Why expensive Microsoft is worth the money

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Nearly a decade on from buying Microsoft, does the investment case for the tech giant still add up?

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.

Back in 2011, the market worried that the growth in smartphones would spell the end for Microsoft's mainly PC-based product suite and these worries provided us with an opportunity to invest in the company at a very attractive valuation.

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.

CLOUDS ON THE HORIZON

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 firms. Moving to the cloud offers customers the opportunity to forego the large investments required to buy and maintain their own computing power, with greater reliability and efficiency.

The development of the cloud completely changed the way that companies built and operated their websites and other software, with early adopters including Netflix and Dropbox.

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 three years as companies look to outsource some, if not all, of their IT and platform infrastructure and software.

After a slower start than some of its main competitors, Microsoft has 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 beat Amazon to a large contract with the Pentagon which has been valued at up to $10bn (£7.7bn) over the next decade.

In addition, Capital One reported the theft of more than 100 million customer records, which were stored on Amazon's system. It seems companies are becoming wary of storing large amounts of their customers' data on Amazon's systems, particularly when Amazon competes directly against them. Walmart started telling vendors as early as two years ago not to use the Amazon platform.

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A INDEPENDENT OPTION

Pitching itself as an independent operator with no direct conflicts of interest, while also taking advantage of existing relationships with customers, has propelled Microsoft's cloud business to grow significantly faster than Amazon's over the last couple of years.

Longstanding relationships with Microsoft as a service provider, we believe, puts the company at an advantage when pitching to businesses now looking to move to the cloud. 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. Although 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 compared to the beginning of the previous decade, with the S&P 500 trading on a P/E multiple of around 18x at the time of writing, compared to approximately 14x 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. While 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. •

The Credo Global Equity fund has returned 27% over the 12 months to the end of December, compared to a sector average of 20.2%.