Microsoft Corporation (MSFT) CEO Satya Nadella on Q4 2018 Results - Earnings Call Transcript

Jul. 19, 2018 9:28 PM ET | **Microsoft Corporation (MSFT)** | 12 Comments | 19 Likes

Q4: 2018-07-19 Earnings Summary

10-K

EPS of $1.13 beats by $0.05 | Revenue of $30.09B (21.80% Y/Y) beats by $857.98M

Microsoft Corporation (NASDAQ:MSFT) Q4 2018 Results Earnings Conference Call July 19, 2018 5:30 PM ET

Executives

Michael Spencer - General Manager, IR

Satya Nadella - Chief Executive Officer

Amy Hood - Chief Financial Officer

Frank Brod - Chief Accounting Officer

Carolyn Frantz - Deputy General Counsel and Corporate Secretary

Analysts

Keith Weiss - Morgan Stanley

Karl Keirstead - Deutsche Bank

Heather Bellini - Goldman Sachs

Mark Moerdler - Bernstein Research

Walter Pritchard - Citi

Phil Winslow - Wells Fargo

Lionel Renshaw - Barclays

Gregg Moskowitz - Cowen & Company

Keith Bachman - Bank of Montreal

Mark Murphy - JP Morgan

Operator

Greetings and welcome to the Microsoft Fiscal Year 2018 Fourth Quarter Earnings Conference Call. At this time all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Michael Spencer, General Manager, Investor Relations. Thank you sir. You may begin.

Michael Spencer

Good afternoon, and thank you for joining us today.

On the call with me are Satya Nadella, Chief Executive Officer, Amy Hood, Chief Financial Officer, Frank Brod, Chief Accounting Officer, and Carolyn Frantz, Deputy General Counsel and Corporate Secretary.

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 reconciliation of differences between GAAP and non-GAAP financial measures.

Unless otherwise specified, we will refer to non-GAAP metrics on the call. The non-GAAP financial measures provided should not be considered as a substitute for, or superior to, the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the Company's fourth-quarter performance in addition to the impact that these items and events had on the financial results.

All growth comparisons we make on the call today relate to the corresponding period of last year unless otherwise noted. We will also provide growth rates in constant currency, when available, as a framework for assessing how our underlying businesses performed, excluding the effect of foreign currency rate fluctuations. Where growth rates are the same in constant currency, we will refer to the growth rate only.

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

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

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

Satya Nadella

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

I'm proud of our strong results this quarter and even more proud of what we have accomplished over the last 12 months. We delivered more than $110 billion in revenue for the full year with double digit topline and bottom line growth. And our commercial cloud business surpassed more than $23 billion in revenue for the year with gross margin expanding to 57%. The strength of our results reflects accelerating innovation and the trust customers are placing in us to power their digital transformation.

I shared our vision for the intelligent cloud and intelligent edge a little over a year ago, a vision that is now quickly becoming reality and impacting every customer in every industry. Everything we have accomplished this year has been about accelerating our lead in this new era and the tremendous opportunity ahead. We focused on the right secular technology trends and growing markets and followed that up with solid roadmap execution.

We reorganized our engineering teams to break free of the categories of the past and better align with the emerging tech stack from silicon to AI to experiences, to better serve the needs of our customers today and long into the future. We reoriented our sales and marketing teams, adding industry and technical expertise to partner more deeply with our customers on their digital transformation journeys. And, most importantly, we drove innovation to deliver differentiated value across the cloud and the edge.

Now, I'll briefly highlight some of our innovation and momentum. We introduced Microsoft 365 to empower employees in the modern workplace. Microsoft 365 is now a multi-billion-dollar business that gives our customers a path to the cloud and broadens our reach with new and underpenetrated markets, including more than 2 billion first-line workers, and industry-specific workflows.

Across Microsoft 365, we are helping people be more productive, collaborate and stay secure on any device with AI infused experiences they use every day, and it's driving usage. We have more than 135 million users of Office 365 commercial. Outlook mobile is being used on more than 100 million iOS and Android devices. And more than 200,000 organizations are using Microsoft Teams as the hub for teamwork.

We invested to make Windows 10 the most modern, secure, always-up-to-date operating system. Windows 10 is now active on nearly 700 million devices, and the growth of the enterprise deployments this year exceeded our expectations.

It was a record year for LinkedIn, now with more than 575 million members and revenue growth of 37% in Q4, the fifth consecutive quarter of revenue acceleration. We saw record levels of engagement and job postings again this quarter, with sessions growth up 41% year-over-year. This strong engagement is driven by quality of the feed, video, messaging and acceleration of mobile usage, with mobile sessions up more than 55% year-over-year. We will continue to invest to make LinkedIn the essential platform to connect the world's professionals and help them achieve more with experiences powered by LinkedIn and Microsoft graphs.

Dynamics 365 gives organizations an alternative to monolithic, siloed suites of business applications with modular, modern, extensible, and AI-driven apps that unlock insights across every part of the organization, from sales to HR. It's gaining traction as our third commercial cloud growth engine, with revenue up 61% year-over-year. Our investments in Power BI, PowerApps and Flow as the new analytics and application platform are gaining significant momentum with ISVs and enterprise customers.

Azure is the only hyper scale cloud that extends to the edge across identity, data, application platform, security and management, and our differentiated architectural approach drove another strong quarter of growth. We are investing aggressively to build Azure as the world's computer.

We expanded our global datacenter footprint to 54 regions, more than any other cloud provider, and with the most comprehensive compliance coverage in the industry. We added nearly 500 new Azure capabilities in the last year alone, focused on both existing workloads and new workloads such as IoT and AI at the Edge. We introduced Azure Stack and Azure Sphere, two first-of-their kind cloud-to-edge solutions that are already seeing strong customer demand.

We are democratizing data science and AI with Azure Cognitive Services, Azure ML, and data services such as Azure Cosmos DB to help organizations of all sizes convert their data into insights and experiences for competitive advantage. The world's leading companies are running on Azure, and I'm especially proud that Walmart chose Azure and Microsoft 365 to accelerate its digital transformation for their associates and customers.

In Gaming, we are pursuing our expansive opportunity from the way games are created and distributed to how they are played and viewed, surpassing $10 billion in revenue this year for the first time. We are investing aggressively in content, community and cloud services across every endpoint to expand usage and deepen engagement with gamers. The combination of Xbox Live, Game Pass subscriptions and Mixer are driving record levels of growth and engagement.

Not only are we investing to grow organically but we are also investing inorganically in opportunities that expand our total addressable market and accrue value to our platforms and our customers. Take LinkedIn. We have united the world's leading professional cloud with the world's leading professional network and proved that we have an integration model that works, enabling LinkedIn to accelerate growth while retaining its member-first ethos.

With GitHub, we recognized the increasingly vital role that developers play in value creation and growth in the era of the intelligent cloud and intelligent edge. Our pending acquisition will enable us to bring our tools and services to new audiences, while enabling GitHub to grow and retain its independence and developer-first ethos and community.

PlayFab accelerates our vision to build a world-class cloud platform for the gaming industry across mobile, PC and console. And the addition of five new gaming studios bolsters our first-party content development to support our fast-growing gaming services.

Microsoft has always been a partner-led company, and partners increasingly see more opportunity on our platforms, inspiring leading companies like SAP, Adobe and GE, as well as fast-growing start-ups like InMobi to play an even larger role in our vibrant and growing partner ecosystem, an asset that gives us scale in this new era.

In closing, our opportunity has never been greater. We will continue to innovate and invest across our solution areas in serving our customers and their unmet and unarticulated needs. With this tremendous opportunity comes great responsibility. We're relentlessly working to instill trust in technology across everything we do. It's why we will continue to lead the industry dialogue on trust, advocate for customer privacy, drive industry-wide cybersecurity initiatives, and champion ethical AI.

Our investments and business model are fundamentally aligned with our customers' long-term interests and success. This opportunity and responsibility grounds us in our mission to empower every person and every organization on the planet to achieve more. I'm proud of our progress, and I'm proud of the more than 100,000 Microsoft employees around the world who are focused on our customers' success in this new era.

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

Amy Hood

Thank you, Satya, and good afternoon, everyone.

This quarter, revenue was $30.1 billion, up 17% and 15% in constant currency. Gross margin dollars increased 19% and 16% in constant currency. Operating income increased 30% and 24% in constant currency. Earnings per share was $1.13, increasing 7% and 3% in constant currency. As a reminder, FY17 included a $1.8 billion tax benefit related to previously non-deductible phone losses.

In our largest quarter of the year, our sales teams and partners delivered exceptional commercial results. We saw strong performance in most of our geographic regions against a backdrop of favorable macroeconomic conditions and positive IT spending trends.

Customer commitment to our cloud platform continues to increase. In FY18, we closed a record number of multi-million-dollar commercial cloud agreements and more than doubled the number of $10 million-plus Azure agreements. Our annuity mix increased 3 points year-over-year to 89%. As a result, commercial bookings increased 18% even with a strong prior year comparable. Commercial unearned revenue was $29 billion, growing 23% and 21% in constant currency, significantly higher than anticipated due to stronger than expected cloud billings.

Our commercial cloud revenue was $6.9 billion, growing 53% and 50% in constant currency with strong performance across the U.S., Western Europe, and the UK. Commercial cloud gross margin percentage increased 6 points to 58%. In line with our commitment at the beginning of the year, we improved the gross margin percentage in each cloud service, with Azure seeing the most significant improvement.

Our company gross margin percentage was 68%, ahead of our expectations, and up 1 point year-over-year from improvement in our More Personal Computing segment, driven by Surface.

FX increased revenue growth by 2 points, 1 point lower than anticipated, due to a stronger U.S. dollar. At the segment level, FX had a positive impact of 3 points on Productivity and Business Processes and Intelligent Cloud and 1 point on More Personal Computing revenue. The FX impact to COGS was immaterial.

This quarter, operating expenses grew 9% and 8% in constant currency, above our expectations due to revenue driven expense, such as sales compensation given the strength of the quarter, and severance expense, primarily in our sales organizations, offset by FX favorability. Strong revenue growth, improved device gross margin percentage, and continued targeted investment in cloud engineering, cloud sales capacity, and LinkedIn created operating income leverage. This quarter, operating income increased again, up 3 points year-over-year.

Now, to our segment results. Revenue from Productivity and Business Processes was $9.7 billion, increasing 13% and 10% in constant currency, in line with our expectations even with the headwinds from a stronger dollar and a higher than anticipated mix of cloud billings in our Office commercial and Dynamics businesses during the quarter. As a reminder, under ASC 606, cloud revenue is ratably recognized while annuity on-premises revenue has a component of upfront recognition. A higher mix of cloud billings is reflected in more unearned revenue and less in-period recognition in a quarter.

Office commercial revenue increased 10% and 8% in constant currency. Office 365 commercial revenue grew 38% and 35% in constant currency and Office 365 commercial seats grew 29%. We continued to see healthy installed base growth and ARPU expansion from customer adoption of premium workloads in E3 and E5. Office consumer revenue increased 8% and 6% in constant currency, driven by recurring subscription revenue and growth in the subscriber base, now at 31.4 million.

Our Dynamics business grew 11% and 8% in constant currency, with double digit billings growth. Dynamics 365 grew 61% and 56% in constant currency.

LinkedIn revenue grew 37% and 34% in constant currency with strong execution across all businesses. As Satya highlighted, engagement continued to accelerate, and we also saw record levels of job postings, benefitting from a robust U.S. job market.

Segment gross margin dollars grew 13% and 10% in constant currency. Gross margin percentage was relatively unchanged year-over-year even as cloud mix increased, driven by margin expansion in Office 365 and LinkedIn.

Operating expenses increased 7% as we continued to invest in LinkedIn, cloud engineering, and commercial sales capacity. Operating income increased 20% and 13% in constant currency.

Revenue from the Intelligent Cloud segment was $9.6 billion, increasing 23% and 20% in constant currency, with better than expected results in both our on-premises and Azure businesses. Server products and cloud services revenue increased 26% and 24% in constant currency, driven by continued strong Azure revenue growth of 89% and 85% in constant currency. Azure per user services performed ahead of expectations with our Enterprise Mobility installed base growing 55% year-over-year to over 82 million. Our on-premises server business grew 8% and 6% in constant currency, with double digit growth in premium server products revenue and healthy renewals, benefiting from the significant value customers see in our hybrid solutions.

Enterprise Services revenue grew 8% and 7% in constant currency, as growth in Premier Support Services and Microsoft Consulting Services was partially offset by a decline in custom support agreements for Windows Server 2003.

Segment gross margin dollars increased 23% and 20% in constant currency. Gross margin percentage was relatively unchanged as material improvement in the Azure gross margin percentage was offset by a growing mix of Azure IaaS and PaaS revenue. Operating expenses increased 11% with ongoing investments in cloud engineering and sales capacity to support top-line growth. Operating income grew 34%, up 30% in constant currency.

Finally, More Personal Computing. Revenue was $10.8 billion, up 17% and 16% in constant currency, with better than expected results in Windows commercial, OEM Pro, and Surface.

In the commercial space, we saw an accelerating pace of Windows 10 enterprise deployments this quarter. Customer demand for modern and secure hardware and stronger than expected PC growth in geographies where Pro mix is high contributed to OEM revenue growth of 14%, ahead of the overall commercial market. Windows commercial products and cloud services grew 23% and 19% in constant currency, driven by double digit billings growth as well as a higher mix of in-quarter recognition from multi-year agreements.

In consumer, OEM Non-Pro revenue declined 3%, slightly below the consumer PC market, driven by continued pressure in entry-level price category, even as we continued to take share in the premium category. Inventory levels were within the normal range.

Search revenue ex-TAC increased17% and 16% in constant currency driven by enhancements to our advertising platform and Bing volume growth across both U.S/ and international markets. Surface revenue increased 25% and 21% in constant currency, driven by strong performance of the latest editions in the portfolio against a low prior year comparable.

In Gaming, revenue grew 39% and 38% in constant currency. Xbox software and services grew 36% and 35% in constant currency, mainly from a third-party title. Xbox Live monthly active users increased 8% to 57 million. Segment gross margin dollars grew 21% and 18% in constant currency. Gross margin percentage increased driven by new Surface editions, offset by sales mix to lower margin businesses.

Operating expenses grew 9% and 8% in constant currency, driven by seasonality changes in advertising spend versus the prior year and investments in engineering across Search and AI. Operating income grew 38% and 32% in constant currency.

Now, back to total Company results. Capital expenditures including finance leases were $4.1 billion and increased on a sequential basis, in line with expectations. Cash paid for property, plant, and equipment was $4 billion, reflecting investments to support growth in our cloud business as well as a $250 million real estate acquisition.

Free cash flow was $7.4 billion and down 15% year-over-year, reflecting higher capital expenditures in support of our cloud business. Cash flow from operations grew 4% year-over-year and included tax payments related to the adoption of ASC 606 and TCJA, as well as an earlier start to the hardware inventory build for holiday than in the prior year. Excluding the impact of these items, operating cash flow grew approximately 13%, driven by strong cloud billings and collections.

Other income and expense was approximately $300 million, lower than expected due to FX re-measurement. Our non-GAAP effective tax rate was 18%, higher than anticipated due to the geographic mix of our revenue. And finally, we returned $5.3 billion to shareholders through dividends and share repurchases, an increase of 16%. Our Q4 share repurchase was $2.1 billion, up 31% year-over-year, but down sequentially, given the suspension of share repurchase activity in advance of the announced GitHub acquisition.

Now, let's move to the outlook. My commentary, for both the full year and next quarter, does not include any impact from GitHub which we still expect to close by the end of the calendar year. Overall, the key drivers and trends of our business for the next fiscal year remain largely unchanged from April and assume a consistent macro environment.

First, on FX. Assuming that rates remain stable, we expect no impact to full year revenue growth, with any FX benefit in H1 offset in H2. FX should decrease COGS and operating expense growth by 1 point. Second, our commercial business. Given corporate IT spend optimism, an increasing demand for cloud services, our strong competitive product position, and consistent sales execution, we expect another year of strong revenue growth and higher annuity mix across our commercial business. As customer commitment to our cloud increases, we are seeing larger and longer term agreements. As a result, we may see increased quarterly volatility in commercial bookings growth and commercial unearned revenue.

Productivity and Business Processes should continue to grow double digits driven by Office 365, Dynamics 365, and LinkedIn. Customer demand for our hybrid offerings should drive high-teens growth in our server products and cloud services revenue KPI. And in Azure specifically, we expect an increasing mix of IaaS and PaaS consumption-based revenue. In Windows, we expect strong business fundamentals in our OEM Pro and Windows commercial businesses, though the rates of revenue growth will slow through the year against a strong FY18 comparable.

Third, commercial cloud gross margin percentage. We expect continued improvement in each commercial cloud service, as well as in the overall commercial cloud gross margin percentage. The rate of improvement will moderate relative to FY18 as revenue mix continues to shift to Azure IaaS and PaaS consumption-based services, and we realize less year-over-year improvement in our per-user services.

We will continue to increase our investments in CapEx to meet the growing demand for our cloud services, although we do expect the growth rate for the year to moderate.

Next, operating expenses. Given our strong execution, we will continue to invest in the trends and growing markets we believe are fundamental to long-term shareholder value creation. Investment in commercial cloud, LinkedIn, gaming, and AI should result in operating expense growth of roughly 7%. Even with these strategic investments and the continued shift to our cloud businesses, we expect operating margin to be up slightly year-over-year.

Other income and expense should be slightly negative, in line with prior guidance, and with quarterly variability primarily due to changes in FX remeasurement, interest rates, and valuation changes with the adoption of the new accounting rules for financial investments.

And finally, tax rate. We've refined our estimates of the impacts from TCJA, the mix of service versus license revenue, and the geographic mix of revenue and now expect our FY19 effective tax rate to be roughly 17% with quarterly variability.

Now, to the outlook for our first quarter. First, FX. Assuming current rates remain stable, we expect FX to increase revenue growth by approximately 1 point and decrease COGS and operating expenses by 1 point. Second, our commercial business. We expect another healthy quarter with commercial unearned revenue down approximately 10% sequentially, in line with historic seasonality. Commercial cloud gross margin percentage will improve slightly on a sequential basis. Third, we expect another quarter of sequential growth in capital expenditures as we continue to support growing, global customer demand.

Now to the segment guidance. In Productivity and Business Processes, we expect revenue between $9.25 billion and $9.45 billion, driven by double digit growth in Office Commercial and Dynamics. LinkedIn revenue growth should remain high on a stronger prior year comparable. In Intelligent Cloud, we expect revenue between $8.15 billion and $8.35 billion. Azure revenue growth should reflect a balance of continued strength in our IaaS and PaaS consumption-based services and a moderating rate of growth in our per-user services. In More Personal Computing, we expect revenue between $9.95 billion to $10.25 billion. In OEM Pro, we expect revenue growth in line with the commercial PC market. And in OEM non-Pro, we expect similar dynamics as seen in Q4.

In Surface, we continue to expect strong performance from our latest editions, including the new Surface Go, to drive growth similar to Q1 of the prior year. Search ex-TAC should see another quarter of mid-teens growth with consistent execution against rate and volume growth opportunities. In Gaming, we expect mid-teens revenue growth with continued strong user engagement on our platform. The software and services growth rate will moderate due to strong third-party titles launched a year ago. We expect COGS of $9.5 billion to $9.7 billion and operating expenses of $9.2 billion to $9.3 billion. Other income and expense is expected to be approximately negative $100 million. And finally, we expect our Q1 effective tax rate to be slightly lower than our full year rate due to the volume of equity vests that take place during our first quarter.

Mike, let’s go to Q&A.

Michael Spencer

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

Question-and-Answer Session

Operator

Thank you. Ladies and gentlemen, at this time, we’ll be conducting a question-and-answer session. [Operator Instructions] Our first question is coming from the line of Keith Weiss with Morgan Stanley. Please proceed with your question.

Keith Weiss

Excellent. Thank you guys for taking the question. And congratulations on a really nice quarter. I wanted to dig into Azure a little bit. I think growth overall in Azure this quarter is probably ahead of most peoples' expectations. And it sounds like the type of business that's being done on Azure is becoming more strategic and changing a little bit. So, Satya, I was hoping you could talk to us a little bit about the types of workloads, the type of sort of services that are being used on Azure, how that's evolved over the past year. And Amy, for you, maybe there is a new KPI, I believe. You gave us sort of the growth in the Enterprise Mobility of 55%. Was that in line with your expectations? Because I know you were sort of tempering our expectations on growth in that part of the business. Is that growing in line with kind of the slowdown you were expecting or is that better than you had imagined?

Satya Nadella

Yes. So, let me -- first of all thanks Keith for the question. And so, let me start. Overall, in terms of the workload mix, it's been fairly stable, which is our hybrid value proposition really has continued to resonate. So, that means there's a bunch of workloads that are migrating to the cloud, people use both Azure Stack plus Azure. So, that continues to drive a lot of IaaS growth for us as people are sort of looking basically to lift and shift a lot of their current data center workloads. Then, on top of it, we even have modernization of apps that is accelerating. And that drives a lot of the higher level services, in particular our data services as well as our AI services when AI services are essentially compute, but what happens is all this compute then requires storage and data, and that's another place where we see increasing acceleration.

The one thing that I would say that I am increasingly seeing is Tier 1 workloads. In some sense, when you think about some of the commitments being made by some of the biggest brands in the world in terms of what they're doing, one, it's very core to their operation; and two, they are running it in the cloud. And so, that's one thing that definitely is a market difference for us.

Amy Hood

And to your question on the per user services, specifically Enterprise Mobility, Keith, it was a bit better than I had anticipated in Q4. And really, driver of these per user services, such as EMS, actually is the value proposition that Satya refers to, and we refer to as Microsoft 365 and we saw strength broadly. And if you think about that, it's the Windows commercial, it's Office 365 commercial and EMS. And really that I think what we heard a lot was the value of the security and management continue to add more supported endpoints, offer really tremendous value to customers. And we did see a bit more strength than I was anticipating in Q4.

Operator

Thank you. The next question is coming from the line of Karl Keirstead with Deutsche Bank. Please proceed.

Karl Keirstead

Amy, the commercial unearned revenue and bookings were again super strong, and evidently Microsoft is benefiting from fairly strong EA renewal activity. So, when you look out into fiscal '19, how would you compare the degree of renewal activity versus fiscal '18 and fiscal '17? It sounds like you're still constructive, but I'd love to hear some color whether it feels as good as the fiscal year you just ended? Thank you.

Amy Hood

Thanks, Karl. Let me break up that question a little bit, because you actually asked a couple of things that are important. Number one, the unearned strength that we saw at the end of Q4, you're right, was very good execution on renewals on a reasonably large renewal base. But, there was also very good execution of adding new workloads, adding new opportunity in Q4, things such as Azure, as an example or Dynamics 365, as an example. So, really Q4 wasn't just renewal activity, it was also new workloads and new value. So, when you look into '19, I am optimistic on both of those fronts, good execution continuing on renewals as well as adding new value, new opportunity. And the third component of the question was really how did the renewal base correlate FY18? And the answer is, it's a little bigger, but it actually has the same amount of volatility quarter-to-quarter, so Q1 renewal base is actually almost equivalent to last year.

Operator

The next question is coming from the line of Heather Bellini with Goldman Sachs. Please proceed with your question.

Heather Bellini

I was wondering, Amy or Satya, if you can help us think about how Azure Hybrid Benefit has changed the type of net expansion rate, you are experiencing on your ELAs that come up for renewal? And I know you are kind of a little bit touching on that with Karl, but is there any way to help to think about how that in particular might be helping the expansion rates of those accounts? And can you help us to think about how this might be -- how that might be helping drive growth in your existing contracts? And then the other question would be. You've mentioned that you are moving some per user consumption that you are going to see more growth in consumption based services versus per user Azure workload growth. And I'm just kind of wondering, if you could share with us, is there any gross margin impact there? Does one have higher gross margins than the other? Is there anything that we should be taking from how you are parsing those comments about how we think of Azure's gross margin progression going forward?

Satya Nadella

So, on the first one, I actually think that these hybrid used benefits are being sort of best kept secrets. So, I'm actually hoping that going into this next fiscal year, we do a much better job and customers do a much better job, but they don't benefit because the advantage Azure has because of the hybrid used benefits across the entire workload are pretty phenomenal, and we had a good set of sessions at our partner meetings this week just really making sure that everybody understand those benefits. So, I don't think that, that is really played out. If anything, all the growth we have seen is in spite of that not being broadly revenue driving growth.

But to your second question I'll even say the following which is that, I think that there is clearly difference in GM between the per user and consumption. But the key is even the consumption services come in different forms, there is the IR services, there is the data services, and some of the higher level services. Some of these IoT services now even have SaaS components to it. So, therefore, I think that the mix will be different by quarter-by-quarter, but increasingly our strategy is in many times to get our customers to get going with what is core storage or core compute, but then they scale into these higher levels of services.

Amy Hood

And I’d say, Heather, the two components just to add. The Azure has a benefit. I think we are starting, as Satya said, we started to see some impact from that in my opinion in Q4 in the on-prem KPI. But it really was more in Windows. And the value as we continue to see in SQL next year I do think there is some opportunity for customers to realize the real value from these hybrid benefits. And so -- as to add confidence to my high teens KPI growth for the year is that this is a very customer value oriented offer.

To your question on GM, Satya has obviously correct on that one. And I’d say the way we think about it is actually more -- we're talking about Azure per user, it really does move more with M365 per user. It's almost better to put that in your mind as behaving more and having more structures more like Office 365 and behaves quite similarly; tends to have good quarters, when we do good execution on Office 365, and so my comments were more and continue to be around having people understand that sales motion, and that it tends to move in that direction.

Operator

Thank you. The next question is coming from the line of Mark Moerdler with Bernstein Research. Please proceed with your question.

Mark Moerdler

So, I’ve two related questions. And the first is, if you look at this quarter, the intelligent cloud revenue grew 23% and the gross margin dollars grew the same 23%, given the SaaS growing lower margin Azure business, we’re not seeing any longer negative margin impact. Have you reached the point where the incremental dollar for Azure revenue is closed to the overall intelligent cloud margin? And then a second, apologize, a slightly long question. CapEx spending in the quarter and the full year were both strong. We could argue the possibilities here, it’s driven by all the capacity of the demand or you having to spend a lot of it on replacing equipment as they’re ageing out. How should we think about the mix in CapEx between building demand and replacing with there?

Amy Hood

Let me take both of those. On the first one, in terms of the GM this quarter, you're right. The improvements particularly in the IaaS and PaaS, gross margin of Azure did offset the cloud mix to Azure within the segment, going forward continuing to see that. I think looking more pressured on gross margin just because the amount of Azure in the mix at the rate is growing, we're still not at that point where a $1 of gross margin in the cloud is equivalent to a $1 on-prem. That being said, we've a lot as you saw this quarter room to grow gross margin dollars, in that even within that frame going into FY'19.

On your second question in terms of capital spent, if you think about it at a high level, our capital expenditures are growing at a lower rate than our overall cloud revenue is growing, and that's why we're starting to see leverage, right, flow through the P&L. And I think that the rate of CapEx growth, as I said in FY'19 will moderate, that happens because of course we're doing some replacement overall. We're adding regions and seeing a lot of global demand, and so -- and improving margin, so I think that's clearly the very high level as you asked the question. I tend to think revenue is growing faster than the capital. You're seeing leverage through the P&L and we'll see a moderating rate in FY'19 even if Q1 is the big quarter. It's just going to be volatile as CapEx tends to be quarter-to-quarter based on both supply chain and demand.

Operator

Thank you. The next question is coming from the line of Walter Pritchard with Citi. Please proceed.

Walter Pritchard

Amy, wondering on the Office side, product and services on the commercial side, you had I think 8% growth. The lowest you've seen, I know 606 drive some volatility in that business. Could you help us understand, what drove that in the quarter? And I know you're making some changes like this support and so forth as you get into the out years. Is there any impact that you expect to the gross rate in that businesses as we look forward from those changes?

Amy Hood

The entire impact in that KPI, I actually feel very good about that number because if you think about the $1 billion plus beat we had for the unearned, it was due to the fact that we had very good mix shift Office 365 in terms of billings in the quarter, almost very little of that gets recognized in quarter. Now, this all goes to the balance sheet. So, my confidence for FY19 in that number being the double digits we talked about in the full year guide, only gets raised by seeing that execution. So, it is really 606 related, if the way to think about it plus a mix of billings and billing strength. So, I don’t really think of that as being negative, and you saw the exact same behavior and dynamics. So, it's a pretty similar in period in quarter impact.

Operator

The next question is coming from the line of Phil Winslow with Wells Fargo. Please proceed with your question.

Phil Winslow

Amy, question for you. You've commented on the positive spread that you're seeing in the Windows OEM business, both overall, but particularly on the commercial side. When you start to think forward in the next, call it, couple of quarters, here obviously, you told us what the positive drivers were. But how do you see this playing out? And can we maintain that positive spread? And if so, why, and if it does maybe narrow sort of how do you think about the narrowing?

Amy Hood

So, let me frame it first as this thing that I and we're are seeing really customers driven, which is, if you started Windows 10 and the value the customers seek. And what we're seeing is accelerating enterprise deployment of Windows 10. When that happens, it does create demand for new devices and modern devices that improved security. So that then in turn results in a better and stronger overall OEM PC commercial market. In addition because of the macroeconomic conditions are actually quite good on this front and with the business optimism creating some wind at our back, I also think people look and say if security and value are important, this is a great time to invest in modern PCs. And particular in market where pro mix has been strong, I continue to expect to see all of those things happen, through the course of next year.

Now, what you will see however, if all those things even do remain true which I expect them to, if the economic environment stays the same. H2 where we've had really strong revenue growth and a really strong market will I think moderate growth wise, just because the base it was coming off in '17 was just a lot lower. So, even if I see all the good things and good trends happening that I feel really create a great opportunity for us to sell Microsoft 365, you will see growth rates moderate next year.

Operator

Thank you. The next question is coming from the line of Lionel Renshaw with Barclays. Please proceed with your question.

Lionel Renshaw

Amy, can I go back to the server product, you partly answered it with the whenever ask and I believe hybrid cloud will be a factor here, but the growth was the best we've seen for a long time. Can you just talk about the drivers that kind of were at play here?

Amy Hood

You're right. The first one was the benefit that we saw from hybrid, in particular, with an outsized impact on Windows Server. The second has been a trend we also talked about a little before. We saw a strong double-digit growth in premium. So, it was mix shift as well as I think strikes in the hybrid benefits as a value across the customers, those two would have otherwise I’d actually call out as drivers for the quarter.

Lionel Renshaw

I mean they should be relatively sustainable, if I listen to them to you?

Amy Hood

I believe the one -- I think really important thing for us is continuing to focus on creating customer value. The concept of adding a lot of value by having and giving comfort to the customers that as they make a commitment to the Microsoft platform that they can move between a commitment to on-prem to the cloud in a high value way, I do believe is a unique thing that we offer at this time.

Operator

The next question is coming from the line of Gregg Moskowitz with Cowen & Company. Please proceed with your question.

Q - Gregg Moskowitz

Satya, this is more of a big picture question, but over a longer term period, I am curios how large you think edge computing will become relative to centralized cloud computing?

Satya Nadella

Yes, I think vision that we have always had is that distributed computing in some sense will remain distributed. So, we don’t split this into, there is an edge computing, there is a cloud computing. The need for computing is on the secular basis going to increase. And as you need to reason over larger amounts of data, you need not only storage and compute to be co-located all over as the world get them embedded with computing, that’s what we are building for.

So if you think about our real competitive advantage and differentiation is, we have one programming model, one identity model, security, management. So that modern developers as well as IT can use the compute available from Azure Sphere to Azure. And the reality is these modern workloads in fact lose it all.

So it's not like I just build and Azure Sphere application. I build and application that’s fundamentally distributed that also happens to ransom and compute on Azure Sphere. That I think the future which is distributed computing going back to what needs to be truly distributed, even driven server-less even versus this thing about let's just have one-time migration to something new.

Operator

Our next question is coming from the line of Keith Bachman with Bank of Montreal. Please proceed with your question.

Keith Bachman

Satya, I wanted to direct this to you, if I could. I'd like to understand how you view dynamics current positioning compared to the market opportunities? And the context of the question is, dynamics remains a fairly small part of Microsoft revenues as well if you look at the market share of where dynamic serve, it's a fairly small part of the markets served. So, what do you think Microsoft needs to do to have a larger impact against the market opportunities?

Satya Nadella

Overall, we are very committed and very bullish about the opportunity in dynamics. With Dynamics 365 for example, what you even to see in this last fiscal year which has been the first full fiscal year where we have this modern, modular approach to business application. I think it's very disruptive in the market place because it brings a very different value proposition. It has a price advantage and the value advantage for customers. And in it what is fundamentally fragmented mark, this is not a business application never was and never will be a winner-take-all. I know folks think about it best state, it's not I mean it's about one small category in one segment called enterprise.

There's a share -- high share consider it 25%, 35% of what have you. So in some sense, this one has always been about being able to serve customers especially in an increasing digitization work, right, which is the need for more business process automation is increasing. Take an IoT project, translate into a preventive maintenance in Azure and then ends up as fields service and Dynamics, that's been one pattern and we've seen a ton of traction with. So to me us going in fact to these new secular growth opportunities while being disruptive to the status quo of anyone who has high margins and very high price monolithic products today is basically our strategy going forward.

Operator

Thank you. Our final is coming from the line of Mark Murphy with JP Morgan. Please proceed with your question.

Mark Murphy

So, Amy, we keep expecting the Office 365 commercial seat growth to decelerate materially at some point, based upon the penetration level. But this quarter that seat growth actually accelerated about a 1 point to 29%. And when we look back on it the trajectory really isn't too different than where it was even a year ago. So I was just curious, is there some underlying driver there that would keep that deceleration relatively manageable going forward? Or what you continue to see that flowing in a way that overtime would exert a little drag on Azure through this per user Azure services?

Amy Hood

This is one where overtime there's certainly is going to be a deceleration. This is a per user business. And 365 has that characteristic and Office has it, EMS has it, and so this quarter actually what we saw, was actually some strength in education was added a good amount seats this quarter as well as good execution across our other segments. And so, we did see a bit of growth that we were excited to see frankly on a segment where we've been working hard to make additional progress and add value. The team has actually done nice job in that segment, created some really modern offers, to get back and to enhance market that as well.

But over the long term and as we continue to move aggressively, we will continue to seek growth dissipate, but I would also say this is going to take longer than I think many people would have thought, there're lots of users as we continue to redefine what Office is that you add to the base. Whether that's first client workers, whether that's an increasing number of small businesses who finally have access and value that we're creating for them across things from scheduling all the way to being able to work through minor business process adjustments like Satya has talked about. So, really as we continue to redefine what Office means from something that people will always associate with Word, Excel and PowerPoint, to things that mean in mobile or video would stream, or collaboration with teams, I think we have opportunity to continue to add those new users, new types of users that we haven't had access before and the capability even to users we have.

Michael Spencer

That wraps up the Q&A portion of today's earnings call. Thank you for joining us today and we look forward to speaking with you all of you soon. You can find additional details on the Microsoft Investor Relations website. Thanks.

Amy Hood

Thank you everyone.

Satya Nadella

Thank you very much.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Again, we thank you for your participation and you may disconnect your lines at this time.