

David Einhorn, Greenlight Capital
Speech Excerpt from Tomorrows Children's Fund Ira W. Sohn Investment
Research Conference
May 23, 2006

I have played rotisserie or fantasy baseball for 22 years. Overall, I've won some and I've lost some. It wouldn't surprise any of you, that I am usually a value buyer of players. I go in to the draft, with a plan, usually to not put too much of my budget into just one player. You get \$260 to spend to buy a team of 23 guys, so I usually don't plan to spend more than \$30 on anybody. That usually takes me out of the running for the very best players who often go for \$45-\$50. But suppose I get to the draft and I see that for some unexpected reason, I can buy A-Rod for \$35 rather than \$50. This isn't supposed to happen. What would I do? I would buy him. I would close my eyes, pay up, break the budget and buy him and make a new plan. It would be too good an opportunity to pass up.

So here is my stock idea. Microsoft is A-ROD! Google is a young company with a great start. I think Google may be Johan Santana who could turn out to be the next Pedro, or could get hurt and turn into the next Kerry Wood. It is hard to see that Google's one successful asset, its lead in developing paid-search, is worth more than half as much as Microsoft. Microsoft is A-ROD. It is simply the best company built in the last 30 years.

This stock is in the same place it was in 1998 and is barely higher than the post NASDAQ bubble collapse lows. It has a ridiculously strong balance sheet and a ridiculously strong market position and it trades at a market multiple. As a deep value investor, it is time to close my eyes, pay up, break the budget and buy it. It is too good an opportunity to pass up. I love A-ROD! I just never thought he'd be on my team.

There are few companies today as entrenched in the world of technology and software as Microsoft. It has a monopoly-like position on the core operating software that runs the vast majority of personal computers. It may be on the verge of a similar position in the operating software that runs the vast majority of mobile devices like smart phones and PDAs. It has a dominant position in business and server software, owns the third largest Internet search franchise and is heavily involved in the video game industry through Xbox consoles and software development.

More importantly, Microsoft is hugely profitable and its profits are growing. In its fiscal 2002 year Microsoft reported \$8.3 billion in operating profits on \$28.4 billion of sales. In its most recent full fiscal year, fiscal year 2005, Microsoft reported \$14.6 billion of operating profits on \$39.8 billion of sales. This represents compounded growth of 21% and 12% in operating profits and revenues over that period. Assuming Microsoft achieves the mid point of its guidance for fiscal year 2007, it will generate \$19 billion in operating profits on \$50 billion of sales. I expect a larger benefit in fiscal 2008 from the launches of Microsoft Vista, Office 2007, and Exchange 2007.

Yet, Microsoft doesn't trade like a stock with highly profitable, dominant market positions growing operating profits in the high-teens. Concerns about the threats posed by the rise of companies like Google and the Open Source movement and maturity in its core software business seem to weigh on the shares despite the company's demonstrated ability to continue to increase profits.

This creates an opportunity. At \$23, Microsoft has a market capitalization of \$235 billion and an enterprise value of \$190 billion after cash and investments, which total to just over \$4 per share. Given guidance for fiscal year 2007 (at the mid point) of \$19 billion in operating profits and \$1.39 in EPS excluding legal charges and making some estimates to adjust for the interest income from its \$43 billion in cash and investments, Microsoft trades at just 10x EBIT and 15x P/E adjusted for the cash and interest income. And these earnings are not the "Pro Forma please back out the stock options as they aren't an expense...or if they are an expense they are a 'non cash' expense "so please ignore them" that most tech companies are still feeding to investors." Let's just agree to call these Big Boy earnings.

When you consider that Microsoft has seven business segments of which only three are likely to be profitable in fiscal year 2007, the valuation looks even better. I estimate that the four unprofitable business segments (Microsoft Business Solutions, MSN, Mobile and Embedded Devices and Home and Entertainment) will probably generate \$9 billion in sales and contribute over \$2 billion in operating losses, making adjustments for the allocation of corporate-level expenses, in fiscal year 2007. Looked at another way, the profitable businesses at Microsoft (Client – which is Windows, Information Worker – which is Office, and Server and Tools) will likely generate \$41 billion in sales and \$21 billion in operating profits, adjusted for the allocation of corporate-level expenses.

If I strip out these unprofitable segments from the consolidated numbers, Microsoft trades at 9x EBIT and 13.5x P/E (on adjusted fiscal 2007 estimates). Chemical Companies, Farm Equipment Companies and Railroads trade at higher multiples than this at the top of their cycles. Even Supermarkets trade higher than this.

And Microsoft's core businesses are growing at a high single digit rate in a period without significant product releases. As Microsoft is about to enter new product cycles in 2007 in all of its core areas, the top line is certain to accelerate. Only in the strange world of tech investing is this considered slow growth. Companies like Coca Cola, Kellogg and Colgate Palmolive would love to get to the growth rate embedded in Microsoft's "slow growth" businesses. All of those trade around 20x earnings.

The market is either assigning a disproportionately large penalty to Microsoft's valuation for the losses from the unprofitable businesses or it is not properly valuing the larger, growing and more important earnings stream from the profitable business lines or both.

Which should have a higher multiple, Microsoft Office or Adobe Acrobat? Adobe trades at 25x next twelve month estimates. Microsoft Office 2007 will have a pdf feature. Will people use Adobe as much as Office, once Microsoft integrates it? Fans of Lotus 123, Word-perfect and Netscape are hard to find these days.

Research in Motion trades at over 20x earnings. I am probably the only one in the room that has never used one of these toys. Microsoft's newest servers embed push e-mail capability usable on a wide number of Window's capable phones. How many businesses are going to stick with RIMM and buy a new server in the next upgrade cycle when Microsoft is giving the capability for free.

Let's talk about the money losing businesses.

As a group, they showed 38% revenue growth last quarter. These are big opportunities that with continued growth will overcome their fixed costs and drive earnings growth.

The two largest drivers of revenues and losses among this group of businesses are the MSN and Home and Entertainment divisions. These are also the two businesses where Microsoft, in an effort to gain share, level the playing field and catch up to the competition, is directing most of the higher incremental R&D and marketing expenses that caught The Street by surprise and sparked the recent large decline in the stock.

But reinvesting for growth isn't always a bad thing and despite the operating losses, these businesses should be assigned positive value. The comps are interesting: Google and Yahoo, the #1 and #2 in Internet search ahead of MSN trade at 14x and 8x sales, respectively; Nintendo a pure play comparable to Microsoft's Xbox franchise trades at 4x sales. Of course, these companies all make money.

The biggest money loser today is Xbox. That division is on pace for \$4 billion in revenue but with losses of over \$1 billion this year. Microsoft says it will be profitable by the second half of Fiscal 2007. No one believes them. Part of the business model is Xbox live gaming. They are up to 3 million paid subscribers. This is a business with very high incremental margins. Once it reaches critical mass, the value will become self-evident. I don't know if they get to break even next year, but I'd be surprised if they don't at least eliminate most of the losses.

The next biggest loser is MSN. Everyone probably knows a little bit about this business because most of you probably visit one of the MSN websites, have a Hotmail email account or use sites on the Internet that are powered by MSN technology or have an alliance relationship with MSN. Think of sites like CareerBuilder.com, MSNBC.com, Expedia.com and Match.com – all sites that have an alliance with MSN. MSN's main business is Internet advertising and paid search and is the same business that Google and Yahoo are in. Microsoft recently decided to "double down" its efforts in this area and will be significantly ramping up R&D and marketing spend to unseat Google. Because of this, MSN will probably lose even more money next year. By the reaction in the stock price to this recent decision it is clear the market doesn't believe Microsoft will be successful and that Google will continue to put MSN in its place. This is not the first time that Microsoft hasn't been the early market leader in an important product. My question is what if Microsoft can do it? What if Bill Gates and Steve Ballmer and all the scientists, technologists and marketers at Microsoft are actually making the right decisions and the right investments for the future? What if they actually do unseat Google or, at least, level the playing field in the fast growing, multi-billion dollar Internet

advertising market that is the darling of the stock market? What's that worth to Microsoft shares?

I am not a techie and I am not going to outline how Microsoft is going to compete and win in every area they have targeted. It is hard to assess the opportunity in something like paid search or next generation interactive television, let alone opportunities in work-flow, real time communications, document management, collaboration, terminal services, portals, unified messaging, media technologies management, anti-spam, business intelligence, storage, security and a whole bunch of other things expressed in hieroglyphics that I don't even know what the abbreviations stand for.

But I do know that Microsoft has invested and is continuing to invest over \$6 billion a year in these things. This investment penalizes operating earnings every quarter. I believe that the current value of Microsoft shares implies that these investments are value destroyers. With Microsoft's history, I am willing to take the other side of that bet without a PhD.

One other large opportunity that is not material to near-term earnings is cutting down on piracy. Last year there were 60 million computers sold with unlicensed Windows software. It isn't hard to see that piracy represents several billion dollars in lost revenue. Microsoft recognizes this. Because of the high margins in software, a one-third improvement alone could be worth a couple billion dollars in operating profit. The newly announced FlexGo initiative seems designed to address part of the piracy opportunity.

Microsoft is in the process of rolling out Windows Mobile software for cell-phones. Gartner estimates that in 2009 one in four cellphones will be a Smartphone. If Microsoft is able to replicate half its PC marketshare success here, this business could easily generate several billion of high margin revenue.

Like the investment in R&D generally, the money losing businesses, and the product upgrade cycle, investors appear to get these opportunities for free.

Finally, let's talk about Microsoft's capital structure. Everyone agrees that it is inefficient. There is no reason for Microsoft to hold \$35 billion of cash and \$8 billion of investments while it generates \$1 billion of new cash every month. I understand the historical reason for the cash build. When Microsoft shares traded at 30-40 times earnings, it was a questionable debate as to whether to repurchase shares or hold the money (of course, dividends were out of the question). Microsoft kept the money. Others in the same situation like Dell spent the money buying back shares. I think Microsoft served its long-term shareholders better.

But today, the situation is quite different. The stock is obviously cheap and they have nothing to do with the money. If Microsoft took the part of its mission to work for shareholders seriously it would optimize its cost of capital. Instead of \$35 billion of cash it should hold perhaps \$40 billion of debt or 2 times EBIT. This sort of recapitalization would return one-third of the market capitalization to shareholders through dividends or buybacks. It would still leave Microsoft with enormous financial resources to defend its market position and pursue its future growth.

I think at current prices, an investment in Microsoft does not require them to fix the capital structure. However, I understand that there is great discontent at Microsoft over the share price. If Steve Ballmer really wants to do something about it, it is pretty straightforward as to what needs to be done. If he won't do it, perhaps someone like Carl Icahn will force the issue. I don't know Carl Icahn...but he seems like a nice guy.