BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Microsoft (MSFT) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 4- (Acceptable)

MSFT reported EPS in the 9/20 quarter of $1.82, 27 cps ahead of the consensus estimate. Revenue of $37.2 billion was roughly $1.4 billion ahead of expectations.

Items that Deteriorated

- Deferred revenue days of sales for the Intelligent Cloud segment continues to decline YOY. We have addressed in past reviews how this is due to the shift towards hybrid cloud contracts in which a component is booked upfront with much of the value tied up in services. These are billed as used and therefore do not result in a buildup of unearned revenue. Continued growth in the RPO (remaining performance obligation) tempers our concern and prevents us from moving the rating to a 3 (Minor Concern). However, we note that the unearned revenue balance has declined YOY on an absolute basis for two straight quarters which is increasing our level of concern.
  (Concern level: MEDIUM)

- The effective tax rate fell to 13.8% in the quarter, below the 16% rate forecast in the company's outlook for the period due to a higher than expected benefit from options. This would have added about 4.5 cps to earnings in the quarter, only a fraction of the reported EPS beat. (Concern level: LOW)

Items to Monitor

- As noted in our previous review, the company extended its estimated depreciable useful lives for server and network equipment effective in the 9/20 quarter. This added 10 cps to EPS in the period. In addition, gross margin would have declined in the quarter rather than the reported 500 bp increase without this non-operational benefit. The company has discussed this prominently in its conference calls and disclosed the exact benefit of the change in the notes of its 10-Q. We therefore assume it has been accounted for in analysts' models.

Deferred Revenue Days Continue to Decline

(Concern level: MEDIUM)

We have documented before that MSFT's deferred revenue in its Intelligent Cloud Segment is declining relative to segment revenues. Intelligent Cloud includes the key *Azure* cloud computing infrastructure and services business. These cloud computing solutions contain components that are recognized upfront as well as service components that are recognized on a usage basis. In addition, the trend has been towards larger, longer-term hybrid cloud contracts. The contracts do not bill much of the total value for the services upfront, so the total value of bookings can increase without a commensurate increase in unearned revenue. Large contracts with some components being recognized upfront and services being paid "as you go" has led to revenue outrunning unearned revenue for several quarters in the Intelligent Cloud segment. As a result, deferred revenue days of sales have been declining for some time and this continued into the 9/20 quarter as seen in the table below:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Intelligent Cloud Revenue	$12,986	$13,371	$12,281	$11,869
Intelligent Cloud Unearned Revenue	$15,039	$16,620	$12,984	$13,766
Intelligent Cloud Def. Rev Days	106.5	113.1	96.2	106.7

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Intelligent Cloud Revenue	$10,845	$11,391	$9,649	$9,378
Intelligent Cloud Unearned Revenue	$15,255	$16,988	$12,531	$12,551
Intelligent Cloud Def. Rev Days	129.4	135.7	116.9	123.1

Not only did deferred revenue days decline by 22 versus the year-ago quarter, deferred revenue has declined on an absolute basis as well.

It is worth noting that the company's outlook for Intelligent Cloud revenue in the 12/20 quarter is a noticeable deceleration from past quarters. The mid-point of the company's guidance was for Intelligent Cloud revenue of $13.675 billion which represents 15% YOY growth. The below table puts this in perspective with previous quarters:

	12/2020 E	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Intelligent Cloud Rev. Growth	15.2%	19.7%	17.4%	27.3%	26.6%	26.6%

The main item that has prevented us from assigning a higher level of concern to the decline in deferred revenue days is that fact that bookings remain strong and the, remaining performance obligation (RPO) which is the total of unearned revenue and amounts under contract that have yet to be recognized or received has not decelerated. The following table shows a breakout of the two components of RPO:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Remaining Performance Obligations	$111,000	$111,000	$93,000	$93,000
Total Unearned Revenue	$36,305	$39,180	$30,397	$31,221
Amt. to Be Recognized in Future	$74,695	$71,820	$62,603	$61,779
Amt. Recognized in the Future % of RPO	67%	65%	67%	66%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Remaining Performance Obligations	$89,000	$91,000	$75,000	$72,000
Total Unearned Revenue	$34,026	$37,206	$28,135	$28,084
Amt. to Be Recognized in Future	$54,974	$53,794	$46,865	$43,916
Amt. Recognized in the Future % of RPO	62%	59%	62%	61%

We see first that total RPO is growing almost 25% YOY which is on par with the growth seen in the previous three quarters. Second, we notice that the portion of RPO attributable to amounts that are under contract but have yet to be invoiced and recorded in unearned revenue is increasing. This fits with the company's narrative that it is signing up longer-term contracts.

Still, we note that the fact that Intelligent Cloud unearned revenue declined YOY on an absolute basis for the last two quarters is increasing our level of concern in this area and we will continue to monitor this issue moving forward.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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