Unlocking Value In Microsoft The Einhorn Way

This morning David Einhorn on CNBC elegantly highlighted the inconsistency in pricing of different asset classes, specifically in the case of Apple (AAPL), which he owns. Einhorn believes AAPL should exploit the low yields/high prices of preferred equity to the advantage of stockholders.

You can read the transcript of Einhorn's interview here so we won't repeat what he said. We don't own AAPL, but his suggestion isn't limited to them. In fact, any company with a strong balance sheet, predictable earnings and a low P/E could avail itself of the same strategy.

So we've applied it to Microsoft (MSFT), another tech giant that we believe is attractively priced. The basic concept is for the company to distribute preferred equity shares to existing shareholders. No cash would change hands; each shareholder would just receive preferred shares proportionate to their shareholdings. But even though no cash has changed hands, we believe it illustrates how value would be unlocked.

Here's how it works (my colleague Henry Hoffman crunched the numbers for this example): MSFT has 8.4 billion shares outstanding for a market cap of $228 BN. It has $43BN of cash net of debt (further assuming a 20% haircut to repatriate the cash from outside the U.S.). So the whole company is priced at $185BN ($228BN-$43BN). MSFT pays a quarterly dividend of $0.23, which costs $7.8BN annually. Suppose the company diverted this dividend fully to pay dividends on the preferred shares, which are all owned by existing stockholders. Assuming a 4% yield on these preferreds would value them at $195BN (7.8 divided by 0.04). So the shareholders would own new securities of this approximate value which they could keep or sell in the marketplace. But they'd still own the common equity. Consensus expectations are for MSFT to earn $24BN in the fiscal year 2013 (ending in June). MSFT’s P/E is 7.7X (excluding Cash).

Diverting $7.8BN to pay preferred dividends reduces the net income available to common equity to $16.2BN. Assuming the same P/E multiple on these reduced earnings would value the equity at $125BN. Combined with the preferred equity, the shareholders would now own securities worth $320BN. On this basis each common share would be worth $37.86 on the day MSFT announced its intention to distribute preferred equity securities to every holder of common equity.

It wouldn’t alter the leverage of the company because the preferred would count as equity and would sit just above common in the capital structure. It also wouldn’t alter the company’s dividend expense, since the dividends that were being paid on the common have simply been diverted to the preferreds. It would highlight the large disparity between the valuation of common equity, with an earnings yield of almost 13% (inverse of the 7.7 P/E ratio) and the 4% yield on a security that sits immediately above common equity in the capital structure.

The P/E on the common equity might fall following the distribution of the preferred equity, but even in the absurd case of the common equity being worthless (hard to imagine given $16.2BN of FY 2013 earnings) the preferred equity’s value is still higher than today’s market cap (ex-cash).

You can play around with the assumptions endlessly. One we like is to further assume that money spent on stock buybacks is additionally diverted to preferred dividends. Buybacks count as cash returned to shareholders in the same way as dividends. MSFT’s five year average buyback expenditure is $9.9BN. Adding this to dividends of $7.8BN creates a preferred dividend of $17.7BN and a value on this class of securities of $442BN. Net income left to common shareholders in this case would be$6.3BN in FY 2013.

David Einhorn made a clever suggestion. It’s a neat way to illustrate the discrepancy in asset markets between fixed income yields and earnings yields.

We hope Steve Ballmer was watching CNBC this morning.

Disclosure: We are long MSFT