Chasing Clouds

In our last piece, we noted that our strategy of not rebalancing our portfolios has worked to our clients' advantage as weak positions, by virtue of their weakness, are diminished over time. The opposite may be said of successful companies, whose continued successes are compounded as the position grows in the portfolio.

Microsoft is one such company; held since the inception of the Best Ideas Portfolio, it has been the largest single contributor to investors' return. However, it had an image problem. For young investors, Microsoft was more redolent of dreary IT lessons playing with Clippy (the feckless, animated Office Assistant) than the complex computing company which today services almost every conceivable level of the technology stack.

This dissonance is what first attracted us to Microsoft. Back in early 2011 consensus dismissed the company, as the advent of smartphones and tablets was believed to have rendered traditional personal computers and laptops antiquated. However, we concluded that with the overwhelming majority of earnings coming not from consumer PCs but corporate customers, Microsoft was down, but not out. Moreover, with a highly profitable track record, a robust balance sheet, and a low P/E multiple, it was undoubtedly an attractive proposition.

However, this image problem has long since been rectified. Over the past few years Microsoft, along with other traditional software companies, has aggressively shifted their business model to the new world of the Cloud and subscription services. For instance, a typical enterprise customer with a cohort of desktops will switch from paying an upfront licence fee with a lengthy implementation cycle, to a subscription service where updates are instantaneous and cost little to implement.

Though much hyped, the Cloud is no fad: Microsoft's commercial Cloud business has been growing at near 100% over the past year. Yet for many years this prosperous new business was largely obscured from investors – buried as it was within the Enterprise Segment – and the impact of the transition was muted in the financials. This is the valuation equivalent of the old "if a tree falls in a forest and no one is around to hear, does it make a sound?" thought experiment. If a company is successful in transitioning to a new business, but investors can't see it, is this reflected in the share price? Unlike the more philosophical original, the answer here is probably not. However, with a rerating from a P/E of around 10x at purchase to over 18x today, including an 18.9% return in USD over the past month, one begins to wonder whether the tree has finally dropped for investors at large.

Redesigning a Leviathan is nothing if not daunting. Nevertheless, driven by its new management team, Microsoft is aggressively transforming to a Cloud-centric company in which the migration to subscription services and the Cloud will bolster growth prospects, earnings stability, and profit margins. At times, longevity may be a burden, as investors remember a company for its pre-eminence in old technologies whilst forgetting it's role in forging technologies anew. Rather than fall victim to the trend away from the personal computer and local server, Microsoft is actively shaping it.

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