

Company Name: Microsoft
 Company Ticker: MSFT US
 Date: 2017-01-26
 Event Description: Q2 2017 Earnings Call

Market Cap: 502,753.09
 Current PX: 65.06
 YTD Change(\$): +2.92
 YTD Change(%): +4.699

Bloomberg Estimates - EPS
 Current Quarter: 0.689
 Current Year: 2.942
 Bloomberg Estimates - Sales
 Current Quarter: 23514.609
 Current Year: 96616.360

Q2 2017 Earnings Call

Company Participants

- Chris Suh
- Satya Nadella
- Amy E. Hood

Other Participants

- Keith Eric Weiss
- Brent Thill
- Heather Bellini
- Karl E. Keirstead
- Mark L. Moerdler
- Walter H. Pritchard
- Mark R. Murphy
- Kash Rangan
- Philip Winslow
- Ross MacMillan
- Raimo Lenschow

MANAGEMENT DISCUSSION SECTION

Chris Suh

Q2 Highlights

GAAP and Non-GAAP Financial Measures

- On our website, microsoft.com/investor, you can find our earnings press release and financial summary slide deck, which is intended to supplement our prepared remarks during today's call and provides the reconciliation of differences between GAAP and non-GAAP financial measures

Acquisition of LinkedIn

- Microsoft completed the acquisition of LinkedIn this quarter and is reporting its results in the Productivity and Business Processes segment beginning on December 8, 2016
- Accordingly, our key investor metrics do not include the impact of LinkedIn
 - Additionally, for Q2 only, we are providing non-GAAP results excluding LinkedIn to help investors compare results to the guidance previously provided for the quarter
- Our press release and slide deck contain supplemental information regarding the impact of LinkedIn on our financial results
- Unless otherwise specified, we will refer to non-GAAP metrics on the call

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- The non-GAAP financial measures provided should not be considered as a substitute for or superior to the measures of financial performance prepared in accordance with GAAP
- They are included as additional clarifying items to aid investors in further understanding the company's second quarter performance in addition to the impact that these items and events had on the financial results

Operating Expenses

- Additionally, any mention of operating expenses refers to segment operating expenses as defined in the footnotes of our Form 10-Q, which include research and development, sales and marketing, and general administrative but excludes the impact of integration and restructuring charges
- All growth comparisons we make on the call today relate to the corresponding period of last year unless otherwise noted
- We also provide growth rates in constant currency when available as a framework for assessing how our underlying businesses performed excluding the effect of foreign currency rate fluctuations

Satya Nadella

Business Highlights

Revenue

- Today I'll share the results of Q2 and discuss what's ahead
- We had a solid quarter overall, delivering \$26.1B in revenue, up 4% in constant currency
- More importantly, we are making progress by innovating in new areas, growing our addressable market opportunity, and transforming our culture
- Wherever I go in my travels, whether it's in conversations with heads of state, NGOs, or CEOs, the common thread is the transformative power of digital technology to unlock new opportunity
- Everyone I meet is talking about building their own digital capability to transform their products, service, and business model
 - They're looking to Microsoft for security, productivity, business process, cloud, and AI platforms to help drive their own transformation

Strategy

- In this last quarter, we have continued to build momentum across all of these areas, and in particular AI
- Just this month we acquired an AI deep learning startup, Maluuba, whose work in natural language processing will help advance our strategy to democratize AI for everyone

Productivity and Business Processes

- With that as a backdrop, I'll turn to progress we have made this quarter by segment, starting with Productivity and Business Processes
- Office 365 commercial seats grew 37% y-over-y and revenue is up 49% in constant currency

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- We're changing the nature of work, with Office as the universal tool kit to help people and teams accomplish more together
- To that end, this quarter we introduced Microsoft Teams, our new chat-based workspace for Office 365
- It brings together the full breadth and depth of Office 365 as well as connections to third-party services, all in a secure hub for teamwork
 - We are seeing strong demand for the preview from our existing Office 365 customers due to the deep integration of the rest of the Office platform
- And at the same time, customers not yet on Office 365 are excited about this new way to work to see Teams as a potential first cloud workload

Office 365

- In addition to collaboration, our innovation and security and compliance continues to drive customer preference for Office 365
- This quarter we added new capabilities to give IT better ways to help their users safely connect to third-party applications
- And for compliance, new eDiscovery capabilities make it easier and faster for organizations to find and analyze information related to legal and regulatory requests

PowerApps

- Customers also find value in the integration of SharePoint with PowerApps and Microsoft Flow to quickly and easily build mobile apps and automate workflows
- In fact, just eight weeks after availability, we have seen more than 0.5mm people use PowerApps or Flow
 - This combination of productivity, security, and agility is incredibly valuable to customers, particularly in sectors like financial services and healthcare

AstraZeneca

- Take Willis Towers Watson, a global financial services firm, who chose our premium enterprise offering, including Office 365 E5
- Global Fortune 500 companies TD Bank and AXA as well as Partners HealthCare and the University of Pittsburgh Medical Center all chose Office 365 for its powerful security and productivity platform
- And AstraZeneca recently upgraded Office 365 E5 for its advanced voice capabilities
- We're also expanding our growth opportunity beyond information workers by creating productivity solutions for retail, restaurant, hospitality, and manufacturing employees, who have traditionally been underserved by technology providers
- Microsoft's StaffHub, a new application in Office 365, provides shift scheduling, messaging, and sharing capabilities for all these front-line workers

Acquisition of LinkedIn

- Now let me talk about the second part of our ambition in this segment, reinventing business process

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- We completed the acquisition of LinkedIn in December, marking the start of our journey to bring together the world's professional cloud with the world's leading professional network
- Our top priority is to ensure we innovate and drive value for LinkedIn members and grow their daily engagement
- The LinkedIn business solutions, hire, market, sell, and learn, represent an expanded market opportunity for Microsoft, and we plan to diligently execute on this opportunity, keeping the member-first ethos in focus

Core Experience

- We are seeing good results with the core experience, with our revamped mobile app driving significant engagement growth in 2016
- This quarter, the sessions on LinkedIn grew more than 20% y-over-y, a consistent level of growth throughout 2016
- We also achieved record levels of mobile page views and feed interaction, creating a healthy foundation for LinkedIn's marketing solutions, which include the rapidly growing Sponsored Updates

Sales Navigator

- We also saw members engage with LinkedIn's hiring products at record levels as part of talent solutions
- And LinkedIn's sales solutions have also seen rapid growth, with Sales Navigator seats up more than 20% y-over-y during the quarter
- Sales Navigator's success on multiple CRM platforms makes it an essential tool for every B2B salesperson and one of our first integration scenarios will be to redefine social selling by enhancing Dynamics 365 with LinkedIn capabilities
- The combination of LinkedIn's business solutions and Dynamics 365 gives us a more comprehensive portfolio of business SaaS solutions and strengthens our position in this growing and competitive market

Dynamics 365

- Dynamics 365 paid seats more than doubled again this quarter and new enterprise customers are increasingly choosing our cloud solutions, with more than 80% choosing Dynamics 365
- DefenseReady is using Dynamics to give military leaders a 360-degree view of their organizations to quickly make informed decisions about capacity planning, and operations
- Amway is using Dynamics 365 to modernize and empower their entrepreneurial sales force around the globe

Intelligent Cloud Segment

- Now let's talk about the progress we are making in our Intelligent Cloud segment
- Our commercial cloud annualized revenue run rate now exceeds \$14B, and we're on track to achieve our \$20B in FY2018
- Customers choose the Microsoft Cloud for the following reasons
- They want a trusted global hyperscale cloud provider that meets enterprise-grade needs
 - They want hybrid support that is architected into the hyperscale service as well as the cloud service

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- They want higher level services to help build their own digital capability across IoT, enterprise app dev, advanced analytics, and AI capability
- Moreover and most importantly, CIOs, CSOs, BDMs, and developers are all seeing the benefit from operational consistency, productivity, and security across their entire digital estate, spanning Windows 10 Cloud and Security Management, Office 365, Dynamics 365, Enterprise Mobility, and Azure

Azure IoT

- A prime example is Mars, \$35B business with 60 brands
- An early adopter of Office 365, Mars is using Office and Windows 10 to transform how its 80,000-strong global workforce collaborates while staying secure
- And more recently, they have begun running mission-critical workloads on Azure with hundreds more on the way, including inventory management using Azure IoT
- Swift Transportation, one of the largest trucking companies in the United States, is digitizing work for nearly 20,000 drivers with Office 365 and Skype and is using Azure to harness the data from their sensor-equipped trucks to optimize driver productivity and safety
- Across industries, we continue to see strong customer demand for our differentiated cloud solutions
 - Azure revenue grew 95% in constant currency this quarter
- Azure premium revenue grew triple digits for the 10th consecutive quarter, and more than three out of four Azure customers are using Premium services

Bot Framework

- We are also leading the next-generation programming model in developer services innovation with conversational bots, microservices, and event-driven serverless compute to help businesses rapidly gain the benefits of cloud infrastructure
- Our bot framework is being used by more than 77,000 developers to do everything from e-commerce to customer service
- Azure functions is helping companies like AccuWeather and Plexure to quickly and easily implement business-critical event-driven serverless processes

Azure Service Fabric

- And everyone from game developers to financial services companies are using Azure Service Fabric for their low-latency high-scale microservices applications
- We're also rapidly expanding our portfolio of data and AI capabilities in Azure
- Cognitive services, now deeply integrated with Azure Data Lake, enables customers to use industry-leading AI capabilities to easily analyze images, text, emotions, speech, sentiments at terabyte scale

New Azure Partnership with OpenAI

- In our push to meet the needs of any developer on any platform, we joined the Linux Foundation, welcomed Google to the .NET Foundation, and announced a new Azure partnership with OpenAI to accelerate our vision

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- At the edge of our cloud, Windows Server 2016 and SQL Server 2016 give enterprises Azure-inspired scale and innovation for secure infrastructure and cloud applications
- Customers have already deployed more than 1mm instances of Windows Server 2016, and the new SQL Server drove a 5X increase in developer downloads in Q2 vs Q1

More Personal Computing

- Now I'll turn to our progress in More Personal Computing
- This quarter, we saw growth across Windows broadly
- First, Windows 10 commercial customers are rapidly adopting Windows 10, driven by their need for a secure and trusted platform
- In fact, this quarter enterprise and education deployments increased 52%
- Accenture, Broward County School District, UnitedHealthcare Group, are just a few that are choosing Windows 10 as their modern, secure enterprise-grade platform
- These three commercial customers alone have already deployed more than 300,000 seats with commitments to deploy over 0.5mm

Consumer PC Market

- The consumer PC market is also stabilizing
- Gamers are increasingly turning to Windows 10 premium PCs for the best gaming experiences, logging more than 26B hours of game play on PCs and tablets this year
- One reason gamers love their Windows 10 PC is because they can connect to their favorite games and social network on Xbox Live
- Xbox Live monthly active users grew to 55mm this quarter, a new record, with growth across PCs, mobile, as well as the console

Windows 10 Holographic Platform

- Windows 10 Creators Update will bring 3D, mixed reality and game broadcasting to all Windows 10 customers
- Partners like Dell, HP, Lenovo, and Acer are investing to deliver cutting-edge virtual reality experiences for customers using Windows 10 Holographic platform
- We are also broadening our opportunity through partnerships with chipset makers Intel as well as Qualcomm, who have committed to build the next generation of modern Windows PCs with advanced security, connectivity, AI, mixed reality, and gaming

Services Innovation and User Engagement

- Our services innovation and user engagement on Windows 10 continues to grow
- Users have asked Cortana more than 18B questions to date, and we are opening up new addressable markets with Cortana Devices SDK

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- BMW, Renault-Nissan, Harman are all using Cortana to embed voice-activated intelligence into their portfolio of products

Surface Studio

- Finally, let's talk about devices
- I'm excited about the customer reception to Surface Studio, our latest innovation in the Surface line and a new device category
- Overall commercial demand for Surface remains strong, with three consecutive quarters of more than 25% growth
- Organizations across industries are looking to Surface to help them achieve more, such as Her Majesty's Revenue & Customs in the United Kingdom rolling out Surface to more than 25,000 of its employees

HoloLens

- We're expanding into new markets with HoloLens
- Commercial customers like ThyssenKrupp Elevator are using HoloLens to enable servicing up to four times faster than ever before, and we look forward to making HoloLens available in China in H1 this year
- As customers embrace these new computers and computing experiences, we're generating enthusiasm for Windows 10 and new forms of expression, creativity, and gaming that it can unleash

New Innovation

- I'm proud of the progress we made this quarter and during the entire H1 the year
- We look to H2 with a clear focus on execution and innovation
 - We have a significant opportunity this year and beyond for growth across every one of our segments
- We're uniquely positioned to build the technology to help every person and organization take advantage of new innovations like AI and use them to drive their own growth and transformation

Amy E. Hood

Financial Highlights

Performance

- I want to reiterate that my commentary reflects our performance inclusive of approximately three weeks of LinkedIn results
- For this quarter only, I will comment on our results excluding LinkedIn for consistency with the guidance provided last quarter
- I encourage you to reference our earnings slides for supplemental information

Revenue, Operating Income and EPS

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- Our second quarter revenue was \$26.1B, up 2% and 4% in constant currency
- Gross margin grew 3%, up 5% in constant currency
- Operating income grew 5% or 8% in constant currency
- And EPS were \$0.83, an increase of 9% and 13% in constant currency
- Excluding LinkedIn, our second quarter revenue was \$25.8B, up 1% and 3% in constant currency
- Gross margin increased 3% and 4% in constant currency
- Operating income grew 8% and 11% in constant currency
- And our EPS was \$0.84, increasing 11% and 15% in constant currency

Geographic Perspective

- Our investment agility and execution focus resulted in strong performance this quarter
- From a geographic perspective, our results were largely in line with macroeconomic trends, with additional benefit from a healthier PC market, particularly in the commercial segment

Commercial Cloud Services

- Our commercial cloud services drove our annuity mix up slightly y-over-y to 84%, even with better than expected transactional revenue performance
- Commercial bookings increased 7% or 12% in constant currency
- Commercial unearned revenue met our guidance range at \$21.1B, growing 8% and 9% in constant currency, even with an FX headwind of approximately \$150mm due to the strengthening U.S. dollar through the quarter
- And our contracted-not-billed balance reached an all-time high, exceeding \$28B

Run Rate Growth

- Our commercial cloud revenue run rate grew to more than \$14B, up 49%
- Our commercial cloud gross margin percentage was 48%, up 2 points from last year, largely driven by improvement in the Azure gross margin percentage
- And gross margin dollars grew again, increasing 62% across the commercial cloud
 - We remain on track for material gross margin percentage and dollar improvement this FY

Gross Margin

- Now to company gross margin, gross margin was approximately 62% inclusive of LinkedIn, up slightly from the prior year
- This quarter, the strengthening of the U.S. dollar relative to major currencies created additional negative FX impact on total and segment level revenue
- On total revenue, FX had a 2-point negative impact, a point more than expected, with no additional impact from LinkedIn

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FX

- In both Productivity and Business Processes and the Intelligent Cloud segments, the FX impact was 2 points, 1 point more than expected
- And in More Personal Computing, FX had a 1-point impact, in line with expectations
- Total operating expenses grew 1% and 2% in constant currency
- Excluding LinkedIn, operating expenses declined 2%, also 2% in constant currency
- Operating expenses were under our guidance range primarily due to a favorable one-time legal settlement and FX benefits

Productivity and Business Processes Segment

- Now let's turn to each segment
- This quarter, revenue from our Productivity and Business Processes segment, which includes LinkedIn, grew 10% and 12% in constant currency to \$7.4B.
- In Office Commercial, revenue increased by 5% and 7% in constant currency, as Office 365 growth again outpaced the shift from the on-premise business
- Office 365 Commercial revenue increased by 47% or 49% in constant currency, driven by a combination of install base growth across all workloads and ARPU expansion

Commercial PC Market

- We also continued to see higher than expected results from our transactional business, in part due to an improving commercial PC market
- Office Consumer revenue grew 22% or 21% in constant currency, as we continued to see an increase in our subscriber base and growth of recurring subscription revenue
- In addition, the higher growth rate this quarter was aided by post-launch inventory drawdown in the prior period

Dynamics Business

- Our Dynamics business grew 7%, up 9% in constant currency, and our Dynamics 365 install base more than doubled
- LinkedIn revenue for the three-week period from December 8 to the end of the quarter was \$228mm
- Segment gross margin dollars grew 5% and 6% in constant currency, while segment gross margin percentage declined due to increasing cloud sales mix as well as roughly a point of impact from LinkedIn
- Operating expenses grew 13%, 14% in constant currency, driven by the LinkedIn acquisition
- Operating income declined slightly but was up 1% in constant currency and up 7% in constant currency excluding LinkedIn

Intelligent Cloud Segment

- The Intelligent Cloud segment delivered \$6.9B of revenue, growing 8% and 10% in constant currency

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- Server products and cloud services grew 12% and 14% in constant currency, with strong momentum in our Azure business and another quarter of double-digit annuity revenue growth
- Post-launch demand and purchasing ahead of currency driven pricing adjustments contributed to a higher than expected transactional revenue, mainly from Windows and SQL Server 2016

Enterprise Services

- As expected, Enterprise Services revenue growth declined this quarter 4% and 2% in constant currency due to lower volumes of Windows Server 2003 service agreements
- Gross margin dollars grew 2% and 4% in constant currency
- And segment gross margin percentage declined due to an increasing cloud revenue mix and a lower Enterprise Services gross margin, partially offset by material improvement in Azure gross margin
- We grew operating expenses by 12% and 13% in constant currency, with continued investment in cloud engineering, sales capacity, and developer engagement
- Operating income declined 7% and 4% in constant currency

More Personal Computing

- Now to our final segment, More Personal Computing, revenue exceeded our expectation at \$11.8B, primarily from stronger than expected performance from our Windows business
- Overall, revenue declined 5% and 4% in constant currency
- Our OEM business grew 5% this quarter
- OEM Pro grew 6%, better than we anticipated, driven by an improving commercial PC market and enterprise demand for Windows 10
- OEM non-Pro grew 5%, ahead of the consumer PC market, as our partner ecosystem continued to see growth and share gains in the Windows premium device category
- Inventory levels remain normal
- Windows commercial products and cloud services grew 5% and 6% in constant currency, with double-digit annuity billings growth and install base expansion

Search Business

- Patent licensing declined this quarter, driven by lower unit volume and revenue per unit
- Our search business ex-TAC grew 10% and 11% in constant currency, with improving profitability and continued growth in Bing from higher revenue per search and search volume

Devices Business

- In our devices business, revenue declined 35%, down 34% in constant currency
- Phone revenue declined 81%, and we closed the sale of our feature phone business during this quarter
- Surface revenue was down 2% and flat in constant currency, as we continued to phase out the Surface 3 device

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- Importantly, Surface gross margin dollars grew 6% and 17% in constant currency from an increasing mix of Pro 4 and Book replacing Surface 3 in the portfolio

Gaming

- In gaming, revenue declined 3% and 1% in constant currency due to lower console hardware pricing and Xbox 360 volumes
- In this holiday quarter, as Satya mentioned, we reached an all-time high of active Xbox Live users, which helped to drive our gaming software and services revenue to 18% and 21% growth in constant currency
 - This marks our first \$1B quarter of digital transactions for our gaming business through our Universal Store across Windows 10 and Xbox One

Gross Margin and Operating Expenses

- Segment gross margin percentage and dollars both increased this quarter
- Gross margin dollars grew 3% and 5% in constant currency, and gross margin percentage expanded with the continued shift to higher-margin products and services
- Operating expenses declined by 12%, also 12% in constant currency, from lower phone expense, a one-time legal settlement, and reduced marketing spend
- Growth from Windows 10, the shift toward higher gross margin products and services in devices and gaming, and disciplined operating expense management resulted in operating income growth of 33% and 37% in constant currency

CapEx and Non-GAAP Effective Tax Rate

- Now back to our overall company results, we invested \$2.5B in CapExs, inclusive of capital leases, as we continued to support customer and partner demand across our commercial and consumer services
- During the quarter, other income and expense was \$186mm
- Our non-GAAP effective tax rate was 22%
- We returned \$6.5B to shareholders through stock repurchases and dividends, completing our prior \$40B share repurchase program this quarter, as we committed

Outlook

FX

- Now let's turn to the outlook, first FX
- We had originally expected FX rates to lessen going into H2
- However, given current rates, we expect continued currency headwinds for the rest of the year
- For Q3, we now expect about 1 point of negative impact on total revenue
- Within the segments, we anticipate about 2 points of negative FX impact in Productivity and Business Processes and Intelligent Cloud, and 1 point in More Personal Computing

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- In Q4, we anticipate about 2 points of negative FX impact on total revenue, 3 points in Productivity and Business Processes and Intelligent Cloud, and 1 point in More Personal Computing

Commercial Business

- Second, our commercial business, we expect our commercial cloud services to continue to drive annuity growth as we expand our install base, grow consumption, and execute well on renewals
- We expect commercial unearned revenue of \$20.2B to \$20.4B, in line with historic seasonality
 - We continue to expect some volatility in our transactional business due to macroeconomic conditions and the ongoing shift to the cloud

CapEx

- Third, CapEx, we will continue to meet customer demand by expanding data center capacity while driving efficiencies through new technologies
- With the addition of LinkedIn, we expect our CapExs, including capital leases, to grow sequentially to support a broader portfolio
- For the full year, including LinkedIn, we continue to expect the CapEx growth rate to be lower than last year

Productivity and Business Processes

- Let's turn to our outlook for the individual segments
- In Productivity and Business Processes, we expect revenue of \$7.65B to \$7.85B
- This reflects the continued annuity shift to the cloud with Office 365, Dynamics double-digit billings growth, and LinkedIn revenue of approximately \$950mm, adjusted for the impact of purchase accounting

Intelligent Cloud

- In Intelligent Cloud, we expect \$6.45B to \$6.65B of revenue, with continued annuity strength and double-digit revenue growth across our server products and cloud services
- Enterprise Services revenue should decline again due to a lower volume of Windows Server 2003 service agreements
- And in More Personal Computing, we expect revenue of \$9.05B to \$9.35B.

OEM Business

- In our OEM business, we anticipate revenue growth will exceed the overall PC market
- Continued growth in Pro, driven by enterprise momentum for Windows 10, should be roughly in line with the commercial PC market, with some additional benefit coming from the prior-year inventory build
- Our OEM non-Pro performance should grow ahead of the market due to strength in the premium device category

Search

- In Search, we expect Bing's revenue growth ex-TAC to be similar to Q2

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- As a reminder, total search revenue growth will slow now that we've passed the one-year anniversary of our Yahoo! deal and the associated change in revenue recognition
- And in Gaming, we expect normal post-holiday trends, with declines in hardware console volumes and pricing balanced by higher engagement, usage, and transaction volume

Devices

- In Devices, we expect revenue to decline, driven primarily by phone
- Surface revenue is expected to decline slightly with our ongoing Surface portfolio mix shift to Pro 4 and Book
- We expect COGS of \$8.35B to \$8.45B, including approximately \$400mm of LinkedIn expenses
- LinkedIn COGS include approximately \$220mm of amortization of acquired intangible assets

Operating Expenses

- We expect operating expenses between \$8.5B to \$8.6B, with about \$970mm from LinkedIn
- The LinkedIn expense includes about \$160mm for the amortization of acquired intangible assets
- For the full year, we now expect operating expenses of \$33.1B to \$33.3B, with about \$2.3B from LinkedIn
- The LinkedIn expense includes roughly \$360mm of amortization of acquired intangible assets
- Other income and expense should be \$150mm
- We continue to expect our full-year non-GAAP tax rate to be 20% +/- 2 points, with variability driven by the proportion of services revenue vs. licensing revenue, the geographic mix of revenue, and the timing of equity vests

QUESTION AND ANSWER SECTION

<Q - Keith Eric Weiss>: I wanted to ask a question about LinkedIn and what our expectation should be for achieving revenue synergies on LinkedIn. It seems like there's a lot of really interesting things you can do with that asset in combining it with your own portfolio. And how should we think about the potential for achieving some expense synergies? Obviously, there's a big cloud base that you could utilize under their assets, and Amy, you've always been very good at keeping expenses very well managed. So just as we go forward past the forward quarter, how should we think about the timeframe for achieving those benefits?

<A - Satya Nadella>: Yeah. Let me start, and then I'll turn it over to Amy to talk about the specifics of the synergies. The core focus, Keith, for us to start with is to ensure that the innovation roadmap we have is all driving member value. The core ethos of LinkedIn needs be about member-first. How do we increase the engagement on the mobile flagship application as well as the revamped desktop experience that's now rolling out? We think that's at the core of being able to in fact then have all of the revenue – have revenue growth in their business solutions with across higher market sell. So that's how I see it. It's a two-sided market which starts with the [ph] health (35:02) of membership and member engagement.

And that is where the product roadmap, whether it's the integration with Office 365 or Dynamics 365, we'll be staying focused on it. We expect to see that roll out pretty rapidly. And as far as the guidance we have given at close in terms of what to expect, for example around EPS impact, those are things that we'll stay committed to. And I'll let Amy add more to it.

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<A - Amy E. Hood>: Yeah, I think Satya is correct. The guidance we gave at the time of the announcement in terms of EPS dilution on – excluding the impact of purchase accounting, being minimally dilutive, 1% +/-, stands, including the goal to achieve synergies where they make sense as we continue to focus on growing the core business and keeping it incredibly healthy and realizing the revenue synergies that we know exist across the businesses.

As a reminder, the two biggest impacts of purchase accounting, one is it does impact the deferred revenue. So the in-quarter revenue and the guidance will look a bit lower due to that, as well as the amortization of intangible expenses, which will also hit. We'll take care to give you insight into those so that you can continue to hold us against the goals we set for ourselves.

<Q - Brent Thill>: There are a number of investors that had been wondering about the sales reorg that takes place February 1. Perhaps this has been a worry that's been overstated. Can you just give us a sense? Are there changes that are happening that will take place February 1 that are different, or is this a minor tweak to the go-to-market going forward?

<A - Satya Nadella>: I can comment on it. I'm not particularly sure exactly what's happening on February 1. I would say the overall change that we are going through, and this has been ongoing for I would say the last multiple years, is transforming our field engagement model, where we're putting a lot more technical depth in the front-line sellers so that they can engage, whether it's data specialists, cloud specialists, security specialists, or even productivity specialists. Because it's super-important for us in this phase when people are looking for solutions to help them visually transform, for us to have a very fundamentally different type of capability in terms of our sales, and that's the transformation. And so we have really reorganized ourselves, both in the headquarters and in the field, to be able to recognize that shift.

What used to be large accounts for us, for example, are not by PC count anymore, and that's a pretty fundamental change. It's by consumption of cloud capacity in many cases. And this is happening all over the world. So that's the transformation that you will increasingly see us push forward, and no status quo on any part of Microsoft's organization should be counted on. If anything, we'll push to make sure that we are addressing what is our growth opportunities pretty aggressively.

<A - Amy E. Hood>: And I think, Brent, in terms of there being a date, a very particular date, this is something, to Satya's point, we've been doing in a step function improvement over time for the past couple years, and we'll continue to do it. And the guidance certainly doesn't imply any type of slowdown in the commercial business. In fact, in some ways, it actually includes an acceleration in certain areas. So I think that's how I tend to look at it.

<Q - Heather Bellini>: Amy, you noted a material improvement in Azure gross margins this quarter. I was just wondering if you could share with us. I guess given how quickly revenue is growing in this area, how fast can we see margins ramp, which obviously were negative? And now that you're getting to some big revenue numbers, is there any reason why at a similar revenue scale you shouldn't be able to match the gross margins of what AWS, what you can back into from the financials of AWS? Can you walk us through the puts and takes? And then once you hit that scale point, is it something that we should see inflect pretty quickly? Thank you.

<A - Amy E. Hood>: Thanks, Heather. Let me start by saying we really do think about and talk about our cloud as containing all of the components, from the IaaS layer to the platform layer to the SaaS layer. You'll hear us talk about Dynamics 365, Office 365, as well as our Azure core and premium services.

And so when I think about the material gross margin improvement we saw in Azure, it continues the path we've actually been on where we've been discussing, as you continue to see customers ask for us and our help in managing their digital estate, consistently, securely through one interface, you'll actually see growth across all components of that cloud. It benefits margin, not just in Azure but across actually the entirety of the cloud. That 2-point y-over-y increase in the commercial cloud gross margin really, even with the massive growth in Azure over the course of the year, certainly implies the improvement that we expected. But I tend to think you will consistently hear both Satya and I refer to our cloud in its entirety. But I do respect people always wonder, so I did comment that we saw material improvement in Azure specifically.

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<Q - Karl E. Keirstead>: Amy, I'm going to ask another question on gross margins, but this time at the Microsoft level. So your prior guidance was for ex-LinkedIn FY2017 gross margins to be down 100BPS. So the quarter you just posted gross margins ex-LinkedIn were actually up. And if I ran the math accurately, it looks like for your March quarter ex-LinkedIn, you're expecting gross margins to be about flat. So it feels like you're outperforming the core Microsoft gross margin guidance you gave before. So are you sticking with the down 100BPS or has that improved? And if it has, what are the one or two biggest drivers of the gross margins feeling a little bit better ex-LinkedIn? Thank you.

<A - Amy E. Hood>: Thanks, Karl. I am sticking with it being about a point. That's the guidance we gave. And even inclusive of LinkedIn, I continue to believe it's about a point. So in some ways, I guess you could say it implies slightly better at the company level, if that's how you're thinking about it.

Really, Karl, what can drive that in addition to the overall gross margin improvement we talk about in the cloud, it's also really the strength we see in our Windows business. And I mean that not just in our OEM business but also across the commercial business for Windows. That tends to have a very good margin profile. And as we continue to improve the margin profile of our devices, we continue to see the OEM business health improve. And actually, we continue to see the growth in the consumer services around the transactions that run through Xbox is also good margin business for us that looks quite different than the hardware profile. So all of those can impact it, Karl, as we look through the rest of the year. But in general, inclusive of LinkedIn, I'm still around 100BPS.

<Q - Mark L. Moerdler>: So, Amy, the on-premise Server & Tools business grew 5%, 7% in constant currency. It was obviously helped by Windows Server 2016 and SQL Server 2016. How should we think about on a longer-term horizon over the next 12 months or even longer how those two should help on the on-premise license or annuity business, on the cloud in Azure? How should we think about the impact of that? Thanks.

<A - Amy E. Hood>: Thanks, Mark. Let me start by saying it's why we tend to focus all up at that server products and services KPI being double digits generally an easier way for us to talk about it all up between Azure and the on-prem business. But let me talk a little bit about what impacted the transactional business this quarter, and then we can talk about how to think about it in Q3 and maybe going forward.

We did and we're encouraged by the customer reaction, even our transactional customers, to the security and management value prop as well as the hybrid nature of our SQL and Windows Server 2016 releases that have taken place this year. That value prop is resonating. We saw some growth. I feel very good about that. And so I do think that can have an impact in H2. You heard me talk a little bit about it. With the major currency changes we saw in Q2, we've also done some price adjustments between certain geos for us. It did pull forward a bit of revenue into Q2. And so it will be a bit of a drag on Q3, which is taken into account in the guide. But I would reiterate the biggest driver of the transactional performance this quarter was really the value prop people saw.

<Q - Walter H. Pritchard>: Amy, I'm wondering if you can talk about – we're still seeing the majority or really all the growth in operating profits come from MPC on a y-over-y basis. And I'm wondering how we should think about the factors impacting and the timing in the handoff of profit growth from MPC to IC and PBP, if that's something that you expect. What are the factors and timing there?

<A - Amy E. Hood>: Right, I would say actually we've also seen some operating income growth in our PBP segment this quarter, up in constant currency, 7% before LinkedIn. So I do want to say some of that impact is absolutely landing as well as growth.

But the heart of your question is really about the MPC transition and IC. The way I think about it, we really – Satya and I and the leadership team decided, gosh, about 18 months ago – it's been a little longer than that now, to over-index on investing because of the TAM we saw in the Intelligent Cloud. We increased hiring and we invested in direct customer acquisition cost. We invested in many of the things Satya just talked about in terms of technical capabilities and our sales force. We're starting to see the benefit of that already in our top line numbers. That 12% or 14% in the server product and services KPI is a very good number. And I continue to expect that we'll see growth in revenue as those resources both get hired, get up to speed, and add value at accounts.

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A lot of that account value frankly, Walter, today is coming in the form of consumed revenue. Consumed revenue is actually a great leading indicator for what we expect our Azure growth going forward to be. And so some of the confidence I think that we have in the transition of that investment in operating expense into even more revenue growth comes from seeing the consumed revenue trend that we're seeing today as well as the pipeline of projects and customers that we have. And so I do think about that being an 18-month investment we've been making. It's starting to pivot to consumed. It will then land as billings and ultimately in our P&L as GAAP revenue in-quarter off the balance sheet.

But I think you're right. We have been working and continuing to reinvest and save through the year as we look to get everything here more efficient. People often think we focus on cut here, add here. It's also about, are we putting every dollar most efficiently to help customers be successful? And I think that's a lot about what you heard Satya talk about the sales transition we're going through, whether it's how we build products. And so I actually am confident you'll start to see that transition land.

<A - Satya Nadella>: I think Amy described it well in answering the very specific technical question about segment reporting and the margins in it. But architecturally, some of the examples I used are about the digital estate that actually doesn't start with Azure. In many cases, it starts with advanced set protection of Windows 10 estate. And then how does that relate to Office 365? How does that relate to Azure Active Directory? And then the workloads that they want to put, which are Tier 1 workloads in Azure.

It's very similar to what happened even in the client server era, but of course the starting points and how this progresses is very different. So we are always thinking at least of the technical architecture that makes us unique and differentiated spanning all of it. And so I don't think of it as margin shifts across the segments, and that's why we think of all of this as one digital estate at least from a customer-end perspective.

<Q - Mark R. Murphy>: Satya, I'm wondering what you think would be required to extend the hyper-growth trajectory for Azure into the future. For example, are there incremental waves of activity on the horizon that you would tie to Tier 1 workloads or large data center migrations or serverless usage which would enable that?

And separate from that, Amy, I'm curious just philosophically. How do you plan to handle price cuts for compute and storage when they occur? Do you think you're better off matching them, exceeding them, or does it make sense perhaps warranting a premium in many cases due to the differentiated IP that you have up the stack?

<A - Satya Nadella>: Yeah, let me start. Overall, I think some of the trends that you've referenced, whether it's Tier 1 workloads or serverless or even complete data center migrations, all of that is happening. Even the customer examples I gave, they were littered with example after example.

For example, in FinServ, some very Tier 1 trading applications now using some of our capabilities in service fabric, which is really a PaaS service, which allows you to manage microservices with low latency and high scale, that's a place where we are seeing in fact activity, whether it's game development or trading applications. We are seeing even interesting use cases of Azure functions, which is completely serverless. In fact, you can think of it as a price cut for anybody who cares about being very, very smart about cloud consumption. Going serverless is something that we in fact advocate.

So across the board, I feel we have the right mix of IaaS, PaaS, SaaS, and per user SaaS services like Azure Active Directory, which gives us the right mix to be able to even have the right margins long term. We're not concentrated in any one layer of the stack, which is something we do by design because our vision has always been that we want to of course offer all of these layers, and customers will choose depending on their needs and their scenarios. And we are now seeing even a single customer estate spanning all of these.

<A - Amy E. Hood>: And, Mark, I'm not sure I want to get into our pricing theory on the call on a go-forward basis in terms of whether or not we match competitors. But what I would say is really fundamentally related to Satya's point around differentiation of the entire stack and what customers are doing in their digital estate. And the ability to earn margin through that is actually more impactful than whether or not you match pricing at the core.

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<Q - Kash Rangan>: One for you, Amy, and one for you, Satya. One, Amy, when I look at your comments on gross margin, clearly you're not in a position to break out Azure-only gross margin. But I'm wondering if we can take a [ph] composite of (52:37) your commercial cloud. Targets are about \$20B. So if I take what I believe could be a rough split between Azure vs. the SaaS segment and look at the best-of-breed companies, I could get about 70% – 75% gross margin when you hit your targets. I'm curious what you think about that. Is that too aggressive or within the ballpark?

And for you, Satya, as cloud computing moves to the enterprise, there's some belief among investors that AWS is going to be a big, strong competitor in the enterprise, which is typically not a stronghold for them. How do we think of Microsoft's enduring strength in the enterprise? And how confident can we be that you should be able to capture your fair share of enterprise workloads as they move to the cloud? Thank you.

<A - Satya Nadella>: Let me start with the second part, and then you can add.

<A - Amy E. Hood>: Yes.

<A - Satya Nadella>: So, Kash, the way I think about it is, even in the client server era, we had tough competition. We had Oracle. We had VMware, and we had many other players we competed with and I grew up competing with. And we now have AWS I think who is going to be a credible competitor. So I feel that, as I said, we have a cloud strategy that is not just about infrastructure. It is about really SaaS and infrastructure. And we want to uniquely think about what are the things that we can do to differentiate and add value to our customers' digital estate in the cloud in that context. And that's where, if you will, our fair share will come from by competing hard where we have to but also mostly thinking about differentiation.

<A - Amy E. Hood>: And in terms of is there a long-term gross margin cloud number that is industry-leading, I think right now there's a benchmark in the SaaS community that's probably around the number you talked about in terms of more SaaS applications. And then as you go down through the layers from PaaS to IaaS, that margin declines, obviously much as it did when that was run as a hardware solution. The margins weren't as high either. And so I do think it will be a blend of those. But certainly at the SaaS end, I understand where you get that benchmark from.

<Q - Philip Winslow>: Just wanted to focus back in on Office 365 on the commercial front. You had another strong quarter of revenue growth obviously at 49% constant currency, but it continues to meaningfully outpace the seat growth, which is still strong, about 37%. So that commentary that you all had given about premium mix in the past, two questions here. First to Satya, when you think about where we are in the progression, call it up to E5 so to speak or E3, how do you think this plays out? And how do you think about the mix of unit growth vs. that premium mix and translating it to revenue?

And then to Amy, I guess I'd argue that maybe we've done the low margin or low gross margin parts of the Office 365 transition. And now as this mix goes up, you're actually not just increasing revenue, but the margin is better too. Is that fair? And then how do you tie that back to your commercial cloud gross margin expectations long term?

<A - Satya Nadella>: Yeah. I can start. On the product side, we think of actually three things we are trying to do on a continuous basis in Office 365. First, even for the customers who are already on Office 365 at any given licensing level, we focus quite a bit on their increased usage and intensity. So for example, one of the comments I made in my remarks was, for example, SharePoint with PowerApps and Flow. That's to us the best way for us to keep having that recurring value. And so we focus quite a bit on adding additional value even to the existing licensing levels and increasing intensity of usage.

Then things like what we are doing to even go to non-knowledge worker audiences in retail or in manufacturing with some of the things that we're doing with staff scheduling for example. That's a way to expand seats even beyond what is the traditional knowledge worker. Of course, we have significant more opportunity in small and medium sized businesses, although we have had good healthy growth there. I think seat growth will come more from material increases internationally as well as with some of the regulated segments of the market finally moving to the cloud. Those are all opportunities ahead.

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And then the last one of course is the new value in things like E5 with voice or analytics and security. So all those three dimensions, there will be variability quarter-to-quarter in terms of what's happening. But in terms of our investments in that core product value, it is actually happening on all those three.

<A - Amy E. Hood>: And to your point on where we are and what's driving that delta and its consistency, frankly, over time, actually still the biggest impact is from the transition to E3. Transitions take time. And so you're just starting to see some of the impact from E5. We're excited about all the customers in trial and are already starting to use the value, whether it's security, increasingly analytics, and ultimately voice. But really from an ARPU perspective, the biggest driver continues to be the transition to E3.

And so then that leads to your question on do you continue to believe there's some margin expansion possible as you add newer and higher value workloads. And of course, the answer to that is we do believe that, but it certainly comes over a period of time and run through our annuity base over that pace.

<Q - Ross MacMillan>: Congratulations from me as well, two questions, one for Amy first. When we look at CapEx, it actually declined y-over-y ex-capital leases, but even with capital leases the growth rate decelerated. And for the full year, it's obviously a pretty wide range, roughly zero to 40% growth. I'm just curious, Amy. With LinkedIn, have you made any changes to your CapEx assumptions for core Microsoft? And I guess I'm pointing to the fact that it did seem to decelerate quite a lot this quarter. And I wondered if there's any additional color you could frame around the growth rate for all-up CapEx plus capital leases. Thanks.

<A - Amy E. Hood>: Sure. Let me first comment on that I've said it will be lower than it was previously. I certainly would help you in that number and say a little lower, just so that you're getting into something closer. I realize zero to 40% is not as helpful.

I would also say that it does tend to be lumpy, and it's why I don't give very specific guidance every single quarter, and it was not at all impacted by LinkedIn. Our real goal for LinkedIn is – over time of course I'm sure they'll want to take advantage as we build new services together of some of our infrastructure assets. But in the short term, the most important thing is they continue to add value and usage and great experience for their members. And so I have really no intention of messing with that in terms of CapExs in the short and next six months for sure. So I think what you're seeing in terms of y-over-y and what does it mean for next year, this next quarter, it will be a sequential increase, but again, it is a bit lumpy.

<Q - Raimo Lenschow>: I wanted to ask on Windows 10. Satya, you talked at the beginning about customers starting to adopt it, and you mentioned three large ones already. Can you talk a little bit about that cycle and how you see everything that's unfolding and what the customer feedback is in terms of their intention to adopt it now vs. waiting for a little bit? Thank you.

<A - Satya Nadella>: I think the overall adoption cycle of Windows 10 in the enterprise is perhaps the best that we have seen in the enterprise for any new release of Windows, and primarily driven by security and manageability of the new Windows, and that's what's been the driver.

But in addition to that, I must say there are two other things that are increasingly becoming fairly relevant in the adoption cycle, which is moving to both Office 365 and Windows 10 and getting essentially to this new frontier for productivity, which is an always up-to-date operating system, which is secure, and an always up-to-date Office experience that is a SaaS service. We're increasingly seeing that resonate, not just in small business and some of the high-tech industry as it has been in the past, but now even in the regulated parts of the enterprise. So we are very excited about that.

The other piece also that's driving is hardware innovation by the entire ecosystem. In fact, the work that we did with the Surface line has really stimulated the entire ecosystem to do some of the best innovative work, and you saw that even at CES. And the enterprise adoption of these new devices is also driving the overall excitement around Windows 10 and Windows 10 innovation.

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