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Feeding Many Mouths

Taking a closer look at Microsoft

BY BILL PARISH • In January of 2000, the total market value of Microsoft reached $700 billion as it became the largest holding in the entire Standard and Poor's 500 index. For anyone owning a S&P 500 index fund, Microsoft automatically was almost 4% of their investment. Microsoft's stock has since declined 58.5%, from $58.38 a share on Dec. 31, 1999, (adjusted for a subsequent split) to $24.21 on March 31. That's a loss of more than $363 billion, an amount exceeding the gross national product of all but a few nations. The loss also happens to be almost five times the total market value of Enron at its peak.

But the market still values Microsoft at $258 billion, and the stock is still 3.4% of anyone's S&P 500 fund. Microsoft stock also is held in millions of other individual accounts, mutual funds and, especially, pension funds. Large public pension funds passively indexing to the S&P 500 are now collectively Microsoft's largest shareholders.

Many private-sector pension plans also lean on a passive investment approach. The only equity-investment choice in Intel's profit-sharing plan is an S&P 500 index fund. Thus Microsoft is automatically the largest single investment for many Intel employees, and the same is true for millions of other people whose pension investments are indexed to the S&P 500. All these people invested in Microsoft automatically, no thought required. They and their investment managers ought to think about that more carefully.

Microsoft has a lot of mouths to feed—about 10.7 billion shares in circulation since the most recent split and, if 1.6 billion employee stock options are counted in, there are or will be 12 billion shares.

Little wonder that Microsoft has graciously consented to pay a dividend, even if it is only eight cents a share. With the decline in share price, some of those 12 billion share mouths were growing hungry. (Not all, of course: Microsoft co-founders Bill Gates and Paul Allen and many of their early employees still have capital gains galore. Their net worth may be down from gargantuan to merely huge, but they can continue to sell stock and feast on capital gains. And if, like Gates and Allen, shareholders reside in Washington, a state with no personal income tax, they are keeping 80 cents on each dollar of gain.)

Microsoft and the market are joined at the hip: If its share price changes $10, the overall market value changes $107 billion, the S&P moves 1.4%. For its fiscal year ended June 2002, Microsoft's gross revenues increased 12% to $28 billion and net income was up 6.5% to $7.8 billion. This is exceptional performance, though perhaps not meriting a price/earnings ratio of 33, three times its revenue growth rate and five times its earnings growth rate.

Microsoft's earnings, moreover, include significant non-cash bartered sales and exclude the cost of stock options.

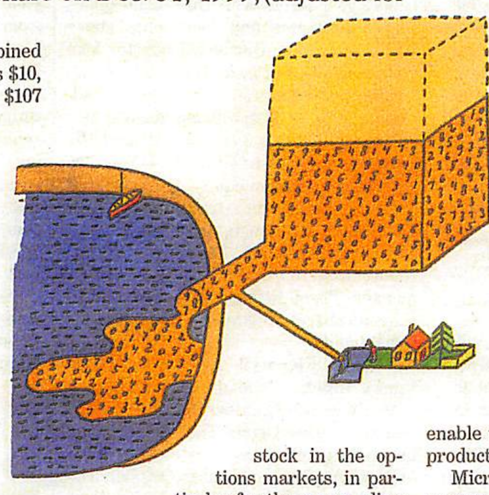
One bartered transaction is with WebMD: In the past fiscal year WebMD agreed to purchase $100 million of advertising on MSN and Microsoft correspondingly agreed to subsidize $100 million worth of medical prescriptions ordered over WebMD. This is still the root of their deal—basically trading checks, not unlike the swaps done by Global Crossing and MCI/WorldCom.

Stock options are a valid benefit and Microsoft should be able to issue all it wants; however, in some recent years as much as 75% of Microsoft's total employee compensation has been paid by simply printing up new stock without a dime of this cost being charged to earnings.

A corporate tax deduction for the full expense was taken as employees cashed in their options, of course. And Microsoft did use corporate cash to buy back stock and offset the dilution. Unfortunately, most of the buybacks were at much higher prices. In buying back 544 million shares over the past three years, Microsoft expended $17 billion.

Inspired in part by the picture of Microsoft operating as a giant tax shelter, a chorus of financial leaders including Fed Chairman Alan Greenspan, former Fed Chairman Paul Volcker, mega-investor Warren Buffett, Senators John McCain and Carl Levin and consumer advocate Ralph Nader all now call for the expensing of stock options.

Also worth noting is that Microsoft has lost billions speculating on its own stock in the options markets, in particular for the year ending June 30, 2001. These losses are unrelated to the employee stock-option program. Some were settled by paying $1.3 billion in cash in addition to issuing billions of dollars worth of new shares in the final quarter of fiscal 2001. As with the cost of stock options, the majority of these losses were never charged to earnings.



Financial engineering aside, thinking carefully about Microsoft also requires thinking about the kind of company Microsoft has become since it helped to create the personal-computer revolution and rode it to greatness. Microsoft is now more like a utility than a tech company, more dependent on the general state of the economy and on job creation than on technical innovation. Its biggest customer is the federal government.

Considering how many people use a computer in their work, a slump in hiring means fewer new licenses for Windows, MS Office and other programs. Gone are the days of huge sales gains from first-time computer users at home and in the workplace. Replacement sales now dominate, and the next generation of replacement sales awaits the next new thing that will only run on new computers. Whatever it may be, it isn't here yet.

Optimistic investors imagine the bounty to Microsoft from the next 500 million people worldwide becoming able to afford a personal computer for the first time. Unfortunately, some of these promising markets are dropping into poverty. Many Argentinians and Brazilians, for example, can't afford a new pair of shoes, never mind a computer with Windows and MS Office. Other low-income countries, such as China, are embracing Linux and other open-source software to make an end run around the supposed Microsoft monopoly.

While Linux may be attractive to poor countries because it's less costly and more reliable than Windows, Linux users in the developed world are excited too because it gives them the ability to see and alter the actual computer code to fit their particular application. Seeing the actual code also allows users to recommend improvements, innovations that enable them to create more competitive products and services.

Microsoft's current attitude about source code is like that of a math teacher hiding numerous parts of an equation and then expecting the students to understand the formula and make optimum use of it.

What results are many unstable programming structures, leading to system crashes. These crashes can occur anywhere, from Websites to aircraft carriers, since the Windows operating system is everywhere.

As Microsoft matures, however, it could make significant changes in its way of life that are more in keeping with its status as an industrial and financial giant.

Perhaps it should imitate General Electric: With over $40 billion in cash and investments, Microsoft is becoming more and more like a bank anyway. Microsoft could expand its scope and aggressively enter the financial-services industry, perhaps by purchasing a major bank. Just as GE founded a credit business by financing its customers' purchases of heavy electric equipment, Microsoft could base a finance operation on its customers' use of money-management software and Web services. ■

BILL PARISH is an accountant and investment adviser in Portland, Ore. He receives e-mail at bill@billparish.com and he has a Website at www.billparish.com

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Maris Bishofs for Barron's