buffett's board and owns some Berkshire stock. Gates is one of the few tech company CEOs that finally embraced the expensing of stock options and now has moved to issuing restricted stock that more properly reflects economic reality through a GAAP income statement.

Other things to like about Bill Gates are that his annual compensation at Microsoft is reasonable at about \$1 million per annum and, more importantly, he doesn't continually grant himself huge amounts of stock at shareholder expense every year ala Michael Dell. We saw him sit through the entire Berkshire Hathaway annual meeting listening attentively on Saturday. He is incredibly smart and the richest guy in the world. Oh, and by the way, he runs a monopoly that has minted money nearly for nearly two decades.



From the chart above, one can see Microsoft's stock has done nothing but decline from the stratospheric levels it reached in 2000. Similar to Coke, earnings have continued to grow at Microsoft for 6 straight years all the while the stock price has contracted. Recently, the company warned expenses would be higher than expected - and rumors that its new operating system Vista might not be out until mid-2007 pushed the stock down rather violently, culminating in an 11% single day drop. "Value" buyers in the low 30s and high 20s now find themselves underwater.

With Microsoft sitting just 46 cents above its 52-week low of \$23.14 as we pen this piece, we too are starting to wonder if it is a buy. Generically, we don't like tech given its obsolescence risk, but Microsoft is a monopoly and one that we feel relatively certain will be in a similarly strong position five or even ten years from now. Microsoft's OS (operating system) and Office seem to have no credible challengers on the horizon. MSFT killed Netscape and now dominates the browser market. After much skepticism,



MSFT now seems to be running the table on Nintendo and Sony with its hugely popular Xbox/Xbox 360. We think media speculation about Google someday mopping the floor with Microsoft is far-fetched to say the least. The drubbing is much more likely to be dished out by Microsoft.

Is Microsoft Cheap? Well at a \$23.60 stock price and 10.415 billion diluted shares in the latest quarter, MSFT's market cap is about \$246 billion. What does one receive for his \$246 billion? Well, first up, one gets \$33.5 billion in cash and short investments (excluding \$1.3 billion MSFT has pledged as collateral). One also gets \$8.9 billion in "equity and other investments" which, if we haircut 50%, yields another \$4.4 billion in value for a total cash investment value of \$37.9 billion. Thus, with no debt, enterprise value (EV) at Microsoft equals roughly \$208 billion (\$246 billion market cap minus \$37.9 billion in cash and investments.)

For the \$208 billion that one is paying for the Microsoft operating businesses one should expect about \$19 billion in operating income (OI) over the next 12 months according to the company. That means buying Microsoft at \$23.60 a share is equivalent to paying about 11x EV/OI. Assuming Microsoft pays 35% in corporate taxes, paying 11x OI is equivalent to paying about 17x net income. Which for most stocks is not cheap, but for a monopoly like Microsoft we think it is fair. In fact, our rough intrinsic value for MSFT, which is essentially 10x OI of \$19 billion plus the \$37.9 billion in cash and investments equates to \$227.9 billion or \$21.88 a share.

To be excited about Microsoft we need to buy at a meaningful discount to \$21.88, which implies a price in the mid to high teens. Will MSFT get that low? It seems unlikely barring a widespread tech and market sell-off. However, the concept of waiting for a fat pitch means just that - waiting. We would love nothing more than to own Microsoft. Over the last 6 years, it has gone from clearly overvalued to fairly valued, if MSFT would cooperate and go down another 30-40%, a true margin of safety will exist. Conversely, a couple more years of stock price stagnation coupled with continued healthy earnings growth could make Microsoft unmistakably attractive. We have waited over 10 years to own Microsoft - another year or two will not kill us.

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