Microsoft FY20 First Quarter Earnings Conference Call

Michael Spencer, Satya Nadella, Amy Hood

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MICHAEL SPENCER:

Good afternoon and thank you for joining us today. On the call with me are Satya Nadella, chief executive officer, Amy Hood, chief financial officer, Frank Brod, chief accounting officer, and 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.

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

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

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

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

Satya Nadella:

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

We're off to a strong start in fiscal 2020, delivering $33 billion in revenue this quarter.

Our commercial cloud business continues to grow at scale as we work alongside the world's leading companies to help them build their own digital capability.

Microsoft provides a differentiated technology stack – spanning application infrastructure, data & AI, developer tools and services, security & compliance, business process, productivity and collaboration.

First, each of these areas represents secular long-term growth opportunity. Second, we are delivering best-in-class innovation and openness in each layer. And third, we offer unparalleled integration and architectural coherence across the entire stack… to meet the real-world needs of customers. Now I'll briefly highlight how we are accelerating our progress and innovation, starting with Azure.

Organizations today need a distributed computing fabric to meet their real-world operational sovereignty and regulatory needs. This quarter we opened new datacenter regions in Germany and Switzerland. And in India, we are bringing the power of the Microsoft cloud to millions of small businesses through our partnership with Jio, one of the largest mobile carriers in the country.

Every Fortune 500 customer today is on a cloud migration journey, and we're making it faster and easier. Just this week, we announced an extensive go-to-market partnership with SAP, making Azure the preferred destination for every SAP customer. And, our partnerships with VMware and Oracle also bring these ecosystems to our cloud.

We are extending beyond the cloud to the edge – enabling customers to get real-time insights where data is generated while ensuring security and privacy. And we're seeing traction in every industry – from Azure Sphere securely connecting Starbucks coffee machines… to Azure Stack enabling scenarios from smart factories and modern, compliant banking, to mobile healthcare in remote areas.

We are reimagining customers' data estates for the cloud era with new limitless capabilities. Azure SQL Database brings hyper-scale capabilities to relational databases. And, Azure Cosmos DB is a low-latency, high availability database for globally distributed applications of any data type.

The quintessential characteristic of every application going forward will be AI, and we have the most comprehensive portfolio of AI tools, infrastructure and services. Azure AI now has more than 20,000 customers, and more than 85 percent of Fortune 100 companies are using Azure AI in the last 12 months.

In healthcare, Novartis chose Azure AI to transform how medicines are discovered, developed and commercialized. Nuance will rely on our cloud to power the patient exam room of the future, where clinical documentation writes itself. And Humana is using Azure AI to build personalized health care solutions for its more than ten million members.

We are also pushing the bounds of how computers and AI can generalize learning beyond narrow domains, collaborating with Open AI on a supercomputing platform to train and run AI models. I'm excited about our partnership and our collective pursuit to democratize AI and its benefits for everyone. Now to developer tools.

The rise of digital IP creation in every organization means developers will increasingly drive and influence every business process and function – and GitHub is where they go to learn, share and collaborate. GitHub has grown to more than 40 million developers, up more than 30 percent since our acquisition a year ago. And more than 2 million organizations use GitHub – including the majority of the Fortune 50.

At Ford Motor Company alone, 8,000 employees use GitHub to innovate and collaborate with a vast ecosystem of third-party software developers. Our acquisition of semantic code analysis engine Semmle this quarter strengthens our security capabilities, enabling developers to more easily find vulnerabilities in large open source codebases. Now let's turn to our workflow cloud, Power Platform.

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

Rising cyberthreats and increasing regulation mean security and compliance are a strategic priority for every organization. We have a comprehensive offering across identity, security and compliance – spanning people, devices, apps, developer tools, data, and infrastructure –to protect customers in today's "zero trust" environment.

It starts with Azure Active Directory Premium, used by more than 100,000 organizations for identity, access management and SaaS application security across heterogeneous environments. It builds with information protection and cloud security with Microsoft Defender Advanced Threat Protection – and now with risk-based vulnerability management. And it extends to Azure Sentinel, now broadly available. Sentinel is a cloud-first service that analyzes security signal at massive scale across the entire organization, using AI to detect, investigate and automatically remediate threats. We'll share more about our expanding opportunity in security at our Ignite conference in the next few weeks. Now, on to business applications.

Dynamics 365 is the only AI-powered business cloud that gives customers a 360-degree view of their business – from marketing and sales, to finance and operations – to unify data and unlock insights. It enables every level of the organization to move from reactive, siloed transactional processes – to proactive, repeatable, and predictable business outcomes.

This quarter, we introduced Dynamics 365 Commerce, a new omnichannel solution to unify back-office, in-store, and digital experiences and deliver personalized content wherever shoppers are.

Dynamics 365 AI Insights apps ingest data from any first-party or third-party source, freeing data from systems of record to power modern systems of engagement and intelligence. New Dynamics 365 Product Insights provides organizations like EcoLab a real-time view of how customers are using their products to maximize customer lifetime value. And Dynamics 365 Connected Store helps retailers like Marks & Spencer analyze observational data to optimize in-store shopping experience.

We are enabling our customers to bridge physical and digital business processes with our mixed reality cloud – spanning HoloLens 2, Azure Mixed Reality services and Dynamics 365 apps. Pharmaceutical company Patheon, for example, is using Dynamics 365 Guides, along with HoloLens 2, to reimagine training for its employees. Now to LinkedIn

We saw record levels of engagement again this quarter across the platform. Marketing Solutions remains our fastest growing segment, up 44 percent year-over-year as marketers leverage our community-building tools to connect with LinkedIn's nearly 660 million members. We continue to innovate across our Talent portfolio – including Talent Solutions, Talent Insights, Glint, LinkedIn Learning – to help every organization attract, retain, and develop the best talent. LinkedIn's Skills Assessments is a new way for members to showcase their proficiencies and become more discoverable to recruiters. Now, turning to Microsoft 365 and Surface.

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

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

Microsoft Teams continues to gain traction, bringing together everything a team needs – chat, voice, meetings, collaboration with the power of Office, and business process workflows – into a single, integrated user experience – all with the highest security and compliance. Teams keeps all of your work, conversations, and meetings in context – eliminating the need to bounce back and forth between different apps – with features like integrated calendaring and one touch to join a meeting from your phone. And we are broadening our opportunity with the 2 billion firstline workers worldwide, adding priority notifications, role-specific targeted messages, and the ability to clock in and clock out of a shift.

Our differentiated offering is driving usage, making Teams the category leader. More than 350 organizations now have more than 10,000 users of Teams.

More broadly, all this innovation is fueling growth. Office 365 commercial monthly active users surpassed 200 million this quarter. And leading organizations like Cerner, Chevron, and The LEGO Group, are choosing our premium Microsoft 365 E5 offerings for their advanced security and productivity experiences. Finally, gaming …

In gaming, we are investing in content, community and cloud services to expand our opportunity with 2 billion gamers worldwide. We saw record Xbox Live monthly active users with strength both on and off console in mobile and PC, and continued growth for Game Pass subscriptions. Gears 5 saw more than 3 million players in its first weekend alone. Ten years in, Minecraft is stronger than ever, with record revenue and usage, and we're bringing the franchise to new audiences with Minecraft Earth. Finally, just last week we started trials of Project xCloud, so gamers can play games wherever and whenever they want, on any device.

In closing, we are accelerating our innovation across the entire technology stack to deliver new value for customers. We are investing aggressively in large markets with significant growth potential. And it's still early days. With that, I'll hand it over to Amy who will cover our financial results in detail and share our outlook. I look forward to rejoining with your questions.

AMY HOOD:
Thank you, Satya, and good afternoon everyone.

This quarter, revenue was $33.1 billion, up 14 percent and 15 percent in constant currency. Gross margin dollars increased 18 percent and 20 percent in constant currency. Operating income increased 27 percent and 32 percent in constant currency. And earnings per share was 1.38, increasing 21 percent and 25 percent in constant currency.

Consistent execution and strong demand for our hybrid and cloud offerings drove a solid start to the fiscal year, with another quarter of double-digit top and bottom line growth. From a geographic perspective, we saw broad-based strength across all markets.

In our commercial business, we again saw increased customer commitment across our cloud platform. In Azure, we had material growth in the number of $10 million plus contracts. Additionally, Microsoft 365 drove new customer adoption as well as expansion in our existing customer base given the strong value Office 365, Windows 10, and Enterprise Mobility and Security provide as a secure, intelligent solution.

As a result, commercial bookings growth was ahead of expectations, increasing 30 percent and 35 percent in constant currency with a higher volume of new business and strong renewal execution. Commercial annuity mix increased to 91 percent and commercial unearned revenue was ahead of expectations at $31.1 billion, up 14 percent and 16 percent in constant currency. Our commercial remaining performance obligation was $86 billion, up 26 percent and 27 percent in constant currency, driven by long-term customer commitments. As a reminder, going forward we will disclose the commercial remaining performance obligation as a KPI which better reflects commitments our customers are making across all contract types.
Commercial cloud revenue was $11.6 billion, growing 36 percent and 39 percent in constant currency. Commercial cloud gross margin percentage increased 4 points year over year to 66 percent as significant improvement in Azure gross margin offset a sales mix shift to Azure. Company gross margin percentage was 69 percent, up 3 points year over year and ahead of our expectations, driven by sales mix to higher margin businesses.

The US dollar was a bit weaker than anticipated, which resulted in slightly less impact to our results. FX reduced revenue growth by less than 2 points and COGS and operating expenses growth by approximately 1 point.

Operating expenses grew 8 percent and 9 percent in constant currency, slightly lower than expectations mainly driven by the timing of marketing and project spend.

And operating margins expanded this quarter driven by the combination of higher gross margins and operating leverage thru effective resource allocation.

Now to our segment results. Revenue from Productivity and Business Processes was $11.1 billion, increasing 13 percent and 15 percent in constant currency, ahead of expectations, primarily driven by our on-premises Office commercial business. Office commercial revenue grew 13 percent and 15 percent in constant currency and benefitted approximately 2 points from transactional strength in Japan. Office 365 commercial revenue growth of 25 percent and 28 percent in constant currency was again driven by installed base growth across all workloads and customer segments as well as higher ARPU. Office 365 commercial seats increased 21 percent with a growing mix from our Microsoft 365 suite. Office consumer revenue grew 5 percent and 6 percent in constant currency, with roughly 7 points of benefit from transactional strength in Japan more than offsetting the strong prior year comparable related to the launch of Office 2019. Office 365 consumer subscribers grew to 35.6 million.

Dynamics revenue grew 14 percent and 16 percent in constant currency, driven by Dynamics 365 revenue growth of 41 percent and 44 percent in constant currency.

LinkedIn revenue increased 25 percent and 26 percent in constant currency with continued strength across all businesses. LinkedIn sessions increased 22 percent as engagement again reached record levels.

Segment gross margin dollars increased 16 percent and 19 percent in constant currency and gross margin percentage increased 2 points year over year as improvements in LinkedIn and Office 365 margins more than offset an increase in cloud revenue mix.

Operating expenses increased 8 percent and 9 percent in constant currency driven by continued investment in LinkedIn and cloud engineering. Operating income increased 23 percent and 27 percent in constant currency.

Next, the Intelligent Cloud segment. Revenue was $10.8 billion, increasing 27 percent and 29 percent in constant currency, ahead of expectations, driven by our on-premises server business. On a significant base, server products and cloud services revenue increased 30 percent and 33 percent in constant currency, driven by continued demand from our hybrid value. Azure revenue increased 59 percent and 63 percent in constant currency with strong growth in our consumption-based business across all customer segments, partially offset by further moderation in our per-user business. Our enterprise mobility installed base grew 36 percent to over 120 million seats benefitting from Microsoft 365 suite momentum.

And our on-premises server business grew 12 percent and 14 percent in constant currency, driven by continued strength across our hybrid and premium offerings, GitHub, and roughly 4 points of benefit from the end of support for SQL and Windows Server 2008.
Enterprise Services revenue increased 7 percent and 8 percent in constant currency, driven by growth in Premier Support Services.

Segment gross margin dollars increased 27 percent and 30 percent in constant currency. Gross margin percentage was up slightly as another quarter of material improvement in Azure gross margin was partially offset by the growing mix of Azure IaaS and PaaS revenue.
Operating expenses increased 22 percent driven by on-going engineering and sales investments in cloud and AI, including GitHub. Operating income grew 33 percent and 38 percent in constant currency.

Now to More Personal Computing. Revenue was $11.1 billion, increasing 4 percent and 5 percent in constant currency, ahead of expectations as better than expected performance in our OEM-Pro and Windows commercial businesses more than offset lower than expected monetization across third party titles within Gaming.

In Windows, OEM non-Pro revenue declined 7 percent, below the consumer PC market with continued pressure in the entry level category. OEM Pro revenue grew 19 percent, ahead of the commercial PC market, driven by strong Windows 10 demand and momentum in advance of Windows 7 end of support. Inventory levels ended the quarter in the normal range.

Windows commercial products and cloud services revenue grew 26 percent and 29 percent in constant currency, driven by healthy demand for Microsoft 365 which carries higher in-quarter revenue recognition.

Surface revenue declined 4 percent and 2 percent in constant currency driven by the timing of product lifecycle transitions ahead of the recently announced product launches.
Search revenue ex TAC increased 11 percent and 13 percent in constant currency driven by Bing rate growth.

In Gaming, revenue declined 7 percent and 6 percent in constant currency, driven by lower console sales. Xbox content and services revenue was relatively unchanged and increased 1 percent in constant currency with growth from Minecraft, Gears of War 5, and GamePass subscriptions offset by a strong third party title in the prior year.

Segment gross margin dollars increased 12 percent and 13 percent in constant currency and gross margin percentage increased 4 points due to higher margin sales mix.
Operating expenses declined 7 percent and 6 percent in constant currency as redeployment of engineering resources to higher growth opportunities was partially offset by investments in Gaming. As a result, operating income grew 28 percent and 31 percent in constant currency.

Now back to total company results. Capital expenditures including finance leases were $4.8 billion, up 12 percent year over year driven by ongoing investment to meet growing demand for our cloud services, and slightly below expectations due to normal quarterly spend variability in the timing of our cloud infrastructure buildout. Cash paid for PP&E was $3.4 billion.

Cash flow from operations was $13.8 billion and increased 1 percent year over year as strong cloud billings and collections were partially offset by tax payments related to the Q4 transfer of intangible property. Free cash flow was $10.4 billion and increased 4 percent. Excluding the impact of these tax payments, cash flow from operations and free cash flow grew 27 percent and 39 percent, respectively.

As expected, in other income and expense, interest income was offset by interest expense, foreign currency remeasurement, and recognized losses on investments. Our effective tax rate was 16 percent, in line with expectations. And finally, we returned $7.9 billion to shareholders through share repurchases and dividends, an increase of 28 percent year over year.

Now let's move to our outlook. Assuming current rates remain stable, we expect FX to decrease Intelligent Cloud revenue growth by approximately 2 points, total company, Productivity and Business Processes, and More Personal Computing revenue growth by approximately 1 point, and have no impact on total company COGS and operating expenses growth.

We expect another strong quarter in our commercial business. Demand for our hybrid offerings and cloud services remains strong and capital expenditures will continue to reflect that. Given the normal variability in infrastructure spend timing, we expect Q2 capex spend to be down slightly on a sequential basis, but still growing from the prior year. And commercial cloud gross margin percentage will continue to improve on a year over year basis even with the continued mix of revenue towards Azure consumption-based services. Now to segment guidance.

In Productivity and Business Processes, we expect revenue between $11.3 and $11.5 billion driven by double digit growth across Office commercial, Dynamics, and LinkedIn.

For Intelligent Cloud, we expect revenue between $11.25 and $11.45 billion. In Azure, we expect continued strong growth in our consumption-based business and moderating growth in our per-user business given the size of the installed base. Our on-premises server business will be driven by demand for our hybrid and premium solutions, as well as the continued benefit from increased demand ahead of the end of support for Windows Server 2008.

In More Personal Computing, we expect revenue between $12.6 and 1$3 billion.
In Windows, overall OEM revenue growth should again be ahead of the PC market as we balance healthy Windows 10 demand and the benefit from the upcoming end of support for Windows 7 with the supply chain's ability to meet this demand in Q2. Based on our customer demand signal and prior end of support cycles, we expect some continued momentum past the January end of support deadline. In Windows commercial products and cloud services, we expect another strong quarter, benefiting from continued Microsoft 365 momentum.
In Surface, the launch of the latest Surface Pro and Surface Laptop devices should drive low double-digit revenue growth on a strong prior year comparable. In Search ex-TAC we expect revenue growth similar to Q1.

And in Gaming, we expect revenue to decline in the mid-20 percent range driven by lower console sales as we near the end of this generation as well as the most challenging quarterly comparable in third party titles from last year. Now, back to overall company guidance.
We expect COGS of $12.45 to $12.65 billion and operating expenses of $10.8 to $10.9 billion. Other income and expense should be approximately $50 million as interest income is partially offset by interest and finance lease expense. And finally, we expect our Q2 effective tax rate to be slightly above the full year rate of 17 percent. Now let me share some additional comments on the full year.

At the company level, we continue to expect double digit revenue and operating income growth, driven by the continued momentum in our commercial business. Given our strong first quarter results and the expected sales mix for the remainder of the year, we now expect operating margins to be up slightly year over year, even as we continue to invest with significant ambition in high growth areas.

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

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

(Operator direction.)

KEITH WEISS, Morgan Stanley: Excellent. Thank you for taking the question and very nice quarter. I also hoping to dig in a little bit into the intelligent cloud business and what you guys are seeing there from a hybrid perspective. And so, maybe one question for Satya and one for Amy.

For Satya, can you talk to us a little bit about sort of how these hybrid engagements are kind of rolling out with the larger customers, how they're contracting from it, and any sense you can give us in terms of in what way do they engage both kind of the on-premise assets as well as the cloud assets, because I think that's part of the equation that's really positively surprising a lot of investors in how well Server & Tools is doing.

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

SATYA NADELLA: Sure, Keith, thanks for the question.

Overall, our approach has always been about this distributed computing fabric or thinking about hybrid as not some transitory phase but as a long-term vision for how computing will meet the real-world needs, because if you think about the long term, compute will migrate to wherever data is getting generated, and increasingly there will be data generated in the real world where just when you think about the cloud, you have to think about the edge of the cloud as a very first-class construct.

And so, in that context, what we see is a couple of things that you see even in the results today. One is the hybrid benefits. That is increasingly what is getting customers excited about the Azure choice and the fact that they can renew knowing that they have the flexibility of both the cloud and the edge, that's definitely driving growth.

Second is we're also gaining share. When you think about what's happening even at the edge, some of our data center edition products are very competitive in the marketplace. And so, you see both of those effects.

But architecturally, we feel well placed. In fact, at our Ignite conference you'll see us even take the next leap forward even in terms of how we think about the architecture, inclusive of the application models, programming models on what distributed computing looks like going forward. So, we feel well-positioned there.

AMY HOOD: And Keith, to your question on sort of durability, we tried to call out the four points that we felt transactionally was due to the end of support and that's 4 of the 12 in USD.

And so, but for us if you step back for a second, the durable trends that Satya just talked about, which is making sure we license in a way that respects this long term reality of where data and compute will be needed is what we call the hybrid value proposition, and the rights to that of course are inherent in how we report this number.

And so, for us what you'll see is premium strengths, which we saw this quarter in both SQL and Windows, because of some of the value proposition of hybrid, and of course a broad strength as well when people feel that flexibility to not be constrained by licensing in terms of how they view their estate.

KEITH WEISS: Excellent. That's super helpful. Thanks, guys.

MICHAEL SPENCER: Thanks, Keith.

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

(Operator Direction.)

HEATHER BELLINI, Goldman Sachs: Great, thank you so much.

This is a question for Amy. I was just wondering, you've been saying for a while now that you're seeing material improvements in Azure gross margins and that's obviously hugely benefitted commercial cloud gross margin.

I'm just wondering if you could share with us how much of the improvement is related to the need to maybe expand data centers at a lower clip than you have been and maybe it's less depreciation and amortization that's coming, that you're starting to recognize, how much of it is due to just better capacity utilization. I'm just trying to get a sense of how much longer you're going to be able to say that for I guess, and just have you guys been ratcheting up your target gross margins for Azure over the years to where you think they could be as you look ahead.

Thank you.

AMY HOOD: Thanks, Heather.

Let me start by saying, in general at the commercial cloud gross margin what you're seeing is revenue growth that for the past almost two years has vastly been faster than our capital expenditure growth.

So, if you start at the top of the frame, what we're seeing is overall gross margin improvement across the portfolio, and improving -- and that comes from a couple of things, which is where you're getting to on Azure. It comes from structural improvement on sort of cost per unit, but it also comes from mix shift of revenue to premium services, from being able to sell more SaaS-like services and consumption services or even premium data services that really do have both more margin but also are quite consistent in terms of their growth, and you see then that represented as improving targets for us.

But I would say in general, Heather, what the team has done is actually delivered on what I think we felt was a five-year roadmap of improving gross margins on a material basis.

Now, as you continue to see the mix shift to the consumption-based Azure services, the overall cloud gross margin won't improve at the same rate, and we've said that, and you'll continue to see that on a go-forward basis as well.

But we do continue to expect Azure, especially on the consumption side, gross margins to improve, and they still have room to improve, especially as we start to see some of these premium services both being made available and being utilized at higher rates.

HEATHER BELLINI: Great, thank you.

MICHAEL SPENCER: Thanks, Heather.

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

(Operator Direction.)

KARL KEIRSTEAD, Deutsche Bank: Thank you. Amy, a question for you. When I look at your next quarter guidance by revenue segment, it seems to equate to an overall revenue growth rate, assuming the midpoint, of about 9 to 10 percent. So, when I combine that with the 14 percent growth you just put up in Q1, it implies that in the second half overall Microsoft revenue growth should remain roughly in the 10 percent zip code to enable you to get to double-digit growth for the full year, despite the fact that you're moving past some fairly key end of support milestones. I think some of us were expecting a little bit more a first half, second half delta.

So, I just wanted to ask you what are the maybe one or two or three drivers that enable you to sustain that growth rate in the second half and if it's fair to assume that your guidance doesn't really reflect any deterioration in the overall spending environment. Thanks a lot.

AMY HOOD: Yes, I think in general, Karl, a couple of things I would point to are many of the things I talked about in the comments that we prepared.

Overall, Q1 was a very strong start commercially from a bookings perspective, with some very strong trends across the board. Whether it is in both the absolute size and number of the Azure commitments that we're seeing, the consistency we're seeing in the consumption growth rates of Azure, the commitments we're seeing to Microsoft 365, some of the signs we're seeing across our Dynamics, the Power Platform, the workflow cloud that Satya referred to, and LinkedIn, it's a good bookings quarter, a good execution quarter on overall contracting value. Renewals were good, recapture rates were good, and new business was good.

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

So, when I think about sort of some of the seasonality that you're talking about, Q2, I felt we were -- I wanted to be clear that that's really a gaming challenge in Q2, and you see that reflected in the margins in Q2 being significantly better than they were last Q2.

And if you think about H2, I do expect Surface will have some easier comparables in H2 and a new portfolio to grow from, so I think that's another change you'll see in trajectory in H2 as well.

KARL KEIRSTEAD: Terrific. Thank you, Amy.

MICHAEL SPENCER: Thanks, Karl.

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

(Operator Direction.)

MARK MOERDLER, Bernstein Research: Thank you and congrats on the quarter.

AI is obviously a large focus and was a large driver of Intelligent Cloud op-ex spending growth this quarter.

Satya, can you give us some more color on where you see Microsoft on the AI journey?

And Amy, is this investing way ahead of revenue or is AI already driving big revenue for Azure? How should we think about it? Appreciate it, thanks.

SATYA NADELLA: No, thanks, Mark. It's a great question, because we look at what's happening with AI having two dimensions to it. One is I would say just our own use of AI as first-party SaaS applications, there's some phenomenal breakthroughs. When you see new transcription features or new computer vision features that come with HoloLens, all of these are being driven by new AI capabilities that are all, by the way, powered by the same cloud infrastructure. We all build everything at Microsoft with first party equals third party, with Azure as the core platform.

And so, what you see us is, in fact, using our own SaaS applications and consumer innovation even to drive the high-end AI capability, but then bring the best-in-class tooling for enterprise customers.

So, for example, like we have innovated even in what does DevOps look like for the machine learning age. That's a unique capability that's there in Azure ML. And those are the types of innovations that are even driving the projects that enterprise customers have on Azure.

So, you'll see us leverage our overall spend, whether it's cap-ex or op-ex across all of what Microsoft does, and then surface them in I think what is perhaps the best way to get traction in the enterprise market, which is great tooling, compliance, security, and that's a place where we are making good progress.

AMY HOOD: And so, for me, Mark, it's a little bit hard for me to say, gosh, we invest in AI here and you'll see is specifically here. What I think you heard through Satya's commentary is actually AI woven through every layer and component of the entire tech stack, and how important that is, whether you're participating at the Dynamics 365 layer with Insights or whether you're using components, like some of our customers are, maybe for natural interaction work.

And so, for me it is almost fundamental to see that cost and investment, because you'll see it in margin and usage, and frankly product differentiation that we can provide versus our competitors.

MARK MOERDLER: Excellent. I really appreciate it. Thank you.

MICHAEL SPENCER: Thanks, Mark.

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

(Operator Direction.)

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

AMY HOOD: Thanks, Brent.

What I would say is for us it has been so important to remain focused on where growth and opportunity exists, and to invest in those areas that are large, expansive and durable TAMs.

And I think when you think about where we've spent our time both building products, investing in marketing, investing in sales capability, technical capability, it has been in many, if not all of those places.

So, when I look and say, where is our execution or how do I think about our ability to execute in a macro environment, for me it is about investing in the right places, executing in a great way, remaining focused on the transition our customers need us to help them through to create their own opportunity and their own growth.

And I think we've done a nice job of being invested in the right places. Satya mentioned a few of them on the call but there are really many. If you think about security, compliance, communications, workflow, business process reinvention, the list can go on and on where I feel like we have set up a multiyear journey to be well-positioned.

And I tend to think of every quarter, every year as an opportunity to continue to differentiate, invest in innovation, and execute well to take share. And so, that's I think how I've approached it.

SATYA NADELLA: And I think that's probably the unifying theme, quite frankly, of all the questions so far, which is what's next. What's next for us is in the apps and infra, go from perhaps first inning to second inning, for data & AI to start the first innings, when it comes to security, compliance, we never participated in this; guess what, we get to participate in a fairly competitive way now. We've built something that didn't even exist a few years ago, which is the workflow cloud. That's a huge opportunity for us. Biz apps, we are very competitive and growing footprint. Even when we think about something like Microsoft 365, we never participated in spite of our past success with all the firstline work and now we get to participate in it.

So, I see long-term secular growth opportunities and we're going to stay focused on making sure our innovation is competitive in all those layers we talked about.

BRENT THIL, Jeffries: Thank you.

MICHAEL SPENCER: Thanks, Brent.

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

(Operator Direction.)

PHIL WINSLOW, Wells Fargo: Thanks for taking my question and congrats on another really impressive quarter.

Satya, I want to focus on the strategic announcements you talked about earlier in the call, Oracle, VMware and obviously the most recent one with SAP. I wonder if you would just walk us through sort of the strategic thoughts behind these, and then also, especially with VMware and Oracle, since those have been out there obviously longer, what's the feedback from customers been?

And then I guess to Amy, how do you think about sort of these big strategic announcements this year actually showing up in the numbers?

SATYA NADELLA: Sure, Phil, thanks.

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

And SAP represents the same, because SAP has got both infrastructure, we now are the preferred cloud, so I think it's a fairly no-brainer for any customer who's an SAP customer who wants to accelerate their migration to the cloud, and innovation from SAP and us that they should move to Azure, and that's what this announcement was all about. And so, we're really looking forward to essentially executing on that strategy and that customer need that we see very clearly.

AMY HOOD: And Phil, to your question on where would we see this, you'd actually see it in a couple of places, not just in Azure, which may in fact, be the most logical extension, but at the heart of this is making it easier, faster, and more reliable for us to help customers move their estate to the cloud and to migrate that with confidence.

And so, when we do that, it's about becoming a committed partner, and you actually see that in broader Microsoft cloud results, whether that's helping even through these partnerships to be able to get closer to tier one workloads, business process changes.

And so, I actually think these are quite important for us to continue to make sure the first goal is customer-centric, which is why we continue to move in this direction.

PHIL WINSLOW: Thanks, guys.

MICHAEL SPENCER: Thanks, Phil.

Operator, we'll take the next question, please

(Operator Direction.)

JENNIFER LOWE, UBS: Great. Thank you.

I think this is probably an Amy question. As I sort of parse through the Dynamics within Office 365 and through the discussion around sustainability of double-digit growth within the commercial segment, you know, we've seen seat count decelerate, also the uplift on pricing maybe isn't as much this quarter as we saw in the past, which leads me to believe that you are seeing a lot of success in the frontline worker piece, and maybe that's a bigger driver of the seat count from here. But can you just -- and at the same time you're seeing strong uptake of the premium SKUs as well.

But as we think about seat count going forward, how much opportunity is there still left on the migration front of commercial licenses versus leaning a bit more on things like frontline worker to sustain that growth, and is there a point where potentially the seat growth and things like frontline could start to eat further into your ability to continue to lift ARPU on the base you already have?

AMY HOOD: Thanks, Jen.

Let me break this question apart, because you're actually asking important dynamics that I don't always think of as tradeoffs, and so I want to make that more clear in my answer.

First, to your question on seat growth, we have room even beyond just firstline workers. Whether that is our ability in small and midsized businesses, on a global basis with mobile-first workers, this is a very broad opportunity for us to reach people trying to accomplish tasks and do their work on devices of any size. And so, there is significant room for us to continue to make progress on that front.

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

Let me separate that from the next dynamic, which is why sort of an average number may not be the best indication, which is our ability to continue to move people to higher value SKUs, whether that's through the addition of really compelling things in security or compliance or communications or collaboration or knowledge or learning where we can add value. Whether we call that E5 or E3, we have room in that transition as well, and new opportunity in a way that I'm not sure I've seen us. I feel very optimistic about M365 -- sorry, Microsoft 365, and our ability to continue to add value. So, hopefully that helps, Jen.

JENNIFER LOWE, UBS: Yeah, that is great, thank you.

MICHAEL SPENCER: Thanks, Jen.

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

(Operator Direction.)

RAIMO LENSCHOW, Barclays: Thanks for squeezing me in.

Quick question on Azure. If I look at the SAP announcement, but you had some other industry announcements out there as well like Humana, et cetera, like how do I think about the progress you guys are making here in terms of getting more into the different industries and to kind of create deeper relationships around Azure rather than just doing kind of simple infrastructure outsourcing? Thank you.

SATYA NADELLA: Yeah, it's a very deliberate strategy that we have. In meeting our customers' needs, we need to have the partners they already work with and want to work with also on our platform. So, it starts sometimes with the customers, whether it's Humana or Walgreens or Walmart and others. It also starts with partners like Nuance, which is another one that we announced recently. And so, the idea is for us to be really ensuring by that by every industry we have the right marquis customers, as well as the partners and have strong go-to-markets.

One of the things that everyone I think in the marketplace understands is Microsoft, especially from a partner perspective, is a great route to market. We have a platform directly with our sales force, as well as our channel, that is very attractive to third-party developers to get on Azure and they've realized those benefits. And in fact, our customers rely on that also as a benefit, because it helps them get the best value from the partners as well.

RAIMO LENSCHOW: Thank you.

MICHAEL SPENCER: Thanks, Raimo.

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

AMY HOOD: Thank you.

SATYA NADELLA: Thank you, all.

(Operator Direction.)

END