

Q4 2021 Earnings Call

Company Participants

- Amy Hood, Executive Vice President and Chief Financial Officer
- Brett Iversen, General Manager of Investor Relations
- Satya Nadella, Chairman and Chief Executive Officer

Other Participants

- Alex Zukin, Analyst
- Brent Bracelin, Analyst
- Brent Thill, Analyst
- Karl Keirstead, Analyst
- Keith Bachman, Analyst
- Keith Weiss, Analyst
- Mark Moerdler, Analyst
- Mark Murphy, Analyst

Presentation

Operator

Greetings, and welcome to the Microsoft Fiscal Year 2021 Fourth Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Brett Iversen, General Manager of Investor Relations. Thank you. You may begin.

Brett Iversen

Good afternoon, and thank you for joining us today.

On the call with me are Satya Nadella, Chairman and Chief Executive Officer; Amy Hood, Chief Financial Officer; Alice Jolla, Chief Accounting Officer; and Keith Dolliver, Deputy General Counsel.

On the Microsoft Investor Relations website, you can find our earnings press release and financial summary slide deck, which is intended to supplement our prepared remarks

during today's call and provides the reconciliation of differences between GAAP and non-GAAP financial measures.

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

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

We will post our prepared remarks to our website immediately following the call until the complete transcript is available.

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

During 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>}

Thanks much, Brett. We had a very strong close to our fiscal year. Our commercial cloud surpassed \$69 billion in annual revenue, up 34%. We are seeing revenue growth across industries, customer segments and geographies with over 50% of sales coming from outside the United States. We continue to grow new franchises for Microsoft in large and growing markets in the past three years alone, gaming, security and now LinkedIn have all surpassed \$10 billion in annual revenue.

Now, I'll highlight our innovation and our expanding opportunity across the tech stack starting with infrastructure.

Moving forward, every organization will need a more ubiquitous and decentralized computing. We're the only cloud provider with the capabilities to support every organizations' multi-cloud hybrid and edge needs. Over the past year, we have added new data center regions in 15 countries across five continents delivering faster access to cloud services and addressing data residency requirements. And, now, we're taking cloud compute to the edge with 5G deployments. Our new Azure Edge services help operators and enterprises deliver ultra-low latency compute fabric and we are also helping operators run their networks in the cloud. AT&T chose Azure to power its 5G core network, making it the first Tier 1 operator to move its existing customer traffic to the public cloud.

We're also expanding our opportunity in hybrid. Today, over 75% of the Fortune 500 use our hybrid offerings. Azure Arc extends the Azure control plane across on-premises, multi-cloud and the edge. With Arc, customers like EY and Telstra can manage their Kubernetes deployments anywhere and deploy Azure SQL databases and run Azure applications services on any infrastructure.

As the digital and physical worlds converge, we are leading in a new layer of the infrastructure stack, the Enterprise Metaverse. AB InBev is using our solutions, including Azure Digital Twins and Azure IoT, to optimize operations from the barley field to the warehouse to distribution.

Customers also continue to choose our infrastructure to run mission-critical SAP solutions. Thousands of enterprises have migrated their ERP workloads to Azure, including Campbell Soup, L'Oreal, Mondelez International, ServiceNow and even SAP. All this innovation is driving larger and more strategic Azure commitments from industry leaders, including Mars in consumer goods, Morgan Stanley in financial services and NEC in IT.

Now on to data. Data is the most strategic asset for every business. We're the only cloud provider that helps organizations build sovereignty over their data by bringing together hyperscale OLTP, analytics and governance workloads. Cosmos DB has become the go-to database, powering the world's most demanding mission-critical workloads. New capabilities help organizations like Albertsons, ASOS, DHL, LaLiga, Maersk, and Swiss Re optimize costs and boost performance. Walmart is using Cosmos DB to handle billions of online requests daily and to ensure millions of customers receive the items they want when they need them.

Azure Synapse brings together data integration, big data and data warehouses into a single service. From ABN AMRO in finance and AmerisourceBergen in pharma to Walgreens in retail and WPP in advertising, organizations are using Synapse to generate insights from massive amounts of structured and unstructured data. Queries performed using Synapse increased 146% over the last quarter alone.

Now on to developers. GitHub is used by 72% of the Fortune 50 to build, ship and maintain software. Organizations like Ford, NASA and Shopify are using new project planning capabilities to help developers better manage projects directly within their

workflow. And Epic Games, Motorola Solutions and Volkswagen Software Group all chose GitHub Advanced Security this quarter to help secure their code.

We are also leading in Enterprise AI. Our new Azure applied AI services help organizations like Dow, Lufthansa and Samsung apply AI to common business scenarios and live captions in Twitter spaces are being powered by our speech services.

Finally, we are bringing the power of our partnership with OpenAI to both professional developers and domain experts. With GitHub Copilot, professional developers can write code faster with less work and using the world's most powerful language model GPT-3 domain experts can build apps using natural language with Power Platform.

Power Platform has become the leading business process automation and productivity suite for domain experts across all functions. Power BI is the leader in business intelligence in the cloud. Organizations in every industry, including Bayer, Cerner, and Rolls-Royce are choosing the platform to foster a data-driven culture. The number of organizations using Power Apps has more than doubled year-over-year.

BASF chose Power Apps to give 122,000 employees the capability to build low-code no-code apps. And at Toyota, Fusion teams of pro-developers and domain experts are using Power Apps and Azure PaaS services to improve quality control. All up, Power Platform revenue increased 83% over the past year.

And now on to Dynamics 365. Every business function, including marketing, sales, customer support and supply chain will need to be reimaged for an AI-first and collaboration-first world and the silos between communications, collaboration and business process have to be broken down. With Dynamics 365, we are building a new generation of business applications to help organizations adapt to this new reality. We continue to gain share. Dynamics 365 revenue accelerated for the third consecutive quarter, up 49% year-over-year.

We are helping businesses to become digitally sovereign over their customer interactions with our customer insights product with organizations like Columbia Sportswear, GNC and the LA Clippers all choosing to unify customer profiles and deliver more personalized experiences.

We are empowering employees for hybrid work by creating a new category of collaborative applications bringing business process directly into the flow of work.

New integrations between Dynamics 365 and Teams enable anyone in an organization to seamlessly view and collaborate on customer records within Teams without having to purchase multiple licenses. Customers want this and no other vendor is doing this today. And we are helping organizations reimagine their core business processes with new apps built for an age of omnichannel communications.

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With Dynamics 365, customer service organizations like Coca-Cola, Renault and Xiaomi have a single comprehensive solution to deliver consistent and personalized support across all channels.

Now onto industry solutions. Over the past year, we have introduced industry clouds for financial services, healthcare, manufacturing, nonprofits and retail. And this quarter we announced our new Microsoft Cloud for sustainability, bringing together capabilities across our stack to create an entirely new business process category to help every organization address this very urgent need.

Now on to LinkedIn. LinkedIn's revenue surpassed \$10 billion for the first time this fiscal year, up 27%, a testament to how mission-critical the platform has become to help people connect, learn and grow and get hired over the course of their careers. In the past five years, since our acquisition, revenue has nearly tripled and growth has accelerated. LinkedIn has become a leader across multiple secular growth areas spanning B2B advertising, professional hiring, corporate learning and sales intelligence.

And from LinkedIn profiles within Office to LinkedIn Learning courses within Microsoft Viva and LinkedIn Sales Navigator leads within Microsoft Dynamics 365, we have brought together the power of LinkedIn and Microsoft to transform how people learn, sell and connect. LinkedIn has more than 774 million members who are more engaged than ever. Sessions were up 30% this quarter compared to a year ago and LinkedIn's advertising business surpassed \$1 billion in revenue this quarter for the first time, up 97% year-over-year, growing three times faster than the category.

Now on to Microsoft 365 and Teams. Hybrid work represents the biggest change to the way we work in a generation and will require a new operating model spanning people, places and processes. We are the only cloud that supports everything an organization needs to successfully make the shift. Microsoft Teams is the new front-end. It's where people meet, chat, call, collaborate and automate business processes all within the flow of work. Teams usage has never been higher. We have nearly 250 million monthly active users as people use Teams each day to communicate, collaborate and co-author content across work, life and learning.

We are leading in the new and growing enterprise phone category. Just like video meetings, chat and business processes happen in Teams, calls happen in Teams creating a huge new opportunity. We have nearly 80 million monthly active Teams phone users with total calls surpassing 1 billion in a single month this quarter and we're just getting started.

Teams is also at the center of orchestrating collaboration across the entire SaaS estate from HR to marketing to finance. Leading third-party SaaS vendors, including Adobe, Atlassian, Salesforce, SAP, ServiceNow and Workday have now built apps that deeply integrate with Teams, bringing every business process and function directly into the flow of work. And we are bringing Teams to consumers, so people can connect and collaborate with family and friends across desktop, mobile and the web.

All this innovation is driving growth. 124 organizations now have more than a 100,000 users of Teams and nearly 3,000 have more than 10,000 users. More broadly, across Microsoft 365, we're seeing double-digit year-over-year seat growth in every segment from frontline and small business to enterprise. Leading companies like Bayer, Siemens, and Vodafone all chose our premium E5 offerings for advanced security compliance voice and analytics.

Now onto employee experience cloud. Having a digital employee experience platform is critical for every organization. With Microsoft Viva, we are creating an entirely new category bringing together communications, learning, well-being and knowledge directly in the flow of work. New capabilities empower leaders to build human capital, nurture well-being and focus on employee results. We are seeing strong interest and early adoption in every industry from American Express and Barclays to AT&T and Mars. Humana chose Viva to help 26,000 employees make the shift to hybrid work, gaining insights on everything from collaboration trends to manager effectiveness.

Now on to Windows. Windows 11 is the biggest update to our operating system in a decade. We are reimagining everything from the Windows platform to the Store to help people and organizations be more productive and secure and to build a more open ecosystem for developers and creators. We are delighted by early feedback. More people have downloaded our early builds than any other Windows release or update in the history of our Insider program. And along with our OEM ecosystem, we are excited to bring Windows 11 to new PCs beginning this holiday.

And with Windows 365, we are creating a new category, the Cloud PC. Just like applications moved to the cloud with SaaS, we are now bringing the operating system to the cloud enabling organizations to stream the full Windows experience to any employee's personal or corporate device.

Now on to security. With the cybersecurity landscape more complex than ever, it's never been clearer that every organization will need to deploy and maintain a zero-trust security architecture. This is driving accelerated demand for our integrated end-to-end solutions, spanning identity, security, compliance and device management across all clouds and all platforms. No other vendor is recognized by analysts as the leader in as many categories. This is reflected in our share gains with nearly 600,000 organizations, including FedEx, Nestle, NTT and Volkswagen using our security offerings across Azure and Microsoft 365.

We saw a 70% increase in the number of small and medium business customers and it's reflected in our sales growth with annual revenue continuing to increase 40% year-over-year. We're going further to protect organizations and our recent acquisitions of CloudKnox, ReFirm Labs and RiskIQ bolster our security capabilities in key areas, including identity management, IoT and threat intelligence.

Now on to gaming. Gaming is the largest category in the entertainment industry and we are expanding our opportunity to reach the world's 3 billion gamers wherever and whenever they play. We are all in on games. At E3 last month, we unveiled our biggest

games line up ever, announcing 27 new titles, which will all be available to Game Pass subscribers.

Game Pass is growing rapidly and it's transforming how people discover, connect and play games. Subscribers play approximately 40% more games and spend 50% more than non-members. We continue to lead in the fast growing cloud gaming market. Just last month -- just last month we made Xbox Cloud Gaming available on PCs as well as Apple phones and tablets via the browser in 22 countries with more to come. Millions have already streamed games to their desktops, tablets and phones. And the Xbox Series S and X are our fastest selling consoles ever with more consoles sold life to date than any previous generation.

Finally, we continue to grow our opportunity in the creator economy adding new ways for players to build and monetize their creations in many of our most popular games, including Flight Simulator and Minecraft. Creators earned more than double what they did a year ago across our titles.

In closing, going forward, every person and every organization will require more digital technology to be more resilient and to transform. We are innovating across the entire tech stack to ensure our customers' succeed in this new era.

With that, I'll hand it over to Amy.

Amy Hood {BIO 18040963 <GO>}

Thank you, Satya; and good afternoon, everyone. This quarter, revenue was \$46.2 billion, up 21% and 17% in constant currency. Earnings per share was \$2.17, increasing 49% and 42% in constant currency.

In our largest quarter of the year, focused execution by our sales and partner teams along with broad-based strength across geographical markets and customer segments drove another very strong quarter of top and bottom line growth.

In our commercial business, healthy demand for our differentiated hybrid and cloud offerings as well as increased long-term commitments to our platform drove significant growth in the number of \$10 million plus Azure and Microsoft 365 contracts. Customer reliance on the Microsoft Cloud drove sequential increases in usage across Teams, Power Platform and our advanced security and identity offerings, which are empowering organizations to shift to hybrid work and modernize business processes.

And in LinkedIn's Talent Solutions business, an improving job market drove strength in annual contracts and job postings.

In our on-premises business, strong annuity performance across Office, Server and Windows also benefited from a greater mix of contracts with higher in-period revenue recognition under ASC 606.

In our consumer business, Windows OEM and Surface were impacted by the ongoing constraints in the supply chain. Search and LinkedIn benefited from an improved advertising market.

And in gaming, we again saw strong engagement across our platform, while demand for our Xbox Series X and S consoles continued to exceed supply.

As a reminder, Q4 was the first full quarter impacted by COVID-19 a year ago across revenue and operating expense. This quarter, even with a declining expiration base, commercial bookings grew 30% and 25% in constant currency, significantly ahead of expectations, driven by strong execution across our core annuity sales motions and an increase in the number of larger long-term Azure contracts. As a result, commercial remaining performance obligation increased 32% and 31% in constant currency to \$141 billion. Roughly 45% will be recognized in revenue in the next 12 months, up 25% year-over-year. The remaining portion, which will be recognized beyond the next 12 months, increased 38% year-over-year, highlighting the growing long-term commitment to our Microsoft Cloud. And our annuity mix increased 1 point year-over-year to 95%.

Commercial cloud revenue also better than expected, was \$19.5 billion as growth accelerated to 36% and 31% in constant currency. Commercial cloud gross margin percentage expanded 4 points year-over-year to 70% with roughly 1 point from the change in accounting estimate for the useful life of server and network equipment assets. Excluding this impact, commercial cloud gross margin percentage increased despite revenue mix shift to Azure, driven by improvement across all our cloud services on a prior-year comparable impacted by strategic investments we made to support significant customer engagement and usage in remote work scenarios, including free trials, flexible financing options and capacity for cloud infrastructure usage.

With the weaker US dollar, FX increased revenue growth by approximately 4 points, about a point more favorable than anticipating -- than anticipated. FX increased COGS growth by approximately 1 point and operating expense growth by approximately 2 points, both in line with expectations.

Gross margin dollars increased 25% and 20% in constant currency. Gross margin percentage was 70%, up 2 points year-over-year with roughly 1 point of favorable impact from the change in accounting estimate. Excluding this impact, company gross margin percentage increased despite sales mix shift to the cloud, driven by the commercial cloud gross margin percentage improvement noted earlier.

Operating expense grew 6% and 4% in constant currency, in line with expectations on a prior-year comparable, that included roughly 4 points of impact from the realignment of our retail stores strategy and 2 points of impact from and increase in bad debt expense. Overall, company headcount grew again this quarter, up 12% year-over-year as we continue to invest across key areas like cloud engineering, sales and customer deployment.

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Operating income increased 42% and 35% in constant currency and operating margins expanded 6 points year-over-year to 41%, including roughly 2 points of impact from the retail stores charge, an increase in bad debt expense in the prior year and nearly 1 point of favorable impact from the change in accounting estimate.

Now to our segment results. Revenue from productivity and business processes was \$14.7 billion and grew 25% and 21% in constant currency with better than expected performance across all businesses. Office Commercial revenue grew 20% and 15% in constant currency. Office 365 Commercial revenue grew 25% and 20% in constant currency, again driven by installed base expansion across all workloads and customer segments as well as higher ARPU. Paid Office 365 Commercial seats increased 17% year-over-year with continued recovery driving acceleration in our small and medium business and frontline worker offerings.

Demand for Microsoft 365, particularly for security, compliance and voice, drove strong E5 momentum again this quarter. E5 now accounts for 8% of our Office 365 Commercial installed base. And on a low prior-year comparable impacted by a slowdown in transactional purchasing, Office Commercial licensing was ahead of expectations, down 8% and 11% in constant currency, also benefiting from higher in-period revenue recognition noted earlier.

In Office Consumer, revenue grew 18% and 15% in constant currency, driven by continued momentum in Microsoft 365 subscriptions, which grew to \$51.9 million, up 22% year-over-year.

Dynamics revenue grew 33% and 26% in constant currency, better than expected. Dynamics 365 revenue growth was 49% and 42% in constant currency with strong momentum in Power Apps and Power Automate, reflecting growing demand for our modern solutions to build apps and automate workflows. Dynamics 365 now accounts for over 70% of total Dynamics revenue.

LinkedIn revenue increased 46% and 42% in constant currency, ahead of expectations against a prior year comparable impacted by the advertising and job markets of a year ago.

Segment gross margin dollars increased 33% and 27% in constant currency and gross margin percentage was up 5 points year-over-year, primarily driven by improvement in our cloud services against a low prior-year comparable impacted mostly by increased usage. The change in accounting estimate drove roughly one point of favorable impact. Operating expense increased 8% and 6% in constant currency; and operating income increased 62% and 53% in constant currency, including 4 points due to the change in accounting estimate.

Next, the Intelligent Cloud segment. Revenue was \$17.4 billion, increasing 30% and 26% in constant currency. We exceeded expectations across our consumption and per user Azure businesses as well as in our on-premises server products business. Overall, server products and cloud services revenue increased 34% and 29% in constant currency. Azure

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revenue grew 51% and 45% in constant currency, driven by strong performance across our core and premium consumption-based services.

In our per-user business, the enterprise mobility and security installed base increased 29% to over 190 million seats.

Our on-premises server business increased 16% and 12% in constant currency, driven by strong annuity performance and benefiting roughly 4 points from the higher in-period revenue recognition noted earlier, particularly in some of our largest deals in the quarter.

Enterprise services revenue grew 12% and 9% in constant currency, driven by growth in Premier Support Services and Microsoft Consulting Services. Segment gross margin dollars increased 32% and 27% in constant currency. Gross margin percentage increased 1 point year-over-year with roughly 1 point of favorable impact from the change in accounting estimate. Operating expense increased 14% and 12% in constant currency; and operating income grew 46% and 39% in constant currency, including 3 points due to the change in accounting estimate.

Now to more personal computing. Revenue was \$14.1 billion, increasing 9% and 6% in constant currency with better than expected performance in Windows Commercial, Gaming and Search, offsetting OEM and Surface weakness from supply chain constraints. OEM revenue declined 3% and Surface declined 20% and 23% in constant currency as both were impacted by the significant supply chain constraints noted earlier in a good demand environment.

Windows commercial products and cloud services revenue grew 20% and 14% in constant currency, driven by demand from Microsoft 365 with some benefit from the higher in-period revenue recognition noted earlier.

Search revenue ex-TAC increased 53% and 49% in constant currency, benefiting from the improved advertising market.

And in gaming, revenue increased 11% and 7% in constant currency. Xbox hardware revenue grew a 172% and 163% in constant currency, driven by demand for our new consoles. Xbox and content and services revenue declined 4% and 7% in constant currency against a high prior year comparable. Segment gross margin dollars increased 8% and 4% in constant currency. Gross margin percentage decreased roughly 1 point year-over-year, driven by sales mix shift to gaming hardware. Operating expense decreased 6% and 7% in constant currency, including approximately 13 points of impact from the retail stores charge in the prior year; and operating income grew 19% and 13% in constant currency.

Now back to our total company results. Capital expenditures, including finance leases, were \$7.3 billion in line with expectations, driven by ongoing investment to support growing global demand and usage of our cloud services. Cash paid for PP&E was \$6.5 billion.

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Cash flow from operations was \$22.7 billion, increasing 22% year-over-year, driven by strong cloud billings and collections. Free cash flow was \$16.3 billion, up 17%, reflecting higher capital expenditures in support of our growing cloud business. For FY '21, we generated over \$76 billion in operating cash flow, up 26% year-over-year and over \$56 billion in free cash flow, up 24% year-over-year.

This quarter, other income and expense was \$310 million, higher than anticipated, primarily driven by net gains on investments. As a reminder, we are required to recognize mark-to-market gains or losses on our equity portfolio.

Our effective tax rate was approximately 15%.

And, finally, we've returned \$10.4 billion to shareholders through share repurchases and dividends, bringing our total cash returned to shareholders to over \$39 billion for the full fiscal year.

Now, before we turn to our outlook, I'd like to provide a few reminders for next fiscal year. Revenue growth rates across all segments will reflect the impact from COVID-19 a year ago though the impacts do shift as we move through the year. Also, our FY '21 operating income and margins benefited from two factors that will be significant headwinds in FY '22. First, the change in accounting estimate for the useful life of server and network equipment resulted in \$2.7 billion of depreciation expense shifting from FY '21 to future periods. And, second, we saved nearly \$1.2 billion in operating expense from COVID-19 related restrictions, which will also moderate in FY '22 as geographies reopen globally.

With those reminders in place, let's move to our next quarter outlook. Accelerating digital transformation and consistent strong execution should drive another quarter of growing commitment to our Microsoft Cloud.

In commercial bookings, our core annuity sales motions should drive healthy growth on a growing expiry base even against a strong prior-year comparable. As always, quarterly volatility in bookings can be driven by an increasing mix of larger long-term Azure contracts, which are more unpredictable in their timing.

Commercial cloud gross margin percentage should decrease roughly 1 point year-over-year with roughly 4 points of negative impact from the change in accounting estimate previously discussed. Excluding the accounting change, Q1 gross margin percentage will increase despite revenue mix shift to Azure, driven by continued improvement across our cloud services on a prior-year comparable impacted by the strategic investments we mentioned earlier. Longer term, which excludes the impact of the accounting change, commercial cloud gross margin percentage will continue to be impacted by the same three things we often discuss; revenue mix shift to Azure, increased usage of our cloud services and ongoing strategic investments to support our customers' success.

In capital expenditures, we expect a sequential increase on a dollar basis as we continue to invest to meet global demand for our cloud services.

Now to FX. Based on current rates, we expect FX to increase revenue growth at the total company and all individual segment levels by approximately 2 points and total operating expense and COGS growth by approximately 1 point.

Next now to segment guidance. In Productivity and Business Processes, we expect revenue between \$14.5 billion and \$14.75 billion.

In Office Commercial, revenue growth will again be driven by Office 365 with healthy seat growth across segments and continued momentum in E5.

In our On-Premises business, we expect revenue to decline approximately 20% consistent with the ongoing customer shift to the cloud.

In Office Consumer, against a strong prior-year comparable, we expect high single-digit revenue growth with continued momentum in Microsoft 365 consumer subscriptions.

For LinkedIn, continued strong engagement on the platform and improvements in the advertising and job markets should drive revenue growth in the high 30% range.

And in Dynamics, we expect continued strength in Dynamics 365, which includes our significant momentum in Power Apps to drive revenue growth in the high-20s.

For Intelligent Cloud, we expect revenue between \$16.4 billion and \$16.65 billion.

In Azure, revenue will be driven by continued strong growth in our consumption based business and our per-user business should continue to benefit from Microsoft 365 Suite momentum, though we expect some moderation in growth rate given the size of the installed base. Therefore, in constant currency, Azure revenue growth should remain relatively stable on a sequential basis.

In our On-Premises Server business, we expect revenue growth in the high single-digits, driven by continued demand for our hybrid and premium annuity offerings against a low prior-year comparable.

And in Enterprise Services, we expect revenue to be in the high single-digits.

In More Personal Computing, we have estimated the Q1 impact of the required Windows 11 revenue deferral that will shift to Q2 to be approximately \$300 million. Therefore, our segment revenue outlook is \$12.4 billion to \$12.8 billion. Given the 10 point estimated negative impact from the deferral, OEM revenue should decline mid to high single-digits in Q1.

In Surface, on a strong prior-year comparable, we expect revenue to decline in the low-teens as we continue to work through the supply chain challenges.

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In Windows Commercial, Products and Cloud Services, continued demand for Microsoft 365 and our advanced security solutions should drive healthy double-digit growth.

In Search ex-TAC, we expect revenue growth in the high-30s, driven by improvements in the advertising market.

In Gaming, we expect revenue growth in the low double digits. Console growth will again be constrained by supply. And on a strong prior-year comparable, Xbox content and services revenue should grow low single-digits.

Now back to company guidance. We expect COGS of \$13.55 billion to \$13.75 billion and operating expense of \$11.6 billion to \$11.7 billion. In other income and expense, interest income and expense should offset each other. And, finally, we expect our Q1 tax rate to be approximately 16%, lower than our expected full year rate given the volume of equity vests in our first quarter.

In closing, we remain focused on driving revenue growth as we invest boldly against the strategic high growth opportunities ahead that will deliver significant value to our customers worldwide. Our outlook for FY '22 reflects this with healthy double-digit revenue and operating income growth. Together, that results in expanded operating margins in FY '22 after excluding the headwinds from the useful life change noted earlier. Together, with our customers and partners, we look forward to FY '22.

Now, Brett, let's go to Q&A.

Brett Iversen

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

Questions And Answers

Operator

Absolutely. (Operator Instructions) Our first question is coming from the line of Keith Weiss with Morgan Stanley. Please proceed with your question.

Q - Keith Weiss {BIO 6993337 <GO>}

Excellent. Thank you for taking the question, guys, and congratulations on a great FY '21, and a great end to the fiscal year. Satya, last year at this time you made a comment that -- you really defined the conversation in software over the past year when you're talking about an acceleration in digital transformation you saw coming out of COVID and I think that's evident in the results that we see here with 25% growth in your commercial bookings growth. What I want to ask you what's the durability of that growth on a going forward basis? Was that acceleration a pull forward of demand and at some point we're

going to have that hard comp? Or do you see durability in this acceleration on a go forward basis? Is there a lot more to come?

And then Amy to you a similar kind of question but more on sort of the margin side of the equation. I think your entire tenure at Microsoft has really been defined by good operational controls and ability to grow gross profit dollars well ahead of OpEx, is that durable longer term? Is there still enough sort of efficiency gains at Microsoft to be able to keep that up over the medium term, if you will?

A - Satya Nadella {BIO 3224315 <GO>}

Thanks so much, Keith, for the question. The way we see the results today reflect that that, but more importantly on a secular basis, as I think about -- I always go back to that number, which is 5% of the world GDP is tech spend, it's projected to double. I think that doubling will happen in a more accelerated pace and we feel well positioned because of the innovation across the stack. Because if you think about it, what's going to happen is, every business, whether you're a retailer or a manufacturer, in the service sector, public sector or private sector, digital adoption is the way you're going to be both resilient as well as transform the core business processes.

And the strength we have is that the entirety of the Microsoft Cloud stack, right. So it's not just about infrastructure or any application, it's the entirety of what we do. And so I think it is durable quarter-to-quarter depending on what happened during the pandemic, depending on the segments that were impacted, for example the consumer segments that were impacted are coming back, and then they will normalize. Whereas in our case, we do. In fact, one of the things I love about sort of our exposure is both it's a worldwide exposure and it has got the right balance between the consumer segments and the enterprise business-to-business segment. So it's a very durable, long-term growth prospect and that we have tough competition. We need to keep innovating, which is what we will stay focused on.

A - Amy Hood {BIO 18040963 <GO>}

And maybe turning to your margin question and while I am obviously proud of the work we've done, Keith, that you referenced as a team, on margins and returns, I would say in general our focus remains and has been for the duration of really Satya and I work together along with the rest of the SLT and on consistently moving our resources and talent to our highest growth and in most differentiated places. When you do that in expansive total addressable markets in the way that I believe we're focused on as an organization, you do see the type of operating leverage that you're referring to and margins. And that, along as you see sort of mathematically with a shift in our revenue to higher overall gross margin segments, you do get the results we've seen. So I feel very good about the work we've done. And as you've heard, I'm quite optimistic about the opportunities we have to invest leading into FY '22 as well.

Q - Keith Weiss {BIO 6993337 <GO>}

Excellent. Thank you so much, guys.

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A - Brett Iversen

Thanks, Keith. Operator, next question please.

Operator

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

Q - Mark Moerdler {BIO 16855032 <GO>}

Thank you very much for taking the question. And, again, also congrats on the quarter. And, Amy, thanks for the details and color, especially in the guidance. So I want to ask about seasonality in Azure. Traditionally we've seen seasonality in the Azure numbers in Q4 and obviously last year we didn't see it because of COVID, but we also didn't see it this year, has something changed that has changed the seasonality of the business and does that continue going forward? And then as a follow-up question, Keith asked about OpEx efficiency overall, but I'd like to ask specifically on the cloud. Is there any reason that cloud OpEx shouldn't continue to grow slower than revenue, obviously on an annual basis not a quarterly basis? Thank you.

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Mark, for the question. Let me cover your first one, which is the seasonality in the Azure business. In some ways, Mark, some of that seasonality frankly was because Azure has two fundamental components. It's got a consumption model as well as a per-user model. The per-user model, which as you well know is far more aligned to our sort of end of year and can be a lot more aligned to our end of year rhythms, it also can have more quarterly volatility in terms of accounting, in terms of revenue recognition, the same topic we often talk about when it comes to Microsoft 365, in terms of more in-quarter recognition. What you've seen is, that did historically represent a larger component of Azure, so added volatility to Q4. As we've seen, our consumption businesses grow and grow consistently and thus far becoming a larger percentage of Azure. You do have more stability, Mark, and so you start seeing less of that volatility that we've historically seen from Q3 to Q4. We still have some of it as we talked about, but I think it's an interesting observation and it's a very good question.

In terms of your comment on cloud revenue and OpEx, yes, I do believe that's durable. We get a lot of focus. We will continue to invest. There's lots of opportunity there, but the market certainly warrants it.

Q - Mark Moerdler {BIO 16855032 <GO>}

Great. That makes sense, and I appreciate all the detail. Thank you very much. Congrats.

A - Brett Iversen

Thanks, Mark. Operator, next question please.

Operator

Our next question is coming from the line of Brent Thill with Jefferies. Please proceed with your questions.

Q - Brent Thill {BIO 1556691 <GO>}

Amy, a lot of questions on margins. I'm curious if you think there is a ceiling in the near term on margins or do you feel that you've got an elevated flight level, if you will, and we shouldn't have to be worrying about that level of margin. Can you just give us any more color as it relates to how you're thinking about that? Thank you.

A - Amy Hood {BIO 18040963 <GO>}

Well, I think for FY '22 on operating margins, which is really where I focus most of my thoughts, as I said, when you exclude the useful life change, I feel very good about margin improvement in FY '22. But what sits behind that, Keith -- I mean, sorry, Brent is, this focus on the first thing I said, which is with every operating expense dollar we invest, are we continuing to invest it in the highest growth places? If you continue to invest in high growth places with differentiation that customers care about and you add value, you continue to see improvements in this area. From time to time, I'm sure there will be quarters where that isn't the case if we have some mix shift in the hardware, et cetera. But in general, over a longer period of time you've seen us focus on this. And so, if you remove a little of the noise with -- of some of the useful life changes and look back a few years, I do think you'd see the biggest needle mover being where we invest the dollars as opposed to the overall amount of them, which should grow based on the opportunity.

Q - Brent Thill {BIO 1556691 <GO>}

Thank you.

A - Brett Iversen

Thanks, Brent. Operator, next question please.

Operator

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

Q - Karl Keirstead {BIO 1542979 <GO>}

Thanks very much. Amy, thank you for giving more formal Azure guidance for the next quarter. That's very helpful. So if Azure is going to remain stable in constant currency, I guess, at 45% and you had indicated that EMS growth should moderate, effectively you're saying that the consumption piece of Azure might accelerate in the September quarter. So I'm wondering if you could unpack that a little bit, is this as simple as prior period commitments ramping at an accelerated pace? Love to hear your thoughts. Thank you.

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Karl. Yeah. No, I think in general you've got the right trajectory. And I do think it's both things. You've heard me say it's both, some of our core as well as premium SKUs. We've seen some nice execution and I think Satya mentioned some of these differentiated places in the Azure Stack where I think we also can see some growth. Data services is a very good point where I feel like we've made a lot of progress. We have a real differentiation and have seen some acceleration in the past couple of quarters.

Q - Karl Keirstead {BIO 1542979 <GO>}

Got it. Thank you.

A - Brett Iversen

Thanks, Karl. Operator, next question please.

Operator

Our next question is coming from Mark Murphy with JPMorgan. Please proceed with your question.

Q - Mark Murphy {BIO 17750249 <GO>}

Yes. Thank you very much. Satya, at the Ignite Conference a few months ago, you commented that cloud architectures have reached peak centralization, I'm wondering what developments are you seeing that inform your viewpoint? And Amy, do you sense uplift in some of those intelligent edge products, such as Azure Stack or others contributing to the improvement in server products growth that we saw this quarter?

A - Satya Nadella {BIO 3224315 <GO>}

Thanks so much for that question. A couple of things that are happening. One is that all our -- up even what we consider the cloud infrastructure is getting increasingly distributed. If you think about the approach we took to our datacenter architecture, the fact that we have more regions is to me, I would say, both the real world needs for the computing architecture side, but also the regulatory and data residency requirements. So we feel we picked the right approach and that's paying dividends today just even in terms of our geographic coverage, our coverage of all of the regulatory requirements.

Then the second piece, of course, is distributed computing will remain distributed and what we are seeing with edge is going to be the case where we will see more of both the old workloads with hybrid benefits and hybrid deployments, as well as new workloads, right.

So if you take the AB InBev Digital Twin meets IoT type of scenario, that's going to require a lot more compute close to their factories. And so, to me, those new scenarios or 5G, I mean think about what AT&T is planning to do, which is a hybrid deployment in a completely new space where there is going to be compute that's located to be able to take core network traffic and use cloud economics. So that's what we think of going

forward, which is really -- compute will remain distributed both because of the needs across geographies, regulation and the very nature of computer architecture.

A - Amy Hood {BIO 18040963 <GO>}

And to the question you asked on how to think about the edge and where to see that in results, really it shows up -- this is one where I would focus on the overall server products and cloud services number, which I think, Mark, was at the heart of your question, because through our purchasing vehicles, the most effective way to purchase for a flexibility with and across the edge and the cloud is sometimes some of the on-prem licensing with hybrid right. So you do see that both in our Azure results, but also depending on how it's purchased in Server KPI.

Q - Mark Murphy {BIO 17750249 <GO>}

Thank you very much.

A - Brett Iversen

Thanks, Mark. Operator, next question please.

Operator

Thank you. Our next question comes from Brent Bracelin with Piper Sandler. Please proceed with your question.

Q - Brent Bracelin {BIO 2447337 <GO>}

Good afternoon, and thanks for taking the call here. Question for you really around \$10 million plus contracts, you called out momentum this quarter and last quarter, my question is around the drivers of these larger enterprise commitments. Is this driven by just the larger scope of deals? Or are you seeing kind of broader attach rate across the whole breadth of Microsoft cloud products? Thanks.

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Brent. Maybe, Satya, I'll take this one first, and if you want to add anything. Brent, unfortunately, I'm going to answer it's everything. And let me talk about why I say that. When you see the size of the contracts increase, it's about the entire scope of what's offered under the Microsoft Cloud. We're seeing both really strong renewals of our core contracts, really strong additions across Dynamics, Power Apps, Power Automate and M365, premium SKUs, security, compliance, voice, which of course increases those commitment sizes and you're seeing the addition of Azure commitments, which we often talk about as these multiyear longer-term contracts. And so, then you do of course see them just have longer duration on -- especially in the case of Azure. So in many ways what we focus on are the components that make up the larger contracts is each component being additive to selling the value that's present across all of our pieces of the Microsoft Cloud. And this was a good execution quarter for us. You see it in the bookings number, even more when you have a declining expiry base and then bookings growth that's that high, you have to do all those things well and that's, I think, really what's reflected

ultimately and transactionally, meaning those larger \$10 million plus contracts being done.

Q - Brent Bracelin {BIO 2447337 <GO>}

Thank you.

A - Brett Iversen

Thanks, Brent. Operator, next question please.

Operator

Thank you. Our next question comes from Alex Zukin with Wolfe Research. Please proceed with your question.

Q - Alex Zukin {BIO 18006605 <GO>}

Hey, guys. Thanks for taking the question. I guess my main question maybe for Satya, you've taken -- you've noted the future of work having changed and you talked about the fusion of Teams into both the application stack, the operating system stack and really amongst the entire Microsoft portfolio, is that driving -- given the acceleration you're seeing in Dynamics, can you talk to the fact is that driving larger deals, new bites of the apple, or how is that changing the landscape, and how do you think about that versus what your competitors are doing?

A - Satya Nadella {BIO 3224315 <GO>}

Yeah. That's a great question. Thanks for that. Multiple things happening and both, some of them are independent secular growth trends and they do reinforce each other.

Let's just take Dynamics, it's probably one of the most exciting things we are seeing is that, coming out of this pandemic, there is an absolute new chapter for a complete new suite all the way from whether it's sales to customer service to marketing to supply chain or digital manufacturing, that's all going to be re-implemented. So there is going to be a complete new cycle of business process automation that is going to be AI-first and collaboration-first.

And that second part is where that intersection between Teams and business process or Dynamics comes through, because you do not want to have a system of record for anything, whether it is a customer or a part or a forecast that you don't want to collaborate on, that you don't want to communicate on and by the way the communications and the collaboration artifacts are part of the record and that's what I think that this new generation of software will enable.

And so you see it in two fronts, one is Teams has become a platform not just for Dynamics, even for Salesforce, for SAP, for Adobe, for ServiceNow, they're all building great integrations into Teams and we will foster that and Dynamics itself of course will integrate deeply with Teams and embed Teams or Azure Communication Services.

So when you think about our omnichannel customer service module, it doesn't look like anything that from two years ago. It's a completely rebuilt omnichannel customer service system, which has all the communication functionality built-in. So it's a pretty exciting space and it also speaks to a lot of the questions around where is the margin, how is it going to sort of evolve. I think tracking what's happening with Power Platform, Dynamics and Teams, I think, probably and it's intersection to even some of our data layers in Azure is perhaps the best indication of some of our competitive differentiation at scale already.

Q - Alex Zukin {BIO 18006605 <GO>}

Perfect. Thank you, guys, so much.

A - Brett Iversen

Thanks, Alex. Operator, we have time for one last question.

Operator

Thank you. Our final question comes from the line of Keith Bachman with Bank of Montreal. Please proceed with your question.

Q - Keith Bachman {BIO 3018411 <GO>}

Hi. Many thanks for taking the question. Amy, I wanted to direct this to you and go back to margins for a second. Is there any comments or color that you could provide. I know you said you focus on the operating margin side, but on the trends you anticipate this year in '22 around gross margins with or without the depreciation schedules. Part B is, on the last quarter call, you indicated that operating expenses might grow kind of mid-teens or low-teens, I should say, in '22. I was wondering if you would want to update the comments on how we should be thinking about operating expense trends as we look at FY '22? Thank you.

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Keith. When I think about your operating expense comments, no, I don't have any update to that. I think, if you think about our headcount growth at 12% plus through the year continuing to invest in some of the places where we saw savings for the year on COVID, I would expect that that is still a good placeholder for people as we work through the year. I mean with the opportunity we see in the market, I think it supports that level. And given our execution when we do invest, which leads me to margin, I feel very good about that.

At the gross margin level, we'll continue to focus really on the same things we've always focused on, which is continuing across our cloud services to see improving margins. You'll continue to see a mix shift to Azure, given the growth we expect there and we'll continue to see gross margin improvements across individual services that make up many of our components across the company. So, in general, I feel like, the gross margin trends are quite healthy heading into '22.

Q - Keith Bachman {BIO 3018411 <GO>}

Okay, great. Thank you.

A - Brett Iversen

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

A - Amy Hood {BIO 18040963 <GO>}

Thank you, everyone.

A - Satya Nadella {BIO 3224315 <GO>}

Thank you.

Operator

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

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