

## Microsoft Corporation

## Rare execution challenges impact Azure, though AI &amp; cloud demand remains strong

Reiterate Rating: BUY | PO: 510.00 USD | Price: 442.33 USD

## Partner incentive changes is the culprit, though fixable

Q2 results/outlook were mixed, though core growth drivers are very much intact. Total revenue of \$69.6 billion (+12% y/y) nicely exceeded our estimate by 2%. Some of the upside came from Office strength, though also less critical businesses such as Windows PCs and consumer Office. Azure growth of 31% was at the low end of guidance, with some impact from execution challenges in the broad partner channel. The issues appear fixable, though will impact revenue in the coming quarters. Key Azure growth drivers such as AI workloads (13% of growth, from 12%) and large direct cloud deals were solid.

## M365 Copilot is becoming a material source of upside

The outlook for Q3 Azure growth of 31% to 32% cc does represent a much anticipated acceleration, though disappointing in light of softer Q2 growth. Technology shipments are still impacting Q3 though not worse than expected, and comments suggest some improvement in Q4. Commercial Office represented a positive, growing 15% y/y cc, exceeding the outlook for 14%. It is more significant that upside came from the strategic Copilot offering. We note that total AI revenue achieved a run rate of \$13 billion, ahead of the outlook for \$10 billion, also validating Copilot strength.

## Better margin provides some latitude for higher capex

Margin was a real positive. 45.5% operating margin exceeded the outlook by a solid 160 basis points and the company raised the outlook for FY25 (up slightly, versus prior -100 basis points). The net result suggests that datacenter and operating expense scale are more than offsetting ramping capex. This gives the company some latitude for added investment. Commentary suggests that capex will remain flattish in Q3 and Q4, though off a higher Q2 base than our forecast. As a result, our FY25 capex estimate moves higher to \$87 billion (32% of revenue) from \$82.2 billion.

## Remains a rare AI winner in both apps &amp; infrastructure

In summary, GPU/CPU shipment delays that had impacted H1 appear to be stabilizing. With solid, sustained demand for core cloud migration and AI workloads and improved execution, we look for a more consistent beat and raise pattern as we move through the year. We revise estimates post guidance and reiterate our Buy rating/top pick. Our PO of \$510 is based on 38x CY26E FCF (versus 35x prior) for potential acceleration for ramping AI cycle. We continue to believe that Microsoft remains uniquely positioned to monetize the vast new AI opportunity across applications and infrastructure at scale.

Estimates (Jun) (US\$)	2023A	2024A	2025E	2026E	2027E
EPS	9.83	11.81	13.03	15.02	17.44
GAAP EPS	9.58	11.81	13.03	15.02	17.44
EPS Change (YoY)	7.3%	20.1%	10.3%	15.3%	16.1%
Consensus EPS (Bloomberg)			13.06	15.11	17.67
DPS	2.65	2.92	3.21	3.16	3.43
Valuation (Jun)					
P/E	45.0x	37.5x	33.9x	29.4x	25.4x
GAAP P/E	46.2x	37.5x	33.9x	29.4x	25.4x
Dividend Yield	0.6%	0.7%	0.7%	0.7%	0.8%
EV / EBITDA*	34.6x	26.7x	22.9x	19.3x	16.3x
Free Cash Flow Yield*	1.7%	2.2%	2.0%	2.3%	2.8%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 6.

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30 January 2025

## Equity

## Key Changes

(US\$)	Previous	Current
2025E Rev (m)	275,858.2	274,996.7
2026E Rev (m)	313,965.3	312,619.7
2027E Rev (m)	359,581.1	358,051.8
2025E EPS	12.65	13.03
2026E EPS	14.70	15.02
2027E EPS	17.38	17.44

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## Stock Data

Price	442.33 USD
Price Objective	510.00 USD
Date Established	17-Jul-2024
Investment Opinion	B-1-7
52-Week Range	385.58 USD - 468.35 USD
Mkt Val (mn) / Shares Out (mn)	3,439,116 USD / 7,775.0
Free Float	100.0%
Average Daily Value (mn)	9303.30 USD
BofA Ticker / Exchange	MSFT / NAS
Bloomberg / Reuters	MSFT US / MSFT.OQ
ROE (2025E)	32.4%
Net Dbt to Eqty (Jun-2024A)	18.2%

GARP = growth at reasonable price

SMB = small and medium sized businesses

ASP = average selling price

Capex = capital expenditure



# iQprofile<sup>SM</sup> Microsoft Corporation

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Return on Capital Employed	24.5%	25.3%	23.6%	24.4%	27.1%
Return on Equity	39.4%	37.2%	32.4%	32.7%	36.1%
Operating Margin	41.6%	44.7%	44.9%	45.4%	45.9%
Free Cash Flow	58,709	74,114	69,769	80,088	95,246

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Cash Realization Ratio	1.2x	1.3x	1.4x	1.4x	1.4x
Asset Replacement Ratio	2.0x	2.0x	2.1x	1.8x	1.6x
Tax Rate	19.1%	18.2%	18.4%	19.0%	19.0%
Net Debt-to-Equity Ratio	12.2%	18.2%	11.8%	8.8%	8.4%
Interest Cover	NA	NM	27.0x	35.5x	41.1x

## Income Statement Data (Jun)

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Sales	211,149	245,165	274,997	312,620	358,052
% Change	6.7%	16.1%	12.2%	13.7%	14.5%
Gross Profit	145,286	171,051	188,525	215,089	247,242
% Change	7.4%	17.7%	10.2%	14.1%	14.9%
EBITDA	101,618	131,763	153,626	182,272	215,462
% Change	4.2%	29.7%	16.6%	18.6%	18.2%
Net Interest & Other Income	788	(1,646)	(4,571)	(4,000)	(4,000)
<b>Net Income (Adjusted)</b>	<b>73,453</b>	<b>88,179</b>	<b>97,135</b>	<b>111,775</b>	<b>129,938</b>
<b>% Change</b>	<b>6.3%</b>	<b>20.0%</b>	<b>10.2%</b>	<b>15.1%</b>	<b>16.2%</b>

## Free Cash Flow Data (Jun)

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Net Income from Cont Operations (GAAP)	71,595	88,179	97,135	111,775	129,938
Depreciation & Amortization	13,861	22,287	30,076	40,278	51,045
Change in Working Capital	(7,923)	(3,524)	16,060	(18,186)	(23,333)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	9,283	11,649	(9,652)	19,507	20,102
Capital Expenditure	(28,107)	(44,477)	(63,850)	(73,287)	(82,505)
<b>Free Cash Flow</b>	<b>58,709</b>	<b>74,114</b>	<b>69,769</b>	<b>80,088</b>	<b>95,246</b>
<b>% Change</b>	<b>-9.4%</b>	<b>26.2%</b>	<b>-5.9%</b>	<b>14.8%</b>	<b>18.9%</b>
Share / Issue Repurchase	(20,379)	(15,252)	(17,591)	(16,000)	(16,000)
Cost of Dividends Paid	(19,800)	(21,771)	(23,950)	(23,501)	(25,527)
Change in Debt	(2,750)	575	(6,712)	0	0

## Balance Sheet Data (Jun)

(US\$ Millions)	2023A	2024A	2025E	2026E	2027E
Cash & Equivalents	34,704	18,315	23,184	31,214	31,214
Trade Receivables	48,688	56,924	54,870	73,840	89,284
Other Current Assets	100,865	84,495	94,481	89,821	102,315
Property, Plant & Equipment	95,641	135,591	169,897	180,590	180,590
Other Non-Current Assets	132,078	216,838	223,485	227,460	231,900
<b>Total Assets</b>	<b>411,976</b>	<b>512,163</b>	<b>565,916</b>	<b>602,925</b>	<b>635,303</b>
Short-Term Debt	5,247	8,942	5,248	5,248	5,248
Other Current Liabilities	98,902	116,344	107,099	120,835	134,119
Long-Term Debt	54,718	58,185	56,976	56,976	56,976
Other Non-Current Liabilities	46,886	60,215	65,107	67,869	70,671
<b>Total Liabilities</b>	<b>205,753</b>	<b>243,686</b>	<b>234,430</b>	<b>250,928</b>	<b>267,014</b>
<b>Total Equity</b>	<b>206,223</b>	<b>268,477</b>	<b>331,486</b>	<b>351,997</b>	<b>368,289</b>
<b>Total Equity &amp; Liabilities</b>	<b>411,976</b>	<b>512,163</b>	<b>565,916</b>	<b>602,925</b>	<b>635,303</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 6.

## Company Sector

Software

## Company Description

Microsoft develops, manufactures, licenses, and supports a wide range of software products. MSFT has transformed its business model from a component driven model (PC, server) to one driven by the need for cloud capacity. Its Azure platform is growing triple digit and is placed second in public cloud. Products incl. O/S, server applns, O365, Xbox, Surface PC etc. The company has three businesses - Productivity and Business Processes (PBP), Intelligent Cloud (IC) and More Personal Computing (MPC).

## Investment Rationale

We believe that Microsoft is well positioned to generate sustained low double digit growth in the coming 3-5 years, led by continued adoption of Azure cloud infrastructure platform, cloud based Office 365 productivity suite and more profitable Games and Game Pass revenue in Xbox. While a revenue mix shift toward lower margin Azure and O365 segments is likely to offset scale benefits NT, operating expense scale is likely to drive stable 50bps annual margin expansion over the coming years.

## Stock Data

Average Daily Volume 21,032,498

## Quarterly Earnings Estimates

	2024	2025
Q1	2.99A	3.30A
Q2	2.93A	3.23E
Q3	2.94A	3.20E
Q4	2.95A	3.30E



# Exhibits

## Exhibit 1: Variance

Total revenue came in 2% ahead of our estimates

\$ in Millions (except per share data)	BofA Estimates	2Q25 Actuals	Variance
Productivity and Business Processes	\$28,634	\$29,437	3%
Intelligent Cloud	\$25,776	\$25,544	-1%
More Personal Computing	\$14,165	\$14,651	3%
<b>Total Revenues</b>	<b>\$68,575</b>	<b>\$69,632</b>	<b>2%</b>
Total Revenues growth y/y cc	10%	12%	2%
<b>Azure revenue</b>	<b>\$18,938</b>	<b>\$18,866</b>	<b>0%</b>
Azure revenue growth y/y cc	32%	31%	0%
Total Cost of Revenue	\$22,006	\$21,799	-1%
Gross Profit	\$46,569	\$47,833	3%
<b>Operating Expenses:</b>			
Research & Development	\$7,897	\$7,917	0%
Sales & Marketing	\$6,543	\$6,440	-2%
General & Administration	\$2,015	\$1,823	-10%
Total Operating Costs	\$16,454	\$16,180	-2%
<b>Operating Income (Loss)</b>	<b>\$30,115</b>	<b>\$31,653</b>	<b>5%</b>
Investment Income / (Expense)	(\$1,500)	(\$2,288)	NM
Pretax Income	\$28,615	\$29,365	3%
Income Tax Expense	\$5,437	\$5,257	-3%
Net Income	\$23,178	\$24,108	4%
<b>PF EPS diluted</b>	<b>\$3.11</b>	<b>\$3.23</b>	<b>4%</b>
Shares (fully diluted)	7,451	7,468	0%
<b>Margin Analysis</b>			
<b>Total Gross Margin</b>	<b>67.9%</b>	<b>68.7%</b>	<b>1%</b>
Research & Development	11.5%	11.4%	(0%)
Sales & Marketing	9.5%	9.2%	(0%)
General & Administration	2.9%	2.6%	(0%)
<b>Operating Margin</b>	<b>43.9%</b>	<b>45.5%</b>	<b>2%</b>
Proforma Tax Rate	19.0%	17.9%	(1%)
<b>Net Margin</b>	<b>33.8%</b>	<b>34.6%</b>	<b>1%</b>

Source: BofA Global Research

BofA GLOBAL RESEARCH

## Exhibit 2: Estimate change

We revised our estimates per guidance

	3Q25E				2025E				2026E			
	Previous Estimate	Previous Y/Y Growth	New Estimate	New Y/Y Growth	Previous Estimate	Previous Y/Y Growth	New Estimate	New Y/Y Growth	Previous Estimate	Previous Y/Y Growth	New Estimate	New Y/Y Growth
Productivity and Business Processes revenue	\$29,510	10%	\$29,531	10%	\$116,513	11%	\$116,800	11%	\$126,612	9%	\$126,630	8%
Intelligent Cloud revenue	\$27,277	23%	\$26,050	17%	\$106,584	22%	\$104,576	19%	\$132,632	24%	\$130,242	25%
<b>Azure revenues</b>	<b>\$22,127</b>	<b>33%</b>	<b>\$20,801</b>	<b>30%</b>	<b>\$83,214</b>	<b>33%</b>	<b>\$81,286</b>	<b>31%</b>	<b>\$109,748</b>	<b>32%</b>	<b>\$106,745</b>	<b>31%</b>
More Personal Computing revenues	\$12,427	-3%	\$12,656	-1%	\$52,762	1%	\$53,621	3%	\$54,721	4%	\$55,748	4%
<b>Total revenues</b>	<b>\$69,214</b>	<b>12%</b>	<b>\$68,237</b>	<b>10%</b>	<b>\$275,858</b>	<b>13%</b>	<b>\$274,997</b>	<b>12%</b>	<b>\$313,965</b>	<b>14%</b>	<b>\$312,620</b>	<b>14%</b>
Proforma net income	\$22,814	6%	\$23,821	10%	\$94,121	7%	\$97,135	10%	\$108,342	15%	\$111,775	15%
Proforma EPS	\$3.07	6%	\$3.20	10%	\$12.65	7%	\$13.03	10%	\$14.70	16%	\$15.02	15%
<b>Free cash flow</b>	<b>\$9,039</b>	<b>69%</b>	<b>\$17,237</b>	<b>-29%</b>	<b>\$69,960</b>	<b>-6%</b>	<b>\$69,769</b>	<b>-6%</b>	<b>\$85,065</b>	<b>22%</b>	<b>\$80,088</b>	<b>15%</b>

Source: BofA Global Research

BofA GLOBAL RESEARCH



## Price objective basis & risk

### Microsoft Corporation (MSFT)

Our price objective of \$510 is based on 38x our CY26E FCF estimate, compared to the prior 35x for potential acceleration from capex scaling. The new multiple of 38x represents an EV/FCF/Growth multiple of 2.3x 17% 2-year CAGR, a premium to the GARP group (27x, or 1.5x 18% growth) for durability of growth.

Downside risks to our price objective: 1) Microsoft could see some near term gross margin pressure as the Azure business grows as a percentage of overall revenue. While Microsoft's on premise offerings offer a high margin profile, growth in these lines of business is decelerating. 2) Enterprise application spending has proven to be highly cyclical, given the more discretionary nature of applications projects. During an economic slowdown, when firms are faced with shrinking IT budgets, projects involving application upgrades, migrations or new installations are often deferred. This could present a higher degree of risk for a bookings deceleration for Microsoft and other application vendors, in the event of an economic slowdown.

## Analyst Certification

I, Brad Sills, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### US - Software Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	8x8	EGHT	EGHT US	Michael J. Funk
	Adobe	ADBE	ADBE US	Brad Sills
	Alarm.com	ALRM	ALRM US	Michael J. Funk
	Amplitude, Inc.	AMPL	AMPL US	Koji Ikeda, CFA
	Asana	ASAN	ASAN US	Michael J. Funk
	BILL	BILL	BILL US	Brad Sills
	Box Inc	BOX	BOX US	Michael J. Funk
	Certara	CERT	CERT US	Andrew Moss
	Datadog Inc	DDOG	DDOG US	Koji Ikeda, CFA
	Dynatrace	DT	DT US	Koji Ikeda, CFA
	Five9	FIVN	FIVN US	Michael J. Funk
	GitLab Inc.	GTLB	GTLB US	Koji Ikeda, CFA
	Global-e Online Ltd.	GLBE	GLBE US	Koji Ikeda, CFA
	HubSpot	HUBS	HUBS US	Brad Sills
	Informatica Inc.	INFA	INFA US	Koji Ikeda, CFA
	Intapp Inc.	INTA	INTA US	Koji Ikeda, CFA
	Intuit	INTU	INTU US	Brad Sills
	JFrog Ltd	FROG	FROG US	Koji Ikeda, CFA
	MeridianLink, Inc.	MLNK	MLNK US	Koji Ikeda, CFA
	Microsoft Corporation	MSFT	MSFT US	Brad Sills
	Monday.com	MNDY	MNDY US	Michael J. Funk
	MongoDB Inc	MDB	MDB US	Brad Sills
	nCino, Inc.	NCNO	NCNO US	Koji Ikeda, CFA
	NICE Ltd.	NICE	NICE US	Michael J. Funk
	NICE Ltd.	NCSYF	NICE IT	Michael J. Funk
	OneStream, Inc.	OS	OS US	Koji Ikeda, CFA
	PagerDuty	PD	PD US	Koji Ikeda, CFA
	RingCentral	RNG	RNG US	Michael J. Funk
	Salesforce.com	CRM	CRM US	Brad Sills
	Samsara	IOT	IOT US	Matt Bullock



**US - Software Coverage Cluster**

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	ServiceNow	NOW	NOW US	Brad Sills
	Shopify, Inc.	SHOP	SHOP US	Brad Sills
	Unity	U	U US	Michael J. Funk
	Weave	WEAV	WEAV US	Michael J. Funk
	Workday Inc.	WDAY	WDAY US	Brad Sills
	Zeta Global	ZETA	ZETA US	Koji Ikeda, CFA
<b>NEUTRAL</b>				
	Autodesk	ADSK	ADSK US	Michael J. Funk
	Bentley Systems	BSY	BSY US	Michael J. Funk
	DocuSign	DOCU	DOCU US	Brad Sills
	Elastic NV	ESTC	ESTC US	Koji Ikeda, CFA
	Freshworks, Inc.	FRSH	FRSH US	Michael J. Funk
	Jamf	JAMF	JAMF US	Koji Ikeda, CFA
	Oracle Corporation	ORCL	ORCL US	Brad Sills
	Paycom	PAYC	PAYC US	Michael J. Funk
	Paylocity	PCTY	PCTY US	Michael J. Funk
	Snowflake	SNOW	SNOW US	Brad Sills
	UiPath	PATH	PATH US	Brad Sills
	Veeva Systems, Inc.	VEEV	VEEV US	Brad Sills
	Vertex, Inc.	VERX	VERX US	Brad Sills
	Zoom Video Communications	ZM	ZM US	Michael J. Funk
<b>UNDERPERFORM</b>				
	AvidXchange, Inc.	AVDX	AVDX US	Brad Sills
	BigCommerce Holdings, Inc.	BIGC	BIGC US	Koji Ikeda, CFA
	BlackLine, Inc.	BL	BL US	Koji Ikeda, CFA
	C3.ai	AI	AI US	Brad Sills
	Confluent	CFLT	CFLT US	Brad Sills
	Coveo	YCVO	CVO CN	Koji Ikeda, CFA
	CS Disco, Inc.	LAW	LAW US	Koji Ikeda, CFA
	Dropbox	DBX	DBX US	Michael J. Funk
	Guidewire Software, Inc.	GWRE	GWRE US	Michael J. Funk
	Twilio	TWLO	TWLO US	Michael J. Funk
	ZoomInfo	ZI	ZI US	Koji Ikeda, CFA
<b>RSTR</b>				
	Blackbaud, Inc.	BLKB	BLKB US	Koji Ikeda, CFA
	CCC Intelligent Solutions	CCCS	CCCS US	Michael J. Funk

**IQmethod<sup>SM</sup> Measures Definitions****Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

**Numerator**

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

**Denominator**

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization

Shareholders' Equity

Sales

N/A

N/A

**Quality of Earnings**

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

**Numerator**

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash &amp; Equivalents

EBIT

**Denominator**

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

**Valuation Toolkit**

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

**Numerator**

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

**Denominator**

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

Basic EBIT + Depreciation + Amortization



**Valuation Toolkit**

**Numerator**

**Denominator**

*iQmethod*<sup>SM</sup> is the set of BofA Global Research standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

*iQdatabase*<sup>®</sup> is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by BofA Global Research.

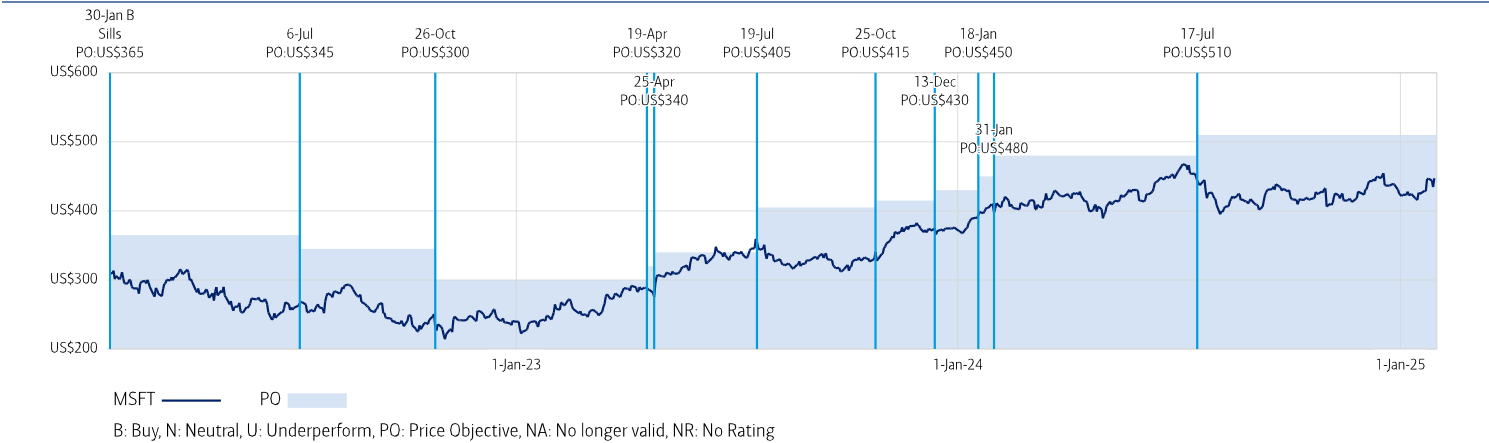
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# Disclosures

## Important Disclosures

Microsoft (MSFT) Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Technology Group (as of 31 Dec 2024)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	209	53.45%	Buy	107	51.20%
Hold	93	23.79%	Hold	47	50.54%
Sell	89	22.76%	Sell	28	31.46%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2024)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1869	54.39%	Buy	1108	59.28%
Hold	766	22.29%	Hold	463	60.44%
Sell	801	23.31%	Sell	370	46.19%

<sup>R1</sup> Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster <sup>R2</sup>
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

<sup>R2</sup> Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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