

Microsoft's (MSFT) CEO Satya Nadella on Q1 2017 Results - Earnings Call Transcript

Oct. 20, 2016 11:45 PM ET | **Microsoft Corporation (MSFT)** | 4 Comments

Q1: 2016-10-20 Earnings Summary

Slides

10-Q

10-Q

EPS of \$0.76 **beats by \$0.08** | Revenue of \$22.33B (3.11% Y/Y) **beats by \$635.52M**

Microsoft Corp (NASDAQ:[MSFT](#)) Q3 2016 Earnings Conference Call October 20, 2016 5:30 PM ET

Executives

Chris Suh - General Manager, IR

Satya Nadella - CEO & Non-Independent Director

Amy Hood - CFO & EVP

Analysts

Brent Thill - UBS

Keith Weiss - Morgan Stanley

Heather Bellini - Goldman Sachs

Karl Keirstead - Deutsche Bank

Mark Moerdler - Bernstein

Walter Pritchard - Citi

Mark Murphy - JPMorgan

Raimo Lenschow - Barclays

Ross MacMillan - RBC Capital Markets

Gregg Moskowitz - Cowen

Brad Reback - Stifel

Operator

Welcome to Microsoft's First Quarter Fiscal Year 2017 Earnings Conference Call. [Operator Instructions]. I would like to turn the call over to Chris Suh, General Manager of Investor Relations. Chris, please proceed.

Chris Suh

Thanks. Good afternoon and thank you for joining us today. On the call with me today are Satya Nadella, Chief Executive Officer, Amy Hood, Chief Financial Officer, Frank Brod, Chief Accounting Officer and John Seethoff, Deputy General Counsel and Corporate Secretary. On our website [Microsoft.com/investor](https://microsoft.com/investor) you can find our earnings press release and financial summary slide deck which is intended to supplement our prepared remarks during today's call and provide the reconciliation and 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 clarifying items to aid investors in further understanding the Company's first quarter performance in addition to the impact of these items and events had on the financial results.

Additionally, any mention of operating expenses refers to segment operating expenses as defined in the footnotes of our Form 10 Q which includes research and development, sales and marketing and general and administrative but excludes the impact of integration and restructuring charges. All growth comparisons we make on the call today relate to the corresponding period of last year unless otherwise noted.

We also provide growth rates in constant currency when available as a framework for assessing how our underlying business has performed excluding the fact of foreign currency rate fluctuations.

During Q1 we provided an update to our key investor metrics for fiscal 2017. We provide these additional metrics to enhance our financial reporting results and provide transparency into our progress against our strategic imperative. We introduced three new metrics. Commercial cloud gross margin percentage, total gaming revenue, and Windows commercial product and cloud services revenue growth. We will be referencing these metrics throughout the commentary today and you can see them in our published API [ph] on the IR website. We'll 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 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 until October 20, 2017. During this call we will be making forward looking statements which are predictions, projections of other statements about future events.

These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the risk factors section of our Form 10K, Form 10Q 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 Chris and thanks to everyone on the phone for joining. Today I will share the results for the first quarter and discussed how we are innovating into growing each of our segments. Overall we are off to a good start in FY '17. We delivered \$22.3 billion in revenue this quarter, an increase of 5% in constant currency. I am proud of the continued progress.

Our platforms are leading profound digital transformation outcomes for both people and organizations. At our IT conference Ignite, I talked about how we are innovating in AI across the entire text back and how I will be infused into everything we do. To accelerate our innovation we've created a dedicated organization to focus on artificial intelligence. As I turned to progress we made by segment this quarter, I will highlight how these investments we're making in AI fuel innovation across all of our ambitions.

Let's start with productivity and business process. We're helping people be more productive by bringing intelligence to familiar office apps they use every day. We recently introduced cloud power intelligence within Word, Excel, PowerPoint and outlook that uses machine learning and advanced natural language processing to help automate related content and connections focus your inbox and more easily create compelling content.

We are also building intelligence into our apps to provide advanced security for customers. This quarter we announced Office 365 threat intelligence which analyzes billions of signals across office Azure Windows and external data sources to give customers broad visibility into attack trends and proactively recommend security policy adjustments. We're extending intelligence to compliance with our new data governance service which helps customers achieve organizational compliance and automate data retention.

These advancements are part of our ongoing commitment to strengthen security for Office 365 customers. We're seeing broad momentum with customers across enterprises, small business and consumers. Monthly active users of Office 365 commercial are now over 85 million, up more than 40% year-over-year. Office 365 commercial seats were also up 40% year-over-year and revenue up 54% in constant currency. Across industries, customers such as eBay, European airline, jet, global pharmaceutical company, Allergan, the Fortune 100 companies like the energy leader Exelon and Liberty Mutual Insurance are choosing Office 365 to help make their employees more productive and secure.

Customers love the power of office on any device. We now have more than 45 million outlook monthly active devices on iOS and android more than 70% increase year-over-year.

Last week we unveiled a new class of purpose built intelligent apps in Dynamics 365 designed to remove any impedance that exists between productivity, collaboration and business process. Using advanced analytics a machine learning, these new apps glean insights from previously siloed data to transform how people work across finance, sales, marketing and customer service. They monitor customer relationship help, reveal connections, forecast demand and predict risk and the deep integration with Office 365 makes it easy to take action communicate and collaborate in real time or schedule a follow up.

Our innovations the Dynamics 365 build on our existing momentum, dynamics online paid seats more than doubled year-over-year and customers increasingly prefer our cloud solutions with more than 70% of the new dynamics CRM and ERP enterprise customers choosing dynamics online. Companies like HP, Inc. are replacing their existing CRM systems with Dynamics 365 to take advantage of the built-in intelligence and our latest release and transforming engagement with customers and partners. Overall, we are well positioned to compete and grow our Sarah in this large and growing market.

Now let's talk about the progress we are making in our Intelligent Cloud segment. Customers continue to choose the Microsoft cloud to help transform their businesses and organizations. Our commercial cloud annualized revenue run rate now exceeds \$13 billion, and we remain on track to achieve our goal of \$20 million in fiscal year 2018. Once enterprise customers choose one of our cloud services they continue to adopt more services.

More than 60% of the fortune 500 now have at least three of our cloud offerings, up 20 points year-over-year. And as with last quarter, we continue to grow our commercial annuity mix which is now at 88%. Customers choose Microsoft for three reasons. They wanted trusted global hyper scale cloud provider to meet the enterprise grade needs, they want hybrid support that is architected into both the hyper scale service and the cloud servers, they want higher level services to help them build their own digital capability inclusive of DevOps, productivity, new IOT and enterprise app development, advanced analytics and machine learning in AI capability.

These differentiated features are leading our cloud infrastructure growth. As revenue once again through to build it just wanted to 21% in constant currency with Azure compete usage more than doubling year-over-year. We continue to invest in and expand our data center footprint which now totals 38 regions including the announcement of our planned expansion into France and the recent opening of data centers in the United Kingdom and Germany.

Enterprises like Nissan alliance, hotels, as well as public sector customers such as the United Kingdom Ministry of Defense, the islands, health services executive are choosing brand tends to transform their organizations while meeting European data sovereignty security and compliance needs. Security and compliance remain paramount for enterprise customers. Azure is already the most trusted most compliant cloud with 49 certifications, more than any other cloud provider and our US government cloud has the highest number of certifications and dedicated data center regions in the industry to meet the stringent requirements of our public sector customers.

We are applying AIT security with the new Azure security Center which leverages advanced analytics and machine learning to detect threats and help enterprise customers respond with comprehensive cyber security and management.

Looking beyond infrastructure services, across industries customers like trucks North America, and are using Azure intelligence services to build powerful new offerings for their customers. More than half of the fortune 500 have our enterprise mobility services up more than 20 points year-over-year. This quarter we released a premium version of our enterprise mobility service that includes advanced security management for SaaS applications, automatic document classification and encryption, advanced identity protection, and we crossed three quarters of 1 billion unique user identities in Azure active directory.

This quarter we announced a number of key partnerships. Adobe and as a be recognized Azure's leadership in the cloud on bringing their industry leading marketing and human resource solutions to our platform, giving our mutual customers powerful new ways to transform their business. Customers and developers are also choosing Azure for its openness. Enabling digital transformation for everyone means supporting the widest range of platform frameworks and tools.

This quarter we announced that we are open source Windows power shall, our industry-leading infrastructure management tool and made it available on Linux. We continue to see strong interest in the previous post SQL Server with 19,000 customers registered including more than half of the fortune 500. It's opening conversations with customers spanning their entire data state both on premise and in the cloud. Azure fabric on Linux enables to high skill microservices and cloud applications. And we announced that our new power platform in Azure capable of extra scale compute will support Café, torch and our own frameworks for deep learning.

Finally, we're building our server products to become the edge of our cloud to support true hybrid computing. The new Windows server 2015 gives IT professionals new layers of security and brings Azure inspired innovation for infrastructure and cloud applications. And we expanded our partnership with doctor to make the commercially supported Docker engine available to Windows 2016 customers at no additional cost.

Now let's talk about more computing were very also seeing intelligence transform Windows 10 and our ecosystem of devices. We now have more than 400 million monthly active devices on Windows 10 and nearly 200,000,000,000 hours of usage. And we are expanding our growth opportunities for Windows with enterprises and an area such as gaming.

Last quarter I outlined three aspects of our Windows strategy. First deliver more value and innovation, particularly for enterprise customers. Second, grow new monetization through services across the unified Windows platform. Third, innovate in new device categories in partnership with our OEMs. Let me talk to the progress we're making in each. This quarter we release Windows 10 anniversary update with advanced security features including Windows defender, threat protection, our cloud enabled service that helps enterprise detect, investigate and respond to advance networking tax. And with threat intelligence sharing capabilities we enable IT to investigate and respond to security threats across Windows 10 and Office 365. Our advancements in security helped to drive by three times at present Windows enterprise deployments over the last six months.

The growth and customer option is also driving increased developers search and Cortana engagement. The number of developers building and updating universal Windows apps is up three times year-over-year, more than 1000 application of been developed using the Cortana API and Windows 10 Cortana search box now has 141 million monthly active users with almost 13,000,000,000 questions asked to date.

Gaming is a leading driver of engagement on Windows 10 and opens up new experience it and scenarios across Windows devices. For the past three consecutive months Xbox one has been the number one selling console in the United States, giving a strong momentum heading into the holiday season. Our highly engage Xbox live database continues to grow across Windows 10 IOS and android up 21% year-over-year, and we have more than 20 billion hours of gameplay on Windows 10 PCs and tablets, more than 500% increase year-over-year.

Our commitment to grow Xbox live community led us to acquire beam this quarter, and innovative and interactive live streaming service that gives viewers the ability to watch and play along with their favorite game in real time. Finally, let's talk about her progress in new device categories. Surface continues to drive category growth and more commercial customers are choosing to deploy service with the deals of 500 devices or more increasing 70% year-over-year and we are reaching more commercial customers of all sizes with the support of our channel partners.

The Windows holographic platform and Microsoft HoloLens are opening up new differentiated opportunities on Windows. This quarter we made Microsoft HoloLens development edition available to all developers and business customers in the US and Canada and last week we expanded our presence to six additional markets. Enterprise customers like Volvo, Japan Airlines and the PGA tour, all embracing Microsoft HoloLens to transform the way they work and create new mixed reality experiences for customers.

It's still early, but it's great to see the innovation and creativity that developers are bringing to the platform and coming in 2017 we will enable our hardware partners to deliver entirely new mixed reality experiences with Windows holographic and on Windows 10. In closing, we are leading digital transformation across all industries and geographies. Creating enormous opportunity for Microsoft and our partners. As we infuse AI into all of our computing platforms and experiences, we will drive even greater transformational value for our customers. In the coming weeks, I'm looking forward to sharing news about our new innovation in Windows 10 and Office 365.

Now let me hand it over to Amy to walk through this quarter's results in more detail and share our outlook and I look forward to rejoining you after for questions.

Amy Hood

Thank you, Satya and good afternoon everyone. This quarter revenue was \$22.3 billion up 3% and 5% in constant currency. Gross margin was flat and up 2% in constant currency. Operating income was flat and grew 4% in constant currency and earnings per share was \$0.76, increasing 9% or 13% in constant currency.

I'm pleased with the strong execution was on the first quarter from our sales teams and the partner ecosystem. Across both our commercial and consumer businesses. Across most markets our results were in line with microeconomic trends. With strength in key markets like the US, Western Europe and Japan. Momentum and cloud services contributed to a total commercial annuity mix of 88%, up two points from the prior year.

We again saw higher than expected transactional deal volume, primarily driven by office commercial products and our small and midsize business segment. This quarter the dollar volume of annuity expirations was significantly larger than the prior year, and was solid renewals from that base, we grew our commercial bookings by 18%.

The larger base also drove our contracted not billed balance to more than 25 The larger base also drove our contracted not billed balance to more than \$25.5 billion. Strong execution resulted in better than expected commercial revenue of \$22.3 billion or an 8% increase in constant currency. Our commercial cloud revenue run rate exceeded \$13 billion this quarter, growing 59%.

As I assure previously, we expect our commercial cloud gross margin percentage to materially improve throughout the year. This quarter our commercial cloud gross margin percentage was 49%, up seven points sequentially, although we do expect variability from quarter to quarter. Importantly, gross margin dollars grew by 61% across the total commercial cloud.

Now the company gross margin. Our company gross margin was approximately 65%, down a little less than two points from the prior year, impacted by an increasing mix of commercial cloud revenue, slightly offset by improvements in more personal computing. The revenue performance in more personal computing largely drove COGS above our expectations. This quarter the FX impact on total and segment level revenue was in line with expectations. FX had a two point negative impact on productivity and business processes and Intelligent Cloud results, and a one point negative impact on more personal computing results.

Total operating expenses were flat and grew 1% in constant currency from investment supporting our commercial cloud. At the company level, operating income grew 4% in constant currency.

Let's turn to each segment where we can now discuss constant currency impacted the revenue and operating income levels. This quarter our productivity and business processes segment delivered results above our expectations with approximately \$6.7 billion in revenue, an increase of 6% and 8% in constant currency. In office commercial revenue increased by 5% and 8% in constant currency as Office 365 growth continued to outpace the shift from our on premise business. We again grew our install base across all the workloads.

In our Office 365 commercial business premium workload mix was above 60%. As mentioned earlier, our transactional results were higher than expected in the small and mid-size customer and segment and benefited from a stabilizing commercial PC market. Office consumer revenue grew 8% also a percent in constant currency benefited from a stronger than expected consumer PC market. Subscriber fee growth and recurring subscription revenue and our dynamics business grew 11% up 13% in constant currency as customer preference for cloud services and CRM online and dynamic the X the timber the two billings and seat growth.

Segment gross margin dollars were flat up 2% in constant currency. Segment gross margin percentage declined on an increase in cloud revenue mix. Operating expenses grew 2%, also 2% in constant currency primarily driven by investments in cloud engineering. Operating income declined slightly but was up 2% in constant currency. Intelligent Cloud segment delivered nearly \$6.4 billion in revenue above our expectations and grew 10% or 10% in constant currency. Server products and cloud services grew 11% and 13% in constant currency. Demand for our hybrid cloud offerings led to another quarter of double digit annuity revenue growth within server products and cloud services, partially offset by a decline in our transactional on premise server business. Server premium products grew double digits in constant currency.

As expected, enterprise services revenue growth slowed this 12.45% and 2% in constant currency, largely due to a decrease in volume of support agreements associated with Windows server 2003 and support. Gross margin dollars grew 2% and 4% in constant currency and segment gross margin percentage declined primarily due to increase in cloud revenue mix, partially offset by significant improvement in Azure gross margin. Given the growth opportunity in cloud, we increased our operating expenses by 21%, also 21% in constant currency to fund cloud engineering, sales capacity and developer engagement. Consequently, operating income declined 14% and 11% in constant currency.

Now to our final segment, more personal computing. Revenue was \$9.3 billion, down 2% and 1% in constant currency and better than expected across multiple businesses. First, our OEM results. Our total OEM business was flat this quarter were in line with the PC market and better than we expected. OEM Pro revenue grew 1%, reflecting the stabilizing commercial PC market, particularly in the US. OEM non-Pro revenue declined by 1%, slightly ahead of the consumer PC market driven by a higher mix of premium devices. Channel inventory levels for OEM Pro and non-Pro remained at normal levels.

We're seeing strong growth in Windows 10 deployments. The annuity portion of our Windows commercial business grew again in constant currency as customers continue to commit to our differentiated security and management solutions.

Overall, our total Windows commercial business revenue across small and mid-size businesses enterprises and academic institutions was flat and grew 2% year-over-year in constant currency. Patent licensing revenue increased this quarter, primarily due to favorable results in our annual contractual agreements. Our search business grew again this quarter driven by rate and volume improvements in being. The our growth rate is moderated we continue to gain share and scale while delivering profit. As expected, devices revenue declined this quarter. Revenue decreased 27% down 25% in constant currency due to a revenue declined 72% to 71% in constant currency.

Surface revenue increased 38% 39% in constant currency driven by year-over-year growth for surface Pro and bulk which launched in Q2 of the prior year. In gaming revenue decline 5% or 4% in constant currency, due to lower console hardware revenue. We continue to see strong engagement on our platform with monthly active Xbox live users up 21%. Our software and services revenue from console, PC in other gaming devices grew 6% or 8% in constant currency. Segment gross margin dollars.1% up 1% in constant currency as decreases due to Xbox consoles and phone were partially offset by our search and surface results. Segment gross margin percentage improved slightly given the revenue shift to higher margin products and services.

Operating expenses decreased 13% also 13% in constant currency primarily based on reduced phone spend and lower marketing spend resulting in segment operating income growth of 26% and 31% in constant currency.

Now back to our company results. We invested \$2.3 billion in capital expenditures, a decline from Q4 but consistent with our plan for investment to support customer and partner demand for our commercial and consumer cloud services. During the quarter we continued to rebalance our investment portfolio which resulted in other income and expense of \$100 million from net recognized gains on investments in income from dividends and interest partially offset by interest expense. Our Non-GAAP effective tax rate was 70% this quarter. As I mentioned before, our income tax rate is impacted by three sectors. The proportion of service revenue versus licensing revenue, the geographic mix of revenue, and the timing of equity and our first quarter equity best impact of the REIT more significantly been in other quarters.

We returned \$6.6 billion to shareholders through stock repurchases and dividends. We also raised our quarterly dividend by 8% to \$.39. With that overview of the quarter, let's turn to the outlook. My commentary for the upcoming quarter does not include LinkedIn. We still expect the transaction to close in the second quarter.

Turning to FX, we expect one point of revenue impact of both the total company and individual segment levels. We expect our commercial business to remain healthy, but we will still see and experience variability our transactional business. We were also see strong annuity growth driven by solid renewal execution and increasing customer adoption and use of our cloud services. Therefore, we expect commercial revenue to be within the region \$21.05 billion to \$21.25 billion.

Next on CapEx, we will continue to invest to meet growing demand and see quarterly variability in spend. We expect the sequential dollar increase in the upcoming quarter. For the full year our total expected CapEx growth rate should be lower than FY '16 event efficiency improvements.

Now let me share some additional thoughts for each segment. In productivity and business processes we expect revenue of \$6.9 billion to \$7.1 billion. We expect the ongoing transition to the cloud to drive install base growth with continuing declines in our transactional business.

For the Intelligent Cloud segment, we expect revenue of 6.5 5 billion For the Intelligent Cloud segment, we expect revenue of \$6.55 billion to \$6.75 million driven by strong annuity growth across our server products and cloud services. We anticipate the enterprise services revenue will decline due to lower volumes of Windows server 2003 service agreement.

We expect more personal computing revenue to be \$11.2 billion to \$11.6 billion. This segment is impacted by different trends in our other two segments so some additional detail.

First on Windows. We expect our OEM business and the underlying PC market to be closely aligned. As a reminder, our OEM Pro business we exited Q2 last year with a slightly higher level of inventory. We currently see normal inventory levels in the channel which will dampen year-over-year growth of it. In search we expect things revenue growth to be similar to Q1. Additionally, we expect that total search revenue growth will slow considerably as we pass the one year anniversary of our young to deal and the associated change in revenue recognition. Phone revenue will continue to decline and as we previously announced, we anticipate closing the sale of our feature phone business in Q2. We expect surface revenue to decline as we anniversary the product launch from a year ago.

And in gaming we expect strong share performance in key markets like the US and the UK this holiday, but overall revenue will decline given lower price points and lower overall console units as mix shift towards Xbox One and Xbox One S. We expect continued active engagement growth on our gaming platform given the holiday season.

We expect COGS to be \$9.7 billion to \$9.9 billion with variability driven by device sales. We expect operating expenses between \$7.85 billion and \$7.95 billion in Q2, and we remain on path for full year operating expense of \$31.1 billion to \$31.4 billion. We expect other income and expenses to be \$150 million as we continue to balance games on equity investments and income from interest and dividends against the interest expense in the net cost of hedging. We continue to expect our full year tax rate to be 20% plus or minus two points with variability due to three factors discussed earlier.

And with that, I'll turn it back to Chris for Q&A.

Chris Suh

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

Question-and-Answer Session

Operator

Certainly. [Operator Instructions]. Our first question comes from the line of Brent Thill with UBS. Please proceed.

Brent Thill

Satya on Azure the numbers were really impressive given how hard the comp was, I'm curious if you could just help out a little more color in terms of what you saw during the quarter and maybe how some of the ticket sizes or sizes these are signs changing from the past year ? Thank you.

Satya Nadella

Overall, again I go back to how we think about Azure. We really have a view of distributed computing which is more expansive doing just even our HyperScale cloud. We think about Azure and our servers as one distributed computing fabric that's building. We also don't think of Office 365 and Dynamics 365 as independent, we think of them altogether building out our commercial cloud because it takes one of the bigger growth areas we have in Azure, it's IoT but it's not just people connecting sensors and collecting data. They collect the data, they store the data, they analyze and do predictions on it but then after you do predictions you got to do something about the predictions. So in many cases they choose to use especially with the new Dynamics 365 field service module automating field service.

So it's those higher level scenarios that we are seeing in addition to the core infrastructure that supports hybrid that I think is accelerating and that's something that obviously we didn't make the decision last quarter to do that. This is a decision we made many, many years ago in some sense inception of Azure was built for a future which is much more distributed computing done in a very different way than the client server area. I think we're just finally getting into the early innings of what is true hybrid computing and it's good to sort of see those in last quarter's results as well.

Operator

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

Keith Weiss

I want to drill in on Office 365 a little bit, 40% growth in commercial space is a really nice number but even nicer number on the revenue line I think 54% of constant currency growth in Office 365 commercial, that seems to imply you guys are seeing some nice ASP increase as the platform matures. Can you talk to us about where we are in that cycle of moving from a E1 to E3, is the E5 part of the equation yet? Are you guys actually moving there yet?

Amy Hood

When I talk about the premium services mix, in our Office Commercial 365 business being about 60%, that is what's driving whether that's the mix shift to E3 or ultimately to E5 you will continue to see and have headroom in that number but you are right, we are encouraged by the ARPU growth and the value proposition that has customers choosing the premium SKUs and continuing to choose those premium SKUs over time.

I don't really think about there being sort of a cap on that when you think about the mix percentage because part of it is as you know not just adding the first few in notes in E3 is continuing to add E5 and new scenarios over time that will continue to create. So hopefully that's helpful but you are right, it is ARPU driven the performance outside of the 40% growth.

Operator

Our next question comes from the line of Heather Bellini with Goldman Sachs. Please proceed.

Heather Bellini

Satya I know that Brent asked you about Azure but I'm just wondering if you could share with us you mentioned that compute usage on Azure I think you said more than doubled or nearly doubled something to that effect. I'm just wondering if you could share with us kind of how you see coming pass [ph] coming along and where do you think we are in getting kind of the easier workloads to the cloud and are you now starting to see the inflection given we did see an inflection in growth on a year-over-year basis this quarter where you are starting to see production significant production workloads that are on premise actually starting to move over as well?

Satya Nadella

We definitely are seeing production workloads that are moving over from on premise, but I think the more interesting thing Heather for us is to see new workloads. When I look at what's happening with say some of the most innovative work we've done around distributed computing which is service fabric and how people are in fact going straight to building out using our past services some of the new HyperScale cloud services using microservices and not only are they doing that but we're also seeing great growth in our serverless infrastructure which is Azure functions.

So I am actually as excited about new cloud growth from new cloud workloads from the same customers so the much interesting thing that I am observing is that it could be the same model customer that was participating with us in the client server area. We are not just building or moving their IT but they are building new digital services for HyperScale and that's what it is probably unique in terms of what is changed year-over-year for us. It's not just the Silicon Valley startups anymore, it is the core enterprise that is also becoming a digital company and we are well positioned to serve them and that's good to see.

Operator

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

Karl Keirstead

Question for Amy. The operating cash flow generation \$11.6 billion was extraordinary. I don't think you've had a 50% plus cash flow margin since early 2012. Is this a little bit of an anomaly may be driven by unearned revenues or is something changing in the business model that might change the rate of cash flow generation in coming quarters as well? Thank you.

Amy Hood

It is actually impacted by the same thing that impacted free cash flow this quarter, which is about a \$1.3 billion on settled cash settlement impact. So you actually see that revert in Q2, although our free cash flow growth of 8% in the quarter was actually very good, and I do feel good about that, but I want to make sure you don't miss understand the root cause that makes the number a bit of an anomaly.

Operator

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

Mark Moerdler

So want to drill in a little more. The margin for commercial cloud improved 7% which given the size is a large improvement. Can you give us some more details on what exactly is driving that margin improvement. You said it's going to be improving over the year, but how sustainable is that drive to improvement?

Satya Nadella

Let me start market and then Amy you can add to it. Again Mark this goes back to a little bit of understanding I guess how we think about both X as well as OpEx in terms of our cloud. The architectural design we have for example when we do X we are buying the four everything that Microsoft does which is everything from Azure to Office 365 Dynamics 365 as well as our consumer services like Xbox live. And you see the growth that we talked about across all of this. Then we have a very common platform both for first party workloads as well as our third party business.

And so then as we drive efficiency and our cloud infrastructure, when we for example use to be more out of our network, that's efficiency that we gain across the marginal cost and gross margin that spans everything that we do. Then also what we think about as the mix our goal is not just to sell commodity services, but to actually use commodity services in some cases as a bootstrap for higher level services because of things like data gravity. So there will be differences quarter to quarter. We may impact on board a few customers who first on board a lot of storage at commodity service levels, and then later on start some of the high level services.

So the margin improvement on a lot over a period of time is something that we are absolutely going to see, but from quarter to quarter there will be more volatility, but I would ask our investor base to think more about the architecture as well as the financial outlays of what we're building. We're not just building Azure we're building from 13 Office 365 Dynamics 365 as well as our consumer services withdrawal cloud oriented and it's a combination of that that's driving margin, but Amy I will let you add there.

Amy Hood

But I would say in terms of sustainability are quarter to quarter, Satya is right. There is going to be very ability the variability is really two things. One is the case of the mix shift to Azure as it grows at the pace we're seeing it does impact quarter to quarter. The overall commercial cloud revenue mix, but I would also say the directionality of the Azure gross margin for example which recent significantly improved we expect to continue. Certainly over the course of this year as we have discussed. So I think the directionality of sustainability is correct and I think the variability can certainly occur from any of the reasons Satya talked about.

Operator

Our next question comes from the line of Walter Pritchard with Citi. Please proceed.

Walter Pritchard

I think Amy am wondering on the segment operating margins guided those per se, but you have sort of flat performance in operating income in an declines in IC with growth in do you expect to see as you get towards the end of the year that the enterprise cloud segments move positive and MPC is not as much of a driver how should we think about the evolution of the product contributions of the over the year?

Amy Hood

Sure. I am actually going to cover in commercial segments as one because really when you think about the commercial cloud, it's really about capturing the opportunity of selling more complete solutions which include dynamics and office plus some components of Azure which is I think really the trend you'll see us talk about from here on out. So what I would say is, he will continue to see us focus on gross margin improvement and we talked about that.

You also continue to see us invest where we see massive market addressable expansion with sales capacity as well. So I think we have pivoted dollars to invest in that opportunity. He will continue to see us do that. But we also expect revenue growth in gross margin growth to come out of that investment. So I do believe that's a continued pace you will see us on, and we feel good about the ROI of the investments we have made especially in those commercial segments.

In MPC, I generally expect he will continue to see improvement through the year just based on the mix of products that we will have over the course of the year, that's not new. Use all the same mechanism last year through the year. As we pivot from our phone business to some of our higher margin product. And so, I suspect you will see a similar pattern on a similar desire by Satya to continue to invest toward growth especially on the commercial side.

Operator

Our next question comes from the line of Mark Murphy with JPMorgan. Please proceed.

Mark Murphy

So Amy, you are reporting an impressive buildup of the long term deferred revenue itself 162% year-over-year. At the same time, some of your partners feel that you are gradually doing away with a three year that have existed for so long at that you are replacing them with the vehicle which is a little more flexible in terms of length of contract in there could be some shorter lengths. Could you help us in terms of how to think through the long term deferred revenue buildup as you do start to mix over to the MPSA?

Amy Hood

Let me break report that long term earned balance a bit. I do really focused and I think it's important if you're trying to understand the buildup of our commercial business to focus only on the unearned commercial balance. Our overall long term under imbalance has been impacted by the Windows 10 deferral over the past.

And so it can make a bit of a distraction towards seen the underlying trends. That being said, our commercial under balance is seeing good growth I'm proud of our performance this quarter. Both sequentially and year-over-year.

If you think about any change we're making or not, in our partner agreements our customer agreements. We still do generally rely the vast majority on three year agreements so whether or not the term were to change, given how we recognize revenue, I will you know if it's going to be material and I do not expect the change are talking about to be material in any way on the commercial unearned balance.

Operator

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

Raimo Lenschow

Quick question more on an industry theme for Satya. We obviously saw a very interesting answer from AWS and [indiscernible] which kind of seems to suggest a hybrid cloud is the way forward [indiscernible] has to react. Can you talk a little bit about your customer feedback around the hybrid cloud offering from you and how your customer is thinking about that working with you together? Thank you.

Satya Nadella

I spoke to this a little earlier because from day one we have this vision of how we want to build for the future distributed computing would include our hyper scale cloud service which is Azure an impact Azure is built on Hyper-V and we always said that we were going to build our server as the edge of our hyper scale cloud and so that's what Windows Server 2016 represents, that's what SQL Server 2016 represents and so we have this unique capabilities like be able to stretch even a single table in a database in SQL 2016 all the way to the cloud for having infinite table capacity and then having your apps and queries work.

How we're doing containers for example in Windows Server 2016 we have great container support as well as support for things like our service fabric so that people can have absolute application portability and in fact people can even [indiscernible] applications.

We have many customers who tier their storage and compute across a hybrid backplane. So this is an architectural design point that we have built from the ground up from day one and it's good to see people validating it now and elsewhere and we will take that as a validation of something that we thought of a long time ago.

Operator

Our next question comes from the line of [indiscernible]. Please proceed.

Unidentified Analyst

Can you just compare and contrast AWS versus Azure versus AWS for me standpoint of the technology footprint that you are offering both these companies? And Amy if you could just comment on the margin structure of your business trip of the business relative to AWS and if you have time talk about the Windows 10 cycle. Why hasn't got to be the best Windows 10 cycle for the enterprise compared to the previous cycle thank you so much.

Satya Nadella

I would say I talked about sort of the reasons the three big reasons why customers choose our cloud in our cloud infrastructure in particular. One, it is about the hybrid design point that is at the core of how we are billed, both Azure as well as our servers. It is because of the higher level services that we have. It is also because of the design point we have around not just Azure but as well as Dynamics 365 and Office 365 and the extensibility of our cloud services across all three of them, and that's really the fundamental reasons why customers choose us. The other thing I will mention is, we have more of a commitment I would say which is been there from a long time to build out a global footprint with more regions and anyone.

We are more certifications than anyone in terms of adhering to both regulated industry as well as digital sovereignty. We've done many things we're the only cloud provider for example that operates in China. We operate in Germany under German law.

And that matters to multinational companies but also are trying to operate across many geographies and jurisdictions. So those are our core attributes that are driving our growth and will continue to stay focused on them.

Amy Hood

In terms of the gross margin question, I feel very good talk about this quarter about our improvement year-over-year and remain confident that we are heading in the right direction and so, I think when you think about that plus the rest of our offerings, I think we're pretty confident.

I will take the opportunity and asked about Windows 10 in the enterprise market that we are encouraged by the pace of deployment, the number of proof of concepts, and actually some of the stability we've seen in the commercial PC market in terms of starting to see some so I think overall I think we will continue to watch, but our security and management value prop I think really is paying off.

Operator

Our next question comes from the line of Ross MacMillan with RBC Capital Markets. Please proceed.

Ross MacMillan

Satya, I actually had a question for you on SQL server as you think about the port to Linux, what if you can provide an update on two things, one, it's just the timing of when we should see that in market and then two, are there other things you need to do to meet that requirement across the landscape.

So for example, you have to think about supporting Java runtimes inside of SQL server moving a little bit away from the traditional that development of armed.

Just curious as to how your Dick about getting your arms around a wider set of use cases on alternative operating systems. Thanks.

Satya Nadella

Overall, we are very, very excited about what we are seeing with SQL on Linux because the entire idea was to be able to have a full conversation around the data as stated with customers. And to now be able to talk about the full SQL estate one of the other conversations that we are having is not just about SQL but our analytics and advanced analytics with where we've done some very, very compelling work again across Linux and Windows and then of course the cloud.

So it's really the combination of SQL advanced analytics and the cloud with things like Azure datalink that are really the choices customers are trying to make as they think about their digital capability and the next generation of services and policy storage and processing capability they need.

Now, in terms of having support for these different runtimes, you're absolutely right, that's the reason why for example on Azure itself Java is first class. We have Linux is first class. We have real openness to all of the frameworks that you can call out to, and that something that we stay very attuned to come out which is we are not trying to fight some old battles.

This is all about being able to serve customers on their needs today and that's what is leading and driving a lot of our choices as well as how we think about our market opportunity.

Operator

Our next question comes from the line of Gregg Moskowitz with Cowen. Please proceed.

Gregg Moskowitz

Satya your make a much bigger bet on AI and rightfully so and you highlighted some very interesting use cases having said that, Microsoft has worked on AI project for quite some time. So can you help us understand what degree of positive change you think will come from the combined group 8 you have recently formed including when you think material AI benefits will become truly ingrained in the customer's workflows and then secondly how should we think about the incremental investment in AI going forward?

Satya Nadella

Overall, I am thrilled about both the AI group that we have formed, the AI research and the heritage we have with them even this week I think we publicly are talking about setting the state-of-the-art when it comes to something like speech recognition and something that we did even with image net an image recognition and object.

So these are capabilities that are not easy to build if you don't have a real commitment to research and then the ability to take that research and then ultimately turn into products.

So the way to measure from the investment side is to see AI when it is infused into everything we do. Take Hololens, the ability of Hololens to be able to see the world, reconstructed and in that world to be able to superimpose holograms, that is AI applied AI that is working today.

When you have Skype translate when two people are talking two different languages and are able to automatically translate without between languages, it's using a deep neural net pens bring together speech synthesis, speech recognition and machine translation with Skype data, that is fairly magical.

When you seeing capable of running flow to create intelligence, that is what we are using impact from our speech and vision work. That is AI as applied today. So I am not waiting for some future date to see ROI from AI, we're very much going forward even the office tools example I used. They're all using AI today.

The PowerPoint designer if you want the most practical use of it, even identify great PowerPoint slides now because of AI. And so, that's how I measure progress.

We are committed to long-term research, but we're also very focused on having the long term research translated into everyday use products, and that's what you will see from us going forward.

Operator

Our last question comes from Brad Reback with Stifel. Please proceed.

Brad Reback

Amy quick question with the recent release of WinServer 16, is there any reason to think that we shouldn't see some uptick in the transactional business, especially with easing comps in the next couple of quarters? Thanks.

Amy Hood

With our annuity mix as high as it is, it can impact at a couple points either way, but I don't think about that as really immaterial impact. You should think about in the next couple of quarters. And our focus will always be making sure we have a clear roadmap for customers to make long-term commitments through annuity and so we are really trying to get away from some of that launch impact that you may normally expect to see.

Chris Suh

So that wraps up the Q&A portion of today's earnings call. We look forward to seeing many of you in the coming months at various investor conferences. For those unable to attend in person these event will be webcast and you can follow our comments at Microsoft investor relations website. Please contact us if you have any additional details if you need any additional details and thank you again for joining.

Satya Nadella

Thank you all. Thanks.

Amy Hood

Thank you.

Operator

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

4 Comments