Microsoft Corporation (MSFT) CEO Satya Nadella on Q3 2019 Results - Earnings Call Transcript

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Q3: 2019-04-24 Earnings Summary

Play Call | 10-Q

EPS of $1.14 beats by $0.14 | Revenue of $30.57B (13.99% Y/Y) beats by $711.34M

Microsoft Corporation (NASDAQ:MSFT) Q3 2019 Results Earnings Conference Call April 24, 2019 5:30 PM ET

Company Participants

Michael Spencer - General Manager, Investor Relations

Satya Nadella - CEO

Amy Hood - EVP & CFO

Conference Call Participants

Heather Bellini - Goldman Sachs

Keith Weiss - Morgan Stanley

Mark Moerdler - Bernstein Research

Karl Keirstead - Deutsche Bank

Jennifer Lowe - UBS

Mark Murphy - J.P. Morgan

Ross MacMillan - RBC Capital Markets

Brad Zelnick - Credit Suisse

Raimo Lenschow - Barclays

Operator

Greetings. Welcome to the Microsoft Fiscal Year 2019 Third Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions]. Please note this conference is being recorded.

I will now turn the conference over to your host Mike Spencer, General Manager of Investor Relations. Mr. Spencer, you may begin.

Michael Spencer

Good afternoon, and thank you for joining us today. On the call with me are Satya Nadella, Chief Executive Officer; Amy Hood, Chief Financial Officer; Frank Brod, Chief Accounting Officer; and Keith Dolliver, Deputy General Counsel.

On the Microsoft Investor Relations website, 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 a reconciliation of differences between GAAP and non-GAAP financial measures. Unless otherwise specified, we will refer to non-GAAP metrics on the call. 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 have on the financial results.

All growth comparisons we make on the call today relate to the corresponding period of last year, unless otherwise noted. We will 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. Where growth rates are the same in constant currency, we will refer to the growth rate only.

We will post our prepared remarks to our website immediately following the call until the complete transcript is available. Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript, and in any future use of the recording. You can replay the call and view the transcript on the Microsoft Investor Relations website.

During this call, we will be making forward-looking statements which are predictions, projections, or other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the risk factor section of our Form 10-K, Forms 10-Q, and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

And with that, I’ll turn the call over to Satya.

Satya Nadella

Thank you, Mike, and thanks to everyone on the phone for joining.

It was another strong quarter with double-digit top-line and bottom-line growth, the result of picking the right secular trends, accelerating innovation and most importantly, relentlessly focusing on our customers' success.

Our trusted, extensible cloud platform spanning application infrastructure, data & AI, productivity and collaboration, as well as business applications enables every organization to create their own intelligent systems and experiences to compete and grow.

Now I'll briefly highlight key areas of innovation and growth across our business.

Microsoft 365 empowers everyone from the largest multinationals to small businesses; from knowledge workers to first line workers with an integrated secure, compliant experience on any device. It is the only comprehensive productivity collaboration and communications solution that integrates with an organization's business process workflows.

Microsoft Teams brings together everything a team needs, messaging, video conferencing, meetings and collaboration into a single integrated user experience scaffolding, eliminating the need for discreet apps that only increase an organization's security and compliance exposure. 91 of the Fortune 100 use Teams, and more than 150 organizations have over 10,000 active users.

And we are expanding Teams to new industries like healthcare, with priority notifications for patient care and the ability to securely access patient records.

Cybersecurity is a central challenge, and Microsoft is the clear leader in cloud security with our unparalleled operational security posture, and our growing portfolio of security and compliance solutions, spanning identity, device endpoints, email, information, cloud applications as well as infrastructure.

In financial services, National Bank of Canada, BNP Paribas, Refinitiv a joint venture between Thomson Reuters and Blackrock, all chose Microsoft 365 for our advanced security and compliance.

We expanded Microsoft Threat Protection to include the Mac and manage vulnerabilities in third-party applications, providing the best defense for customers' heterogeneous environments. And we introduced two first-of-their-kind services: Azure Sentinel analyzes security signals at massive scale across an entire organization, using AI to detect, investigate and respond rapidly to threats. Microsoft Threat Experts is a new cyberthreat hunting service that provides access to our security experts on demand.

All this innovation is driving growth. Office 365 Commercial now has 180 million users. Our EMS installed base reached 100 million. And the Outlook apps on iOS and Android surpassed more than 100 million users for the first time this quarter.

We expanded our Surface family of devices with the Surface Hub 2S, which brings together Teams, Windows, and our category creating Surface hardware to power teamwork for organizations like Volvo, Domino's Pizza, Northwestern University and NASA Jet Propulsion Labs.

Finally, Windows 10 is now active on more than 800 million devices and continues to gain traction in the enterprise as the most secure and productive operating system.

Moving to business applications.

Today, traditional systems of record and engagement are often siloed, limiting the value of an organization's most important asset, its data. Dynamics 365 solves this challenge connecting all their systems and creating digital feedback loops, enabling any organization to become a true AI-first company.

The Open Data Initiative we announced last year with Adobe and SAP delivers on this promise, and is already enabling customers like Unilever to unify their business data across all their lines-of-business applications to unlock new AI-driven insights.

Personalization is increasingly key to every organization's marketing strategy enabling them to effectively engage customers, tailor their experiences and increase return on investment. Tivoli is one of the world's oldest amusement parks is using AI in Dynamics 365 to help personalize marketing campaigns and transform how their first-line workers engage with guests, reducing churn and increasing customer loyalty.

And we are not stopping there. We are leading in two emerging categories: robotic process automation and mixed reality. Our Power Platform brings together robotic process automation with self-service analytics and no code-low code app development.

Recent updates enable citizen developers to build higher-quality PowerApps faster and easier and along with new capabilities in Power BI empower customers like SNCF, France’s national railway, to create a more data-centric culture.

Our new HoloLens 2 is the most advanced, intelligent edge device available and in combination with Dynamics 365 and new Azure mixed reality services enables organizations like PACCAR and Chevron to digitize physical spaces and interactions to empower their first-line employees with the right information at the right time in the context of their business process work.

All this innovation is driving growth. Revenue from our Power Platform grew triple-digits year-over-year, and for the first time, more than 50 percent of our Dynamics revenue was driven by the cloud.

Moving to LinkedIn.

LinkedIn again exceeded expectations across all lines of business driven by record levels of engagement in the feed, content shared across the platform, the messages sent this quarter.

Marketing Solutions was up 46% year-over-year, and customers are relying on our new Pages experience and audience targeting capabilities to connect with LinkedIn’s nearly 630 million members.

We saw record job postings again this quarter and are making it easier for job seekers to find more relevant and higher paying jobs and get personalized salary insights.

We have the most comprehensive solution for every organization to manage and engage their most important resource, their talent. New tools in Glint empower managers to quickly analyze and action feedback to have the greatest impact on team performance. And with our combination of LinkedIn Talent Solutions, Talent Insights, LinkedIn Learning, and Glint, we are helping employers access data driven insights to attract, retain and develop the best talent in an increasingly competitive jobs marketplace.

Now let's talk about Azure.

From the outset, we took a differentiated approach to the cloud to meet the real world needs of customers. Our architectural advantage is a clear reason for our success. Azure is the only true hybrid hyperscale cloud that extends to the edge. Operational sovereignty is increasingly critical to customers, and Azure uniquely provides consistency across development environments, operating models and technology stacks, whether connected or disconnected to the public cloud. And we're accelerating our innovation.

Azure Stack extends our hybrid differentiation, enabling customers like Airbus Defense and Space to build and run cloud applications at the edge. And now with our new Azure Stack HCI, customers can build and run virtualized applications on-premise in a consistent way.

Azure Data Box Edge is a powerful new AI-enabled edge appliance that sits within a customer's environment in their data center or on a factory floor so that they can use AI to reason over data at the edge.

More than 95% of the Fortune 500 run their workloads on our cloud, including TD Bank. And AT&T chose Azure to shape the future of 5G with computing at the edge.

We are building Azure as the world's computer, with more global datacenter regions and now two in South Africa and more compliance certifications than any other cloud provider. And just last week we announced two new Azure government regions to meet the stringent requirements for maintaining the security and the integrity of classified US government workloads.

Every organization needs an IoT strategy to manage the 20 billion connected devices coming online by 2020. Our comprehensive Azure IoT platform enables customers to build, manage and secure their connected devices, and our recently announced acquisition of Express Logic furthers our goal, bringing our cloud to more than 6 billion MCU-powered endpoints.

BMW Group is partnering with us to speed the adoption of industrial IoT, both in automotive and more broadly in manufacturing, and Renault-Nissan-Mitsubishi Alliance and Volkswagen both chose Azure to fuel their new connected car experiences.

Data and analytics is the foundation for building an organization’s AI capability, and we are investing to make Azure the best cloud for data estates from data warehousing to real-time stream analytics. Daimler chose Azure as its new platform for big data and advanced analytics, and third-party analysts affirm our price performance lead in this fast-growing space.

And we are investing to make Azure the best place to build AI. This quarter we introduced new Azure Cognitive Services for fraud detection and image identification. Telefonica is using Azure AI services to create new intelligent experiences for their customers around the world and transform customer engagement.

The developers will play an increasingly vital role in value creation and we are committed to giving them the tools they need to be productive on any platform. GitHub surpassed 36 million registered users, and free private repositories expanded the opportunities for all developers, with private repo creation more than doubling this quarter. The new Visual Studio 2019 optimizes developer productivity and team collaboration.

And I’m excited to share more about how we are empowering developers at our Build conference in two weeks.

Now to gaming.

We are investing in content, community and cloud to capture our massive opportunity in gaming, delivering record user engagement again this quarter.

Microsoft Game Stack brings together our tools and services to empower game developers from independent creators to the biggest game studios to build, operate and scale cloud-first games across mobile, PC and console. Our Xbox Live community now 63 million strong is key to our approach and we are enabling developers to reach these highly engaged gamers on iOS and Android for the first time.

Our fast-growing gaming subscription service, Game Pass, is expanding our reach, bolstered by our growing pipeline of first-party content. And Project xCloud, our new game streaming service will be in public trials later this year.

In closing, I’m energized by our progress and incredibly optimistic about our opportunity ahead.

Across all of our businesses, we are delivering differentiated value for customers and creating new categories of growth that position us well for the future.

With that, I'll now hand it over to Amy who will cover the financial results in detail and share our outlook. And I look forward to rejoining for your questions.

Amy Hood

Thank you, Satya, and good afternoon everyone.

This quarter, revenue was $30.6 billion, up 14% and 16% in constant currency. Gross margin dollars increased 16% and 18% in constant currency. Operating income increased 25% and 27% in constant currency. And earnings per share was $1.14, increasing 20% and 22% in constant currency.

Our sales teams and partners delivered strong results across each of our segments, once again resulting in double-digit top and bottom-line growth. From a geographic perspective, most markets performed in line with our expectations, however, results in Japan were much stronger than we anticipated.

In our Commercial business, cloud services strength drove our annuity mix to 90%, up 1 point year-over-year. Commercial unearned revenue was better than expected at $25.1 billion, up 19% and 20% in constant currency. Commercial bookings growth was strong, increasing 30% and 34% in constant currency.

Bookings growth was driven by healthy renewals on an expiration base that was over 20% larger than a year ago as well as an increase in the number of larger, long-term Azure contracts. As a reminder, an increased mix of these larger, long-term Azure contracts with low upfront billings will drive more volatility in our commercial bookings and unearned revenue growth.

Commercial Cloud revenue was $9.6 billion, growing 41% and 43% in constant currency, highlighted by healthy growth in the US, Western Europe, the UK, and Germany. Commercial cloud gross margin percentage increased 5 points year over year to 63% driven again by significant improvement in Azure gross margin.

Company gross margin percentage was 67%, ahead of our expectations, and up year over year primarily from an increase in margin in our More Personal Computing segment due to sales mix shift.

FX reduced revenue growth by 2 points and COGS growth by 1 point in line with expectations.

FX reduced operating expenses growth by 1 point, less than anticipated. Even with this headwind, operating expenses grew in line with expectations, increasing 9% and 10% in constant currency.

Strong revenue growth, improving gross margins, and disciplined investment in strategic and high growth areas resulted in operating margin expansion.

Now to segment results.

Revenue from Productivity and Business Processes was $10.2 billion, increasing 14% and 15% in constant currency, ahead of expectations driven by performance in Japan and LinkedIn.

Office commercial revenue grew 12% and 14% in constant currency. Office 365 commercial revenue grew 30% and 31% in constant currency driven by installed base expansion across all workloads and customer segments, as well as ARPU growth from our customers' continued shift to our E3 and E5 offerings. Office 365 commercial seats grew 27% and benefited from the strong performance of our Microsoft 365 academic offers. Office consumer revenue grew 8% and 10% in constant currency, ahead of our expectations, with 4 points of growth from transactional sales in Japan. Office 365 consumer subscribers grew to 34.2 million.

Our Dynamics business grew 13% and 15% in constant currency, driven by Dynamics 365 revenue growth of 43% and 44% in constant currency. We saw continued progress in our Finance and Operations offering, with strong growth in customer billings and deployments.

LinkedIn revenue increased 27% and 29% in constant currency with continued strength across all businesses. LinkedIn sessions increased 24% as engagement once again reached record levels.

Segment gross margin dollars increased 15% and 17% in constant currency and gross margin percentage increased 1 point year over year as improvements in LinkedIn and Office 365 margins more than offset increased cloud mix.

Operating expenses increased 4% and 6% in constant currency driven by continued investment in LinkedIn and cloud engineering. Operating income increased 28% and 30% in constant currency.

Next, the Intelligent Cloud segment. Revenue was $9.7 billion, increasing 22% and 24% in constant currency, ahead of expectations driven by continued customer demand for our differentiated hybrid offerings. Server products and cloud services revenue increased 27% and 29% in constant currency. Azure revenue grew 73% and 75% in constant currency, driven by strong growth in our consumption-based business across all customer segments, partially offset by tempering growth in our per-user business. Our enterprise mobility installed base grew 53 percent to over 100 million seats. And our on-

premises server business grew 7% and 9% in constant currency, driven by the continued strength of our hybrid solutions, premium offerings, and GitHub, as well as increased transactional demand ahead of end of support for Windows Server and SQL Server 2008.

Enterprise Services revenue increased 4% and 5% in constant currency, driven by growth in Premier Support Services.

Segment gross margin dollars increased 21% and 23% in constant currency. Gross margin percentage decreased slightly as the growing mix of Azure IaaS and PaaS revenue was partially offset by another quarter of material improvement in Azure gross margin.

Operating expenses increased 22% and 23% in constant currency, driven by continued investment in cloud and AI engineering, GitHub, and commercial sales capacity. Operating income increased 21% and 23% in constant currency.

Now to the More Personal Computing segment. Revenue was $10.7 billion, increasing 8% and 9% in constant currency as better than expected performance in Windows was partially offset by lower than expected Gaming revenue.

In Windows, the overall PC market was stronger than we anticipated driven by improved chip supply that met both unfulfilled Q2 commercial and premium consumer demand as well as better than expected Q3 commercial demand. Therefore, OEM Pro revenue grew 15% and OEM Non-Pro revenue declined 1%.

Inventory levels were within the normal range.

Windows commercial products and cloud services revenue grew 18% and 20% in constant currency, with continued double-digit billings growth and a higher mix of in-quarter recognition from multi-year agreements. Windows 10 deployments across new and existing devices remained healthy.

In Gaming, revenue grew 5% and 7% in constant currency, below expectations, driven by lower than expected monetization across third party titles and console sales. Xbox software and services revenue grew 12% and 15% in constant currency, with continued momentum in Xbox Live and Game Pass subscriber growth.

Surface revenue grew 21% and 25% in constant currency, driven by continued strength across our consumer and commercial segments, particularly in Japan.

Search revenue ex-TAC increased 12% and 14% in constant currency, primarily driven by Bing rate growth.

Segment gross margin dollars increased 13% and 15% in constant currency and gross margin percentage increased 2 points due to sales mix shift to higher margin products in Windows and Gaming.

Operating expenses increased 1% and 2% in constant currency and operating income increased 25% and 28% in constant currency.

Now back to total company results.

Capital expenditures including finance leases were down sequentially to $3.4 billion, and lower than initially planned, primarily due to normal quarterly spend variability in the timing of cloud infrastructure buildout. Cash paid for property, plant, and equipment was $2.6 billion.

Cash flow from operations increased 11% year over year driven by strong cloud billings and collections. Free cash flow was $11 billion and increased 19% year over year, reflecting the timing of lower cash payments for property, plant, and equipment.

Other income was $145 million, driven by interest income and net gains on derivatives and investments, offset partially by debt and finance lease expense.

Our effective tax rate came in lower than anticipated at 16%.

And finally, we returned $7.4 billion to shareholders through share repurchases and dividends, an increase of 17%.

Now let's move to next quarter's outlook.

First on FX. Assuming the current rates remain stable, we expect FX to decrease revenue growth by approximately 2 points and COGS and operating expenses growth by approximately 1 point. Within the segments, we anticipate about 2 points of negative FX impact on revenue growth in Productivity and Business Processes and Intelligent Cloud, and 1 point in More Personal Computing.

Second, we again expect customer demand and solid execution to drive continued strong performance across our commercial business in our largest quarter of the year. The expiry base will grow in Q4, but at a more moderated rate than in Q3 and we expect commercial unearned revenue to increase 36% to 37% sequentially.

Commercial cloud gross margin percentage should continue to improve year over year as material improvement in Azure gross margin will be partially offset by the continued mix of revenue towards Azure IaaS and PaaS services.

Third, CapEx, our full year outlook remains unchanged. Therefore, we expect a sequential dollar increase in capital expenditures in Q4 as we continue to invest to meet growing customer demand.

Now to segment guidance.

In Productivity and Business Processes, we expect revenue between $10.55 billion and $10.75 billion. The Office commercial revenue growth rate will be slightly down sequentially as is normal for Q4 due to the high mix of cloud billings during this quarter. As a reminder, under ASC 606, a higher mix of cloud billings is reflected in more unearned revenue and less in-period revenue recognition. Dynamics should see another quarter of double-digit revenue growth driven by Dynamics 365. LinkedIn revenue growth should be in the low 20's against a high prior year comparable.

In Intelligent Cloud, we expect revenue between $10.85 billion and $11.05 billion. In Azure, we expect continued strong growth in our consumption-based business and moderating growth in our per-user business given the increasing in size of the installed base. In our on-premises server business, demand for our hybrid solutions and premium offerings should remain strong, and we expect continued benefit from the upcoming end of support for Windows Server and SQL Server 2008, though as a reminder, the prior year comparable will impact the year over year growth rate.

In More Personal Computing, we expect revenue between $10.8 billion and $11.1 billion. In Windows, overall OEM growth rates should normalize, with revenue growth roughly in line with the PC market.

In Surface, we expect low double-digit growth, with continued momentum across our commercial and consumer segments.

In Search ex-Tac, we expect revenue growth similar to Q3.

And in Gaming, we expect revenue to decline year over year, driven by the tough comparable in Xbox software and services and the continuation of the hardware trends from Q3.

Now, back to overall company guidance.

We expect COGS of $10.65 billion to $10.85 billion and operating expenses of $10.7 billion to $10.8 billion.

Other Income and expense should be approximately $50 million as interest income is partially offset by interest and finance lease expense.

And finally, we expect our effective tax rate in Q4 to be approximately 17%, with some potential volatility given it is the final quarter of our fiscal year.

Now, I'd like to provide some closing thoughts as we look forward to FY20.

Overall, we feel very good about the progress we've made thus far in FY19. Our decision to invest with significant ambition in high growth areas coupled with strong execution has resulted in material revenue growth at scale and a stronger position in many key markets.

As FY20 approaches, we again see tremendous opportunity to drive sustained long-term growth. We will invest aggressively in strategic areas like Cloud through AI and GitHub, Business Applications through Power Platform and LinkedIn, Microsoft 365 through Teams, Security, and Surface as well as Gaming.

At the same time, we will continue to drive improvement and efficiency as our business scales. This consistent approach of investing in future growth while delivering strong operating performance will result in double-digit revenue and operating income growth in FY20 with stable operating margins.

With that, Mike, let’s go to Q&A.

Michael Spencer

Thanks, Amy. We'll now move over to Q&A. Operator, can you please repeat your instructions?

Question-and-Answer Session

Operator

[Operator Instructions]. Our first question comes from the line of Heather Bellini from Goldman Sachs. Please proceed with your question.

Heather Bellini

Amy, if I go back and look through your KPIs, it looks like the year-over-year growth in commercial bookings has never been this high on a constant currency basis, at least I was able to go back through fiscal '13. You mentioned an increase in the number of larger long-term Azure contracts which obviously is a driver of this. But is there any more color you could share? Is this coming from a handful of customers? I mean if that are just driving all of their like outsourcing everything to you guys and shutting down their data centers? Or do you see this as kind of a broad based trend, even in some of the industries that have been slow to move to the cloud where this is really starting to snowball?

And then the follow up would be just Azure gross margins where you guys have done a remarkable job just continuing to increase efficiency there. How much room is left to go and how do you think about the percentage of COGS in Azure that are variable versus fixed and has the ratio been changing?

Amy Hood

Great, Heather. Let me try to take both of those questions. On your commercial bookings growth question, I find it easier to think about commercial bookings before I answer the larger question about one-time in two ways. The first is the expiration base absolutely does matter and that's how we talked about it, and we had a actually very good quarter here in terms of renewals and what I think of as revenue we capture. We're able to grow the revenue in existing contracts, and so that absolutely contributed and has contributed over the past couple of years to what I do believe has been reasonably consistent, commercial bookings strength versus the expiration base.

The second component is what I would put in a bucket of new business. Whether that new business comes as what you saw this quarter are two ways. There was some on-prem strength this quarter, it does show-up in bookings, it doesn't show up in unearned and it does show up in the P&L, we had a good quarter there. And we did have some large Azure contracts which tend to be longer dated and tend to have low billings upfront. That means it shows up in bookings and again not in the unearned balance in the same way, and so you will see as we go forward and you are already starting to see it more volatility in this number, not just based on the way we've traditionally talked about it which is the movement of the expiration base but also in some of these larger and longer term commitments by what we now think of not just as customers but these are really now partnership relationships that we have where to your point we're co-collaborating to help customers be successful as they build their digital future. And so you will see a little bit of volatility in this number as those contracts and the type of contracts start to land.

On your second question of Azure GM we have continued to see strong improvement in the core gross margin as Azure team has done a nice job on a number of fronts, continue to make progress on both software innovation but also importantly hardware innovation and working with our supply-chain to continue to have and see benefits on that side, and also is increasing use of premium services also contributed to Azure gross margin improvement.

So while we remain focused on efficiency and the utilization of the hardware and software is also important to continue to see premium upsell, premium workload usage, so the customers are getting the most out of their deployments and usage of the Azure platform.

In general it hasn’t changed a ton in terms of that final component about fixed versus I think variable base, it's still been in the I think low [40%] [ph] as a range for us in terms of what depreciation versus what's more variable.

Operator

Our first next comes from the line of Keith Weiss from Morgan Stanley. Please proceed with your question.

Keith Weiss

A very impressive quarter. I'm going to speak a similar question to Heather’s but [indiscernible] try to get a higher level answer. In terms of -- during this quarter, it just sounds to me like I heard Amy talk more about exceeding expectations than we have in prior quarters and exceeding plan more than we have in prior quarters. This matches up from what we are hearing in CIO surveys and talking to customers, it sounds like there is an inflection point going on in adoption of cloud and digitalization effort. So the question to you is, are you seeing that, are you starting to see an inflection point in terms of these adoption trends and the investment that you guys have made behind this really starting to take hold? And then perhaps a follow up for Amy. So operating margins really exceeded our expectations this quarter and I think consistent with expectations, can you talk a little bit about kind of what drove that and kind of why we wouldn’t see as much as that on a go forward basis in terms of operating margin expansion?

Satya Nadella

Yes, thanks Keith for the question. So let me start. I think overall, what we're seeing is continued momentum, if you think about even our overall approach has been to have a view of an architecture that is grounded in our customers’ needs. So we always believe that in distributed computing, you need a cloud and an edge. You need hybrid and guess what, today in 2019, hybrid has become much more main stream. But we were talking about this even five years ago.

They also sort of said things that will matter in this transition to the cloud will be consistency and productivity. So for example, whether it's developer productivity or IT productivity, it’s not any one dimension, you need to bring IT and developers together to drive agility in an organization and their digital capability building. This is again, a place where we've had traditional strength. And that's showing up in the marketplace.

And also if you look at our cloud stack, we have application and infrastructure, data and AI, productivity and collaboration, as well as business applications. That's pretty unique again. So that's, I think, what is showing up at scale as competitive differentiation and that's what you see in our numbers. But the most importantly, I think you see it in the customer momentum and what I believe is what is customer success. Digital technology today is not about tech companies doing innovation. It is about the rest of the world doing innovation with technology and Microsoft is uniquely in position to enable that.

Amy Hood

And on your operating margin question Keith, there's a couple of things I would say that. In this quarter in particular, the places where we had a lot of outperformance were especially high margin areas, and I would point out three. The first is obviously the OEM and chip supply. The improvement in that in Q3 is obviously very high margin and also the bottom.

Japan as a geography for us is a high transactional market. And so when Japan is strong, it tends to be a very high margin landing down to the bottom line. And the other one is the on-premises server number which is very good in terms of hybrid demand this quarter also with high margin. So when that happens, you do see because it's a lot of -- almost 100% in quarter recognition, a lot of help at the operating margin line.

Now, the more sustainable conversation I think we continue to have on operating margin is our ability to pick the right secular markets in the right secular trends, you see significant revenue growth. We continue to focus on improving the gross margin of each individual product area, which creates leverage over time. And finally, focused investment and operating expense and that obviously creates leverage. And I think you do see that in general through the year as we continue to keep that formula.

Operator

Our next question comes from the line of Mark Moerdler from Bernstein Research. Please proceed with the question.

Mark Moerdler

Congratulations on a really strong quarter everyone. Amy, Satya -- Amy, can you delve into the impact of Azure hybrid benefits on Azure revenues, serving tools, renewals, I don't think it's really well understood. Is it having more meaningful impact on Azure's reported revenue growth because of the fact that some of this is apparent in serving tools? And Satya can you give us some added color on why this specific offering is resonating so well with customers, which is what we're hearing?

Satya Nadella

Yes, maybe I can start on the second part and then leads to the first question. I would say Mark the main thing that this offering enables is the flexibility with which customers can adopt hybrid computing. And as I've always said that there is -- hybrid computing is important for workloads that are more in the characteristic -- can be characterized as lift, shift and modernize, so that's one motion. And then there is a new load hybrid as well which is people are building in fact they're doing AI training job in the cloud but want to deploy the model close to the edge. And in both of the cases, hybrid benefits actually help with -- our business model is basically differentiated in supporting the architectural need and the flexibility needs. The one additional thing I'd mention, which is increasingly becoming clearer to us is operational sovereignty will become important, the world and its distributed computing needs is not going to become some margin as set of requirements but it's going to be very heterogeneous, very in many cases regulated and so what we provide in terms of both the technology and the business model I think shows up with the maximum flexibility.

Amy Hood

And then let me talk a little bit about the question from server products and services and how to think about the hybrid use benefits. In general today Mark almost all of that benefit shows up in what I would say as the on-premise KPI, and so over time though how you should think about that it will eventually show up in Azure consumed revenue growth, this is a benefit that’s fundamentally about high value and flexibility and meeting customers where they are so that they can make a determination of when to make that choice. And so it tends to be like it's focusing people back on the all up KPI because it's a best representation of where customer commitment and usage of our architected from the beginning hybrid cloud. But to your specific questions it shows up today in the on-prem number is where you can see most of the strength of that value and over time as it gets used and consumed it will show lot more in the Azure ACR number.

Operator

Our next question comes from the line of Karl Keirstead from Deutsche Bank. Please proceed with your question.

Q - K**arl Keirstead**

Amy, I'd like to ask you about the big revenue beat in the Intelligent Cloud segment that drove much of the upside and in particular the server product KPI that was just addressed up 9%. I'm just wondering if you could frame how material the contribution of the Version 2008 upgrades were? And assuming that that lift can continue throughout calendar 2019, could it be enough to keep that the on-prem KPI you described it flat or even up slightly in the coming two quarters despite the tougher comps?

Amy Hood

Thanks, Karl. When I think about the on-prem number I really divide it into things that have durable value and things I think of as more one-time. When I think about the durable trends that I expect to see it's been the hybrid value prop that we really just talked about on Mark's last question. And then the premium mix. Those two we have seen and continue to see. I do think we saw some benefit of end of support, but I would not say it was the primary benefit this quarter. The primary benefit was the two things I just talked about. End of support obviously we've got SQL in July and then Windows in January. And so I do think we saw some impact, particularly in SQL and I do expect to see some of that in Q4. But the Q4 comparable for on-prem is very big. And so even with some of that benefit of the durable trends, plus I think a more temporal one of end of support, I do expect to see a deceleration in that number in Q4.

Operator

Our next question comes from like of Jennifer Lowe from UBS. Please proceed with your question.

Jennifer Lowe

Great, thank you. I wanted to turn to the Office 365 Commercial business a bit. And that's been consistent very strong performer for you on and was again this quarter. But maybe just two related questions there. First, if I heard you, right, Satya I think you said there was 180 million users now on Office 365 Commercial which seems like you're hitting a lot of the customers that you thought might be there a couple of years ago. So I was just curious to get your view on how far along you are in that adoption cycle. And if there's still a lot more opportunity in terms of see expansion in the upcoming year? And then related, Amy you mentioned E3 and E5 are both pretty big contributors on the ASP front in the quarter. Are we kind of seeing shifting where E5 is sort of increasing in relevance in E3's played out a bit or is it sort of equally balancing, just curious to get sort of the mixing there as well? Thank you.

Satya Nadella

Sure. In terms of overall reach of Office 365, we continue to see significant opportunity going forward on multiple dimensions. So for example, we never participated as much in I'd call it non-developed markets, medium and small businesses with all of the sophisticated workloads. So, now that with a SaaS approach, you can reach a much broader base of business customers all over the world, is one opportunity.

The second opportunity is, if you look at Teams, as an example, we are now reaching a lot of first-line workers. So this is whether it's in healthcare, whether it's in manufacturing, whether it's in retail, just not knowledge workers, but where you now have messaging solutions, as well as business process workflows integrated. So it's that combination of things going from knowledge workers to first-line going and the ability to reach all sizes of businesses is what's going to continue to help us I think have overall seat growth or socket growth. And then of course, there is the other dimension, which is the levels of Office 365 all the way to E5 with significant value.

And the one thing I'd mention is the having compliance security that spans all of these tools, is also proving out to be a very big architectural advantage in a customer value proposition because I think, our customers look to use more SaaS applications, they don't want an exponential increase in their security exposure or more compliance burden. And so therefore, Office 365's approach resonates even there.

Amy Hood

And Jen maybe a little to your question, which is fundamentally about seat growth and ARPU as the drivers of that all up Office 365 Commercial growth number. This quarter and a little bit last I actually think some of the ARPU increase has been masked by some of the trends in seat growth. What I mean that is that 27% seat growth is starting to include some lower ARPU seats that Satya just mentioned whether that's in academic, in edu, in front-line workers and that's really important for us to keep having that seat growth even if it's not at the same ARPU level those are not seats that we ever could reach before at any level and that's absolutely new opportunity for us. But it does tend to mask a little some of the ARPU improvement that we've seen, it's still E3 and E5, there's opportunity on both, although we are starting to see the impact of E5 in net ARPU number.

Operator

Our next question comes from the line of Mark Murphy from J.P. Morgan. Please proceed with your question.

Mark Murphy

Satya, we've seen many indications of Azure winning a greater share of enterprise workloads recently. Do you think that you have found the right formula now for Azure to win the majority of workloads in the enterprise IT world? And then Amy just given the trajectory and the long-term commitments that you mentioned there, do you see it pass for Azure to surpass Office 365 Commercial and thus become the largest revenue stream for Microsoft I would say in the next couple of few years?

Satya Nadella

Sure, I'll start Mark and having grown up essentially in our infrastructure business at Microsoft, I would say that compared to even the previous eras where we did well in the client server era, in face of tough competition and in this era again in the face of a different set of competitors, we are doing well and we are doing well much better than we did in the previous era because we are seeing these tier 1 workloads which we never saw in the past. If you think about it in the client server era we never participated in the core of the digital infrastructure or financial services or in healthcare or in retail or in manufacturing and absolutely when we think about the digital transformational and design wins, deployment, consumption, it's kind of like what we would have done with some ISVs of the past, how we worked perhaps with SAP in the 90s when we were coming out with SQL server and they were coming out with R3 is what we are now doing with many, many, many businesses as they build out their digital businesses. So that' sort of perhaps characterizes for you what's new in terms of Microsoft's own growth in this space.

Amy Hood

And the way that would show up Mark is a little bit I think where you were leading with the question you asked which is when we think about the Microsoft commercial cloud at $9.6 billion and growing over 40% how do you see that evolving and really the question is we have quite a bit of per seat or per user type businesses but what Satya just talked about is really about the Azure concept or participating both in an expand scenario total addressable market which I think people have talked about for a long time but what was different about what Satya just said is our ability to frankly to have higher share in the next era than we had in the last era. And so if you look at then our ability to grow in the Azure would be larger or over any period of time then ARPU seat or per user businesses it certainly could be but I don’t want that to really diminish the fact that there is a lot of room for us and our per seat businesses particularly across LinkedIn, the Power platform work we're doing. Satya mentioned security, identity, compliance, there is a lot of room for us to continue to add value and growth in that area as well.

Operator

Our next question comes from like of Ross MacMillan from RBC Capital Markets. Please proceed with your question.

Ross MacMillan

Thanks so much and my congratulations as well. We continue to see this really nice progression in the commercial cloud gross margin and you called out the Azure gross margin improvements. And within that there's some moving pieces. I think you’ve got better utilization and efficiency of core Azure. You've got premium services, and then you've got this counter prevailing force of the different growth in consumption versus user base.

Two questions on this, one for Satya. On the premium services, I'm just curious as to, which one or two or three are you seeing maybe break out become the largest or grow the fastest, which are most meaningful at this point?

And then secondly for Amy, as we think about this trend, are you convinced that we'll continue to see not just for fiscal Q4, but into fiscal ‘20 and beyond consistent progression and growth in the overall commercial cloud gross margin? Thanks.

Satya Nadella

Sure. I mean, on the first question Ross as far as our premium services, just even on the application infrastructure side, for example, in compute, there is increasing need for things like IoT services. Essentially, there is a new business application like set of services that are getting developed to help people manage their complex IoT application development. IoT Central is a good example of that when you have many, many connected devices, you need a control plane for many of those devices, so that you contain the complexity of your app deployment, security management. That's one example. The other one is of course data. And the sophistication of the data aid is growing exponentially, both in terms of the needs of the databases required, the processing that is required close to data. So that's another place where something like Cosmos DB which is very unique in capability in the marketplace is definitely another service that's got real traction. Even data warehousing, the scale at which this is another market which we never participated in, in the past, whereas now we are one of the most competitive products when it comes to benchmarking around data warehousing. So those are all things that I would say are premium services that just talking about new applications being built on Azure, not counting all of the SaaS applications about that.

Amy Hood

And to your overall commercial progress margin question. You're right, the fundamental driver is when I look forward into next year, I expect each service just like it did this year to really see gross margin improvement, whether that service is LinkedIn or Dynamics or Office 365, Azure per user or Azure IaaS in PaaS, but what you'll see is a revenue mix shift, right, that will offset that to Azure IaaS and PaaS. And so what that generally will do, will be a headwind to continued gross amount of the improvement even though you'll see individual improvement across all the GM services, and you'll continue to see Azure increase as a percentage of the total revenue.

Operator

Our next question comes from the line of Brad Zelnick from Credit Suisse. Please proceed with the question.

Brad Zelnick

I want to follow-up on Karl's question but more generally on database products with the end of support coming for SQL Server [2008] in July, Satya, can you tell us how that sparking conversations with customers about database offerings on Azure and moving workloads to the cloud. And Amy help can you perhaps help us contextualize the opportunity to move traditional database workloads onto Azure and what the expansion economics look like?

Satya Nadella

Yes, a couple things Brad. One is, overall the need to get on the latest and greatest database technology just because of what is the increasing need for compute and data at the edge is what's driving a lot of the conversations on SQL Server. Interesting enough, we have a lot of requirements around edge devices even, so that you can have databases with compute so that you can really have what is needed at the edge, that’s sort of one conversation. The other one is in terms of the cloud migration there is a variety of different used cases, we see people are using SQL DB, which is essentially PaaS service but it's a complete compatibility of SQL Server, they want to managed services around SQL Server which we have. And so both of those are all happening in parallel. A good example of this is in fact even the rewrite of complete revamp I would say of Dynamics. Dynamics 365 and its architecture at least in my eyes is a thing of beauty because it's completely been rewritten for the new database technology, whether it is on the data base side or on the data warehouse side, again uses a whole bunch of micro services and functions so that you can do AI close to data. That type of architectural approach is what we see is possible now for every SaaS application vendor out there as well. Because you think about the number of SaaS -- the number of business applications that were built on SQL Server I feel that that's an architecture that can support both what they want to do on the edge, but as well as on the cloud.

Amy Hood

And on the contextualizing opportunity, the reason I said it's not the primary driver is because of that vast, vast majority of our server business is annuity based. And so when it's annuity based there is really no opportunity to see it as upside in Q4 from an end of support frame. For the smaller portion of our business it’s still non-annuity per transactional, it does provide as I talked about earlier some opportunity but it’s not that large just because the nature of the commitment our customers now is far more of the annuity type.

Operator

Our next question comes from the line of Raimo Lenschow from Barclays. Please proceed with your question.

Raimo Lenschow

Can you talk on the Windows OEM side? You mentioned that the chipset situation is kind of easing a little bit. Are we kind of fully done there in terms of what do you see there from the Intel side and does that create some pent-up demand for the coming quarters as people are thinking about moving over to Windows 10 with the end of life coming up?

Amy Hood

Thanks, Raimo. I think we actually in Q3 as I said met sort of the unfulfilled Q2 demand and Q3, so I don't think of it as a pent up situation heading into Q4 and our guide certainly does not indicate that, that is what we believe will happen. And what I would say is I think there we feel good about the supply in the Commercial segment and the Premium Consumer segment, which is where the vast majority of our revenue is in OEM. And so I think in those segments, we feel fine for Q4.

Michael Spencer

That wraps up the Q&A portion of today's earnings call. Thank you for joining us today and we look forward to speaking with all of you soon.

Amy Hood

Thank you.

Satya Nadella

Thank you all.

Operator

This concludes today's conference. And you may disconnect your lines at this time. Thank you for your participation.