Why Is Microsoft Stock Falling, and is it a Generational Buying Opportunity? | MSFT Stock Analysis

24 MIN · YOUTUBE · HTTPS://WWW.YOUTUBE.COM/WATCH?V=-L17M7NYQGI
https://www.youtube.com/watch?v=-l17m7nYQgI

SUMMARY

Microsoft's stock has experienced a significant decline of 18% in the past month and 24% year-to-date, primarily due to headwinds such as its reliance on OpenAI, memory shortages, and shifts in its business model. Despite these challenges, there are positive indicators for the company's future growth, particularly in its commercial bookings and operational efficiency.

- *Microsoft's stock is down 18% in the last month and 24% year-to-date, driven by investor concerns over its reliance on OpenAI and memory shortages.*
- *OpenAI's potential IPO delay raises fears about Microsoft's revenue tied to its computing services for OpenAI, which is a major customer.*
- *Memory shortages are negatively impacting PC and Xbox sales, leading to increased costs for data center construction.*
- *Microsoft anticipates a decline in Windows OEM revenue and Xbox content sales, with expectations of worsening conditions.*
- *Despite challenges, Microsoft's revenue per employee is increasing, indicating improved operational efficiency.*
- *The company is investing heavily in AI, but the immediate financial returns are not meeting investor expectations.*
- *Microsoft's stock is currently undervalued, trading at a low forward price-to-earnings ratio, suggesting a potential buying opportunity.*
- *The speaker believes Microsoft can adjust to market changes and maintain its competitive edge, viewing it as a top investment opportunity.*

Microsoft stock is down 18% in the last month and it's because of the same things that have caused its underperformance all year here in 2026. It's down about 24% year to date. But those things worsened over the previous few weeks and previous month which caused more investor selling. So let's take a look at those things closer, those headwinds a little bit more closer and let's compare them to the upside. the positives about Microsoft and then let's revisit the valuation and check in on this stock and see if it's still a buying opportunity because remember I've had Microsoft stock rated as one of the best stocks you can buy this year.

Obviously, it's been a huge disappointment. But I didn't rate it as one of the best stocks to buy to begin the year. I only rated it as one of the best stocks to buy after the stock price crashed following the company's first earnings report of 2026. That's when I bought Microsoft stock from my portfolio. That's when I upgraded

Microsoft stock to a great buying opportunity. So, I want to check in here and see if that uh bullcase is still intact.

I want to thank the Mly full for sponsoring this video. Visit fool.com/parkev for the 10 best stocks to buy now. So I wanted to highlight uh provide an overview of the headwinds and then dig deeper into each one of these things. The first of course is its exposure to open AAI for compute revenue. And then of course over the recent few weeks, if you didn't notice, there were some reports that came out that suggested Open AAI might delay its IPO because of funding concerns because of concerns about valuation, how it might not be able to attract the valuation that it was hoping to attract when it IPOed. And initial estimates were that it was going to IPO later in 2026. So, if that deadline is pushed back, that's a concern for Microsoft because hundreds of billions of dollars, and we'll see this a little bit later, of Microsoft's remaining performance obligations are connected to OpenAI. Open AAI is the primary customer for Microsoft's computing that they're selling through their cloud services segment. That's where they're spending hundreds of billions of dollars building those data centers and they're generating significant revenue by renting computing capacity to Open AI. So if Open AI, which investors are already concerned about their financial position because they're losing so much money, if their IPO is delayed, that means that they're not going to have as much money as expected by the end of this year and perhaps they won't have as much money as was expected ever because the valuation is not where uh investors were hoping it would be. as anthropic is gaining competitive advantage especially in this agentic AI era. So over the last few weeks that concern was just exacerbated it just increased and so that caused a bit of selling part of the selling that we saw in Microsoft stock over the previous few weeks is undoubtedly attributed to those concerns with its association with open AI.

The next headwind memory shortages. So this is impacting Microsoft in three ways primarily. First of all, negative impact on PC sales. So memory is a component in personal computers, laptops, PCs, etc. that consumers and businesses purchase. And if those prices for components are increasing and companies are increasing prices, manufacturers are increasing prices on personal computers, PC sales are likely to decline. And we saw about a week, week and a half ago, Apple said it was raising prices on its laptops and some of its computers as a result of higher prices. And then other manufacturers have already raised prices. And so the forecasts for PC sales, computer sales are significantly negative now because as you already know, higher prices means lower demand.

And so unit sales for PCs are likely to decline. And we'll see more specifically how much of a negative impact Microsoft expects from these declines in its segment. And then Xbox sales. uh we saw Microsoft raise prices on Xbox and that's likely to cause another decline in unit sales and of course with its recent acquisition of Activision Blizzard that's going to that's become a meaningful segment for Microsoft and the decline in unit sales of Xbox that will be a headwind for the company as well they expect a significant impact there and then finally a huge increase in a cost of building data centers Microsoft noted a $25 billion incremental increase in the cost to bulb data centers and they attributed it to rising memory prices. So the memory shortage has been a huge headwind. And then since Micron reported quarterly financial results and noted that they increased memory prices by 60% compared to the same quarter last year, the fears of higher memory prices are exacerbated over the recent few weeks for Microsoft causing another portion of the share price decline we see here over the previous month. And then of course the bigger longer term threats its dependency on open AI for the foundation model and it has access to open AAI's foundation model I believe until 2028 is their contract where Microsoft can use open AAI's chat GPT foundation model. And so Microsoft is racing to build its own AI model so that when its contract for access to OpenAI's model is over, Microsoft can have access to an AI model. It's behind notably here. It's not a large player. Google of course has its own AI models with Gemini. It's well ahead of Microsoft and so Microsoft is playing catch-up and so it's limited progress on a homegrown model that can be a concern that can leave the company behind in the competitive race here. And then finally, last but not least is overall business, the way work is being done is shifting to areas of lesser competitive advantage for Microsoft. And Microsoft's own revenue is shifting to areas of lesser competitive advantage.

More of its revenue is coming from cloud services. And this is a segment where Microsoft has less of a competitive advantage compared to you know Windows OEM revenue compared to the productivity suite revenue. Those are areas where Microsoft had more competitive advantage, more sticky revenue, more longer duration, more sustainable, higher margin business and it's now shifting more towards cloud services and agentic AI threatens to shift the way people work even further away from Microsoft's core competitive advantage.

So these four factors have ebbed and flowed in terms of how worried investors are about these things uh throughout 2026 and in the last month they just got worse. Those risks and those concerns from investors worsened and that led to the share price decline for Microsoft. But let's learn more about this to see you know how concerned should we be as investors as shareholders of Microsoft myself. So, Microsoft in its most recently quarterly earnings call highlighted that their bookings decreased by 4% compared to the same quarter last year. When you include aser commitments from open AAI so open AAI didn't commit to new contracts, new bookings for computing and partly because I think Microsoft wanted to limit its counterparty risk. It didn't want so much commitment with Open AI because that's money that Open AAI owes to Microsoft. Open AAI isn't in a strong financial position. So, they're not it's not like OpenAI is saying, "Here, let me give you a $10 billion deposit to lock in a contract." OpenAI is just saying, "Let's sign a deal 10 years, $150 billion or some large number, right, with the long duration contract." And OpenAI is not putting very much in terms of a down payment or a deposit. It just wants to lock in that compute. And Microsoft is growing concerned that it's allocating and giving Open AAI these types of commitments where Microsoft is not sure if OpenAI will have the money to pay for the computing power it's committed to purchase. And overall, Microsoft its remaining performance obligation is massive at $627 billion of backlog. Ordinarily, this kind of backlog would give investors a lot of confidence about the company's upcoming revenue in upcoming years. But investors are not confident because so much of that, several hundred billion of that 627 billion is attributed to Open AI.

But this was up 99% year-over-year. 99% year-over-year. And again, if you if normally when you report these kinds of numbers, it gets investors excited. But because it's with OpenAI, investors have not been excited. And so, you can understand why I pointed out that headwind earlier with OpenAI delaying its IPO that increases this risk to Microsoft's RPO. if OpenAI was able to IPO at a strong valuation and raise the kind of numbers that um SpaceX was able to raise, you know, close to $100 billion in cash for selling only 5% of equity of the company. That would create a lot more capital injection and it'll also open up more opportunity for Open AI to raise even more capital. Right? It's not going to be a one-time thing where Open AAI goes public, they raise, let's say, $75 billion, and then that's it. They close the books. That's not likely to be the case because it's going to take several years, in my opinion, for Open AAI to become a self- sustaining business where they don't need to go back to investors and ask for more capital. So, OpenAI needs to just open that opportunity and start the cash coming in from investors so that they can go back and tap into that source again and again as long as they continue growing and continue to need the computing power. But with that source closed or still closed and question marks surrounding when or if that will open, that really raised the risk for Microsoft.

The good news for investors is that when adjusting for the impact from Open AI, Microsoft expects healthy growth in commercial bookings as more of the contracts expire and need to be renewed. So that's good news that Microsoft is expanding. It's broadening out its customer base and that's partly attributed to Microsoft you know slowly separating itself from open AI and not committing so much computing power so much computing resources to open AI which is making available more computing to rent out to other companies and thereby decreasing Microsoft's risk. So I highlighted Windows and uh OEM revenue. Microsoft highlighted that Windows OEM revenue should decline in the high teens. So this could be 17 18 19% decline compared to the same quarter last year. And if I were to wager, I would say that since these latest developments, since Microsoft, this was in late April when Microsoft last updated investors with this conference call, and since then the conditions have worsened. So, I wouldn't be surprised if they adjust this and it actually declines in the mid 20% range instead of the high percent range. And so, already Microsoft was expecting a hit to Windows revenue even 3 months ago, but the situation has worsened since then. So, I would expect an even more significant negative to Windows OEM revenue from Microsoft.

Similarly, in Xbox content and services, they expect revenue to decline in the low teens level. Again, the situation has worsened. So, I would expect the decline to move up to the high teens or even low 20s% decline in this category here for Microsoft. So, on to the memory shortage. Microsoft highlighted they expect capital expenditure to increase to over $40 billion in the upcoming quarter. The sequential increase includes $5 billion from higher component pricing. $5 billion just in one quarter for higher component pricing. And the only component that's experienced a significant increase in pricing is memory. Storage has also increased in pricing, but uh in terms of Microsoft and its spending, it's memory that's causing the biggest increase in cost for building the data center. Overall for 2026, for calendar 26, they expect to spend $190 billion in capex. That includes approximately $25 billion impact from higher component pricing.

$25 billion incremental increase in the cost to build these data centers. So, it's not like Microsoft is getting more compute by spending $25 billion more. They're just getting a higher cost to build out the same amount of capacity they were expecting to build out for 2026. That's a huge impact and that's worsening. The situation is worsening in terms of supply and demand for memory and it's likely to remain that way until at least the middle of 2027 and perhaps even longer than that. So that's one of the reasons I've been highlighting that, you know, these companies, Microsoft included, uh, Amazon, Meta, they've all noted, Alphabet, that they'll be spending tens of billions of dollars more in 2026 as a result of higher component pricing.

They're not going to sit back and let this happen. I think this will begin their thoughts and discussions on bringing in-house some of the memory and storage components they need for data centers. Similar to how they did for CPUs and GPUs, nearly all of those big hyperscalers have their own program and proprietary CPUs and

GPUs. And I suspect that they're all discussing doing the same thing for memory and storage because of the situation they notice in the marketplace and the duration of the supply demand situation continuing.

They're not going to sit back and accept these kinds of pricing movements and they'll likely start at least discussing. I wouldn't be surprised over the next uh 6 to9 months if we start hearing about uh something coming out of those discussions some decisions to offset some of these risks of higher component pricing and shortages for building out the data set. So, Microsoft, one of the things that investors need to take note of, what I have here overlaid together in the purple, you have Microsoft's revenue, and it's grown to over $318 billion in the previous decade, up from $80 billion. So, its revenue has roughly quadrupled in the previous decade. Phenomenal growth at scale with strong profit margins. But what's more impressive in the orange there is the revenue per employee. And the reason I overlaid these charts instead of separating them is I want you to see the slope of the increase in the revenue per employee and how that's stronger than the slope in the growth in revenue. So they're experiencing significant growth in the revenue per employee. And I suspect that will continue and that will persist.

Microsoft noted in their most recent conference call that I just shared with you that they have fewer employees than they did last year. Despite the fact that their revenue jumped by roughly $50 billion compared to the same time last year, they have fewer employees. They're generating more revenue with fewer people. And that's a direct result of their investments in AI and that's still in the early stages. They're going to spend another roughly $200 billion here in calendar 2026. And they probably won't see the benefits of those investments until early calendar 2028.

And so as they continue seeing these developments, these kinds of improvements in productivity, they'll continue investing in artificial intelligence, not just for renting the capacity and generating revenue by renting their compute, but also utilizing AI internally to lower the cost of development, to lower the cost of customer support, to lower the cost of projects and and uh productivity enhancements to their productivity suite, etc. etc. This is the primary uh benefit here to Microsoft internally in terms of use of artificial intelligence.

And then if you look at their cash flow from operations to sales, that's been soaring as well. It's up to 53 12% up from around 40% in 2017. Now this excludes the capital expenditures in artificial intelligence and it's an interesting situation because cash flow from operations does not include capital expenditures as I mentioned but if you include that the free cash flow turns close to negative but those investments in AI are resulting in better operations better performance but what investors are concerned about is the proportional increase in productivity, the proportional increase in revenue, in margins as a result of AI has not been exciting. And I'm on on that same page there. I'm not as excited about their performance improvements compared to the hundreds of billions of dollars they're spending on AI. I would have liked to have seen a more meaningful positive impact elsewhere in the company's financial statements. And a more comprehensive measure is their return on invested capital which peaked at around 32% in 2022 and has been trending downward. So return on invested capital does incorporate capital expenditure. It incorporates all of the capital Microsoft puts out into the business and then measures the return they get invested capital. Now a figure of 26% is excellent. Don't get me wrong. It puts Microsoft at a level of above 2:1. Uh you've heard me talking about the ROIC compared to the WACCC return on invested capital compared to the weighted average cost of capital. Uh general rule of thumb is a ratio above one means the company is adding value to shareholders when it makes capital investment. And to do that at a small scale is difficult enough. But Microsoft is doing this at a scale where they're investing hundreds of billions of dollars. So that's impressive that they have that ratio and it's well above 2:1.

But the question mark remains, how persistent is this or will the downtrend continue? I'm on the page here of suggesting it's not going to move lower. Microsoft has demonstrated to investors that they are effective allocators of capital, especially with the current management team. Satia Nadella at the helm has demonstrated excellent allocation of capital and so I'm giving the company the benefit of the doubt that they will generate a sufficient return on invested capital from all these investments they're putting out in AI but the market doesn't agree Microsoft stock is now trading at its cheapest valuation uh on a forward price to earnings basis in really long time it's trading at a forward PE of 22. And I have data here going back to July of 2023. And you can see it's hardly ever been cheaper when measuring on a forward price to earnings basis. And then when I measured the valuation using my own customized discounted cash flow valuation model, it too looks similarly undervalued at $371 per share. It's near its 52- week low of $349 per share and well below the fair value. UI calculated at $519 per share.

So the market is pessimistic about Microsoft stock and the concerns I highlighted in the introduction of the video are the primary reasons investors are suggesting during with if you evaluate their trading and their selling of Microsoft stock that these concerns are major and that Microsoft will be unlikely to have counters to these these risks and make adjustments to these risks that can offset these declines. But I'm of the camp and I'm in the camp that they will be able to adjust to these changes that their long-standing relationships with customers and enterprises, the embedded position Microsoft holds, not just with consumers, but enterprises. Think of all of the businesses around the world. All of the processes that are embedded in Microsoft's ecosystem, whether you're thinking about Windows OEM or the productivity suite or the cloud services, all of that. It's Microsoft's game to lose and they are behind to be sure. They are behind and they are at risk of losing a significant share of that business. But I do see them making adjustments. I do see them being able to counter those losses and with the valuation already down, I like the risk versus reward here for Microsoft longer term. So, I still think this is one of the top 12 buying opportunities for investors right now. I updated that ranking today on June 30th. I own Microsoft stock in my portfolio. I'm interested in adding