

Company Name: Microsoft
 Company Ticker: MSFT US
 Date: 2017-10-26
 Event Description: Q1 2018 Earnings Call

Market Cap: 778,384.74
 Current PX: 101.31
 YTD Change(\$): +15.77
 YTD Change(%): +18.436

Bloomberg Estimates - EPS
 Current Quarter: 1.078
 Current Year: 3.828
 Bloomberg Estimates - Sales
 Current Quarter: 29176.708
 Current Year: 109522.313

Q1 2018 Earnings Call

Company Participants

- Chris Suh
- Satya Nadella
- Amy E. Hood

Other Participants

- Keith Eric Weiss
- Heather Bellini
- Philip Winslow
- Karl E. Keirstead
- Walter H. Pritchard
- Kirk Materne
- Mark L. Moerdler
- Adam Holt
- Michael Nemeroff
- Raimo Lenschow
- Ross MacMillan

MANAGEMENT DISCUSSION SECTION

Chris Suh

Adoption of New Accounting Standard

As a reminder, this is Q1 we're reporting our results under the new revenue standard, ASC 606

As we detailed during a conference call we hosted on August 3, the adoption of the standard had several impacts, but most materially, the revenue recognition of Windows 10 OEM licenses and the license component of on-premises annuity contracts

As we discuss our Q1 results and share our outlook on the call, please keep in mind the following:

- First, the new standard allows us to simplify the communication of our results by eliminating the non-GAAP revenue reporting
- Second, there's no change in customer billings, cash flows or revenue recognition for our cloud services, hardware, enterprise services and advertising businesses
- And lastly, the quarterly seasonality of our revenue within a given year does change, and we may experience higher quarterly volatility as well

The prior periods we will reference on this call and in the earnings materials on our IR website have been restated to reflect adoption of this new standard

During our August 3 call, we also translated our outlook for Q1 into the new standard, and all references to expectations on this call refer to that translated guidance

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- You can find additional information on this accounting change located on the IR website

All growth comparisons we make on the call today will relate to the corresponding period of last year, unless otherwise noted

We'll 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

Major Accomplishments

We are off to a very strong start in FY2018, delivering double digit top and bottom line growth and exceeding \$20B in commercial cloud ARR, outpacing the goal we set just over two years ago

I'm proud of our team's work behind these results that spanned all of our segments

We now have 120mm monthly active users of Office 365 Commercial

We have more than 530mm LinkedIn members

Dynamics 365 customers grew 40% y-over-y

Azure Compute usage more than doubled this quarter and revenue grew 90%

- And Windows 10 Commercial monthly active devices grew 90% y-over-y

These results reflect our accelerating innovation as well as increased usage and engagement across all businesses as customers continue to choose Microsoft to help them transform

Strategic Business Review

Amy will cover our financial results in more detail, but today I wanted to talk about the key areas of innovation and opportunity for growth in 2018 and beyond

Our focus is on bringing our technology and products together into experiences and solutions that deliver new value for customers by galvanizing around five key solution areas

Innovations in Microsoft 365

- First, top of mind for every CEO is empowering their own employees for the modern workplace
- Microsoft 365 is our core offering to address this \$500 billion-plus market
- We are bringing together Office 365, Windows 10 and Enterprise Mobility + Security as a complete integrated solution for organizations of all sizes
- It represents a profound shift in the way we design
 - Build and deliver our productivity solutions
 - Moving to a people-centered approach
 - Spanning all their devices to unlock creativity
 - And inspire teamwork while simplifying security and management

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Windows 10 Fall Creators Update

- This past quarter, we launched a wave of innovation across Microsoft 365
- The Windows 10 Fall Creators Update empowers people with new AI-first interfaces, ranging from voice-activated commands through Cortana, inking, immersive 3D content storytelling and Mixed Reality experiences
- Cloud sharing and co-authoring experiences are now natively enabled with OneDrive files on demand
- We are making Windows 10 more accessible to everyone with new features like the eye control, which gives people the ability to operate a PC using just their eyes
- You'll see a great lineup of Windows 10 devices this holiday from the new Surface Book 2 to a vibrant range of devices from our OEM partners

Windows Mixed Reality

- This month, we also introduced Windows Mixed Reality broadly
- Mixed Reality, which is a voice, gaze and gesture interface, will fundamentally change the way people and teams collaborate
- Our work with Ford is a great example of this promise
 - Ford's designers are using Mixed Reality to blend 3D holograms digitally with models and physical production vehicles, allowing them to experiment and iterate on design much more quickly

HoloLens

- HoloLens, Windows VR headsets and Microsoft 365 enable any customer to blend physical and digital worlds across devices, empowering people to collaborate in the same shared experience from anywhere in the world
- AI is infused across Microsoft 365 in a myriad of helpful ways, making it easier for people to create high-impact presentations and documents, automate routine tasks and search and discover people and content in highly personalized and relevant ways

AI-First Workloads

- Beyond new AI capabilities in PowerPoint, Word, OneNote, SharePoint, we're enabling AI-first workloads like Bing and Cortana using the Microsoft Graph
 - Soon, you'll be able to search not only the public Internet but also corporate intranet sites, line of business applications and people with Bing for Business, now in private preview
- With Cortana, you'll be able to query your calendar and automate tasks like scheduling a meeting or replying to an e-mail using just your voice
- Microsoft Teams is core to our vision for the modern workplace as a digital hub for teamwork, bringing together conversations, meetings and content into a single canvas
- We are integrating AI and cognitive services to make meetings more productive for users today and longer-term

AI-Based Security Approach

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- Lastly, Microsoft 365 connects users, devices and SaaS applications into a single control plane to simplify IT management while providing comprehensive security across the entire digital estate
- Today's sophisticated threats require AI-based security approaches
- Using the Microsoft Intelligent Security Graph, we process billions of signals to detect and remediate threats
- New conditional access capabilities evaluate risk in real-time based on the user's account, device and application and physical location
- Our leading-edge security and management capabilities are just one reason customers trust Microsoft 365 for their modern workplace needs

LinkedIn and Business Applications

- Now, I'll turn to LinkedIn and our business applications
- From the outset, the priority one was to ensure that LinkedIn, on its own, accelerate its mission and growth while retaining its culture as part of Microsoft
 - Nearly one year in, we are ahead of plan with LinkedIn contributing positively to EPS ex-purchase accounting in FY2018

Record Levels of Engagement

- Second, we're seeing record levels of engagement
- LinkedIn is on target to surpass 21B sessions this CY and has seen its fourth consecutive quarter of 20%-plus sessions growth
- Engagement across the platform is strong, with 65% y-over-y growth in jobs, visitors across mobile and desktop, 60% growth in feed update views and nearly 40% growth in messages sent, driven by more ubiquitous messaging

Innovation and Execution

- Third, innovation and execution are accelerating in both the business and in the product integrations across Microsoft, with a positive reception to native video, career advice marketplace and this week's launch of smart reply messaging
- LinkedIn profile integration in Office 365 delivers rich people insights from both the LinkedIn Graph and the Microsoft Graph
- The Microsoft Relationship Sales solution brings together LinkedIn Sales Navigator and Microsoft Dynamics to transform business-to-business sales through social selling
- Dynamics 365 for talent with LinkedIn Recruiter and Learning gives HR professionals a complete solution to compete in the talent marketplace
- You'll see more product integration in FY2018 as we continue to accelerate our innovation to connect the world's leading professional cloud with the world's leading professional network

Microsoft Cloud

- Now, I'll turn to two areas of our hybrid cloud value proposition, applications and infrastructure and data and AI

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- We've been focused on addressing the real-world needs of customers with our differentiated approach to the cloud, architecting for hybrid consistency, developer productivity, AI capabilities and trusted security and compliance
- Moreover, customers are choosing the Microsoft Cloud for its operational consistency, productivity and security that spans the entire digital estate, inclusive of Windows 10 security and management, Dynamics 365, Enterprise Mobility + Security and Azure
- Let's double-click on hybrid
- To support the emerging intelligent cloud, intelligent edge application pattern, you need a consistent stack across the public cloud and the edge
- Merely providing colocation services or connectivity between on-premise data centers and the public cloud is not sufficient to meet customer needs

Azure

- You need consistency across the development environment, operating models and technology stacks
- Azure provides this consistency across the entire stack, inclusive of identity, data, app platform, security and management at the edge and in the cloud
 - Our hybrid cloud is one of the reasons nearly every Fortune 500 company has chosen to partner with Microsoft
- Costco recently chose Azure as its hybrid cloud platform, and we are excited to partner with them on their digital transformation
- Core currency of any business going forward will be the ability to convert their data into AI that drives competitive advantage

Azure SQL DB

- Azure SQL DB makes it possible for customers to take SQL Server from their on-premise data center to a fully-managed instance in the cloud with no code changes
- SQL 2017 is now broadly available on Windows, Linux, Docker containers, with everything built in, including the ability to run AI compute close to the data with Python or R

Azure Cosmos DB

- Azure Cosmos DB is the first globally distributed multimodal database that enables developers to write apps for IoT and other event-based serverless applications
- We're accelerating our innovation to help every developer be an AI developer with approachable new tools from Azure Machine Learning Studio for creating simple ML models to powerful Azure Machine Learning Workbench for the most advanced AI modeling and data science
- We continue to enhance our cognitive services to give every enterprise powerful building blocks to create their own AI applications

Investment

- Finally, we continue to invest in making Azure the most trusted cloud with AI-based security built in

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- Azure confidential computing enables encryption of in-use data to ensure that information is always under customer control, a first for any public cloud
- Our ongoing data center expansion brings Azure to 42 regions globally, more than any other cloud provider and 69 compliance offerings and the most comprehensive compliance coverage in the industry
- And new Azure availability zones provide new levels of resiliency for high-availability apps within a region and across regions

Gaming

- Now, let me turn to our last solution area, Gaming
- We are mobilizing to pursue our expansive opportunity in the \$100 billion-plus gaming industry, broadening our approach to how we think about gaming end-to-end, from the way games are created and distributed to how they are played and viewed

Gaming Assets

- We will continue to connect our Gaming assets across PC, console and mobile and work to grow and engage the more than 53mm Xbox Live member network more deeply and frequently with new services like Game Pass and Mixer
 - And we are a few days away from launching the Xbox One X, the most technically advanced and powerful console ever built
- Moreover, we have high expectations for our Gaming business to bring more people to more Microsoft experiences and broaden our engagement and usage scenarios. This means fundamentally rethinking how we measure progress in Gaming

Innovation

- While we continue to innovate across the console, PC and Xbox Live services, we see substantial additional opportunities across e-sports and streaming
- At 20% this quarter, our software and services revenue growth reflects the early-stage potential of this larger opportunity
- We also see the opportunity to empower developers who work on console, PC and mobile games to use our cloud infrastructure and services to enhance their game play and community
- Gaming pushes the boundaries of hardware and software innovation, with some of the most CPU and GPU-intensive applications and content, giving us a huge opportunity in the cloud
 - As one example, PUBG Corp., with the hit game PLAYERUNKNOWN'S BATTLEGROUNDS, is not only partnering to make Xbox the exclusive console at launch but is also running on Azure

Summary

- In closing, across the company, we are mobilizing to pursue our five core customer solution areas
- We are partnering deeply with our customers so that our new technologies and innovations can help them digitally transform, grow and thrive

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Amy E. Hood

Financial Results

Earnings Summary

- This quarter:
 - Revenue was \$24.5B, up 12% and 11% in constant currency with better than expected performance across all segments
 - Gross margin increased 15%
 - Operating income increased 15%
 - and EPS was \$0.84, increasing 17%

Revenue Drivers

- Our strong start to the FY with double digit top and bottom line growth is a result of our consistent execution and ongoing investment in product innovation and sales capacity
- At a company level, LinkedIn contributed approximately 5 points of revenue and gross margin growth and had a 4 point drag on operating income
 - Excluding the cost of amortization of acquired intangibles, LinkedIn contributed \$78mm to operating income
- We are confidently ahead of our original financial commitment for LinkedIn
- We now expect LinkedIn, ex-purchase accounting, to be accretive to EPS this FY
- Our results were in line with macroeconomic trends, with better than expected performance from large markets like France, Japan and the UK and stabilization in markets like Brazil and Russia
- Our sales team and partners delivered strong commercial results this quarter
- Multiyear commitments from customers contributed to an 89% annuity mix
- On a roughly flat dollar volume of EA expirations, we grew commercial bookings 14% and 9% in constant currency
- Commercial unearned revenue came in higher than we expected at \$21.5B, primarily from higher Software Assurance billings and FX benefit
- Our commercial cloud business had another quarter of robust revenue growth and material gross margin improvement
- Revenue exceeded \$5B this quarter, growing 56% y-over-y and gross margin increased 8 points to 57%, with improvement in each cloud service, most notably in Azure

Gross Margin

- Our company gross margin was 66%, up 2 points from prior year as sales mix of higher-margin products and services, along with improving cloud margins, more than offset the impact of the growing cloud mix of revenue and LinkedIn amortization cost
- The FX impact of a weaker than expected U.S. dollar increased total company revenue growth by 1 point

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- At the segment level, FX had minimal impact on Productivity and Business Processes and increased revenue growth in both Intelligent Cloud and More Personal Computing by 1 point
 - FX added 1 point of growth to operating expenses this quarter, which grew 16% and 15% in constant currency
- LinkedIn contributed 14 points of growth, including \$154mm of amortization of acquired intangible expense

Segment Results

Productivity and Business Processes

- Now to our segment results
- Revenue from Productivity and Business Processes segment grew 28%, also 28% in constant currency, to \$8.2B with better than expected results due to FX as well as Office commercial, consumer and LinkedIn
- LinkedIn contributed 18 points of growth
- Office commercial revenue increased 10% as revenue mix continued to shift to Office 365 Commercial
- Office 365 Commercial revenue grew 42% from strong installed base growth and ARPU expansion
- Companies like Lowe's and Devon Energy chose Office 365 to connect their employees and empower them in the modern workplace
 - And with our channel partners, we added on average more than 50,000 small and medium business customers each month, a trend we have sustained for more than 3 years
- Office 365 Commercial seat growth was up 1 point sequentially to 32% and declined 8 points y-over-y
 - We do expect that y-over-y trend to continue, given the increasing size of the base
- Office consumer revenue increased 12% or 10% in constant currency, driven by recurring subscription revenue and growth in our subscriber base, now at 28mm
- Our Dynamics business grew 13% and 12% in constant currency, driven by the revenue mix shift to Dynamics 365
- Customers like the U.S. Department of Veterans Affairs and the Seattle Seahawks have adopted Dynamics 365 to modernize their business processes
- Dynamics 365 grew 69%, same in constant currency, with continued installed base and ARPU growth
- LinkedIn revenue for the quarter was approximately \$1.1B, a bit better than we expected
 - Post-acquisition sales execution has been strong with record levels of user engagement
- This quarter, LinkedIn sessions again grew more than 20%

Gross Margin

- Segment gross margin dollars grew 25% and 24% in constant currency with 15 points of contribution from LinkedIn, including \$218mm of amortization
- Gross margin percentage declined due to the impact of LinkedIn-related amortization

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OpEx and Operating Income

- Operating expenses grew 54% and 53% in constant currency with 49 points from LinkedIn, including \$154mm of amortization expense
- Operating income increased 3% and 4% in constant currency, with 10 points of negative impact from LinkedIn

Intelligent Cloud

- The Intelligent Cloud segment delivered \$6.9B in revenue, growing 14% and 13% in constant currency with better than expected performance driven by hybrid cloud results as well as FX
- Server products and cloud services revenue grew 17%, also 17% in constant currency, with another quarter of double digit annuity revenue growth
- Azure revenue grew 90% and 89% in constant currency and Azure premium revenue grew triple digits for the 13th consecutive quarter
 - Our unique ability to provide a distributed hybrid model for the intelligent cloud and intelligent edge continues to attract customers to Microsoft
- Symantec, the industry's largest security vendor, has adopted a company-wide hybrid strategy with Azure, including delivery of its Norton consumer products to a global community of more than 50mm people
- And financial services firms like Bank of America, TD Bank and Sumitomo Mitsui Banking Corporation are all using Azure and its data services to improve customer experiences

Enterprise Services

- Enterprise Services revenue grew 1% and was flat in constant currency as premium support services growth offset declines in custom support agreements for Windows Server 2003
- Segment gross margin dollars grew 10%, the same in constant currency, and segment gross margin percentage declined due to the increasing cloud revenue mix and lower Enterprise Services margins, partially offset by material improvement in Azure gross margin
- This quarter, operating expenses grew 3%, or 2% in constant currency, from ongoing investments in sales capacity and engineering
- Operating income increased 20%, the same in constant currency

More Personal Computing

- Now to More Personal Computing
- Revenue from this segment was \$9.4B with FX as well as each core business contributing to the segment's better than expected results
 - Excluding phone, revenue grew 3%, the same in constant currency
- Both the commercial and the consumer PC markets were better than we expected, contributing to OEM revenue growth of 4%
- OEM Pro revenue grew 7%, ahead of the commercial PC market from a higher mix of premium SKUs and a couple points from timing of license purchases

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- We continued to see Windows 10 deployment cycles drive commercial customer hardware demand
 - OEM non-Pro revenue was down 1%, in line with the consumer PC market and reflecting healthier conditions in key markets like Brazil and Russia
- Inventory levels were in the normal range for a pre-holiday quarter
- Windows commercial products and services grew 7% and 6% in constant currency, mainly driven by seat growth
- We continue to see enterprise customer momentum, with Coca-Cola Company, Her Majesty Revenue & Customs and Rogers Communications choosing Windows 10 for its intelligent security features and advanced management capabilities
- Patent licensing declined this quarter, primarily due to a one-time impact of IP deals signed in the prior year
- Search revenue ex TAC grew 15%, the same in constant currency, from higher revenue per search and stronger than expected performance from volume

Online Businesses

Revenue Drivers

- Our online businesses showed healthy improvement in revenue growth and profitability as we realized the benefits of scale
- Our Surface business grew 12% and 11% in constant currency, driven by sales of the new Surface Laptop in both the commercial and consumer segments
- We continued to see solid execution through the product lifecycle transition between Pro 4 and our new devices
- Gaming revenue grew 1% and was flat in constant currency as Xbox software and services growth offset declines in hardware
- Software and services revenue grew 21%, or 20% in constant currency, driven by continued growth in monetization
- Our engaged user base grew 13% to 53mm monthly active users across Xbox One, Windows 10 and mobile platforms
 - Additionally, new services like Game Pass and Mixer, which create more opportunity for engagement and monetization, showed encouraging early results

Gross Margin, OpEx and Operating Income

- Segment gross margin dollars increased 10%
- Gross margin percentage increased primarily due to sales mix shift to higher-margin products and services
- Operating expenses declined 1%, or 2% in constant currency, from lower Windows and Gaming marketing spend and our last full quarter of significant benefit from phone savings
- Operating income grew 26%, the same in constant currency

Other Financial Results

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Cash Flow

- Now back to our overall company results
- This quarter, we invested approximately \$2.7B in CapExs, including finance leases, down sequentially and lower than originally planned mainly due to quarter-to-quarter volatility
- Cash paid for property and equipment was approximately \$2.1B
- Our significant capital investment continues, mainly based on customer demand and usage signal, and the teams remain focused on gross margin improvement as they deploy services globally to meet that demand signal

FCF

- FCF grew 10% from operating cash flow growth of 8%
- As a reminder, in the prior year, we had \$1.3B in unsettled cash equivalent positions that reversed the following quarter
 - Excluding this amount, FCF increased 27% from higher customer collections following strong billings growth and working capital improvements in the hardware business, primarily driven by our exit from the phone business

Other Income and Expense

- Other income and expense was \$276mm, a little more than planned, as we continued to see opportunities in the equity market to realize gains throughout the quarter

Tax Rate and Shareholders Return

- Our effective tax rate was 18%, 1 point lower than we expected, primarily due to geographic mix of revenue
- This quarter, we returned \$4.8B to shareholders through dividends and share repurchasers

Q2 Outlook

FX

- Now, let's turn to Q2 outlook
- First on FX
- Assuming current rates remain stable, we expect FX to increase revenue growth by 1 point, COGS growth by 1 point and OpEx growth by 2 points
- Our commercial business should remain healthy, with solid renewal execution and increasing customer demand for our hybrid cloud services and new cloud solutions like Microsoft 365

Commercial Bookings

- Turning to commercial bookings
- As you know, the underlying dollar volume of EA expirations impacts commercial bookings growth

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- For the full year, total expirations will be up slightly, but Q2 expiration dollar volume will be down roughly 20%, impacting our Q2 commercial bookings growth
 - We expect commercial unearned revenue to be down approximately 7% sequentially, reflecting normal seasonality
- We remain committed to material improvement in our commercial cloud gross margin percentage
- Margin performance is variable quarter-to-quarter, driven by revenue mix and seasonality, as well as the timing of infrastructure spend
- We expect continued y-over-y margin improvement and sequential trends consistent with prior years

CapEx

- Next to CapEx
- We will increase our capital investment to meet growing demand and capacity needs
- And on accrual dollar basis, we expect a sequential dollar increase next quarter

Productivity and Business Processes

- In Productivity and Business Processes, we expect revenue between \$8.75B and \$8.95B
- Office 365 commercial growth will continue to outpace the transactional decline
- We expect a more moderate rate of growth in our Office consumer business, given the prior-year comparable

Dynamics

- In Dynamics, we expect continued double-digit revenue growth, driven by the shift to Dynamics 365
 - And we expect approximately \$1.2B of LinkedIn revenue, reflecting continued strong sales execution by the team

Intelligent Cloud and Enterprise Services

- In Intelligent Cloud, we expect revenue between \$7.35B and \$7.55B, with another quarter of double-digit revenue growth across server products and cloud services
- As a reminder, starting in Q2 of last year, the launch of Windows Server 2016 drove strong on-premises performance, resulting in 6% constant currency growth for server products
 - This comparable will impact the segment's y-over-y growth rate
- We expect Enterprise Services revenue growth to be similar to last quarter, driven by Premier Support Services offsetting declines in custom support agreements

More Personal Computing

Windows

- In More Personal Computing, we expect revenue between \$11.7B to \$12.1B

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- First on Windows
- OEM revenue should track roughly in line with the overall PC market
- Specifically, OEM Pro revenue growth should be more aligned to the commercial PC market, normalizing for a couple points of growth from the timing of licensing purchasing in Q1

Devices

- Next, Devices
- In Surface, we expect revenue to be up slightly from Q1 as we continue to transition to the new Surface Pro, ramp Surface Laptop and launch the Surface Book 2
- Also in November of last year, we closed the sale of our feature phone business, so this will be the final quarter of revenue comparability impacted by the phone
- We expect double-digit revenue growth in search ex-TAC, reflecting continued strong performance in both rate and volume

Gaming

- And finally, Gaming
- We expect revenue growth from the launch of the Xbox One console and continued healthy growth of software and services revenue
- In Q2, the higher mix of Gaming hardware revenue will significantly impact both the segment and company gross margin percentages
- We expect COGS between \$11B and \$11.2B, in the normal range for a holiday quarter with new device launches and including 1 point of FX headwind
 - This includes approximately \$400mm of LinkedIn COGS, of which \$220mm is related to amortization expense

OpEx

- We expect operating expenses of \$9.1B to \$9.2B, which includes 2 points of FX headwind
 - This includes \$1.1B of LinkedIn expenses, of which \$154mm is related to amortization

Other Income and Expense

- Other income and expense should be approximately \$450mm as we continued to take gains in our equities portfolio
 - And we expect this pace to continue until the end of the FY

FY2018 Outlook

FX

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- Now, let me share some additional comments on FY2018, given our strong first quarter results, our business momentum and the changing currency landscape
- First on FX
- For the full year at current rates, we expect FX to increase revenue, COGS and OpEx growth at the company level by 1 point
 - Therefore, we now expect full-year operating expense growth, excluding LinkedIn, to be between 4% and 5%
 - This is unchanged from our prior outlook except for the updated FX impact

Margins

- Second, on margins
- With our strong Q1 results and the FX impacts I just outlined, we are trending a bit better on both gross and operating margin relative to our original full-year outlook of down roughly 1 point each
- We now expect operating margin, ex-LinkedIn, to be up y-over-y, even as we increase investment to support long-term top line growth in commercial cloud, AI, Mixed Reality, quantum, new hardware launches and the continued transformation of our sales team

Tax Rate

- Third, tax rate
- We're updating our full-year tax rate to 22%, +/- 2 points, with variability due to the mix of service and license revenue, geographic mix of revenue and timing of equity vest
 - And expect next quarter's tax rates to come in at the midpoint of that full-year range

QUESTION AND ANSWER SECTION

<Q - Keith Eric Weiss>: Satya, a question for you. We've been seeing Intelligent Cloud growing very well for quite some time, Azure sustaining very, very impressive growth rates, but even the server and tools businesses sustaining growth. When we think about the drivers of that growth, is this just continued share gains by Microsoft, enabling you guys to outgrow the market? Or have you started to see stuff like AI and all these additional cognitive services that you bring to the market actually accelerating workload growth within your customers? You're actually like building new market opportunity for yourselves with these additional services.

<A - Satya Nadella>: And I would say all of the above. One of the things that we started always, we always believed in distributed computing, and we've built for that so when we say hybrid, we never thought of it as some kind of a temporary state but we always thought the edge and the cloud was going to be where the application pattern was in fact going to get to. In fact, I'm very excited about some of the new workloads.

If I look at whether it's IoT or AI, the two workloads that are new, both of them require both computation and intelligence on the edge and a very new way to do even computation, which event-driven computation. So we feel good about new workload growth. We feel good about this lift-shift modernize motions that are happening. We feel that we're well positioned for both meeting today's realities of our enterprise customers, but most importantly, where on a secular basis I believe hybrid computing is going, which is to this architectural pattern of intelligent cloud, intelligent edge.

<Q - Heather Bellini>: I had a question related to Azure. You guys mentioned on the call that premium services grew triple digits for the 13th quarter in a row. And I was wondering if you could give us a sense for how to think about the

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percentage of workloads that are now running premium services as a percentage of the total. And/or are we at the point now where that's a high enough percentage of the mix that we're at a tipping point here, where what seems like very significant gross margin progression is going to continue at this similar clip? Thank you.

<A - Satya Nadella>: I mean, I can start and, Amy, you can add to this. The premium services, for example, the way we think about them is in everything related to our data is, and especially the higher level databases, so I'm not talking about raw storage but this is Cosmos DB or Azure DB or any of data services, our IoT services, our AI services are all the premium services. And there is a path. Every customer sometimes just starts with infrastructure as a service and some storage. And then the lift-shift turns into lift-shift and modernize and that's where these premium services get activated. So they definitely are margin accretive for us, but most importantly, they add a tremendous amount of value to the customers. And I'll let Amy add any additional color to that.

<A - Amy E. Hood>: And I think, Heather, it gives me a good opportunity to talk a little bit about the real drivers of the Azure gross margin improvement. There are really, when you think about it, three. The first one's just pure revenue scale. We've done such a terrific job, I think, of growing and focusing and the innovation we put in and having our sales teams, through investments we've made for the past couple of years, and competency building, land that at customers.

The second component, and the one you'd asked about, is a little bit about that premium services revenue mix. And you're absolutely seeing the impact of that growth as mix show up in the gross margin. And addition to the workloads Satya mentioned, I'll also bring up EMF. EMF continues to be I think of incredible value to customers. And I think we've done a very good job of pointing out its competitive advantages, and we're seeing that also benefit margins.

And finally, just the strong work on the infrastructure team, both between hardware innovation done at everything from the network, all the way to the prox and their integration with each other as well as the software innovation being done on top of it. Those things together, with premium being a component of that, are all lending itself to gross margin improvement.

<Q - Philip Winslow>: I just wanted to focus in on Office because you've obviously spent a fair amount of time on Azure, the gross margins there. But within Office, you've got several secular trends as well as just mix shift going on there just from a price point perspective as well as the gross margin between the different levels of E1, E3, E5. So wondering if you could give us some color of what we're seeing there, because obviously, there's healthy, healthy seat growth, revenues outpacing and it seems like margins are as well. So just provide us more color on sort of what we've been seeing and kind of how you think about that trending going forward?

<A - Satya Nadella>: Let me just start at the highest of levels, because for us again, and in this last quarter, some of the innovation that we launched I think is also pretty key as you look forward to what it means for Office and Office growth. One of the new suites we have is called F1 and this is about first-line work. So Office is no longer limited just to the knowledge workers. In fact, we see significant opportunity for some of our teamwork, collaboration, communications, as well as scheduling software to be very, very relevant for anyone who's on the manufacturing plant or a retail specialist. Some of our social tools like Yammer are increasingly getting used for broad communications, inclusive of Skype for Teams.

So I just wanted to put that in there as well, as there is of course E3. There is E3 to E5. But there is also F1, which is increasing the overall penetration and not to mention the small business segment, and of course all the markets that we participate in with Office 365 where we don't have much of a server business at all. We sold Office on-premise or Office perpetual clients. But now you can have a small business in a country like India, buy Office 365 as a subscription service. So those are all the things that are in play.

<A - Amy E. Hood>: And I do think that's important, Keith, in terms of the innovation and the value. I think sometimes, on this call in particular, we talk about there's installed base growth and there's ARPU increases. Sitting underneath that is this very large 120mm dollar-monthly active users in commercial. And they're experiencing frankly the latest innovations that the company has built. So I look and say, seeing growth in that number allows us to actually grow the ARPU, and the new services that Satya mentioned continues to let us grow the installed base.

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Innovations around teams, innovations in AI in the actual Office products themselves are now being experienced by our customers. I think when you have that happen over time, it builds confidence in the product and it builds confidence in end-user confidence in itself. And then purchasers are happy to continue to add SKUs and add and move up the scale. We still, this is primarily the ARPU growth, continues to be some of the earlier transitions we've always talked about. It's that E3 transition as well as installed base growth. E5 continues to see encouraging signs. We're starting to see it enter but that will take a long time, as we've talked about, to actually land in ARPU.

<Q - Karl E. Keirstead>: This one for Amy. Amy, just a general sort of corporate-wide question on gross margins. Your revenue and COGS guide, if I ran the math correctly, imply about 60% gross margins for the December quarter. So that's going to be down y-over-y and I suspect below some of the street estimates. But it sounds like your tone is a little bit better for gross margins for the full year. So I just want to make sure I leave the call understanding what's happening here. Is the conclusion that Q2 is somewhat of a one-off, given the uptick in lower-margin hardware and thereafter will return to a more normal y-over-y pattern on gross margins? Thank you.

<A - Amy E. Hood>: Thanks, Karl. Actually, this is really all the gaming Xbox One console launch. It's very specific. And so every other gross margin trend across IC, across PBP and across the rest of the MPC portfolio exhibits the exact same fundamental drivers and improvement. And so really, this is really 100% the Xbox One X impact in Q2 of the launch on the company gross margin and in particular, the MPC gross margin.

<Q - Walter H. Pritchard>: I think another question for Amy here. Just looking at the dependent – trying to figure out the dependency of your Azure growth this year on the volume of annuity up for renewal. I know last year, you had very, very strong growth in annuity on that renewal cycle, and you're talking about some pressure in Q2 and then a slightly up trend for the year. But how dependent is Azure growth in customers attaching that to the volume of annuity up?

<A - Amy E. Hood>: Yeah, I wouldn't call it pressure, Walter, just how I think about it. There's just an expiration base that comes up every quarter.

<Q - Walter H. Pritchard>: Understood.

<A - Amy E. Hood>: And there's volatility to it. So the way to think about it is over the year, it's up a little and in Q2, it happens to be just a low quarter of the 12 that come up through the cycle, much like Q4 was quite large in the cycle. And Azure actually falls a couple of patterns. It's not just about EA attach although it absolutely can be one of the motions. Because it tends to be project-based as well and many of the investments we've made in sales capacity, and the reason we did some of the sales transformation, was to invest a lot more in that project-led motion, which is a bit disconnected actually from the EA renewal cycle, and you've really seen that. The Azure pace is not, if you drew a line, as correlated to EAs as it even was 3 years ago, as we've I think matured the product and matured our sales cycles.

<Q - Kirk Materne>: I'll add my congrats on the quarter. Satya, yesterday you were down at the GE event and announcing the partnership with them around Predix. And I was wondering, when we think about the opportunities for Azure to be that sort of trusted platform for ISVs, can you just talk about how you think the progress is going on that front? Because it seems to obviously just expand your overall TAM and the kind of use cases you can address by bringing partners like GE onto your platform. Thanks.

<A - Satya Nadella>: Overall, I think you sort of speak to I think one of the big advantages and one of the big value propositions we have on to both sides. One is to the enterprise customer. We are a trusted partner. And we support them with their hybrid computing needs and their AI needs. One of the things that we emphasize is it's not about our technology, but it's our ability to transfer that capability to our customer because they're increasingly becoming, whether you're in retail or you're in oil and gas or you're in financial services, every one of them is trying to build their own software capability and we are uniquely capable of doing so.

The second part is the ISVs. We now, in fact, one of the big areas of investment this year was the core sell capacity in our field so that ISVs can be successful on our platform. Whether it is GE or Adobe and many others can all now benefit, both because of our enterprise partnership and credibility, and more importantly because of the field resources we have put in place. So we are really looking forward to accelerating our business with GE and many others to come.

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But it's a very important core sell motion and more importantly building trust on both sides of that equation.

<Q - Mark L. Moerdler>: I'd like to look at Dynamics 365. It's been growing really fast. It was center stage at Envision in almost every presentation and discussion. Can you talk more about how you think about the opportunity and give us a sense of which of the offerings right now within 365, whether it's CRM or Talent or ERP or whatever, are driving the growth and could be part of the future growth? Thanks.

<A - Satya Nadella>: The way we designed Dynamics 365, both on the technology front as well as on the business model front was to get away from what I would describe as the old-school suite-based selling or suite-based building of these things, whether it's CRM or ERP or SCM. Because we realized that, for example, you take any IoT project that is starting in Azure, it first translates into an analytics workload that pulls through some Azure high router analytics services. And then immediately after you do something like preventive maintenance, you need field service. And all they need is just a very robust field service module that's cost-effective and efficient. And so we're able to attach that to that project.

Similarly on Talent, they want to be able to – if you start on LinkedIn with hiring, you want to be able to do the on-boarding and talent management. That's the module you want. Even on the operations side, we are realizing that even if you keep your financials the same, there is need, and with increasing digitization, there is more operational modules that you need. So that's what we've designed it for. So the growth is actually across the board. It's coming in customer service. It's coming in sales. It's coming in talent. It's coming in operations, and we have some very competitive price points there.

The other one is that there is no such thing as a canonical business. There's no such thing as a canonical business in time. That means things are always changing. So customization, customization and composition, especially with Office 365, is very important, and this is where we have some very differentiated offer with Power BI, PowerApps and Flow. And that's another big driver of some of that growth across our enterprise customers.

<Q - Adam Holt>: That was some quarter. I'm tempted to ask about the strength in Windows, which I know you don't talk about much and don't get much questions about. But really since we've launched, the question that I get by far the most is around the long-term margin potential in Azure. And with the gross margins being as good as they were this quarter, without giving us long-term guidance, is there any reason to believe that the long-term operating margins in Azure couldn't be – we just saw AWS put up a mid-20s operating margin. Is there anything structural that would lead us to believe that you couldn't do something in that range? Or how should we think about the long-term framework for that business? Thank you.

<A - Satya Nadella>: I'll start, Adam. The one thing I'd say is when I think about the long-term margin, I actually think of the long-term margin across our cloud. I mean, when we even make our CapEx decisions, which is one of the drivers of margin, we think of first of all, first party equals third party. A lot of what we do even in Windows, mostly people don't recognize it, but one of the most important services we run is Windows Update as a cloud service. And so we have a lot of value that is across the board cloud services, whether it's Xbox Live, Windows Update, Office 365, Dynamics 365, and of course all of the Azure services. And we're going to build scale across all of them.

And so we would not – in fact, we will be very aggressive in taking margin in one place, which is different as we see a path to margin in a different spot. That's something that we want to make sure we follow more our opportunity in a customer across the board vs. trying to micromanage to certain margins in very specific opportunities, because we think that it's the integrated ability for us to deliver value is which I think long term is what the customers expect of Microsoft.

<A - Amy E. Hood>: And I would just add that as we think about that long-term trajectory, our ability to continue to improve margins in our SaaS portfolio and our PaaS portfolio and IaaS portfolio still exists. And our ability to blend them into interesting products that solve customer solutions, which may not even be priced as the component parts, is I think how we think about, especially in our solution areas that Satya talks about, how we talk about delivering it to a customer. So while I'm confident in our ability to continue to grow the core margin, I do think for us in particular, it really is a portfolio that we believe that we need to manage appropriately.

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<Q - Michael Nemeroff>: My question is on the Gaming business. Given the even larger focus you're putting on this segment in the near-term, how quickly or in what timeframe do you think Gaming revenue could grow at or above the average gaming industry growth rate of mid to high-single digits? And I know you don't break out segment margins, but could you give us a sense of how you think about Gaming from a normalized contribution margin perspective relative to MPC and your overall company-wide margins, excluding the one-time Xbox launch effects? Thanks.

<A - Satya Nadella>: I can start again. I would say from a Gaming perspective, one of the bigger changes that has happened in the last, I would say, couple of years is one, of course the vibrancy of the Xbox Live network across the PC and the console and now increasingly even on the phone because of titles like Minecraft. And once you have the network, you have plenty of different opportunities. In particular, we now have a subscription offer with Game Pass that's off to a good very good start and our goal is to be able to have essentially a Netflix for games, so that we can have the game subscriptions that people can use across all of the devices that they play in.

The other area is streaming. As you know, there is game playing and game watching and there is secular growth on both fronts. And we feel very, very good about the engagement increases in a pretty unique value proposition we have in Mixer. So that's another opportunity that we believe will shape in addition to things like e-sports and so on.

So it's the totality of that. And one of the numbers that I did put in my script was that 20% growth in what we call software and services, that's perhaps a leading indicator of where we think the opportunity lies. These are early days for us, but that said, that's probably one of the key numbers to watch as we make progress and execute.

<A - Amy E. Hood>: And because of that, you're actually already seeing that impact in the MPC gross margins. Even this quarter is a great example. There was material improvement in gross margin in that segment, and a lot of that was actually due to the higher margins that we have structurally in that software and services revenue from Xbox. And as I believe, the industry that Satya is talking about pivots to be more about the engagement and monetization of that member network, you can expect that margin profile as well of our traditional, more hardware-focused Xbox to evolve, to be a real combination of those two things going forward. And structurally, that would of course have higher operating margin.

<Q - Raimo Lenschow>: The conversation we have on around Azure and adoption there seems to be changing with customers, where they seem to be seeking a deeper relationship with you guys now, given that your maturity has increased quite a bit over the last few quarters. Can you talk to that? Is that something that just I picked up, or is that what you're seeing in your conversations as well? Thank you.

<A - Satya Nadella>: Hopefully, we picked it up a lot earlier than you did. But we have. So we do have a very different dialogue. You think about it, all of the customers that we have worked with, we have always worked with them historically even in our server days. But to your point, Raimo, I think what has happened is the change, even in the financial services, the segments that you all represent, the kinds of workloads now that are moving to the cloud has qualitatively changed.

In the past we participated, but a lot of Tier 1 workloads were not on Microsoft stack, whereas now, a lot of Tier 1 workloads are in fact increasingly on Microsoft cloud. And so to me, that represents a qualitative change, and so the type of dialogue we have, whether it's with an auto company or a financial services company or a retail company, is much deeper, much broader. And I would use the word we are deeply partnering with them. It's no longer just simple vendor relationships, because as they are trying to build their own software capability, they need a trusted partner who's more interested in making sure that they build their own technology capability. And that's what we're investing in.

<A - Amy E. Hood>: And I would say, Raimo, a way to think about this is we've always had that trusted relationship, which we're incredibly proud of as a company with our enterprise customers. The investments we've made over the past years are about hiring the type of talent that can go and sit with a customer and drive the customer's successful outcomes of the projects they deploy. And that's what we mean. It's about the investment we've made in capability, the evolution of the product and its innovation. And I think using and trying to continue to earn the customer trust to deliver these world-class workloads. So I do think this is really an output of multiple years of concentration on

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delivering that capability.

<Q - Ross MacMillan>: Satya, I was curious. You've made a number of announcements with Adobe over the last year or so. And it seems like Microsoft's product and Adobe's products are getting more intertwined. And just curious from your perspective, if you could just maybe give us some insights into where you see the big opportunities to work with a vendor like Adobe and what are the go to market actions that you're seeing being more successful? Thank you.

<A - Satya Nadella>: Yes, we're very excited about the partnership with Adobe. And as you said, Adobe and Microsoft have partnered. In fact, across our entire histories in many of the areas, but increasingly across of the creative cloud and their Document Cloud as well as their Experience Cloud, we have plenty going on.

In fact, we are very excited about what we are doing with our devices and Adobe and with Windows because I think Windows and Windows 10 Creators Update is the ideal platform for all of the creators in the world because of the innovation in Windows and the innovation in devices, both Surface Book as well as our OEM devices. So that's one area that I think you will see. I would love if you're an illustrator or a Photoshop user, you should just check out the dial support that they have in Surface, which just is beautiful.

And then you go to Office 365. We have a partnership with them on e-signatures. We have good interoperability between our respective document clouds. That will in fact continue. And then on the creative side or on the experience side, in fact we are adding a lot of data and AI capability, which is obviously key to Adobe as an ISV.

So we're looking forward to the, ultimately the impact all this has with customers in terms of their ability to take advantage of our respective value and for them to be able to benefit from it all. And so these kinds of partnerships, whether it's with Adobe or others, we are very focused on making sure that ISVs and partners have success on our platforms. And that's sort of our core heritage, and that's something that we want to absolutely focus on.

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