Equity Research
North America

United States of America

Internet & PC Applications Software

Microsoft

Reuters: MSFT.O Bloomberg: MSFT NASDAQ: MSFT

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STOCK RATING	OVERWEIGHT–V
Price (January 22, 2004)	$27.76
52-Week Range	$30.00-22.55

Stock ratings are relative to the analyst's industry (or industry team's) coverage universe.

GICS SECTOR	INFORMATION TECHNOLOGY
US Strategist Weight	15.9%
S&P 500 Weight	18.4%

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Analysis of Sales/Earnings

January 23, 2004

CQ4: Impressive Results…

- Better than expected revenue/profit growth…
  Revenue of 10.15B (up 19% Y/Y, up 24% Q/Q) vs. our $9.71B was driven by strong Info Worker (up 27% Y/Y to $2.9B); solid PC unit growth (12% Y/Y vs. initial 'upper single digit' estimate); 13% Y/Y server unit growth (with Window Servers growing faster at 19% Y/Y) and foreign currency benefits ($312MM). Emerging businesses continuing to ramp well. Pro forma operating income of $3.68B (up 6% Y/Y, up 17% Q/Q) beat guidance of $3.2-3.3B and our $3.26B estimate on better-than-expected revenue growth and higher-than-expected gross margin (80% vs. our 79%). Unearned revenue was below expectations, down 11% Y/Y, 5% Q/Q to $7.9B vs. our expectations of 8.1B, down 9%Y/Y, 2% Q/Q.
- Increased guidance for F2004…feels like the worst is over
  F2004 revenue to $35.6-35.9B (up 11-12% Y/Y) from $34.8-35.3B; operating income to $10.3-10.6B including $2.2B in charges related to the Stock Option Transfer Program. Excluding those charges, operating income would be in the range of $12.5-$12.8B, up from previous guidance of $11.3-11.6B; diluted EPS to $0.82-0.83 from $0.86-0.88; however excluding the $0.14 impact from the Stock Option Transfer Program, diluted EPS would be in the range of $0.96-0.97. Microsoft noted that IT spending, PC unit growth and consumer demand are improving.
- Company more upbeat about business trends…
  Forecasts for the direction of F2004 revenue and operating income, in addition to recent earnings results, have been encouraging relative to prior expectations. While declines in unearned revenue in CQ3 and CQ4 cause some concern, the fact that revenue guidance continues to rise offsets majority of issue. Ability to execute in F2005 should be key catalyst for stock price.
- Internet & PC Applications Software view is Attractive
  We continue to believe that, at the margin, online is gaining share from offline, that this will occur for some time to come, and that this should benefit the Internet leaders.

FY ending Jun 30:	2002A	2003A	2004	2005E
Revenue ($MM)	28,365	32,187	35,885	38,260
Prior Revenue ($MM)	–	–	35,231	37,434
Operating Income ($MM)	12,570	13,201	12,336	13,380
Prior Operating Income ($MM)	–	–	11,866	12,984
Operating EPS ($)	0.92	0.98	0.97	1.03
Prior Operating EPS ($)	–	–	0.88	0.94
P/E	30	28	29	27

Market Cap ($MM)	300,085
Shares Outstanding (MM)	10,810

Q'trly EPS	2002A actual	2003 actual	2004E curr	2004E prior
Q1	0.22	0.21	0.24A	–
Q2	0.25	0.26	0.28A	–
Q3	0.25	0.27	0.24E	0.21E
Q4	0.21	0.23	0.21E	0.19E

e = Morgan Stanley Research estimates;
2004E & 2005E include equity compensation expense

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CQ4: Impressive Results…

Microsoft CQ4:03 Highlights

What We Liked:

1) Better than expected revenue growth (up 19% Y/Y vs. 14% estimate and up 24% Q/Q) to $10.15B vs. our $9.71B estimate -- Key business drivers were solid -- 12% PC unit growth (vs. an initial 'upper single digit' estimate) and 13% server unit growth. Based on our estimates, Microsoft drives about 35% of its revenue from consumers; 35% from enterprises; and 30% from SMBs and it appears that consumer businesses grew fastest, followed by SMBs, then enterprises. Note - Reported revenue also benefited from favorable foreign exchange rates. Had the rates been constant Y/Y revenue would have been $312MM lower.

Areas of strength on a product segment basis included:

- **Information Worker** (up 27% Y/Y, up 27% Q/Q, to 29% of revenue at $2.9B) beat our expectations of 17% Y/Y growth driven by solid adoption for Office 2003 (retail package product revenue grew 36%), strong OEM sales, and the earn-back of previously deferred revenue. Additionally, revenue recorded in the quarter included $137MM related to purchases of Office 2003 prior to its availability.
- **Client** (up 21% Y/Y, up 9% Q/Q, to 30% of revenue at $3.1B) benefited from especially strong PC unit growth primarily in the consumer and notebook spaces. Windows Professional mix was 55%, down from 62% Q/Q (largely due to consumer seasonality), but consistent Y/Y. Microsoft raised its forecast of PC unit growth for F2004 (June 2004) from upper single digits to double digit growth (assume 10-11%).
- **Server Platforms** (up 21% Y/Y, up 14% Q/Q, to 21% of revenue at $2.1B) with strength in Windows-based servers, SQL server and Exchange. Microsoft noted that, while the total server hardware market grew an estimated 13% Y/Y, Windows Server shipments increased 19% Y/Y. Server revenue results should react positively toward a continued shift in the market to lower cost X86 server architecture. In addition, Exchange Server 2003 and Small Business Server 2003 both launched in CQ4. Windows Server, Microsoft's SQL Server, Microsoft Exchange Server, and Server CALs all showed double digit revenue growth due to accelerating purchases of higher-priced enterprise additions, the adoption of Windows 2003 and Exchange 2003 Servers as well as strong overall license growth. Note: Exchange has now sold 124MM seats and continues to be the leading messaging solution for companies. Consulting and premier product support businesses grew 29% Y/Y.
- **MSN** (up 19% Y/Y, up 11% Q/Q, to 5% of revenue at $546MM) up on a 47% increase in online advertising sales (and search) to an estimated $292MM in revenue (or half of the segment revenue). Growth continued to be governed by the 2% Y/Y falloff in MSN narrowband subscribers to 8MM (essentially flat Q/Q). This month MSN also launched MSN Premium, its newest Internet subscription software. MSN Premium integrates advanced communication capabilities, security and protection technology, and rich information services and productivity applications.
- **Mobile/Embedded Devices** (up 66% Y/Y, up 19% Q/Q, to 1% of revenue at $63MM) up on strong results across all products. The company does expect that MapPoint growth will slow in coming quarters, given that the present growth rate reflects the acquisition of Vicinity Corporation in FQ2:03.
- **Business Solutions** (up 41% Y/Y, up 48% Q/Q, to 2% of revenue) beat our estimates of 20% Y/Y growth. Navision sales were strong, primarily due to continued growth in product licensing. Growth from this product segment, which targets SMBs and includes Great Plains, bCentral and Navision, is key to monitor, for tapping this market is critical for future growth.

2) Emerging businesses continuing to ramp well -- In recent years, Microsoft has been aggressively driving new business initiatives to offset slowing secular growth in PC and Office shipments (represented in the Client [30% of revenue] and Information Worker [29% of revenue] product groups, respectively). In addition, Microsoft did a very crafty job of migrating its enterprise (and SMBs to a degree) business models to more of a licensing business -- the majority of that benefit accrued in F2003, with total reported revenue up 13% in a very challenging environment. We have noted for a while that F2004 would likely prove to be Microsoft's most challenging growth year ever. And the company's F2004 revenue guidance of 11-12% Y/Y (compared with CQ3 guidance of 8-10% Y/Y growth for the same period) implies slowing growth rates. That said, we are encouraged by the recent revenue (and relative profit…from loss levels) growth momentum of the emerging businesses (Server, MSN, Home/Entertainment, Business Solutions and Mobile/Embedded Devices) which accounted for 41% of CQ4 revenue. We continue to believe these trends could bode well for F2005 when we could see acceleration in Microsoft's revenue growth from these initiatives, combined with a turnaround in the economy and IT spending, plus potential up ticks in PC unit growth.

In effect, Microsoft has newer, faster growing businesses that account for 41% of revenue (albeit a disconcerting 1.4% of CQ3 operating income on a collective basis); however in aggregate, Microsoft's higher growth businesses (excluding Client, Information Worker and Server and Tools) continue to lose less (operating income for these segments improved by over 20%, or $88MM from CQ2 to CQ3). The Client business, which accounts for 30% of revenue (and more than half of operating income counting other divisional losses) is largely tied to PC unit growth, while the Information Worker (primarily Office) business which accounts for 29% of revenue (and more than half of operating income) is largely tied to IT spending. The good news here is that the two largest groups (based on revenue contribution) appear to have a solid outlook, while Information Worker continues to be a bit of a wild card. That said, we are relatively optimistic that in 6-12 months it may become apparent that, from a ramp perspective, the recently debuted (10/21/2003) Office 2003 (in the Information Worker product segment) could prove to be the most successful version of the product ever launched -- the bad news is that the product is a bit ahead of its time, the good news is that it's a very good product…and in our view, a game changer for desktop applications software. Notably, retail sales of Office 2003 have been robust, corporate interest is high, and there is a significant customer base that could potentially upgrade from previous versions to the latest platform.

3) Pro forma operating income of $3.68B ahead of forecast -- $3.68B (up 6% Y/Y, up 17% Q/Q) in operating income excluding $2.2B in charges related to the Stock Option Transfer Program was ahead of our $3.26B estimate and company guidance of $3.2-3.3B, owing to the better-than-expected revenue growth, continued expense control, and with higher-than-expected gross margin (80% vs. our 78.8% estimate).

4) Increased guidance for F2004 -- F2004 revenue to $35.6-35.9B (up 11-12% Y/Y) from $34.8-35.3B. The company guided operating income to $10.3-10.6B including $2.2B in charges related to the Stock Option Transfer Program. Excluding those charges, operating income would be in the range of $12.5-$12.8B, up from a comparable previous guidance of $11.3-11.6B. The company guided diluted EPS to $0.82-0.83 from $0.86-0.88; however excluding the $0.14 impact from the Stock Option Transfer Program, diluted EPS would be in the range of $0.96-0.97. Our F2004 point estimate for revenue growth is 11% with 13% growth for Information Worker; 10% for Client; 16% for Server Platforms; 7% growth for MSN; flat for Home/Entertainment; 22% for Business Solutions and 41% for Mobility/Embedded Systems.

5) Cash/equivalents up 22% Y/Y, 2% Q/Q, to $52.8B -- Cash & equivalents rose $1.1B Q/Q to account for 17% of market cap or about $4.88 per share. CQ4 operating cash flow was $4.6B compared with $3.4B in CQ3. Investors continue to express frustration regarding Microsoft's significant cash position. We think the large cash hoard speaks to Microsoft's opinions about: 1) legal concerns; 2) business transition issues - this margin decline continues to be substantial and 3) commitment to remaining flexible/opportunistic in a rapidly changing technology environment.

6) Continued stock repurchases -- During CQ4, Microsoft spent approximately $730MM to repurchase 30.5 MM shares. This is lower than usual, owing to restrictions related to the options transfer program with J.P. Morgan Chase. We expect Microsoft to continue to manage dilution through more stock buybacks.

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7) New product launches look promising -- Over the past few quarters, Microsoft has shipped several important products, including Windows Server 2003, Xbox Live!, Small Business Server 2003, Exchange Server 2003, Office 2003, and most recently, MSN Premium. Key products in the pipeline include Longhorn (expected in C2005-2006, beta expected in Summer 2004) and the next version of Visual Studio .NET.

8) While operating margin of 36.2% was above our 33.6% estimate, it's a far cry from the ~45% margins of the glory days -- Microsoft has clearly been hammering away at R&D and marketing to endeavor to drive growth in its businesses. A key question we keep asking is 'will operating margins rise in F2005 and F2006?' If they do, it'll likely be good for the share price and visa versa.

9) Gross margin of 80% beat our 78.8% forecast -- The company continues to focus on cost efficacy, from business processes, to marketing expenditures to consulting.

10) DSOs were at 53 days compared to a 55 days Y/Y -- The increase in reported DSOs (which include changes in unearned revenue in the average sales number) was led by a strong increase in billings.

What We Didn't Like:

1) While revenue growth exceeded expectations, there were light spots in several product segments -- Home & Entertainment (down 5% Y/Y, up 118% Q/Q, to 12% of revenue at $1.266B) below our expectation of a 4% Y/Y decline. Microsoft reiterated that it expects to have an installed base of 14.5-16MM Xboxes by FY04-end (June 2004). We continue to be encouraged by the momentum of this product and are impressed by its relative late cycle strength which we think should bode well for the next generation Xbox when it ships in C2005/2006E. Xbox Live! momentum remains impressive with subscribers growing to 750K — on track to meet the company's 1MM subscriber target by June 2004 — and this online initiative, plus the rising appreciation for the power graphics processing are helping differentiate the product. In the U.S., December NPD data shows that Xbox continues to maintain its number two position in consoles and has increased the life-to-date software attach rate to 6.4. Through CQ4, MSFT had sold 13.7MM consoles worldwide since launch, 8.6MM consoles in North America, 3.7MM consoles in Europe, and 1.4MM consoles in Japan and Asia Pacific region.

2) Unearned revenue declined to $7.9B, down 11% Y/Y and 5% Q/Q -- Short-term unearned revenue (to be recognized as revenue within the next 12 months) was $6.2B (down 6% Q/Q) while Long-term unearned revenue was $1.6B (down Q/Q). Microsoft indicated that the $395MM decline in unearned revenue was attributed to 1) the recognition of $137MM in previously deferred revenue associate with Office 2003 upgrade rights 2) a net decrease of $210MM in unearned revenue from volume licensing programs. Currently, the company is seeing a larger volume of license-only business in the SMB market--turning this business into annuities may be a key focus area for the company.

Microsoft expects unearned revenue to decline Q/Q in CQ1:04, but bounce back to CQ4:03 levels by the end of CQ2:04 -- we estimate $7.35B in CQ1 and $7.85B in CQ2.

Note that, all in, recognition of unearned revenue related to annuity licensing agreements accounted for 22% of total CQ4 revenue, flat Y/Y as a % of revenue. Microsoft expects to recognize its unearned revenue as follows: $2.56B in CQ1 (or 30% of our estimated revenue); $1.94B in CQ2 (or 23% of our estimated revenue); $1.08B in CQ3; and $0.65B in CQ4.

The riddle of unearned revenue is that, when you have it, it can be a wonderful thing. But once you've had it, if it starts to go away and is not replaced, it can wreak havoc…

What Does the Model Say?:

Bottom line, the model says that Microsoft remains a company in transition as revenue growth rates (for higher margin products) slow and opex continues to ramp as Microsoft's pushes to develop new products and enter new markets. The company's forecasts for the direction of F2004 revenue and operating income, in addition to recent earnings results, have been encouraging relative to expectations not so long ago. That said, the continued decline in unearned revenue over CQ3 and CQ4 certainly gives one pause. All eyes will be on the trends for CQ4…At this point, best as we can tell with our forecasting, the outlook for the underlying business should continue to improve.

1) Increasing F2004 and F2005 revenue, operating income and EPS estimates. -- We are increasing our F2004 revenues estimate to $35.9B from $35.2B, increasing operating income to $12.37B from our previous estimate of $11.87B ; and operating EPS to $0.97 from our previous estimate of $0.88. For now, we have revenue growth decelerating to 11% in F2004E, from 13% in F2003E, and we assume an operating income decline (including investment gains and equity comp) of 1%, down from growth of 5% in F2003E. For F2005, we are increasing our revenue estimate to $38.26B from $37.43B, increasing our operating income estimate to $13.38B from $12.98B, and we are upping our EPS estimate to $1.03 from $0.94.

2) Operating Expense -- We anticipate increases in Y/Y operating expense going forward. The company expects operating expenses including equity comp to represent approximately: 22-23% of revenue for R&D, 23% of revenue for sales and marketing and roughly 7% of revenue for G&A (driven by higher legal fees). Total equity compensation expense for CQ4:03 was $3.2B (including $2.2B of charges related to the completion of the stock option transfer program), compared with $1.06B for the same quarter last year.

3) Declining Operating Income Growth -- On a pro forma basis, the company anticipates operating income will decline roughly 1% in F2004, largely as a result of the increase in operating expenses as a % of revenue, due to marked increases in marketing and R&D to support its growing new businesses. In addition, operating income including all charges will be lower, as stock compensation expense is impacted extraordinarily by $2.2B for the full year to total $5.7B.

4) Valuation -- Our valuation methodology is based on two valuation techniques — analysis of discounted cash flow (DCF), and discounted future price-to-earnings (P/E). Obviously, forecasting revenue and earnings for high-beta companies entering evolving markets is fraught with risk — and all valuation methodologies are subject to general equity market conditions. We believe there is long-term valuation upside if Microsoft executes. In addition, MSFT's cash balance contributes $4.88/share and represents ~17% of its market capitalization. Specifically, our 10-year discounted-cash-flow valuation is $40 (assumes a 9.5% discount rate and a 7% terminal growth rate), while our discounted-future-price-to-earnings valuation suggests a $26-32 valuation.

Thoughts on F2005:

We maintain that many observers may not fully appreciate the degree of change Microsoft has gone through over the past five years: 1) Operating margins have fallen each year from a peak of 51% in F1999 to what will likely be 34% in F2004E; 2) the company has restructured management (including a new CEO and CFO) and divisional structure; 3) launched/expanded a bevy of new, futuristic, money-losing initiatives (including MSN, Xbox, Web Services, Business Solutions and Mobile & Embedded Device efforts); 4) the company has rolled seven divisional CFOs into the core business units to help focus on profitability and accountability; and 5) the company has changed its options based compensation system. Now, in our view, the key question is when/if we begin to see the payoff. Increasingly, our bet is that F2005 and F2006 should be the years . . . and this should bode well for investors.

As noted earlier the new initiatives have begun to drive substantive revenue growth and with the turn of MSN to profitability in CQ3:03, the aggregate loss levels from the new stuff have begun to move in the right direction.

While MSFT hasn't provided guidance for F2005, we are now assuming that the company grows revenue by 7%, expenses by 5%, maintains gross margins of 83% and supports Y/Y margin expansion to 35% from 34% with 8% operating income growth. We think the company can do this, but the question is will it? The key will likely relate to taking a hard line on expense control. And if the economy remains strong, and the Office 2003 cycle kicks in, there could be upside to the revenue estimates.

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Exhibit 1

Microsoft CQ4:03E vs. CQ4:03A Snapshot

($ Millions Except EPS)

	Est. vs. Act. 12/03E	12/03A	Comments
Revenue	**$9,708**	**$10,153**	**- up 19% Y/Y, above our 14% estimate; Unearned Rev down $395MM to $7.9B - down 11% Y/Y vs. our -9% Y/Y e**
Information Worker	2,662	2,895	- up 27% Y/Y vs. our +17% Y/Y est; up due to lower deferral rate (higher rev earned)
Client	3,003	3,059	- up 21% Y/Y and versus our +19% Y/Y estimate; Windows OEM licenses grew 27%
Server and Tools	2,054	2,134	- up 21% Y/Y and versus our +17% Y/Y estimate; strong growth in Windows Server, SQL Server & Exchange
MSN	493	546	- up 19% Y/Y and versus our +8% Y/Y estimate; driven mainly by 47% growth in Network ad revenues
Home & Entertainment	1,275	1,266	- down 5% Y/Y and versus our (4%) Y/Y estimate; decline is due to timing of Xbox holiday offering
Business Solutions	161	190	- up 41% Y/Y versus our +20% Y/Y estimate; growth driven by Navision and Business Contact Manager
Mobile and Embedded Devices	59	63	- up 66% Y/Y and versus our +56% Y/Y estimate; growth driven by all businesses including MapPoint
Other (Expedia revenue)			
Estimated Unearned Revenue Earnout			
from FQ4:03	***2,050***	*2,050*	
from FQ1:04	***2,620***	*2,620*	
from FQ2:04			
Company Guidance	**$9.7-9.8B**		
Cost of Goods (x)	2,058	2,029	
Gross Profit	7,650	8,124	- 77% GM versus our 79% estimate; down largely from inclusion of $215MM in stock comp expense
Operating Expenses	4,388	4,444	- opex 44% of net revenue; versus our estimated 45%
R&D (x)	1,253	1,051	- lower than expected R&D
Marketing (x)	1,845	1,881	
G&A (x)	320	486	
Estimated Equity Compensation Expense (w)	970	1,027	
Operating Income	**3,262**	**3,680**	**- up 13% over our estimate (excluding equity comp expense) and above top end of company guidance**
One-Time Stock Transfer Compensation Expense (pre-tax)			
Reported Operating Income			
Other Expense			
Company Guidance	**$3.2-3.3B**		
Interest Income	500	837	
Operating Income (excluding Equity Compensation)	4,829	5,544	
Operating Income (excluding realized invest. gains)	**3,762**	**4,517**	
Realized Investment Gains	100	0	
Operating Income (including realized invest. gains)	3,862	4,517	
Taxes	1,274	763	
Extraordinary Benefit from Stock Transfer Compensation Expense		725	
Net Income (Operating)	2,587	3,029	
One-Time Stock Transfer Compensation Expense (after-tax)		1,480	
Non recurring charge	--	--	
Goodwill Amortization add back (FAS 142)	--	--	
Net Income (Reported) (f)	2,587	1,549	
Operating EPS (excl. stock options expense)	0.30	0.34	
Operating EPS (excl. realized investment gains)	$0.23	$0.28	- $0.05 above our $0.23 estimate
Operating EPS (incl. realized investment gains) (j)	0.24	0.28	
Reported EPS	0.24	0.14	
Company Guidance	**$0.23-0.24**		
Shares Outstanding (MM)	10,900	10,810	
Dividend per Share	$0.16	$0.16	
Growth Rate			
Revenue (Y/Y)	14%	19%	
Information Worker	17	27	
Client	19	21	
Server and Tools	17	21	
MSN	8	19	
Home & Entertainment	(4)	(5)	
Business Solutions	20	41	
Mobile and Embedded Devices	56	66	
Other (Expedia)	--	--	
Revenue (Q/Q)	18	24	
Expenses (Y/Y)	40	42	
Expenses (Q/Q)	19	20	
Operating Income (Y/Y)	(6)	6	
Operating Income excluding investment gains (Y/Y)	(6)	13	
Operating Income (including investment gains) (Y/Y)	(9)	6	
Operating EPS (excluding invest gains) (Y/Y)	(6)	14	
Reported EPS (Y/Y)	NM	NM	
Margin Analysis			
Gross Margin	78.8%	80.0%	
Operating Margin	33.6	36.2	
Pretax Margin	39.8	44.5	
Net Margin	26.7	29.8	
Expenses as Pct. of Revenue			
Cost of Goods Sold	21.2%	20.0%	
Operating Expense	45.2	43.8	
R&D	12.9	10.4	
Marketing	19.0	18.5	
G&A	3.3	4.8	
Equity Compensation Expense	10.0	10.1	

Source: Morgan Stanley Equity Research

This note summarizes Microsoft's CQ4 results. For our analysis of Microsoft's CQ3 results, including our company overview, investment thesis, key positives, risks, and stock catalysts, see our, October 24th note, "CQ3: Good Stuff, Bad Stuff".

CQ4:03 FINANCIAL DETAILS

CQ4 revenue of $10.15B beat our/First Call estimates, -- Microsoft reported CQ4 revenue of $10.15B (up 19% Y/Y, up 24% Q/Q) vs. our estimate of revenue of $9.71B, First Call's $9.74B and company guidance of $9.7-9.8B. Revenue upside was driven by higher-than-forecast growth in almost all segments: Information Worker segment was up 27% Y/Y vs. our 17% Y/Y estimate, Client was up 21% Y/Y vs. our 19% Y/Y estimate, Server was up 21% versus our 17% estimate, and MSN was up 19% Y/Y vs. our 8% Y/Y estimate.

CQ4 operating income of $3.68B was above our estimate and guidance -- CQ4 Pro forma operating income excluding $2.2B in charges related to the Stock Option Transfer Program of $3.68B (up 6% Y/Y, up 17% Q/Q) was above our estimate of $3.26B and guidance of $3.2-3.3B.

CQ4 operating EPS of $0.28 above our/First Call estimates -- $0.28 in operating EPS excluding $0.14/share in after-tax charges related to the Stock Option Transfer Program was above our estimate/FC estimate of $0.23 (adjusting FC consensus of $0.30 by $0.07 for equity compensation expense) and the company's guidance of $0.23-0.24.

Exhibit 2

Microsoft: CQ4:03 at a Glance

	CQ4:03A	CQ4:03E	CQ3:03A
Revenue ($MM)	$10,153	$9,708	$8,215
Q/Q Revenue Growth	24%	18%	2%
Y/Y Revenue Growth	19%	14%	6%
Gross Margin	80.0%	78.8%	83.2%
Operating Income (MM)	$3,680	$3,262	$3,148
Operating Margin	36.2%	33.6%	38.3%
Net Oper. Income ($MM)	$3,034	$2,587	$2,614
Net Rep. Income ($MM)	$1,554	$2,587	$2,614
Operating EPS (incl. inv.)	$0.28	$0.24	$0.24
Reported EPS	$0.14	$0.24	$0.24
Shares Outstanding (MM)	10,810	10,900	10,885

Source: Company reports, Morgan Stanley estimates

Foreign exchange rates -- Reported revenue for the quarter benefited from favorable exchange rates by approximately $312MM. Going forward, we should note the inherent foreign exchange risks (and potential rewards) in such a business.

Pro forma gross margin of 80.0% was down versus 83.2% last quarter -- Operating margin also decreased to 36.2% vs. 38.3% last quarter.

Stock Option Transfer Program -- As noted, MSFT took a large one-time stock compensation charge of $2.2B in conjunction with its Stock Option Transfer Program with J.P. Morgan Chase. In July, Microsoft jointly announced both its plan to issue restricted stock to its employees instead of options as well as the Stock Option Transfer Program that allowed employees to trade in their underwater options for a cash payment, a portion payable immediately with the rest paid over the next two to three years. In December, J.P. Morgan Chase purchased the options with the intention of holding the options and hedging the risk.

Investment Income was $842MM, compared to $763MM in CQ3:03. Investment income was stronger than expected, due to the higher interest income earned on a larger investment portfolio. The company's effective tax rate remained at 33%.

Cash/equivalents up 2% Q/Q at $52.8B — Cash rose $1.1B Q/Q to $52.8B, and was up 22% Y/Y. Microsoft used ~ $730MM to buy back ~ 31MM shares. Microsoft indicated that it would continue to actively manage dilution through stock buy backs, but that it would be opportunistic in doing so.

Other Balance Sheet Items — Accounts receivable increased $1.1B sequentially to $5.6B due to strong billings, while reported DSOs (which include changes in unearned revenue in the average sales number) decreased to 53 from 55 in CQ4:02. With the payout of a $0.16 dividend on 11/7/2003, the company's current liabilities decreased by $1.7B.

Exhibit 3

Microsoft: Unearned Revenue at a Glance

	CQ4:02	CQ1:03	CQ2:03	CQ3:03	CQ4:03
Unearned Revenue (Billions).	$8.84	$8.53	$9.02	$8.25	$7.85

Unearned revenue decreased 11% Y/Y and 5% Q/Q from $8.25B to $7.85B. The unearned revenue is divided between $6.23B (down 9% Y/Y, down 6%Q/Q) of short term unearned revenue (which will be recognized over the next year), and $1.62B (down 20% Y/Y, flat Q/Q) of long-term unearned revenue. Recognition of unearned revenue related to multi-year licensing agreements during the quarter accounted for approximately 27% of total revenue (flat Q/Q and up 500bps Y/Y).

Exhibit 4

Microsoft Guidance

	FQ3:04E (Mar)	F2004E
Revenue ($B)	$8.6-8.7	$35.6-35.9
Previous Revenue ($B)	--	*$34.8-35.3*
Operating Income ($MM)	$3.0-3.1	$10.3-10.6
Plus: Extraordinary Stock Option Transfer Program Expense ($MM)	--	$2.2
Adjusted Operating Income	$3.0-3.1	$12.5-12.8
Previous Adjusted Operating Income	--	*$11.4-11.7*
Stock-Based Compensation ($B) (excluding extraordinary expense)	$0.75	$3.5
Diluted EPS	$0.23-0.24	$0.82-0.83
Plus: Extraordinary Stock Option Transfer Program Expense per Share	--	$0.14
Adjusted Diluted EPS	$0.23-0.24	$0.96-0.97
Previous Adjusted Diluted EPS	--	*$0.86-0.88*

Source: Microsoft, Morgan Stanley Internet Research

Exhibit 5

Revised Morgan Stanley Estimates for Microsoft

	CQ1:04E	F2004E	F2005E
Revenue ($B)	$8.6	$35.9	$38.3
Operating Income ($B)	$3.1	$12.3	$13.4
EPS (incl. investment gains and equity comp expense)	$0.24	$0.97	$1.03
Previous Revenue ($B)	--	$35.2	$37.4
Previous Operating Inc. ($B)	--	$11.9	$13.0
Previous EPS (incl. investment gains; excluding equity comp expense)	--	$0.88	$0.94

Source: Morgan Stanley Internet Research

VALUATION:

We rate MSFT Overweight-V. Our valuation methodology is based on two valuation techniques — analysis of discounted cash flow (DCF), and discounted future price-to-earnings (P/E). Obviously, forecasting revenue and earnings for high-beta companies entering evolving markets is fraught with risk — and all valuation methodologies are subject to general equity market conditions. We believe there is long-term valuation upside if Microsoft executes. In addition, MSFT's cash balance contributes $4.88/share and represents ~17% of its market capitalization. Specifically, our 10-year discounted-cash-flow valuation is $40 (assumes a 9.5% discount rate and a 7% terminal growth rate) and our discounted-future-price-to-earnings valuation suggests a $26-32 valuation.

See Exhibits 14 and 15 for underlying valuation assumptions.

Comments on P&L Impact of Stock Options Grants per Microsoft Disclosure

Per Microsoft's quarterly earnings disclosures, the company expenses equity compensation as a result of its adoption of FAS 123, on July 1, of F2004 (July 1st C2003).

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Exhibit Index

Please see analyst certification and other important disclosures starting on page 24.

Internet & PC Applications Software — Mary Meeker & Brian Pitz

Industry Investment Thesis

We continue to believe that the Internet is still in the early stages of becoming a central communications, information, commerce, and entertainment medium.

We estimate there are 750+ million Internet users worldwide using the Internet an estimated average of roughly 30-45 minutes per day. We expect the number of Internet users to grow at 15% annually for the next several years, with stronger growth in non-US markets. And we believe that usage growth (in part because of ongoing broadband adoption) should continue to be higher, thus demonstrating compelling underlying growth trends.

Given this relatively robust underlying growth, we continue to believe that the leading Internet companies should, over time, be able to generate strong double-digit top-line growth, and as the financial models scale towards higher long-term margins, should be able to generate even stronger earnings growth — AKA leverage. If the leaders execute to their opportunities, we believe that the leaders could continue to demonstrate classic growth-stock undervaluation characteristics.

While the general economic environment continues to be challenging — we note that according to our analysis, most GDP forecasts for 2001 were too high by 90%+ and 97% of the companies in the S&P 500 missed earnings on the down side at least once in 1999-2001 — we point out that many of the leading Internet companies are supporting very strong revenue growth, and that CQ4:02 appears to have been a positive inflection point. In C4Q:02, we note that Y/Y growth rates for the Internet leaders were compelling — 100% Y/Y growth for Expedia (70% pro forma with Classic Custom Vacations acquisition), 51% for Yahoo! (34% pro forma with HotJobs acquisition), 89% Y/Y growth for eBay (55% pro forma for PayPal acquisition), and 28% for Amazon.com.

In general, near term, we remain focused on what we consider to be key underlying positive trends:

1) The **Internet should prove to be the growth distribution channel of the decade** — Companies that benefited from leveraging the PC as their distribution channel — like Microsoft and America Online — created significant new businesses and shareholder wealth. We believe an emerging group of still relatively early-stage companies should do the same with the Internet.

2) **Search/Find/Obtain (SFO) is becoming a global reality and may be the next 'killer application' of the Internet** — Google, eBay, Amazon.com, Yahoo!, Expedia, Microsoft and Overture have driven this, and it benefits users/vendors as it helps reduce friction and makes markets more efficient. And strong SFO momentum for music & digital media is becoming increasingly apparent.

3) **Residential broadband (with an estimated 78MM+ global subscribers as of CQ3:03) has hit critical mass** — The early stage (and strong growth momentum, up 61% Y/Y in CQ3:03 to 78MM) of consumer broadband adoption, and the powerful usage patterns of broadband (vs. narrowband) users, at work and home, should help pace strong growth for leading beneficiaries.

4) The **Underlying growth rate for global Internet usage remains strong** — in spite of (and, perhaps, in part, because of) a very challenging economic and social environment, growth rates for global Internet usage/users remain strong.

5) **Online continues to gain share from offline** — Note Expedia in travel, eBay in collectibles, Yahoo! in news. e-commerce accounts for only 1.54% (and rising) of retail sales in the US.

6) **"Mind share" well above "market share" demonstrates growth opportunity** — an estimated 700+ million Internet users and, for example, only 37 million active Amazon.com customers?

7) **Internet momentum/opportunity is compelling compared to other media** – Per a Spring, 2002 US survey by SRI, consumers spent 13% of media usage on the Internet (up 23% Y/Y) vs. slower growth for TV (48% of media usage), radio (31%), newspapers (5%) and magazines (3%).

8) The **consumer appears to be alive and well for key technology-related purchases** — Internet, digital cameras, MP3 players, WiFi, video games… could the consumer (vs. the enterprise) drive the next leg of technology-related growth and a PC upgrade cycle? In addition, we believe that many **small to medium-sized enterprises (SMBs) have benefited** from the increased usage of the Internet as vendors/users/sellers.

9) **Technology platform-driven convenience, low (and transparent) prices/pricing, uniquely strong 24x7 customer service, and extensive selection have been key factors behind growth** in leading online commerce (and information) sites and should continue to spur growth for the leaders. In addition, we believe that positive trends for the ramps in *used* and *replacement* goods continue to be quite strong, assisted by rising user confidence (in part, through customer ratings and feedback) in obtaining these types of goods/services.

10) **Online advertising trends could surprise on the upside** & online premium services have begun to ramp. In the next 6–12 months we believe the compelling ROI will become more apparent to advertisers. We believe online advertising (including search) could grow 20+% in 2003 and accelerate in 2004.

11) **Handful of industry leaders gaining share** with less competition on almost all fronts and **operating leverage with inherently scalable models is powerful** — for example, Amazon.com got big fast, spent lots of money, now what? Fixed costs and operating leverage, in our view.

12) Positive earnings surprises can be, more often than not, followed by more of the same…

Microsoft Overview

Investment Thesis:

MSFT has done an impressive job of navigating through a challenging economic environment over the past few years as demonstrated by its 12% Y/Y revenue growth in F2002 and 13% growth in F2003. We continue to maintain that F2004 revenue growth could slow to 11%, though growth could accelerate longer term given impressive growth from its server and Internet initiatives (including search) and economically sensitive growth from its information worker and client businesses. Our estimates assume low double-digit PC unit growth and no economic recovery -- improvements in either should bode well for upside to our estimates. Additionally, we are of the view that the software business is going through a sea change driven by the still early stage adoption of the Internet; in effect, this trend is creating a much bigger market opportunity for the business as software gets integrated into more products and that, increasingly, Microsoft may be well positioned to drive and benefit from that change and growth.

Key Positives:

1. **Market leader** — Microsoft is No. 1 PC operating systems and applications software provider (all-in, 61% of F2003 revenue and 119% of operating income).
2. **Diversifying revenue streams and new product cycles** — The company is expanding its presence in server platforms (21% of CQ4 revenue), MSN (5% of CQ4 revenue), home and entertainment (12% of CQ4 revenue) versus desktop software (59% of CQ4 revenue). Longer-term product launches include new versions of Exchange Server, SQL Server, Client Software (Windows Longhorn), Windows Services for Unix (SFU) and new versions of MSN and Internet Explorer.
3. **Microsoft's .NET Initiative** — With recent consolidation of Great Plains, Navision, and bCentral into Microsoft Business Solutions (MBS), we believe Microsoft may have found an entry point into the global market for Web services — small-to-medium size businesses (SMBs). This, we believe, may be an important high-margin revenue stream for the company in the future.
4. **Impressive cash flow generation --** Cash flow from operations was $4.6B in CQ4.
5. **Strong balance sheet/commitment to innovation** — As of CQ4, Microsoft had roughly $53B in cash and the highest tech R&D budget compared to its peers.
6. **Heightened focus on the enterprise** — Microsoft continues to take aim at UNIX and Linux platforms, reaching 28% dollar and 60% unit share in 2002 vs. 25% dollar and 59% unit share in 2001, according to IDC Server Tracker. As companies migrate their UNIX servers to Intel-based architectures, companies have more often used Linux as the host operating system for its UNIX applications. With SFU, Windows hopes to grow incremental share.

Key Risks:

1. **Continued slow worldwide PC demand (impacts core Windows and Office businesses)** — In CQ4 PC unit growth increased 12% while in CQ3 PC unit growth increased in the mid-teens, according to Microsoft. We are conservatively assuming that growth should remain at mid-single digit levels, but expect that these levels could improve modestly.
2. **Continued worldwide economic softness** could further negatively affect consumer confidence and IT spending. If we do not see improvements in profits, the pressure on IT spend likely will not abate and consumer spending will be muted. Pressure on IT spending has probably been a driver of the decrease in unearned revenue as companies are less likely to lock-in long-term deals without much visibility.
3. **Uncertainty surrounding new product initiatives** in untested areas, such as Xbox, Business Solutions, and .NET.
4. **Spike in new license agreements in F2003 provides a tough comparison for F2004** — Several factors could mitigate this risk: 1) on-going improvement in renewals of ratably recognized Enterprise Agreements (EAs) in F2004; 2) migration of Microsoft SMB customers to the new EAs; 3) improved economic/IT spending visibility; and 4) improved PC unit growth.
5. **Continued declines in unearned revenue for F2004** — Total unearned revenue in CQ4 was $7.9 billion (down 11% Y/Y and 5% Q/Q). We anticipate unearned revenue will decrease by 13-14% over the next two quarters given the tough comps over F2003. However, we estimate that 32% of our estimated revenue for F2004 has been booked and should provide visibility in a weak economy. It will be key to monitor the acceptance of the recently released version of Office.
6. **Linux and non-commercial software** continues to provide threats to market share in the server business, though we note that Windows and Linux continue to gain share vs. UNIX.
7. **Legal issues** —Although significant hurdles have passed (i.e. U.S. government, California litigants), more civil cases, the EC, Sun Microsystems, Be Software, burst.com, etc. remain. That said, the recent (CQ2:03) settlement with AOL Time Warner/Netscape demonstrates that MSFT aspires to get these issues behind the company.
8. **Increased competition/margin pressure** may force Microsoft to further reduce pricing (e.g., Xbox), raise marketing/promotions (including Windows, Office, MSN, Xbox, .NET, and Tablet PC), or increase R&D (such as .NET). As Windows and Office contribute lower percentages of revenue, margin pressure may be on-going issue.
9. **Xbox reception and loss levels** — We expect Xbox losses of $1.5–2 billion before it turns profitable. We believe the real test for the platform will be in C2004 and beyond, as Microsoft builds up content, continues to roll out its online initiative and launches Xbox II in C2005/06 -- we are optimistic.
10. **Growing new billings against a large base** in a difficult spend environment will continue to prove challenging for the company.
11. **Executing with excellence on multiple fronts** remains an internal challenge for management of the company.

Please see analyst certification and other important disclosures starting on page 24.

Microsoft Overview ***(continued)***

Stock Catalysts:

1. **PC Growth in C2004 —** Not factored in our estimates is a possible PC upgrade cycle (with ongoing assists from consumers and SMBs) in F2004.
2. **Resolution of the legal cases —** EC and many civil suits remain unresolved.
3. **Uses of cash —** We believe the company will clarify its position on cash, dividends and stock buybacks with better visibility of its unresolved legal issues. We continue to believe that roughly 5-25% of Microsoft's cash balance may be conservatively earmarked for potential legal rulings and/or settlements.
4. **Success of upcoming product launches —** We are optimistic of new software releases, as well as efforts in search and advertising at MSN, and the eventual release of Xbox II.
5. **Economic recovery/IT spending improvement**
6. **Piracy** — Global software piracy is estimated at $11 billion and Microsoft products account for a large share.
7. **Demonstrated positive margin momentum in money losing business lines** — Business Solutions, Home & Entertainment, and CE/Mobility. Note that MSN turned its first profit in CQ3:03.

Valuation:

With MSFT, we believe there is long-term valuation upside if the company executes. In addition, MSFT's cash balance contributes $4.88/share and represents ~17% of its market capitalization. We combine several valuation methods: ten-year DCF ($40, using a 9.5% discount rate and 7% terminal growth rate) and discounted future price-to-earnings ($26-32).

Exhibit 6

Microsoft Quarterly Income Statement

($ Millions Except EPS)

	F2002				F2003				F2004E			
	9/01(p)(q)	12/01(r)(s)	3/02	6/02(t)	9/02(u)	12/02(v)	3/03	6/03	9/03	12/03	3/04E	6/04E
Revenue	$6,126	$7,741	$7,245	$7,253	$7,746	$8,541	$7,835	$8,065	$8,215	$10,153	$8,624	$8,893
Information Worker	1,801	2,116	2,128	2,167	2,268	2,285	2,327	2,349	2,287	2,895	2,583	2,678
Client	2,095	2,548	2,290	2,427	2,807	2,534	2,527	2,526	2,809	3,059	2,779	2,779
Server and Tools	1,435	1,569	1,511	1,642	1,625	1,763	1,827	1,925	1,866	2,134	2,101	2,156
MSN	348	372	404	447	427	459	508	559	491	546	528	531
Home & Entertainment	267	960	778	448	485	1,327	453	483	581	1,266	430	473
Business Solutions	74	73	75	86	106	135	147	179	128	190	150	224
Mobile and Embedded Devices	24	26	26	36	28	38	46	44	53	63	52	52
Other (Expedia revenue)	82	77	33									
Estimated Unearned Revenue Earnout												
from FQ4:03									***2,650***	***2,050***	***1,530***	***1,000***
from FQ1:04						***4,149***			***--***	***2,620***	***1,950***	***1,380***
from FQ2:04									***--***	***--***	***2,560***	***1,940***
Company Guidance								**$7.8-7.9B**	**$7.9-8.1B**	**$9.7-9.8B**	**$8.6-8.7B**	
Cost of Goods (x)	884	1,544	1,395	1,368	1,239	1,931	1,118	1,176	1,379	2,029	1,264	1,501
Gross Profit	5,242	6,197	5,850	5,885	6,507	6,610	6,717	6,889	6,836	8,124	7,360	7,392
Operating Expenses	2,345	2,696	2,552	3,011	3,479	3,141	3,002	3,900	3,689	4,444	4,239	5,006
R&D (x)	1,013	1,044	1,066	1,184	1,203	626	645	1,039	1,124	1,051	1,271	1,539
Marketing (x)	1,145	1,479	1,240	1,543	1,100	1,395	1,203	1,918	1,201	1,881	1,804	2,216
G&A (x)	187	173	246	284	126	94	183	324	349	486	414	548
Estimated Equity Compensation Expense (w)					1,050	1,026	971	619	1,015	1,027	750	703
Operating Income	2,897	3,501	3,298	2,874	3,028	3,469	3,715	2,989	3,148	3,680	3,122	2,386
One-Time Stock Transfer Compensation Expense (pre-tax)										2,205		
Reported Operating Income	2,897	3,501	3,298	2,874	3,028	3,469	3,715	2,989	3,148	1,475	3,122	2,386
Other Expense												
Company Guidance								**$3.1-3.2B**	**$3.0-3.1B**	**$3.2-3.3B**	**$3.0-3.1B**	
Interest Income	612	573	627	556	516	515	455	471	484	837	725	1,054
Operating Income (excluding Equity Compensation)					4,699	5,113	5,238	4,141	4,647	5,544	4,597	4,143
Operating Income (excluding realized invest. gains)	3,509	4,074	3,925	3,430	3,544	3,984	4,170	3,460	3,632	4,517	3,847	3,440
Realized Investment Gains	50	(57)	102	0	(63)	269	232	262	269	0	0	0
Operating Income (including realized invest. gains)	3,559	4,017	4,027	3,430	3,481	4,253	4,402	3,722	3,901	4,517	3,847	3,440
Taxes	1,139	1,285	1,289	1,098	1,149	1,403	1,453	1,228	1,287	763	1,269	1,135
Extraordinary Benefit from Stock Transfer Compensation Expense									0	725	0	0
Net Income (Operating)	2,420	2,732	2,738	2,332	2,332	2,850	2,949	2,494	2,614	3,029	2,577	2,305
One-Time Stock Transfer Compensation Expense (after-tax)									0	1,480	0	0
Non recurring charge	1,113	449	--	806	291	297	156	572	--	--	--	--
Goodwill Amortization add back (FAS 142)	--	--	--	--	--	--	--	--	--	--	--	--
Net Income (Reported) (f)	1,307	2,283	2,738	1,526	2,041	2,552	2,794	1,922	2,614	1,549	2,577	2,305
Operating EPS (excl. stock options expense)					0.28	0.33	0.34	0.27	0.30	0.34	0.28	0.25
Operating EPS (excl. realized investment gains)	$0.21	$0.25	$0.24	$0.21	$0.22	$0.25	$0.26	$0.21	$0.22	$0.28	$0.24	$0.21
Operating EPS (incl. realized investment gains) (j)	0.22	0.25	0.25	0.21	0.21	0.26	0.27	0.23	0.24	0.28	0.24	0.21
Reported EPS	0.12	0.21	0.25	0.14	0.19	0.23	0.26	0.18	0.24	0.14	0.24	0.21
Company Guidance							**$0.24**	**$0.23-$0.24**	**0.23**	**$0.23-0.24**	**$0.23-0.24**	
Shares Outstanding (MM)	11,133	11,112	11,129	11,060	10,933	10,883	10,864	10,862	10,885	10,810	10,900	10,910
Dividend per Share							$0.08			$0.16		
Growth Rate												
Revenue (Y/Y)	6%	18%	13%	10%	26%	10%	8%	11%	6%	19%	10%	10%
Information Worker	(6)	(3)	(1)	0	26	8	9	8	1	27	11	14
Client	10	21	10	17	34	(1)	10	4	0	21	10	10
Server and Tools	16	4	(0)	4	13	12	21	17	15	21	15	12
MSN	8	37	24	13	23	23	26	25	15	19	4	(5)
Home & Entertainment	(11)	134	230	130	82	38	(42)	8	20	(5)	(5)	(2)
Business Solutions	640	813	838	8	43	85	96	108	21	41	2	25
Mobile and Embedded Devices	33	44	53	112	17	46	77	22	89	66	13	19
Other (Expedia)	86	75	(44)	--	--	--	--	--	--	--	--	--
Revenue (Q/Q)	(7)	26	(6)	0	7	10	(8)	3	2	24	(15)	3
Expenses (Y/Y)	8	8	2	2	48	16	18	30	6	42	41	28
Expenses (Q/Q)	(21)	15	(5)	18	16	(10)	(4)	30	(5)	20	(5)	18
Operating Income (Y/Y)	4	10	10	4	5	(1)	13	4	4	6	(16)	(20)
Operating Income excluding investment gains (Y/Y)	10	10	11	4	1	(2)	6	1	2	13	(8)	(1)
Operating Income (including investment gains) (Y/Y)	(9)	3	10	(5)	(2)	6	9	9	12	6	(13)	(8)
Operating EPS (excluding invest gains) (Y/Y)	12	12	12	7	1	(2)	7	1	3	14	(8)	(1)
Reported EPS (Y/Y)	(43)	(15)	8	NM	59	14	5	28	NM	NM	NM	NM
Margin Analysis												
Gross Margin	85.6%	80.1%	80.7%	81.1%	84.0%	77.4%	85.7%	85.4%	83.2%	80.0%	85.3%	83.1%
Operating Margin	47.3	45.2	45.5	39.6	39.1	40.6	47.4	37.1	38.3	36.2	36.2	26.8
Pretax Margin	58.1	51.9	55.6	47.3	44.9	49.8	56.2	46.2	47.5	44.5	44.6	38.7
Net Margin	39.5	35.3	37.8	32.2	30.1	33.4	37.6	30.9	31.8	29.8	29.9	25.9
Expenses as Pct. of Revenue												
Cost of Goods Sold	14.4%	19.9%	19.3%	18.9%	16.0%	22.6%	14.3%	14.6%	16.8%	20.0%	14.7%	16.9%
Operating Expense	38.3	34.8	35.2	41.5	44.9	36.8	38.3	48.4	44.9	43.8	49.1	56.3
R&D	16.5	13.5	14.7	16.3	15.5	7.3	8.2	12.9	13.7	10.4	14.7	17.3
Marketing	18.7	19.1	17.1	21.3	14.2	16.3	15.4	23.8	14.6	18.5	20.9	24.9
G&A	3.1	2.2	3.4	3.9	1.6	1.1	2.3	4.0	4.3	4.8	4.8	6.2
Equity Compensation Expense					13.6	12.0	12.4	7.7	12.4	10.1	8.7	7.9

(p) To more effectively compare operating EPS (including investment gains) on a sequential basis, we have kept realized gains at the company's previously guided level of $50MM and moved all additional gains above and beyond guidance (about $183MM) below the operating line, to non-recurring charges. After subtracting the $183MM from the $1.82B and tax affecting the difference, the adjusted non-recurring charge equals $1.113B.
(q) Operating EPS (including investment gains) does not include the FQ1 $1.82B write off for First Call comparison purposes. The net effect equals an adjustment to Operating EPS (including investment gains) of $0.20.
(r) MSFT recognized a $660MM charge ($449MM post-tax or about $0.08 EPS) related to the antitrust civil litigation as G&A. We have moved the charge below the operating line, as it is non-recurring. Operating EPS adjusted for the charge is $0.49, as opposed to the $0.41 reported by MSFT.
(s) We have adjusted MSFT F2002E operating EPS guidance of $157-$1.60 to include $0.28 related to one-time non-recurring charges related to civil suit legal payments ($0.08) recognized in FQ2 and losses on investments recognized in FQ1:02 ($0.20)
(t) Operating EPS (including investment gains) does not include the FQ4 $1.19B write off for First Call comparison purposes. The net effect equals an adjustment to Operating EPS (including investment gains) of $0.15.
(u) 7/02 Navision acquisition included in Business Solutions revenue
(v) Though MSFT has elected to treat a $210MM charge related to the estimated settlement of pending state antitrust and unfair competition class action lawsuits as G&A, we have pulled it below the line and treated it as a non-recurring charge. Also, included as a non-recurring charge is a $126 one-time tax benefit related to a recent court ruling reversing previously accrued taxes..
(w) MSFT to start expensing equity compensation in F2004
(x) As of FQ2:04, MSFT has begun to embed stock compensation expense in cost of goods sold and each operating expense item. We have estimated the breakdown of stock compensation for F2004 and have not restated F2003.

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Please see analyst certification and other important disclosures starting on page 24.

Exhibit 7

Microsoft Annual Income Statement

($ Millions Except EPS)

	Annual						
	F1999 (h)	F2000	F2001	F2002(q)(r)	F2003(v)	F2004E	F2005E
Revenue	$19,747	$22,956	$25,296	$28,365	$32,187	$35,885	$38,260
Information Worker	--	--	8,420	8,212	9,229	10,443	10,756
Client	--	--	8,182	9,360	10,394	11,426	11,997
Server and Tools	--	--	5,837	6,157	7,140	8,257	9,330
MSN	--	--	1,315	1,571	1,953	2,096	2,348
Home & Entertainment	--	--	1,143	2,453	2,748	2,751	2,753
Business Solutions	--	--	106	308	567	692	816
Mobile and Embedded Devices	--	--	70	112	156	220	259
Other (Expedia revenue)	--	--	223	192			
Estimated Unearned Revenue Earnout							
from FQ4:03							
from FQ1:04							
from FQ2:04							
Company Guidance					**$31.9-32.0B**	**$35.6-35.9B**	
Cost of Goods (x)	2,814	3,002	3,455	5,191	5,464	6,172	6,504
Gross Profit	16,933	19,954	21,841	23,174	26,723	29,713	31,756
Operating Expenses	6,890	8,644	10,121	10,604	13,522	17,377	18,376
R&D (x)	2,970	3,775	4,379	4,307	3,512	4,985	5,733
Marketing (x)	3,231	4,141	4,885	5,407	5,616	7,102	8,096
G&A (x)	689	728	857	890	727	1,796	2,048
Estimated Equity Compensation Expense (w)					3,666	3,495	2,500
Operating Income	10,043	11,310	11,720	12,570	13,201	12,336	13,380
One-Time Stock Transfer Compensation Expense (pre-tax)							
Reported Operating Income							
Other Expense	--	--	--	--			
Company Guidance						**$11.4-11.7B**	
Interest Income	1,258	1,673	2,020	2,368	1,957	3,100	3,186
Operating Income (excluding Equity Compensation)						18,931	19,066
Operating Income (excluding realized invest. gains)	11,301	12,879	13,740	14,938	15,158	15,436	16,566
Realized Investment Gains	680	1,666	1,337	95	700	269	400
Operating Income (including realized invest. gains)	11,866	14,545	15,077	15,033	15,858	15,705	16,966
Taxes	4,153	5,055	4,976	4,811	5,233	4,455	5,599
Extraordinary Benefit from Stock Transfer Compensation Expense						725	0
Net Income (Operating)	7,713	9,490	10,101	10,222	10,625	10,525	11,367
One-Time Stock Transfer Compensation Expense (after-tax)						1,480	0
Non recurring charge	--	179	3,874	2,368	1,316	--	--
Goodwill Amortization add back (FAS 142)	--	225	300	--	--	--	--
Net Income (Reported) (f)	7,685	9,516	6,527	7,854	9,309	9,045	11,367
Operating EPS (excl. stock options expense)					1.22	1.18	1.19
Operating EPS (excl. realized investment gains)	$0.66	$0.77	$0.83	$0.91	$0.93	$0.95	$1.01
Operating EPS (incl. realized investment gains) (j)	0.70	0.86	0.91	$0.92	0.98	0.97	1.03
Reported EPS	0.70	0.86	0.67	$0.71	0.86	0.83	1.03
Company Guidance						**$0.82-0.83**	
Shares Outstanding (MM)	10,964	11,073	11,141	11,109	10,886	10,883	11,000
Dividend per Share					$0.08	$0.16	
Growth Rate							
Revenue (Y/Y)	29%	16%	10%	12%	13%	11%	7%
Information Worker	--	--	--	(2)	12	13	3
Client	--	--	--	14	11	10	5
Server and Tools	--	--	--	5	16	16	13
MSN	--	--	--	19	24	7	12
Home & Entertainment	--	--	--	115	12	0	0
Business Solutions	--	--	--	191	84	22	18
Mobile and Embedded Devices	--	--	--	60	39	41	18
Other (Expedia)	--	--	--	--	--	--	--
Revenue (Q/Q)	--	--	--	--	--	--	--
Expenses (Y/Y)	18	25	17	5	28	29	6
Expenses (Q/Q)	--	--	--	--	--	--	--
Operating Income (Y/Y)	45	13	4	7	5	(7)	8
Operating Income excluding investment gains (Y/Y)	48	14	7	9	1	2	7
Operating Income (including investment gains) (Y/Y)	60	23	4	(0)	5	(1)	8
Operating EPS (excluding invest gains) (Y/Y)	48	16	7	11	2	2	6
Reported EPS (Y/Y)	67	23	(22)	5	21	(3)	24
Margin Analysis							
Gross Margin	85.7%	86.9%	86.3%	81.7%	83.0%	82.8%	83.0%
Operating Margin	50.9	49.3	46.3	44.3	41.0	34.4	35.0
Pretax Margin	60.1	63.4	59.6	53.0	49.3	43.8	44.3
Net Margin	39.1	41.3	39.9	36.0	33.0	29.3	29.7
Expenses as Pct. of Revenue							
Cost of Goods Sold			13.7%	18.3%	17.0%	17.2%	17.0%
Operating Expense	34.9%	37.7%	40.0	37.4	42.0	48.4	48.0
R&D	15.0	16.4	17.3	15.2	10.9	13.9	15.0
Marketing	16.4	18.0	19.3	19.1	17.4	19.8	21.2
G&A	3.5	3.2	3.4	3.1	2.3	5.0	5.4
Equity Compensation Expense					11.4	9.7	6.5

(p) To more effectively compare operating EPS (including investment gains) on a sequential basis, we have kept realized gains at the company's previously guided level of $50MM and moved all additional gains above and beyond guidance (about $183MM) below the operating line, to non-recurring charges. After subtracting the $183MM from the $1.82B and tax affecting the difference, the adjusted non-recurring charge equals $1.113B.

(q) Operating EPS (including investment gains) does not include the FQ1 $1.82B write off for First Call comparison purposes. The net effect equals an adjustment to Operating EPS (including investment gains) of $0.20.

(r) MSFT recognized a $660MM charge ($449MM post-tax or about $0.08 EPS) related to the antitrust civil litigation as G&A. We have moved the charge below the operating line, as it is non-recurring. Operating EPS adjusted for the charge is $0.49, as opposed to the $0.41 reported by MSFT.

(s) We have adjusted MSFT F2002E operating EPS guidance of $157-$1.60 to include $0.28 related to one-time non-recurring charges related to civil suit legal payments ($0.08) recognized in FQ2 and losses on investments recognized in FQ1:02 ($0.20)

(t) Operating EPS (including investment gains) does not include the FQ4 $1.19B write off for First Call comparison purposes. The net effect equals an adjustment to Operating EPS (including investment gains) of $0.15.

(u) 7/02 Navision acquisition included in Business Solutions revenue

(v) Though MSFT has elected to treat a $210MM charge related to the estimated settlement of pending state antitrust and unfair competition class action lawsuits as G&A, we have pulled it below the line and treated it as a non-recurring charge. Also, included as a non-recurring charge is a $126 one-time tax benefit related to a recent court ruling reversing previously accrued taxes..

(w) MSFT to start expensing equity compensation in F2004

(x) As of FQ2:04, MSFT has begun to embed stock compensation expense in cost of goods sold and each operating expense item. We have estimated the breakdown of stock compensation for F2004 and have not restated F2003.

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 8
Microsoft — Revenue by Channel

($ in Millions)

	F2003				F2004E				Annual Data			
	9/02	12/02	3/03	6/03	9/03	12/03E	3/04E	6/04E	F2002	F2003	F2004E	F2005E
Total Revenue	$7,746	$8,541	$7,835	$8,065	$8,215	$10,153	$8,624	$8,893	$28,365	$32,187	$35,885	$38,260
Y/Y Change	26%	10%	8%	11%	6%	19%	10%	10%	12%	13%	11%	7%
Total Finished Goods	$5,092	$5,998	$5,340	$5,576	--	--	--	--	$19,369	$22,006	--	--
Pct. of Total	66%	70%	68%	69%	--	--	--	--	68%	68%	--	--
Y/Y % Change	23	12	8	14	--	--	--	--	11	14	--	--
Q/Q % Change	4	18	(11)	4	--	--	--	--	--	--	--	--
Worldwide OEM	$2,654	$2,543	$2,495	$2,489	--	--	--	--	$8,996	$10,181	--	--
Pct. of Total	34%	30%	32%	31%	--	--	--	--	32%	32%	--	--
Y/Y % Change	34	7	9	6	--	--	--	--	14	13	--	--
Q/Q % Change	13	(4)	(2)	(0)	--	--	--	--	--	--	--	--

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 9
Microsoft — Revenue by Product Group

($ Millions)	F2003				F2004E							
	9/02	12/02	3/03	6/03	9/03	12/03	3/04E	6/04E	F2002	F2003	F2004E	F2005E
Total Revenue	$7,746	$8,541	$7,835	$8,065	$8,215	$10,153	$8,624	$8,893	$28,365	$32,187	$35,885	$38,260
Y/Y % Change	26%	10%	8%	11%	6%	19%	10%	10%	12%	13%	11%	7%
Q/Q % Change	7%	10%	(8%)	3%	2%	24%	(15%)	3%	--	--	--	--
Information Worker	$2,268	$2,285	$2,327	$2,349	$2,287	$2,895	$2,583	$2,678	8,212	9,229	10,443	10,756
Pct. of Total	29%	27%	30%	29%	28%	29%	30%	30%	29%	29%	29%	28%
Y/Y % Change	26%	8%	9%	8%	1%	27%	11%	14%	-2%	12%	13%	3%
Q/Q % Change	5%	1%	2%	1%	(3%)	27%	(11%)	4%	--	--	--	--
Client	$2,807	$2,534	$2,527	$2,526	$2,809	$3,059	$2,779	$2,779	9,360	10,394	11,426	11,997
Pct. of Total	36%	30%	32%	31%	34%	30%	32%	31%	33%	32%	32%	31%
Y/Y % Change	34%	(1%)	10%	4%	0%	21%	10%	10%	14%	11%	10%	5%
Q/Q % Change	16%	(10%)	(0%)	(0%)	11%	9%	(9%)	(0%)	--	--	--	--
Server and Tools	$1,625	$1,763	$1,827	$1,925	$1,866	$2,134	$2,101	$2,156	6,157	7,140	8,257	9,330
Pct. of Total	21%	21%	23%	24%	23%	21%	24%	24%	22%	22%	23%	24%
Y/Y % Change	13%	12%	21%	17%	15%	21%	15%	12%	5%	16%	16%	13%
Q/Q % Change	(1%)	8%	4%	5%	(3%)	14%	(2%)	3%	--	--	--	--
MSN	$427	$459	$508	$559	$491	$546	$528	$531	1,571	1,953	2,096	2,348
Pct. of Total	6%	5%	6%	7%	6%	5%	6%	6%	6%	6%	6%	6%
Y/Y % Change	23%	23%	26%	25%	15%	19%	4%	(5%)	19%	24%	7%	12%
Q/Q % Change	(4%)	7%	11%	10%	(12%)	11%	(3%)	1%	--	--	--	--
Home & Entertainment	$485	$1,327	$453	$483	$581	$1,266	$430	$473	2,453	2,748	2,751	2,753
Pct. of Total	6%	16%	6%	6%	7%	12%	5%	5%	9%	9%	8%	0%
Y/Y % Change	82%	38%	(42%)	8%	20%	(5%)	(5%)	(2%)	115%	12%	0%	0%
Q/Q % Change	8%	174%	(66%)	7%	20%	118%	(66%)	10%	--	--	--	--
Business Solutions	$106	$135	$147	$179	$128	$190	$150	$224	308	567	692	816
Pct. of Total	1%	2%	2%	2%	2%	2%	2%	2%	1%	2%	2%	2%
Y/Y % Change	43%	85%	96%	108%	21%	41%	2%	25%	191%	84%	22%	18%
Q/Q % Change	23%	27%	9%	22%	(28%)	48%	(21%)	49%	--	--	--	--
Mobile and Embedded Devices	$28	$38	$46	$44	$53	$63	$52	$52	112	156	220	259
Pct. of Total	0%	0%	1%	1%	1%	1%	1%	1%	0%	0%	1%	2%
Y/Y % Change	17%	46%	77%	22%	89%	66%	13%	19%	60%	39%	41%	18%
Q/Q % Change	(22%)	36%	21%	(4%)	20%	19%	(17%)	1%	--	--	--	--
Other (Expedia Revenue)									192			
Pct. of Total									2%			
Y/Y % Change									-14%			
Q/Q % Change									--			

Fiscal year ends in June.
E = Morgan Stanley Research Estimates

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 10

Microsoft - Revenue/Profit Contribution Analysis by Segment

	F2002				F2003				F2004E			
(in $ thousands)	**9/01**	**12/01**	**3/02**	**6/02**	**9/02**	**12/02**	**3/03**	**6/03**	**9/03**	**12/03**	**3/04E**	**6/04E**
Total Revenue	**$6,126**	**$7,741**	**$7,245**	**$7,253**	**$7,746**	**$8,541**	**$7,835**	**$8,065**	**$8,215**	**$10,153**	**$8,624**	**$8,893**
Growth (Y/Y)	--	--	--	--	26%	10%	8%	11%	6%	19%	10%	10%
Growth (Q/Q)	--	26%	-6%	0%	7%	10%	-8%	3%	2%	24%	-15%	3%
Total Gross Profit	**5,242**	**6,197**	**5,850**	**5,885**	**6,507**	**6,610**	**6,717**	**6,889**	**6,836**	**8,124**	**7,360**	**7,392**
% of Revenue	*86%*	*80%*	*81%*	*81%*	*84%*	*77%*	*86%*	*85%*	*83%*	*80%*	*85%*	*83%*
Growth (Y/Y)	*6%*	*9%*	*6%*	*3%*	*24%*	*7%*	*15%*	*17%*	*5%*	*23%*	*10%*	*7%*
Growth (Q/Q)	*-8%*	*18%*	*-6%*	*1%*	*11%*	*2%*	*2%*	*3%*	*-1%*	*19%*	*-9%*	*0%*
Total Operating Income	**2,897**	**3,501**	**3,298**	**2,874**	**3,028**	**3,469**	**3,715**	**2,989**	**3,148**	**3,680**	**3,122**	**2,386**
% of Revenue	*47%*	*45%*	*46%*	*40%*	*39%*	*41%*	*47%*	*37%*	*38%*	*36%*	*36%*	*27%*
Growth (Y/Y)	*4%*	*10%*	*10%*	*4%*	*5%*	*-1%*	*13%*	*4%*	*4%*	*6%*	*-16%*	*-20%*
Growth (Q/Q)	*5%*	*21%*	*-6%*	*-13%*	*5%*	*15%*	*7%*	*-20%*	*5%*	*17%*	*-15%*	*-24%*
By Product Group	**9/01**	**12/01**	**3/02**	**6/02**	**9/02**	**12/02**	**3/03**	**6/03**	**9/03**	**12/03**	**3/04E**	**6/04E**
Information Worker Revenue	1,932	2,202	2,061	2,133	2,268	2,285	2,327	2,349	2,287	2,895	2,583	2,678
% of Total Revenue	*32%*	*28%*	*28%*	*29%*	*29%*	*27%*	*30%*	*29%*	*28%*	*29%*	*30%*	*30%*
Growth (Y/Y)	--	--	--	--	*17%*	*4%*	*13%*	*10%*	*1%*	*27%*	*11%*	*14%*
Growth (Q/Q)	--	*14%*	*-6%*	*3%*	*6%*	*1%*	*2%*	*1%*	*-3%*	*27%*	*-11%*	*4%*
Operating Income	1,476	1,737	1,608	1,619	1,879	1,883	1,939	1,692	1,591	--	--	--
% of Total Operating Income	*51%*	*50%*	*49%*	*56%*	*62%*	*54%*	*52%*	*57%*	*51%*	--	--	--
% of Category Revenue	*76%*	*79%*	*78%*	*76%*	*83%*	*82%*	*83%*	*72%*	*70%*	--	--	--
Growth (Y/Y)	--	--	--	--	*27%*	*8%*	*21%*	*5%*	*-15%*	--	--	--
Growth (Q/Q)	--	*18%*	*-7%*	*1%*	*16%*	*0%*	*3%*	*-13%*	*-6%*	--	--	--
Client Revenue	2,076	2,675	2,303	2,296	2,807	2,534	2,527	2,526	2,809	3,059	2,779	2,779
% of Total Revenue	*34%*	*35%*	*32%*	*32%*	*36%*	*30%*	*32%*	*31%*	*34%*	*30%*	*32%*	*31%*
Growth (Y/Y)	--	--	--	--	*35%*	*-5%*	*10%*	*10%*	*0%*	*21%*	*10%*	*10%*
Growth (Q/Q)	--	*29%*	*-14%*	*0%*	*22%*	*-10%*	*0%*	*0%*	*11%*	*9%*	*-9%*	*0%*
Operating Income	1,708	2,114	1,875	1,832	2,482	1,965	1,988	1,846	2,264	--	--	--
% of Total Operating Income	*59%*	*60%*	*57%*	*64%*	*82%*	*57%*	*54%*	*62%*	*72%*	--	--	--
% of Category Revenue	*82%*	*79%*	*81%*	*80%*	*88%*	*78%*	*79%*	*73%*	*81%*	--	--	--
Growth (Y/Y)	--	--	--	--	*45%*	*-7%*	*6%*	*1%*	*-9%*	--	--	--
Growth (Q/Q)	--	*24%*	*-11%*	*-2%*	*35%*	*-21%*	*1%*	*-7%*	*23%*	--	--	--
Server and Tools Revenue	1,330	1,444	1,369	1,489	1,625	1,763	1,827	1,925	1,866	2,134	2,101	2,156
% of Total Revenue	*22%*	*19%*	*19%*	*21%*	*21%*	*21%*	*23%*	*24%*	*23%*	*21%*	*24%*	*24%*
Growth (Y/Y)	--	--	--	--	*22%*	*22%*	*33%*	*29%*	*15%*	*21%*	*15%*	*12%*
Growth (Q/Q)	--	*9%*	*-5%*	*9%*	*9%*	*8%*	*4%*	*5%*	*-3%*	*14%*	*-2%*	*3%*
Operating Income	350	402	343	314	519	498	421	410	370	--	--	--
% of Total Operating Income	*12%*	*11%*	*10%*	*11%*	*17%*	*14%*	*11%*	*14%*	*12%*	--	--	--
% of Category Revenue	*26%*	*28%*	*25%*	*21%*	*32%*	*28%*	*23%*	*21%*	*20%*	--	--	--
Growth (Y/Y)	--	--	--	--	*48%*	*24%*	*23%*	*31%*	*-29%*	--	--	--
Growth (Q/Q)	--	*15%*	*-15%*	*-8%*	*65%*	*-4%*	*-15%*	*-3%*	*-10%*	--	--	--
MSN Revenue (includes Expedia)	431	462	501	530	427	459	508	559	491	546	528	531
% of Total Revenue	*7%*	*6%*	*7%*	*7%*	*6%*	*5%*	*6%*	*7%*	*6%*	*5%*	*6%*	*6%*
Growth (Y/Y)	--	--	--	--	*-1%*	*-1%*	*1%*	*5%*	*15%*	*19%*	*4%*	*-5%*
Growth (Q/Q)	--	*7%*	*8%*	*6%*	*-19%*	*7%*	*11%*	*10%*	*-12%*	*11%*	*-3%*	*1%*
Operating Income	(199)	(211)	(141)	(195)	(97)	(157)	(92)	(48)	58	--	--	--
% of Total Operating Income	*-7%*	*-6%*	*-4%*	*-7%*	*-3%*	*-5%*	*-2%*	*-2%*	*2%*	--	--	--
% of Category Revenue	*-46%*	*-46%*	*-28%*	*-37%*	*-23%*	*-34%*	*-18%*	*-9%*	*12%*	--	--	--
Growth (Y/Y)	--	--	--	--	--	*-26%*	*-35%*	*-75%*	*-160%*	--	--	--
Growth (Q/Q)	--	*6%*	*-33%*	*38%*	*-50%*	*62%*	*-41%*	*-48%*	*-221%*	--	--	--
Home & Entertainment Revenue	236	833	943	399	485	1,327	453	483	581	1,266	430	473
% of Total Revenue	*4%*	*11%*	*13%*	*6%*	*6%*	*16%*	*6%*	*6%*	*7%*	*12%*	*5%*	*5%*
Growth (Y/Y)	--	--	--	--	*106%*	*59%*	*-52%*	*21%*	*20%*	*-5%*	*-5%*	*-2%*
Growth (Q/Q)	--	*253%*	*13%*	*-58%*	*22%*	*174%*	*-66%*	*7%*	*20%*	*118%*	*-66%*	*10%*
Operating Income	(68)	(180)	(97)	(521)	(177)	(348)	(190)	(225)	(273)	--	--	--
% of Total Operating Income	*-2%*	*-5%*	*-3%*	*-18%*	*-6%*	*-10%*	*-5%*	*-8%*	*-9%*	--	--	--
% of Category Revenue	*-29%*	*-22%*	*-10%*	*-131%*	*-36%*	*-26%*	*-42%*	*-47%*	*-47%*	--	--	--
Growth (Y/Y)	--	--	--	--	--	*93%*	*96%*	*-57%*	*54%*	--	--	--
Growth (Q/Q)	--	*165%*	*-46%*	*437%*	*-66%*	*97%*	*-45%*	*18%*	*21%*	--	--	--
Business Solutions Revenue	74	73	75	86	106	135	147	179	128	190	150	224
% of Total Revenue	*1%*	*1%*	*1%*	*1%*	*1%*	*2%*	*2%*	*2%*	*2%*	*2%*	*2%*	*3%*
Growth (Y/Y)	--	--	--	--	*43%*	*85%*	*96%*	*108%*	*21%*	*41%*	*2%*	*25%*
Growth (Q/Q)	--	*-1%*	*3%*	*15%*	*23%*	*27%*	*9%*	*22%*	*-28%*	*48%*	*-21%*	*49%*
Operating Income	(39)	(41)	(48)	(68)	(68)	(93)	(67)	(80)	(79)	--	--	--
% of Total Operating Income	*-1%*	*-1%*	*-1%*	*-2%*	*-2%*	*-3%*	*-2%*	*-3%*	*-3%*	--	--	--
% of Category Revenue	*-53%*	*-56%*	*-64%*	*-79%*	*-64%*	*-69%*	*-46%*	*-45%*	*-62%*	--	--	--
Growth (Y/Y)	--	--	--	--	--	*127%*	*40%*	*18%*	--	--	--	--
Growth (Q/Q)	--	*5%*	*17%*	*42%*	*0%*	*37%*	*-28%*	*19%*	*-1%*	--	--	--
Mobile and Embedded Devices	14	17	24	69	28	38	46	44	53	63	52	52
% of Total Revenue	*0%*	*0%*	*0%*	*1%*	*0%*	*0%*	*1%*	*1%*	*1%*	*1%*	*1%*	*1%*
Growth (Y/Y)	--	--	--	--	*100%*	*124%*	*92%*	*-36%*	*89%*	*66%*	*13%*	*19%*
Growth (Q/Q)	--	*21%*	*41%*	*188%*	*-59%*	*36%*	*21%*	*-4%*	*20%*	*19%*	*-17%*	*1%*
Operating Income	(48)	(61)	(46)	(85)	(33)	(39)	(42)	(61)	(32)	--	--	--
% of Total Operating Income	*-2%*	*-2%*	*-1%*	*-3%*	*-1%*	*-1%*	*-1%*	*-2%*	*-1%*	--	--	--
% of Category Revenue	*-343%*	*-359%*	*-192%*	*-123%*	*-118%*	*-103%*	*-91%*	*-139%*	*-60%*	--	--	--

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Please see analyst certification and other important disclosures starting on page 24

Exhibit 11

Microsoft Balance Sheet

($ Millions)

	F2002				F2003				F2004E	
	9/01	12/01	3/02	6/02	9/02	12/02	3/03	6/03	9/03	12/03
Total Assets	**$61,367**	**$65,387**	**$68,379**	**$67,646**	**$70,235**	**$72,359**	**$74,482**	**$81,732**	**$84,281**	**$85,937**
Current Assets	**44,332**	**47,988**	**47,827**	**48,576**	**50,043**	**52,931**	**54,672**	**58,973**	**60,910**	**62,400**
Cash & Equivalents and Short-term investments	36,163	38,229	38,693	38,652	40,475	43,424	46,178	49,048	51,622	52,777
Real Cash Change (e)	*4,563*	*2,066*	*464*	*(41)*	*1,823*	*2,949*	*2,754*	*2,870*	*2,574*	*1,155*
Accounts Receivable	3,615	5,095	4,230	5,129	4,450	4,894	4,075	5,196	4,533	5,608
Deferred Income Taxes	1,993	1,972	2,086	2,112	2,401	2,347	2,257	2,506	2,206	2,068
Other	2,561	2,692	2,818	2,683	2,717	2,266	2,162	2,223	2,549	1,947
PP&E	2,261	2,240	2,182	2,268	2,189	2,257	2,208	2,223	2,193	2,178
Equity Investments and Other Assets	14,774	15,159	18,370	16,802	18,003	17,171	17,602	20,536	21,178	21,359
Liabilities + Shareholders' Equity	**61,367**	**65,387**	**68,379**	**67,646**	**70,235**	**72,359**	**74,482**	**81,732**	**85,162**	**85,937**
Liabilities	**12,862**	**13,839**	**14,079**	**15,466**	**16,719**	**16,547**	**16,200**	**16,820**	**17,986**	**16,594**
Accounts Payable	1,143	1,229	1,136	1,208	1,189	1,342	1,310	1,573	1,341	1,360
Accrued Compensation	586	899	822	1,145	851	1,060	1,129	1,416	869	1,143
Unearned Revenue	5,849	6,621	6,914	7,743	9,131	8,836	8,532	9,015	8,247	7,852
Absolute Change	*235*	*772*	*293*	*829*	*1,388*	*(295)*	*(304)*	*483*	*(768)*	*(395)*
Seq. Change	*4%*	*13%*	*4%*	*12%*	*18%*	*-3%*	*-3%*	*6%*	*-9%*	*-5%*
Income Taxes Payable	2,131	2,396	2,477	2,420	3,459	2,954	2,915	2,044	2,600	3,500
Other	3,153	2,694	2,730	2,950	2,089	2,355	2,314	2,772	4,929	2,739
Shareholders' Equity	**48,505**	**51,548**	**54,300**	**52,180**	**53,516**	**55,812**	**58,282**	**64,912**	**67,176**	**69,343**
Check	0	0	0	0	0	0	0	0	(881)	0
Shares Outstanding	**11,133**	**11,112**	**11,129**	**11,060**	**10,933**	**10,883**	**10,864**	**10,862**	**10,885**	**10,810**
Ratio Analysis										
Cash Per Share	$3.25	$3.44	$3.48	$3.49	$3.70	$3.99	$4.25	$4.52	$4.74	$4.88
Book Value per Share	$4.36	$4.64	$4.88	$4.72	$4.89	$5.13	$5.36	$5.98	$6.17	$6.41
Days of Accts. Receivable (a)	53	59	53	64	52	52	47	58	50	54
Days of Accts. Payable	116	72	73	79	86	63	105	120	88	107

(a) Based on L6M annualized revenue.
(b) Based on L12M net operating income.
(c) Cash & Equivalents increased $857MM from proceeds of preferred stock offering on 12/17/96.
(d) Other assets includes $1 billion investment in Comcast.
(e) Real cash change excludes one time events.
(f) Cash & Equivalents decreased $190MM due to purchase of WebTV Networks.
(g) Cash & Equivalents increased $79MM from proceeds of Softimage sale to Avid Technology.
Fiscal year ends in June.

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 12

Microsoft — Unearned Revenue by Term and Product Group

($ millions)	9/00	12/00	3/01	6/01	9/01	12/01	3/02	6/02	9/02	12/02	3/03	6/03	9/03	12/03	3/04E	6/04E
		F2001				F2002				F2003			F2004E			
Total Unearned Revenue	**4,766**	**5,124**	**5,305**	**5,614**	**5,849**	**6,621**	**6,914**	**7,743**	**9,131**	**8,836**	**8,532**	**9,015**	**8,247**	**7,852**	**7,352**	**7,852**
Y/Y Change	*16%*	*20%*	*19%*	*17%*	*23%*	*29%*	*30%*	*38%*	*56%*	*33%*	*23%*	*16%*	*-10%*	*-11%*	*-14%*	*-13%*
Q/Q Change	*-1%*	*8%*	*4%*	*6%*	*4%*	*13%*	*4%*	*12%*	*18%*	*-3%*	*-3%*	*6%*	*-9%*	*-5%*	*-6%*	*7%*
Short-Term	--	--	--	**4,395**	**4,620**	**5,300**	**5,568**	**5,920**	**6,841**	**6,810**	**6,798**	**7,225**	**6,620**	**6,229**	**5,882**	**6,282**
Y/Y Change	--	--	--	--	--	--	--	*35%*	*48%*	*28%*	*22%*	*22%*	*-3%*	*-9%*	*-13%*	*-13%*
Q/Q Change	--	--	--	--	*5%*	*15%*	*5%*	*6%*	*16%*	*0%*	*0%*	*6%*	*-8%*	*-6%*	*-6%*	*7%*
Long-Term	--	--	--	**1,219**	**1,229**	**1,321**	**1,346**	**1,823**	**2,290**	**2,026**	**1,734**	**1,790**	**1,627**	**1,623**	**1,470**	**1,570**
Y/Y Change	--	--	--	--	--	--	--	*50%*	*86%*	*53%*	*29%*	*-2%*	*-29%*	*-20%*	*-15%*	*-12%*
Q/Q Change	--	--	--	--	*1%*	*7%*	*2%*	*35%*	*26%*	*-12%*	*-14%*	*3%*	*-9%*	*0%*	*-9%*	*7%*
Unearned Revenue related to multi-year licensing agreements										**1,879**	**2,037**	**2,258**	**2,218**	**3,166**	**2,560**	**1,940**
% of total revenue										*22%*	*26%*	*28%*	*27%*	*31%*	*30%*	*22%*

($ millions)	9/00	12/00	3/01	6/01	9/01	12/01	3/02	6/02	9/02	12/02	3/03	6/03	9/03	12/03	3/04E	6/04E
		F2001				F2002				F2003			F2004E			
Total Unearned Revenue	**4,766**	**5,124**	**5,305**	**5,614**	**5,849**	**6,621**	**6,914**	**7,743**	**9,131**	**8,836**	**8,532**	**9,015**	**8,247**	**7,852**	**7,352**	**7,852**
Y/Y Change	*16%*	*20%*	*19%*	*17%*	*23%*	*29%*	*30%*	*38%*	*56%*	*33%*	*23%*	*16%*	*-10%*	*-11%*	*-14%*	*-13%*
Q/Q Change	*-1%*	*8%*	*4%*	*6%*	*4%*	*13%*	*4%*	*12%*	*18%*	*-3%*	*-3%*	*6%*	*-9%*	*-5%*	*-6%*	*7%*
Client	**2,473**	**2,593**	**2,645**	**2,639**	**2,661**	**2,879**	**2,925**	**3,023**	**3,221**	**3,252**	**3,145**	**3,165**	**3,013**	**2,954**	**2,766**	**2,954**
% of Total	*52%*	*51%*	*50%*	*47%*	*46%*	*43%*	*42%*	*39%*	*35%*	*37%*	*37%*	*35%*	*37%*	*38%*	*38%*	*38%*
Y/Y Change	--	--	--	--	*8%*	*11%*	*11%*	*15%*	*21%*	*13%*	*8%*	*5%*	*-6%*	*-9%*	*-12%*	*-7%*
Q/Q Change	--	*5%*	*2%*	*0%*	*1%*	*8%*	*2%*	*3%*	*7%*	*1%*	*-3%*	*1%*	*-5%*	*-2%*	*-6%*	*7%*
Information Worker	**1,428**	**1,638**	**1,677**	**1,780**	**1,959**	**2,339**	**2,391**	**2,757**	**3,485**	**3,264**	**3,138**	**3,305**	**3,009**	**2,635**	**2,467**	**2,635**
% of Total	*30%*	*32%*	*32%*	*32%*	*34%*	*35%*	*35%*	*36%*	*38%*	*37%*	*37%*	*37%*	*36%*	*34%*	*34%*	*34%*
Y/Y Change	--	--	--	--	*37%*	*43%*	*43%*	*55%*	*78%*	*40%*	*31%*	*20%*	*-14%*	*-19%*	*-21%*	*-20%*
Q/Q Change	--	*15%*	*2%*	*6%*	*10%*	*19%*	*2%*	*15%*	*26%*	*-6%*	*-4%*	*5%*	*-9%*	*-12%*	*-6%*	*7%*
Server and Tools Platforms	**516**	**565**	**636**	**650**	**740**	**954**	**1,176**	**1,595**	**2,050**	**1,962**	**1,893**	**2,185**	**1,917**	**1,945**	**1,821**	**1,945**
% of Total	*11%*	*11%*	*12%*	*12%*	*13%*	*14%*	*17%*	*21%*	*22%*	*22%*	*22%*	*24%*	*23%*	*25%*	*25%*	*25%*
Y/Y Change	--	--	--	--	*43%*	*69%*	*85%*	*145%*	*177%*	*106%*	*61%*	*37%*	*-6%*	*-1%*	*-4%*	*-11%*
Q/Q Change	--	*9%*	*13%*	*2%*	*14%*	*29%*	*23%*	*36%*	*29%*	*-4%*	*-4%*	*15%*	*-12%*	*1%*	*-6%*	*7%*
All Other	**349**	**328**	**348**	**546**	**488**	**449**	**422**	**368**	**375**	**358**	**356**	**360**	**308**	**318**	**298**	**318**
% of Total	*7%*	*6%*	*7%*	*10%*	*8%*	*7%*	*6%*	*5%*	*4%*	*4%*	*4%*	*4%*	*4%*	*4%*	*4%*	*4%*
Y/Y Change	--	--	--	--	*40%*	*37%*	*21%*	*-33%*	*-23%*	*-20%*	*-16%*	*-2%*	*-18%*	*-11%*	*-16%*	*-12%*
Q/Q Change	--	*-6%*	*6%*	*57%*	*-11%*	*-8%*	*-6%*	*-13%*	*2%*	*-5%*	*-1%*	*1%*	*-14%*	*3%*	*-6%*	*7%*

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 13

Microsoft Cash Flow Statement

($ Millions)

	F2002				F2003					
	9/01	12/01	3/02	6/02	9/02	12/02	3/03	6/03	9/03	12/03
Operations										
Net income	$1,283	$2,283	$2,738	$1,525	$2,041	3,237	$2,794	$1,921	$2,614	1,549
Depreciation and amortization	282	295	148	359	273	319	375	472	328	300
Depreciation					*201*	*222*	*204*	*378*	*205*	*254*
Stock based compensation										3,232
Net Recognized losses on investments	1,517	(55)	(210)	1,172	475	140	(17)	(218)	(279)	(321)
Change in Working Capital	307	1,042	1,445	378	3,383	119	1,017	514	761	(186)
Unearned revenue	2,069	2,721	2,521	3,841	4,093	2,500	2,463	3,463	2,214	2,774
Recognition of unearned revenue	(1,879)	(1,949)	(2,089)	(3,012)	(2,743)	(2,795)	(2,770)	(2,984)	(2,983)	(3,166)
Stock option income tax benefits	415	336	346	499	365	307	329	375	489	148
Deferred income taxes	(839)	(22)	144	301	(939)	87	503	685	6	(985)
Change in Other liabilities	389	1,435	186	(345)	817	15	(373)	16	(328)	1,385
Change in Accounts receivable	69	(1,468)	654	(878)	751	(349)	823	(1,038)	676	(1,004)
Change in Other assets	83	(11)	(317)	(28)	(9)	354	42	(3)	(328)	662
Cumulative effect of accounting change	0	0	0	0	1,048	0	0	0	1,015	
Net Cash From Operations	3,389	3,565	4,121	3,434	6,172	3,815	4,169	2,689	3,424	4,574
Financing										
Common stock issued	391	395	425	286	539	365	485	731	695	189
Common stock repurchased	(1,125)	(141)	(676)	(4,127)	(3,497)	(936)	(839)	(1,214)	(1,045)	(730)
Structured stock repurchase	0	0	0	0	0	0	0	0	0	0
Put warrant proceeds	0	0	0	0	0	0	0	0	0	0
Preferred stock dividends	0	0	0	0	0	0	0	0	0	0
Common stock dividends	0	0	0	0	0	0	(857)	0	0	(1,729)
Net Cash From Financing	(734)	254	(251)	(3,841)	(2,958)	(571)	(1,211)	(483)	(350)	(2,270)
Investing										
Additions to property and equipment	(150)	(172)	(166)	(282)	(160)	(276)	(182)	(273)	(167)	(172)
Cash proceeds from sale of Softimage	0	0	0	0	0	0	0	0	0	0
Acquisition of Companies, net of cash acquired	0	0	0	0	(870)	(9)	(12)	(172)	(4)	0
Purchases of investments	(16,020)	(16,419)	(27,809)	(29,138)	(26,685)	(19,406)	(25,106)	(18,424)	(24,598)	(22,377)
Maturities of investments	861	1,429	1,801	4,563	3,230	3,302	710	1,963	2,650	825
Sales of investments	11,840	13,482	22,178	23,157	23,588	14,370	20,384	16,816	18,371	19,775
Net Cash From Investing	(3,469)	(1,680)	(3,996)	(1,700)	(897)	(2,020)	(4,206)	(90)	(3,748)	(1,949)
Net Change in Cash and Equivalents	(814)	2,139	(126)	(2,107)	2,317	1,224	(1,248)	2,116	(674)	355
Effect of Exchange Rates on Cash and Equiv.	5	4	(14)	7	5	38	(4)	22	4	26
Cash and Cash Equivalents, Beginning of Period	3,922	3,113	5,256	5,116	3,016	5,338	6,600	5,348	6,438	5,768
Cash and Equivalents, End of Period	3,113	5,256	5,116	3,016	5,338	6,600	5,348	7,486	5,768	6,149
EBITDA	**3,179**	**3,796**	**3,446**	**3,233**	**3,301**	**3,788**	**4,090**	**3,461**	**3,476**	**3,980**

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 14

Microsoft — Discounted Price/Earnings Valuation

(Equity Value $MM)

	Downside Case			Base Case			Upside Case		
Implied C2002-C2005E Revenue CAGR		9%			9%			18%	
CY2005E Revenues		$40,000			$39,599			$50,000	
Operating Margin (excl. investment/interest income)	*26%*	*36%*	*38%*	*26%*	*36%*	*38%*	*26%*	*36%*	*38%*
Net Margin	*24%*	*31%*	*32%*	*24%*	*31%*	*32%*	*24%*	*31%*	*32%*
C2005E Net Income	$9,600	$12,330	$12,800	$9,504	$12,207	$12,672	$12,000	$15,413	$16,000
C2005E EPS	$0.86	$1.10	$1.15	$0.85	$1.09	$1.13	$1.07	$1.38	$1.43

1 Yr Fwd P/E	Discount Rate	Valuation			Valuation			Valuation		
20 x	10%	$183,505	$235,696	$244,673	$181,665	$233,333	$242,221	$229,381	$294,620	$305,842
	15%	179,465	230,507	239,286	177,666	228,196	236,887	$224,331	$288,133	$299,108
25 x	10%	$229,381	$294,620	$305,842	$227,082	$291,667	$302,776	$286,727	$368,275	$382,302
	15%	$224,331	$288,133	$299,108	$222,082	285,245	296,109	$280,414	$360,167	$373,885
30 x	10%	$275,258	$353,544	$367,010	$272,498	$350,000	$363,331	$344,072	$441,930	$458,763
	15%	$269,197	$345,760	$358,929	$266,498	342,294	355,331	$336,496	$432,200	$448,662
35 x	10%	$321,134	$412,468	$428,179	$317,915	$408,333	$423,886	$401,417	$515,585	$535,223
	15%	$314,063	$403,386	$418,751	$310,915	$399,342	$414,553	$392,579	$504,233	$523,439
40 x	10%	$367,010	$471,392	$489,347	$363,331	$466,666	$484,441	$458,763	$589,240	$611,684
	15%	$358,929	$461,013	$478,573	$355,331	$456,391	$473,775	$448,662	$576,266	$598,216

(Per Share)

1 Yr Fwd P/E	Discount Rate	Valuation			Valuation			Valuation		
20 x	10%	$16	$21	$22	$16	$21	$22	$21	$26	$27
	15%	$16	$21	$21	$16	$20	$21	$20	$26	$27
25 x	10%	$21	$26	$27	$20	$26	$27	$26	$33	$34
	15%	$20	$26	$27	$20	$26	$27	$25	$32	$33
30 x	10%	$25	$32	$33	$24	$31	$33	$31	$40	$41
	15%	$24	$31	$32	$24	$31	$32	$30	$39	$40
35 x	10%	$29	$37	$38	$28	$37	$38	$36	$46	$48
	15%	$28	$36	$38	$28	$36	$37	$35	$45	$47
40 x	10%	$33	$42	$44	$33	$42	$43	$41	$53	$55
	15%	$32	$41	$43	$32	$41	$42	$40	$52	$54

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Exhibit 15

Microsoft — Discounted Cash Flow (DCF) Analysis

($ Millions)	C2000	C2001	C2002	C2003E	C2004E	C2005E	C2006E	C2007E	C2008E	C2009E	C2010E	TERMINAL VALUE
REVENUE	$23,776	$26,847	$30,785	$34,036	$37,072	$39,599	$42,371	$45,337	$48,510	$51,906	$55,271	
Y/Y Growth	--	*13%*	*15%*	*11%*	*9%*	*7%*	*7%*	*7%*	*7%*	*7%*	*6%*	
EBITDA	11,768	13,771	13,768	14,061	14,005	15,571	17,260	18,594	19,972	21,550	23,051	
Y/Y Growth	--	*17%*	*0%*	*2%*	*0%*	*11%*	*11%*	*8%*	*7%*	*8%*	*7%*	
As % of Revenue	*49%*	*51%*	*45%*	*41%*	*38%*	*39%*	*41%*	*41%*	*41%*	*42%*	*42%*	
CASH TAXES	4,686	4,818	4,938	5,050	5,227	5,744	6,271	6,686	7,119	7,606	8,058	
As % of EBITDA	*40%*	*35%*	*36%*	*36%*	*37%*	*37%*	*36%*	*36%*	*36%*	*35%*	*35%*	
WORKING CAP CHANGE	3,134	2,746	4,103	4,249	1,914	236	131	127	(160)	29	521	
As % of Revenue Increase	--	*89%*	*104%*	*131%*	*63%*	*9%*	*5%*	*4%*	*-5%*	*1%*	*15%*	
CAPEX	991	937	831	847	817	843	868	894	921	949	967	
As % of Revenue	*4%*	*3%*	*3%*	*2%*	*2%*	*2%*	*2%*	*2%*	*2%*	*2%*	*2%*	
FREE CASH FLOW	9,224	10,762	12,102	12,413	9,875	9,220	10,251	11,140	11,772	13,025	14,546	622,588
Y/Y Growth	--	--	--	*3%*	*-20%*	*-7%*	*11%*	*9%*	*6%*	*11%*	*12%*	
NPV of Free Cash Flows	--	--	--	12,413	9,018	7,690	7,808	7,749	7,478	7,556	7,707	329,839

DCF Valuation Target for 12/31/03	
Net Present Value (NPV)	**$384,844**
Less Debt	$0
Plus Cash	$52,777
Full Value	$437,621
Shares Outstanding ('000) - Diluted	10,810
Hurdle Rate*	**9.5%**
Future Growth Rate	**7.0%**
DCF Per Share Value	**$40**

DCF Valuation Sensitivity

Fut. Growth Rate \ *Discount Rate*	**9.0%**	**9.5%**	**10.0%**	**11.0%**
4.0%	$25	$23	$22	$19
5.0%	$29	$27	$24	$21
6.0%	$36	$32	$28	$23
7.0%	$49	$40	$35	$27
8.0%	$90	$61	$47	$33

Terminal Value as a % of NPV
86%

Implied Exit EBITDA Multiple	**Implied Exit Future Cash Flow Multiple**
27x	43 x

Comments on Assumptions

Revenue: DCF conservatively assumes 7% C2003-C2010 revenue CAGR, with potential upside coming from improved economic/IT spending visibility, improved PC unit growth, traction in consumer efforts, and execution in web services and Business Solutions.

EBITDA: Peak C2001 margin of 51%, declining to 41%-42% in outer years. Could be conservative owing to diminishing losses in consumer efforts, increased traction in higher-margin revenue streams (i.e. Servers and desktop software), and improved cost control.

Working Cap: significant source of cash.

Capex: assumption only for new facilities and roughly 1-2% of revenue going forward (low capex model).

** Note that we use a Hurdle Rate rather than the Weighted Average Cost of Capital (WACC) as the discount rate for our DCF analysis. We believe that a Hurdle Rate is more appropriate because it more accurately reflects what we view as company-specific risks. We calculate the Cost of Equity at 8.4% based on a risk-free rate of 3.9% taken from the 10 year U.S. Government Bond Yield as of 10/31/02; a risk premium of 4.0% from Morgan Stanley Economics Research estimates of expected equity risk premium; and beta of 1.11 from Bloomberg relative to the S&P 500 as of 10/31/02. Note that Microsoft's debt is immaterial.*

***In determining cash flows, we forecast out revenue, EBITDA, cash taxes, working capital changes, and capex through C2010E. Free cash flow in a year is equal to EBITDA minus cash taxes minus working capital uses minus capex. We then use the hurdle rate to calculate the present value of each year's free cash flow. The terminal value is the C2010E free cash flow multiplied by the future growth rate and divided by the difference between the hurdle rate and future growth rate. The net present value is the sum of the present value of all the free cash flows. To determine DCF per share value, we subtract debt and add cash to the net present value and then divide by shares outstanding.*

EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization; NPV = Net Present Value; A-T Debt Cost = After-Tax Debt Cost. Source: Morgan Stanley Internet Research

Source: Morgan Stanley Internet Research

Fiscal year ends June

Source: Morgan Stanley Internet Research; E = Morgan Stanley Research Estimates

Please see analyst certification and other important disclosures starting on page 24

Exhibit 16

Internet & PC Applications Software Coverage Universe Comps Table

PRICE INFORMATION

Company	Ticker	Rating	1/21/04 Price	Diluted Shares	Mkt Cap. (MM)	% Price Change 2001	2002	2003	2004 YTD	52-Week Range	
Amazon.com	AMZN	O-V	56.20	394	$22,136	(30%)	75%	179%	7%	$61	$20
Ask Jeeves	ASKJ	U-V	23.35	58	1,352	39	(25)	608	29	25	3
CNET	CNET	E-V	8.82	141	1,239	(44)	(70)	152	29	10	1
drugstore.com	DSCM	E-V	7.91	70	554	115	23	130	43	9	2
eBay	EBAY	O-V	64.38	662	42,634	103	1	91	(0)	67	36
FreeMarkets	FMKT	E-V	7.88	46	361	26	(73)	4	18	10	4
Intuit	INTU	O-V	49.54	199	9,846	8	10	13	(6)	54	33
Microsoft	MSFT	O-V	28.30	10,885	308,046	53	(22)	6	3	30	23
priceline.com	PCLN	E-V	21.22	40	845	343	(73)	86	19	40	7
VeriSign	VRSN	E-V	19.90	244	4,851	(49)	(79)	103	22	21	7
Yahoo!	YHOO	O-V	47.38	637	30,202	(41)	(8)	175	5	50	17
Nasdaq	COMP	--	2,143	--	--	(21)	(32)	50	7	2,150	1,253
MSH	MSH	--	515	--	--	(24)	(43)	65	8	524	268
MOX	MOX	--	15	--	--	(52)	(43)	64	12	15	7
S&P 500	SPX	--	1,148	--	--	(13)	(23)	26	3	1,149	789

FUNDAMENTALS

Company	Revenue C03E	Revenue C04E	Operating Income C03E	Operating Income C04E	Operating EPS C03E	Operating EPS C04E	F03E Gross Marg.	F03E Oper. Marg.
Amazon.com	$5,169	$6,155	$348	$466	$0.62	$0.90	24%	7%
Ask Jeeves	105	--	(75)	--	0.36	--	80	19
CNET	242	277	(17)	10	(0.16)	0.03	43	(7)
drugstore.com	246	391	(16)	(6)	(0.22)	(0.07)	20	(6)
eBay	2,165	3,000	695	983	0.75	1.04	81	32
FreeMarkets	152	175	0	5	0.03	0.10	54	0
Intuit	1,776	2,034	448	539	1.50	1.71	80	25
Microsoft	34,036	37,072	12,768	12,858	0.96	1.00	83	38
priceline.com	867	868	15	25	0.45	0.66	17	2
VeriSign	1,044	949	184	185	0.55	0.55	57	18
Yahoo!	1,473	2,298	296	504	0.37	0.53	86	20
S&P 500	--	--	--	--	55.00	--	--	--

VALUATION

Company	P/E Ratios C03E	P/E Ratios C04E	C03-C06 EPS CAGR (%)	C03E P/E to Growth	Mkt Cap to Rev C03E	Mkt Cap to Rev C04E	Ent. Value to EBITDA C03E	Ent. Value to EBITDA C04E
Amazon.com	91	62	53	1.7	4.3	3.6	55	43
Ask Jeeves	65	--	--	--	12.8	--	46	--
CNET	--	--	--	--	5.1	4.5	1,626	46
drugstore.com	--	--	--	--	2.3	1.4	--	148
eBay	86	62	32	2.6	19.7	14.2	51	37
FreeMarkets	435	133	198	2.2	2.4	2.1	18	18
Intuit	33	29	13	2.6	5.5	4.8	16	14
Microsoft	30	28	6	5.3	9.1	8.3	18	18
priceline.com	77	53	38	2.0	1.0	1.0	26	20
VeriSign	36	36	13	2.8	4.6	5.1	14	14
Yahoo!	129	90	45	2.9	20.5	13.1	65	36
S&P 500	21	--	12	1.8	--	--	--	--

Source: Morgan Stanley Internet Research

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The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Brian Pitz, Mary Meeker.

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(as of December 31, 2003)

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	592	32%	241	38%	41%
Equal-weight	856	46%	287	46%	34%
Underweight	402	22%	98	16%	24%
Total	1,850		626		

Data include common stock and ADRs currently assigned ratings. For disclosure purposes (in accordance with NASD and NYSE requirements), we note that Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively. However, Overweight, Equal-weight, and Underweight are not the equivalent of buy, neutral, and sell but represent recommended relative weightings (see definitions below). An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O). The stock’s total return is expected to exceed the average total return of the analyst’s industry (or industry team’s) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

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More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst’s view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months. Ratings prior to March 18, 2002: SB=Strong Buy; OP=Outperform; N=Neutral; UP=Underperform. For definitions, please go to www.morganstanley.com/companycharts.

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Attractive (A). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark named on the cover of this report.

In-Line (I). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark named on the cover of this report.

Cautious (C). The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark named on the cover of this report.

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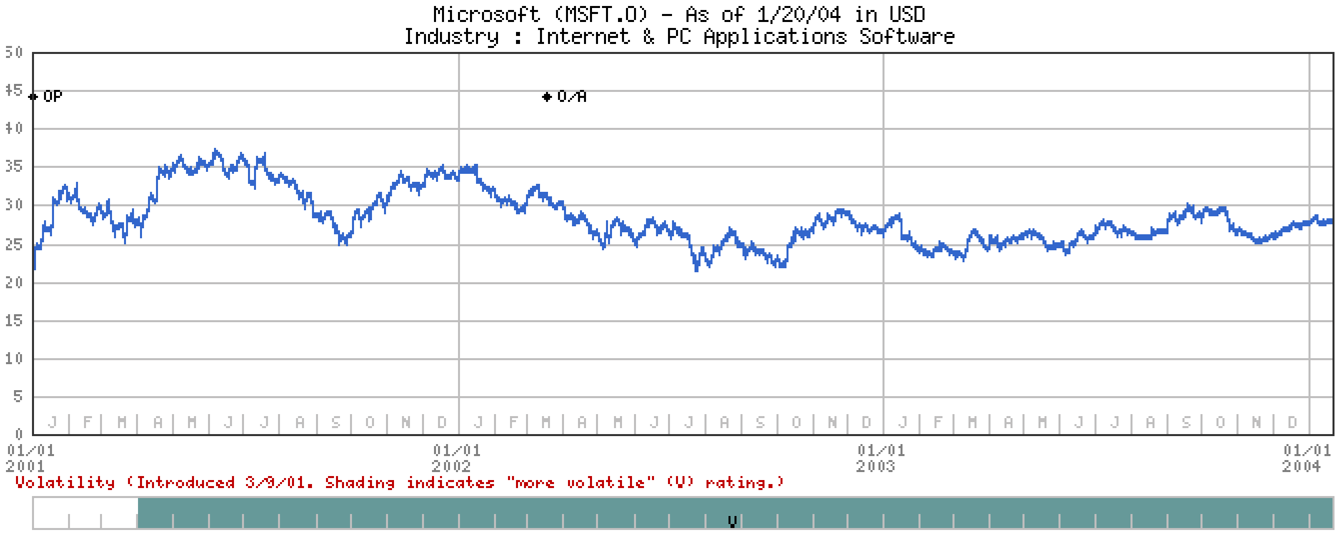
Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 5/16/96 : OP; 3/18/02 : O/A

Price Target History: 8/4/97 : NA

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target No Price Target Assigned (NA)

Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)

Stock Ratings abbreviated as below (Effective 3/18/02, ratings appear as Stock Ratings/Industry View) ◆

Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAV)

Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAV)

Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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INDUSTRY COVERAGE: INTERNET & PC APPLICATIONS SOFTWARE

Company	Ticker	Rating	as of	Price at 01/21/04
Amazon.com	AMZN.O	O–V	03/18/02	$56.20
Ask Jeeves	ASKJ.O	U–V	03/18/02	$23.35
CNET	CNET.O	E–V	03/18/02	$8.82
drugstore.com	DSCM.O	E–V	03/18/02	$7.91
eBay	EBAY.O	O–V	07/10/02	$64.38
FreeMarkets	FMKT.O	E–V	07/30/02	$7.88
Intuit	INTU.O	O–V	03/18/02	$49.54
Microsoft	MSFT.O	O–V	03/18/02	$28.30
priceline.com	PCLN.O	E–V	03/18/02	$21.22
VeriSign	VRSN.O	E–V	04/26/02	$19.90
Yahoo!	YHOO.O	O–V	03/18/02	$47.38

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