June 16, 2011

Mr. Reed Hastings
Lead Director, Microsoft Board of Directors
One Microsoft Way
Redmond, WA 98052-6399

To Ladies and Gentlemen of the Board:

We are writing to recommend certain actions that the Board should seriously consider to significantly enhance shareholder value of Microsoft. Our funds have been a shareholder of Microsoft since 2006 and currently own over 11 million shares. Despite continuing robust revenue and EPS growth, Microsoft's common stock has dramatically underperformed the market. We believe the Board and senior management can remedy this situation through a clearly articulated strategy to return capital to shareholders. We believe a well-designed capitalization strategy would generate immediate and ongoing attractive returns for shareholders, and quickly drive the share price into the high-$30's (over 50% upside from today's price). As long-term shareholders, we strongly believe that only through an optimized capital structure can Microsoft best deliver attractive returns to shareholders and continue to execute on its long-term operating and strategic goals.

Since the beginning of 2000, Microsoft's stock has significantly lagged the overall stock market, underperforming the S&P 500 index by 58%. In fact, the shares are effectively unchanged since June 1998 despite strong operational performance in revenue and earnings. Over the past 13 years, the company's valuation multiples have compressed severely: the Enterprise Value/Sales ratio plummeted from 24.3x to 2.4x while the P/E ratio dropped from 62x to 10x. Microsoft's current valuation is the lowest in its history. Even in comparison to other mega cap technology stocks, like IBM, Microsoft's shares have not fared well. Since mid-1998, Microsoft cumulatively grew total sales by over 350% vs. only 29% at IBM, yet IBM shares outperformed by 197% over this same timeframe. For the first time in two decades, IBM's market capitalization recently surpassed that of Microsoft.

We believe the reasons for this underperformance are essentially twofold: 1) the market is skeptical of Microsoft's ability to successfully transition to the emerging mobile and cloud computing environments, and 2) the company lacks a well-defined and articulated capital allocation strategy. Although Microsoft has admittedly been late in addressing several key market opportunities (i.e., search, virtualization, tablets, smartphones), it appears that the company is now taking the right path strategically. We believe the market under appreciates the cloud initiatives in Azure/Office 365, the search/mobile partnerships with Yahoo and Nokia, the decision to embrace ARM-based architecture and especially the recently announced Skype deal. As all of you are well aware, there have been an increasing number of frustrated shareholders, with some even calling for an immediate change in leadership.

We believe Microsoft can build a steady and supportive shareholder base that will afford senior management the time to execute on its business plan by adopting a clearly-articulated, forward-looking capital allocation strategy. We appreciate that Microsoft has returned over $150 billion to shareholders over the last decade. Unfortunately, the ad hoc, often backward-looking and temporal nature of these payments has made it difficult for prospective investors to build a defensible investment thesis around the return of capital. At Microsoft's current cheap valuation, the combination of a forward-looking capital strategy and existing operational strategy makes a highly compelling near-term and long-term investment opportunity.

We recommend that Microsoft take the following steps to greatly enhance shareholder value: 1) issue $40 billion of debt (targeting net debt on the balance sheet of zero); 2) use net proceeds from the debt offering to conduct an aggressive one-time share buyback; 3) use 100% of ongoing domestic free cash flow of $10 billion for payment of common dividends; and 4) borrow against ongoing international free cash flow of $15 billion to buy back shares each year. We estimate this recapitalization would enable the company to repurchase approximately 20% of its shares outstanding today, increase the annual dividend to $1.48 per share (6% yield based on current stock price), and buy back up to 9% of the shares outstanding each year (depending on price of buyback).

We see this plan as a winning strategy for several reasons: 1) it clearly articulates to investors a sound strategy for a meaningful and consistent return of capital; 2) it intelligently invests cash in an undervalued asset (Microsoft stock); 3) it exploits an extremely low interest rate environment; 4) it enables the company to attract a new set of yield-seeking investors; 5) it demonstrates the company's own confidence in its business prospects; 6) it provides significant EPS accretion (~25% according to our analysis); and 7) it eliminates the distraction of a depressed stock price (low employee morale, frustrated investors, Board distraction, etc.), allowing management to pursue its long-term strategy. If executed as outlined, we expect such a change would lead to an immediate <u>and</u> ongoing revaluation of the company's shares (see Exhibit I).

This capital allocation strategy may not sound like a dramatic departure from the company's current procedures but the clear articulation, forward-looking nature, and consistent commitment, combined with the magnitude of the capital structure reallocation, can make all the difference in the shares' valuation. In recent years, several large companies have implemented similar strategies and shareholders have been aptly rewarded. For example, since initiating their respective capital reallocation strategies, AutoZone has outperformed the S&P 500 by 152% (see Exhibit II), DirecTV has outperformed by 251% (see Exhibit III) and Time Warner Cable has outperformed by 130% (see Exhibit IV).

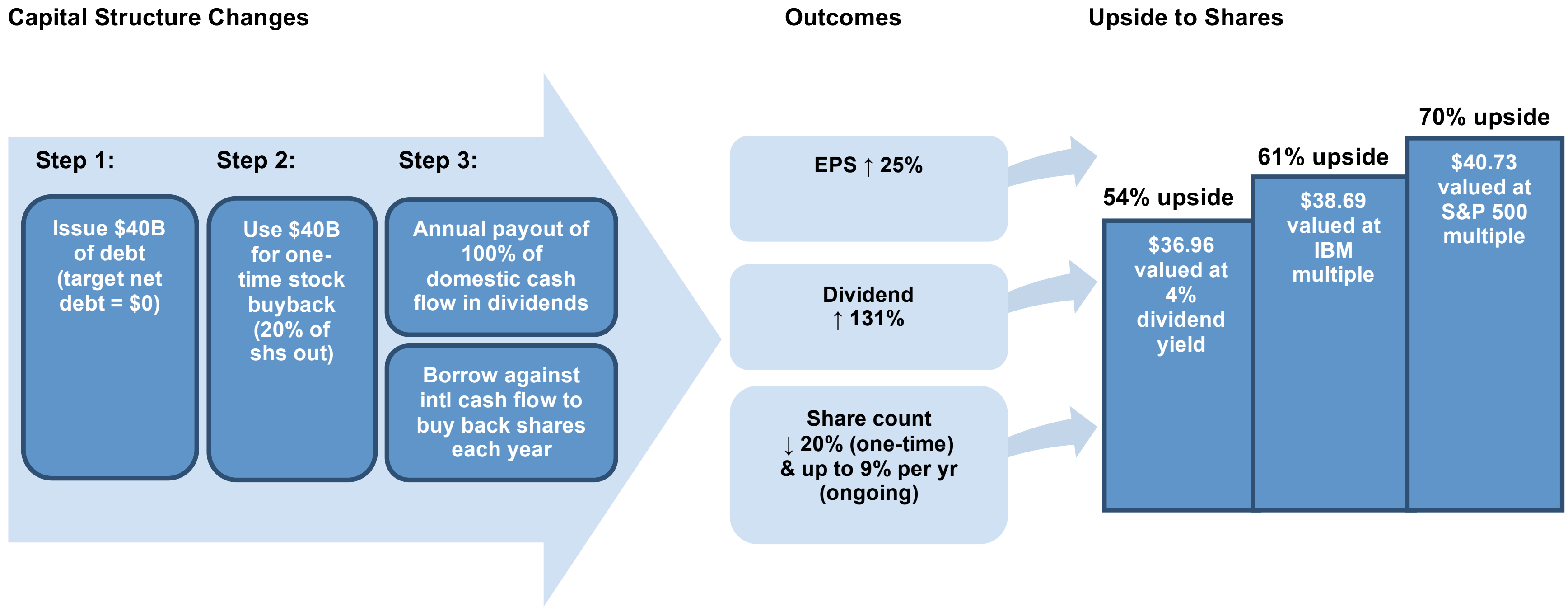
In conclusion, Microsoft's existing capital structure is sub-optimal and its current capital allocation strategy is not working. Shares have continued to underperform for over a decade. Even the most patient investors are growing impatient. And, it could be years before investors will know if the current operational plan will be effective. However, the capital markets are offering a unique opportunity to significantly enhance shareholder value. Long-term interest rates are near generational lows and investors currently have a voracious appetite for large quantities of high-quality investment grade debt. At the same time, the equity market is dramatically undervaluing the company's shares (trading at less than 8x earnings, ex-cash). This creates a timely opportunity to economically reduce your share count through a one-time share buyback financed by cheap debt. With fewer shares outstanding, the company can ensure that future cash flows and value creation will accrue to the remaining shareholders (including the thousands of Microsoft employees that own stock) who believe in the company's strategy. As such, we strongly urge the Board to act on this opportunity and take immediate steps to outline and execute a well-defined and articulated capital allocation strategy.

Thank you for your consideration.

X Investment Management, LP

X, Managing Partner

EXHIBIT I: CAPITAL STRUCTURE AND OUTCOMES



Notes & Assumptions

- Issue $40 billion of debt at a 4% interest rate (this compares to MSFT's current 10-year debt at 3.4%) and 25% tax rate
- Use net proceeds from the debt offering to conduct a one-time share buyback of approximately 20% of shares outstanding at the current share price
- Use 100% of ongoing domestic free cash flow of $10 billion for payment of common dividends (increasing the annual dividend to $1.48/share)
- Borrow against ongoing international free cash flow of $15 billion to buy back up to 9% of shares each year (depending on price of buyback)

EXHIBIT II – AUTOZONE (AZO) CORPORATE ACTIONS

- On 6/26/08, AZO raised their Debt/EBITDAR target ratio from 2.1x to 2.5x in order to become more aggressive with share repurchases.
- Since then, AZO has authorized more than $4 billion in share repurchases, reducing their share count by 30% (as of 2/12/11).
- AZO has also issued debt on 3 occasions, totaling $1.75 billion.
- As a result of these actions, the stock is up 156% through 5/31/11 (vs. the S&P 500 up 5%).

AZO Cumulative Percent Change, 6/26/08 - 5/31/11

	Stock Return	Rel. Return	Total Return	Rel. Return
AZO	156.4%	--	156.4%	--
S&P 500	4.8%	151.6%	11.9%	144.4%

AZO Revenue & EPS

	2007	2008	2009	2010	2011E	4-Yr CAGR
Revenue	$6,170	$6,523	$6,817	$7,363	$7,997	6.7%
EPS	$8.53	$10.04	$11.78	$14.97	$19.18	22.5%

Source: Factset and Reuters

EXHIBIT III – DIRECTV (DTV) CORPORATE ACTIONS

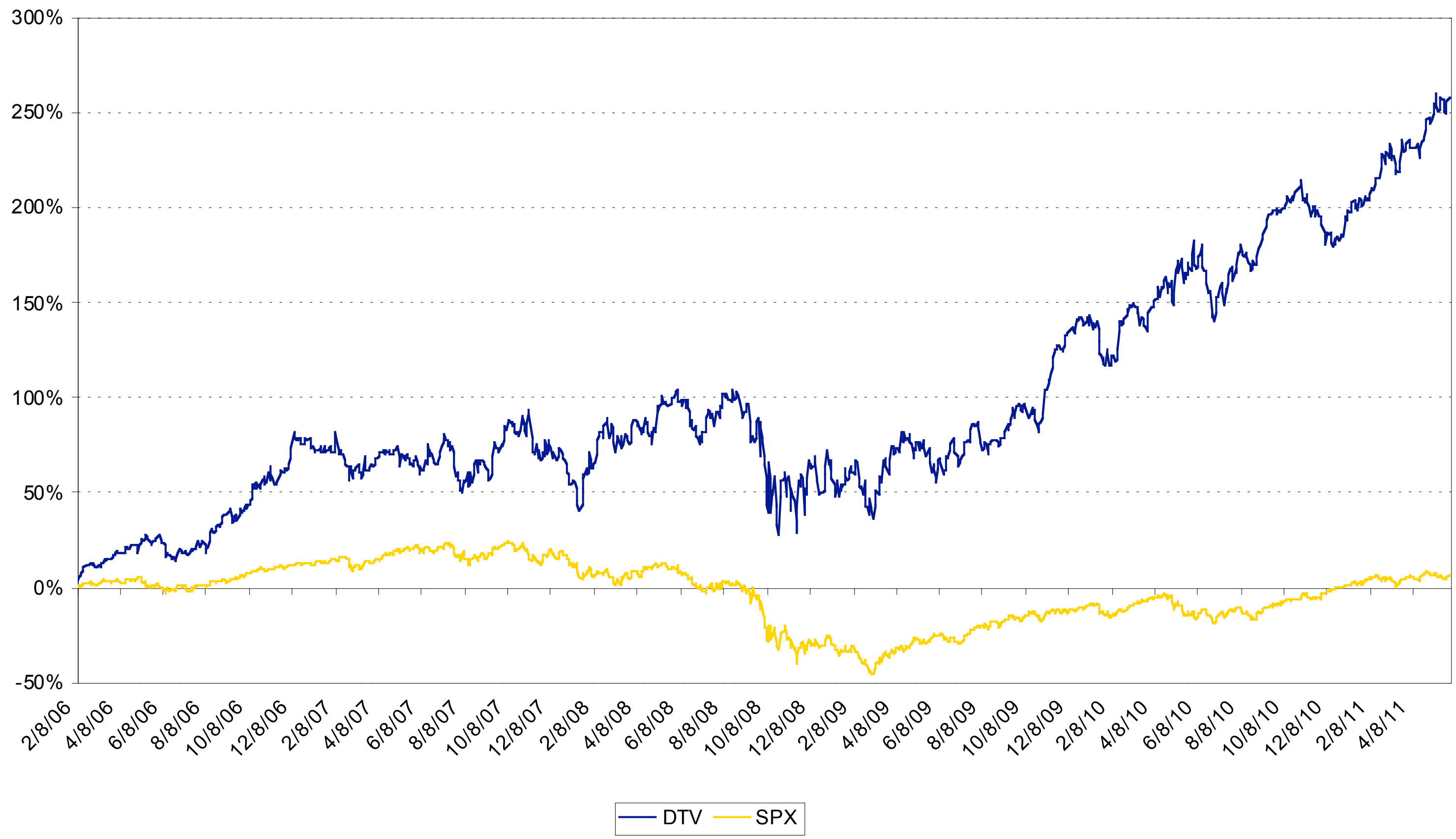
- Since 2006, DTV has authorized $21.5 billion in share repurchases and used $16.4 billion to buy back shares (as of 3/31/11), reducing their share count by 43%.
- During this time, DTV also issued debt totaling $10.5 billion, which was used for share repurchases and debt financing.
- On 5/6/10, mgmt announced a target Gross Debt / LTM US EBITDA of 2.5x.
- As a result of these actions, the stock is up 257% through 5/31/11 (vs. the S&P 500 up 6%).

DTV Cumulative Percent Change, 2/8/06 - 5/31/11

	Stock Return	Rel. Return	Total Return	Rel. Return
DTV	257.5%	--	257.5%	--
S&P 500	6.3%	251.2%	18.9%	238.6%

DTV Revenue & EPS

	2005	2006	2007	2008	2009	2010	2011E	6-Yr CAGR
Revenue	$13,165	$14,756	$17,246	$19,693	$21,565	$24,102	$26,695	15.2%
EPS	$0.22	$1.12	$1.20	$1.36	$1.44	$2.48	$3.23	71.1%



Source: Factset and Reuters

EXHIBIT IV – TIME WARNER CABLE (TWC) CORPORATE ACTIONS

- On 3/12/09, TWC conducted a 1-for-3 reverse split and issued a special dividend of $30.81 (split-adjusted). They issued $3 billion in debt to partially fund the dividend.
- TWC authorized a $4 billion share repurchase program in Nov 2010; $1.3 billion has been used. Mgmt has a target leverage ratio of Net Debt / Adj. EBITDA of 3.25x.
- TWC increased their regular quarterly dividend by 20% to $0.48 in 2011.
- As a result of these actions, the stock is up 209% through 5/31/11 (vs. the S&P 500 up 79%).

TWC Cumulative Percent Change, 3/12/09 - 5/31/11

	Stock Return	Rel. Return	Total Return	Rel. Return
TWC	209.0%	--	222.7%	--
S&P 500	79.2%	129.8%	87.5%	135.2%

TWC Revenue & EPS

	2008	2009	2010	2011E	3-Yr CAGR
Revenue	$17,200	$17,868	$18,868	$19,662	4.6%
EPS	$3.75	$3.05	$3.64	$4.53	6.5%

Source: Factset and Reuters