[NASDAQ: MSFT]: The Context Monopoly

Summary

Microsoft closed Friday at $373, which puts the company at about $2.77T of market value and roughly 22x trailing GAAP earnings (23x if we strip out the OpenAI accounting gains and losses), and leaves the stock 33% below its 52-week high of $555 from last July. Most of that damage came this year: the shares are down 23% since December 31 and 17% in June alone, and on Thursday they touched $349.20 before recovering. Over the same stretch the business did the opposite of what the price implies, with revenue growing 17-18% in each of the first three quarters of fiscal 2026, Azure growing 39-40% every quarter, and the March quarter beating on revenue, operating income and EPS.

The disagreement is out in the open. TCI cut Microsoft from about 10% of its portfolio at the end of 2025 to roughly 1% by March, an exit of around $8B, on the view that AI threatens Office and to a lesser degree Azure. Pershing Square spent the same quarter buying, and its 13F showed about $2.09B of stock at March 31. Both sides frame it the same way: either AI disrupts Microsoft or it helps Microsoft. We think the more useful question is who owns the context that enterprise AI has to run on (the email, the Teams chats and meeting transcripts, the calendars, the SharePoint and OneDrive files, and the permission structure that decides who may see what), and for most large companies the answer is already Microsoft.

We also think the market is too pessimistic about the money going into the ground. Azure, a $75B business in fiscal 2025, is now about a third of revenue and growing 40% while it is still short of capacity, and management expects growth to tick up as new data centers come online in the second half of the year. If that capacity earns what the current capacity is earning, today's capex is the front end of a much larger cloud business, not a hole in the cash flow. On that view our base-case DCF is worth about $467 a share (25% upside), our bull case, in which Azure stays above 30% for three more years and Copilot and agent revenue compound on the context layer, about $657 (76%), and our bear case about $260 (30% downside) if the capex never earns a decent return while AI adoption also negatively impacts Microsoft's business, but we see this as a very low likelihood outcome.

The business

Microsoft reports three segments. Productivity and Business Processes ($35.0B of revenue in the March quarter, up 17%) holds Microsoft 365, LinkedIn and Dynamics; Intelligent Cloud ($34.7B, up 30%) holds Azure, the server products and enterprise services; More Personal Computing ($13.2B, down 1%) holds Windows, devices, Xbox and search. Microsoft Cloud, which cuts across the first two segments, did $54.5B in the quarter, up 29%. The trailing four quarters add up to $318.3B of revenue, and fiscal 2025 (to June 2025) was $281.7B, up 15%.

The economics have always rested on being the default. Excel did not become the language of corporate finance because it was always the best spreadsheet; it became the standard, and once a company's models, forecasts and reporting lived in Microsoft's file formats, switching meant converting years of work, breaking integrations and retraining everyone, which almost nobody did. Under Satya Nadella the same position moved to the cloud: Microsoft 365 is now the productivity stack for most large enterprises, and Azure is the second of the three hyperscale clouds, competing with AWS on infrastructure and with Google on both infrastructure and productivity, while Salesforce, Oracle and SAP are strong in narrower parts of the enterprise.

What makes Microsoft unusual is that it sits on both layers at once. AWS has the larger cloud but no productivity franchise to speak of; Google has a productivity suite that wins in smaller and newer companies but has never displaced Office in the large enterprise. Microsoft has the infrastructure, the distribution to the knowledge worker, and the documents, mail and meetings that the work actually consists of.

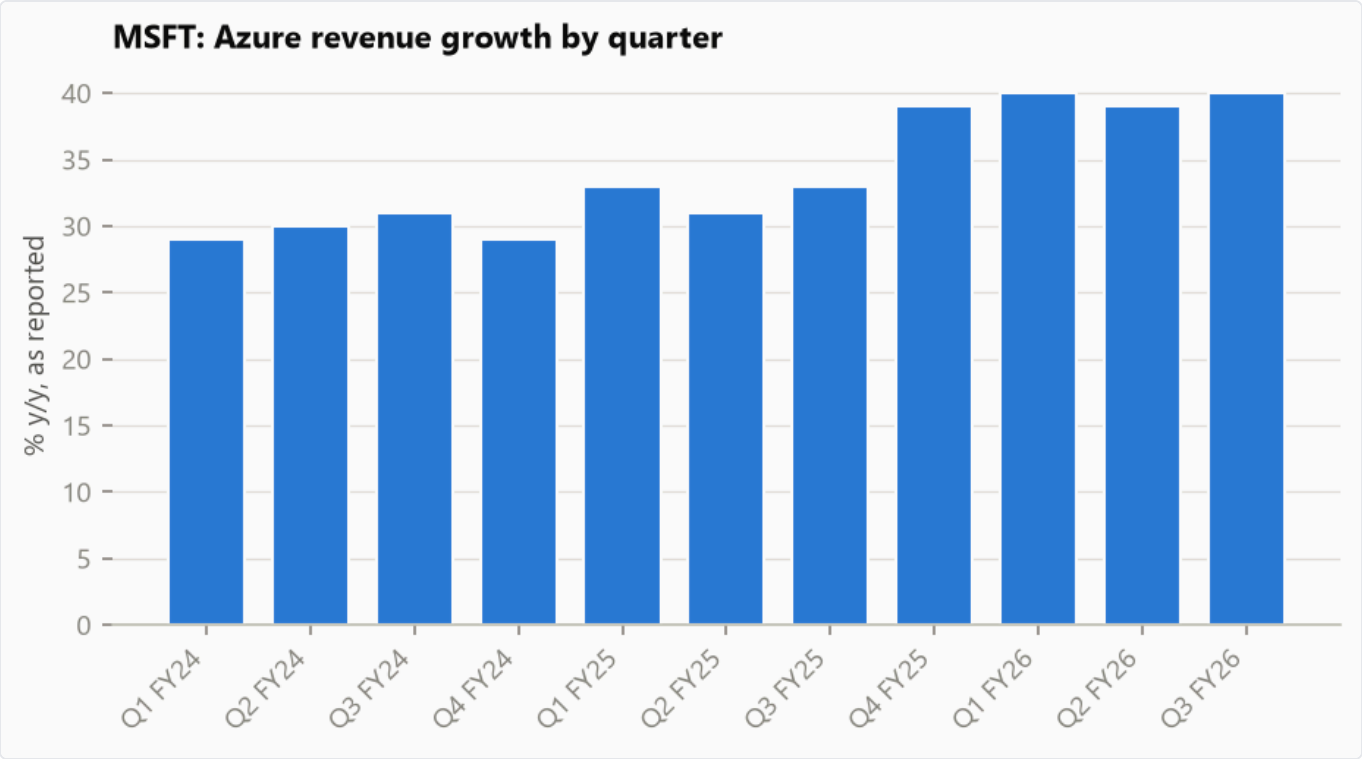
Thesis

1. The context layer is the asset, and Microsoft already owns it. An AI agent is only as useful inside a company as the context it can reach. For a typical large enterprise that context lives in Outlook, Teams (including call recordings and meeting transcripts), calendars, SharePoint and OneDrive, all of it already mapped to an org chart and a permission model that says which employee may see which document. Individual knowledge workers are trying to assemble a version of this by hand with consumer apps; Microsoft has it by default for hundreds of millions of seats, accumulated over decades, and it gets deeper with every email sent and every meeting recorded. An agent wired into that graph can answer questions about the organization that no standalone model can, and the switching cost is no longer the file format but the institutional memory itself.

2. Models are becoming interchangeable, which moves value toward whoever owns that context and the distribution on top of it. Users already move between Claude, ChatGPT and Gemini depending on the task, and enterprises are increasingly doing the same. If the model is a component, the scarce thing is the governed data it operates on and the channel through which it reaches employees. That is a better position than owning any single model, and Microsoft gets it without having to win the model race (its roughly 27% stake in OpenAI, worth about $135B when the restructuring closed last October, is a call option on top).

3. Azure is accelerating, and it is now big enough to carry the whole company. Microsoft disclosed Azure's revenue for the first time last July: more than $75B in fiscal 2025, up 34%. Growth then stepped up, to 39-40% in every quarter of fiscal 2026, which puts Azure at roughly $104B this year by our math, about a third of total revenue. The chart below shows how the rate moved from around 30% two years ago to 40% today, and it did so while management was telling investors it could not build fast enough: it expects to stay capacity-constrained "at least through 2026" and guided to a modest

acceleration in the second half of the calendar year as new capacity lands. A business growing 40% while rationed is one we'd expect to grow at least that fast once the rationing eases, and at a third of revenue every ten points of Azure growth adds more than three points to Microsoft's.



Azure growth stepped up from about 30% to about 40% as AI capacity came online. Source: Microsoft quarterly earnings releases.

4. The monetization has started, and it is bigger than the market gives it credit for. Microsoft 365 Copilot passed 20M paid seats in the March quarter, with seat additions up 250% year over year, at a $30 per user per month list price. The broader AI business is running at more than $37B a year, up 123%. More important than either number is where pricing is heading. On the April call Nadella said the per-user business "will become a per-user and usage business," which means revenue starts to scale with the number of agents doing work inside the tenant, not only with the number of employees, and that is exactly the variable that should grow if the context layer matters.

GitHub moved to usage-based pricing on June 1, and nearly 90% of the Fortune 500 have already built agents with Copilot Studio.

5. Demand is ahead of supply, and the backlog says so. Commercial remaining performance obligation reached $627B at March 31, up 99%. A large part of that is OpenAI's $250B incremental Azure commitment, but even excluding OpenAI the backlog grew 26%, and about a quarter of the total should be recognized in the next twelve months. That is the strongest evidence we have that the capex will earn a return: much of the capacity being built is already spoken for under contract.

We'd add one observation that we think gets lost: Microsoft 365 commercial cloud, the franchise TCI is worried about, grew 19% in the March quarter. Admittedly part of that is Copilot being sold into the base, but that is the point.

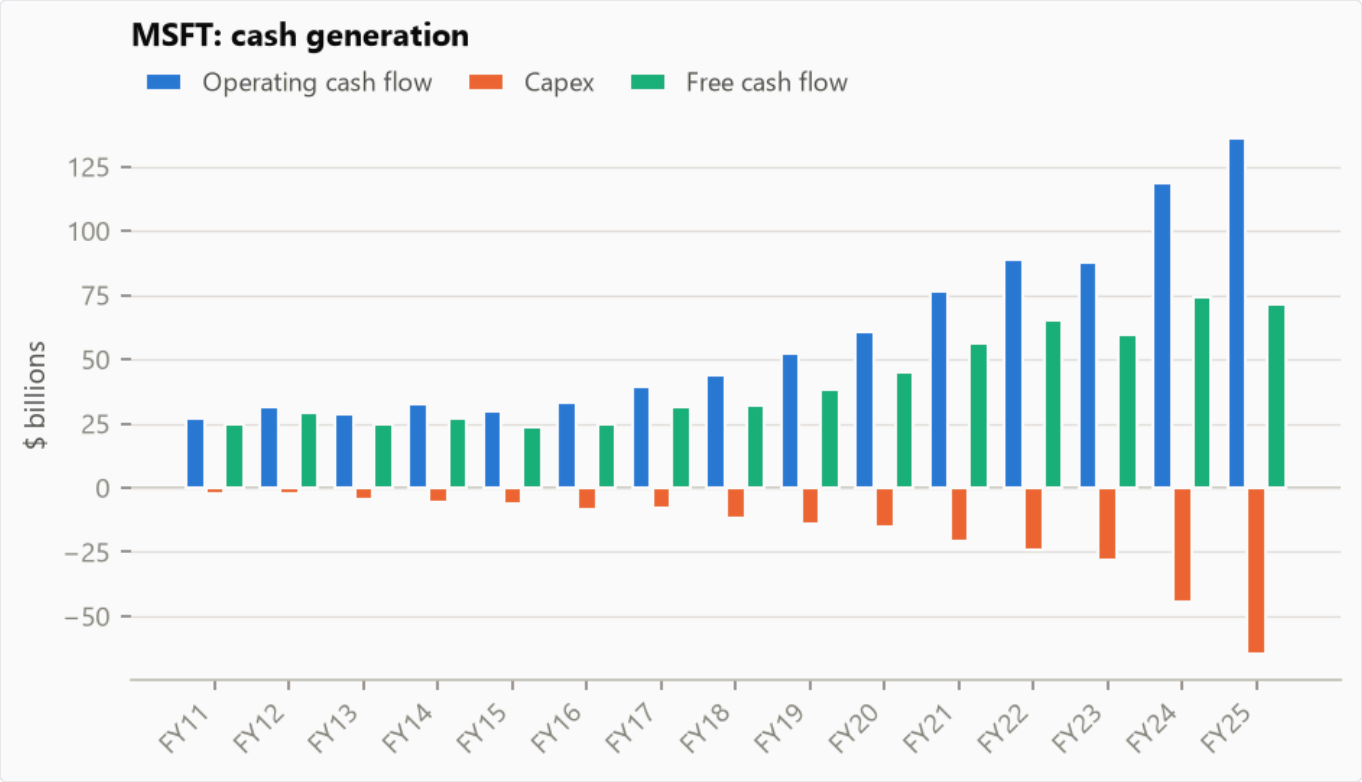
Why the stock is down

The selloff has three sources, and only one of them is about the business. The first was the December quarter, reported January 28: revenue beat at $81.3B, up 17%, but Azure growth eased to 39% from 40% while capex jumped to $37.5B in the quarter, and the stock fell 10% the next day. The second was a broad software selloff in February on the fear that AI agents reduce demand for seat-based software, which hit Microsoft as the largest software company regardless of its own numbers; the calendar first quarter ended with the stock down 23.5%, its worst quarter since 2008. The third is the capex itself. Management now expects about $190B of capital spending in calendar 2026, including roughly $25B of higher component prices, and guided the June quarter above $40B, with about two-thirds of the spend going to short-lived GPUs and CPUs. Even the good quarter did not help. The March results beat on every line, yet the stock fell 3.9% the next day because Azure acceleration was described as "modest" and the capex guide rose again. By late June, with the shares down 17% for the month, Michael Burry disclosed December 2028 calls struck around $700 and said he regarded roughly $350 as an attractive entry, and the stock rose 5.7% on Friday. We'd rather not lean on any of these investors (TCI may be right, and Burry's options are a different trade from owning the shares), but the spread of views tells us the market has no settled answer, which is usually when a large, profitable business gets priced on its fears.

Financials

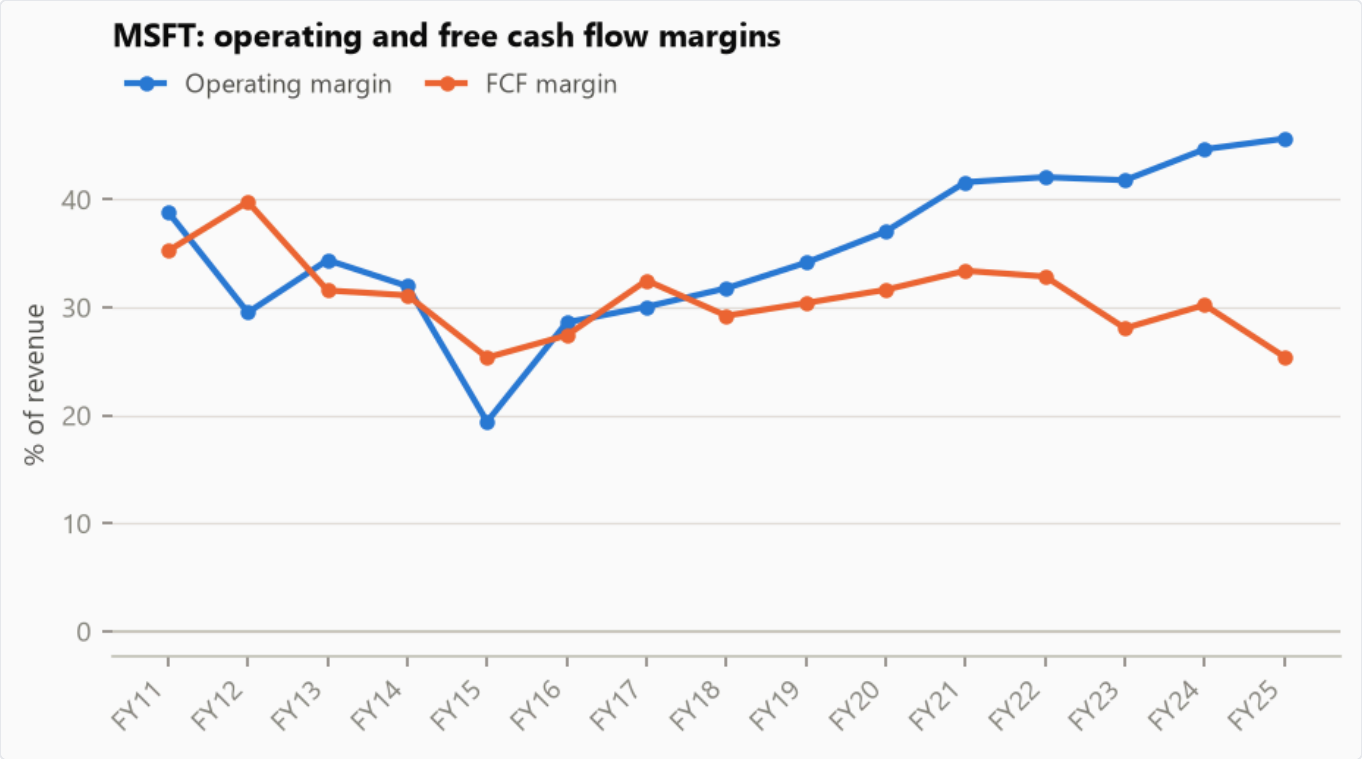
The income statement is in very good shape. March-quarter operating income was $38.4B, up 20%, for a 46% operating margin, diluted EPS was $4.27, up 23%, and management expects the fiscal 2026 operating margin to come in about a point higher than last year even after roughly $900M of one-time retirement costs in the June quarter. For fiscal 2027 it has already guided to another year of double-digit revenue and operating income growth, with headcount down and operating expenses growing in the mid-to-high single digits.

Free cash flow is where the build shows, and the 10-K history puts it in proportion. Capex was $15.4B in fiscal 2020 and $64.6B in fiscal 2025, more than four times as much in five years, and operating cash flow grew from $60.7B to $136.2B over the same period, so free cash flow still rose, from $45.2B to $71.6B. In fiscal 2026 the build stepped up again: operating cash flow was $46.7B in the March quarter, up 26%, but after $31.9B of capex only $15.8B was left, and the December quarter produced about $5.9B. Over the trailing four quarters free cash flow was about $73B ($25.6B, $25.7B, $5.9B and $15.8B), roughly flat on fiscal 2025 even though trailing revenue is 13% higher.



Operating cash flow has kept pace with a fourfold rise in capex since fiscal 2020. Source: Microsoft Corporation 10-K filings via SEC EDGAR, fiscal 2011-2025.

The margin history is the more useful guide to what the capex is doing. Operating margin rose from about 30% in fiscal 2017 to 46% in fiscal 2025, while the FCF margin, which sat between 29% and 33% from fiscal 2017 to fiscal 2022, fell to 25% last year and is below 20% this year. The gap between the two lines is the build. Operating margin is already absorbing the depreciation on the new capacity and still rising, which tells us the capacity in service is earning its keep; the FCF margin is low because Microsoft is paying today for capacity that will earn revenue over the next several years. We think that gap closes, and our valuation is built on how fast.



Operating margin kept rising through the build while the FCF margin fell to 25% in fiscal 2025. Source: Microsoft Corporation 10-K filings via SEC EDGAR, fiscal 2011-2025.

Two things temper the picture. Microsoft Cloud gross margin fell to 66% in the March quarter from 69% a year earlier and is guided to about 64% in June, so AI infrastructure is dilutive at the gross line for now. And GAAP earnings swing with OpenAI equity accounting: a $7.6B net gain added $1.02 to December-quarter EPS, while the September quarter carried a loss, which is why we look at both the GAAP and the ex-OpenAI multiple.

The balance sheet is the least of the concerns. At March 31 Microsoft had $78.2B of cash and short-term investments against $57.0B of debt including leases, about $21B of net cash, and it returned $10.2B to shareholders in the March quarter.

The dividend is $0.91 a quarter, about a 1.0% yield at $373.

Valuation

At $373 the equity is worth $2.77T and, net of the $21B of cash, the enterprise about $2.75T. That is 22x trailing GAAP EPS of $16.80 and 23x the $16.19 we get after removing the OpenAI items, and a free cash flow yield of 2.6% on the trailing $73B. Neither multiple looks cheap in isolation, and the FCF yield looks expensive, which is why we think the stock has to be valued on what the cash flow looks like once the build starts to pay rather than on what it is today.

Our DCF starts from fiscal 2026, which ends on Tuesday and is almost entirely reported: $241.9B of revenue through March plus the $86.7-87.8B guided for June gives about $329.1B, up 17%. We split it into Azure, about $104.2B (fiscal 2025's $75B grown 39%), and the rest of Microsoft, about $224.9B, because the two grow at very different rates and Azure's share of the total rises every year in every case. For free cash flow we take the $47.3B reported through March and assume about $14B in the June quarter, where capex is guided above $40B, for roughly $61B, an 18.6% FCF margin. We value the business as of the end of June, so fiscal 2027 is the first discounted year, at a 9% discount rate (fair, we think, for a company with net cash, a 46% operating margin and recurring revenue) and 3% terminal growth. Today's diluted share count is 7.43B.

Base case: Azure re-accelerates and the build earns its return. Azure grows 40% in fiscal 2027 as the capacity coming online in the second half of 2026 meets a backlog that is already contracted, then fades to 33%, 27% and 22% and down to 7% by fiscal 2036. The rest of Microsoft grows 8% in fiscal 2027 (Microsoft 365 commercial cloud is growing 19%, the consumer and Windows businesses are flat to down) and slows to 4%. That gives consolidated growth of 18% in fiscal 2027, above the June-quarter guide of 13-15% because Azure is now a third of the base, fading to 6% by fiscal 2036. The FCF margin recovers from 20% to 32% by fiscal 2032, a little above the 29-33% Microsoft earned before the build, because the AI capacity is running at the 46% operating margin the income statement already shows and capex growth slows behind revenue.

Fiscal year	Azure ($B)	Azure growth	Rest of Microsoft ($B)	Revenue ($B)	Growth	FCF margin	FCF ($B)	Discount factor	PV ($B)
FY2027	145.9	40%	242.9	388.8	18%	20%	77.8	0.917	71.3
FY2028	194.0	33%	259.9	453.9	17%	23%	104.4	0.842	87.9
FY2029	246.4	27%	278.1	524.5	16%	26%	136.4	0.772	105.3
FY2030	300.6	22%	294.8	595.4	14%	29%	172.7	0.708	122.3
FY2031	354.7	18%	312.5	667.2	12%	31%	206.8	0.650	134.4
FY2032	407.9	15%	328.1	736.0	10%	32%	235.5	0.596	140.4
FY2033	456.8	12%	344.5	801.3	9%	32%	256.4	0.547	140.3
FY2034	502.5	10%	358.3	860.8	7%	32%	275.5	0.502	138.3
FY2035	542.7	8%	372.6	915.3	6%	32%	292.9	0.460	134.7
FY2036	580.7	7%	387.5	968.2	6%	32%	309.8	0.422	130.7

The ten years of discounted FCF add up to $1,205.6B, call it $1,206B. Terminal value is $309.8B x 1.03 / (0.09 - 0.03) = $5,318B, which discounted at 0.422 is worth $2,244B today. Enterprise value is $1,206B + $2,244B = $3,450B, plus $21.3B of net cash gives equity of $3,471B, and $3,471B / 7.43B shares = $467.20 a share, 25% above the $373 price.

Bull case: Azure stays above 30% and the context layer gets monetized. Azure grows 44% in fiscal 2027 and stays above 30% through fiscal 2029, because the backlog fills the new capacity as fast as it is built and agents run their inference on Azure, then fades to 8%. The rest of Microsoft grows 10% for

two years as Copilot and agents become a second growth engine on top of the seat base: if paid Copilot seats went from 20M to 100M at $30 a month, that alone would be $36B of annual revenue, before any usage-based agent revenue, which is the part Nadella is pointing at. Because the incremental revenue is software and cloud capacity sold into tenants Microsoft already serves, the FCF margin rises to 37%, close to the 35-40% Microsoft earned in fiscal 2011 and 2012, when capex was a small fraction of what it is now.

Fiscal year	Azure ($B)	Azure growth	Rest of Microsoft ($B)	Revenue ($B)	Growth	FCF margin	FCF ($B)	Discount factor	PV ($B)
FY2027	150.0	44%	247.4	397.4	21%	21%	83.5	0.917	76.6
FY2028	207.0	38%	272.1	479.1	21%	25%	119.8	0.842	100.9
FY2029	273.2	32%	296.6	569.8	19%	29%	165.2	0.772	127.5
FY2030	347.0	27%	323.3	670.3	18%	32%	214.5	0.708	151.9
FY2031	423.3	22%	349.2	772.5	15%	34%	262.6	0.650	170.7
FY2032	499.5	18%	373.6	873.1	13%	36%	314.3	0.596	187.3
FY2033	574.4	15%	396.0	970.4	11%	37%	359.0	0.547	196.4
FY2034	643.3	12%	415.8	1,059.1	9%	37%	391.9	0.502	196.7
FY2035	707.6	10%	436.6	1,144.2	8%	37%	423.4	0.460	194.8
FY2036	764.2	8%	454.1	1,218.3	6%	37%	450.8	0.422	190.2

Discounted FCF sums to $1,593.0B. Terminal value is $450.8B x 1.03 / 0.06 = $7,739B, worth $3,266B at 0.422. Enterprise value of $1,593B + $3,266B = $4,859B plus $21.3B of net cash is $4,880B of equity, and $4,880B / 7.43B = $656.84 a share, 76% above the current price.

Bear case: the build only partly pays. Even here we give the capex some credit, because the backlog is contracted and the capacity coming online is already sold. Azure grows 32% in fiscal 2027, below this year's pace, as AI compute pricing falls, then its growth roughly halves every two years to 4% by fiscal 2036; the rest of Microsoft grows 5% and slows to 2% as agents pressure the seat base and Copilot stalls near today's seat count. Capex stays heavy because the GPUs have to be replaced on a short cycle, so the FCF margin recovers only to 25%, the level of fiscal 2025, and stays there.

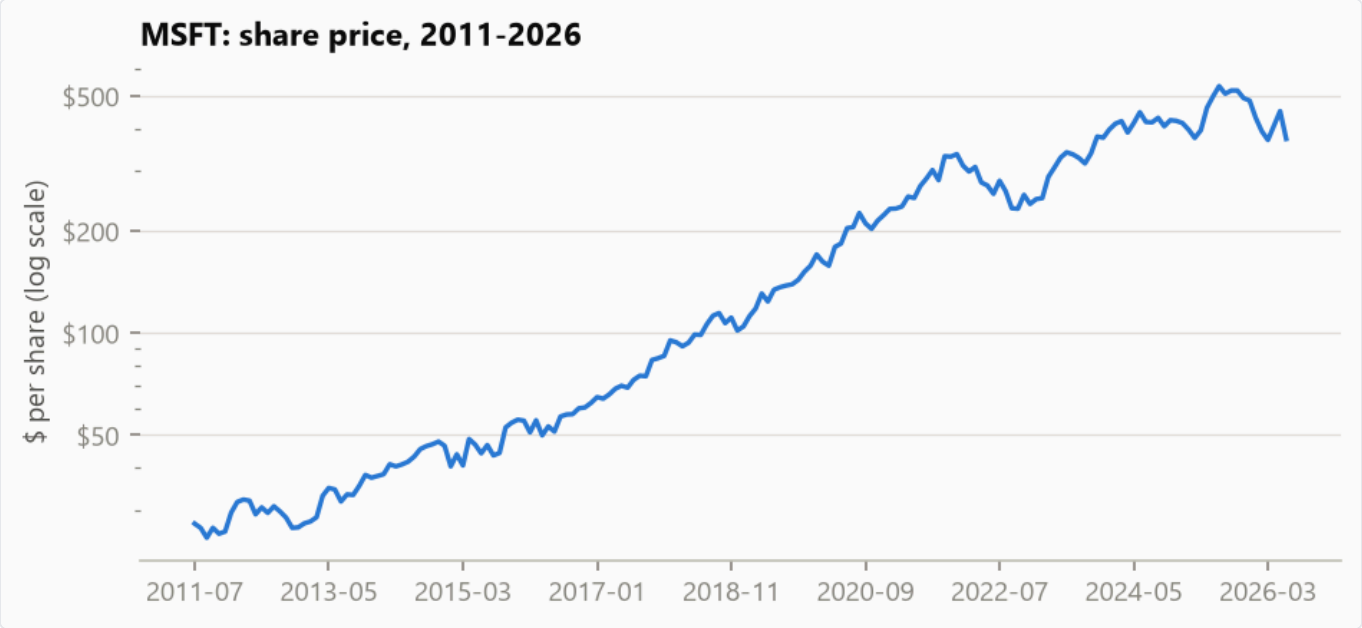
Fiscal year	Azure ($B)	Azure growth	Rest of Microsoft ($B)	Revenue ($B)	Growth	FCF margin	FCF ($B)	Discount factor	PV ($B)
FY2027	137.5	32%	236.1	373.6	14%	17%	63.5	0.917	58.2
FY2028	170.5	24%	245.5	416.0	11%	19%	79.0	0.842	66.5
FY2029	201.2	18%	252.9	454.1	9%	21%	95.4	0.772	73.6
FY2030	229.4	14%	260.5	489.9	8%	23%	112.7	0.708	79.8
FY2031	254.6	11%	268.3	522.9	7%	24%	125.5	0.650	81.6
FY2032	277.5	9%	276.3	553.8	6%	25%	138.4	0.596	82.5
FY2033	296.9	7%	284.6	581.5	5%	25%	145.4	0.547	79.5

Fiscal year	Azure ($B)	Azure growth	Rest of Microsoft ($B)	Revenue ($B)	Growth	FCF margin	FCF ($B)	Discount factor	PV ($B)
FY2034	314.7	6%	290.3	605.0	4%	25%	151.2	0.502	75.9
FY2035	330.4	5%	296.1	626.5	4%	25%	156.6	0.460	72.0
FY2036	343.6	4%	302.0	645.6	3%	25%	161.4	0.422	68.1

Discounted FCF sums to $737.7B, about $738B. Terminal value is $161.4B x 1.03 / 0.06 = $2,771B, worth $1,169B at 0.422. Enterprise value of $738B + $1,169B = $1,907B plus $21.3B of net cash is $1,928B of equity, or $1,928B / 7.43B = $259.53 a share, 30% below the current price.

Case	What has to happen	Value per share	vs. $373
Bear	Azure growth halves every two years, FCF margin stuck at 25%	$260	-30%
Base	Azure 40% in fiscal 2027 then fades, FCF margin back to 32%	$467	+25%
Bull	Azure above 30% to fiscal 2029, Copilot and agents compound, FCF margin 37%	$657	+76%

We'd weight the cases roughly 15/50/35, which gives about $502 a share, 35% above the price. The base case does not ask for anything heroic: Azure grows at the rate it is growing today for one more year and then decelerates every year after, and the FCF margin returns to roughly where it was before the build. What it does assume, and the market currently does not, is that the capacity Microsoft is paying for today earns a return like the capacity it already runs.



Fifteen years of compounding, interrupted by the 2022 drawdown and this year's. Monthly closing price, 15 years to 2026-06-28, log scale. Source: Yahoo Finance.

Risks

The capex is the real risk, and we don't want to wave it away. Spending of about $190B in calendar 2026, mostly on chips that wear out in a few years, only makes sense if utilization and pricing hold, and the falling cloud gross margin (69% to 66%, guided to 64%) shows that the AI capacity is less profitable today than the cloud it is being added to. Our base case assumes that gap narrows as the capacity fills; if AI compute becomes a commodity before the build is paid back, the bear case is roughly what we would expect, and we'd note that the bear case is not a disaster scenario for Microsoft as a business, it is a disaster for anyone paying $373 for it.

The TCI argument deserves a fair hearing as well. If AI-native tools let companies do the same work with fewer seats, the per-user model that built Office shrinks, and the context layer only protects Microsoft if it can charge for usage rather than for heads. Management's own words suggest it sees this, but the transition from seats to consumption is unproven at this scale, and the 19% growth in Microsoft 365 commercial cloud is a current result, not a guarantee.

OpenAI is a concentration risk inside the backlog, and inside our Azure numbers. Including OpenAI the RPO doubled; excluding it, it grew 26%, so a large part of the headline depends on one customer that is burning cash and that, since last October, is free to buy compute from other clouds. The partnership terms (revenue share through 2030, royalty-free IP access through 2032, per management) are better defined than they were, and Amy Hood described the predictability as "a real positive," but the dependence runs both ways.

The rest is smaller. Earnings quality is noisy because of the OpenAI equity accounting, More Personal Computing is shrinking (Xbox content and services down 5%, Windows OEM and devices down 2%), and data protection rules in Europe could limit how far organizational data can be used to ground agents. A recession would slow seat growth and Copilot deployments, although the backlog gives Microsoft more visibility than most software companies have.

Catalysts

- Fiscal Q4 results in late July, against a guide of $86.7-87.8B of revenue and 39-40% constant-currency Azure growth; a print at the top of the Azure range is the first evidence for our base case.
- The first explicit fiscal 2027 capex view, expected with those results; any sign that capex growth slows while Azure holds near 40% changes the FCF debate.
- Capacity coming online in the second half of calendar 2026, which management expects to produce Azure acceleration.
- Further Copilot seat and agent usage disclosure as pricing moves toward consumption.
- Second-quarter 13F filings in mid-August, which will show whether Pershing added and whether other holders followed TCI out.

Conclusion

We'd own Microsoft here as a core position. The price reflects a business whose growth fades and whose margins never recover from the AI build, while the operating results through March point the other way: Azure is a third of revenue and accelerating while short of capacity, the backlog that will fill the new data centers is already signed, and operating margin is still rising with the depreciation of that build inside it. The market is arguing about whether AI hurts or helps Microsoft; we think the more durable fact is that the data and permissions every enterprise agent needs already sit inside Microsoft's products, and that the shift from seats to usage is how that position gets paid.

If the June-quarter results and the first fiscal 2027 capex view show Azure accelerating while capex growth slows, we'd expect the stock to move toward our $467 base case and then the $657 bull case; if Copilot adoption stalls and capex keeps rising, the $260 bear case is the honest downside, but we think that outcome is unlikely.