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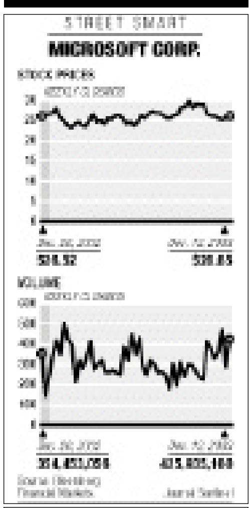
Microsoft valued lower than peers

Improving economy likely to spur firm's business, analyst says

By KATHLEEN GALLAGHER, kgallagher@journalsentinel.com

Street Smart



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Investment

Microsoft Corp., Redmond, Wash., develops, makes, licenses, sells and supports software products, and develops the MSN network of Internet products and services. Web site: *www.microsoft.com.*

Analyst

Ignatius L. Smetek, president and chief investment officer at Arcataur Capital Management LLC in Milwaukee.

- Microsoft Corp.Microsoft Corp.
- Ticker/Exchange: MSFT, Nasdaq
- Dec. 5 price: $25.98
- 52-week range: $22.79 to $29.96
- Dividend yield: 0.9%
- Long-term debt: 19%
- Return on equity (12 months ending 9/30): 19%
- Total shares outstanding: 10.8 billion
- *Earnings/share (2004): $1.13
- *Earnings/share (2005): $1.25
- P/E ratio (2004): 23.58
- P/E ratio (2005): 21.32

*Analysts' estimates for year ending June 30.

Microsoft shares have underperformed the market this year because of investor fears about several company-specific factors. But Smetek says that presents an opportunity to buy this stock at an attractive valuation and watch the company take advantage of an improving economy and a big cash position that provides a lot of financial flexibility.

"You're getting a rare opportunity to buy it at what I think is a pretty good valuation," he said. "The company has produced stable earnings growth of about 10 percent a year, and it produces a lot of cash flow - so as the economy improves, their cash flow improves."

There are four main reasons Microsoft shares haven't risen much more than 10% since mid-March, compared with the more than 30% increase in the Standard & Poor's 500 index.

Investors in October hammered this stock when it announced earnings for the quarter ending Sept. 30 because the company's unearned revenue came in below expectations. Unearned revenue - money the company knows is coming - declined because fewer big companies signed agreements with Microsoft that would promise them better availability and discounts for future product upgrades.

"During the recession, companies started saying, 'What are we getting for these things,' " Smetek said.

Investors have also been skittish because the company is just finishing a program with J.P. Morgan to allow Microsoft employees to get some value from out-of-the-money stock options. It has hurt the stock because J.P. Morgan had incentive as it took on exposure to sell Microsoft stock short, which tends to drive down the price.

"It's created somewhat of a liquidity issue, but it's coming to an end," Smetek said.

Investors have also worried about litigation against Microsoft in the European Union focused on unbundling its Media Player and competition from the Linux operating system.

Smetek says he doesn't think the European Union litigation is as significant as similar litigation the company endured in the United States. "And once it's alleviated, it's a positive for the stock," he said.

The improving economy is beginning to spur technology spending, which is positive for Microsoft's business, Smetek said. However, Microsoft shares are still being valued at a much lower level than those of many of the company's peers.

"During the last nine months the stock market did well, driven by technology and an expected improvement in the economy - but here's the largest company in the middle of that, and they've pretty much underperformed," Smetek said.

Microsoft has $65.5 billion, or about $6 a share, in cash. That allows the company the flexibility to buy back its shares or raise its dividend - and it makes the stock price look even more reasonable.

"If the stock is at $26, you're essentially paying $20 for the operations," Smetek said.

He says this stock is best for investors looking for a high quality company that's a market leader to serve as a core technology holding.

Smetek began buying Microsoft in client accounts in March in the low $20s and would still buy these shares for new accounts up to $26. He says he would buy them aggressively under $25, and he believes Microsoft shares could go as high as $32 in the next 12 to 18 months.

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