ATLANTIS RESEARCH

A SERVICE OF ATLANTIS INVESTMENT CO., INC.
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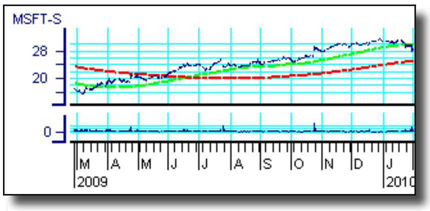
Microsoft (MSFT) — BUY

Update 01/29/2010 — **Rank: 2**

Valuation At a Glance	
Price	$28
EPS 06/30/2010	$1.95
EPS 06/30/2011	$2.20
P/E Calendar 2010 EPS	13.4X
Mkt Cap($MM)	$252,239
Mkt Cap/Ann Rev	3.3X



Closing stock price and volume are shown in blue lines on top and bottom of chart. 200 day moving average stock price is shown in red and 50 day moving average stock price is shown in green.

Microsoft reported the strongest revenue growth in years for the December, 2009 quarter, but even a restoration of 15% PC unit volume growth could not excite investors to bid up the stock. Total revenues of $19.0 billion for December, 2009 increased 14% from the previous year, while adjusted pro forma revenues of $17.3 billion (excluding deferred revenue on Windows upgrades) increased 4%. Operating income at 44.8% of total revenues improved 9.1% from the previous year. Pro forma EPS of $0.60 per share increased 28% from the previous year.

Consumers are still the driving force of this PC recovery, with PC units sold to consumers up more than 20% from the previous year, while PC units sold to businesses remained flat. Server volume growth was disappointing, with Microsoft's server and tools segment revenues up only 2% from the previous year. We note that Intel's server volume growth exceeded PC unit volume growth, possibly an early warning sign that Windows Server may be losing market share to Linux operating systems for servers. Xbox 360 unit sales decreased (13%) for the previous year, reflecting incursion of lower priced Sony Playstation during the holiday season. Online revenues decreased (20%), with online advertising revenue down (2%). Although management sounds pleased with Microsoft's new search engine Bing's performance over the first 8 months since introduction, Bing has yet to make a meaningful contribution to Microsoft's revenues or operating profits.

Windows 7 appears to have stemmed PC market share loss to Linux netbooks and to Apple's iMacs for now, although long term loss of PC market share still appears certain, based on appeal of low end netbooks running Linux and attractive iMac features at the high end. Virtualization of PCs with server software and cloud computing is an emerging threat to Microsoft's established base of enterprise customers for standard office software.

Guidance for FY 2010 (ending June, 2010) indicates revenues in a range of $26.2-$26.5 billion, with Windows revenue expected to grow in line with PC unit sales, while business PC sales continuing to lag consumer PC unit sales growth. Server revenue growth is expected to exceed server unit volume growth. Entertainment revenue is expected to finish FY 2010 flat with the previous year. Windows Office 2010 (still in beta test) is expected to ship late during FY 2010 (ending June, 2010), with little revenue impact until FY 2011.

Microsoft's financial strength is still exceptional, with cash flow from operations of $5.0 billion for 2Q FY 2010 (ended December, 2010). Microsoft invested $5.4 billion to repurchase shares during the first 6 months of FY 2010 (ended December, 2010), retiring 2% of total outstanding shares. Balance sheet cash (including marketable securities) of $36.1 billion provides Microsoft with flexibility to acquire large businesses or to accelerate the stock repurchase program.

We increased our pro forma EPS estimates slightly due to higher than expected Windows revenue for 2Q FY 2010 (ended December, 2010). We now forecast pro forma EPS of $1.95 per share for FY 2010 (ending June, 2010), up 15% from FY 2009, to be followed by 12% growth to pro forma EPS of $2.20 per share for FY 2011.

We increased our ranking on Microsoft stock to BUY with a new target price of $35 per share. Recovery of the PC market should carry Microsoft's growth through FY 2010 (ending June, 2010) with little risk, while revenue growth and EPS growth for FY 2011 also appears assured, due to pending shipment of Windows Office 2010.

Update comments present the analyst's thoughts on current events and recent reports affecting the stock price. Full analysis of the company's prospects for growth, including positive and negative factors, investment rationale, competitors, suppliers, customers, and key variables for investor consideration are presented in Summary Focus Reports attached.

NOTE: Estimates are based on guidance for pro forma EPS as provided by Microsoft management. Pro forma EPS adds back deferred revenue on sale of Windows operating system and excludes regulatory fines and legal settlements, restructuring and severance charges, operating expense reduction from capitalized R&D expenses, anti-trust matters and tax adjustments. Pro forma EPS was $0.60 per share for 2Q FY 2010 (ended December, 2009). Pro forma EPS was $1.12 per share for the first 6 months of FY 2010 (ended December, 2009). GAAP EPS was $0.74 per share for 2Q FY 2010 (ended December, 2009). GAAP EPS was $1.14 per share for FY 2010 (ended December, 2009).

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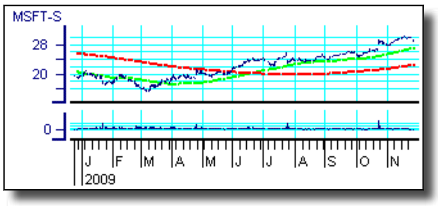
Microsoft (MSFT) — HOLD

Update 11/30/2009 — **Rank: 3**

Valuation At a Glance	
Price	$29
EPS 06/30/2010	$1.90
EPS 06/30/2011	$2.15
P/E Cal 2010 EPS	14.2X
Mkt Cap($MM)	$262,483
Mkt Cap/Ann Rev	5.1X



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Microsoft faces mixed results during Holiday sales for 2009, as low end netbooks offered by diverse OEMs to consumers at less than $400 add new Windows XP users at a time when Microsoft would prefer to see users buy high end notebooks running Windows 7. These are the PCs selling in volume for the holidays through Best Buy and other electronics retailers. Microsoft's new retail stores should do well featuring high end notebooks running Windows 7, as well as Xbox consoles and games, Zune music players, and consumer electronics featuring Microsoft software and services. While consumers prioritize holiday spending to meet their primary needs, it appears corporations remain in lock-down mode on new technology spending. We read the trends as offering some modest cheer for Microsoft 's near term earnings, but long term concern over Microsoft's basic strategic position.

Microsoft's efforts with Intel to develop the Windows market for netbooks running Intel's Atom microprocessor may cannibalize Microsoft's overall operating system transition strategy. Success of low end netbooks increases probability that Google's Chrome OS will succeed as an alternative to Microsoft Windows XP, Vista or Windows 7 operating systems, with lower power use, faster boot up, and integrated online apps. Google expects Chrome OS netbooks to be available for 2010 Holiday sales. Ironically, Microsoft's Windows Live appears to support Chrome OS remarkably well, based on Google's demonstration of the beta version of Chrome OS last week, a strategy that should keep Microsoft Office users happy even if they choose to leave Windows operating systems behind to carry new non-Windows notebooks and netbooks. Windows Live is Microsoft's answer to the new reality of personal computing: it all has to be accessible on the web.

We think Windows Live is the best thing Microsoft has offered customers in years, enabling remote users of Office software an integrated online environment for working on Microsoft Office files, with Windows Live Messenger for IM, Hotmail for email, Calendar, SkyDrive data storage, photo sharing and social websites including Facebook and Twitter, all easily accessed though any browser. Offer for a free business website now up on Windows Live provides an easy way for business users to transition their custom apps to cloud through Windows Azure cloud computing platform. Windows Live may prove to be not only a brilliant extension of Windows based apps to mobile computing, but also a way for Microsoft to recapture escapees from Windows operating systems.

Microsoft's near term results will not reflect full benefit of the shipment of Windows 7 operating system, as deferral of revenues through FY 2010 will move most of the benefit of Windows 7 launch to the last 6 months of FY 2010. We project Microsoft revenues of $17.4 billion for 2Q FY 2010 (ending December, 2009), up 4%, with pro forma EPS of $0.55 per share, up 17% on improved mix and lower spending.

We maintain our HOLD rank on Microsoft stock, reminding our readers that our 18 month time frame for recommendations forces us to place more weight on intermediate and long term trends than on near term results. Microsoft's shipment of Windows 7 provides an opportunity to force an upgrade for Windows Office programs, with Office 2010 to be shipped during the last 6 months of FY 2010 (ending June, 2010). This internally generated Microsoft upgrade cycle coincides with challenging industry trends, including midrange market share loss to virtualized desktops through cloud computing, high end market share loss to Apple's iMacs, and low end market share loss to non-Windows netbooks. Technology spending decisions by Microsoft's most lucrative market, corporations, are impacted by recession, and may be swayed by opportunities to achieve productivity through investment in virtualized and remote solutions. Long term, cloud computing changes PC demand dynamics, inevitably challenging Microsoft's established business model.

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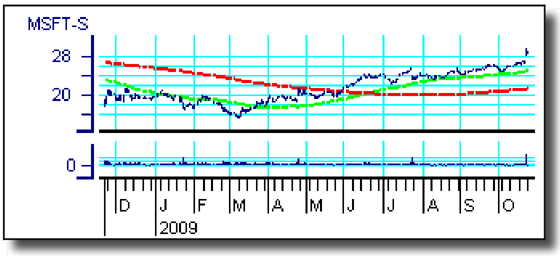
Microsoft (MSFT) — HOLD

Update 10/27/2009 — **Rank: 3**

Valuation At a Glance	
Price	$28
EPS 06/30/2010	$1.90
EPS 06/30/2011	$2.15
P/E Cal 2010 EPS	13.6X
Mkt Cap($MM)	$251,704
Mkt Cap/Ann Rev	4.9X



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Microsoft stock traded sharply higher, up 5% while most other stocks were down. Revenues of $12.6 billion on a GAAP basis for 1Q FY 2010 (ended September, 2009) decreased (14%). Adding back deferred revenue of $1.5 billion, pro forma revenues of $14.4 billion declined only (4%). Operating margin of 34.7% decreased (5.1%) from the previous year. Pro forma EPS was $0.52 per share, up 8% from the previous year, providing the first positive EPS comparison in the past year.

Management appears confident that economic rebound is under way, taking heart from 6% growth for OEM license sales, while PC unit sales were flat. According to Microsoft management, PC unit sales increased 15% from June, 2009. Consumers have prioritized consumer electronics purchases, while businesses are still cautious. Gartner reported 0.5% growth in PC unit sales from 3Q 2008. IDC reported global PC shipments increased 2.3% for 3Q 2009, with HP maintaining #1 position, followed by #2 Acer , #3 Dell, #4 Lenovo and #5 Toshiba. Microsoft reports a higher "attach rate" of Windows on notebooks, a positive trend offsetting low end market share loss to netbooks running free Linux operating system Ubuntu.

We note Microsoft normally sees a 9 month ramp in sales following new Windows operating system introductions. Revenue deferral will limit positive impact of this revenue ramp through the end of FY 2010. Windows 7 versions of Office products, to be known as Microsoft Office 2010 suite, should provide significant incremental revenue during the last 6 months of FY 2010. Microsoft plans to offer a public beta version of Microsoft Office 2010 at the Professional Developers Conference in November, 2009. We think it is unlikely that corporate purchasers will upgrade all desktop PC users to Windows 7 before testing Windows 7 for at least 6 months.

Uncertainty regarding Entertainment Division sales trends may be resolved by the end of the holiday season, as Microsoft gains experience with retail stores, offsetting lifecycle sales decline for Xbox 360. Microsoft's first retail store opened in Scottsdale, Arizona this week, providing a new focus on retail sales. We think Microsoft's entertainment products, particularly Xbox 360, should benefit from this new retail format.

Microsoft provided no guidance for revenue or EPS for FY 2010 (ending June, 2010), indicating only that planned expenses will be less than previously projected, in a range of $26.2-$26.5 billion. Our estimate for pro forma EPS of $1.90 per share for FY 2010 (ending June, 2010) assumes that EPS comparisons will be particularly favorable for the last 6 months of FY 2010. We forecast revenue of $17.4 billion for 2Q FY 2010 (ending December, 2010), up 5% from the previous year, with pro forma EPS of $0.55 per share, up 17% from depressed EPS of $0.47 per share for the previous year.

We upgrade our ranking on Microsoft to HOLD on rebounding PC unit sales. Upgrade rate for Windows 7 will determine ultimate success of Microsoft in restoring earnings momentum for 2010 and beyond. We are still concerned that upgrades to Windows 7 may be less than expected by bullish investors, impeding stock price action.

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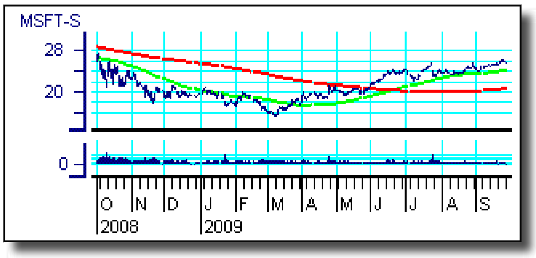
Microsoft (MSFT) — SELL

Update 09/28/2009 — **Rank: 4**

Valuation At a Glance	
Price	$26
EPS 06/30/2010	$1.90
EPS 06/30/2011	$2.15
P/E Cal 2010 EPS	12.8X
Mkt Cap($MM)	$228,110
Mkt Cap/Ann Rev	4.4X



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Microsoft stock is buoyed by bullish investors seeking a position in the stock prior to the launch of Windows 7, expected before the end of October, 2009, but we caution once again that upgrades to Windows 7 may be fewer than expected. We expect Vista notebook users to upgrade to Windows 7, but most PCs users are still running Windows XP, the operating system Microsoft would like to leave behind.

PC users hesitate to leave durable XP, and most will probably wait months before even considering a decision on Windows 7. This indecision should be expected to impact both home and business users of Microsoft Windows, with the upgrade decision also determined by purchasers' exposure to recession. While Windows 7 will be the choice for new purchasers of a PC, industry forecasters still predict (10%) fewer PCs will be sold during 2009, with as many as 15% of total PC units to be low end netbook computers, where Windows is not viewed as essential. Microsoft is also impacted by Apple's market share gains among high end tech savvy users, including IT professionals, as well as graphics publishers and designers.

New product buzz on Microsoft's Courier project (a planner-sized notebook PC with dual screens and a novel touchscreen user interface) signals excitement for a probable sellout device. We have not yet heard what vendor may be selling Courier, or which EMS company may be hired to build it. Courier appears to be a 2010 launch that should keep excitement high while providing Microsoft with a hot product to draw traffic to its new retail stores.

Near term financial results will be uninspiring for investors. Results for Microsoft's 1Q FY 2010 (ending September, 2009) will include deferral of $1.1-$1.3 billion in revenue, to be delayed until launch of Windows 7 (expected before the end of October, 2009). This revenue deferral accounting policy ensures that Microsoft will report another quarter with sharp EPS decline. Investors must wait until January, 2010 to see earnings increase from Microsoft. We forecast revenues for 1Q FY 2010 (ending September, 2009) will be sequentially flat at $13.0 billion, indicating decline of (14%) from the previous year. We estimate pro forma EPS of $0.35 per share for 1Q FY 2010, down (37%) from pro forma EPS of $0.48 per share for the previous year.

We maintain our SELL rank on Microsoft stock. While investor enthusiasm rides on momentum for upgrades to Windows 7, impact of recession and market share loss may prevent Microsoft from achieving bullish expectations.

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NOTE: Estimates are based on guidance for pro forma EPS as provided by Microsoft management. Pro forma EPS excludes regulatory fines and legal settlements, restructuring and severance charges, operating expense reduction from capitalized R&D expenses, anti-trust matters and tax adjustments. Pro forma EPS was $0.36 per share for 4Q FY 2009 (ended June, 2009). Pro forma EPS was $1.70 per share for FY 2009 (ended June, 2009). GAAP EPS was $0.34 per share for 4Q FY 2009 (ended June, 2009). GAAP EPS was $1.62 per share for FY 2009 (ended June, 2009).

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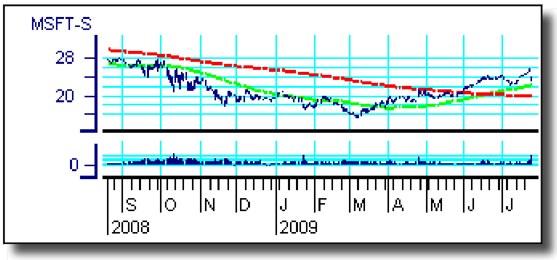
Microsoft (MSFT)
Update 07/27/2009

SELL
Rank: 4

Valuation At a Glance	
Price	$23
EPS 06/30/2010	$1.90
EPS 06/30/2011	$2.15
P/E Cal 2010 EPS	11.7X
Mkt Cap($MM)	$209,362
Mkt Cap/Ann Rev	4.0X



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Microsoft's revenue disappointment impacted trading in tech stocks on Friday, July 24, 2009, with Microsoft stock trading down (9%), only 3 months ahead of the launch of its next operating system, Windows 7, to launch in October, 2009. Revenues for 4Q FY 2009 (ended June, 2009) decreased (14%), with Microsoft's most profitable division, client software, down (29%). Revenues for Microsoft's business division (including Microsoft Office software) decreased (13%) for 4Q FY 2009, with server and tools segment down (6%), entertainment (mostly Xbox) down (25%) and online (MSN) revenues down (13%). Operating margin of 29.2% decreased (6.7%) from the previous year. Pro forma EPS of $0.36 per share (excluding $0.02 per share of unusual charges) decreased (22%).

Microsoft's revenue decline should be viewed in the context of the recession-impacted PC industry. According to Microsoft management, based on the numbers they see from OEM client Windows Vista placements on all kinds of PCs, overall industry PC shipments are down (5%-(7%) for 2009, with "traditional" desktop PCs down (16%)-(18%), while the notebook segment increases market share. Netbooks (low cost lightweight PCs with small screens) now represent 11% of PC industry volume.

Microsoft's problem is that businesses are delaying IT spending due to recession. Results for 1Q FY 2010 (ending September, 2009) will include deferral of $1.1-$1.3 billion in revenue, to be delayed until launch of Windows 7. This revenue deferral accounting policy ensures that Microsoft will report another quarter with sharp EPS decline. Investors must wait until January, 2010 to see up earnings from Microsoft. We forecast revenues for 1Q FY 2010 (ending September, 2009) will be sequentially flat at $13.0 billion, indicating decline of (14%) from the previous year. We estimate pro forma EPS of $0.35 per share, down (37%) from pro forma EPS of $0.48 per share for the previous year.

We maintain our SELL rank on Microsoft stock. We view Microsoft differently than most investors. We think Microsoft's dominance of PC software may be coming to an end, as Apple gains market share and as low cost Linux based computers offer users an Internet-only processing model. While launch of Windows 7 presents an opportunity for a strong upgrade cycle, a sluggish economy and a cautious outlook for IT spending may hold upgrades to a lower level than for previous versions of Windows.

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Microsoft (MSFT) — SELL

Update 07/08/2009 — **Rank: 4**

Valuation At a Glance	
Price	$23
EPS 06/30/2009	$1.70
EPS 06/30/2010	$1.90
P/E Calendar 2010 EPS	11.3X
Mkt Cap($MM)	$200,607
Mkt Cap/Ann Rev	3.7X

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Google's announcement of Chrome OS for 2010 launch on a number of desktop, notebook and netbook computers places Microsoft in direct competition with well known PC names pushing Linux desktop software. Previous Linux desktops from Red Hat, Novell and open source Ubuntu failed to garner full support from PC manufacturers. Now, for the first time, a fully competitive branded Linux-based operating system software package will be available from Google, already known to PC manufacturers for free Google Pack, Google Apps and Google Docs. While Microsoft is unlikely to forfeit dominance of midrange PCs to Google, purchasers of low end PCs and netbooks may be well served by the Google Chrome OS alternative to Microsoft Windows.

Google's Chrome browser launched less than 1 year ago, and now claims more than 30 million regular users (including me). Google's first full scale operating system, Android, is now shipping on mobile phones and netbooks, demonstrating full compatibility with Intel's Atom microprocessor, as well as with AMD and ARM microprocessor designs. Chrome OS is to be built on the well known Linux kernel, providing instant access to proven drivers for memory and hard drive management. Voila! The desktop application platform is Chrome browser (much easier to use and faster than Microsoft Internet Explorer, users report), while all else for users is the Internet.

We think the basic Chrome OS desktop package will be Google Desktop. Most third party software included in Google Pack now runs on both Linux and Windows. Free Google Pack is available including Google Chrome Web browser as well as alternative Firefox browser with Google toolbar, Google Apps (including Gmail, Calendar, Docs) Google Desktop with Sidebar, Picasa and Google Photos Screensaver for picture management, Adobe Reader for document viewing, security software including Spyware Doctor and Norton Security Scan, IM alternatives Google Talk and Skype, RealPlayer for audio and video, and Google Earth.

Chrome OS PCs should provide easy out-of-the-box access to Internet applications. We see a PC market segment evolving where all storage and applications run on the Internet, while PC based storage and file management is no longer used. How big is this evolving market segment? We think all of the netbook market (10%-25% of 2009 shipments) plus as much as 25% of midrange PC users would be happy with this alternative. We add this up to a challenge of 40% of the PC market potentially lost to Microsoft.

Microsoft's battles with Google are about to move far beyond paid search. If Microsoft loses the desktop, Bing will not be much help, although Microsoft's users of Bing paid search would not be blocked by this new Google Chrome OS. Access to Bing is, of course, readily available through Chrome browser.

We maintain our SELL rank on Microsoft. Potential loss of market share to Google Chrome OS, starting in 2010, adds to Microsoft's market share loss to Apple already evident at the high end of PCs, while server virtualization and Linux desktop alternatives provide other alternatives for low end computing. Microsoft's dominance of PCs is crumbling.

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ATLANTIS RESEARCH SERVICE

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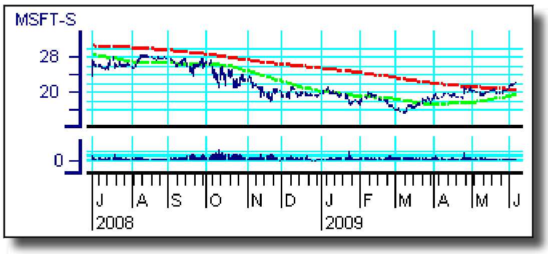
06/05/2009

Software Industry

Microsoft MSFT $22

SELL **Ranking: 4**

Price	$22
EPS 06/30/2009	$1.70
EPS 06/30/2010	$1.90
P/E Cal 2010 EPS	11.1X
Mkt Cap ($MM)	$197,135
Annualized Revenue	$54,592
Mkt Cap/Ann Rev	3.6X



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Current Quarter Estimate	
FY ending 06/30/2009	
Next Quarterly Report	06/30/2009
Expected Report Date	07/20/2009
Revenue Estimate	$14,000 vs $15,837
EPS Estimate	$0.36 vs $0.46
Previous Quarter EPS	$0.39

Company Contacts	
Phone Number	(425) 882 8080
Location	Redmond, WA
CEO	Steven A. Ballmer
CFO	Chris Liddell
IRC (425) 706 3703	Bill Koefoed
Website	microsoft.com

Comments:

Slowdown in PC shipments for FY 2009 hinders revenue growth.

Windows 7, to ship during FY 2010, provides upside potential.

Loss of market share to Apple and low end Linux systems highlights aging franchise.

New Bing search engine is an attempt to galvanize Internet strategy.

Share repurchase supports EPS.

Valuation Comments

Microsoft appears reasonably valued at 11.1X our calendar 2010 EPS estimate of $2.00 per share, at the low end of the range of 10.2X-27.7X for software companies, as shown in the valuation table at the top of page 3 of this report. On the basis of market cap relative to annualized revenues, Microsoft's market cap of $197 billion values Microsoft's annualized revenues of $54.6 billion at 3.6X, slightly below the average of 3.7X market cap to annualized revenues for software companies. Microsoft's long term record of consistent profitability and premier position in PC operating systems and applications for the Microsoft Windows brand would indicate a premium multiple would be justified. However, slower EPS growth, with EPS decline forecast for FY 2009, coupled with visible loss of market share, indicates change in investor perception of Microsoft's upside potential. Assuming Microsoft achieves 8% EPS growth rate and assuming a target P/E ratio of 110% of the EPS growth rate, our model suggests a target price of $18 per share, implying potential for (21%) decline from today's price.

NOTE: Estimates are based on guidance for pro forma EPS as provided by Microsoft management. Pro forma EPS excludes regulatory fines and legal settlements, restructuring charges, anti-trust matters and tax adjustments. Pro forma EPS was $0.39 per share for 3Q FY 2009 (ended March, 2009). Pro forma EPS was $1.34 per share for the first 9 months of FY 2009 (ended March, 2009). GAAP EPS was $0.33 per share for 3Q FY 2009 (ended March, 2009). GAAP EPS was $1.28 per share for the first 9 months of FY 2009 (ended March, 2009).

ATLANTIS RESEARCH

Investment Rationale

Positives

- Microsoft enjoys the premier position in PC operating systems and applications. Although worldwide PC unit shipments decreased almost (11%) to 302 million units for 2008, Microsoft still has #1 share of more than 80% for its Windows operating system, with Apple representing only 8% of the market and Linux PCs less than 10%. Microsoft now expects PC unit shipment to decline in a range of (9%)-(12%) through FY 2009 (ending June, 2009), with market share returning to stability for 2010.

- Microsoft looks to Windows 7 to reverse negative demand trends. Beta version of Windows 7 was released during March, 2009 to favorable reviews. Full launch of Windows 7 is expected for October, 2009, to be followed by Microsoft Office 2010 during the last 6 months of FY 2010 (ending June, 2010). Best Buy will start pre-sales of Windows 7 in July, 2009.

- Microsoft's worldwide installed base for Windows upgrades should provide growth for many years. OEM sales of Windows (operating system software preinstalled on new PCs - reported as Client segment) provided a very profitable $16.9 billion in sales for FY 2008 (ended June, 2008), with sales down (8%) to $11.6 billion for the first 9 months of FY 2009 (ended March, 2009), due to lower industry PC unit shipments. Client segment operating margin of 74.9% for the first 9 months of FY 2009 indicates strength of Microsoft's Windows franchise in generating ongoing profits years after initial product introduction.

- New versions of Microsoft Office, the ubiquitous office productivity solution, should pull additional revenues once Windows 7 has been adopted by office users. Microsoft's Business Division segment (representing sales of Microsoft Office and Microsoft Dynamics software) saw a sales gain of 5% to $14.3 billion for the first 9 months of FY 2009 (ended March, 2009), despite lower PC unit sales and despite lower Client revenue, with operating income up 3% to $9.3 billion.

- Rapid growth for Microsoft's Server and Tools business has been driven by demand for SQL Server, Windows Server, and Core CAL (client access licenses). Server and Tools revenue increased 13% to $10.6 billion for the first 9 months of FY 2009 (ended March, 2009), with operating income up 25% to $4.0 billion. Microsoft is gaining server market share from Unix and IBM.

- Bing, Microsoft's new search engine, launched to favorable reviews in June, 2009, may help Microsoft to galvanize Internet strategy. Bing appears to offer an enhanced search experience for online shopping and travel services, with maps optimized to locate local businesses. First impression of Bing indicates competitive impact may be greater on Yahoo! than on Google.

- Share repurchase supports EPS. Microsoft continued share repurchase during the first 9 months of FY 2009 (ended March, 2009) in response to market opportunities, when Microsoft's stock tumbled to less than $16 per share, investing $9 billion to repurchase more than 500 million shares. During the 4 years since June, 2005, Microsoft repurchased 29% of total shares outstanding. Cash flow from operations at an annual rate of $20 billion indicates Microsoft's ability to continue share repurchase, while still having significant funds available to make acquisitions and fund capital expenditures. Microsoft has $25.3 billion in balance sheet cash available as of March, 2009.

Negatives

- News of rapid erosion of traditional PC unit sales signals pressure on Microsoft to restore revenue momentum during a period of dramatic market share loss. Microsoft's revenues of $13.6 billion for 3Q FY 2009 (ended March, 2009) decreased (6%) from the previous year, as traditional PC unit sales declined (15%)-(17%) from the previous year, impacting Microsoft's key Client revenue segment, with an unprecedented (16%) revenue decline. Operating margin of 32.5% increased 2.0% from the previous year as management reduced expenses, down (16%) from the previous year. Pro forma EPS of $0.39 per share decreased (17%) from the previous year.
- Microsoft estimates total PC industry units for 3Q FY 2009 (ended March, 2009) declined (7%)-(9%) from the previous year, with growth only at the low end, driven by low cost netbook computers, while traditional desktop PC units decreased (15%)-(17%) from the previous year. Market share loss in high end PCs has a dramatic impact on Microsoft, as Apple wins customers for high end computing with its attractive iMacs. Microsoft estimated high end PC units (defined as "premium SKUs") were down by (20%). At the low end, Microsoft's Windows XP lost market share to Linux, as low cost netbook computers running Linux flood the market, the choice for almost 10% of consumer PC sales during the first 3 months of 2009. Although some netbooks run Windows XP, Microsoft realizes much lower revenue per unit on netbooks than on a traditional PC.
- Microsoft's non-Windows businesses are once again struggling to show improvement. Entertainment revenue was flat at $6.6 billion for the first 9 months of FY 2009 (ended March, 2009), with profits down (55%) to $299 million. Cumulative Xbox 360 game console sales now exceed 105 million. MSN reported flat revenues for the first 9 months of FY 2009, with online revenues down (14%) for 3Q FY 2009 (ended March, 2009).

- Microsoft's gains in Windows Mobile software (installed on 25% of smartphones worldwide, far exceeding market share for Symbian (licensed by Nokia), Linux, or Palm, are threatened by moves by Intel and Qualcomm to dominate netbooks with new mobile chipsets supporting non-Windows operating systems. Intel's pending merger with Wind River heralds market share gain for open source Linux and Wind River's proprietary VxWorks as mobile alternatives. Qualcomm's new chipset Snapdragon is expected to run Google's Android as the preferred operating system. iPhone with 27% and BlackBerry with 33% share the large portion of the smartphone market inaccessible to Microsoft.

- Microsoft's failure to merge with Yahoo! with a rejected takeover offer in the spring of 2008 highlights Microsoft's need to regalvanize Internet strategy. Although Microsoft Internet Explorer is still the #1 Internet browser, market share has tumbled to less than 75%, due to success of Firefox, a free browser supported by Mozilla, an open source organization, now claiming more than 20% market share, Google's Chrome at 8% share, and Apple's Safari, at 8%.

- Windows XP is still available preinstalled from Dell and other PC vendors more than 2 years after introduction of Windows Vista, surprising observers who expected Windows Vista to be the only choice for a Microsoft operating system. While price may be the most important reason for the lingering dedication to Windows XP, users report impatience with Windows Vista features. Delayed commitment to Windows Vista provides opportunity for small business and enterprise customers to consider Linux based PCs as a low cost alternative.

- Low cost systems undermine Microsoft's new developments. While Microsoft has felt the impact of Linux and other open systems primarily in competition for server software, free desktop Linux available "open source" from Ubuntu is sufficiently comprehensive and easy to use that some business and consumer customers may decide to risk a move away from Windows. Low cost netbooks accelerate this trend. Decision by corporations to support "virtualized" desktops freezes a portion of the market with low cost virtualized Windows XP for many users that were previously high end customers for Microsoft desktop software products.

- Microsoft stock price underperformance highlights loss of investor perception of invulnerability. Microsoft stock declined (26%) for the period from May, 2008 to May, 2009, compared to only (14%) decline for Oracle and (18%) decline for both IBM and Red Hat.

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Software Industry Valuation

Company	Ticker	Price 06/05/2009	FY	2008 EPS	2009 EPS	2010 EPS	P/E 2010E	SHARES OUT	MKT CAP	ANN REV	MKT CAP/ ANN REV
CA	CA	$18	03/31/2009	$1.55	$1.55	$1.75	10.2	541.0	$9,473	$4,140	2.3
			CAL	$1.37	$1.40	$1.72					
Microsoft	**MSFT**	**$22**	**06/30/2008**	**$1.87**	**$1.70**	**$1.90**	**11.1**	**8904.0**	**$197,135**	**$54,592**	**3.6**
			CAL	**$1.88**	**$1.75**	**$2.00**					
Novell	NOVL	$4	10/31/2008	$0.27	$0.27	$0.30	13.7	345.8	$1,425	$862	1.7
			CAL	$0.22	$0.25	$0.30					
Oracle	ORCL	$21	05/31/2008	$1.30	$1.40	$1.55	13.1	5187.0	$107,423	$21,832	4.92
			CAL	$1.40	$1.43	$1.58					
Red Hat	RHT	$20	02/28/2009	$0.86	$0.60	$0.70	27.7	197.8	$3,940	$665	5.9
			CAL	$0.82	$0.62	$0.72					
SAP*	SAP	$42	12/31/2008	$2.74	$2.35	$2.75	15.4	1187.0	$50,174	$13,711	3.7
Industry Average							**15.2**				**3.7**

*SAP EPS shown for ADRs, with revenue and EPS converted at $1.43 euro/dollar

Software Industry Key Variables

- **Decline in Global IT Spending.** Scrambling to reduce forecasts, Gartner now expects global IT spending to decline (3.8%) for 2009. Forrester projects a decline of (2.0%) for 2009, including spending on network hardware, computer software, and IT consulting and outsourcing services. IDC reports that worldwide IT spending decelerated from 6.9% growth for 2007 to less than 5.0% for 2008 as a result of slowdown in US economy, with growth of only 0.5% for 2009 to a total IT market of $1.4 trillion. IT spending has been impacted by global recession.

- **Penetration of New Technologies.** Penetration of new software technologies, such as ERP (enterprise resource planning), CRM (customer resource management), and SCM (supply chain management) supported higher productivity for US office workers, enabling lower expense growth and faster response time. Achievement of payback on investment in these systems has been a key focus for CIOs (Chief Information Officers) for the past 20 years. We now expect the focus of CIOs to shift to technologies that integrate all of these productivity systems, expanding their reach beyond the enterprise walls to encompass suppliers, customers, and vendors as key information sources and participants in enterprise decision making. This new focus will drive investment in clustered networks and Internet-enabled information systems, with accelerated investment in applications supported by "middleware" and distributed databases. This trend favors Oracle's RAC systems and Fusion Middleware, IBM's WebSphere, SAP's NetWeaver and Oracle-owned BEA WebLogic Server, all expected to see continued rapid growth within the global market for IT spending.

- **Shift to Open Systems.** Open systems enable lower cost and rapid cross-platform deployment to enterprise customers, leading many to choose open source software as the preferred option for new investment. Linux continues to gain market share from UNIX and proprietary operating systems such as those traditionally emphasized by IBM, Sun Microsystems (Solaris) and Microsoft (Windows). According to IDC, Linux now represents more than $20 billion of total hardware and software sales, including 15% of US server revenue. As revenue for each Linux server may be less than 40% of a typical Windows or UNIX server, we estimate Linux has achieved 40%-45% market share of server unit shipments. Linux has the full support of IBM, Oracle, and Sun Microsystems, all offering Linux-based applications. Red Hat emerged as a new contender on the enterprise scene over the past 8 years due to devotion to Linux server software, supplemented by acquisition of JBoss for SOA (service oriented architecture) open systems applications development. New Linux application server developments competing with JBoss include Gluecode (acquired by IBM in 2005) and GlassFish, an open source development project sponsored by Sun Microsystems.

- **Impact of Windows Vista.** Introduction of Windows Vista for corporate customers in November, 2006 has proven to be less of a disrupting factor for IT spending on larger system commitments than previously feared. We view the transition to Windows Vista as presenting an irritant to systems software vendors that may prove to be a long term benefit, as corporate customers may see the benefit of open systems and Internet enabled software to minimize cost of transition in desktop software. Novell, with openSUSE, and Ubuntu, a free Linux desktop operating system, provide low cost alternatives in delivering Internet access to the desktop for selected functional areas.

- **Impact of Internet Delivery.** US corporate investment in the Internet for delivery of services is still in its infancy. Investment in the corporate web site will move beyond presentation of basic information, as tools such as paid search, online advertising, online multimedia conference and "click-to-call" links evolve into platforms for truly integrated sales and marketing. Other functions, including product design, manufacturing, supply chain control, distribution, and customer service all require similar Internet-enabled functionality to handle demand for online access to goods and services. Development of "cloud computing" contributes to faster evolution in this long term process.

- **Appeal of ASP.** Long term trends to deliver applications software over the Internet, instead of for exclusive use installed on a local PC or a corporate network, offer both an opportunity and a threat to established software companies. Many Internet users find little benefit to PCs other than to access the Internet. Small business applications and some enterprise functions are now available on the Internet in an ASP (application services provider) mode that offers users convenience, low capital cost, and no maintenance expense. We expect all applications software vendors to identify this market as an opportunity to develop versions of their best selling software to run in an ASP mode.

- **Consolidation of Software Vendors.** Acquisitions play a key role in growth of all major software companies, as customers pare down their vendor lists, demanding software that works across platform components. IBM's acquisitions of Cognos in 2007, Rational in 2003 and Lotus in 1995 contributed to growth of their software business. Oracle acquired AG Edwards in 2004, PeopleSoft in 2005, Siebel Systems and Sunopsis in 2006, Hyperion Solutions in 2007, and BEA Systems in 2008, with pending acquisition of Sun Microsystems to add Java platform to Oracle's repertoire. Acquisitions for CA include Wily Technology and iLumin in 2006 after a long string of acquisitions adding products to Unicenter, CA's Unix systems center. Novell's mergers with SUSE Linux and Ximian in 2004 provided a path to restore growth through Linux. Red Hat's acquisition of JBoss was required for a small company to expand from its niche in server software to offer applications development tools.

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Microsoft Quarterly Trends

	3Q FY 08 03/31/2008	4Q FY 08 06/30/2008	1Q FY 09 09/30/2008	2Q FY 09 12/31/2008	3Q FY 09 03/31/2009
Revenues	$14,454	$15,837	$15,061	$16,629	$13,648
% change yr/yr	-0%	18%	9%	2%	-6%
Operating margin	30.5%	35.9%	39.8%	35.7%	32.5%
EPS - Pro Forma	$0.47	$0.46	$0.48	$0.47	$0.39
EPS - GAAP	$0.47	$0.46	$0.48	$0.47	$0.33

Technology Change

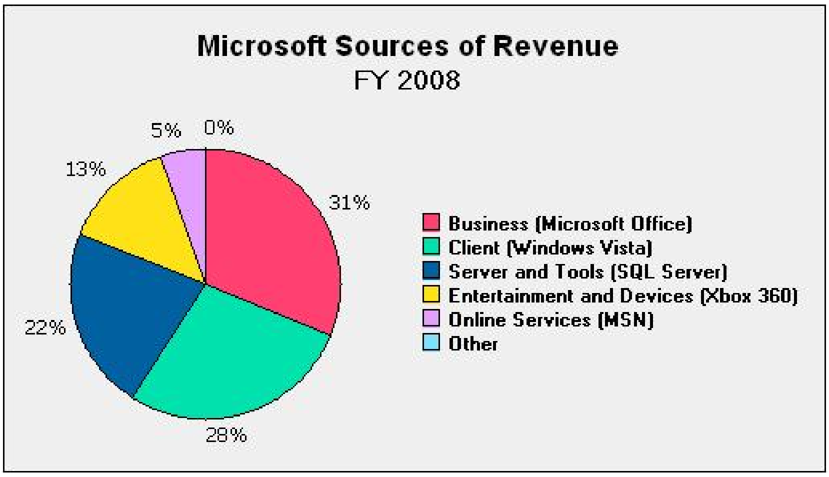
Long term trends to deliver applications software over the Internet, instead of for exclusive use installed on a local PC, offer both an opportunity and a threat to Microsoft. Many Internet users find little benefit to their PCs other than to access the Internet. Small businesses applications and some enterprise functions are now available on the Internet in an ASP (application services provider) mode that offers users convenience, low capital cost, and no maintenance expense. Other vendors are likely to develop this market more aggressively than Microsoft. We expect that Microsoft will eventually define online services as a target market and spend aggressively to develop a presence through acquisition or direct investment.

Competitors

Microsoft's dominance in PC operating systems is intact, although competitors have made gains in recent years. Linux, an open source software movement supported by many large companies including IBM, SAP, Oracle and Sun Microsystems (now in pending merger with Oracle), has evolved several desktop versions to compete with Windows. Microsoft faces 2 credible domestic contenders for Linux PC operating systems (an open source version, Ubuntu, and a licensed version from Novell) as well as a significant international contender, Red Flag Linux, in Asia. OpenOffice.org, an open source foundation supported by Sun Microsystems, provides a sturdy alternative to Microsoft Office. Although unable to compete on all features, OpenOffice is easy to use and adequate for basic word processing and spreadsheet tasks. Other applications programs running easily on Linux PCs include Mozilla Firefox browser, RealPlayer, and Adobe.

Free Google Software

Google Desktop and Google Pack present potentially significant new competition for software applications. Google Desktop and Google Pack may be downloaded from Google website and are available preinstalled on Dell PCs in the US market and on many brands of PCs outside the US. While not competing directly with Microsoft for market share in PC operating systems, Google Desktop and Google Toolbar provide sufficient Internet browsing, downloading, and communications functionality to enable users to enjoy the full gamut of Internet functionality without committing to any other Microsoft product than Windows XP. Google Docs, simplified office applications running online using OpenOffice formats, has proven to be an acceptable solution for office workers in many disciplines.



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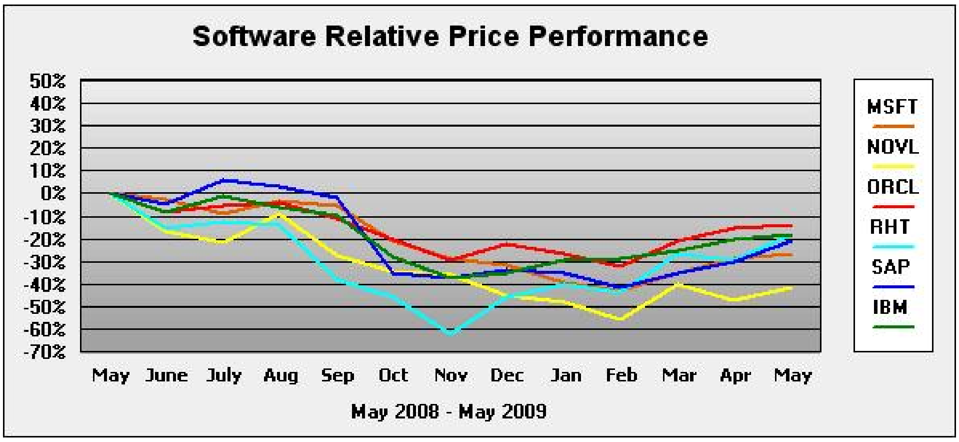
Software Industry Fundamentals

Company	Ticker	Latest Quarter	Annualized Rev	Revenue Growth yr/yr	R&D % of rev	Sales & Marketing % of rev	G&A % of rev	Operating Margin	Cash per Share	Accounts Receivable DSO	Deferred Rev % of Annualized Rev
CA	CA	03/31/2009	$4,140	-5%	12.4%	28.9%	11.8%	30.3%	$5.01	74	83%
Microsoft	**MSFT**	**03/31/2009**	**$54,592**	**-6%**	**16.2%**	**21.9%**	**6.7%**	**32.5%**	**$2.85**	**61**	**23%**
Novell	NOVL	04/30/2009	$862	-9%	20.7%	35.1%	11.5%	16.2%	$3.06	58	76%
Oracle	ORCL	02/28/2009	$21,832	2%	12.4%	19.3%	3.5%	46.4%	$2.23	51	23%
Red Hat	RHT	02/28/2009	$665	17%	21.1%	36.8%	14.5%	23.9%	$3.35	71	82%
SAP**	SAP	03/31/2009	$13,711	-3%	15.2%	21.4%	5.5%	20.5%	$3.56	124	22%



Software Price Performance

Sort by Highest to Lowest
May 2008 - May 2009

Oracle	ORCL	-14%
Red Hat	RHT	-18%
IBM	IBM	-18%
SAP	SAP	-21%
Microsoft	**MSFT**	**-26%**
CA	CA	-34%
Novell	NOVL	-41%