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WEALTH

New year, new decade, same stock

Starting a new year, or decade for that matter, is a unique opportunity to reflect. One where we both consider the changes that have occurred over the past 10 years, but also try to anticipate what the next period may bring. At the start of 2020, it thus feels like the right time to look back at one of our longest and most successful investments and in particular, one which we also believe will continue to provide an attractive return in the years to come.

The world looked very different back at the start of the previous decade. For example, smartphone users only made up around 20% of the population in the USA, compared to around 80% today. In 2011, the market worried that the growth in smartphones would spell the end for Microsoft's mainly PC based product suite. These worries provided us with an opportunity to invest in the company at a very attractive valuation despite it having what we believed to be a steadily growing and robust earnings stream from products entrenched with its corporate customer base.

For some companies, a successful investment thesis can play out over a relatively short period of time. For others, as time passes, new reasons to continue to be invested reveal themselves. In the years since we initially bought the position, not only did PCs continue to stay relevant, but the integral role of Microsoft's operating system and suite of products has allowed the company to maintain its market leading position. Perhaps more importantly though: during this time, a large new opportunity also opened up for Microsoft, namely the commercial cloud business.

Amazon has long been the dominant player in cloud infrastructure. The company had already invested a substantial amount in the hardware required to run its own online platform when it started to rent some of its spare capacity to other companies. Moving to the cloud offers customers the opportunity to forego the large investments required to buy and maintain their own computing power. It also offers better reliability whilst also making it easier to increase capacity and provides cost efficiency. The development of the cloud completely changed the way that companies built and operated their websites and other software. Early adopters included Netflix and Dropbox, for example.

Both Amazon and Microsoft, alongside other competitors such as Google, IBM and Oracle, have invested in building gigantic data centres across the world. As a result, the cloud infrastructure industry has almost doubled in the last 3 years as companies look to outsource some if not all of their IT and platform infrastructure as well as software. After a slower start than some of its main competitors, Microsoft has since progressed to sit in a comfortable second place behind Amazon today, with a market share still growing in relative terms.

In recent months, Amazon's cloud computing business has suffered a series of setbacks. Most notably, Microsoft won a large contract with the Pentagon which has been valued at up to $10bn over the next decade. Amazon had previously been seen as the favourite to win this business. In addition, Capital One Financial Corp reported that they had more than 100 million customer records stolen – these were stored on Amazon's system. Moreover, it seems as though companies are starting to become wary about storing large amounts of their customers' data on Amazon's systems, particularly when Amazon competes directly against them. For example, Walmart started telling vendors as early as two years ago not to use the Amazon platform.

Pitching themselves as an independent operator with no direct conflicts of interest, whilst also taking advantage of existing relationships with customers, has propelled Microsoft's cloud business to grow significantly faster than Amazon Web Services over the last couple of years. We further believe that Microsoft will continue to increase its share of the market as many of the businesses now looking to move to the cloud are more cautious about the technology and the potential issues surrounding security and compliance. Longstanding relationships with Microsoft as a service provider, we believe, puts the company at an advantage when pitching to some of these businesses. Moreover, winning the Pentagon contract will have done no harm to the company's reputation as a trusted provider. In addition, we believe that Microsoft's unique ability to bundle cloud-based infrastructure services, software and database products (now also hosted on the cloud) will be compelling to such customers.

Whilst it is difficult to argue that Microsoft is currently trading at a cheap valuation in absolute terms, we do see value on a relative basis. Microsoft today is a different proposition to the company we originally invested in nine years ago. It is growing faster and has a significantly longer and more attractive runway. However, even now, it trades at a multiple comparable to many companies with significantly lower growth outlooks. The cloud infrastructure business is still nascent, with various estimates of penetration at between 10 and 20%. Therefore, we believe that there is still significant scope for growth. The advantages that the cloud offers businesses tie in with trends such as more flexible working arrangements and hot-desking. In addition, the cost advantages and scalability are attractive attributes.

The market also looks different at the start of 2020 as compared to the beginning of the previous decade, with the S&P 500 trading on a P/E multiple of around 18 times at the time of writing, compared to approximately 14 times at the start of 2010. In the current environment, we consider Microsoft's valuation to be attractive relative to its growth profile and the other opportunities on offer.

Whilst the company and the investment thesis have evolved in the years since our initial purchase, we remain confident about the prospects for Microsoft as we enter a new decade.

Important notice