

Internal and external analysis of microsoft



Microsoft Corporation was founded by Bill Gates and Paul Allen in Redmond, Washington on April 4th, 1975. The company was formed to commercialize BASIC operating system created by Gates and Allen after drawing inspiration from Popular Mechanics magazine. By 1978, Microsoft exceeded USD 1 million in sales. In 1981, Microsoft entered in to a contract with IBM to provide OS (operating system), known as PC-DOS for IBM's personal computers. The contract did not restrict Microsoft from selling the OS to other manufacturers and Microsoft did that by changing product name of the product to MS-DOS. In 1986, Microsoft went public at \$21 per share in one of the most successful IPO's of that decade.

Microsoft diversified its product offerings to include GUI based operating systems, OS for servers, a range of productivity suites, gaming and entertainment and support services. The company currently has five business divisions: Windows and Windows Live Division, Server and Tools Division, Online Services Division, Microsoft Business Division and Entertainment and Devices division. Microsoft clocked revenues in excess of \$62 billion for year 2010.

Internal Analysis: Strengths

Human Resources: Microsoft has 88, 414 employees worldwide. The company has 53, 735 employees in the U. S., majority of whom, 40, 371 work in the Puget Sound region of Washington State, headquarters of Microsoft. Microsoft has a rigorous recruitment process and only the best and the brightest are given an opportunity to work for the company. Microsoft recruits from campuses of top colleges and universities from around the world and the company has a highly diversified workforce. Microsoft provides

high pay and great benefits in addition to a highly competitive work environment and thus is a magnet for high achievers. Thus, this network or ecosystem of more than 88, 000 brilliant minds is the most important strength of the company.

Ability to operate across cultures: In a highly globalized marketplace, ability to operate in different cultures can be an extremely important competitive advantage. Microsoft operated from 629 sites across the world out of which 373 are outside the U. S. Thus, the company has generated capability to operate successfully in different cultures. This strength will keep increasing in importance as foreign markets become bigger and more significant to growth of Microsoft.

Strong Management: Microsoft has a policy of internal promotion. Microsoft's managers have been working with the company for many years (in most cases, senior managers have worked their whole life for Microsoft) and have a clear understanding of company's vision and values. These manager's have been successful in the company's unique work environment by using available resources and facing external challenges, thus they are proven administrators and leaders and experts in the segments Microsoft operates in. The company's Top Management is comprised of leaders who have shaped the Computer and Information Technology industry in the past and have potential of doing that in the future. The company also has a strong board comprised of entrepreneurs headed by Bill Gates, Microsoft's Ex-CEO, one of the richest men in the world, founder of the company and one of the few men who shaped the personal computing industry.

A Proven R&D Process: Microsoft has focused on R&D to maintain and increase lead in segments that the company operates in. R&D is also expected to open new revenue streams for the company. Microsoft allocates a high percentage of revenue to R&D. For example, Microsoft spent \$8.2 billion on R&D in 2010 compared to revenues of \$62 billion. This huge spending allows Microsoft to pursue a wider array of technologies if necessary. The high R&D spending coupled with excellent human resources leads to creation of superior products.

Microsoft is also using cross-functional teams to increase R&D efficiency. The company is also using cross-cultural teams to increase efficiency. Microsoft uses economies of scale to improve production efficiency. The company has huge fixed costs associated with R&D but negligible variable costs. The company spreads fixed costs over a large number of units to increase production efficiency.

Strong Brand Recognition: Microsoft has been one of the leaders of the information technology revolution and its operating systems are used on almost 70 percent of computers worldwide. Thus, the company has unparalleled brand name recognition among target customers. This brand recognition means that Microsoft has the ability to charge premium prices from its customers, has the ability to attract top talent to work for the company and the strong brand name also helps Microsoft in launching new products in the market.

Intellectual Property Rights: Microsoft's products are protected through intellectual property rights. Thus, the source code of the company is a

valuable resource that Microsoft has. The company aggressively protects IP and has the resources in place to do so in the future. Since, this IP rights restrict competitors from duplicating Microsoft's technology, they are strengths.

Installed Product User base: Microsoft has a large user base. The company's operating system is used by more than 70 per cent of personal computers in the world and its productivity suites do not face any strong competitor. Since the company's current products are well received in the market, Microsoft has the option of using the installed user base to launch new products. This installed user base have the potential to become early adopters of Microsoft's future products.

Production: Microsoft has a streamlined production process. Once Microsoft creates successful product, the company can generate more revenues by releasing newer versions of that product. Microsoft has become extremely efficient at doing this. Moreover, the quality of the process is improved with every product cycle due to the learning curve and this leads to lower costs of production. The company has a highly intellectual workforce leading to new ideas being bounced and incorporated in the production process fostering innovation.

Most of Microsoft's products are considered to be more superior to those of competitors by customers. For example, Microsoft's Windows 7 operating system, Office productivity suite and Kinect gaming system are very innovative and considered to be of superior quality. The company has recently upgraded these products according to customer needs.

Marketing: Microsoft's Sales and Marketing support group comprises of 37, 276 employees worldwide. Considering the recent increases in revenues of Microsoft, we can infer that these employees are efficient and sales per employee are on the rise. However, we have not seen any significant innovation in the sales process by Microsoft. The marketing team does score high on customer responsiveness with Microsoft's team being perceived by customers to be highly professional, responsive and attuned to their needs. The company is also releasing more stable and user friendly versions of its products to decrease customer deflection rates and increasing marketing efficiency.

Service: Microsoft's products are used in critical functions by individuals, businesses and governments. Thus, reliability and after-sales service are very important to overall value of the product. Microsoft has a dedicated and qualified support staff in all major markets it server. This leads to faster resolution of any problems that customers might face. Thus, the service model is efficient and responsive. The quality of service is also rated high by customers and there have seldom been any cases of negative reviews by customers. The company is innovative in providing service by leveraging new mediums such as internet.

The company has also improved its products in response to customer demands. The company's new products are free of bugs and full of features that are valued very highly by customers. The company has taken action to resolve all customer complaints about previous products. For e. g. all the bugs as well as instability issues of Windows Vista were solved in Windows 7,

the latest version. Windows Mobile 7 is also well received and competing well in the smartphone space.

Information Systems: Bill Gates ensured that Microsoft used the most advanced information-technology available or even develop it if it's not there. He wrote about Microsoft being a paperless office as early as release of his book "Business @ The Speed of Thought" in 1999. The company has infrastructure in place to foster a innovative and competitive environment. Microsoft was one of the first corporations to make most of their processes paperless so that information can be made available on a timely basis. This also made the process more efficient since changes can be made more easily and quality improved. This concept was highly innovative when the company adopted it and has been replicated in almost all industries.

Infrastructure: Microsoft has created strong infrastructure because the company has been building on it since inception. Top management is still the same as it was when the company was formed. This means that the company culture has remained intact and become even stronger. Microsoft has successfully managed changes in organizational structure with changes in size of the company.

Internal Analysis: Weaknesses

New product development: Microsoft's operating system dominated the 80's and the company's productivity suite dominated the business landscape in the 90's. However, Microsoft has not been able to bring a new product in the market in the last decade that dominated the market place. The company successfully forayed into the entertainment segment with launch of X-Box

but it is sharing leadership with Sony and Nintendo in that segment. Thus, new product development seems to be a major weakness for the company. This weakness would keep increasing in importance as company's old products lose revenues or market share.

Financial Considerations:

Strong Financial Performance: Microsoft Corporation is one of the most valuable companies in the world. It has resulted in three employees becoming billionaires (Bill Gates, Paul Allen, Steve Ballmer) and thousands of employees becoming millionaires or centi-millionaires. Microsoft has reported strong revenues and net income across all operating segments during recent years.

The financial highlights of the company for the previous five years are tabulated below:

FINANCIAL HIGHLIGHTS

(In millions, except per share data)

Year Ended June 30,

2010

2009

2008

2007

2006

Revenue

\$

62, 484

\$

58, 437

\$

60, 420

\$

51, 122

\$

44, 282

Operating income

\$

24, 098

\$

20, 363

\$

22, 271

(c)

\$

18, 438

\$

16,380

Net income

\$

18,760

\$

14,569

\$

17,681

(c)

\$

14,065

\$

12,599

Diluted earnings per share

\$

2.10

\$

1.62

\$

1.87

\$

1. 42

\$

1. 20

Cash dividends declared per share

\$

0. 52

\$

0. 52

\$

0. 44

\$

0. 40

\$

0. 35

Cash and cash equivalents and short-term investments

\$

36, 788

\$

31, 447

\$

23, 662

\$

23, 411

\$

34, 161

Total assets

\$

86, 113

\$

77, 888

\$

72, 793

\$

63, 171

\$

69, 597

Long-term obligations

\$

13, 791

(a)

\$

11, 296

(b)

\$

6, 621

\$

8, 320

\$

7, 051

Stockholders' equity

\$

46, 175

\$

39, 558

\$

36, 286

\$

31, 097

\$

40, 104

(a) Includes \$1. 25 billion of convertible debt securities issued in June 2010 and \$3. 75 billion of debt securities issued in May 2009. See Note 12 – Debt in the Notes to Financial Statements.

(b) Includes \$3. 75 billion of debt securities issued in May 2009. See Note 12 – Debt in the Notes to Financial Statements.

(c) Includes charge of \$1. 4 billion (€899 million) related to the fine imposed by the European Commission in February 2008.

Source: Microsoft 2010 Annual Report

Company's Net Income and Cash on hand are showing an increasing trend. Thus, we can infer that the company is earning good profits from current product sales but does not have significant growth opportunities to invest cash in.

Ratio Analysis:

Ratio

Microsoft

Oracle

Google

Current P/E

10. 9

23. 4

22. 1

ROIC

35. 4%

13. 8%

18. 4%

Debt/Equity

0. 20

0. 43

0. 00

R&D (% of Rev.)

13. 4%

12. 8%

12. 8%

EBIT Margin

41%

30. 9%

36.8%

Quick Ratio

2.2

2.2

4.0

Receivables T/O

5.5

8.5

7.1

We can see from the Ratio Analysis between Microsoft and its rivals Oracle and Google that Microsoft is leading in most categories. Microsoft has the highest Return on Invested Capital, highest EBIT margin and the lowest Quick Ratio. This means that the company is financially very strong. The low P/E ratio may be a result of negative outlook of future growth opportunities by the investment community.

External Analysis:

Opportunities

The high growth rate of emerging economies: Almost 46% of Microsoft's revenues come from emerging markets. The company has the understanding and experience on how to operate in these markets. However, most of the revenues have been generated by company's software publishing business.

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U. S. online services businesses have not been very successful in emerging markets. A case study would be Google's dominant market share in U. S. but a small market share in China. Culture plays a very big role in these markets.

With the rise in disposable incomes in these economies, Microsoft's Entertainment business is bound to show great growth in future. The companies operating in developing countries lack the technological expertise to compete in this segment and Microsoft should enjoy high penetration in these markets in the near future.

Threats:

Low cost of production: The industry is very dynamic. The cost of producing a new product is very low. Many successful new products have been created by engineers operating in garages. Although, large corporations invest large sums in R&D, revolutionary new products such as Google search engine have been known to have been developed by geeks without any corporate affiliation. Thus, innovation is driving this industry. For eg., Microsoft's Hotmail email lost share to start up Yahoo! in the 90's and Yahoo! has lost market share to Google during the last decade. The Windows operating system has yet to meet a credible threat due to high penetration but the gaming industry is another game. Microsoft has recently taken lead in the gaming market with introduction of Kinect but the lead may be short lived.

Porter's Five Forces:

Risk of Entry of Potential Competitors: Microsoft operates in software development, online services and entertainment and devices industry. The cost of production in these industries is low but the cost of R&D is high. Thus

a company has to invest a large amount of capital in R&D and does not realize economies of scale unless R&D results in a successful product. On the other hand, there is a risk that an individual innovator may be able to create the next “ hot” technology. There is strong brand loyalty in this industry due to high customer switching costs. Organizations hesitate before changing available technology due to operational risks. Government regulation does not restrict new players from entering this industry. Thus, the risk of entry of potential competitors is low.

Rivalry among established companies: The industries Microsoft operates in are consolidated and are dominated by a few large players such as Microsoft, Oracle, SAP, Apple, Google, Facebook etc. Normally the companies in consolidated industries are interdependent and one company’s action is followed by reactions from competitors. However, most players in these industries have differentiated products and hence severe price competition does not exist.

The industries are in growth stage and globally the market is growing. This results in moderation in competition among existing players. Exit barriers are high in form of emotional attachments to the industry. Rivalry among companies is moderate.

The bargaining power of buyers: Microsoft operates in industry in which most players have differentiated products. Moreover, Microsoft has a virtual monopoly in some segments. Since the products are differentiated, buyers cannot play one supplier against another. The switching costs are high due

to operational risks and specialized nature of goods. Due to these factors, the bargaining power of buyers is low.

The bargaining power of suppliers: The product that Microsoft produces has few substitutes and those substitutes are not able to meet the need in a satisfactory manner. The customers would also have to bear high switching costs in order to move away from Microsoft's products. Thus, Microsoft has high bargaining power and can charge premium prices for its products.

Threat of Substitute products: The threat of substitute products is low in Windows, Business and Online Services division. However, there are substitutes available in Server and Tools and Entertainment devices markets. For example, if Microsoft increases prices of Xbox, buyers may switch to Sony's Play station.

Thus, we can infer from the five forces model that Microsoft has a moderately high capacity to increase prices and earn higher income.

Industry Life-Cycle Consideration:

Some of Microsoft's divisions are in mature industries while some are in growth industries.

Windows and Server & Tools Division: These divisions operate in mature industries. The threat of new entrants is low and profit margins are moderate. The growth of Windows operating system is linked to personal computers shipped and this number has been stable during the last few years.

Entertainment & Devices, Online Services and Business Division: These divisions operate in growth industries. New customers are being added every day. Industry profitability remains high, with new players entering every year. The demand for new products is strong and is expected to increase as emerging economies grow at a faster pace. The competition is currently very intense and is expected to increase in the future since innovation is the driving force of this industry.

Macro Forces:

Almost 46% of Microsoft's revenues come from emerging markets. The company has the understanding and experience on how to operate in these markets. However, most of the revenues have been generated by the company's software publishing business. U. S. online services businesses have not been very successful in emerging markets. A case study would be Google's dominant market share in U. S. but a small market share in China. Culture plays a very big role in these markets.

With the rise in disposable incomes in these economies, Microsoft's Entertainment business is bound to show great growth in the future. The companies operating in developing countries lack the technological expertise to compete in this segment and Microsoft should enjoy high penetration in these markets in the near future.

The national context has a considerable impact in the software and online services industry. The ability of customers to afford new technologies is a major factor for the growth of this industry. Moreover, the United States is known for technologically advanced products and its corporations have a global clout.

Hence, the national context helps Microsoft in achieving competitive advantage in the global landscape.

The industry sales were global but research was mainly concentrated in United States and Japan. Now that research centers have opened in developing countries like China and India, there is threat of new products from these countries that may bite in to profits of established players.

Strategic Groups: Microsoft is part of a strategic group within industries it operated in. The Windows, Server and Tools, and Business Division are part of a strategic group that produce quality products, have high R&D expenses and provide good customer services. In other words, these are premium products for which the customers have to pay premium prices (another member of this group would be Oracle) There is another strategic group within this industry which provides its software for free.

Business Level Strategy:

Microsoft has pursued the Differentiation strategy. The company has focused R&D dollars towards fulfilling customer needs that are not served. The Windows OS was the first OS which made optimal use of Graphical User Interface. The Office productivity suite had more tools than any other productivity suite on the market and increased customer productivity significantly. The company also differentiated products by providing extremely good customer service. Customer service is poor for most products that compete with Microsoft products in the Windows and Business division segments.

The basis for differentiation is different between product segments.

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Windows and Windows Live: The products in the Windows and Windows Live include Windows operating system, Windows live (formerly Hotmail) and Internet Explorer browser. The company cannot compete with the cost leadership strategy in these segments because competitor products are free in most categories and Microsoft is a for-profit entity, and thus, cannot give products for free and generate profit. For example, Linux operating system, Firefox web browser and Google's Gmail email service are all free.

Microsoft's operating system is user friendly, stable and has the ability to run all major software. The company had also adopted a strategy to bundle Windows OS with email and web browser in order to make the product more attractive to customers. Microsoft was slow on innovation with Windows during the last decade but their Windows 7 product has received rave reviews from customers. Customer service is always high and the company provides excellent support for older versions of software even after release of newer versions. The company also differentiates its products based on superior customer service and support that the company provides.

Server and Tools: The products in this segment are differentiated on basis of quality and customer responsiveness. More people are familiar with Windows user interface than any other operating system in the world and most applications run on Windows. This is considered quality by most customers since they do not have to think about compatibility issues every time they purchase a new program. Quality and Customer service are very important in the Server and Tools product and Microsoft competes on basis of these differentiators.

Online Services Division: The online services division's products include Bing search engine, MSN online and channels. The search engine has to be optimized to provide better search capability than the competition to drive revenues. The online portals and channels have to create attractive content to entice subscribers and then advertisers to increase revenues. Microsoft has not choice in this segment but to differentiate products.

Business Division: 90 per cent of Microsoft Business Division's revenues are driven by sales of Office productivity suite. Before Microsoft created Office, the market was server by different companies who offered one or the other tool. There was no integrated productivity suite available in the market.

Microsoft's Office was differentiated based on this factor. The Office productivity suite was the first integrated suite in the market and it was highly reliable and had tools that increased productivity sharply. There are free products available in the market such as Google and Open Office. However, these products are not compatible with Windows or if you open a Windows Office file in these products, they do not reflect correctly.

The quality of Windows Office suite is superior compared to other products. Thus, this product is differentiated based on Quality, Innovation and Customer Responsiveness.

Entertainment and Devices: The products in this segment are differentiated based on quality, innovation and customer responsiveness. The Xbox Kinect gaming system and games developed by Microsoft's divisions such as Halo, are state of the art products which are extremely popular among target

customers. These products are highly innovative, of great quality and are backed by good customer responsiveness.

Microsoft segments markets based on end use of products. Windows OS comes in Home and Professional editions. The Home edition is targeted towards students and customers buying PC's for personal use while the Professional edition is targeted towards businesses. The Office productivity suite comes in Student and Professional edition. The student edition which has limited capabilities but is extremely affordable is targeted towards students while the Professional edition with full range of tools is targeted at businesses. The Xbox Kinect is targeted towards teenagers and young adults who are avid gamers (or are candidates for being converted into one).

The market dominance achieved by Microsoft cannot be achieved just by developing one distinctive competency. A combination of Quality, Innovation and Customer responsiveness are reasons of sustainable competitive advantage that Microsoft enjoys. However, the most important contributor going forward would be innovation and Microsoft needs to strengthen this competency even more.

The advantage of pursuing this strategy is that the company enjoys healthy profit margins. The company also created barriers to entry for competitors since they cannot imitate products due to Intellectual Property rights owned by Microsoft. The company also enjoys high customer loyalty. The disadvantage is that Microsoft's R&D costs in dollar terms are higher than most competitors in most business segments it operated in.

Value Creation Frontier:

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According to Hill and Jones, Value creation frontier represents the maximum amount of value that the products of different companies inside an industry can give customers at any one time by using different business models.

Companies such as Microsoft have differentiated products and they have to rank high on Innovation, Quality and Customer responsiveness to market their products successfully. Companies with cost differentiation strategy such as Sun Microsystems have to keep their costs low so that they may be able to provide generic products to customers at the lowest cost.

la0505 value creation frontier

Source: Hill and Jones: Strategic Management ppt slides

There is a constant battle to push the value creation frontier further out and companies have to constantly innovate to retain leadership position.

Corporate Level Strategy:

Microsoft's organizational structure is a product structure giving the company flexibility to pursue different corporate level strategies for different product divisions. These product divisions in turn generate revenues in billions (more than many Fortune 500 companies). The company is pursuing strategy of full vertical integration in Windows and Business software segments and a taper vertical integration strategy in the Games and entertainment segment. Microsoft controls the entire value chain, from conception of product to distribution to customer, for the Windows and Business software segment. Microsoft designs the software in-house, the

code is written by Microsoft engineers and the product is sold on Microsoft websites.

Windows, Server & Tools and Business Division: These divisions are vertically integrated. The core competence of these divisions is development of operating and business application software. The company has rich experience in this field and is a global leader in the industry. Microsoft has built these resources and capabilities over decades and they are not easily replicable. Hence, the company has become extremely efficient in the process and has the ability to create value through vertical integration.

Microsoft's source code is an extremely valuable asset for the company and outsourcing any kind of software development work may lead to a threat to its security. Thus the company does not outsource any operations that it is currently performing in-house nor does the company invest in building infrastructure to do activities that are currently outsourced.

Online Services Division: Microsoft tried to pursue horizontal integration strategy in Online Services Division recently. The company made a \$47.5 billion hostile offer to takeover Yahoo in 2008. Microsoft did not have a significant presence in the search engine space despite sinking billions of dollars in R&D for Bing search engine. The merger with Yahoo would help Microsoft realize economies of scale. T