MATURITY *Institute* OMS Organizational Maturity Services LLP

Organizational Maturity Rating (OMR) Research Note

Prepared for:
US Asset Manager

Regarding:
Microsoft Corporation

What is an OMR?

After over 20 years in development, Organizational Maturity Rating (OMR) is a highly sophisticated, analytical methodology that gets under the organizational 'skin' and offers an analytical perspective to complement conventional financial and investment analysis. It is designed specifically for the purpose of assessing ***the extent to which an organization has the human capital management (HCM) capability to achieve the most sustainable competitive advantage and market value***.

OMS LLP is approved by the Maturity Institute to carry out Organizational Maturity Ratings (OMR) and analysis. This views the value potential of a corporation from two distinct perspectives: -

- **Market value:** both step change, through innovation, and incremental improvements measured by way of specific reference to baseline improvements in the **four key variables of O*utput (O), Costs (C), Revenue (R) and Quality (Q)*** *of product and/or service*.

- **Operational Risk:** the probability of significant business risk attributable to ineffective HCM.

A company may be producing relatively high financial returns based on conventional criteria (EBITDA, ROCE, RONA etc.). OMR identifies additional value creation opportunities that arise from greater integration of HCM, business strategy and operational planning. An OMR captures a whole system view of the organization with discernible links to value creation and risk.

The methodology that underpins OMR covers the key criteria for determining the quality of leadership and management capability with respect to HCM. Markets will change, economic cycles will come and go and business models may have a natural life cycle but organizational maturity analysis identifies underlying fundamentals for sustainable value generation. Where these are in place the organization will gain competitive advantage through adaptability and agility. Where effective HCM is absent the organization will be susceptible to instability, risk and long-term value erosion. The OMR approach is therefore designed as a reliable and predictive indicator of relative competitive advantage and future performance.

The way an organization manages people is often a highly sensitive issue. Therefore, in carrying out our OMR we attempt to engage organizations during the analytical process to participate and view their OMR as the basis for a confidential, constructive and mature dialogue around their HCM capability. While it is always the intention of OMS LLP to fully engage the senior leadership of the rated organization, this research note and OMR was produced without any active involvement from Microsoft management.

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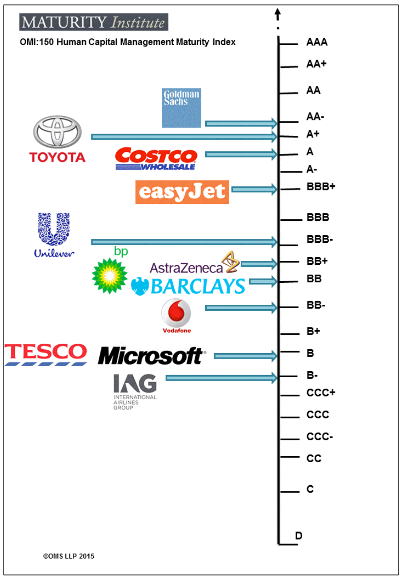
Organizational Maturity Services
www.omservices.org

Microsoft Corporation

OMR rating ‘B’ (as at 24 February 2015)

Where is a ‘B’ on the scale?



The OMR Scale follows the conventional ‘AAA’ credit rating scale with 22 gradations ranging from D to AAA. The first benchmark OMR was Toyota, which was originally rated as AAA (it has now been re-rated as A+). The highest scoring current OMR is Goldman Sachs with an AA-. Organizations such as Goldman Sachs and Toyota are extremely rare, which produces a significantly skewed distribution towards the low end. The most significant break point on the scale is where the board and executive eventually overcome a ‘hurdle’ once they understand the true relationship between actual value and human capital: this is represented on the scale as a shift from BB+ to BBB-.

Overall Rating

Human Capital Value – significantly unrealised
Human Capital Risk – moderate to high

An OMR rating of B denotes an organization whose approach to HCM is limited to conventional human resource management (HRM) practices that are generally non-evidence-based and unmeasured. B is the peak of the population distribution: organizations at this point tend to copy peer group HR ‘best’ practices and therefore achieve negligible competitive advantage.

Whatever the source of Microsoft’s results in the past, it is highly unlikely that they came from a particular capability in HCM. This means, from an investor’s viewpoint, that there are still significant value opportunities available from even simple improvements in its organizational maturity. On the downside, Microsoft’s comparatively low rating means it is relatively unstable. This may go some way to explaining why Microsoft has often missed or been late to exploit new innovations (e.g. web browsers, mobile telecoms etc.) B also indicates a greater business risk relating to human capital. Intellectual capital can leave more readily; key people may fail to cooperate effectively with others; or the company’s long held ‘fear culture’ can hide or mask underlying issues rather than help to address them.

Business context

Microsoft’s early history was one of market domination in PC operating systems and desktop software. It had an obsessive goal of defending its monopoly position for many years under its former CEO Steve Ballmer who has a reputation as a forceful and driven executive. While Microsoft has used its significant resources in the past to fund and fuel innovation, it is well documented that it has failed to keep pace with comparators, despite having some first mover advantages. The viability of the original business model has been questioned for some considerable time and despite current market capitalization achieving the highs of former years, the question remains as to how prepared

Microsoft is to weather future changes in technology and markets. While Microsoft remains cash-rich some of these underlying issues may be obscured. However, significant costs (SMGA 23% in 2014) and an R&D spend of $11.3 billion may not be supportable in the future if there are further failures (such as Vista). This may also help to explain why its appetite for acquisitions appears undiminished under new CEO Nadella's short tenure but a lack of attention to HCM may read across to at least some of these acquisitions not realising their purported value potential under Microsoft's ownership.

Leadership

An OMR considers the CEO position to be the key influencer in HCM. Microsoft's current CEO, Satya Nadella, joined the company in 1992 but has only been in post since February 2014. Consequently, it is too early to see evidence of any outcomes to gauge the impact from his approach to HCM. A review of his public pronouncements to date does not point to any well-conceived or coherent strategy for HCM; neither is there any indication that any greater importance is being attached to HCM for Microsoft's future success and value. However, his leadership philosophy *appears* to be more reflective and collegiate and open to learning than his predecessors and these attributes may prove to be important in aiding organizational maturity development in terms of knowledge sharing, genuine innovation and the fostering of better decision-making.

Organizational culture

Microsoft has been long held up as an employer of choice and remains so today according to many surveys and listings. This may well be reflected in the company's ability to remain attractive to and retain much of its 'talent'. However, there is significant evidence that Microsoft has ingrained cultural traits that have discouraged good performance management, inhibited effective collaboration, and stifled learning and healthy decision-making. In short, the company's cultural traits have impinged on its ability to derive maximum value from its human capital and despite an obvious change in leadership style there is little available evidence to demonstrate that its new leadership has addressed any deficiency in this respect.

The 9 OMR indicators

We rated Microsoft against our standard criteria (see separate OM30 survey questionnaire) using available data. These are then subdivided into 9 critical areas that provide key indicators to form our maturity rating.

1. Purpose

Microsoft's stated purpose is not easily identified from corporate literature but within its latest Annual Report it is stated to be as follows:

"Our mission is to enable people and businesses throughout the world to realize their full potential by creating technology that transforms the way people work, play, and communicate. We develop and market software, services, and hardware devices that deliver new opportunities, greater convenience, and enhanced value to people's lives."

Despite this narrative and Nadella's leadership style, our view is that Microsoft's primary purpose continues to be the maximization of shareholder return on a short to medium term basis. For example, it is evident from Nadella's LTPS award, which is only five years in duration and is solely based on shareholder return (using the benchmark of the S&P500), that Microsoft leadership is heavily incentivised on this basis, without any inclusion of performance measures against broader value creation such as product innovation, technology development or service quality.

Such an underlying purpose can easily conflict with long-term value creation and can skew behaviour towards short-term financial goals. From a risk perspective, shareholder return primacy can often be a source of short-term decision-making and behaviour at both leadership and management levels that may not be in the long-term interests of either the organization or investors. For example, Microsoft has seen deterioration in customer satisfaction according to the ACSI since 2011, which is an important driver of long-term value and may not be adequately addressed, particularly with short-term stock price recovery and new technology bets being a focus of the new CEO.

2. Value focus and creation

OMR analysis defines value as a combination of Output, Revenue, Cost and Quality. Value creation comes from innovation and the highly competent management of all these related variables, in sync. No variable should receive exclusive attention to the detriment of another (e.g. investment in R&D has to be balanced with successful output; cost cutting in the form of headcount reduction should not be at the expense of lower product or service quality, which can then impact on revenue generation). An OMR is a gauge of whether a company has management skills around these variables; particularly in terms of how they enable every employee, supplier and other relevant stakeholder to be focused on the same value variables.

Microsoft has historically valued market scale, dominance and the maximization of short-term profit. The company is extremely strong financially but has missed high value opportunities historically with a primary focus on protecting core revenues, destroying competition (e.g. Netscape) and trying to use its financial strength to gain a share in new markets after copying first movers, rather than being genuinely innovative (e.g. social media, mobile telecoms and search). With competition more widespread and fiercer than ever, such an approach is unlikely to offer the same potential advantages as it may have in the past. This inevitably places greater pressure on Microsoft management to create value through internal innovation and, or acquisition of nascent technology. In both areas it can only maximise the chances of success if it manages key human capital more effectively.

3. Human capital governance

Microsoft seems not to recognize the concept of human governance. This is not uncommon where shareholder value is the overriding goal. Governance places a much broader responsibility on the shoulders of the board and executive. Governance regards the effective management of human capital as one aspect of their societal responsibility but simultaneously as the source of long term shareholder value. This means making the best use of all human potential, while at the same time safeguarding that human capital from poor management practice and pressure to act unethically. This should sit comfortably with Nadella's religious beliefs but needs to be both articulated coherently and form an embedded part of the company's vision, values and strategy.

4. Human capital integration

We see little evidence that human capital and its management are factored into strategic planning. Microsoft appears to work on creating an enjoyable and challenging working environment. It has also increasingly focused on diversity & inclusion initiatives (in response to embarrassing CEO comments on gender). We view this as evidence that while Microsoft is very focused on its employer brand, there is little strategic coherence in how this links to sustained human capital value creation.

With regard to a human capital performance and value system, Microsoft announced in late 2013 that they were dispensing with their long-standing forced ranking process of staff performance management. The annual process of forced distribution has been widely researched for many years and is recognised as a source of significant potential damage in terms of HCM[1]. The fact that Microsoft has only recently modified their system means that performance management is likely to be evolving within the organization. However, any approach that focuses on an annual management tool such as performance appraisal highlights a significant lack of maturity and a failure to grasp the important philosophy of constant performance management linked to value i.e. daily/weekly objective setting, effective feedback and task focused dialogue.

5. Business vision & strategy

There is growing evidence that organizations that provide a clear, long term vision with an integrated and coherent business strategy are more likely to foster an environment within which all human capital (workforce, suppliers etc.) work towards shared goals. We see little evidence of a long-term vision and strategy to connect human capital to sustained value creation. While we accept that the Tech sector can be highly disruptive to existing technologies on a short-term basis, suggesting that long-term vision and strategic planning is difficult, this has always been the case historically for all industry sectors. As with many Tech peers, and indeed in line with other cash rich sectors (e.g. Pharma), Microsoft appears less strategic and more speculative in orientation, making bets on various products and technology (12 acquisitions have been made or announced to date during Satya Nadella's CEO tenure).

6. Whole system

With the exception of global conglomerates, organizations create most value when viewed and managed as a coherent whole system. Within this, organizations have myriad human capital systems, which should complement and strengthen the organization. From a human capital perspective we see little evidence of whole system thinking or approach. From CEO pay (a separately created reward system that disconnects leadership from the workforce - as opposed to a more seamless extension of a firm-wide system), to a fragmented global organization that has given rise to competing internal elements, we believe that Microsoft needs significant work to knit together its whole system and its often conflicting human systems. For example, it could make a good start by declaring its working principles on remuneration and reward.

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[1] For comparison purposes, from our own research, Goldman Sachs is the only organization that appears to make this questionable management practice work effectively albeit by using a different method to the norm

7. Evidence-based decision-making

Microsoft is a data-driven organization yet we see no evidence of human capital metrics and analytics that can provide leaders and managers with good management insight to aid decision-making. Even with its limited human capital perspective of attracting and retaining talent, there is no evidence provided which demonstrates that Microsoft is effective here, nor in how this links to value creation.

8. Philosophy on never ending improvement

Microsoft has always purported to be an innovative organization as highlighted by its 2013 externally facing Innovation Management Framework report, which despite much narrative around culture, fails to clearly identify how firms should build human capital capability for innovation. OMR looks specifically at the cost and rate of innovations relative to key indicators, including market value. We see no evidence of internally driven innovation or improvement measures, with much seemingly being acquired from outside the firm. There also appears to be little evidence of a culture of never ending improvement – something that is a foundation for mature, learning organizations.

9. Human capital risk management

Microsoft state in their latest 10Q filing that their only material risk with respect to human capital is limited to attracting and retaining key talent that provides necessary skills and expertise. This demonstrates Microsoft's conventional philosophy with respect to managing human capital and its aim to remain a "Great Place to Work". It provides little insight into how Microsoft ensures that the staff they have attracted and retained are creating the most value possible and in how the company understands the nature of human capital risk.

Human capital risk permeates all company systems; from resourcing, reward, learning and performance management to quality assurance. A mature corporation ensures that such risk is constantly assessed and mitigated where necessary. There is no evidence that Microsoft engages in effective human capital risk management.

Key questions for investors

- Where is Nadella's thinking when it comes to the question of HCM?
- What evidence is there that Microsoft has generated greater collaboration across its workforce that has yielded value outcomes?
- How does performance management now work, post 'forced distribution', and how does it foster a high value culture?
- Why is senior executive pay geared so heavily to short to medium-term stock price improvement; what encourages long-term value oriented behaviour; what are Microsoft's key reward principles?

- Is there a measurement of internal innovation that generates value, and if so, what is it for 2014?
- How does Microsoft ensure effective management decision making, which includes all key contributors?
- What mechanisms exist to effectively acquire and disseminate critical knowledge across the organization?
- To what extent does Microsoft have a culture that promotes never-ending improvement and how is this encouraged and measured?
- In making acquisitions, how does the company assess human capital value and risk issues that may impact on success, and what efforts does it make to assimilate them without any loss in value?
- Why is human capital risk limited to attracting and retaining talent? Is any other human risk assessed?

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