A Strategic Audit of Microsoft

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A Strategic Audit of Microsoft

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Abstract

This paper provides an analysis of Microsoft’s current market placement and performance, based off external and internal factors, as well as tools such as SWOT analysis. The goal of this audit is to provide an understanding of Microsoft’s current positioning and strategy, as well as a look into possible paths going forward. Additionally, alternative strategies are discussed, and a recommendation is made to which Microsoft should pursue to continue its success. The recommendation reached is that Microsoft should focus on keeping numbers of active Windows users up, as well as pursue a subscription-based model for Windows updates and pricing. The audit provides an implementation plain for this recommendation as well as contingencies and metrics to judge it by.
Background

Microsoft was founded in 1975 by Bill Gates and Paul Allen in Albuquerque, New Mexico. Gates would go on to lead the company for its first 25 years until he stepped down in 2000. (BBC, 2006) Under Gates leadership, Microsoft became one of the most recognizable and powerful companies in the world. Microsoft created the most popular operating system in the world in Windows, and the most popular productivity suite in Microsoft Office. Bolstered by these products, Microsoft was the largest company in the world at the turn of the century. Following Gates departure from the CEO post, Steve Ballmer took control of the company. (CNN, 2019) Under Balmer’s leadership between 2000-2014, Microsoft lost some of its edge. Even though it introduced some eventually successful products such as Microsoft Azure, this period in Microsoft’s history was marked with missteps. Several unpopular operating systems such as Windows Vista and Windows 8 were released, and Microsoft had a large-scale commercial failure in the Windows Phone and purchase of Nokia. (Warren, 2016) Microsoft stayed profitable however, bolstered by its immense market control over operating systems and productivity suites. Microsoft has weathered the storm and seems to have returned to its earlier days with the introduction of Satya Nadella as CEO in 2014. (Microsoft, 2014)

Leadership

Microsoft’s current CEO is Satya Nadella, who has led the company to impressive success and growth since he took over the position from Steve Balmer in 2014. When Nadella took control, Microsoft was in an unenviable position. While Microsoft still was a successful company, it was far from the heights that Ballmer had inherited in 2000. Since Ballmer became CEO, Microsoft had lost its position as the most valuable company in the world and had failed to predict trends in
technology. Microsoft had a failed phone operating system, a largely derided operating system in Windows Vista, and was slow to embrace new trends in cloud computing. Nadella set out to change this lack of innovation and turn the company’s fortunes and culture around.

Since becoming CEO, Nadella has made several major changes in overall company strategy that have been successful at increasing Microsoft’s valuation and reputation. First, he de-prioritized Windows, which had been the core of Microsoft’s strategies since its beginnings. Instead of focusing on the relatively mature offering of Windows, Nadella shifted Microsoft’s focus onto its cloud offerings. Azure has expanded rapidly under Nadella, and now accounts for more than 10% of Microsoft’s total revenues. These changes have been central to Microsoft’s growth, as the company has reclaimed its place as the world’s most valuable company as of 2019. (Greene, 2018)

**Risks and Issues**

One of the largest risks facing Microsoft today is the continued slowing of the PC market. (Deutsche Welle, 2017) Windows is still one of Microsoft’s biggest earners. More Personal Computing, the segment containing Microsoft’s Windows and hardware products, accounts for 38% of total revenue. (Microsoft, 2019) Over the past several quarters, Microsoft has seen some parts of the Windows segment lose revenues. In particular, the consumer versions of windows have seen year over year losses throughout the last 6 quarters. The larger problem however is the fact that PC sales have been steadily declining over the past several years. In the first quarter of 2019, PC sales had fallen 4.6% worldwide since the first quarter of 2018. (Market, 2019) It doesn’t matter how high Window’s market share is if the market itself is shrinking. This trend does not only affect the Windows business, it affects Microsoft’s hardware sales as well as its
Office sales. Microsoft needs to have a long-term strategy to confront this problem that will affect many of its largest product lines.

Another major risk to Microsoft’s continued success and growth is Azure’s place in the highly competitive cloud services market. Currently, Azure is a distant second to Amazon’s AWS service, although it is closing the gap. (Rama, 2018) Much Microsoft’s recent growth and success has been driven by Azure’s explosive growth. Microsoft needs a long-term strategy to continue differentiating itself to not only keep its position in the cloud services market against smaller offerings like Google Cloud and IBM Cloud, but also to continue growing in market share against AWS. If Azure were to stop growing or lose market share, it would be disastrous for Microsoft’s value.

**Segments**

With over 130,000 employees, Microsoft is a massive corporation with dozens of products spread across many different markets. These products are split up into 3 distinct segments: Productivity and Business Processes, Intelligent Cloud, and More Personal Computing. (Microsoft, 2019)
The first of Microsoft’s business segments is Productivity and Business Processes. This segment contains some of Microsoft’s oldest and most well-known products, such as the commercial offerings of Office and Office 365, consumer versions of Office, LinkedIn, and Microsoft Dynamics. The segment created $35 Billion in revenue in 2018, up from $29.9 Billion in 2017. The Productivity segment accounts for around 32% of revenue for Microsoft and 36.8% of all Profits. (Microsoft, 2019)

The Productivity segment represents the core of Microsoft’s traditional software business and continues to show strong growth even though it is a relatively mature market segment. Both the consumer and commercial versions of office continue to grow at a strong pace of around 10% year over year, and the subscription-based Office 365 version of these products show even stronger growth. The commercial version of Office 365 has had around 30% growth each year, and the
consumer version is holding steady at ~30 million active subscribers. Overall the segment has shown strong growth in revenue, active users, and income over the past several years.

The future of the Productivity and Business Processes segment will be driven by the two most recent additions to it, LinkedIn and Office 365. Office 365 was introduced in 2011 and was created as a version of the existing Office Productivity suite centered around a yearly subscription model, and a cloud-based system to make sharing files easy for enterprise customers. The experiment seems to have paid off so far, as 365 has been driving significant growth for Office since its creation. LinkedIn was acquired by Microsoft in 2016 for $26.2 Billion, giving Microsoft access to over 400 million users. LinkedIn has continued to grow under Microsoft’s new leadership, with revenue up 37% in the past year, as well as increased engagement and active users on the site.

**Intelligent Cloud**

The Intelligent Cloud contains some of Microsoft’s fastest growing and newest product lines. Products in this segment include all of Microsoft’s server and cloud offerings, such as SQL Server, Visual Studio, Azure and the newly acquired Github. This segment also contains Microsoft’s enterprise consulting services. Overall, the Intelligent Cloud contributed $32 Billion in revenue to Microsoft’s bottom line in 2018, and $11.5 Billion in profit. This means that the Intelligent Cloud makes up 29% of revenue and 33% of profit. This makes the Intelligent Cloud the smallest segment in terms of revenue.

The Intelligent Cloud is made up of two main parts, Server/Cloud and Enterprise Services. Of these two sub-segments, server is the one that has been driving growth in the segment, almost entirely through Azure growth. While Microsoft’s server products have had a
small growth of 2-5% a year, Azure has had explosive growth of over 90% year over year for the past several quarters. On the other hand, Enterprise Services have been slowly growing, even having a quarter of negative growth in Q4 of 2017. According to Microsoft’s Annual Report, this slow growth is mainly due to the continued decline of custom support agreements for older versions of Microsoft Windows Server.

The continued growth of the Intelligent Cloud segment is clearly centered around Azure, Microsoft’s Software as a Service (Saas) and Infrastructure as a Service (Iaas) platform. Azure was released in 2008 to compete with the exploding IaaS market, and other services such as Amazon Web Services. Azure continues to have incredible growth and is the largest single driver of growth for Microsoft’s revenue. Microsoft will continue to focus on Azure expansion and increasing market share for the IaaS market. Another recent development in the Intelligent Cloud segment is the acquisition of Github in 2018 for $7.5 Billion, giving it access to Github’s 28 million active developers.

**More Personal Computing**

Microsoft’s final segment is More Personal Computing, which contains Windows, hardware devices such as the Microsoft Surface, Microsoft’s gaming division, and search. More Personal Computing contributes the largest percentage of Microsoft’s yearly revenue, at $42 billion, or 38% in 2018. While contributing the most revenue, More Personal Computing actually has the lowest percentage of profit at only 30%.

Growth and revenue in this segment are fairly spread out, over the past several quarters, Windows has grown significantly in professional and commercial license revenues, while the consumer non-professional license revenues have fallen over the last year. Surface revenue has
also held steady at around $1 billion per quarter. The gaming sub-segment has seen growth in revenue over the past year and continues to have strong numbers for Xbox Live users, which is the main metric used for health of the gaming division. The segment has also been driven by strong growth in the search market with 15% year over year growth.

**Current Situation**

Currently, Microsoft is in one of the best positions in its history and is one of the best positioned corporations in the world. Microsoft has recorded record profits and revenues, with over $110 billion in revenue and over $35 billion in profits. (Microsoft, 2019) Additionally, Microsoft has been trading places with Apple over the past year for the title of most valuable publicly traded company in the world.

Microsoft is not only succeeding in terms of raw numbers, but also in terms of product placement and growth. Microsoft has seemingly succeeded in transitioning their older products such as Office to a new era, with Office 365 driving strong growth. Microsoft has also been able to succeed in the new market of cloud services, with Azure performing strongly and showing continued growth. Far from some of the missteps of the past decade, Microsoft is seemingly driving innovation rather than chasing it.

**Situation Analysis**

**Internal Analysis**

For the purpose of analysis, Microsoft will be examined using the SWOT framework. Internally, SWOT examines the strengths and weaknesses of Microsoft’s current position. Since Microsoft’s business segments are so varied, they in turn have different strengths and weaknesses.
Productivity and Business Processes

For Productivity and Business Processes, Microsoft’s main strength is their experience in the market, transition to a subscription-based model, and market dominance. Microsoft has dominated the office suite market since the inception of Microsoft Office in 1988 and have constantly been defining the market and best practices for productivity software. This experience and history have made it so nearly every corporate worker in the United States is familiar with Microsoft Office, making it the default choice for enterprises around the world. In addition to having historic market share, Microsoft has successfully transitioned to a new cloud and subscription-based model. When cloud-based productivity, options started entering the market in the 2010’s such as Google’s G Suite, Microsoft quickly announced the next generation of Office, Office 365. Office 365 is a subscription-based model that gives customers constant flow of updates, rather than an upgrade every few years. 365 has been a significant success, with revenues passing traditional Office licenses in late 2017. (Bright, 2017) Additionally, corporate users who subscribe to Office 365 spend up to 80% more in the long term on licenses vs traditional Office licenses, meaning that as well as growing their market share, they are also making more revenue per user. (Keizer, 2015)

While this is all very good, Microsoft’s productivity segment does have some weaknesses. Primarily, the success of Office 365 in the corporate environment has been offset by significantly weaker growth in the consumer market. Even though consumer subscriptions to Office 365 have been growing in the past several years with over 30 million active subscribers, revenues per user have been falling, in contrast with enterprise licenses. While growth of enterprise licenses is regularly 10-15% year of year, consumer subscription revenue only grew 1 percent year over year in Q2 of 2019. Additionally, some of this subscriber growth is pushed by 1-year licenses
bunded with other products, which do not necessarily add to Microsoft’s bottom line. An additional weakness with this segment is that the market is saturated. Since Microsoft already has so much of the market share when they grow market share for Office 365, they aren’t taking market share away from competitors in many cases but taking away market share from their own traditional licenses. This means that even though revenues are growing due to higher revenue per user in Office 365, eventually this growth will slow when a significant majority of Office users are using 365 rather than one time use licenses.

**Intelligent Cloud**

For Intelligent Cloud, the main strength is the unique offerings of Microsoft Azure. Azure has grown quickly since it’s introduction even though it was not the first cloud offering on the market. It has several unique advantages that come from Microsoft’s other services. Azure is easily integrated into any other piece of the Microsoft framework, such as the already widely used Windows Server as well as Microsoft’s dot net software development framework. Since so many large companies were already heavily invested in the Microsoft stack due to Windows market penetration, Azure has become the preferred cloud platform for Fortune 500 businesses, with Microsoft claiming usage in over 95% of such organizations. (Microsoft, 2019)

Additionally, Microsoft has strengthened its position even further by expanding Azure support to other operating systems such as Linux. This opens Azure to be used by even more clients, even those who are not traditionally invested in the Microsoft stack. This is a change from Microsoft’s previous stance and helps to continue push Azure growth.

The Intelligent Cloud’s weaknesses stem from the same factors that give it strength. Due to high investment in making Azure compatible with existing Microsoft software, it is more difficult to set up for non-windows systems. Other competitors offer easier solutions, which a significant
number of clients make use of. Additionally, Azure is focused on large consumers, which gives it good penetration for Fortune 500 companies, but leaves a void in the market for smaller companies and individual consumers, which are served by other offerings. Additionally, Microsoft’s high investment into making it attractive for large companies have made Azure comparatively more expensive than its competitors, which make it even more difficult for Microsoft to penetrate the market for medium and small companies.

**More Personal Computing**

The Strengths of More Personal Computing are like those of Productivity and Business Processes. The main strength is the significant market share and consumer base that Microsoft has built up through decades of being the market leader in operating systems. Windows has consistently had 80% of the worldwide PC operating system market share for the past decade, which has created a massive user base who are used to using Windows as their primary operating system. This has created a world were Windows is the default operating system for enterprise and personal use. Microsoft continues to supplement this already strong market share with partnerships with PC manufacturers, ensuring that a vast majority of new PC’s are running Windows. Additionally, Microsoft has positioned Windows as the default OS for businesses and continues to offer synergy between their operating system segment with the other two segments, driving increased Azure and Office 365 sales.

The weaknesses of More Personal Computing are also similar to Productivity and Business Processes. Operating systems is a very mature market, which can be seen by stagnating growth for both enterprise and consumer versions of Windows. In Q2 2019, enterprise license revenue fell by 2%, while consumer revenue fell by 11% year over year. This factors into the fact that More Personal Computing is the slowest growing Microsoft business segment. Microsoft has
thus far been unable to find a way to increase overall revenues with Windows like they were able to do with Office 365. This lack of innovation could hurt Microsoft in the long term if they can’t find a way to increase monetization from existing Windows users, especially for enterprise customers that are willing to pay more money for licenses, and more often as shown by the success of Office 365. Being at the top of the operating systems market means there is little room for growth in market share.

Overall, Microsoft is performing strongly, which is shown by its increased revenues and profits over the past several years. Growth has been strong since Nadella took control in 2014 in several segments, and the current outlook is good.

**External Analysis**

For an external analysis, Microsoft’s opportunities and threats to each business segment will be examined.

**Productivity and Business Processes**

For Productivity and Business Processes, one of Microsoft’s main opportunities is to continue advancing its cloud infrastructure and integration with Windows. Microsoft’s goal for Office 365 should be to have every active user on a 365 license rather than a traditional one, especially for business. By continuing to push integration for the software that these businesses already have, Microsoft can continue growing the market share of Office 365 vs traditional Office, further increasing the revenue per user.
The main threat to Productivity and Business Suites is G Suite, Microsoft’s main competitor in the space. Google is the first significant competitor that Microsoft has had in many years to the productivity suite marketplace and could usurp Microsoft’s market share. G Suite adoption has been growing rapidly with over 5 million active enterprise subscribers in 2018. (Google, 2018) Although they still hold a vast majority of the market, Microsoft needs to be wary of this new force the market and continue to make advances in the subscription and cloud-based suite market if they hope to hold on to that market share.

**Intelligent Cloud**

For Intelligent Cloud, a significant opportunity is the market for small and medium sized companies. Currently, Azure is mainly focused on large enterprise consumers who are already invested heavily in Microsoft infrastructure and software. While that is an immensely valuable market, if Azure hopes to continue its massive 90% year over year growth, they need to target new markets. If Microsoft invested in a lower cost, lower barrier to entry version of Azure that was less tied to Windows, they could increase market penetration for smaller enterprises and individual consumers, which has traditionally been the domain of AWS. Exploiting this opportunity could help Azure continue its constant growth while still holding on to its existing larger enterprise clients.

The major threat to Intelligent Cloud is the ever-increasing number of competitors coming to nip at Azure’s heels. Even though Azure has a significant market share as the second largest cloud service provider, they need to be wary not only of AWS, their larger competitor, but also of the multitude of smaller offerings who could outpace their growth in the same way that Azure is outpacing AWS. There are dozens of IaaS offerings from other companies, each of which are vying for Microsoft’s market share. If Microsoft was to somehow lose hold of Windows market
share, less companies would have an incentive to choose Azure over cheaper or simpler offerings, so Microsoft must take steps to keep that edge.

**More Personal Computing**

For More Personal Computing, Microsoft’s opportunity to increase the revenue per user in a similar way to their successes with Office 365. With the global PC market shrinking, and Microsoft already at a significant majority of market share, they should focus on increasing revenue per user they already have rather than trying to gain more market share in new users that don’t really exist. If they experimented with a subscription-based model for Windows in the same vein as Office 365, Windows could be providing consistent monthly income from each active user, instead of one-time purchases whenever a new computer is bought. Since the number of new computers is decreasing, Microsoft must find some way to make up for it to keep its core product of Windows relevant.

As mentioned in the opportunities, the biggest external threat to More Personal Computing is the global decline in PC sales. PC sales have been steadily declining in the past several years, and as PC sales are what drives Windows sales, this is obviously a problem. Additionally, since Microsoft is a hardware manufacturer who makes PC’s in the Microsoft Surface line, this problem hits More Personal Computing in more than one area.
This threat is at the core of all of Microsoft’s business, since less PC’s means less Windows users, which could mean less Office 365 users, which means less companies invested in Microsoft infrastructure which means less Azure users.

**Strategy Goals and Evaluation Criteria**

The goals for Microsoft revolve around several different metrics. For Productivity and Business Processes the goal should be to increase the number of active Office 365 subscribers, especially enterprise licenses. These licenses drive the growth in revenue in a market that is not rapidly expanding and give a stable source of revenue and profit to Microsoft to take advantage of its large market share. For Intelligent Cloud, it should be to maximize the number of active users of Azure services, especially for large enterprise clients. This is hard to quantify in number of users, so total revenue from Azure is an easier metric to use. For More Personal Computing, the metric that should be most important is number of Windows users, especially enterprise subscribers, as well as the revenue per user. Revenue per user is becoming more important as the global PC market shrinks. To reiterate, the 4 criteria that possible strategies will be judged on are as follows:

- Enterprise Office 365 Subscribers
- Azure Revenue
- Windows active users
- Windows revenue per user
Strategy Alternatives

One of options that Microsoft could pursue is simply keeping the status quo in its strategy. That seems to be the following: continue increasing Azure investment, mainly for enterprise clients, continue pushing Office 365, and not make a significant change to Windows product lines. If current trends continue, this strategy would have the following effects: Office 365 would continue to increase subscribers and revenues for a few more years, as it continues to take over more of the productivity suite market from traditional Office licenses. Eventually though, these growths would stagnate as Office 365 becomes the dominant solution, limiting further growth in subscriber numbers. Azure revenues would continue to grow at its quick rate, increasing revenues as the cloud services market increases with Azure remaining the dominant player in enterprise cloud offerings. Finally, windows revenues and users would continue to decrease as the worldwide PC market declines. Overall benefits of this plan or increased Azure revenue and increased Office 365 revenue with the con of continuing lowered revenues from Windows.

Another option that Microsoft has is to transition Windows licenses from a 1 time buy only to a subscription-based model in the same way that Office has transitioned into Office 365. If consumers respond to this change in the same way as they responded to the Office 365 change, they would continue to use Windows at the same high rate and gradually switch over to the subscription offering. Much like Office 365, this new model would be used by enterprise clients first and followed more slowly by consumers. In terms of active users for Windows, this would likely have a drop off in the short term as some consumers would be turned off by the change. This would be offset by the increases in revenues per user much like in Office 365. Long term, having a subscription model with more frequent updates and stable revenue could increase the connectivity of Windows with cloud offerings. This could help increase Azure revenues in turn,
as well as Office 365 subscriptions as it would be possible to bundle Microsoft’s subscriptions together.

A final, more extreme alternative would be to make Windows a free operating system. This would obviously make Windows revenue $0, which would be a bad thing. This could have beneficial effects though, as Windows active users would increase. Expanding the base of Windows users would have the beneficial effect of getting more enterprises and consumers in the Windows ecosystem, which would increase the number of possible users for Azure, and Office 365. It seems unlikely though that the lost billions in revenue from Window’s licenses would be offset by the increases in Azure and Office 365 users and revenues.

Recommendations
Microsoft should deal with its biggest threat, the stagnation of the worldwide PC market, head on by introducing a subscription-based model for the Windows operating system. This would solve the major problem of slowing Windows sales and revenues, while not negatively affecting other important metrics such as Office 365 users and Azure revenue. Going off the model of the Office 365 rollout, it seems likely that while there would be short-term anxiety from consumers with the change in pricing model, eventually the market would normalize to it, and overall user numbers would be unaffected. There would be significantly increased revenues from subscription models compared to traditional pricing, as seen by Microsoft’s success with Office 365, where enterprise clients spend up to 80% more on subscription models in the long term compared to the traditional buy once licenses. In addition to the direct positive impact on Windows revenues, it would open up more opportunities for connectivity between Microsoft services. Just like Office 365 opened up more online and cloud options for Office with significantly more frequent updates, having a subscription-based Windows model with more consistent revenue and updates
would make it possible for Microsoft to increase built in cloud options. Microsoft should use this increased revenue to make it even easier to connect Azure and Office 365 resources with Windows PC’s. This will in turn increase Azure revenues as it becomes easier to use. Bundling subscriptions between Windows and Office will also increase the number of Office 365 users. This course of action will help all of the strategy metrics chosen.

**Implementation Plan**

The rollout of subscription-based Windows should be a several step process, much like Office 365 has been. Rather than immediately canceling the sale and support of traditional Windows offerings, Microsoft should rollout the subscription model over the course of 5 years. The first year should be spend by introducing the offering of a subscription-based Windows enterprise license. This license should offer additional support for Azure and Office 365 services to help get businesses to be early adopters. Microsoft should aim to have a cheaper consumer offering by the end of 3 years to follow up on the enterprise service after it has widespread adoption. This will give consumers more time to get used to the idea of a subscription-based model and gives Microsoft the ability to focus on the Enterprise services for several years, which are more important in terms of revenue for Windows as well as increased revenues for Azure and Office 365. Finally, by the end of 5 years, Microsoft should have completely replaced its traditional Windows offering, completing the process.
Contingency Plan

Clearly, there is a possibility that this plan will fail. Either enterprise or consumers could completely reject the idea of a subscription model for Windows. Having several stages for rollout gives Microsoft time to adjust to the market and make sure that these changes will be accepted. If Enterprises completely fail to adopt the new model, Microsoft can simply discontinue it, since they will still be selling the traditional offering for the first 5 years of rollout. Similarly, if Enterprises accept the change but consumers don’t, Microsoft can choose to differentiate the two versions of Windows. Having the feature heavy enterprise version cost more over time with the benefit of more features with a buy once consumer version would just be like the existing Office model, which has proven to be effective for now. Finally, if the market rejects the subscription model for some reason after the 5 years have passed, Microsoft can simply re-bundle the subscription version of Windows as a buy once traditional license. This plan doesn’t change the software or technology much, just the pricing model which makes it relatively easy for Microsoft to renege the changes if needed in the future.
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