Q3 2017 Earnings Call

Company Participants

- Amy E. Hood, Chief Financial Officer & Executive Vice President
- Chris Suh, General Manager-Investor Relations
- Satya Nadella, CEO & Non-Independent Director

Other Participants

- Brad Reback, Analyst
- Heather Bellini, Analyst
- Karl E. Keirstead, Analyst
- Keith Eric Weiss, Analyst
- Kirk Materne, Analyst
- Mark L. Moerdler, Analyst
- Mark R. Murphy, Analyst
- Philip Winslow, Analyst
- Ross MacMillan, Analyst
- Walter H. Pritchard, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to Microsoft's third quarter fiscal year 2017 earnings conference call. At this time, all participants are in a listen-only mode. A brief question-and-answer will follow the formal presentation. As a reminder, this conference is being recorded.

I would like to turn the call over to Chris Suh, General Manager of Investor Relations. Chris, please proceed.

Chris Suh {BIO 17955231 <GO>}

Thanks, Reyna. Good afternoon and thank you for joining us today. On the call with me today are: Satya Nadella, Chief Executive Officer; Amy Hood, Chief Financial Officer; Frank Brod, Chief Accounting Officer; and John Seethoff, Deputy General Counsel and Corporate Secretary.

On 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.

As a reminder, this is the first full quarter of LinkedIn results. As a result, comparisons made to prior years will be affected accordingly. During the call, Amy will discuss the financial impact of LinkedIn as she provides an overview of business results for the quarter. Our key investor metrics remain unchanged due to the LinkedIn acquisition.

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 third 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'll 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.

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 until April 27, 2018.

During this call, we will make 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, Chris, and thanks to everyone on the phone for joining. Today I'll share the results of the third quarter and discuss what's ahead.

I'm proud of the progress this quarter. We delivered $23.6 billion in revenue, up 7% in constant currency. Across all industries, organizations are looking to digitally transform with the state-of-the-art cloud services, AI, and new natural user interface technology. Increasingly, these organizations are turning to Microsoft as a partner they can trust for the innovation and building their own digital capability.

Now let's look at the progress we made this quarter by segment, starting with Productivity and Business Processes. We crossed a major milestone with more than 100 million monthly active users of Office 365 Commercial. Office 365 Commercial seats grew 35% year over year, and revenue is up 45% in constant currency. Across industries, customers recognize Office 365 is the productivity platform of choice, companies like H&R Block, Johnson & Johnson, and Deutsche Börse AG, LVMH, as all chose Office 365.

And we continue to innovate and add new value. This quarter we made Microsoft Teams broadly available to Office 365 customers in 181 markets. Our new chat-based workspace is already empowering a new way to work for more than 50,000 customers, including Accenture, J. Walter Thompson, J.B. Hunt, and Expedia. Teams also creates a new platform opportunity for developers to reach 100 million Office 365 users with rich extensibility for bots, apps, and services.

Additionally, we are expanding the relevance of Office 365 to new segments. Retail, hospitality and manufacturing companies have a huge need to empower their front-line employees. Our expanded offering for this segment includes Microsoft StaffHub, Teams, OneDrive, Skype for Business, and more to give these critical employees a robust collaboration toolkit to maximize their impact.

Now let me talk about the second part of our ambition in this segment, reinventing Business Process. Accelerating our growth with LinkedIn by driving value for members and customers remains our top priority. This quarter we redesigned the LinkedIn desktop to create a more seamless intuitive experience across devices. We continue to invest in the LinkedIn Feed, bringing curated news and views to help members stay informed on what's most important to them. Our innovation across both the desktop and mobile is driving strong engagement momentum, with sessions up more than 20% again this quarter.

LinkedIn marked an important milestone this week, exceeding 500 million members, and our jobs platform hit new record levels with more than 10 million jobs posted. This strong momentum with jobs and engagement is continuing to fuel the growth across talent, marketing, sales, and learning solutions.

We took significant steps this week to redefine social selling with deeper integration of Sales Navigator with Dynamics 365, enabling sales professionals to dramatically increase their effectiveness by drawing on the relationships in their personal networks. Customers like Visa are choosing Dynamics 365 because of our deep integration across Office 365 and now Sales Navigator. I'm excited to put the Microsoft enterprise sales force and partner ecosystem behind this new opportunity.

Dynamics 365 solves a critical challenge for businesses, helping them break free of monolithic siloed suites of applications to unlock insights across the entire organization. You see this in our new Dynamics 365 talent applications, which combines HR business processes with LinkedIn Recruiter to help companies manage the employee lifecycle from recruiting to retention. Our innovation in Dynamics is driving strong revenue growth, with Dynamics 365 up 82% in constant currency this quarter.

Now let's talk about the progress we are making in our Intelligent Cloud segment. Our Commercial Cloud annualized revenue run rate now exceeds $15.2 billion. Customers are increasingly choosing the Microsoft Cloud. They value our differentiated approach as the most trusted global hyperscale cloud with hybrid support and higher-level services to help drive their digital transformation. Moreover, they appreciate the agility, operational consistency, and security across the entire digital estate, spanning enterprise mobility, Office 365, Dynamics 365, and Azure.

Take Maersk, the largest transport and logistics firm in the world with operations in 130 countries and a fleet of over 1,000 vessels. Maersk began their journey to the Microsoft Cloud with Office 365, Enterprise Mobility and Security in Windows 10. They chose Dynamics 365 for operations to streamline container production and maintenance. Now Maersk is using Azure to digitally transform its supply chain management and global trade. The intelligent services in Azure deliver up-to-the-minute insights on carrier performance and equipment usage with real-time data visualization and advanced analytics, enabling them to trim costs and create new revenue streams. For a company that ships 17 million containers annually, the ability to react quickly can mean the difference of tens of millions of dollars to the bottom line. This is a great example of our three clouds coming together to enable deep digital transformation.

Across industries, customers are choosing Azure. UBS announced they're using Azure for risk management, and GEICO chose Azure for hybrid capabilities. Publicis Groupe announced that they will use Azure and Cortana Intelligence Suite to deliver AI-powered marketing solutions at scale. Flipkart, India's this leading online marketplace, chose Azure as the platform to enable their rapid growth.

We continue to rapidly innovate and add new capability to drive further customer value. Microsoft IoT Central is the first SaaS offering that provides the end-to-end solution for organizations of all sizes to manage their entire IoT ecosystem across devices, cloud, analytics, networks, and software. This week at Hannover Messe, the world's largest industrial trade show, manufacturers showcased how they're using our solutions to transform all aspects of manufacturing, from water management to food and beverage packaging, to improving safety on the factory floor. When it comes to AI, this quarter we made our cognitive services for face recognition and computer vision broadly available to enable any developer to become an AI developer.

We're excited about how Azure Stack and SQL Server are helping define the edge computing paradigm. Azure Stack will enable customers to extend Azure capability to their private data center in a truly consistent hybrid computing environment. SQL Server 2017, coming this fall, is the first database with cloud tiering and artificial intelligence built in. It runs on Windows and Linux, supports docker container deployment and popular programming languages such as R and Python for machine learning and data science. We will share more about all these advances and more at our upcoming Build Developer Conference.

Now I'll turn to our progress in More Personal Computing. Almost two years ago we introduced a new approach with Windows 10, transforming the way customers experience Windows on all their devices. Now customers are always up to date running the most

secure Windows ever. This quarter, the Windows business grew 5% in constant currency, and we delivered the next phase of innovation with the Creators Update.

Creators Update is about inspiring the creator in us all. We create technology so that others can create their own content and technology. We want to empower people to paint in 3D or paint with numbers in Excel. We empower people to create in Word or in Minecraft. These new forms of creation and expression are shaping Windows for the next generation.

Gaming is a key scenario to expand our opportunity across the PC and console. We are building on our already strong foundation with Xbox One and our Xbox Live community, up 13% to 52 million active users this quarter. With Creators Update, we integrated gameplay broadcasting into Windows 10 PCs as well as Xbox One. We're off to a very strong start with both streamers and viewers. In fact, the majority of the streaming in this industry today is on the PC and console, and we are uniquely positioned to provide the best, most complete gaming experience, from hardware to software to broadcast services. It's early days and we are excited to pursue this new growing opportunity. This quarter, we also revealed more about our forthcoming Project Scorpio, which will be the most powerful console ever and will enable true 4K gaming in the living room.

Our commercial customers continue to adopt Windows 10 as the secure trusted platform of choice. Customers like the Department of Education in the United Kingdom, British Telecommunications, the Adventist Health System, one of the largest healthcare providers in the United States, all chose Windows 10.

When I talk to businesses and government leaders, they value security and privacy of their data, the reliability of their systems, and choice and control over how and when they deploy. We remain committed to our core values of trust, transparency, privacy, and security for every customer.

Finally, devices; this quarter our Surface results fell short of expectations, impacted by end of product lifecycle and increased price competition. We continue to innovate and invest in creating new computers and computing experiences. Surface Pro, Book, Hub, Studio, HoloLens are all creating new markets for the Windows ecosystem and pushing differentiation with new natural user-interface capabilities, ink, vision, voice, touch, and mixed reality.

In the context of mixed reality, we just passed the one-year anniversary of Microsoft HoloLens. We now have more than 150 exclusive HoloLens apps in the store. Moreover, many of our commercial customers are using HoloLens to drive digital transformation and seeing real impact. HoloLens-based innovation was featured front and center at NRF, HIMSS, and most recently this week at Hannover.

Digital transformation across these industries is being shaped by new technologies, from IoT to mixed reality to AI and the cloud. thyssenkrupp Elevator is using HoloLens and Azure to digitize their entire sales and order process, shortening delivery times by four times, and they chose Dynamics 365 to enable transformation in their Steel division.

Leading global medical technology company Stryker chose Office 365 to empower employees and is using HoloLens to improve operating room designs for surgeons, staff, and ultimately the patients. All this creates a strong foundation for the broader opportunity ahead with digital transformation.

I'm proud of the progress this quarter. I'm enthusiastic about what's to come. In the coming weeks, we will share more about how Microsoft is innovating uniquely to empower every customer, from students and teachers to business professionals to developers.

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

Amy E. Hood {BIO 18040963 <GO>}

Thank you, Satya, and good afternoon, everyone.

Our third quarter revenue was $23.6 billion, up 6% and 7% in constant currency; gross margin grew 7% and 9% in constant currency; operating income grew 2% or 5% in constant currency; and earnings per share was $0.73, an increase of 16% and 19% in constant currency.

This was the first full quarter of company results of LinkedIn, which had a significant impact on revenue, gross margin, and operating income. At a company level, LinkedIn contributed approximately 4 points of revenue and gross margin growth and 6 points of drag on operating income growth, which includes $371 million from amortization of acquired intangibles.

From a geographic perspective, our results were mostly in line with macroeconomic trends. Our performance in Japan was better than expected, driven by increased public sector spending and improved market conditions.

Our commercial annuity mix was 88%, even with another quarter of higher than expected transactional revenue results. Commercial bookings increased 12% or 11% in constant currency. Commercial unearned revenue followed historical seasonal trends, coming in at $20.4 billion and growing 9% and 10% in constant currency. And our contracted-not-billed balance increased to more than $27.5 billion.

Another strong quarter of cloud services performance drove our commercial cloud revenue run rate over $15.2 billion, growing 52%. Our commercial cloud gross margin percentage increased to 51%, up 6 points from last year, with improvement across Office 365, Azure, and Dynamics. And gross margin dollars grew 74%, keeping us on pace for material gross margin percentage and dollar improvement this fiscal year. As a reminder, our commercial cloud includes Office 365, Azure, Dynamics 365, and other cloud properties, but does not include LinkedIn.

Our company gross margin was 66%, better than anticipated and up 1 point, as the sales mix of higher-margin product and services coupled with commercial cloud margin improvement more than offset the impact of $218 million of LinkedIn amortization.

Now to FX. This quarter, the U.S. dollar was weaker than expected. As such, we had 1 point less FX impact across our individual reporting segments, even though overall company impact was still approximately 1 point as guided. FX impacted the Productivity and Business Processes and Intelligent Cloud segments by 1 point and had minimal impact in More Personal Computing.

Total operating expenses grew 12%, with LinkedIn contributing 13 points of growth, including $153 million of amortization of acquired intangibles expense.

Now, let's move to the segment results. Revenue from Productivity and Business Processes segment grew 22% and 23% in constant currency to $8 billion, with LinkedIn contributing 15 points of growth. Office commercial revenue increased 7% and 8% in constant currency. Office 365 commercial revenue increased 45%, driven by installed base growth across all workloads and continued ARPU expansion. Our transactional results came in higher than expected, mostly from performance in large markets like Japan and Western Europe.

Office consumer revenue increased 15% and 14% in constant currency, primarily from recurring subscription revenue as well as growth in our subscriber base.

Our Dynamics business grew 10% and 11% in constant currency, with Dynamics 365 customer momentum contributing to double-digit billings growth.

LinkedIn revenue for the quarter was $975 million.

Segment gross margin dollars grew 15% and 17% in constant currency, with 11 points of contribution from LinkedIn, including $218 million of amortization of acquired intangibles. Gross margin percentage declined due to a higher mix of cloud revenue and the impact of LinkedIn-related amortization.

Operating expenses increased 44% and 45% in constant currency, with 43 points from LinkedIn, including $153 million of amortization expense. Operating income declined 7% and 4% in constant currency, with 13 points of impact from LinkedIn.

The Intelligent Cloud segment delivered approximately $6.8 billion in revenue, growing 11% and 12% in constant currency. Server products and cloud services revenue increased 15%, up 16% in constant currency, demonstrating durable double-digit growth. Azure revenue increased 93%, up 94% in constant currency, and annuity revenue again grew double digits. Azure premium revenue grew triple digits for the 11th consecutive quarter, with more than 80% of Azure customers using our premium services.

Our Windows Server and SQL Server transactional business continued to perform well; with better than expected results mainly from Japan and continuing post-launch demand. As expected, Enterprise Services revenue declined 1% and was flat in constant currency due to a lower volume of Windows Server 2003 custom support agreements.

Segment gross margin dollars grew 6% and 7% in constant currency, and segment gross margin percentage declined due to an increasing cloud revenue mix and lower Enterprise Services margins, partially offset by material improvement in Azure margins. We grew operating expenses by 11%, with ongoing investment in sales capacity, cloud engineering, and developer engagement. Operating income was flat and up 3% in constant currency.

Now to More Personal Computing, revenue was $8.8 billion, declining 7%, as Phone and Surface results offset healthy growth in Windows, search, and gaming. Our OEM business grew 5% this quarter. OEM Pro revenue grew 10%, ahead of the commercial PC market, mainly due to a higher mix of premium SKUs. Additionally, the commercial PC market was slightly below our expectations, negatively impacted by channel production timing changes and upcoming Windows SKU pricing changes. Commercial end customer demand signals remain consistent and positive.

OEM non-Pro revenue declined 1%, ahead of the consumer PC market, with continued positive impact from the Windows Premium device category. Overall, inventory levels remain in the normal range.

Windows Commercial products and services grew 6%, with healthy enterprise demand as customers continued to deploy Windows 10 for its advanced security and management capabilities. Patent licensing declined this quarter, primarily from lower revenue per unit. Search revenue ex-TAC grew 8% and 9% in constant currency, driven by higher revenue per search and search volume.

Devices revenue declined 51%. We had no material Phone revenue this quarter. Our Surface business declined 26% and 25% in constant currency, as heightened price competition and product end-of-lifecycle dynamics resulted in lower than expected Surface Pro unit volumes.

Our gaming business grew 4% and 6% in constant currency, as Xbox Live revenue growth offset declines in hardware. Xbox Live monthly active users grew 13% across Xbox One, Windows 10, and mobile platforms, which contributed to software and services revenue growth of 7% and 8% in constant currency.

Segment gross margin dollars were flat, up 2% in constant currency. Gross margin percentage increased with the sales shift to higher-margin products and services. Operating expenses declined 11% and 10% in constant currency from lower Phone expense and Surface launch-related marketing spend in the prior year. Operating income grew 20% in 23% in constant currency.

Now back to overall company results, we invested approximately $2.1 billion in capital expenditures, including capital leases, less than we expected, as a portion of the expense

will move into Q4. Other income and expense was $322 million, greater than originally planned, as we saw more opportunities in the equity market to realize gains during the quarter.

Our non-GAAP effective tax rate was approximately 23%.

We returned $4.6 billion to shareholders, continuing our balanced approach to capital allocation through share repurchase and dividends. After a period of accelerated buyback, we've resumed a buyback pace consistent with our historical trends.

Now let's turn to the outlook, first FX. Given current rates, we now expect less FX headwinds in our fourth quarter. We expect about 1 point of negative impact on total revenue. Within the segments, we anticipate about 2 points of negative impact in Productivity and Business Processes and Intelligent Cloud and 1 point in More Personal Computing.

Second, our commercial business, the fourth quarter is an important one for our commercial business, and we expect continued annuity growth and healthy renewals as customers adopt and use our growing portfolio of Commercial Cloud services. We expect unearned revenue between $26.8 billion and $27 billion, in line with historical seasonality.

Additionally, we have a large expiry base in the fourth quarter, and our sales execution on renewals and upsell opportunities, while contemplated in our unearned revenue guidance, should also show up in a larger contracted-not-billed balance and commercial bookings growth.

Third, capital expenditure, we expect CapEx to grow sequentially and year over year. Quarterly spend variability will continue, and we remain on track for our full-year capital expenditure year-over-year growth curve to slow.

Let's move to the individual segments. In Productivity and Business Processes, we expect revenue of $8.2 billion to $8.4 billion, driven by the ongoing annuity shift to cloud and Commercial Office 365. In Office consumer, we expect growth rates to moderate from prior quarters, which were impacted by prior-year comparables. We expect consistent growth from Dynamics and approximately $1.05 billion of revenue from LinkedIn, adjusted for the impact of purchase accounting. Similar to Q3, we anticipate that LinkedIn, excluding amortization, will have minimal impact on segment operating income, and we continue to expect it to be minimally dilutive to non-GAAP EPS this fiscal year.

In Intelligent Cloud, we expect $7.2 billion to $7.4 billion in revenue. Performance trends from Q3 should continue into Q4, with annuity strength and double-digit revenue growth across our server products and cloud services. Enterprise Services should decline with lower volumes of Windows Server 2003 custom support agreements.

In More Personal Computing, we expect revenue of $8.4 billion to $8.7 billion. In our OEM business, we anticipate that revenue growth will be more aligned with the overall PC

market. OEM Pro growth will continue to be driven by Windows 10 Enterprise momentum and aligned to a commercial PC market that should return to typical seasonality. Our non-Pro revenue is expected to be above the consumer PC market, with continued benefit from a strong mix of premium devices.

In search, we expect Bing's revenue growth ex-TAC to be similar to Q3.

In gaming, we expect to see continued healthy user engagement on our Xbox platform, and we look forward to E3 in June, where we will share more on Project Scorpio and new titles for next fiscal year.

And in devices, we expect revenue to decline with negligible revenue from Phone. With Surface, we expect a more moderate rate of decline given the prior-year comparable and current market dynamics. We expect COGS of $8.2 billion to $8.3 billion. This includes approximately $420 million of LinkedIn COGS, of which $220 million is related to amortization. We expect operating expenses of $9.1 billion to $9.2 billion, with roughly $1 billion from LinkedIn, of which $150 million is related to amortization.

We now expect full-year operating expenses between $32.9 billion and $33 billion, with approximately $2.3 billion from LinkedIn. That includes about $360 million of amortization expense.

Other income and expense should be about $150 million. And for tax, we expect the full fiscal year non-GAAP effective tax rate to be approximately 21% plus or minus 1 point.

Finally, we encourage you to watch a few upcoming events, our Education event on May 2, our Dynamics 365 event on May 3, and the upcoming keynote from Bill to learn more about our ambitious plans leading into FY 2018. We will also host our financial analyst briefing on May 10. The webcast will be available our Investor Relations website.

Chris, let's move to Q&A.

Chris Suh {BIO 17955231 <GO>}

Thanks, Amy. We'll now move to the Q&A portion of today's call. Operator, can you please repeat the instructions?

Q&A

Operator

Thank you. Our first question comes from line of Keith Weiss from Morgan Stanley. Please proceed.

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

Excellent, thank you very much for taking the question and a very nice quarter. I wanted to dig into Azure a little bit. You gave us some really interesting statistics about gross margins going up, premium mix going up. One of the concerns I hear a lot from investors is what happens when we get these price cuts that go back and forth between you guys and AWS? It doesn't seem like the price cuts this quarter really affected you guys. So I was hoping you could shed some light on how – to what degree do those price cuts actually affect you.

And then on the flip side, where does all that growth come from? Where do you get that tripling of premium growth from what kind of workflows are coming on board to actually drive the underlying growth in that business?

A - Satya Nadella {BIO 3224315 <GO>}

Sure, thanks for the question, Keith. Let me start and then, Amy, if you want, you can add. Again, Keith, when we look at either the capital expense or the technical architecture, and the general approach we take is about all of our cloud. When you look at what we're trying to get done between Azure, we don't really see these themes across Azure or 365, Dynamics 365, and also the things that we're doing with Xbox Live, for example, all billed as one cloud infrastructure and a set of rich services in the cloud.

So for example, some of the cognitive capabilities that are there in Azure first come because of our first-party AI investments, whether it's been speech or vision or anything else. Even the infrastructure that is there in Azure came out of some of our first-party investments in Office 365 or again Bing in other areas. So we have an approach which takes all of our cloud pieces together.

And that same thing is reflected even in the customer journeys. I think the Maersk example I walked you through is probably a good one, where it may start with some commodity workload on Azure or it may start with Office 365, but then it will end up with HoloLens and someone using Dynamics 365 for increased automation. In the case of Maersk, they were using field service and operations inside of Dynamics 365.

So to me, those high-level services will over time attach in Azure, but also in Dynamics as well as in Office 365. So to me, that's why Azure is pretty strategic for us, not just for the attachment of high-level services in what is defined as Azure, but the all-up digital transformation opportunity. That's how Amy and I even think about our margin structure. We need to improve in each one of the elements, but all-up we need to improve because we think that increased opportunity is what's unique about our approach.

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

And I think what you're hearing in that answer from Satya, Keith, is really about whether the premium services exist as you heard at the Azure layer, or whether they show themselves in our Productivity and Business Processes segment.

The fact that you may see competition where there may be less differentiation, the real differentiation is where you've always been able to achieve margin and margin expansion,

which is in the completeness of the solution or its delivery, the completeness of the business process change or not. And so I think while I do understand that people will ask a lot about that price competition at the lower level, I think what you're seeing is because we're able to continue to move people up the stack, including all the way up to the business process layer, I think you'll continue to see us be confident in our ability to move and create margin and growth.

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

Outstanding, thank you very much.

A - Chris Suh {BIO 17955231 <GO>}

Thanks, Keith. We'll go to the next question, please.

Operator

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

Q - Karl E. Keirstead {BIO 1542979 <GO>}

Hi, thanks. I've got a follow-up, actually, on Azure, maybe to you, Satya, and it's the interplay between the cloud piece Azure and mostly the on-prem piece, what you guys call the server product. Most of your peers obviously, when they're pivoting to the cloud, are seeing weakness on the on-prem side. But what's unique about Microsoft is not only is Azure growth accelerating, but your server product growth at 7% is up meaningfully year over year as well, so we're not seeing that trade-off with Microsoft. I suspect part of the explanation is that a lot of the Azure growth is net new, but I'm just curious. When do you think customers will actually start migrating existing on-prem Microsoft workloads into Azure such that that server product line might start to decelerate? Do you think there's a prospect of that occurring in fiscal 2018? Thank you.

A - Satya Nadella {BIO 3224315 <GO>}

Yeah. The timeframes of these migrations and so on are a lot more complicated than they perhaps appear on the surface. So here's what we think of. For example, right when everyone's talking about the cloud, the most interesting part is the edge of the cloud. Whether it's IoT, whether it's the auto industry, whether it's what's happening in retail, essentially compute is going where the data gets generated, and increasingly data is getting generated at the volumes in which it's drawing compute to it, which is the edge.

So if you look even at our announcements over this quarter, a lot of what we have done with IoT is create an IoT edge. Of course, we have an amazing cloud with the SaaS services for IoT, but the edge compute, the ability to run a neural network at the edge, do inferences at the edge is exciting. Azure Stack is going to completely change what hybrid is and the expectations customers have with hybrid. I mean, GEICO example is a good one.

What's happening with SQL Server, SQL Server is no longer just about a database that's on-premise. It's a database that's on-premise that can be tiered with the cloud. A single table can be extended to the cloud. The queries will work across both the tiering. And so to me, the innovative work we're doing is what I would characterize as the future of true distributed computing, which is it will remain distributed. And that's what we are building towards. We'll talk a lot more and build on that about that architecture and what we're seeing with customers.

Then given that what you are saying is true, which is there will be some which will be lift and shift of workloads, but then there is lift, shift, and modernizing of workloads. And in that modernizing phase, it's not just being modernized to live only in what is called a cloud, but it will also be modernized to live in the edge of the cloud. And so that's the transformation at play. That's a multiyear and a generational transformation. Quarter to quarter, there will be all kinds of volatility. But what is clear to me and clear to Microsoft's engineers is that we have a very clear world view of what is it that we want to get done, and we stay focused on it.

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

And I think, Karl, to your question about how that shows up, it's why you hear us focus more on the all-up KPI between Azure and this transactional or on-premise number, because the line between them, both strategically and literally, is more important to be blurred and going in that direction. And so this quarter, you saw a little bit healthier than we had thought, I pointed out. It tends to be – in this instance, Japan was a little better. It can be product-launch related. It can be macro-impacted. But whether or not you see that in transactional, the Uber trend of being able to see it through the all-up KPI, the dynamic Satya has talked about, you're going to hear us talk more and more about, whether it's a quote-unquote, on-prem server launch or an Azure feature, about the integration of the two.

Q - Karl E. Keirstead {BIO 1542979 <GO>}

Perfect, thank you.

A - Chris Suh {BIO 17955231 <GO>}

Thank you, Karl. We'll go to the next question, please.

Operator

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

Q - Heather Bellini {BIO 2268229 <GO>}

Great, thank you. Again, I had a follow-up on Azure as well. I was just wondering, Satya, if you could share with us – and I know I've asked this in the past – but just any qualitative commentary you could give us about PaaS adoption. And I'm also wondering in particular, given the high percentage of workloads on Azure running Linux, what type of

services are you typically seeing run on top of the OS? And how do you see your monetization of those workloads playing out over time?

And then, Amy, just the follow-up for you would just be – and I apologize, we had another earnings call tonight, so I might have missed it – but you usually give a comment about out-year OpEx on the call, and I was just wondering if you had any high-level thoughts there. Sorry, thank you.

A - Satya Nadella {BIO 3224315 <GO>}

Sure, Heather, thanks for the question. Overall qualitatively, in terms of PaaS adoption of Azure, a lot of it comes with what's happening, for example, in the services we talk about, like IoT. We now have a much higher-level managed service. We even launched a new packaging of it with the IoT Central, which allows developers who are building IoT solutions, instead of assembling it themselves to be able to use this managed service to be that much more agile and productive. So that's usually the way we make the atomic parts available as well as these essentially SaaS services or PaaS services.

Same thing with data, the DocumentDB is a massive thing for us. It's the planet-scale database that supports JSON and much more, and we see that as a core part of the data tier for many, many applications. We even see, obviously, the end-user parts of the infrastructure when it comes to enterprise mobility. So all-up, we have multiple pieces.

The other areas, course, the entire toolchain of what's happening with Visual Studio to continuous integration, to continuous deployment, and that's a place where we have a very, very differentiated solution for developers and developer productivity, which in some sense you can think of as like the Office 365 for developers. But that's all part of Azure. So those are the places where there are PaaS services.

But as I said earlier in response to the question, we also welcome the use of, I'll say, the most atomic building blocks of Azure, whether it just be a Linux container, Azure functions, which is very cost-efficient for developers, because we know that over time, it may be not just PaaS services in Azure, it could be in fact a Dynamics 365 module. The canonical example for me is someone who collects data, does a prediction, ultimately then has to do something about that prediction, which means some automation like field service. So a lot of what is Dynamics field service is actually in our module growth we are seeing because of Azure IoT, and that relationship is not just about Azure PaaS.

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

And to your specific question, Heather, on FY 2018 and OpEx, I did not because we're going to see each other and have more time on May 10 at the analyst briefing, and that's where I'll take some more time to walk through FY 2018.

Q - Heather Bellini {BIO 2268229 <GO>}

Thank you.

A - Chris Suh {BIO 17955231 <GO>}

Thank you, Heather. We'll go to the next question, please.

Operator

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

Q - Mark L. Moerdler {BIO 16855032 <GO>}

Thank you, excellent, two questions. What were the drivers of the big growth in Dynamics 365? Is this large seasonality specifically in this quarter? Is it a big deal, or should we expect growth in the same vicinity for the near future?

And then as a second question, as discussed in, one of the previous questions about Server & Tools and the healthiness of that growth, I'm trying to understand the drivers. Is this the product refresh cycle? Is it Azure driving customer upgrades? Is it something else? Can you give a bit more color? That would be helpful. I appreciate it.

A - Satya Nadella {BIO 3224315 <GO>}

Sure, Mark, and let me start and then Amy, you can add. On the Dynamics 365, we're at the very, very beginning phase of the transition of Dynamics from primarily being on-premise to now being a very modern modular SaaS service. The Dynamics 365 momentum is picking up. I talked about the revenue growth rate, and that's definitely going to be what's going to be true in the quarters to come and the years to come.

But we do have a huge on-premise base. There is still a need for those on-premise products. That will continue, but our focus is on transitioning to the cloud. And you've seen us do this successfully with Office 365. You've seen us do that with Azure. And now we're ready to do that mainstream across what has been traditionally known as CRM and ERP without in fact us thinking and talking about those suites because we think that is a pretty old concept to have suites like that, which is we have now really made the entire Dynamics 365 much more modular, modern, and much more efficient for customers. So that's what's happening in Dynamics.

Same thing on Azure, which is – the driver is – a lot of it is net new. IoT, for example, was not a workload on the old server world, whereas it's one of the big workloads for us. Same thing with AI, not an old workload. So there's new growth in Azure. There is the lift, shift, and modernize motion as well, as well as a new need for the edge of the cloud. So all three of them are in play, while recognizing we had a large business called the Server Licensing business. So we have three new things that we're driving and a lot of large licensing pieces that are just transitioning into these three motions.

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

And in particular, in this quarter, how to think about I think some of the in-period outperformance versus what we see consistently, in the bucket of consistently, premium

workload growth has been consistent for us. The double-digit annuity growth has been consistent for us, and that I think is a driver we continue to look for and be confident in its execution quarter to quarter.

In the more temporal bucket this quarter as well as last you saw a bit of it, some geo help in certain geos that may see and be more transactional in nature. Japan happens to be one of those geos. And then we are still seeing some post-launch impact, specifically on the Windows Server side and selling higher-end SKUs post-launch, which has to do with some of the value inherent. So that's how I break down the drivers, Mark.

Q - Mark L. Moerdler {BIO 16855032 <GO>}

Excellent, I appreciate it. Thank you and congrats.

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

Thanks.

A - Chris Suh {BIO 17955231 <GO>}

Thank you, Mark. We'll take the next question.

Operator

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

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

Hi, thanks, two things, Amy. I think you mentioned in the script that Windows – there was some Windows volatility around some new SKU pricing. Could you go into some detail there?

And then secondarily – I know we may get this at Analyst Day, but around ASC 606, I knew you're going to adopt that early, and I think that will change to some degree your annuity revenue. I wondered if you could give us any color, even directionally, on what percentage of that annuity revenue is licensed that after ASC 606 will go up front.

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

Great. On ASC 606, we will talk about it in detail actually on May 10 in terms of the timing and what you can expect. You will also note in the 10-Q this quarter, we do give a look at the initial impact on an annual basis, using last year as an example.

The biggest difference on an annual basis with the adoption of ASC 606 will really just be the change from Windows OEM. Now what we will talk about in more detail is that the quarter-to-quarter results in any given year will be a little bit more volatile. But over any annual period, the biggest difference will really just be the change in some ways back to how we thought about OEM revenue. So that's what I would think of on ASC 606.

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

And then a question on...

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

Windows, I'm sorry. I answered them in the opposite order. And on the Windows pricing, which we talked about, we do and always have worked with Windows SKUs as we release new products and add new value. This quarter, we had a bit of a mix shift to a higher-end SKU. And starting in April, we've introduced other SKUs that have more value in them at lower processing specs. And so what you'll continue to see is that would normalize. Even though we saw some high-end SKUs this quarter do well, I would expect in Q4 to have the normal breadth of those SKUs and revert back to looking much more like the commercial PC market itself.

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

Great, thank you.

A - Chris Suh {BIO 17955231 <GO>}

Thank you, Walter. We'll go to the next question, please.

Operator

Our next question comes from the line of Brad Reback with Stifel. Please proceed.

Q - Brad Reback {BIO 3441314 <GO>}

Great, so two quick questions. First off, Amy, there's been a lot of talk about tax law changes on the corporate side. Would a repatriation holiday impact how you guys allocate capital back to shareholders?

And then just real quickly, on the OpEx side, I know you don't want to get too specific, but over the last few years you've been able to effectively reallocate upwards of $2 billion from the Phone business elsewhere. Is there still a fair amount of ability to reallocate internally? Thanks.

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

Great, let me take both of those. Let me separate your first question because I think you're really asking two that I probably don't relate as directly, and I should do that for you. We've been a longtime advocate of structural tax reform, and so we'll just wait and see how things play out. And as decisions get made and proposals clarified, we'll share more about what that means for us.

Next, in terms of how we thought about that impacting capital return, as you know, I think we've been and executed a significant capital return program over the past couple years, including accelerating the buyback program that I think I feel very good about at the corporate level in terms of the value it's created. And so I wouldn't say that I view those

two things as waiting for one to do the other. We've in fact continued to do what we thought created the most value for shareholders, which is to invest in ourselves, acquire companies that help us expand our TAM and grow, return dividends, as well as repurchase shares. And we've continued to do that this quarter as well. I think you'll continue to see us take a balanced approach, but I don't think of those as being related.

The last question on OpEx, I think over the past couple of years, we've continued to make decisions that said every dollar we spend, are we putting it in the right place for the long term, whether that's reallocating or adding new. And what we expect is to grow new markets and perform really well in them with every dollar that we invest, whether, frankly, Brad, it's in OpEx or in COGS. At this point, both of those are very large buckets of investments, which Satya and I as well as the whole senior leadership team spend the majority of our time picking markets and making sure we execute in them.

So in terms of our ability to continue to do that, of course there are opportunities. We learn, frankly, I think every week where we can do better and where we can continue to invest to accelerate. That being said, I don't view any OpEx number as a constraint. More I view, is the return healthy? Is it growing the top line? Are we executing well on it? And if we are, it will make sense to spend more and if we aren't, it won't. And so I tend to take that approach as opposed to solving for any one number.

Q - Brad Reback {BIO 3441314 <GO>}

Great, thanks very much.

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

Thanks.

A - Chris Suh {BIO 17955231 <GO>}

Thank you, Brad. We'll take the next question.

Operator

Our next question comes from the line of Kirk Materne with Evercore ISI. Please proceed.

Q - Kirk Materne {BIO 5771115 <GO>}

Thanks very much and congrats on the quarter. Amy, I want to follow up on your last point around investment and return on it. Around this time last year, you guys started spending a lot more or investing a lot more in OpEx on the Intelligent Cloud side in particular. This quarter, you saw Intelligent Cloud operating profit on a constant currency basis get back to growth again, which I think shows that those investments indeed made some sense.

Now that you have spent a lot, you've obviously added a lot in sales and marketing resources, R&D resources on that front. Could you just give us I guess qualitatively how you're thinking about that? It seemed like last year, you needed to catch up to a certain degree in terms of go-to-market capabilities. Do you feel better I guess where you are

today versus your position, say, a year ago, just in terms of being able to capture the opportunity on the Intelligent Cloud side? Thanks.

A - Satya Nadella {BIO 3224315 <GO>}

I'll start and then I'll transition to you, Amy. I don't view it that narrowly quarter to quarter or even year to year. These are generational opportunities that what's at play when it comes to the Intelligent Cloud or what's happening in augmented reality. Either one of those things, I think if we started viewing it quarter to quarter or year to year, we'll completely miss the trend. We definitely need to be smart about two things that Amy said before, which is pick markets that are secular growth markets and got big TAM. And most importantly, what's our role in it? Is this something that the world needs Microsoft to be doing, or is it well served by others? That's where we spend most of our cycles in.

The fact that we put some salespeople and then there's increased productivity is something that we obviously celebrate and we track very closely. But the places where we are more likely to go and put our OpEx in the coming quarters, in the coming years are going to be about revenue that's going to show up for multiple years out. And it won't be very transparent to you, and that's how it is. If we had not gotten started on some of the distributed computing infrastructure in a completely different place, we wouldn't have even had Azure. But I completely understand that all of you measure us to what we have done for you lately. And that's a fine way and we'll keep account of it, but that's not how it works.

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

I think the important part in what Satya says is the distinction between really engineering investments that take multiple years of investment and world view on a TAM and holding ourselves accountable to sales and marketing investments. And are they earning the right return? Are we doing them in the right way? Are they in the might market? Are we investing in the right types of people, in the right capabilities?

What I look and say that this number shows is that we are doing and it is encouraging that the plan that we put in place, that the sales team has done a really terrific job of executing on. And all that does is build more confidence that both we've picked a good market and we're investing in the right type of people to make sure we land that opportunity at customers. And then the most important thing is that the customers' success is what will breed revenue for the next quarter, the next year. And especially in this market, a generational move here really means, especially for many of the workloads being moved, these pay off every year for the next 10.

A - Chris Suh {BIO 17955231 <GO>}

Great, thank you, Kirk. We'll go to the next question, please.

Operator

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

Q - Mark R. Murphy {BIO 18840231 <GO>}

Yes, thank you very much. Satya, I'm curious, how is the pace of the conversations around Internet of Things, machine learning, and cognitive services? And also, what are you seeing as the killer app types of use cases that could resonate with customers in terms of the more mainstream applicability?

And also, Amy, just given the strength in commercial bookings and also commercial bookings guidance, macroeconomically do you see any signs of enterprise budgets opening up somewhat or different activity levels, more receptivity to transformative projects? I'm just trying to understand maybe how we can separate out your company-specific momentum against any conceivable incremental macro tailwind.

A - Satya Nadella {BIO 3224315 <GO>}

That's great, so let me start. The best way to think about how people are using, whether it's Azure or Dynamics 365 or other capabilities we have, is in the context of that digital transformation and the outcome. So when you say killer apps, the killer apps are how are customers able to reimagine how they think about customer engagement, how they think about employee empowerment or the operational efficiency, or how they can change the products and the business models and the products.

And if you look at even the examples I used in this quarterly earnings call, Maersk and what they are trying to do across all of those is pretty transformative. There is machine learning in AI. There is IoT. There is new type of business process automation with operations. All of that is transforming Maersk. What thyssenkrupp has done in their Elevator business and other business units by using anything from HoloLens to a front-line worker to how they're fundamentally moving their business model from essentially the margin on the thing to the margin on the service, which has machine learning and AI built into it. Those are the killer transformation opportunities that we are seeing.

And in fact, it's not about in fact taking any old workload per se, but it's about reimagining what they want to do across these. And in that context, of course, they're lifting and shifting some of the older workloads, but they're modernizing the entire business process flow. And that's what's I think the killer opportunity, not any one technology, but the entire flow.

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

And I think your question about is it really budgets, I think you used the phrase opening up. What I think is really interesting is, I don't know, I read probably the same CIO surveys you all do. Frankly, the numbers in those in terms of IT spend or intent to spend, they aren't much different than we've seen. For me, what I think is missing in that question is really – it's not about any one customer saying wait, I'm going to spend 2% more or 3% more. These are companies actually deciding that the change is required, not from an infrastructure perspective, but to change how they're running their business itself.

And so things that used to look more to them like capital expense or COGS or not just an IT budget, this is literally changing every business process they run or changing the

services they offer, and thinking about literally driving their revenue differently. And so I don't really associate it probably as much with a quote-unquote, budget that sits in IT very narrowly. This is really about every budget that sits not just in IT, but under every functional leader of a company being spent differently and being spent on our technology.

A - Chris Suh {BIO 17955231 <GO>}

Thank you, Mark. We'll take the next question, please.

Operator

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

Q - Ross MacMillan {BIO 1994797 <GO>}

Thanks very much. Two, I think both for Amy. The first is that now that Azure gross margins have turned positive, would you say it would be reasonable to assume that the Creative Cloud gross margins should continue to increase sequentially going forward, or could other factors still create some volatility quarter to quarter?

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

Overall, we continue to expect each service is going to get better and better. That happens from two things, premium mix revenue doing well, as well as the efficiencies we expect to get in COGS resulting in gross margin improvement.

Now to your specific question on can you expect it every quarter sequentially, the answer is not really. The mix amongst the services will always result in a pacing change. And so while year over year you may not see as much, but you will see more sequential volatility as, frankly, you've seen over the past six quarters, even when we've seen improvements in each of the underlying and underlying services, which tends to be how I focus on it a bit more.

Q - Ross MacMillan {BIO 1994797 <GO>}

That's helpful, and maybe one other, if I could. Just on CapEx, I know there was a timing delta here between Q3 and Q4, but I just wanted to step back. If you think about your CapEx plans ex-LinkedIn as you came into the year and how you think you'll end up, are you going to be about on plan, or do you think you'll be above or below? Thanks.

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

Thanks. In general, for the full fiscal year, we'll be right at or a little below where I thought we would have been, and so that's why the full-year perspective that growth will slow is still on track. And for simplicity, I generally would think about all the delta from Q3. I would encourage you just to move it into Q4 as you think about what to expect.

Q - Ross MacMillan {BIO 1994797 <GO>}

Okay, thanks so much.

A - Chris Suh {BIO 17955231 <GO>}

Thanks, Ross. We'll have time for one final question, please.

Operator

Our last question will come from the line of Phil Winslow with Wells Fargo. Please proceed.

Q - Philip Winslow {BIO 6300579 <GO>}

Awesome, thanks, guys, for sneaking me in. Just a question on Office commercial. You guys reported another strong quarter here, about 8% constant currency growth. And, obviously, you're continuing that acceleration that you've had over the first three quarters of this year. Now, I guess the question to Satya and then Amy. Satya, you still have a positive mix shift going on here because we see the unit count growth, but also the revenue growth, so positive spread there. Maybe help me walk through where you think we are in this life cycle of Office 365 because you obviously have a lot of SKUs.

And then, Amy, in that context, to the last question on gross margins for commercial cloud. Obviously, we've made a lot of headway on Azure. How do think where we are similarly on the life cycle on the gross margin side of Office 365?

A - Satya Nadella {BIO 3224315 <GO>}

Yeah, I can start. I think with Office 365, we are trying to expand the appeal of Office 365 on multiple dimensions. A lot of what we are still seeing in play is the rapid adoption or the increased adoption of Office 365 E3, which is what I think is driving a lot of the growth, the ASP growth. Now we have a good start with what is at the high end of the enterprise value, which is E5, some of the value we have. Whether it's voice or analytics and security, it resonates. And we're learning, we're improving, and we're pushing forward on that front.

At the same time, we're also introducing new SKUs for the front-line worker. This is one of the other first-time trends I'm seeing where CEOs are more interested in productivity of their front-line workers, and so that's another exciting space. It comes at a different ASP point, so it's not exactly the same as E5, but very important for us strategically to be able to increase the appeal of Office 365. We also are working to make Office 365 and seeing good traction in segments like small business.

The other aspect of Office 365 which is important for us is the international element because we really never had very high penetration of our higher-end service SKUs in the international markets. And we finally get to do that with the service offering. So those are all the areas. Where there's significant room left – and we're not just standing still in terms of adding value for new segments, so those are all in play.

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

And the way you've seen that, and I'll relate it to margins, is this continued and consistent installed base growth, and even still having the opportunities Satya laid out. And most of the ARPU improvement that we've seen has been, in fact still due to the E3 transition, not due to the E5 transition. So we still feel quite good about the opportunity, especially in some of the customers that have already moved to E3.

And then in terms of gross margin, margin actually here has been steadily improving. We've been in this business a bit longer and it's more mature. I do think here the opportunity is also ARPU-based actually here in terms of continuing to see margin improvement is continuing raise the dollars per user that we realize to continue to see that grow.

Q - Philip Winslow {BIO 6300579 <GO>}

Awesome. Thanks, guys.

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

Thanks.

A - Satya Nadella {BIO 3224315 <GO>}

Thank you.

A - Chris Suh {BIO 17955231 <GO>}

That wraps up the Q&A portion of today's call. We look forward to seeing many of you in the coming months at various investor conferences and events. You can find the details, including webcast information, at the Microsoft Investor Relations website. Thank you for joining us today.

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

Thanks, all.

A - Satya Nadella {BIO 3224315 <GO>}

Thank you very much.

Operator

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

FINAL

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