

Hyperion Asset Management

Company Profile

Microsoft Corporation

Main Business Activities

Microsoft Corporation's (Microsoft) business is organised into three segments:

- 1) Productivity and Business Processes providing productivity applications for commercial and consumer customers (Microsoft Office, Office 365) and business solution applications (Dynamics, Dynamics 365 and LinkedIn);
- 2) Intelligent Cloud with server operating systems and tools (database software, software development tools), support and consulting services and cloud-based solutions (IaaS, PaaS and SaaS through Azure); and
- 3) More Personal Computing providing operating systems to commercial customers, original equipment manufacturers (OEMs) who sell to commercial customers and consumers, video gaming (consoles, other hardware, software and related services), devices (PCs, Tablets, Surface), and search (Bing).

Microsoft has pivoted its businesses from on-premise to cloud-based offerings, and is benefiting from businesses undergoing a digital transformation. Microsoft have a diversified business mix that is exposed to varied structural tailwinds including the structural shift to cloud computing, the shift to Software-as-a-Service (SaaS) based productivity tools, the shift to online and multi-device gaming and the shift to digital advertising.

Key Value Proposition to Customers

The value proposition of Microsoft's SaaS applications such as Office and Dynamics, their Windows operating systems and their cloud computing and server tools, is the improved operational productivity for knowledge workers, businesses and consumers. Microsoft's products improve the productivity and collaboration for workers and are cloud-based, enabling employees to seamlessly work in hybrid environments while always having the most up to date software releases and providing unlimited capacity. Microsoft's Office product is the global leader and with their incumbency, there is inherent trust and familiarity in using these tools from businesses and consumers. The breadth of Microsoft's products, from cloud computing, to productivity applications and their Teams platform provide a seamless and powerful tool for businesses to collaborate and increase the understanding of their operations. Employees are often the highest cost item for businesses and therefore improvements in productivity can generate meaningful cost savings and profit expansion.

In terms of the value proposition to Azure customers, the shift from on-premise to the cloud, reduces expenses, increases flexibility and allows consumers to gain access to the latest technology. Azure offers a number of advantages such as their hybrid capability, enabling enterprises to easily combine their on-premise and cloud-based workloads, providing them with the capability to stage their migration to the cloud over time. Azure has the broadest infrastructure in terms of available regions for cloud customers.

Sustainable Competitive Advantages and Outlook

Microsoft's Office product has established a first mover advantage and is the dominant incumbent in terms of productivity applications. Google Docs is the nearest competitor with an estimated market share of only 2%. Microsoft's sustainable competitive advantage is driven by the familiarity of their tools, as well as the high switching costs due to Office being the foundation of businesses for decades. Microsoft has transitioned their business to a SaaS offering which increases predictability and provides a recurring revenue stream. The breadth of Microsoft's products across cloud computing, productivity applications and Teams provides a compelling value proposition to users, resulting in a more seamless experience, increasing efficiency and providing enhanced business insights.

In terms of Microsoft's cloud computing business, Azure has a number of competitive advantages over competitors:

- 1) Hybrid capability which enables enterprise customers to easily combine existing infrastructure (which often runs Microsoft platform tools and software applications) with Azure offerings. This allows for a flexible migration to the cloud;
- 2) Enterprise relationships and sales force whereby Microsoft already has an established sales force with existing enterprise relationships (although they have had to transition from selling up-front licenses to subscriptions) and can incorporate cloud offerings into existing contracts; and
- 3) Has the largest number of available regions for cloud compute customers.

Overall Company Growth Options

Microsoft is undergoing a transition to a cloud-based, subscription revenue style business from a transactional business model approach. The majority of Microsoft's growth will come from their Commercial Cloud businesses. This includes revenue from Office365, Dynamics365, Azure and some of their LinkedIn business. Hyperion estimate underlying Commercial seat growth for Office 365 is growing at 7% to 9% per annum. Growth for Commercial Office365 is benefiting from the shift from on-premise to cloud-based, with higher average revenue per users across their lifetime. As users migrate to the SaaS offering, there is additional growth opportunity to upsell into higher premium products (E3 to E5). This results in overall Office revenue growing above seat based revenue growth. Microsoft's Teams now has nearly 250 million monthly active users and remains undermonetised, with the standard version included for free in Office subscriptions. As Microsoft continue to innovate and expand the range of features across their products, Hyperion believe they are likely to have strong pricing power and the ability to upsell into higher priced products.

Azure revenue growth is driven by the structural shift from on-premise workloads to cloud-based workloads. Ultimately, the majority of workloads will be in a cloud environment in the long term. Hyperion believe we are at an early stage in transitioning to cloud-based workloads with 20% of workloads having been shifted to the cloud. Security is also a large opportunity as workloads shift to the Cloud. Microsoft has disclosed that as of 2021 that Security is a \$10 billion annualised revenue business for them and is increasingly sought after by enterprises due to heightened cyber attacks. Microsoft has growth opportunities from other businesses including Dynamics365, particularly from Customer Relationships management and Power Platform, Gaming as well as advertising and talent solutions via LinkedIn.

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