Company Name: Microsoft
Company Ticker: MSFT US
Date: 2017-07-20
Event Description: Q4 2017 Earnings Call

Market Cap: 563,496.17
Current PX: 73.16
YTD Change($): +11.02
YTD Change(%): +17.734

Bloomberg Estimates - EPS
Current Quarter: 0.757
Current Year: 3.206
Bloomberg Estimates - Sales
Current Quarter: 23880.591
Current Year: 104516.080

Q4 2017 Earnings Call

Company Participants

- Chris Suh
- Satya Nadella
- Amy E. Hood

Other Participants

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

MANAGEMENT DISCUSSION SECTION

Chris Suh

GAAP and Non-GAAP Financial Measures

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

Unless otherwise specified, we will refer to non-GAAP metrics on the call

The non-GAAP financial measures provided should not be considered as a substitute for or superior to the measures of financial performance prepared in accordance with GAAP

Satya Nadella

Business Highlights

Revenue

- This quarter, we delivered $24.7B in revenue, up 10% in constant currency
- For the year, we are at $96.7B in revenue, up 5%
- I am proud of the progress, particularly the strength of our Commercial Cloud results

- FY2017 all up was a tremendous year of customer momentum with Cloud, AI, and digital transformation
- Our technology worldview of an intelligent cloud and an Intelligent Edge is resonating with businesses everywhere
- Every customer I talk to is looking for both innovative technology to drive new growth as well as a strategic partner who can help build their own digital capability
- Microsoft is that trusted partner

Productivity and Business Processes

- Now let's look at the progress we have made this quarter by segment, starting with Productivity and Business Processes [PBP]
- The workplace is transforming, from changing employee expectations, a need for more diverse skills and globally distributed teams, and an increasingly complex threat environment
- Only Microsoft gives customers a comprehensive approach for this new culture of work
- Earlier this month, we introduced Microsoft 365, which brings together Office 365, Windows 10, and Enterprise Mobility and Security in a complete secure solution to empower employees, safeguard businesses, and simplify IT management

Microsoft 365

- Microsoft 365 is a fundamental shift in how we design, build, and go to market to address customer needs
- Fortune 500 customers FedEx, Dow Chemical, Staples, Progressive Insurance all chose Microsoft 365
- The success of our secure productive enterprise offering with its triple-digit seat growth is one reason we are investing in Microsoft 365 for businesses of all sizes
- We continue to see strong growth of Office 365 with customers like Nissan, Quicken Loans, KeyBank, Deutsche Telekom all choosing Office 365
- And importantly, customers are moving beyond core workloads to adopt higher-value workloads
  - For example, we have seen a significant increase in SharePoint usage, which nearly doubled y-over-y
  - The classroom is also transforming

Teams

- This quarter we introduced Microsoft Teams in Office 365 for Education, the digital hub for students and teachers
- Microsoft Teams gives educators a whole new way to create and inspire modern classroom environments
- With rich learning tools and the ability to have digital conversations with students, share materials, manage assignments, Teams gives educators more time to focus on doing what they love the most, teaching

Business Processes

- Now I'll talk about the second part of our ambition in this segment, reinventing Business Processes

- We're investing in LinkedIn flagship experience to create new value for members and customers and accelerate growth
- We saw continued momentum in mobile and strong engagement across the platform, with sessions up more than 20% for the third consecutive quarter
- And we continue to innovate new ways for members to maximize the value of the platform

New Messaging Overlay

- We launched a new messaging overlay, resulting in record levels of messages sent on LinkedIn, and introduced a career advice marketplace that will let members easily tap into the professional expertise of more than 500mm members around the world
- On top of that, Talent Solutions saw record level growth in confirmed hires and in mail response rates this quarter

Microsoft Relationship Sales Solution

- I've talked about the opportunities with Dynamics and LinkedIn
- Earlier this month, we launched Microsoft Relationship Sales Solution, bringing together LinkedIn Sales Navigator and Microsoft Dynamics, as well as Dynamics 365 solutions for retail and talent
- In a world where customers are increasingly digitizing every business process, we continue to invest and expand our portfolio of modern modular business applications that are infused with AI

ISV Cloud Embed

- We also introduced ISV Cloud Embed to make it easier for partners to modernize their existing business process applications and build new ones using Dynamics 365, Power BI, PowerApps, and Microsoft Flow
- A global healthcare solution provider and partner, Indegene, is using it to create a mobile CRM solution for medical sales
- Customers like HSBC, Best Buy, Dolce & Gabbana all chose Dynamics 365 to transform their own business processes and experience the benefits of moving away from monolithic suites

Intelligent Cloud Segment

- Now let's talk about the progress we are making in our Intelligent Cloud segment
- Our Commercial Cloud annualized revenue run rate now exceeds $18.9B
- This quarter's cloud growth puts us squarely on track to reach the goal we set a little over two years ago of $20B in Commercial Cloud ARR in FY2018
- More than ever before, customers are placing their trust in the Microsoft Cloud

Azure Revenue

- Azure revenue accelerated this quarter, growing 97% y-over-y

- CIOs and business decision-makers increasingly prefer Azure as they make decisions about their cloud strategy
  - They value our hybrid consistency, developer productivity, AI capabilities, and trusted approach
- And we keep investing in cloud computing to create broader economic benefit and opportunity, as we have done with our South Africa data center expansion, bringing Azure to 40 regions globally, more than any other cloud provider
- And as part of our commitment to trust, we are helping our customers prepare to be GDPR [General Data Protection Regulation] compliant and meet the requirements of the European Union ahead of the enforcement deadline
- AXA Global, KPMG, Dun & Bradstreet, Hearst, Walgreens, T-Mobile, and Sephora all chose Azure to transform their businesses

Content and Collaboration Service

- Box announced that it will bring its content and collaboration service to Azure and plans to use our AI to simplify discovery and use of all types of content across the enterprise
- And Baidu will use Azure to take its autonomous driving platform worldwide
- The core currency of any business going forward will be the ability to convert their data into AI that drives competitive advantage
  - It all starts with having the support for the comprehensive data estate, spanning Azure Database, Cosmos DB, Data Warehouse, Data Lake, combined with SQL Server
- Azure Cosmos DB is the industry's first globally distributed database service
- It enables customers to securely and reliably power data-intensive applications at unprecedented scale and performance, from IoT to AI to mobile and much more
- Retailer Jet.com is using Azure Cosmos DB to process trillions of transactions every day

Azure AI Infrastructure and Services

- Customers are infusing AI into their products and services, using Azure AI infrastructure and services such as Bot Framework and cognitive services
- Sabre, a leading technology provider to the global travel industry, is piloting AI-powered solutions for travel agencies to better serve customers
- And Dixons Carphone is using Azure and our cognitive services to boost customer engagement and provide a more consistent seamless experience across online and in their stores
  - Azure is also unique in its support for these emerging Intelligent Cloud and Intelligent Edge applications

Azure IoT Edge

- Azure IoT Edge extends cloud intelligence to edge devices
- This means IoT devices can act locally at the edge while taking advantage of the cloud for global coordination and machine learning at scale

    - Azure is the first cloud to provide true hybrid support that customers predominantly choose

- Azure Stack extends Azure to enable developers to build and deploy applications the same way, whether they're run on the Intelligent Cloud or at the Intelligent Edge so customers can meet any regulatory requirement and bring cloud applications to remote or disconnected locations, like cruise ships or oil rigs

Personal Computing

Windows 10

- Now I'll turn to our progress in More Personal Computing
- Against a backdrop of more than 500mm Windows 10 monthly active devices and continued broad progress across the Windows ecosystem, I want to highlight a couple of key strategic areas this quarter
- Windows 10 is made to inspire the creator in all of us and is pivotal to enabling employees to transform the way they work
    - Increasingly, commercial customers value Windows 10 as the foundation for a secure modern workplace
- Enterprise and education deployments increased 33% over the last quarter, as companies like NASCAR, Emirates Airlines, BMW Group, Bank of China all adopted Windows 10
- This quarter we introduced Windows 10 S, streamlined for simplicity, security, and superior performance and tailored for the classroom
- Our goal for Windows 10 S is to develop a vibrant ecosystem with partners like Acer, ASUS, Dell, Fujitsu, HP, Samsung, and Toshiba to introduce a new class of modern devices that enables affordable powerful scenarios from Windows Ink to 3D
- We also introduced the Surface laptop and the new Surface Pro this quarter to continue to build and create momentum for new Windows device categories

Gaming

- Now on to gaming, our gaming business now is more than $9B and growing profitably
- The gaming world is evolving faster than ever before, from game player across multiple devices to the explosive growth in streaming and e-sports to new subscription services and mixed reality scenarios
- We're uniquely positioned to capture a large share of this opportunity because of our ability to unite the global community of gamers through Xbox Live, now 53mm strong and growing, and to enable new experiences across PC, console, and mobile
- Our approach is to let gamers play the games they want with the people they want on the device they want
- At E3, we celebrated the passion of gamers by introducing Xbox One X, broadening our portfolio of gaming devices with the world's most powerful console

New Services

- We launched two new services that broaden our reach and enrich the gaming experience, both of which are off to a very strong start

- Mixer, our new live streaming service, makes it easier than ever before for gamers to create and share across platforms and to interact in entirely new ways
- The Xbox Game Pass is a digital subscription service that expands our existing gaming value proposition

Closing Remarks

In closing, I'm proud of the progress this year, both in our own continued transformation and in how we're empowering customers to digitally transform

As technology disrupts every industry and has the power to make a difference in the lives of everyone, we strive to create local opportunity and growth and impact in every country around the world

Our platforms and tools help drive small business productivity, large business competitiveness, and public sector efficiency

We also support new startups, improve educational health outcomes, and empower human ingenuity

Our sense of purpose lies in our customers' success

Transformation is a continuous process of renewal and reinvestment

We will continue to invest in the high-growth opportunities, lead innovation in cloud and AI, and bring our technology and products together into experiences and solutions that unlock new value for customers

Amy E. Hood

Financial Highlights

Revenue, Gross Margin, Operating Income and EPS

- This quarter, revenue was $24.7B, up 9% and 10% in constant currency, with stronger than expected performance across all segments
- Gross margin grew 11% and 12% in constant currency
- Operating income increased 13% and 16% in constant currency
- And EPS was $0.98, increasing 42% and 43% in constant currency, which includes $0.23 from the utilization of Phone-related losses from prior years that were previously non-deductible
- At a company level, LinkedIn contributed approximately 5 points of revenue and gross margin growth

Operating Loss

- LinkedIn's operating loss of $361mm was a 6-point drag on total company operating income growth and is entirely attributable to the $371mm of amortization of acquired intangibles recorded in COGS and OpEx

By Geography

- From a geographic perspective, our results were mostly in line with macroeconomic trends
- The large markets like the U.S., Germany, and Japan performed better than we expected

- We had a strong quarter in our commercial business, reflecting terrific execution from our sales teams and partners in the largest quarter of our year
- We increased commitment to our Commercial Cloud and healthy renewals on a record volume of expirations
- We closed the highest number of multimillion-dollar Azure deals to date and improved our annuity mix to 86%, up 3 points y-over-y
  - As a result, commercial bookings grew 30% and commercial unearned revenue was $27.8B, significantly higher than we expected
- Our contracted-not-billed [CNB] balance increased to more than $31.5B

Commercial Cloud

Revenue and Gross Margin

- As Satya mentioned earlier, our Commercial Cloud annualized revenue run rate exceeded $18.9B this quarter, growing 56%
- We finished the year with nearly $15B in Commercial Cloud revenue
- At the start of the year, we committed to material improvement in Commercial Cloud gross margin percentage and dollars
- This quarter, our Commercial Cloud gross margin percentage was 52%, up 10 points y-over-y, with positive gross margin in each cloud service
- Commercial Cloud gross margin dollars grew 92% from strength across all services
- Our company gross margin was 66%, up 1 point from the prior year, as sales mix of higher-margin products and services offset the impact of a growing mix of cloud revenue and $217mm of LinkedIn amortization cost

FX and Operating Expenses

- FX was mostly in line with our expectations, with 1 point of negative impact on total revenue growth, even with the slightly weaker than expected U.S. dollar
- At the segment level, FX had a negative impact of 2 points on Productivity and Business Processes, 1 point on Intelligent Cloud, and 1 point on More Personal Computing
- Total operating expenses grew 9% and 10% in constant currency, with LinkedIn contributing 12 points of growth, including $154mm of amortization of acquired intangibles expense

Segment Results

Productivity and Business Processes Segment

- Now to our segment results, revenue from our Productivity and Business Processes segment grew 21% and 23% in constant currency to $8.4B, with LinkedIn contributing 15 points of growth

Revenue

- Office Commercial revenue increased 5% and 6% in constant currency

- Office 365 Commercial revenue grew 43% and 44% in constant currency, with continued install base growth across all workloads, ARPU expansion, and emerging E5 momentum
- For the first time, Office 365 Commercial revenue surpassed revenue from our traditional licensing business
- Office Consumer revenue increased 13%, driven by recurring subscription revenue and growth in our subscriber base

Dynamics Business

Revenue, Gross Margin, Operating Expenses and Income

- Our Dynamics business grew 7% and 9% in constant currency, and Dynamics 365 grew 74% and 75% in constant currency
- LinkedIn revenue for the quarter was approximately $1.1B, a bit better than expected
- Segment gross margin dollars grew 14% and 16% in constant currency, with 12 points of contribution from LinkedIn, including $217mm of amortization
- Gross margin percentage declined from increasing cloud revenue mix and the impact of LinkedIn related amortizations
- Operating expenses increased 41%, with 40 points from LinkedIn, including $154mm of amortization expense
- Operating income declined 8% and 5% in constant currency, with 12 points of impact from LinkedIn

Intelligent Cloud Segment

Revenue

- The Intelligent Cloud segment delivered $7.4B of revenue, growing 11% and 12% in constant currency
- Our server product and cloud services revenue grew 15% and 16% in constant currency, with double-digit annuity revenue growth
- Azure revenue growth accelerated to 97%, up 98% in constant currency
- Azure premium revenue grew triple digits for the 12th consecutive quarter
- Enterprise Services revenue declined 3% and 1% in constant currency, driven by lower volume of Windows Server 2003 custom support agreements, partially offset by growth in premier support services

Segment Gross Margin

- Segment gross margin dollars grew 8% and 9% in constant currency, and segment gross margin percentage declined due to increasing cloud revenue mix and lower Enterprise Services margins, partially offset by material improvement in Azure margins
- We grew operating expenses by 2% and 3% in constant currency, with continued investment in sales capacity and developer engagement
- Operating income increased 15%, up 18% in constant currency

Personal Computing

OEM Business

- Now to More Personal Computing, revenue from this segment was $8.8B, down 2% and 1% in constant currency, with 4 points of decline from Phone
- Our OEM business grew 1% this quarter, as both our commercial and consumer OEM businesses were slightly ahead of the PC market
- OEM Pro revenue grew 3%, ahead of the commercial PC market, mainly due to a higher mix of premium SKUs
- Windows 10 deployment cycles continue to drive commercial customer hardware demand
- OEM non-Pro revenue was flat, ahead of the consumer PC market, with continued positive impact from Windows Premium device mix
- Inventories remain in their normal range

Windows Commercial Cloud Products and Services

- Windows Commercial Cloud products and services grew 8%, driven by annuity revenue growth
- Enterprise customers increasingly chose Windows 10 on new and existing devices, which led to install base growth and higher adoption of our cloud security solutions
- Patent licensing declined this quarter, primarily from lower revenue per unit
- Search revenue ex-TAC grew 10% and 11% in constant currency, driven by higher revenue per search and search volume
- Devices revenue declined 28% and 27% in constant currency

Surface and Gaming Business

- Our Surface business performed better than we expected, declining 2% and 1% in constant currency, with strong sales execution on our Surface Pro product transition and early positive signals from customers and partners on our Surface laptop launch in June
- Our gaming business grew 3% and 4% in constant currency
- Xbox software and services growth of 11%, 13% in constant currency, offset declines in hardware
- And our engaged user base grew 8% to 53mm monthly active users across console, mobile, and Windows 10 platforms

Segment Gross Margin

- Segment gross margin dollars increased 9% and 10% in constant currency
- Gross margin percentage increased, primarily due to a sales mix shift to higher-margin products and services
- Operating expenses declined 10% and 9% in constant currency from lower Phone expense as well as Surface and gaming marketing spend in the prior year
  - As a result, operating income grew 68% and 72% in constant currency

Company Results

CapEx, FCF, Other Income and Expense

- Now back to the overall company results
- This quarter we invested approximately $3.3B in CapExs, including capital leases, up sequentially in part due to the planned Q3 data center spend pushed into this Q4
  - This includes approximately $2.3B of cash paid for property and equipment, which was down y-over-y as we utilize more capital leases
- FCF grew 50% y-over-y, driven primarily by operating cash flow growth of 30% as well as lower cash outlays for CapEx
- Operating cash flow increased due to higher collections from customers following strong billings growth, as well as working capital improvements in our hardware business
- Other income and expense was $215mm, more than originally planned, as we continued to see opportunities in the equities market to realize gains throughout the quarter

Tax Rate, Share Repurchases and Dividends

- Our non-GAAP effective tax rate was negative 6%, significantly lower than we expected, due to $1.8B impact related to the utilization of prior years' losses from our Phone business that were not deductible in the years incurred
- Excluding this item, our non-GAAP effective tax rate was 19% this quarter and 20% for the full year
- This quarter, we returned $4.6B to shareholders through share repurchases and dividends

Outlook

Now, let's turn to the outlook

The key trends for FY2018 from the financial analyst briefing remain largely unchanged

For the full year, we expect about 1 point of negative FX impact, assuming current rates remain stable

Commercial Business

- In our Commercial business, we anticipate that increasing demand for cloud services and healthy renewals will continue to drive a higher annuity mix
- Our commercial transactional business will continue to decline, driven by the transition to the cloud

Gross Margin and Capital Investment

- We remain focused on improving our Commercial Cloud gross margin percentage in each of our cloud services
- As a reminder, given seasonality and revenue mix, Commercial Cloud gross margin will experience quarterly variability
- Cloud migrations, deployments, and new scenarios are driving greater customer usage

- We will increase our capital investment to meet growing demand and capacity needs
- Total CapEx spend will continue to have variability quarter-to-quarter
- At the company level, our gross margin percentage should decline about 1 point in FY2018, with increasing cloud revenue mix, a full year of LinkedIn amortization, and hardware launches, including our new console, Xbox One X.
    - We expect LinkedIn quarterly amortization expense in COGS to be approximately $220mm or about $880mm for the full year

Operating Expenses and Margin

- Next, operating expenses
- You should think about our FY2018 operating expenses in two categories: first, organic Microsoft expenses, which we expect to grow between 3% and 4%, reflecting the investments we are making to support our top line growth; second, LinkedIn
- We are making incremental investments in LinkedIn to fuel its continued strong revenue growth
- Additionally, we will recognize our first full year of operating expenses, including $620mm of amortization expense
- Importantly, we expect our company operating margin to only decline by about 1 point, as we continue to grow our cloud revenue, we fund new investment to support growth in strategic areas and absorb $1.5B of LinkedIn amortization in COGS and OpEx
    - Excluding the LinkedIn impact, operating margin should be flat y-over-y

Tax Rate

- Next, our effective tax rate
- As a reminder, our tax rate is impacted by at least three major factors: the proportion of services revenue vs. licensing revenue; the geographic mix of revenue; and the timing of equity vest
- As cloud revenue mix increases, we anticipate our tax rate will move higher
- With quarterly variability based on these factors, we anticipate our full-year non-GAAP tax rate to be 23% +/- 2 points
- And finally, we expect LinkedIn ex-purchase accounting to be non-dilutive in FY2018, as it was in Q4

Commercial

- Now to the outlook for next quarter
- Based on current FX rates, we expect less than 1 point of negative impact on revenue growth overall and for each segment
- We expect Commercial unearned revenue to be within the range of $24.85B to $25.05B

Productivity and Business Processes

- In Productivity and Business Processes, we expect revenue between $8.1B and $8.3B

- Office 365 Commercial revenue growth will continue to be driven by installed base growth, ARPU expansion, and adoption of premium services like E5, and should outpace the rate of transactional decline
- We expect a more moderate rate of growth in our Office Consumer business given prior-year comparables

Dynamics Business

- In our Dynamics business, Dynamics 365 will continue to drive our cloud mix higher
- And we expect approximately $1.1B of revenue from LinkedIn, adjusted for the impact of purchase accounting

Intelligent Cloud

- For Intelligent Cloud, we expect revenue between $6.9B and $7.1B
- Customer demand for Azure and our hybrid cloud offerings remains strong
- And we anticipate another quarter of double-digit revenue growth across server products and cloud services
- Enterprise Services should decline, given lower volumes of custom support agreements

Personal Computing

Revenue

- We expect More Personal Computing revenue, between $8.6B and $8.9B
- We anticipate OEM revenue will move more closely in line with the PC market
- Devices revenue growth will continue to be impacted by the prior-year Phone comparable
- Surface revenue will continue to be driven by the product lifecycle transition between Pro 4 and our new Surface laptop and Surface Pro
- In search, Bing's revenue growth ex-TAC should be similar to prior quarters
- And we expect gaming to have typical seasonality revenue pattern for a pre-holiday quarter

COGS and CapEx

- We expect COGS between $8.2B and $8.3B, including approximately $400mm from LinkedIn
- LinkedIn COGS include about $220mm of amortization
- We expect CapEx on an accrual dollar basis to be similar to Q4, as we grow our investment to meet demand
- We expect operating expenses of $8.6B to $8.7B, with about $1B of LinkedIn, of which roughly $155mm is related to amortization

Other Income, Expense and Tax Rate

- Other income and expense should be about $250mm, as we expect to realize more gains in our equities portfolio

- Given the volume of equity vest that occur in our first quarter and based on today's stock value, we expect our first quarter non-GAAP effective tax rate to be approximately 4 points lower than the estimated full-year tax rate

New Revenue Standard

- Finally, we adopted the new revenue standard, ASC 606, effective at the start of FY2018
- To assist in the transition, Chris along with our Chief Accounting Officer, Frank Brod, will be hosting a conference call in early August to discuss these changes, present historical restated financial results, and share Q1 guidance converted to the new standard

QUESTION AND ANSWER SECTION

<Q - Heather Bellini>: Amy, I had a question about Commercial Cloud COGS. And I was wondering if you could give us a sense of what percentage of these roughly is related to depreciation. And how should we think about the pace of your CapEx deployments vs. what you have been experiencing in Commercial Cloud to support the initiatives and the vast growth opportunities that you see ahead as we look out over the next 12 to 24 months, if there's anything you can share with us around that? Thank you.

<A - Amy E. Hood>: Let me break down the question a couple ways. Overall, when you think about COGS and the pacing, the depreciation rates of our servers don't change. It's generally over a three-year period, and there are other pieces of equipment that have longer or shorter depreciation lives, so that pace of depreciation doesn't change per se.

If you're looking to see how we see demand, obviously this quarter, in Q4, we felt very good about cloud demand across all three services, but in particular with Azure. I feel confident in our ability to produce gross margin improvement across all those services. I feel confident in our ability to continue to make progress on our overall Commercial Cloud gross margin growth, and I am encouraged by the demand signals we're getting. All of those things, I think it's not really about the pace. It's as much about the progress and demand and meeting those things as closely as we can, and I feel really good about the team's execution.

<Q - Keith Eric Weiss>: A very nice quarter. There are a lot of rumors and speculation around sales reorganization of you guys shifting around resources to better distribute to the cloud and the new technology. I was wondering if you guys could dig into that for us a little bit. What kind of changes are taking place in terms of go-to-market distribution heading into FY2018?

<A - Satya Nadella>: Let me start there. And first of all, thank you for the question, Keith. Overall, the approach we have taken for multiple years now is to transform everything that we do inside the company, whether it's the product creation, how we are organized in the RMB, how we think about breaking down any silos and category definitions we may have had in the past, how we think about even marketing and the marketing approach, and then of course, even with the go-to-market. And this transformation is ongoing. This has been happening over multiple years, but we have now got very good customer momentum because ultimately this is all driven by the opportunity at hand, which is much bigger than anything that we have participated in the past, so the total addressable market is much bigger. And second, our customer expectations and our partner expectations of how we show up with them has changed.

And so over the years, we have been making changes. And now that we have a lot more momentum and critical mass, we are going to that next phase, and that's what you're seeing us in terms of changing the skill sets, changing the scope of how we show up to support the digital transformation needs of both large customers as well as small businesses.

<A - Amy E. Hood>: And I think in many ways, Keith, what we've done is really a natural extension of some of the investments we've made over the past 18 months to add technical resources, to be more present in customer accounts, to really drive their transformation towards success outcomes. You're seeing it even in our Intelligent Cloud results last quarter and this quarter. We're taking that learning over the past 18 months and really applying it at a broader scale across the sales force to put those resources where we feel confident that they'll have a good long-term return in that next phase of transformation.

<Q - Karl E. Keirstead>: Amy, there were a lot of numbers in this print that look very strong, but one that stood out to me was the commercial bookings growth of 30%. You did touch on it a little bit in your remarks, but if you don't mind, I'd love to ask you a few questions.

One is, you mentioned that maybe part of the strength was terrific execution on renewals. Does it feel like maybe last quarter was a little bit of a renewal flush; in other words, it might have been a bit of a one-time phenomenon? Secondly, is Microsoft doing anything different around contract structure or invoicing too that would result in bookings being unusually high, maybe collecting a little bit more up front? And lastly, is it fair to interpret the strong bookings performance as giving us, and I suppose you, comfort in your revenue growth profile in FY2018 as all those bookings obviously convert to converted revs? Thank you.

<A - Amy E. Hood>: Thanks, Karl. I'll make sure I cover off on most of those. Let me start by saying the biggest driver in commercial bookings growth this quarter was excellent execution on a large base of renewals. The second component of that is the execution on new revenue. In particular, Azure as well as Windows Commercial, and billings in the quarter were very good and quite encouraging overall. There was no change in any way to invoicing, people paying earlier, paying more up front. That's definitely not an impact on that number.

And so overall, I think while it is certainly aided by the large expiry base because it tends to impact the CNB balance the most, it's really, I think to your point, it is clearly encouraging because it gives us a very good base of support going into FY2018 to come into the GAAP reporting numbers.

<Q - Walter H. Pritchard>: Amy, I'm wondering on the gross profit growth, I was looking at the slide deck, and it looks like gross profit growth in PBP was up about 2%. You saw some strong trends in different parts of that business, and I think that 2% I would have thought would have been higher. Could you help us understand the puts and takes around gross profit growth in PBP?

<A - Amy E. Hood>: There are a couple things, but in general it's almost always mix shift. While we saw improvement in the gross margin percentage in Office 365 and continue to make progress on that, it's also the balance. This is Q1 where we've actually seen the balance tip in terms of recognized revenue to online vs. perpetual. So I actually feel very good that as we continue to accelerate the growth trajectory that you're not seeing, frankly, much impact on the gross margin line, and we're seeing a lot of leverage in that through OpEx all the way down to the operating income line.

<Q - Mark L. Moerdler>: Amy, Commercial Cloud ARR grew 24% Q-over-Q, which is the largest Q-over-Q growth so far. I completely understand that Q4 is a big quarter for closing business, but $3.7B is a large number. Can you give us some more color on exactly what's driving this growth? And then I have a quick follow-up.

<A - Amy E. Hood>: Sure. When you think about – you're right. It is a big number, and I feel very good about it. And for the year on a pure basis, it was $15B of Commercial Cloud revenue. So we're starting to get to that point, Mark, where you have a big base which is still growing at a fast rate, and so especially ARR numbers can see big jumps in the one that you saw this quarter. And you're right, Q4 is also historically quite a big quarter, and this one certainly was as well.

But you also saw – and what really does matter, especially in Azure, is usage growth, really consumption growth, having customers use, deploy, be successful, and really continue to get you think meters up and running, and that continues to build on itself. And so when you start to see that, you can and I do think we'll continue to see good growth in this number.

<Q - Mark L. Moerdler>: Excellent. As a quick follow-up, how should we think of how that sets us up for 2018 in terms of hitting expectations, beating expectations, continuing strong 40% to 50% y-over-y growth?

<A - Amy E. Hood>: Let me start by saying first, I feel very good about meeting our stated goal of $20B in Commercial Cloud ARR. Next, I think across every service, the momentum we've seen in Q4, and in particular I would say I think not many people focus on it, but even things like Windows, E5, advanced threat protection services, those types of deployments really will add to momentum in our offerings.

One of the things we often talk about is we sell Microsoft 365. That's Windows 10 with security and services. It's a modern workplace that includes up-to-date Office 365. It includes EMS. We really did see strength across all of them, so I don't really think it's about a percentage, but it's about each of them continuing to make progress.

<Q - Philip Winslow>: A question first for Amy on Office 365. Office 365 Commercial revenue continues to outpace the unit growth of monthly active users. So you're still seeing that trend up to E3, E5, et cetera. I wonder if you could take us through where we are in that life cycle.

And also, just to follow on your comment to the last question, Satya, you launched at Inspire Microsoft 365 that Amy just mentioned. How should we think about Microsoft 365 in the context of Office 365, also just given the fact that Windows Commercial actually accelerated this quarter as well?

<A - Satya Nadella>: Maybe I can start, and then...

<A - Amy E. Hood>: Why don't you start, and I'll do the next one?

<A - Satya Nadella>: So one of the things that we're very excited about and have learned a lot from is the secure productive enterprise offer that we have had now last year, and in fact in Q4 it really accelerated significantly. And so that's helped us in fact come up with Microsoft 365 as this very strong offering that brings together Office 365, Windows 10, as well as our Enterprise Mobility and Security, and support even cross-platform devices. So we think of the modern workplace as having a very significant footprint of Windows, but also people will use phones with iOS and Android. But they need both productivity, creativity, security across all of this estate of art there. And that's where I think we have a competitive advantage and a great value proposition.

So that's what Microsoft 365 embodies. It's today available for enterprises, and in the fall you will have the midmarket version of it, which I think is another very big opportunity because it really helps take what we have learned in the large enterprises and scale it to where perhaps the need is even more acute. And so we're excited about that, where at Inspire the partner channel obviously is very excited about it as well.

<A - Amy E. Hood>: And, Phil, to your point, and it's a nice transition from Satya's point about especially the midmarket offering coming in the fall for Microsoft 365, is the install base growth. You're right. In terms of Office Commercial 365, the primary driver is still install base, both the transition as well as new. I think we're optimistic as we head into FY2018 for the install base growth that's possible, in particular for some of these mid-market offerings that we're quite proud of.

The ARPU growth that you saw and have seen in the past couple of quarters continues to primarily still be related still to the E1 to E3 transition. When we mentioned E5, I think that's frankly encouraging for us because all of these premium offers do best when you start the deployment motion. People start using E1, then they use E3, and then you start to see the momentum in E5, and we did see that. However, in terms of ARPU impact, very, very small in quarter. So that's something that over time you would continue to see improvement in, in terms of impact on ARPU.

<Q - Kash Rangan>: I'm curious if you can shed a little bit more light on commercial bookings growth of 30%. Clearly, that's off the charts. And also when I look at the $18.9B of annualized revenue, and judging from the fact that the commercial business, non-Azure component of it was about steady and growth rate [indiscernible] (46:28) Azure went through some significant acceleration, which has yet to be reflected in your forward-looking revenue. So if you can just shed a little bit more light and drill into any two or three product SKUs or areas or geographies that contributed to that off-the-charts performance, that will be great. That's it for me. Thank you very much and congrats.

<A - Amy E. Hood>: Thanks, Kash. Let me go through the bookings. Again, with that 30%, the first and best contributor to that is the strong performance on the renewals in quarter. It was reasonably consistent, Kash. There's not a geo in particular that I would say was a massive outlier, although in two of our largest geos, the U.S. and Germany, they did have very good years, in particular in Q4.

Now, if you separate the fact that we had the large base, which clearly contributes to that bookings number being big, aside from that, in particular Azure, in the last – to your point, did it really show up in that $18.9B? It didn't. The strong billings growth really showed up in that unearned outperformance, which you saw vs. the guide, and it was significant, and a lot of that is the Azure billings. I think we felt very good. Those as well I think were pretty broad-based across industry. I would also say across geo. And so while we of course get some strength from our largest geos, and I would say they were probably the largest contributors, it was actually quite broad. There's not really one place for me to say that we just saw it here.

And then the final component that I would say was better than we anticipated, and where you'd see that, Kash, again vs. the unearned guidance and the beat that we had there, was that final piece around our security value prop. ATP, Windows annuity growth was very good. That's in the KPI Windows Commercial products and services, is the place you'll look and see that number. And outside of that, those really are the biggest contributors.

<Q - Kash Rangan>: Thank you.

<A - Satya Nadella>: If I can add one thing, I'll just say that nothing shows up in just one quarter. We have been working on this for a long time, whether it's the product and the approach we have taken, from IaaS to PaaS to SaaS, even the diversity of our SaaS offerings. And also how we think about going to market, all of these have been multiple years of hard work. And clearly there is momentum across the board. And that I think is what you're seeing, and we're excited about this quarter's execution and performance, and I think it bodes well for what we do in the future. But the key is for us to recognize that this is about long-term commitment to a big opportunity and making sure that you line up your execution against that.

<A - Amy E. Hood>: And I think maybe I should have also mentioned – when you think about seeing that type of performance – and Satya mentioned it's not just because of work done this quarter. It's a great point. But it's also the investments we've made. We've committed. We did sales overlays. We added technical resources. We put resources at customers ahead of the curve. We did that. You saw that in the Intelligent Cloud OpEx growth over the past few quarters. That execution is what's landing.

<Q - Mark R. Murphy>: Amy, going back to the large size of the expiry base in Q4, when we look back three years to June 2014, in that quarter the commercial bookings grew 23%. I'm just curious. Is that representative of the portfolio that flowed through into this quarter on a three-year cycle, or is it more complex than that?

And also, does it include or exclude LinkedIn contributions for the current period?

And just finally, I'm wondering. Again, looking back three years, it was a different number in the September quarter that followed. And can you help us just with the y-over-y growth of the expiry base for the September quarter? I'm not sure if you had commented on that.

<A - Amy E. Hood>: Okay, you're right. Mark, it's not exactly – if I said is Q3 from three years ago exactly the expiry base, it's not exactly, but it is directionally. And so that's a good example to say every three years tends to be the length of our agreements, and so you do tend to see that repeated. And so that's what we mean by the record or the largest expiry base, and that is the pattern.

In terms of LinkedIn having any impact, it did not. So that is the cleanest way to think about that number.

<Q - Ross MacMillan>: I'm actually going to ask a question about the traditional server products business, which once again had a pretty strong growth rate, up 5%. I think the last few quarters you've been trending at mid-single digits or even higher. And, Amy, I'd just love your thoughts as we progress through FY2018, just so we think about this in the right way. How would you expect that growth rate to trend, and should we be aware of the comps that come up in Q2 and beyond?

<A - Satya Nadella>: Maybe I can start and at least give you how we think about it technically and product-wise, and then we can go into talking about the future in terms of the results itself.

First of all, we don't think of our servers as distinct from our cloud. In other words, the Intelligent Cloud and the Intelligent Edge is the architecture or pattern for which we are building. Whether it's SQL Server 2017 or with Windows Server, the container service, everything that we do assumes that distributed computing will actually remain distributed. And it turns out that it's helpful to think about it that way both for customers who are rationalizing their portfolios of apps as they lift, shift, modernize as to what they run in their data centers or in our data centers, but also forward-looking new workloads.

If you look at some of the most exciting things that are happening in the cloud, is cloud applications that reactively require an edge. Azure IoT or Azure Stack are becoming the runtime to the edge, where you do need not only the ability to do compute and storage, but to run the AI inference on the edge. So to me, that's what we are building to. It's actually a big architectural shift from thinking purely of this as a migration to some public cloud to really thinking of this as a real future distributed computing infrastructure and applications that I quite frankly feel very, very good about leading.

And so in that context, our server license revenue will fluctuate based on what the macro is and these transitions and mix shifts. But from a forward-looking perspective, I want us to be very clear that we anticipate the edge to be actually one of the more exciting parts of what's happening with our infrastructure.

<A - Amy E. Hood>: And so that leads – why I always tend to say I don't focus as much on the mix per se. I know both of them will matter and both of them are important, and so that's why I tend to focus on that all-up server KPI combination of the progress in the cloud, Azure, as well as the edge, which is the on-prem. And so I think we remain confident in that double-digit target that we have for that KPI. And there isn't really, I don't think, a comparability challenge per se, but that's why we try to keep it at that high level, to not get too tied to one or the other, given we know the TAM expansion that's possible. We know we can grow within it.

And I apologize, I didn't answer Mark's last component, so let me just go back. I had forgotten, which was, was there anything unique in the expiry base for Q1. The answer is it's up a little y-over-y and certainly not the same type of Q4 comparable. When we tend to have these, we try to call them out, like we did in Q3 leading into Q4. So Q1 I would say is just up a little, so I wouldn't expect any material impact.

<Q - Raimo Lenschow>: I wanted to drill in on the premium service in Azure. Satya, you talked a little bit about SharePoint taking off and being a big part. Can you talk a little bit about the portfolio you have there? And I also wanted to contrast it a little bit with one of your main competitors who keeps coming out with products just to get to that premium service and the advantage that you guys have given the IP that you've built up over the years. Thank you.

<A - Satya Nadella>: Yes, I think we have premium services, whether it's in Office 365 or on the Fast side with Dynamics 365. And that's where the SharePoint comment came that there's a lot more in Office 365 adoption cycle beyond Exchange or email.

On the Azure side, my comments in fact walk that entire tree, so to speak, which is there's the infrastructure there, where in fact, even on the infrastructure side, there is no such thing as one generic infrastructure when I look at the diversity of the virtual machines, what's happening with AI infrastructure with GPU compute, so there's a lot of richness there. The layer above that for me is the data estate. One of the exciting things is the growth in Azure DB, the growth in Cosmos DB, our Data Warehouse product, the Data Lake, so that's a place where we are seeing significant attach. On top of the data is where the AI service is, whether it's the Box framework, the cognitive services. So that's all the rich services where we are seeing significant customer action.

The other side of it is the edge. So Azure IoT smart service both in the cloud and the edge. And Azure Stack now, truly starting this quarter, is going to be another way to extend out the rich services of Azure even beyond public cloud deployment. So that's what hopefully gives you a flavor for the IP that we have.

And then one linchpin that we have between in fact our Fast services as well as Azure is Azure Active Directory. 90% of all the enterprises use Active Directory, and all of them rendezvous with Azure Active Directory irrespective of what applications they have in whichever cloud because that becomes a very key control plane for IT.

<Q - Brad Reback>: Amy, as the Azure business continues to gain scale and, to Raimo's question, the premium mix continues to become a bigger part of that, is there any reason to think that the gross margin gains shouldn't accelerate in 2018 vs. where they were in 2017? Thanks.

<A - Amy E. Hood>: Thanks, Brad. The way I tend to think about is with any service, you want the gross margin itself to improve. And that includes in the Azure services components themselves. The difference between core compute and store vs. the premium layers can be significant, and we've had improvement across all of them. So the real question on how and where should the Azure gross margin be is about the ultimate mix of those. We saw significant improvement this year. We expect a lot of improvement again next year on each of those service lines. And where the actual mix occurs among those lines, I think we'll just have to wait and see, and that's why I tend to not focus at that layer. It's like can you get every service better or can you make material improvement. And then, of course, can you get usage and consumption going, that leads to premium service usage. And of course, over time, you'd expect a higher mix of premium vs. core