What Warren Buffett Can Teach Microsoft

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In the very early cash-strapped days of Microsoft, Bill Gates made a resolution that he'd get the company to the point that it always had enough cash to run for a year, even if it never received a dime from anyone.

Today, with annual expenses of $20 billion and cash and investments of $54 billion, Microsoft can theoretically operate with zero revenue for nearly three years. Are the dividend mongers right in putting pressure on the company to pay out all the excess cash to shareholders? Alternately, shouldn't they spend at least $30-odd billion on a large stock buyback?

Contrary to popular opinion, Microsoft is a fragile business. While the company has a wide range of products and services ranging from Hotmail to MSNBC to Xbox, more than 68% of revenue and 107% of operating profit come from just two product families – Windows and Office.

Without them, the company wouldn't be making a dime, even with the $10 billion in revenue the other products bring in. Windows and Office need upgrades to make money, and upgrades are only compelling with revolutionary improvements. DOS to Windows was revolutionary. Office 2000 to Office XP is ho-hum.

Windows Server, SQL Server, MSN, Hotmail, Expedia, Xbox, Microsoft Press, Microsoft Consulting, Great Plains, bCentral, Pocket PC and Windows CE are all terrific well-positioned Microsoft offerings. Many are market leaders. Yet, in aggregate, they drain about a billion a year from the company's coffers.

Depends on Upgrades

One might argue that Windows and Office are so ubiquitous in our everyday lives that, by themselves, they make the Microsoft business-model bulletproof. Well, not quite.

The problem for Microsoft in developed markets like the U.S. is that unit growth in PCs is anemic. The heady days when the installed base of PCs posted double-digit gains every year are behind us, and Microsoft is heavily dependent on upgrades. Without the upgrade revenue, both Windows and Office revenue would shrink dramatically.

Both Windows and Office face formidable competition – from themselves! The latest versions of both products aren't revolutionary relative to their previous versions. There simply aren't substantial differences between Office XP, Office 2000 or Office 98. Despite repeated upgrades, my user experience with Word and Excel has remained unchanged for the last five years. And the $300 that Microsoft charges for the Office upgrade makes it a significant buying decision. Similarly, one would be hard-pressed to find meaningful differences between Windows XP and Windows Me for the typical user.

Over the last 27 years, Microsoft has undertaken hundreds of major endeavors and projects. Only two of these have yielded great results. The rest have either lost money or are insignificant in the broad scheme of things. Both the successful endeavors borrowed heavily from the products of other companies – Windows from Apple and components of Office from the likes of Lotus and Word Perfect.

Microsoft has never created a large scale, profitable innovative product. Today the company is investing billions into next generation Windows -codenamed Longhorn. Longhorn is expected to be released in 2006 and is supposedly a quantum leap forward from Windows as we know it. But based on Microsoft's past record on innovation, the odds of Longhorn's being a runaway success are slim.

Product Cycles

Should Longhorn fail to capture our imagination, Microsoft would have no good upgrade story for its installed base for years to come. Microsoft would face the real possibility of declining revenue and possible losses - even as the company continues to own the installed based of Office and Windows.

Thus Gates' fixation on keeping boatloads of cash is fully justified. Microsoft's cash reserves are critical for the company to survive a single missed upgrade cycle in order to be around to capture the next cycle.

Secondly, the $54 billion in reserves in many ways is similar to the U.S. nuclear stockpile - it sends a powerful message to any would-be competitor to stay away from its turf. So, for its deterrent value alone, Microsoft needs the cash. Finally, the entire cash hoard represents about $10/share in value, or about 18% of the company's market cap. Think of it as an insurance policy protecting the remaining 82% of value in the event of a calamity in the years ahead.

If Microsoft needs to keep the cash in the company for all the aforementioned reasons, the question that arises is how should the stockpile be managed?

Buffett Approach

Bill Gates should take a close look at Warren Buffett's business model at Berkshire Hathaway. Managers at the various Berkshire companies use whatever portion of the cash flow they generate to grow their respective businesses and send the rest to Omaha for Buffett to allocate as he sees fit. Net users of cash (like Executive Jet) get whatever cash they need from Omaha to continue growing their business.

Think about how potent a business model Microsoft would have if they had Warren Buffett as the main allocator of all excess capital. The software unit would keep whatever cash it needed to run its business and send all the excess cash to Buffett to allocate. It would be allocated in a manner allowing maximized returns while maintaining sufficient liquidity to fund any crisis in the all-important software unit.

If Microsoft adopted this approach, its return on the idle cash would improve substantially, and it's conceivable that, like Berkshire Hathaway, the company would continue to thrive long after the sun had set on its dominant software business.

But Warren Buffett isn't available or probably interested in allocating capital for Microsoft. That's not a problem. While there will never be another Buffett, there are close cousins of his around who'd be worth talking to. Folks like Bill Ruane, Staley Cates, Mason Hawkins, Bill Nygren, Marty Whitman, Lou Simpson or Bill Miller would each do a far better job with the cash than Microsoft has thus far. To top it off, I'm sure Buffett would oblige his pal Bill and agree to interview and approve the Chief Capital Allocator at Microsoft.

Berkshire Hathaway, for much of its long history, was only in the textile business. Using its very modest excess cash flow, Berkshire Hathaway in its present form was created. The morph of Berkshire Hathaway from a sleepy New England company producing men's suit liners to the present day conglomerate generating more than $100 million of cash a week is one of the best business lessons of our age.

Microsoft, are you listening?

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