Q1 2020 Earnings Call

Company Participants

- Amy E. Hood, Chief Financial Officer
- Michael Spencer, General Manager of Investor Relations
- Satya Nadella, Chief Executive Officer

Other Participants

- Brent Thill, Analyst
- Heather Bellini, Analyst
- Jennifer Lowe, Analyst
- Karl Keirstead, Analyst
- Keith Weiss, Analyst
- Mark Moerdler, Analyst
- Philip Winslow, Analyst
- Raimo Lenschow, Analyst

Presentation

Operator

Welcome to the Microsoft Fiscal Year 2020 First Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. (Operator Instructions). As a reminder, this conference is being recorded. I would like to turn the call over to Mike Spencer, General Manager of Investor Relations. Thank you. Please proceed.

Michael Spencer {BIO 20838577 <GO>}

Good afternoon. Thank you for joining us today. On the call with me are Satya Nadella, Chief Executive Officer; Amy Hood, Chief Financial Officer; Frank Brod, Chief Accounting Officer; and Keith Dolliver, Deputy General Counsel. On the Microsoft Investor Relations website, you can find our earnings press release and financial summary slide deck, which is intended to supplement our prepared remarks during today's call and provides a reconciliation of differences between GAAP and non-GAAP financial measures. All growth comparisons we make on the call today relate to the corresponding period of last year, unless otherwise noted. We'll also provide growth rates in constant currency when available as a framework for assessing our underlying businesses performed, excluding the effect of foreign currency rate fluctuations. Where growth rates are the same in constant currency, we will refer to growth rate only. We will post our prepared remarks to our website immediately following the call until the complete transcript is available.

Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript, and in any future use of the recording. You can replay the call and view the transcript on the Microsoft Investor Relations website. During this call, we will be making forward-looking statements, which are predictions, projections and other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the risk factor sections of our Form 10-K, Forms 10-Q and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement. And with that, I'll turn the call over to Satya.

Satya Nadella {BIO 3224315 <GO>}

Thank you, Mike and thanks to everyone on the phone for joining. We are off to a strong start in fiscal 2020 delivering $33 billion in revenue this quarter. Our Commercial Cloud business continues to grow at scale as we work alongside the world's leading companies to help them build their own digital capability. Microsoft provides a differentiated technology stack spanning application infrastructure, data and AI, developer tools and services, security and compliance, business process, productivity, and collaboration. For each of these areas -- first, each of these areas represents secular long-term growth opportunity. Second, we are delivering best-in-class innovation and openness in each layer and third, we offer unparalleled integration and architectural coherence across the entire stack to meet the real-world needs of our customers.

Now I'll briefly highlight how we are accelerating our progress in innovation, starting with Azure. Organizations today need a distributed computing fabric to meet their real-world operational sovereignty and regulatory needs. This quarter, we opened new data center regions in Germany and Switzerland, and in India, we are bringing the power of Microsoft Cloud to millions of small businesses through our partnership with Jio, one of the largest mobile carriers in the country. Every Fortune 500 customer today is on a cloud migration journey and we are making it faster and easier. Just this week, we announced an extensive go-to-market partnership with SAP making Azure the preferred destination for every SAP customer. And our partnerships with VMware and Oracle also bring these ecosystems to our cloud. We are extending beyond the cloud to the edge, enabling customers to get real-time insights where data is generated while ensuring security and privacy and we are seeing traction in every industry from Azure Sphere securely connecting Starbucks coffee machines to Azure Stack enabling scenarios from smart factories and modern compliant banking to mobile healthcare in remote areas.

We are re-imagining customers' data estates for the cloud era with new limitless capabilities. Azure SQL database brings hyperscale capabilities to relational databases and Azure Cosmos DB is a low latency, high availability database for globally distributed applications of any data type. The quintessential characteristic of every application going forward will be AI and we have the most comprehensive portfolio of AI tools, infrastructure and services. Azure AI now has more than 20,000 customers and more than 85% of the Fortune 100 companies are using Azure AI in the last 12 months. In healthcare, Novartis chose Azure AI to transform how medicines are discovered, developed and commercialized. Nuance will rely on our cloud to power the patient exam room of the future where clinical documentation writes itself and Humana is using Azure AI to build personalized healthcare solutions for its more than 10 million members. We are also pushing the bounds of how computers and AI can generalize learning beyond narrow domains, collaborating with OpenAI on a supercomputing platform to train and run AI models. I'm excited about our partnership and our collective pursuit to democratize AI and its benefits for everyone.

Now to developer tools. The rise of digital IP creation in every organization means developers will increasingly drive and influence every business process and function and GitHub is where they go to learn, share, and collaborate. GitHub has grown to more than 40 million developers, up more than 30% since our acquisition a year ago and more than 2 million organizations use GitHub including the majority of the Fortune 50. At Ford Motor Company alone, 8,000 employees use GitHub to innovate and collaborate with the vast ecosystem of third-party software developers. Our acquisition of semantic code analysis engine, Semmle this quarter, strengthens our security capabilities, enabling developers to more easily find vulnerabilities in large open source code bases.

Now let's turn to our workflow cloud Power Platform. Automating workflows across every function will be key to productivity gains for every organization. We are building Power Platform as the extensibility framework for both Microsoft 365 inclusive of Microsoft Teams as well as Dynamics 365. It brings together low-code, no-code app development, robotic process automation and self-service analytics enabling everyone in an organization to build an intelligent app or workflow where none exists. Power Platform already has more than 2.5 million monthly active citizen developers. Power apps helps domain experts, those closest to the business problem to design, build and publish custom apps fast and 84% of the Fortune 500 have already created Power applications.

Now let's talk about security. Rising cyber threats and increasing regulation means security and compliance are a strategic priority for every organization. We have a comprehensive offering across identity, security and compliance, spanning people, devices, apps, developer tools, data and infrastructure, to protect customers in today's zero trust environment. It starts with Azure Active Directory Premium used by more than a 100,000 organizations for identity, access management and SaaS application security across heterogeneous environments.

It builds with information protection in cloud security with Microsoft Defender Advanced Threat Protection and now with risk-based vulnerability management. And it extends to Azure Sentinel, now broadly available. Sentinel is a cloud-first service that analyzes security signal at massive scale across the entire organization using AI to detect, investigate, and automatically remediate threats. We'll share more about our expanding opportunity in security at our Ignite Conference in the next few weeks.

Now on to business applications. Dynamics 365 is the only AI-powered business cloud that gives customers a 360 degree view of their business. From marketing and sales to finance and operations to unified data and unlock insights. It enables every level of organization to move from reactive, siloed, transactional processes to proactive, repeatable and predictable business outcomes. This quarter, we introduced Dynamics 365 Commerce, a new omni-channel solution to unify back-office, in-store, and digital experiences and deliver personalized content wherever shoppers are. Dynamics 365 AI Insights app ingests data from any first party or third party source, stream data from systems of record to power modern systems of engagement and intelligence. New Dynamics 365 product insights provides organizations like Ecolab a real-time view of how customers are using their products to maximize customer lifetime value. And Dynamics 365 Connected Store helps retailers like Marks & Spencer analyze observational data to optimize in-store shopping experience. We are enabling our customers to bridge the physical and digital business processes with our mixed reality cloud spanning HoloLens 2, Azure Mixed Reality services and Dynamics 365 applications. Pharmaceutical company, Patheon, for example is using Dynamics 365 Guides along with HoloLens to re-imagine training for its employees.

Now to LinkedIn. We saw record levels of engagement again this quarter across the platform. Marketing Solutions remains our fastest growing segment, up 44% year-over-year as marketeers leverage our community-based tools to connect with LinkedIn's nearly 660 million members. We continue to innovate across our talent portfolio including Talent Solutions, Talent Insights, Glint, LinkedIn Learning to help every organization attract, retain, and develop best talent. LinkedIn Skill Assessments is a new way for members to showcase their proficiencies and become more discoverable to recruiters.

Now turning to Microsoft 365 and Surface. Earlier this month, we unveiled our broader Surface lineup to date including two new dual-screen devices coming next year. We are re-imagining every layer with how we infuse AI from silicon up to device form factors and the role of operating systems to help people be more productive and creative in a multi-sense, multi-device world. We will continue to invest across form and function to create categories that benefit our entire OEM ecosystem and our expanded partnership with Samsung builds on our promise to help people be more productive on any device anywhere, bringing OneDrive, Outlook in your phone and more to new Samsung devices.

Microsoft 365 is the world's productivity cloud and the only comprehensive solution that empowers everyone, from the C-suite to first line workers with an integrated secure experience on any device. We're infusing AI across Microsoft 365 to help make work more intuitive and natural. New Presenter Coach in PowerPoint makes anyone a better public speaker. New capabilities in Word enable professionals to transcribe or record audio files while staying in the flow. Video is more searchable, shareable and first-class within Microsoft 365 with Stream and new inking capabilities let users create and reply to comments from anywhere using pen or voice.

Microsoft Teams continues to gain traction bringing together everything a team needs, chat, voice, meetings, collaboration with the power of Office and business process workflow into a single integrated user experience, all with the highest security and compliance. Teams keeps all of your work, conversations and meetings in context, eliminating the need to bounce back and forth between different apps with features like integrated calendaring, one-touch to join meetings from your phone, and we are broadening our opportunity with 2 billion first-line workers worldwide adding priority notifications, role-specific targeted messages, and the ability to clock in and clock out of a shift. Our differentiated offering is driving usage, making Teams the category leader. More than 350 organizations now have more than 10,000 users of Teams. More broadly, all this innovation is fueling growth. Office 365 Commercial monthly active users surpassed 200 million this quarter. The leading organizations like Cerner, Chevron and The LEGO Group are choosing our premium Microsoft 365 E5 offerings for their advanced security and productivity experiences.

Finally, gaming. In gaming, we are investing in content, community and cloud services to expand our opportunity with 2 billion gamers worldwide. We saw record Xbox Live monthly active users with strength both on and off console in mobile and PC and continued growth for Game Pass subscriptions. Gears 5 saw more than 3 million players in its first weekend alone. 10 years in, Minecraft is stronger than ever, with record revenue and usage, and we are bringing the franchise to new audiences with Minecraft Earth. Finally, just last week, we started trials of Project xCloud where gamers can play games wherever and whenever they want on any device. In closing, we are accelerating our innovation across the entire technology stack to deliver new value for customers. We are investing aggressively in large markets with significant growth potential and it's still early days. With that, I'll hand over to Amy, who will cover our financial results in detail and share our outlook and I look forward to rejoining for your questions.

Amy E. Hood {BIO 18040963 <GO>}

Thank you, Satya and good afternoon everyone. This quarter, revenue was $33.1 billion, up 14% and 15% in constant currency. Gross margin dollars increased 18% and 20% in constant currency. Operating income increased 27% and 32% in constant currency, and earnings per share was $1.38, increasing 21% and 25% in constant currency. Consistent execution and strong demand for our hybrid and cloud offerings drove a solid start to the fiscal year with another quarter of double-digit top and bottom line growth. From a geographic perspective, we saw broad-based strength across all markets. In our Commercial business, we again saw increased customer commitment across our Cloud platform. In Azure, we had material growth in the number of $10 million plus contracts. Additionally, Microsoft 365 drove new customer adoption as well as expansion of our existing customer base given the strong value Office 365, Windows 10, and Enterprise Mobility + Security provide as a secure intelligent solution.

As a result, commercial bookings growth was ahead of expectations, increasing 30% and 35% in constant currency, with a higher volume of new business and strong renewal execution. Commercial annuity mix increased to 91% and commercial unearned [ph] revenue was ahead of expectations at $31.1 billion, up 14% and 16% in constant currency. Our commercial remaining performance obligation was $86 billion, up 26% and 27% in constant currency, driven by these long-term customer commitments. As a reminder, going forward, we will disclose the commercial remaining performance obligation as a KPI, which better reflects commitments our customers are making across all contract types. Commercial Cloud revenue was $11.6 billion, growing 36% and 39% in constant currency. Commercial Cloud gross margin percentage increased 4 points year-over-year to 66%, a significant improvement in Azure gross margin, offset a sales mix shift to Azure. Company gross margin percentage was 69%, up 3 points year-over-year and ahead of our expectations driven by sales mix to higher margin businesses. The US dollar was a bit weaker than anticipated, which resulted in slightly less impact to our results. FX reduced revenue growth by less than 2 points and COGS and operating expenses growth by approximately 1 point. Operating expenses grew 8%, and 9% in constant currency, slightly lower than expectations, mainly driven by the timing of marketing and project spend. And operating margins expanded this quarter driven by the combination of higher gross margins and operating leverage through effective resource allocation.

Now to our segment results. Revenue from Productivity and Business Processes was $11.1 billion, increasing 13% and 15% in constant currency, ahead of expectations primarily driven by our on-premises Office Commercial business. Office Commercial revenue grew 13% and 15% in constant currency and benefited approximately 2 points from the transactional strength in Japan. Office 365 Commercial revenue growth of 25% and 28% in constant currency was again driven by installed base growth across all workloads and customer segments as well as higher ARPU. Office 365 Commercial seats increased 21% with a growing mix from our Microsoft 365 suite. Office Consumer revenue grew 5% and 6% in constant currency, with roughly 7 points of benefit from transactional strength in Japan, more than offsetting the strong prior-year comparable related to the launch of Office 2019.

Office 365 consumer subscribers grew to 35.6 million. Dynamics revenue grew 14% and 16% in constant currency driven by Dynamics 365 revenue growth of 41% and 44% in constant currency. LinkedIn revenue increased 25% and 26% in constant currency with continued strength across all businesses. LinkedIn sessions increased 22%, as engagement again reached record levels. Segment gross margin dollars increased 16% and 19% in constant currency and gross margin percentage increased 2 points year-over-year, as improvements in LinkedIn and Office 365 margins more than offset an increase in cloud revenue mix. Operating expenses increased 8% and 9% in constant currency driven by continued investment in LinkedIn and cloud engineering. Operating income increased 23% and 27% in constant currency.

Next, the Intelligent Cloud segment. Revenue was $10.8 billion, increasing 27% and 29% in constant currency, ahead of expectations, driven by our on-premises server business. On a significant base, server products and cloud services revenue increased 30% and 33% in constant currency driven by continued demand from our hybrid value. Azure revenue increased 59% and 63% in constant currency, with strong growth in our consumption based business across all customer segments, partially offset by further moderation in our per-user business.

Our enterprise mobility installed base grew 36% to over 120 million seats benefiting from the Microsoft 365 suite momentum and our on-premises server business grew 12% and 14% in constant currency driven by continued strength across our hybrid and the premium offerings, GitHub and roughly 4 points of benefit from the end of support for SQL and Windows Server 2008. Enterprise Services revenue increased 7% and 8% in constant currency, driven by growth in Premier Support Services. Segment gross margin dollars increased 27% and 30% in constant currency. Gross margin percentage was up slightly as another quarter of material improvement in Azure gross margin was partially offset by a growing mix of Azure IaaS and PaaS revenue. Operating expenses increased 22% driven by ongoing engineering and sales investments in cloud and AI, including GitHuB. Operating income grew 33% and 38% in constant currency.

Now to More Personal Computing. Revenue was $11.1 billion, increasing 4% and 5% in constant currency, ahead of expectations as better than expected performance in our OEM Pro and Windows Commercial businesses more than offset lower than expected monetization across third party titles within gaming. In Windows, OEM non-Pro revenue declined 7% below the consumer PC market, with continued pressure in the entry-level category. OEM Pro revenue grew 19% ahead of the commercial PC market driven by strong Windows 10 demand and momentum in advance of the Windows 7 end of support. Inventory levels ended the quarter in the normal range.

Windows Commercial products and cloud services revenue grew 26% and 29% in constant currency driven by healthy demand for Microsoft 365, which carries higher in-quarter revenue recognition. Surface revenue declined 4% and 2% in constant currency driven by the timing of product lifecycle transitions, ahead of the recently announced product launches. Search revenue ex-TAC increased 11% and 13% in constant currency driven by Bing rate growth. In Gaming, revenue declined 7% and 6% in constant currency driven by lower console sales. Xbox content and services revenue was relatively unchanged, and increased 1% in constant currency, with growth from Minecraft, Gears of War 5 and Game Pass subscriptions, offset by a strong third party title in the prior year. Segment gross margin dollars increased 12% and 13% in constant currency, and gross margin percentage increased 4 points due to higher margin sales mix. Operating expenses declined 7% and 6% in constant currency as redeployment of engineering resources to higher growth opportunities was partially offset by investments in gaming. As a result, operating income grew 28% and 31% in constant currency.

Now back to total company results. Capital expenditures, including finance leases were $4.8 billion, up 12% year-over-year, driven by ongoing investment to meet growing demand for our cloud services and slightly below expectations due to normal quarterly spend variability in the timing of our cloud infrastructure build out. Cash paid for PP&E was $3.4 billion. Cash flow from operations was $13.8 billion, and increased 1% year-over-year as strong cloud billings and collections were partially offset by tax payments related to the Q4 transfer of intangible property. Free cash flow was $10.4 billion and increased 4%. Excluding the impact of these tax payments, cash flow from operations and free cash flow grew 27% and 39% respectively. As expected, in other income and expense, interest income was offset by interest expense, foreign currency re-measurement, and recognized losses on investments. Our effective tax rate was 16% in line with expectations. And finally, we returned $7.9 billion to shareholders through share repurchases and dividends, an increase of 28% year-over-year.

Now let's move to our outlook. Assuming current rates remain stable, we expect FX to decrease Intelligent Cloud revenue growth by approximately 2 points, total company, Productivity and Business Processes and more Personal Computing revenue growth by approximately 1 point, and have no impact on total company COGS and operating expenses growth. We expect another strong quarter in our Commercial business. Demand for our hybrid offerings and cloud services remain strong and capital expenditures will continue to reflect that. Given the normal variability in infrastructure spend timing, we expect Q2 CapEx spend to be down slightly on a sequential basis, but still growing from the prior year. And commercial cloud gross margin percentage will continue to improve on a year-over-year basis, even with the continued mix of revenue toward Azure consumption-based services.

Now to segment guidance. In Productivity and Business Processes, we expect revenue between $11.3 billion and $11.5 billion driven by double-digit growth across Office Commercial, Dynamics and LinkedIn. For Intelligent Cloud, we expect revenue between $11.25 billion and $11.45 billion. In Azure, we expect continued strong growth in our consumption based business and moderating growth in our per-user business given the size of the installed base. Our on-premises server business will be driven by demand for our hybrid and premium solutions, as well as the continued benefit from increased demand ahead of the end of support for Windows Server 2008. In More Personal Computing, we expect revenue between $12.6 billion and $13 billion. In Windows, overall OEM revenue growth should again be ahead of the PC market as we balance healthy Windows 10 demand and the benefit from the upcoming end of support for Windows 7 with the supply chain's ability to meet this demand in Q2. Based on our customer demand signal and prior end of support cycles, we expect some continued momentum past January end of support deadline.

In Windows Commercial products and cloud services, we expect another strong quarter, benefiting from continued Microsoft 365 momentum. In Surface, the launch of the latest Surface Pro and Surface laptop devices should drive low double-digit revenue growth on a strong prior-year comparable. In Search ex-TAC, we expect revenue growth similar to Q1. And in Gaming, we expect revenue to decline in the mid-20% range driven by lower console sales as we near the end of this generation as well as the most challenging quarterly comparable in third party titles from last year. Now back to overall company guidance. We expect COGS of $12.45 billion to $12.65 billion, and operating expenses of $10.8 billion to $10.9 billion. Other income and expense should be approximately $50 million as interest income is partially offset by interest and finance lease expense. And finally, we expect our Q2 effective tax rate to be slightly above the full year rate of 17%. Now, let me share some additional comments on the full year. At the company level, we continue to expect double-digit revenue and operating income growth, driven by continued momentum in our Commercial business. Given our strong first quarter results and the expected sales mix for the remainder of the year, we now expect operating margins to be up slightly year-over-year even as we continue to invest with significant ambition in high growth areas. With that, Mike, let's go to Q&A.

Michael Spencer {BIO 20838577 <GO>}

Thanks, Amy. We'll now move over to Q&A. With respect to others on the call, we request the participants please only ask one question. Operator, can you please repeat your instructions.

Questions And Answers

Operator

Thank you. At this time, we'll be conducting a question-and-answer session. (Operator Instructions) Our first question comes from the line of Keith Weiss with Morgan Stanley.

Please proceed.

Q - Keith Weiss {BIO 6993337 <GO>}

Thanks. Thank you for taking the question and very nice quarter. I was hoping to dig in a little bit into the Intelligent Cloud business, and what you guys are seeing there from a hybrid perspective and so maybe one question for Satya and one for Amy. For Satya, can you talk to us a little bit about sort of how these hybrid engagements are kind of rolling out with the larger customers, how they are contracting from it? And any sense you can give us in terms of, in what way that they have to engage both kind of the on-premise assets as well as the cloud assets because I think this part of the equation is really positively surprising a lot of investors and how well Server & Tools is doing.

And then maybe for Amy, you could help us understand sort of when we look at Server & Tools up 14% in constant currency, which is well ahead of our expectations, how should we think about the durability of that in terms of what comes from sort of the pull forward of demand ahead of some tactical Server and Windows Server explorations? And what is going to be more durable over time on the back of those pull forwards?

A - Satya Nadella {BIO 3224315 <GO>}

Sure, Keith, thanks for the question. Overall, our approach has always been about this distributed computing fabric or thinking about hybrid as not as some transitory phase, but as a long-term vision for how computing will meet the real world needs because if you think about the long-term, compute will migrate to wherever data is getting generated and increasingly there will be data generated in the real world, where just when you think about the cloud, you have to think about the edge of the cloud as a very first-class construct. And so in that context, what we see is a couple of things that you see even in the results today.

One is the hybrid benefits. That is increasingly what is getting customers excited about the Azure choice and the fact that they can renew, knowing that they have the flexibility of both the cloud and the edge, that's definitely driving growth. Second is, we are also gaining share. When you think about what's happening even with the edge, some of the -- our data center addition products are very competitive in the marketplace. And so you see both of those effects but architecturally, we feel well placed. In fact at our Ignite Conference, you will see us even take the next leap forward even in terms of how we think about the architecture inclusive of the application models, programming models on what distributed computing looks like going forward. So we feel well positioned there.

A - Amy E. Hood {BIO 18040963 <GO>}

And Keith to your question on sort of durability, we're trying to call out the four points that we felt transactionally was due to the end of support and that's 4 of the 12 in USD. And so, but for us, if you step back for a second, the durable trends that Satya just talked about, which is making sure we license in a way that respects this long-term reality of where data and compute will be needed is what we call the hybrid value proposition, and the rights to that of course are inherent in how we report this number. And so for us, what you'll see is premium strength, which we saw this quarter in both SQL and Windows because of some of the value proposition of hybrid and of course broad strength as well. When people feel that flexibility to not be constrained by licensing in terms of how they view be there, let's say.

Q - Keith Weiss {BIO 6993337 <GO>}

Excellent. That's super helpful. Thanks guys.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Keith. Operator, we'll take the next question please.

Operator

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

Q - Heather Bellini {BIO 2268229 <GO>}

Great, thank you so much. And this is a question for Amy. I was just wondering, you've been saying for a while now that you're seeing material improvements in Azure gross margins and that's obviously hugely benefited Commercial cloud gross margin. I'm just wondering if you could share with us how much of the improvement is related to the need to maybe expand data centers at a lower clip than you have been, maybe it's less depreciation and amortization that's coming that you're starting to recognize? How much of it is due to just better capacity utilization? And I'm just trying to get a sense of, how much longer you are going to be able to say that for, I guess, and just have you guys been ratcheting up your target gross margins for Azure over the years to where you think they could be, as you look ahead? Thank you.

A - Amy E. Hood {BIO 18040963 <GO>}

Thanks, Heather. Let me start by saying, in general, at the Commercial cloud gross margin, what you're seeing is revenue growth that for the past, almost two years has vastly been faster than our capital expenditure growth. So if you start at the top of the frame, what we're seeing is overall gross margin improvement across portfolio, and improving -- and that comes from a couple of things, which is where you're getting to on Azure. It comes from structural improvement on sort of cost per unit, but it also comes from mix shift of revenue to premium services from being able to sell more SaaS-like services and consumption services, or even premium data services that really do have both more margin, but also are quite consistent in terms of their growth and you see then that represented as improving targets for us.

But I would say in general, Heather what the team has done has actually delivered on what I think we felt was a five-year roadmap of improving gross margins on a material basis. Now as you continue to see the mix shift to the consumption-based Azure services. The overall cloud gross margin will improve at the same rate, and we've said that and you'll continue to see that on a go-forward basis as well. But we do continue to expect Azure, especially on the consumption side gross margins to improve and they still had room to improve, especially as we start to see some of these premium services both being made available and being utilized at higher rates.

Q - Heather Bellini {BIO 2268229 <GO>}

Great, thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Heather. Operator, we'll take the next question please.

Operator

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

Q - Karl Keirstead {BIO 1542979 <GO>}

Well, thank you. Amy question for you. When I look at your next quarter guidance by revenue segment, it seems to equate to an overall revenue growth rate, assuming the midpoint of about 9% to 10%. So when I combine that with the 14% growth you just put up in Q1, it implies that in the second half overall Microsoft revenue growth should remain roughly in the 10% zip code to enable you to get to double-digit growth for the full year, despite the fact that you're moving past some fairly key end of support milestones. I think some of us were expecting a little bit more of a first half-second half delta. So I just wanted to ask you, what's -- what are the, maybe one or two or three drivers that enable you to sustain that growth rate in the second half? And if it's fair to assume that your guidance doesn't really reflect any deterioration in the overall spending environment? Thanks a lot.

A - Amy E. Hood {BIO 18040963 <GO>}

Yeah, I think in general, Karl, a couple of things I would point to, or many of the things I talked about in the comments that we've prepared. Overall, Q1 was a very strong start commercially, from a bookings perspective with some very strong trends across the board. Whether it is in both the absolute size and number of the Azure commitments that we're seeing, the consistency we're seeing in the consumption growth rates of Azure. The commitments we're seeing to Microsoft 365. Some of the signs we're seeing across our Dynamics, the Power platform, the workflow cloud that Satya referred to and LinkedIn, it's a good bookings quarter, a good execution quarter on overall contracting value.

Renewals were good, recapture rates were good and new business was good. So with that confidence, some of those same trends that we had talked about, of course show up through the year. And we've tried to be consistent in that, while end of support we'll make four points here and there each quarter. The more sustainable trends are the fact that our commercial cloud overall offer significant value and differentiation to customers and they are making longer-term commitments, and we continue to grow ARPU.

So when I think about sort of some of the seasonality that you're talking about, Q2, I thought we were, I wanted to be clear that that's really a gaming challenge in Q2. And you see that reflected in the margins in Q2 being significantly better than they were last Q2. And if you think about H2, I do expect Surface, we'll have some easier comparables in H2 and a new portfolio to grow from. So I think that's another change you'll see in trajectory in H2 as well.

Q - Karl Keirstead {BIO 1542979 <GO>}

Terrific. Thank you, Amy.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Karl. Operator, we'll take the next question please.

Operator

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

Q - Mark Moerdler {BIO 16855032 <GO>}

Thank you. And congrats on the quarter. AI is obviously a large focus and it was a large driver of intelligence -- OpEx spending growth this quarter. Satya, can you give us some more color on where you see Microsoft on the AI journey? And Amy, is this investing way ahead of revenue or is AI already driving big revenue for Azure? How should we think about it? I appreciate, thanks.

A - Satya Nadella {BIO 3224315 <GO>}

Well, thanks Mark. It's a great question because we look at what's happening with AI having two dimensions to it. One is, I would say just our own use of AI as first-party SaaS applications. There are some phenomenal breakthroughs when you see new transcription features or new computer vision features that come with HoloLens. All of these are being driven by new AI capabilities, that are all by the way powered by the same cloud infrastructure. We all build everything at Microsoft, with first party equals third party with Azure as the core platform. And so what you see us is in fact using our own SaaS applications and consumer innovation even to drive the high-end AI capability, but then bringing the best in class tooling for enterprise customers.

So for example, like we have innovated even in, what does DevOps look like for the machine learning age? That's a unique capability that's there in Azure ML. And those are the types of innovations that are even driving the projects that our enterprise customers have on Azure. So you will see us leverage our overall spend, whether it's CapEx or OpEx across all of what Microsoft does and then Surface them in I think what is perhaps the best way to get traction in the enterprise market, which is great tooling compliance, security and that's a place where we're making good progress.

A - Amy E. Hood {BIO 18040963 <GO>}

And so, for me Mark, it's a little bit hard for me to say, gosh, we invest in AI here and you'll see it specifically here. What I think you heard through Satya's commentary is actually AI woven through every layer and component of the entire tech stack. And how important that is whether you're participating at the Dynamics 365 layer with Insights or whether you're using components like some of our customers are may be for a natural interaction work. And so for me, it is almost fundamental to see that cost in investment because you'll see it in margin and usage and frankly product differentiation that we can provide versus our competitors.

Q - Mark Moerdler {BIO 16855032 <GO>}

Excellent. I really appreciate it. Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Mark. Operator, we'll take the next question please.

Operator

Thank you. Our next question comes from the line of Brent Thill with Jefferies. Please proceed.

Q - Brent Thill {BIO 1556691 <GO>}

Thanks. Amy, there's been a lot of macro concern among tech investors, given some of the peers in your group have seen some weakness. It doesn't seem that you have seen anything but I'm curious if you could just comment on what you're seeing from a demand perspective?

A - Amy E. Hood {BIO 18040963 <GO>}

Thanks, Brent. What I would say is, for us, it has been so important to remain focused on where growth and opportunity exist, and to invest in those areas that are large, expansive and durable (inaudible). And I think when you think about where we spend our time both building products, investing in marketing, investing in sales capability and technical capability, it has been in many, if not all of those places. So when I look and say, where is our execution, or how do I think about our ability to execute in a macro environment, for me it is about investing in the right places, executing in a great way, remaining focused on the transition, our customers need us to help them through to create their own opportunity and their own growth.

And I think we've done a nice job of being invested in the right places. Satya mentioned a few of them on the call, but there are really many. If you think about security, compliance, communication, workflow, business process reinvention, the list can go on and on where I feel like we have set up a multi-year journey to be well positioned. And I tend to think of every quarter, every year as an opportunity to continue to differentiate, invest in innovation and execute well to take share. And so that's I think how I've approached that.

A - Satya Nadella {BIO 3224315 <GO>}

And I think that's probably the unifying theme, quite frankly, of all the questions so far, which is what's next. What's next for us is in the apps and infra go from perhaps first innings to second innings. For data and AI to start the first innings. When it comes to security, compliance, we never participated in this. Guess what, we get to participate in a fairly competitive way now. We've Build, something that didn't even exist a few years ago, which is the workflow cloud. That's a huge opportunity for us. Biz Apps, we are a very competitive and growing footprint. Even when we think about something like Microsoft 365, we never participated in spite of our past success with all the first-line work, and now we get to participate in it. So I see long-term secular growth opportunities and we are going to stay focused on making sure our innovation is competitive in all those layers, we talked about.

Q - Brent Thill {BIO 1556691 <GO>}

Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Brent. Operator, we'll take the next question please.

Operator

Thank you. Our next question comes from the line of Phil Winslow with Wells Fargo. Please proceed.

Q - Philip Winslow {BIO 6300579 <GO>}

Yeah, thanks guys for taking my question and congrats on another really impressive quarter. Satya, I want to focus on the strategic announcements you talked about earlier in the call, the Oracle, VMware and obviously the most recent one with SAP. What -- just walk us through the sort of the strategic thoughts behind these and then also, especially with VMware and Oracle, since those are out there, obviously longer. What's the feedback from customer -- customer has been? And then I guess to Amy, how do you think about sort of these big strategic analysis this year actually showing up in the numbers?

A - Satya Nadella {BIO 3224315 <GO>}

Sure, Phil. Thanks. So overall, I think this is again one of those things where in the past, we participated in the infrastructure business, but we had a fairly narrow footprint, which is, we had our own infrastructure that supported primarily our databases and our operating systems, whereas with the migration to the cloud, our customers are looking for us to be a provider of all their infrastructure needs, which is heterogeneous. And that's what has really led us at the infrastructure layer to have partnerships with VMware and Oracle. We, as you know, have first-class support for Windows and Linux, Java and .Net, Postgres and SQL, VMware, Red Hat as well as obviously Windows Hypervisor.

So, I feel that we now have that ability to be able to take the entire infrastructure estate, the entire data estate and really add value with these partnerships. And SAP represents the same because SAP has got both infrastructure. We now are the preferred cloud. So I think it's a fairly no-brainer for any customer who is an SAP customer who wants to accelerate their migration to the cloud and innovation from SAP and us that they should move to Azure, and that's what this announcement was all about. And so we are really looking forward to essentially executing on that strategy and that customer need that we see very clearly.

A - Amy E. Hood {BIO 18040963 <GO>}

And Phil, to your question on where would we see this. You'd actually see it in a couple of places, not just in Azure, which may in fact be the most logical extension. But at the heart of this, this is making it easier, faster and more reliable for us to help customers move their estate to the cloud. And to migrate that with confidence. And so when we do that, it's about becoming a committed partner. And you actually see that in broader Microsoft Cloud results whether that's helping even through these partnerships to be able to get closer to Tier 1 workloads, business process changes and so I actually think these are quite important for us to continue to make sure the first goal is customer centric, which is why we continue to move in this direction.

Q - Philip Winslow {BIO 6300579 <GO>}

Thanks guys.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Phil. Operator, we'll take the next question please.

Operator

Thank you. Our next question comes from the line of Jennifer Lowe with UBS. Please proceed.

Q - Jennifer Lowe {BIO 6926228 <GO>}

Great, thank you. I think this is probably an Amy question, as I sort of parse through the dynamics within Office 365 and through the discussion around sustainability of double-digit growth within the commercial segment. We've seen seat count decelerate, also the uplift on pricing maybe isn't as much as quarter as we saw in the past, which leads me to believe that that you are seeing a lot of success in the front-line worker piece and maybe that's a bigger driver of the seat count from here. But can you just, and at the same time you're seeing strong uptake of the premium SKUs as well. But as we think about seat count going forward, how much opportunity is there still left on the migration front of commercial licenses versus leaning a bit more on things like frontline worker to sustain that growth. And is there a point where potentially the seat growth and things like frontline could start to eat further into your ability to continue to lift ARPU on the base you already have?

A - Amy E. Hood {BIO 18040963 <GO>}

Thanks, Jen. Let me break this question apart, because you are actually asking important dynamics that I don't always think of is trade-offs. And so I want to make that more clear in my answer. First, your question on seat growth. We have room even beyond just first line workers, whether that is our ability in small and mid-sized businesses, on a global basis with mobile first workers, this is a very broad opportunity for us to reach people, trying to accomplish tasks and do their work on devices of any size, and so there is significant room for us to continue to make progress on that front.

Now, could that end up with some ARPU pressure long term? It certainly could. But the important for me, I don't think of that as being necessarily a negative. We used to really make no money through the seats that we just talked about. And so every dollar or multiple dollars or many dollars earned on those new seats is all new revenue, new opportunity and new socket for us.

Let me separate that from the next dynamic, which is why sort of an average number may not be the best indication, which is our ability to continue to move people to higher value SKUs, whether that's through the addition of really compelling things in security or compliance or communications or collaboration or knowledge or learning, where we can add value. Whether we call that E5 or E3, we have room in that transition as well and new opportunity in a way that I'm not sure, I've seen that. I feel very optimistic about M-365, I'm sorry, Microsoft 365 and our ability to continue to add value. So hopefully that helps, Jen.

Q - Jennifer Lowe {BIO 6926228 <GO>}

Yeah, that's great. Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Jen. Operator, we'll take our last question now, please.

Operator

Thank you. Our last question comes from the line of Raimo Lenschow with Barclays. Please proceed.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Hey, thanks for squeezing me in. Quick question on Azure, if I look at the SAP announcements, but you had some other industry announcements out there smell like Humana, et cetera, like how do I have to think about the progress you guys are making there in terms of getting more into the different industries and to kind of create deeper relationships around Azure evolving and just doing kind of simple infrastructure outsourcing. Thank you.

A - Satya Nadella {BIO 3224315 <GO>}

Yeah, it's a very deliberate strategy that we have in meeting our customers' needs, we need to have the partners they already work with and want to work with also on our platform. So it starts sometimes with the customers whether it's Humana or Walgreens or WalMart and others. It also starts with partners like Nuance, which is another one that we announced recently. And so the idea is for us to be really ensuring that by every industry, we have the right marquee customers as well as the partners and have strong go-to markets. One of the things that everyone I think in the marketplace understands is Microsoft for especially from a partner perspective is a great route to market. We have a platform directly with our sales force, as well as our channel, that is very attractive to third-party developers to get on Azure, and they realize those benefits and in fact our customers rely on that as also as a benefit because it helps them get the best value from their partners as well.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

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

A - Amy E. Hood {BIO 18040963 <GO>}

Thank you.

A - Satya Nadella {BIO 3224315 <GO>}

Thank you all.

Operator

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