Q1 2019 Earnings Call

Company Participants

- Amy E. Hood, Chief Financial Officer & Executive Vice President
- Michael Spencer, General Manager, Investor Relations
- Satya Nadella, Chief Executive Officer & Director
- [0JNPYG-E Michael Spencer]

Other Participants

- Brad Alan Zelnick, Analyst
- Brad Robert Reback, Analyst
- Heather Bellini, Analyst
- Jennifer Swanson Lowe, Analyst
- Keith Eric Weiss, Analyst
- Mark R. Murphy, Analyst
- Philip Winslow, Analyst
- Raimo Lenschow, Analyst
- Ross MacMillan, Analyst
- Walter H. Pritchard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Greetings, and welcome to the Microsoft Fiscal Year 2019 First Quarter Earnings Conference Call. As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Mike Spencer, General Manager, Investor Relations. Thank you. You may begin.

Michael Spencer {BIO 20838577 <GO>}

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 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 will also provide growth rates in constant currency when available as a framework for assessing how our underlying businesses perform, 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'll post our prepared remarks to our website immediately following the call until the complete transcript is available. Today's call is being webcast live and recorded. If you ask a question, 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 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 Factors 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 {BIO 3224315 <GO>}

Thank you, Mike, and thanks to everyone on the phone for joining. We're off to a very strong start in fiscal 2019, delivering record revenue and profit. Every organization today needs tech intensity to compete and grow in an increasingly digital world.

There are two aspects to this. Think of it as a simple equation. First, every organization needs to be a fast adopter of best-in-class technology, second, they'll need to build their own proprietary digital capability. Our cloud platforms and tools enable our customers to build tech intensity, while ensuring we're addressing their tough questions around trust, both trust in technology and trust that they have a partner whose business model is aligned to their success.

No customer wants to be dependent on a provider that sells them technology on one end and competes with them on the other. Getting this equation right is key to their success going forward. Microsoft is uniquely positioned to help.

Now I'll briefly highlight how we are innovating across our solution areas. A little over a year ago, we introduced Microsoft 365 to help organizations of all sizes empower their employees in the modern workplace. Today it's a multi-billion dollar business that gives our customers a path to the cloud and broadens our reach with new and under-penetrated markets. Customers from large multinationals like Eli Lilly to Rio Tinto first-line field workers to small businesses that are all choosing Microsoft 365.

Cybersecurity is a central challenge. Microsoft Security differentiation is based on two things: first, our unparalleled operational security posture, second, our comprehensive product suite spanning identity, information, application and device protection.

We analyze more than 6.5 trillion signals each day, process 450 billion authentications monthly and scan 400 billion e-mails for malware and phishing each month. This massive signals generate insights that fuel security innovations for customers. New capabilities in Microsoft 365 detect, investigate and remediate sophisticated cybersecurity threats across every endpoint, saving IT professionals thousands of hours.

Microsoft Security Score gives organizations a dynamic report card on their security posture. In identity management, Microsoft is already a leader with Azure Active Directory and we are innovating with new capabilities to eliminate passwords for the hundreds of thousands of Azure AD connected apps that businesses use every day.

The future of productivity and collaboration will be defined by AI innovation and new AI-driven features across Microsoft 365 from automated slide design to proactive Cortana reminders to enhanced search experiences and real-time meeting transcription to org analytics are all augmenting human capability, making it easier for people to focus on what matters most.

Another differentiator is Microsoft Teams. Microsoft Teams is the only enterprise-grade solution that brings together messaging, video conferencing, meetings, and web-based collab into a single integrated user experience scaffolding. It eliminates the need for discrete single-point solutions that only increase an organization's security and compliance exposure.

Customers recognize this value. Teams is now the hub for teamwork for 329,000 organizations, including 87 of the Fortune 100 And we are adding automated translation support for meetings, shift scheduling for first-line workers, and new industry-specific offerings including healthcare and small business.

Windows 10 continues to gain traction in the enterprise as the most secure and productive operating system and more than half of our commercial device installed base is now on Windows 10. Surface continues to set the bar for the industry with five new category-leading Surface devices including the new Surface Go. Microsoft 365 and Surface are inspiring our OEM ecosystems to innovate and we have the strongest line of devices going into the holiday season.

Moving to business applications, AI-powered digital feedback loops that connect products, operations, customers, and employees to create predictive power, automate workflows, and ultimately improve outcomes are key to all organizations. Dynamics 365 uniquely addresses this need. We expect Dynamics to deliver more than $2.5 billion in revenue this year with half of that total coming from Dynamics 365.

And this quarter, we introduced Dynamics 365 AI, a new class of AI applications built for an era where the systems of record and engagement are converted into intelligence.

Dynamics 365 Mixed Reality digitizes the physical spaces and interactions. Companies like Chevron and ZF Group are already using it to transform training and design for their first-line workers, and H&M, the world's second-largest clothing retailer is relying on Dynamics 365 to digitize its critical business processes.

These customers and others recognize the advantage of our modular extensible approach over the traditional SaaS model of monolithic suites of siloed apps. And our investments in our analytics and application platform spanning Power BI, PowerApps, and Flow are driving momentum with customers and have made us a leader in no-code app building and business analytics in the cloud.

Our Open Data Initiative, a strategic partnership with Adobe and SAP takes this even further, delivering on our vision of one unified data model to provide unparalleled business insight from behavioral, transactional, financial and operational data. Together we'll enable data to be exchanged and enriched across systems, making it a renewable resource that enables new intelligent customer experiences.

LinkedIn continues to be an essential platform to connect the world's professionals, with sessions growth of 34% year-over-year and record levels of messages sent and content shared. We're innovating with new experiences that leverage the LinkedIn and Microsoft Graphs such as the ability to e-mail LinkedIn connections directly from Microsoft 365. Strong engagement across the platform is fueling demand for sponsored content and marketing solutions and talent solutions, which saw record job postings again this quarter.

Talent Insights is a new self-service analytics solution that gives HR professionals competitive intelligence and labor market trends for an increasingly competitive jobs market. And the pending acquisition of Glint brings employee insights alongside LinkedIn's Workforce Insights to create a powerful solution to help customers attract, retain and develop the best talent.

Now turning to Azure. Customers from multinationals like Volkswagen, Anheuser-Busch InBev, Mastercard to fast-growing startups like Grab are recognizing the architectural advantage of a consistent computing stack from the cloud to the edge.

Azure is the only hyperscale cloud that extends to the edge across identity, data, application, platform, as well as security and management. We introduced 100 new Azure capabilities this quarter alone, focused on both existing workloads like security and new workloads like IoT and edge AI.

With Azure Confidential Computing, Azure is now the first cloud to provide a secure platform for protecting the confidentiality and the integrity of data while in use adding to our existing security protections to encrypt data in transit as well as in rest.

Every company needs a strategy to take advantage of the billions of IoT devices entering the market each year. Azure Sphere, our end-to-end solution for securing microcontroller powered devices is now broadly available and seeing strong customer interest. Azure

Digital Twins is a new service that models relationships and interactions across people, places and devices.

We're investing to make Azure the best cloud for enterprise data. Our data services spanning SQL Database, Cosmos DB, Data Warehouse, and Data Lake provide the most comprehensive data platform needed for enterprise data estates. Azure ML builds on this foundation to further democratize data and AI to unlock insights, helping data scientists build and train AI models faster then deploy them through the cloud or to the Edge.

Across industries, our customers and partners are using services like these to transform. BMW introduced an agent to redefine how people interact with their cars. Beulah, which processes 65% of the world's grain, is relying on Azure Cognitive Services to improve food safety. Shell is applying AI across its enterprise to optimize deal productivity and keep workers safe. And this week at Sibos Conference, the Microsoft cloud is front and center, powering financial services transformation for organizations such as SWIFT, which is enabling secure payment transfers on Azure.

Finally, our pending acquisition of GitHub, which we expect to close shortly, recognizes the increasingly vital role developers play in value creation and growth across every industry. I'm excited about the opportunity to bring our tools and services to new audiences while enabling GitHub to grow and retain its developer-first ethos.

Now I'll turn to gaming. We continue to broaden our reach with more than 2 billion gamers worldwide and expand our opportunity, from the way games are distributed, to how they're played and viewed. We are investing in content, community and cloud services across every endpoint to expand usage and deepen engagement.

First-party content is key to our approach and we now have 11 game studios in our portfolio to deliver differentiated content for our fast-growing services like Game Pass. Xbox Live now has 57 million monthly active users and Mixer usage growth is accelerating. This loyal, high-value community is our strongest asset, creating expanding opportunity for monetization of first- and third-party games. Fortnite is a good example of that and all up, we are seeing record software and services revenue and engagement being driven on our platform.

Earlier this month, we announced Project xCloud, a breakthrough game streaming technology that puts gamers at the center of their gaming experience, enabling them to play games in high fidelity wherever and whenever they want on any device. And it will empower game developers to scale to hundreds of millions of new users across devices. It's early days, but I'm excited about our road map.

Across our businesses, we are accelerating innovation, picking the right secular trends, investing in large growing markets, many of which are still in their infancy. Additionally, every one of our solutions is reinforcing our core intelligent cloud and intelligent edge platform. Not only are we optimistic about the opportunity for us and for our customers, we also recognize our responsibility.

We were one of the first companies in the United States to require suppliers doing substantial business with us to provide paid time off for their employees. And this quarter we took a further step to ensure that these suppliers also provide their employees with paid parental leave. We're ensuring that our enterprise class security innovation not only helps our largest customers but also protects small businesses and consumers who are often the most vulnerable to attacks.

Finally, we are putting AI into the hands of change makers to address society's most pressing challenges with initiatives like AI for Humanitarian Action, which supports critical disaster recovery efforts around the world and more. This recognition of our broader responsibility coupled with our bold innovation makes me incredibly optimistic about our opportunity ahead.

With that, now I'll hand over to Amy, who will cover our financial results in detail and share our outlook and I look forward to rejoining you after for questions.

Amy E. Hood {BIO 18040963 <GO>}

Thank you, Satya, and good afternoon everyone. This quarter revenue was $29.1 billion, up 19% and 18% in constant currency. Gross margin dollars increased 18%. Operating income increased 29% and 28% in constant currency and earnings per share was $1.14, increasing 36% and 33% in constant currency, another quarter of double-digit revenue and operating income growth drove a record start to the fiscal year.

We saw strength across each of our segments with strong sales execution by our partners and sales teams. Customer demand for our hybrid and cloud offerings drove the quarter and we continued to benefit from favorable macroeconomic and IT spending trends.

Now to our commercial business. As a reminder, starting this quarter, the commercial portion of LinkedIn is included in these metrics. Our commercial revenue annuity mix increased 1 point year-over-year to 90%. Commercial unearned revenue was $27.3 billion, growing 22% and 21% in constant currency, in line with expectations.

On an expiry base that was roughly flat year-over-year, commercial bookings were better than expected and increased 15% and 16% in constant currency, benefiting from larger long-term Azure contracts, growth in Azure consumption overages and pay-as-you-go contracts and strength in on-premises revenue.

These contract types impact bookings, reported revenue and unearned revenue in different ways. Let me explain. First, under ASC 606, hybrid and on-premises offerings drive bookings growth and more in-period revenue recognition. Therefore, there's less impact on unearned revenue.

Second, growth in Azure consumption overages and pay-as-you-go contracts drive bookings growth and in-period revenue, but have little impact on unearned revenue. And finally, long-term Azure contracts drive significant bookings growth, but have a smaller impact on in-period revenue and unearned revenue. The inclusion of LinkedIn results was immaterial to the growth rates of commercial unearned and commercial bookings.

Commercial cloud revenue was $8.5 billion, growing 47% and 46% in constant currency with strong performance in the U.S., Western Europe and the UK. Commercial cloud gross margin percentage increased 4 points to 62%, driven again by significant improvement in Azure gross margin.

Company level, gross margin percentage was 66%, down slightly year-over-year, with sales mix shift to gaming and commercial cloud. FX increased overall company and Productivity and Business Processes revenue by 1 point, in line with guidance. The impact to Intelligent Cloud and More Personal Computing revenue was immaterial, 1 point less favorable than expected. FX impact was immaterial to COGS and operating expenses, about 1 point less favorable than expected. Even with that headwind, operating expenses grew 8%, in line with expectations.

Our engineering and sales capacity investments in large growing markets continue to deliver differentiated value for our customers, while generating material operating income leverage. This quarter, we increased operating margin nearly 3 points year-over-year.

Now to the segment results. Revenue from Productivity and Business Processes was $9.8 billion, increasing 19% and 18% in constant currency, ahead of expectations, driven by both the on-premises and cloud businesses. Office commercial revenue grew 17% and 16% in constant currency, driven by continued Office 365 commercial growth and approximately 3 points of growth from increased demand ahead of a price increase with the launch of Office 2019.

Office 365 commercial revenue grew 36% and 35% in constant currency, with installed base expansion across all customer segments and ARPU growth as customers shift to E3 and E5 workloads. Office 365 commercial seats grew 29%, and in line with last quarter, benefited from strong performance of our Microsoft 365 academic offers.

Office consumer revenue increased 16% and 17% in constant currency, driven by growth in Office 365 subscription revenue and approximately 5 points of growth from increased channel demand ahead of a price increase with the launch of Office 2019. Office 365 consumer subscribers grew to 32.5 million.

Dynamics revenue grew 20%, including a few points from a greater mix of contracts with higher in-period recognition under ASC 606. Dynamics 365 grew 51% and 49% in constant currency. LinkedIn revenue increased 33% with strong execution across all businesses.

Segment gross margin dollars grew 18% and 17% in constant currency and gross margin percentage declined slightly year-over-year as cloud mix offset LinkedIn and Office 365 margin expansion. Operating expenses increased 7% and 8% in constant currency with ongoing investments in LinkedIn, cloud engineering and commercial sales capacity to support top-line growth. Operating income increased 29% and 27% in constant currency.

Revenue from Intelligent Cloud was $8.6 billion, increasing 24%, better than anticipated, driven by demand for our hybrid offerings. Server products and cloud services revenue grew 28%. Azure revenue increased 76%, in line with our expectations with strong growth across both consumption and per-user base businesses.

Our on-premises server business grew 10% and 9% in constant currency, driven by continued demand for premium versions and hybrid solutions, as well as increased demand ahead of Q2 price increases for certain versions of our server products.

Enterprise services revenue grew 6% 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 28% and 27% in constant currency.

Gross margin percentage increased year-over-year as material improvement in Azure gross margin percentage offset the growing mix of Azure IaaS and PaaS revenue. Operating expenses increased 19% and 20% in constant currency, driven by ongoing investments in cloud and AI engineering and commercial sales capacity. Operating income grew 37% and 35% in constant currency.

Now to more Personal Computing. Revenue was $10.7 billion, increasing 15% with significantly better than expected results in gaming. Gaming revenue increased 44% and 45% in constant currency with better than expected results across both software and services and hardware.

Xbox software and services revenue grew 36%, with continued strength from a third-party title. Xbox hardware revenue grew 94% and 96% in constant currency with earlier than expected sell-in of holiday hardware bundles.

In Windows, we saw healthy Windows 10 commercial deployments as the OEM ecosystem continued to benefit from customer demand for modern and secure software and hardware. OEM Pro revenue grew 8%, a few points ahead of the commercial PC market from a higher mix of premium licenses. Windows commercial products and cloud services revenue increased 12%.

In consumer, OEM non-Pro revenue declined 5%, below the consumer PC market with continued pressure in the entry-level price category. Inventory levels were within the normal range.

Search revenue ex-TAC increased 17%, driven by Bing rate growth and increased volume in U.S. and international markets. In Surface, revenue grew 14%, driven by Surface Book 2 and Surface Go.

Segment gross margin dollars grew 10% and gross margin percentage decreased due to sales mix to our lower-margin gaming business. Operating expenses declined 1%. As a result, operating income grew 23%.

Now back to our total company results. As expected, capital expenditures including financed leases were up sequentially to $4.3 billion, driven by ongoing investment to meet demand for our cloud services. Cash paid for property, plant and equipment was $3.6 billion. Free cash flow was $10.1 billion and decreased 2% year-over-year due to higher capital expenditures in support of our cloud business.

Cash flow from operations increased 10% year-over-year with strong cloud billings and collections, partially offset by our first annual TCJA payment of $1.5 billion. Excluding the TCJA payment, free cash flow grew 12% and operating cash flow grew 22%. Other income was $266 million, higher than anticipated, due to realized gains in the recording of mark-to-market gains under the new accounting rules for financial investments.

Our effective tax rate was 14%. As a reminder Q1 and Q3 rates are impacted by the volume of equity vest during those quarters. This Q1, the impact was a bit more than expected due to the movement of our share price within the quarter. And finally, in line with our continued commitment, we returned $6.1 billion to shareholders through dividends and share repurchases, an increase of 27% year-over-year.

Now let's turn to our outlook. Given that we expect the GitHub acquisition to close shortly, my commentary includes the full impact of the deal including purchase accounting, integration and transaction-related expenses based on our current understanding of the purchase price allocation and related deal accounting. We continue to expect the deal to be minimally dilutive to FY 2019 and FY 2020 EPS on a non-GAAP basis and accretive to FY 2020 operating income on a non-GAAP basis.

For Q2, first FX. Assuming current rates remain stable, we expect no impact to revenue growth. FX should decrease COGS and operating expense growth by approximately 1 point.

Second, our commercial business. We expect another quarter of healthy performance with solid bookings growth. Commercial unearned revenue is expected to grow approximately 19% year-over-year even with the ongoing shift toward the cloud contracts discussed earlier. Commercial cloud gross margin percentage should continue to improve on a year-over-year basis though at a more moderated rate than prior years given the continued mix of revenue toward Azure consumption-based services. Margin improvement will continue to vary on a quarterly basis driven by revenue mix, seasonality and the timing of infrastructure spend.

Third, we expect ongoing year-over-year growth in capital expenditure as we support growing demand. Given infrastructure spend timing, Q2 CapEx should be roughly in line with Q1.

Now to our segment guidance. In Productivity and Business Processes, we expect revenue between $9.95 billion and $10.15 billion. Office commercial and Dynamics should continue to exhibit double-digit growth, driven by strong cloud performance but with some moderation due to the on-premise drivers discussed earlier. Office consumer will see continued momentum in new subscribers but overall revenue growth will be negatively impacted as channel inventories normalize. LinkedIn revenue growth should remain healthy though on a stronger prior-year comparable.

For Intelligent Cloud, which includes GitHub, we expect revenue between $9.15 billion and $9.35 billion. In Azure, we expect healthy growth across our consumption and per-user base businesses though per-user services growth will moderate given the size of the installed base.

In More Personal Computing, we expect revenue between $12.8 billion and $13.2 billion. OEM Pro revenue growth should be in line with the commercial PC market. As a reminder, prior year comparables strengthened throughout the remainder of the year.

In Windows commercial products and cloud services, we expect continued strength, as well as the benefit of a low prior-year comparable. And for OEM non-Pro, we expect similar dynamics to Q1. In Surface, revenue growth should accelerate, with the impact of recently launched devices including Surface Pro 6 and Surface Laptop 2. Search ex-TAC results should be similar to Q1 with durable growth in rate and volume.

In gaming, we expect revenue growth to moderate due to a prior year comparable that included the launch of Xbox One X. Software and services growth should be similar to Q1, with continued benefit from a third-party title plus overall platform strength.

Now back to our company results. We expect COGS of $12.2 billion to $12.4 billion and operating expenses of $9.8 billion to $9.9 billion. Other income and expense should be approximately $50 million as interest income and investment gains are partially offset by interest expense. And finally we expect our Q2 effective tax rate to be slightly above the full year estimate of 17%.

Now a few comments on the fiscal year. First FX. Assuming current rates remain stable, we expect a 1 point headwind to full-year revenue growth with any benefit in H1 offset in H2. FX should decrease COGS and operating expense growth by approximately 1 point.

Second, operating expenses. We remain unchanged in our commitment to invest in strategic priorities that are key to driving long-term value creation. With the addition of GitHub as a strategic priority, we now expect operating expenses to grow roughly 8%. Growth excluding GitHub is expected to be in line with our prior guidance of roughly 7%.

Third, on operating margin. Even with the full GAAP impact of GitHub purchase accounting now included in our guidance, we continue to expect our operating margin to be up slightly year-over-year. Margin leverage is a direct result of our focused investments in the right technology trends coupled with consistent execution.

For CapEx, we continue to expect the growth rate for the year to moderate even as we meet demand for our cloud services. Regarding the GitHub acquisition, we remain committed to an incremental share buyback beyond the normal quarterly pace, though it's expected to fully offset stock consideration issue in the transaction by the end of the fiscal year. And finally, we continue to expect the full year effective tax rate to be roughly 17% with quarterly variability.

And with that, Mike, let's go to Q&A.

[0JNPYG-E Michael Spencer]

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

Q&A

Operator

Thank you. Our first question is coming from the line of Heather Bellini with Goldman Sachs. Please proceed with your question.

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you very much for the question. Amy and Satya, if I look at your Intelligent Cloud segment, and in particular the server products and cloud services, those continue to defy gravity a little bit here. And I'm just wondering if you could just give us a sense of how much may be the pricing changes that went into effect at the beginning of the quarter that you're in now might have helped drive spending last quarter ahead of them going into effect. But also, can you share with us how the Azure Hybrid Benefit message might also be impacting Azure growth rates? Thank you.

A - Satya Nadella {BIO 3224315 <GO>}

Sure. Thanks Heather for the question. I'll start and then Amy you can add. I mean, I think what you're fundamentally seeing in that overall KPI is what I think are two major advantages we have. One is an architectural technology advantage around hybrid, right. So we don't think of hybrid as some stopgap as a move to the cloud. We think about it's the coming together of distributed computing where the cloud and the edge work together for not just the old workloads, but most importantly for new workloads. And that's where we are seeing some very significant good feedback loops and shaping even our future road map. And this is a place where we are leading.

The second thing, as you pointed out in your question, is we have a business model advantage. The Azure benefits are things both for Windows Server as well as for SQL which I think are very, very unique to us and you see that. So the combination of the technology advantage and the business model advantage is what I see in the results, whether it's the standalone Azure growth, which is what we expected and it's very strong and the server KPI is even stronger. So I think that's at least how I would answer that question.

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

And to your specific question, Heather, on the impact of some of the price increases that went into effect in Q2, I'd say it's a couple of points. So I would not sort of over-rotate on that topic. The overall number, even if you take a couple points off that 28% is a very good performance, that I believe to Satya's point, is the impact you've seen of the very aligned technology road map on the architecture plus a business model that matches it.

Q - Heather Bellini {BIO 2268229 <GO>}

Great. Thank you very much.

A - Michael Spencer {BIO 20838577 <GO>}

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

Operator

Thank you. The next question is coming from the line of Keith Weiss with Morgan Stanley. Please proceed with your question.

Q - Keith Eric Weiss {BIO 6993337 <GO>}

Excellent. Thank you for taking the question and very nice quarter guys. I wanted to dig into capital efficiency here around your cloud assets a little bit. This quarter you talked about Azure gross margins coming in, sort of continuing to improve really nicely. CapEx came in. I mean the growth there is slowing a little bit. Can you talk to us about sort of what's kind of driving that? Is it sort of the move to higher-level services so you get like better pricing against the capital? Is this sort of you're just not sort of pouring down as much cement, if you will, in terms of database expansion? Is it like better productivity of the core sort of compute stuff? Like can you help us understand sort of how capital intensity is trending in that Azure in particular but more broadly in the cloud businesses?

A - Satya Nadella {BIO 3224315 <GO>}

It's a great question, Keith. I would say the way we think about our capital efficiency and I in fact added that even to my commentary this time, which is we're building this intelligent cloud, intelligent edge platform to span everything, not only the Azure business but also the future of game streaming to what we are doing at Microsoft 365 or Dynamics 365.

For the first time, what you see across Microsoft is really one platform which spans all of these businesses and all of the margin structures that are there represented in it. So that's where if you think about the thing that Amy and I focus a lot on is the capital efficiency end-to-end in that context versus getting caught up in even the capital efficiency as measured by any one of these individual pieces, because we think that's what Microsoft's uniqueness long term lies.

But that said on Azure, you're absolutely right. What you are seeing is two things. One is things like the Azure Hybrid Benefits as well as the higher-level services that create I think uniqueness both as well as good margins long term. I mean, especially on the database side is one place where I would say from a year-over-year worth of progress, whether it's just Azure database by itself. I mean that service with full compatibility with SQL Server is a fantastic value proposition for our customers who have huge estates whether it's the Data Warehouse that's become very, very competitive, the Data Lake. And Cosmos DB I think is very unique in its capability. So that's one place where as you know, any AI project first starts with data, and that's one place where we are seeing good traction.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Keith. Operator, we'll move to the next question.

Operator

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

Q - Philip Winslow {BIO 6300579 <GO>}

Hey. Thanks, guys, for talking my question and congrats on another great quarter. I just wanted to focus in on Office. Obviously, Amy, you called out some of the positives from the price increase that's coming up. But if I look at just Office 365 both commercial and consumer, just continued just strong growth on both those two. And especially on the commercial side, there's still that gap between seat growth and revenue growth. So if you kind of just think where you are and I guess in terms of just sort of the life cycle here and obviously, we've got multiple SKUs, maybe just kind of give us an update of how you're sort of think about where you stand and then especially as you think about the full year here, how you sort of expect these metrics to progress?

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

Sure. And I'm actually going to expand my comments a little bit because the sales motion is really broader than Office 365. The sales motion is really about Microsoft 365. And what that encompasses is both the Office 365 value proposition, but also our management and security value proposition with EMS as well as Advanced Threat Protection and Windows value that shows up in that Windows commercial services KPI.

So the bucket of those together, what we're seeing is many of the workloads and movement to E3 within Microsoft 365 and to E5 continue to have good pull. There's great customer demand for the value that comes in security and analytics, in meetings, in voice, in collab. And I think when you look at the value, I think we feel good about the opportunity to continue to move these users including new first-line or frontline users that we've not had access before.

We got room on user growth, which you continue to see that number go up across segments. And we've got room in ARPU, which you've continued to see us have. So in many ways your question shows itself in Office, but the trends are the same if you look at EMS growth or if you were to look at that Windows commercial growth number.

A - Satya Nadella {BIO 3224315 <GO>}

And I'd just add that the seat growth as well as the ARPU growth, one of the things even in spite of the success we may have achieved in the past, we never were that successful in penetrating with all of our workloads when it comes to small business and definitely across the globe. So that's another dimension that you see play out as well.

Q - Philip Winslow {BIO 6300579 <GO>}

Awesome. Thanks.

A - Michael Spencer {BIO 20838577 <GO>}

Great. Thanks, Phil. Yeah, thanks, Phil. Operator, we'll move to the next question please.

Operator

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

Q - Raimo Lenschow {BIO 4664646 <GO>}

Hey, thanks for taking it. Satya, can you focus on gaming for a little bit? With the xCloud you kind of announced something that the whole industry have kind of been dreaming about as like the Holy Grail where you want to go eventually have it all in the cloud, delivered from the cloud and subscription service. Can you talk a little bit about the innovation that is involved in you being able to starting to deliver that now? Thank you.

A - Satya Nadella {BIO 3224315 <GO>}

Sure. But before I get to streaming, the thing that I'll say is most critical when you think about gaming is having a platform where the gamers are already there. That means you need to have a platform that has a community around it and monetize as well.

So when you see some of the KPIs and some of the strength you saw in quarter, that's the foundation of Xbox. Xbox has the key gaming community and the monetization capabilities. Whether it's first-party games or third-party games, we are best-in-class in that monetization and that's what's reflected in the results.

So given that structural position, we are going to make sure that we keep increasing the strength of the community. You see that already with Minecraft going to all platforms and that increasing the intensity of the community and you'll see us do more of that. Obviously, bringing Game Pass to even the PC is going to be a big element of that.

And then streaming is just a natural sequence of it. And the advantage we have with streaming is, we have a massive cloud advantage. And so we're going to bring obviously what we're doing with Azure, Azure networking, all to bear in ensuring that Xbox and xCloud is one of the best workloads for it.

So that's how I see it. It, of course, will increase our reach, but what I am most excited about is the core content and community and the platform we have for monetizing that usage. And that I think is really what gives us even the permission to think about streaming.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Okay. All right. Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Great. Thanks, Raimo. Operator, we'll please move to the next question, please.

Operator

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

Q - Jennifer Swanson Lowe {BIO 6926228 <GO>}

Great. Thank you. I know you mentioned GitHub is closing soon. It's obviously not closed yet. But given you've got a few months under your belt now since it was announced and an opportunity to solicit some feedback from the developer communities that maybe aren't using Microsoft technologies on a regular basis, but are very active with GitHub, do you have a sense yet of what the opportunities might be to do outreach to those developers that might be working closely with competing platforms? And how closely you can kind of hug them into the Microsoft ecosystem versus just leaving GitHub as sort of a self-sustaining entity now that you have a little bit more opportunities to discuss that with customers in the field?

A - Satya Nadella {BIO 3224315 <GO>}

Sure. First of all, thank you for the question. We're very excited about GitHub closing. And quite frankly, primarily I'm excited because for us, as I've always said, GitHub is not a means to some other end. It's an end on to its own, which is, we've always cared about developer and developer productivity and especially at a time like this when there are more developers outside of the tech industry as the world goes digital.

We think this is perhaps one of the big SaaS opportunities going forward. And so therefore that's why we want to ensure that everything we do and the number one priority for Nat and team at GitHub will be all about maintaining that GitHub community, the ethos around developers at the core.

That said, I think we will do what is necessary to make sure that our products and services that are on Azure or elsewhere, our tooling, which are already many open source projects on GitHub, we do a good job of earning that developer trust and developer adoption. But we are very grounded in the fact that it has to be earned and not something that we will inherit because of being owners of GitHub.

The second thing I'll also mention is that, to me the opportunity to win, I would say, new class of developers, we are making progress. In fact, this morning I was reading a news article in Hacker News, which is a community where we have been working hard to make sure that Azure is growing in popularity. And I was pleasantly surprised to see that we have made a lot of progress, in some sense, that at least basically said that we are neck to neck with Amazon when it comes to even elite developers as represented in that community. So we have more work to do, but we're making progress on all dimensions.

Q - Jennifer Swanson Lowe {BIO 6926228 <GO>}

Great. Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Jen. Operator, we'll move to the next question, please.

Operator

Thank you. The next question is coming from the line of Brad Zelnick with Credit Suisse. Please proceed with your question.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Thanks very much and congrats on a great start to the year. Amy, in your comments, you cited the continued benefit from a strong IT spending environment and it's very clear from your results there's a lot of Microsoft-specific success and execution happening here as well. But as you look at your pipelines and all the various signals you see in the market, do you have a view on how long the environment persists and what are the indicators that give you confidence?

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

Thanks, Brad, for the question. In general, the way I tend to look at this is the interactions we have with customers and the markets we're in and do we feel like they're expansive. And so, when I look at the businesses that we've built and the businesses we're investing in and do I feel like this needs for tech intensity that Satya talked about, that will ultimately drive the desire and need for customers to adopt technology, we're in the right places.

And that's the signal actually we hear back from customers, whether that is Microsoft 365, Dynamics 365 and a new worldview on what business processes and business applications can look like. Whether it's frankly our views on gaming that Satya just discussed, I feel like the signal we're hearing is that we're in the right part of the market with customer-focused value that can deliver a high ROI to them, no matter what that IT budget looks like. And so I think as long as we focus on providing that value, we'll feel good about our opportunity to both grow and take share in the market.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Fantastic. Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Thanks, Brad. Yeah, thanks Brad. Operator, we'll please move to next question.

Operator

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

Q - Walter H. Pritchard {BIO 4672133 <GO>}

Thanks. Amy, I'm wondering if you could talk about Azure, the outlook for the year. I know growth rate's been a bit volatile. I think you had a pretty strong Q4 including (45:02) that business. Maybe you could help us understand relative to the growth we're seeing right now how you expect the Azure trajectory to play out for the year?

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

Sure. Let me spend a couple minutes on that. We actually saw better bookings in Q1 again on Azure, as I mentioned, just like we did in Q4. And so obviously that's certainly encouraging as we look on a go-forward basis for the rest of the year. But as I think about – I tend to focus as you know on the all-up server and product KPI because the Azure hybrid benefits that exist with Windows Server and SQL Server are really valuable to customers if they want to move to Azure on their own terms, is the single best value proposition to a customer to make a commitment there.

And so, if we start to focus on one number or the other, I think we're missing the fact that our customer method and go-to-market is actually through the overall product portfolio. And so, I tend to probably as you might imagine be more confident than I was in coming out of Q4 with a strong Q1 in that overall hybrid demand and Azure signal plus good Azure bookings when I talked about my confidence in high teens growth in that KPI for the rest of the year.

Q - Walter H. Pritchard {BIO 4672133 <GO>}

Great. Thank you, Amy.

A - Michael Spencer {BIO 20838577 <GO>}

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

Operator

Thank you. Our next question is coming from the line of Mark Murphy with JPMorgan. Please proceed with your question.

Q - Mark R. Murphy {BIO 1542399 <GO>}

Thank you, and I will add my congrats. Amy, last quarter you had mentioned that you could see increased volatility in time, in commercial bookings growth as you were talking about the commitments were increasing to larger and longer-term agreements. But this quarter, the ex-free portfolio was flattish and yet your commercial bookings grew 16%. I think presumably a very powerful performance with the renewals, the expansions and the new bookings, and I don't think you repeated that comment about bookings volatility in the same way. So I'm just curious, maybe could you help us connect the dots on that performance and also the potential for volatility in either direction going forward?

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

Sure, thank you. That's a great question. You will see volatility in the bookings number for the reasons we've laid out before, the changing expiry base, but also large contracts and commitments done by Azure. And to your point, we actually saw it this quarter because we again saw a quite good performance in some of these larger long-term Azure contracts which added on a flat expiry base to that 15% bookings growth, which was good.

And so what that means is, you'll see some volatility in that and you're also going to see some volatility in commercial unearned, specifically because whenever you see hybrid strength, it won't land as much in unearned. So as the business gets bigger and we do bigger and larger deals and some of them are on-prem and some of them are in Azure, you're going to see volatility frankly in both of those.

But what I try to do is think about the impact of all the key data points which is how did we do in-quarter, how did we do on the unearned revenue on the balance sheet and how did we do in overall bookings. And if I triangulate between all those three, just like I did in Q4, I feel really good about our commercial performance.

Q - Mark R. Murphy {BIO 1542399 <GO>}

Thank you.

A - Michael Spencer {BIO 20838577 <GO>}

Great. Thanks, Mark. Operator, we'll move to the next question please.

Operator

Thank you. The next question is coming from the line of Ross MacMillan with RBC Capital Markets. Please proceed with your question.

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks so much. Maybe two for Amy. Just first on that KPI of Azure plus server products, that high teens number was obviously a lot better this quarter. But is that still the framework for the year? And then actually on Windows, we've seen such elevated strength on the Pro side, I think because of the corporate Win 10 cycle. And I wondered if you could just, as we think about the back half of the current fiscal year and we come up against some tougher comps, I wondered if you could just help us sort of think through that and how we should think about the puts and takes on that refresh cycle? Thanks.

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

Sure. On the first question on the server and product KPI, obviously the strong performance this quarter gives me higher confidence in my commitment to high teens growth in that number. But I'll update that generally longer in the quarter and will give me through Q2 before I make a longer commitment.

And then separately on Windows 10 and the strength we've seen in OEM Pro, and I would also say it mirrors in some ways you're also going to see some of that growth and strength in Windows commercial, so let me answer them a bit together. The Windows 10 Pro strength and I think commercial strength we've seen, we continue to see good signs on the commercial refresh, really security, manageability of modern hardware and software together continues to be a good signal for us.

We continue to watch the end of support. It's really critical for us for customers to have a terrific experience as we upgrade them and ask them to move to Windows 10 with a lot of value. That end of support is about five quarters away, so we'll continue to expect good signal and good demand in that Pro segment. And it should, to your point, match increasingly the market and we do get to some slightly bigger comps in H2 which I would agree with.

But I don't want to diminish the signal because the signal is demand is very good for Windows 10 and upgrades in modern hardware when they realize the benefits. And so even if you have a tougher comp, I think the demand signal and our opportunity to continue to sell Microsoft 365 in that process and then upgrade to Office 365 as they do deployments is a big opportunity for us to excel.

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks so much.

A - Michael Spencer {BIO 20838577 <GO>}

Great. Thanks, Ross. Operator, this will be our last question. We'll take it now please.

Operator

Thank you. Our final question is coming from the line of Brad Reback with Stifel. Please proceed with your question.

Q - Brad Robert Reback {BIO 3441314 <GO>}

Okay, thanks very much. Maybe one for Satya. Satya, as you think about the Dynamics business going forward, how do you weigh the potential need to do a larger acquisition there versus just organic development or small tuck-ins? Thanks.

A - Satya Nadella {BIO 3224315 <GO>}

Yeah. I mean overall, I feel very, very good about the opportunity ahead in business applications for us. And I think about the combination of both Dynamics 365 as well as what we're doing on the LinkedIn side. They all represent our participation in business applications. And the thing that I – what's happening out there in the marketplace is, as things become more digital, there is in fact more need for business process automation.

At the same time, there is a need for the application suite to be built very differently. And that's where I think we have an architectural advantage again with Dynamics 365. It's much more modular, it's modern, it's extensible with this power platform that gives us the ability to do things for customers and serve them in ways that is very differentiated. So that's our primary focus. We'll always look at opportunities outside. But in a time when there is a real fundamental shift in the category when it comes to both business models and technology, we feel we're well positioned to ride that.

Q - Brad Robert Reback {BIO 3441314 <GO>}

Great. Thanks very much.

A - [0JNPYG-E Michael Spencer]

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

A - Satya Nadella {BIO 3224315 <GO>}

Thank you all.

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

Thanks all.

A - Satya Nadella {BIO 3224315 <GO>}

Thank you.

Operator

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