Presentation

Operator

Greetings, and welcome to the Microsoft Second Quarter Fiscal Year 2014 Earnings Conference Call. [Operator Instructions] . As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Chris Suh, with -- Manager -- General Manager, Investor Relations for Microsoft. Thank you, Chris. You may begin.

Chris Suh
General Manager of Cloud & Enterprise Finance

Thank you, operator. On our website, microsoft.com/investor, is our financial summary slide deck, which is intended to follow our prepared remarks and provides a reconciliation of differences between GAAP and non-GAAP financial measures.

As a reminder, we will post today's 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 any future use of the recording. You can replay the call and view the transcript at the Microsoft Investor Relations website until January 23, 2015.

During this call, we will be making forward-looking statements which are predictions, projections or other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings press release, in the comments made during this conference call and in the Risk Factors section of our Form 10-K, Form 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.

Before I hand the call over to Amy, please keep in mind that all growth comparisons we make on the call today will relate to the corresponding period of last year. Also, unless specified otherwise, all impacted numbers for the current quarter have been adjusted for the cumulative effect of last year's revenue deferrals and recognitions related to Windows, Office and Xbox video games.

As a reminder, with our new segment reporting structure, we have consolidated adjustments of this nature into corporate and other to provide better comparability of operating results. You can find details of the adjustments and the reconciliation of differences between GAAP and non-GAAP financial measures in our financial summary slide deck.

And with that, I'll turn it over to Amy.

Amy E. Hood
Executive VP & CFO

Thank you, Chris. Good afternoon, and thank you all for joining us today. As I look back on the quarter, I am pleased with the results as we exceeded our expected revenue growth while continuing to maintain our focus on improved execution and cost management.

Our Devices and Consumer segment had a very good quarter and grew 13% with the successful holiday. Our Commercial segment had another great quarter and grew 10% to over $12 billion as we continue to deliver on our differentiated cloud strategy. We performed well this quarter and you see it in our financial results.

This holiday we continued to make significant progress in the consumer space, headlined by Xbox One, which launched in 13 markets and sold in 3.9 million units in just over 5 weeks. According to NPD group figures, Xbox One was the leading console in the U.S. for the month of December, which was its first full month in market. When adding in Xbox 360, which held the third spot, Xbox led the U.S. market with 46% share in December. We are excited for this enthusiastic response from our loyal customers and are working to increase the availability of Xbox One.

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With Surface, demand continued to grow, benefiting from improved execution at retail and favorable reviews of the new Surface devices. Sequentially, both units and revenue more than doubled this quarter, with customers recognizing Surface's differentiated value proposition as one device for everything in their life. We feel good about the progress we have made over the past couple of quarters and are enthusiastic about the overall opportunity ahead with Surface.

The Windows ecosystem as a whole is also making important progress. Earlier this fall we launched Windows 8.1 which enabled smarter, faster and more personalized devices, and our OEM partners are taking advantage of this. Over the last few months, they've delivered a breadth of differentiated devices designed to meet a wide range of customer needs. We're encouraged by what we've been able to accomplish with our partners, and collectively, we will continue to focus on driving the Windows ecosystem forward.

Now let me share some perspective on what we saw in the PC market, which was slightly better than our expectation. Business PCs grew again for the third consecutive quarter and benefited from an improving macro environment, better availability of innovative new hardware and a refresh cycle ahead of Windows XP end of support.

Additionally, growth was higher in large enterprises than small- and medium-sized businesses. Consumer PCs, while better than our expectations, continued to be soft as they faced challenges from competing form factors. And as a general theme, developed markets outperformed emerging markets.

Windows continued to be the platform of choice for business. This quarter, Windows Pro revenue grew 12% and outpaced the underlying business PC market. This was driven by faster growth in both enterprises and developed markets where Pro attach is higher. Windows non-Pro revenue, however, was down 20%, reflecting the dynamics of the consumer PC market.

Now let's move to our Commercial business where key metrics remain strong. Bookings grew 12% and renewal rates remained in line across our product portfolio, even with the large, expiring base in the quarter. Unearned revenue grew 12%, and our contracted not-billed balance is at a record level of over $23 billion. To me, this is important as these long-term commitments demonstrate the confidence that customers have in our product roadmap, where we are investing in key areas such as Big Data, infrastructure management and cloud computing.

In Big Data, our upcoming release of SQL Server 2014, builds on the momentum we've established. Offering a complete business intelligence solution for Big Data, SQL Server is driving significant in-memory performance gains. Additionally, it enables hybrid cloud solutions with cloud backup and disaster recovery, as well as providing enhanced availability and security.

Hybrid infrastructure and management offerings also continue to be important priorities. Windows Server, Azure and System Center are the centerpieces of our hybrid cloud strategy, and together, they enable portability and scalability of workloads. Using our suite of products, customers get high-scale virtualization, built-in software-defined networking and hybrid business continuity that enable their modern data centers.

As CIOs look to cloud computing to reduce costs and deliver business agility, they are turning to our cloud services. Office 365 and Dynamics CRM Online offer customers the ability to transition easily to the cloud and benefit from enterprise-class features and a familiar user interface. Additionally, Windows Azure provides the scalability and flexibility that addresses their evolving infrastructure and platform needs.

In summary, we had a very good quarter across our Consumer and Commercial business. We are taking share with many products and seeing improvements in areas where we needed to be better. As we do this, we continue to prioritize the deployment of our resources to areas that accelerate innovation and deliver products that our customers love.

With that overview of the quarter, I'll hand it over to Chris to give more details about our performance before I come back and share thoughts on our outlook.

Chris Suh

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General Manager of Cloud & Enterprise Finance

Thanks, Amy. First I'm going to review our overall results, and then I'll move on to the details by reporting segment.

We had a successful holiday quarter, and our broad, diversified portfolio helped us deliver record revenue in Q2. Total revenue was up 11% to $24.5 billion, and without the impact of foreign exchange, revenue would have been higher by $196 million or 1 percentage point.

Cost of goods sold increased 46%. This increase was primarily due to costs associated with the new Xbox and Surface products, which launched this quarter, and also growth in cloud infrastructure supporting our consumer and commercial offerings. Even as we invest in our devices and services initiatives, gross margin was flat at $16.2 billion.

Operating expenses grew 3%, which was below our guidance, as we continue to focus on prioritizing spend towards strategic growth initiatives. Operating income and earnings per share both declined 4% to $8.0 billion and $0.78, respectively.

This quarter, we returned $4.3 billion of cash to shareholders in buybacks and dividends, our highest amount in the last 12 quarters.

I'm now going to talk through the performance of each of our reporting segments. In our Devices and Consumer segment, revenue grew 13%. Within this, the licensing segment, which primarily includes Windows OEM, Consumer Office and Windows Phone declined 6%, reflecting the overall PC and device market trends.

We continue to see similar dynamics to the previous quarter. Total Windows OEM revenue declined 3%. As Amy described, the 12% growth in Windows Pro was offset by 20% declines in Windows non-Pro. Excluding the impact of China, where we continue to draw down inventory levels, Windows non-Pro revenue declined 14%.

Office attach, including our cloud offerings, was up again this quarter. Traditional Consumer Office licensing revenue declined 24%. However, we estimate that approximately 16 percentage points of this decline was due to the shift to Office 365 Home Premium. Excluding this impact, traditional Consumer Office outperformed the underlying consumer PC market.

Next, I'll move to our Hardware segment, where revenue grew $1.9 billion or 68%, driven by a good holiday quarter for our consumer devices. Xbox One had a record launch, and together with Xbox 360, we shipped 7.4 million consoles. For Surface, we saw improved sales of Surface RT and also introduced Surface 2 and Surface Pro 2 into the market.

Moving to the Devices and Consumer Other segment. As a reminder, this segment includes our online marketplaces, advertising, Xbox Studios, Office 365 Home Premium and other consumer products and services. Revenue in this segment declined 10% when compared to last year when we launched Halo 4.

Search advertising revenue grew 34%, driven by continued revenue per search improvement and query volume growth. Bing has now grown its share of search queries to 18.2% in the U.S.

Office 365 Home Premium adoption continues to be strong. With this service, customers are always running the most up-to-date version, have content available across their devices with SkyDrive integration and get free Skype minutes. The overall value proposition is resonating well with customers and we now have more than 3.5 million subscribers. For the quarter, it accounted for more than 15% of total Consumer Office licenses sold.

Turning now to our Commercial segment. All-up commercial revenue and gross margin across both on-premise and cloud services grew 10%. Commercial Licensing segment, which reflects our traditional software licensing, grew 7%, and our Commercial Other segment, which captures our commercial cloud services, as well as our Enterprise Services business, grew 28% to $1.8 billion. As economies of scale benefits accrue to these Online Services, we're seeing gross margin expansion in our Commercial Other segment.

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We saw continuing strength across our Commercial portfolio. Server product revenue grew 12%. In the Data Center, the premium version of Windows Server, which targets Tier 1 application workloads, saw a significant revenue growth again this quarter. Revenue for System Center grew double digits, and Hyper-V, our virtualization product, gained 5 points this year over the last year.

In our Data Platform business, SQL Server continued to outpace the market and revenue grew double digits, with SQL Server Premium revenue growing over 25%. Our Commercial Office product also remained strong, growing 10%. Within this, our productivity server offering, SharePoint, Exchange and Lync continued to perform well, with Lync growing over 25%. We're excited about the unified communications opportunity as we combine the enterprise richness of Lync and the global reach of Skype to transform the communications experience.

We're pleased with our momentum in cloud services. This quarter, revenue for commercial cloud services again grew over 100% as customers of all sizes continued to leverage our cloud services to improve productivity, reduce costs and leverage a secure and trusted platform. We are seeing broad-based adoption as Office 365 seats, Azure customers and Dynamics CRM net seat adds all grew over 100%. We now have 70% of the Fortune 500 companies using at least one of our cloud services.

Having now reviewed our results for this past quarter, let me turn it over to Amy to discuss our forward-looking guidance.

Amy E. Hood
Executive VP & CFO

Thanks, Chris. Before I get into our expectations for the quarter, let me quickly touch on Nokia. We continue to expect that the deal will close this quarter but are still in the process of securing all regulatory approvals and meeting closing conditions. So all guidance provided here assumes no impact from Nokia. Assuming the deal closes this quarter, we will include Nokia in our guidance starting in the fourth quarter.

Looking ahead to the third quarter, we are expecting a similar macro environment to what we saw this quarter. As such, many of the dynamics from the second quarter will likely continue into the third.

With that, let's get into the outlook, starting with Devices and Consumer. In licensing, we expect revenue to be $4.1 billion to $4.3 billion. This range reflects similar dynamics to what we saw in the second quarter with business PCs growing, strong Pro mix and headwinds in consumer PCs. In Hardware, we expect revenue to be $1.9 billion to $2.0 billion. This reflects continued post-launch momentum with Surface 2, Surface Pro 2 and Xbox One, with the upcoming launch of the Xbox exclusive game, Titanfall. And in Devices and Consumer Other, we expect revenue to be about $1.8 billion.

Moving on to Commercial. In what is a seasonally slower quarter, we are confident in our ability to continue to be the vendor of choice with our productivity and infrastructure offerings. In Commercial Licensing, we expect revenue to be $10.4 billion to $10.6 billion. In Commercial Other, we expect revenue to be about $1.8 billion, reflecting continued momentum in our commercial cloud business. We expect COGS to be $6.1 billion to $6.3 billion next quarter. This range primarily reflects variability associated with our Hardware business.

Moving on to operating expenses. We expect OpEx to grow 5% to 6% to $7.7 billion to $7.8 billion. We are also reducing and narrowing the range for our full year guidance to $31.2 billion to $31.5 billion. As a reminder, other income and expense includes dividend and interest income, offset by interest expense and the net cost of hedging. We expect these items to generally offset one another. We still expect our full year tax rate to be between 18% and 20%.

We now expect full year capital expenditures to be about $6 billion, which is down about $500 million from our prior guidance. This reduction is primarily driven by improved capacity utilization and scale benefits as we converge our Online Services infrastructure platforms while continuing to support the strong demand that we see in business. Adjusting for prior year tech guarantees and product deferrals, we expect unearned revenue to sequentially decline, as it has in prior years.

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So in summary, I feel good about the financial results this quarter. We are executing well across the company as demonstrated by share gains in our commercial business, but we are also making important inroads with our consumer offerings. Looking ahead, there is a lot to be excited about as we continue our transformation around One Microsoft.

With that, I'll turn it back to Chris, and we'll take your questions.

Chris Suh
General Manager of Cloud & Enterprise Finance
Thanks, Amy. And with that, we'll move on to Q&A. Operator, please go ahead and repeat your instructions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of John DiFucci with JPMorgan Chase.

John Stephen DiFucci
JP Morgan Chase & Co, Research Division

Obviously, nice upside in the Hardware business with Surface and Xbox. But my question is on the licensing business and so bear with me a little bit here. You had both licensing businesses, Device and Consumer and Commercial Licensing. They were both better than expected, at least by about $100 million each. At the same time, deferred revenue was shy by, I don't know, something like $250 million. But there's some conflicting things here. I'm just trying to get my head around this. The contracted, not billed, Amy, you pointed out was really strong. It's a big jump by somewhere around $2 billion sequentially. And you also saw some nice traction, the commercial cloud services more than doubled, assuming it's small but -- so here's my question. With all that happening, is there a shift happening with your on-premise corporate business to more transactional versus ratable contracts? That would sort of help out to help offset the financial implications as you shift to sort of cloud services on the corporate side. Is that what's happening with all these movements? Sorry about all the details.

Amy E. Hood
Executive VP & CFO

I really appreciate the question because it's going to let me help expand on a couple of dynamics, which I think are at work here. So now I'm going to ask you to bear with me with a little bit of a long answer. Let me start by your comments, I think, around the overall commercial licensing bucket. What I'm going to expand to include as you did, the overall Commercial business, both cloud and licensing. There are a number of metrics that I tend to look at together as opposed to individually to think about how we did in the quarter. You touched on, one, unearned, which grew 12% this quarter, which is quite good; the second is bookings, which grew 12% in the quarter, which is very good; renewal rates, which were in line across our products; and finally, the CNB balance, the contracted not billed balance, being up sequentially, $2 billion, as you point out, is very big. If you think about those together as a group, those data points are very important because, together, I would say any -- I think you said a couple hundred short on unearned. With those data points together, I would say there's no shortage in terms of Commercial Licensing and Commercial Other strength all up. As you know, contracted but not billed tends to be at the end of a quarter, right? We signed a bunch of contracts that we can't bill for until the very beginning of the next. Think about that as business done in quarter. You'll see that come into the unearned balance, frankly, in Q3, as well as into adjusted. So that dynamic answers, really, the first question and a part of the question you asked. Now that could have -- so that's sort of a separate piece. Then you said, "Well, some of the dynamic could be explained by some strong transactional business in the quarter." I would say there's one place, and I would actually separate these things because the first was good and the second was better than we thought. Office non-annuity or transactional did a little better than we thought in quarter as well, and so that's a good point that we didn't bring out. But that is another, sort of, component of the 10% all-up commercial growth. Now -- so I guess my answer is I agree with your transactional comment, but I disagree that it's probably the overall -- it's a component of a "short fall in unearned". I would say both are actually quite good.

John Stephen DiFucci
JP Morgan Chase & Co, Research Division

That's fairly helpful, but actually, just a clarification on the contracted not yet billed. You said that -- and yes, contracts get signed at the end of the quarter. But -- so you're saying that the big jump, primarily, was because they just hadn't been billed yet versus signing. I could see if you were just signing longer-term deals, that you're going to build annually, but that's not what's happening. It's more about just -- is that accurate? Either one could happen.

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Amy E. Hood
Executive VP & CFO

Yes, that's right. If something was actually billed at the end of the quarter, it goes into unearned. Contracted but not billed is actually that the contract was signed but because the billing won't quite take place until after the end of the fiscal quarter, it ends up in contracted but not billed as opposed to unearned.

John Stephen DiFucci
JP Morgan Chase & Co, Research Division

Right. But are we seeing any -- like, typically, your contracts are 3 years, but are we seeing any extension on the average contract length?

Amy E. Hood
Executive VP & CFO

No, no. That's not one of the impacts.

Operator

Our next question comes from the line of Mark Moerdler with Sanford C. Bernstein.

Mark L. Moerdler
Sanford C. Bernstein & Co., LLC., Research Division

Two quick questions. The first one is, can you give us any sense of how much of the Office 365 and the Home Premium could be generated by net new users as compared to simply the move over existing users? And then I'll ask a second one.

Amy E. Hood
Executive VP & CFO

Mark, that's actually -- here's how I think about the value prop because I can't really say these are sales through retail and through OEM, generally, whether it's a net new user or not. What I can say is that attach overall went up in the Office Consumer business, which I would say is and could be a sign that some of those are net new. And I would hope that to be the case. The value prop of Office 365 Home Premium really does expand the footprint. It allows for multiple users. It has cross-platform capabilities with Office for Mac. It's got mobile capabilities as well and allows for easier trial. So it does sort of lower many of the barriers to experience and try the products. So while I can't point and say there's an exact number that is a new user, I can certainly say with attach going up, that dynamic is helpful.

Mark L. Moerdler
Sanford C. Bernstein & Co., LLC., Research Division

Excellent. The second quick question on it -- the second quick question is on the Windows side. Any sense whether or not -- we've seen obviously an improvement on the numbers on here. Do you believe that's being driven purely by an improvement going on, on the market? Is the Windows 7 refresh accelerating as we get closer to the day? Any sense of what the drivers are, both on the consumer and the enterprise side, as to why we're seeing the pickup?

Amy E. Hood
Executive VP & CFO

Sure. I covered a little bit in my comments, but it's probably worth spending a little bit more time. Let me start with the business market. I think there really are 3 factors that I would point to particularly in the business environment. And the first one may, Mark, also help on the consumer side. The overall macro spending environment is better. It's a little better than we thought. And in businesses, we're seeing it -- you're seeing it in some of the IT spend forecasts you all put out. They're being raised and I think that has an impact. The second is I think our partners have done a very good job expanding the types and availability of new and interesting hardware. That brings people to the store and I think is encouraging

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sign. And finally, as you asked, at the end of life of XP. That is -- that has been an impact, and we expect it to continue to be, as we said, in Q3. But I wouldn't point to simply one of the factors as being the reason, but it is a combination of those factors.

Operator

Our next question comes from the line of Phil Winslow with Crédit Suisse.

Philip Alan Winslow
Crédit Suisse AG, Research Division

I just have a question back on the Windows volume licensing side. You kind of touched on it earlier. But you saw a 10% growth this quarter versus 6% last quarter, so you continue to have very healthy growth here. One of the questions I've been getting from some clients is, a, what's driving that; and b, when we get -- as we get, sort of, closer and then actually pass the official end of life of XP, how do you think that's going to affect the growth in Windows licensing sort of beyond that point?

Amy E. Hood
Executive VP & CFO

Thanks, Phil. Let me -- I'm going to take the opportunity to make your question 2 questions. One is to talk about Windows volume licensing overall and, secondly, allow me to talk a little bit about the places that you could see the impact of Windows XP in the current quarter, and I think that will help as you think about Q3 going forward. In volume licensing, you're right, it did grow 10% in Q2. And we do believe we are seeing some of the benefits of that growth is the end of life of Windows XP. But it's also reflective of the value many of our bigger customers are seeing in upgrading to the enterprise version of Windows. The enterprise SKU includes things like DirectAccess, Windows To Go, the corporate image, AppLocker. And those really are differentiating, and they really do matter to many CIOs. So I think specifically on VL, while end of life of XP is one component, it's certainly not the only component. Now if I expand your question to sort of -- and I think, in a way, John asked about it, too -- I mean, Mark asked about it, too, is the end of life of XP. One place that we've talked about it was Windows and how does it play in to the business PC growth; the second we talked about was volume licensing; and the third, which I actually talked about in John's question, was Office and some transactional strengths. Some of the strengths that we saw in Office transactionally really can be linked back to the end of life of XP. As people refresh a PC and if they're buying Pro, those people often are Office customers. And so if they tend to buy on a transactional basis, they'd also see some impact through Office. I think you can tie that back to some of the outperformance we saw in the quarter as well.

Operator

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

Heather Anne Bellini
Goldman Sachs Group Inc., Research Division

Amy, I wanted to ask if you could share with us how you see the gross margin profile of the company changing as you continue with your journey to be a devices and services company. And as you look out to when the transition is complete, and I know you probably don't know when exactly that's going to occur, how do we think about what it will look like?

Amy E. Hood
Executive VP & CFO

Heather, thanks. This is one of those questions that I think is best taken in a bit of a chunk. First of all, I think if you look at our Commercial segment, I'll do it all up because I think it's relatively easy with that breakdown. In general, and you saw it this quarter, even if we continue to invest in the infrastructure to support our cloud conversion of our commercial customers to Azure and Office 365 and CRM Online, our actual gross margin remains flat, which means we're increasing our utilization and growing gross margin in the commercial cloud business as we continue to see traction. Over time, I continue to believe our Commercial business, in the absolute, moving to the cloud is a net positive, as we talked about before, to

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overall profit, including increasing the amount of gross margin we make as a company. So that -- I think this quarter was 83%-ish, so that, I would take as a separate bucket from our Devices and Consumer business. And now what's interesting is we have a couple of business models there with different gross margin profiles. And you're actually seeing the impact of some of that in this quarter. Xbox, as we know, especially with new consoles like the One, tend to be gross, margin-negative on the front. This is a heavy quarter for that. Over time, through the attach, a second -- first-, second-, third-party games and other services, the margin profile with any console life changes. But it's never going to be an 83% gross margin. It's just a different business, even for the market leader and even successfully generating cash in return. That is different from other businesses we also have in D&C. So I think the important thing that I tend to focus on as I go through all these businesses is continued margin improvement within the business, continued efficiency within the business and continued focus on the absolute profit within each of those areas. And then the mix then becomes more of a math equation as we continue to grow the overall amount of cash and profit the company generates.

Operator

Our next question comes from the line of Brent Thill with UBS.

Brent John Thill
UBS Investment Bank, Research Division

Amy, just back on contracted not billed. You had 4 quarters over $21 billion and then jumping up obviously to north of $23 billion. That jump that happened, can you just help us understand what the buckets of -- that made that jump up this quarter. Was -- is there an easier way to think through where that actually came from?

Amy E. Hood
Executive VP & CFO

Yes. Yes and no, of course. Brent, let me say, contractual -- contracted but not billed is related to the number of expirations we have in the quarter. Chris and, I think, I both talked about, we did have a lot of expirations in the quarter. When those tend to fall at the end, it can impact the actual magnitude is the absolute number of expirations. And then that timing of when those fall in the quarter can also impact how it's recognized. And that's why I never really look at it separately from unearned, bookings and renewals together. And so -- because timing is one thing, that's why I tend to put them in a bucket and say together, it's a good and healthy trajectory.

Brent John Thill
UBS Investment Bank, Research Division

And just real quick, on the multi-year agreements, you mentioned the healthy renewals. Any color you can add to the re-up on the size of what you're seeing in general across some of those bigger multi-year agreements?

Amy E. Hood
Executive VP & CFO

I think in general, it reflects the same trends we've been seeing. It's across our broad portfolio. You see it with -- across Windows, Office and Server. If you look at our KPIs, I think that points out that it's pretty broad-based. So I don't think there's any one particular area I would call out. It's really more about platform health and commitment.

Operator

Our next question comes from the line of Walter Pritchard with Citigroup.

Walter H Pritchard
Citigroup Inc, Research Division

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Question on the consumer retail side. This is the first year, I think, you've had full retail store presence. You also, I believe, had some presence in some of the Best Buys with sort of mini stores in there. And I'm wondering sort of what your takeaway is from the holiday season, and if those efforts, you think, were part of the reason why you had a pretty successful holiday season, especially on the PC side and what that experience suggests that you should do in the future in terms of retail store buildout and general investment around retail.

Amy E. Hood
Executive VP & CFO

Thanks, Walter. When we talk about improved retail execution, I really think that's a partnership, as you said, with retailers, with our OEMs and with our efforts to really improve both the devices, the assortment and the experience of buying in the PC aisle. So I do feel good about the investments we've made there, and we've made them, I think, thoughtfully and continue to keep a focus on cost and expense as we do that. So do I think it's had an impact? I do. But I really think the broader impact was investments and commitments we had with our partners to also improve the retail buying experience.

Operator

Our next question comes from the line of Keith Weiss with Morgan Stanley.

Keith Weiss
Morgan Stanley, Research Division

I wanted to dig into gross margins in the quarter because by my estimates, you guys outperformed the guidance for gross margin that you gave in the quarter. Despite the fact that you saw significant outperformance in D&C Hardware, which, as you were saying, especially for something like Xbox One, which is just out of the gate, we had expectations of being very low, if not negative gross margins. Can you help us understand a little bit of where that gross margin outperformance came from? Was any of it in D&C Hardware getting better yields or, sort of, better gross margins on those products than your expectations? And if not, where did the outperformance come from?

Amy E. Hood
Executive VP & CFO

Thanks, Keith. I'm glad you asked that question. With our outperformance, as you pointed out, in D&C Hardware, we did actually see increased COGS related to that. However, that was offset by some COGS improvement and savings we saw across other areas as we continue to focus on efficiency and execution. And so you're right, we did see COGS grow with Hardware, but we were able to find savings elsewhere as we focused on improved execution.

Operator

Our next question comes from the line of Rick Sherlund with Nomura Securities.

Richard G. Sherlund
Nomura Securities Co. Ltd., Research Division

Just a follow-up to an earlier question on the contracted but unbilled. We're seeing with VMware that they had a surge of 3-year contracts coming out of the recession, and a lot of those were coming back for renewal now. Is that what you were suggesting as you've got an unusually large volume of contracts coming up for renewal?

Amy E. Hood
Executive VP & CFO

Rick, that's a yes. In many ways, you've seen this over covering our company for a while. Expirations can be chunkier. That's not a year statement. This quarter, we had a big expiry base. I wouldn't characterize it as sort of abnormally large, but the timing is a bit related to 3 years ago and the timing of some of the contracts. So it's probably a consistent driver.

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Richard G. Sherlund
Nomura Securities Co. Ltd., Research Division

Okay. And last quarter, we talked a bit about -- are there any metrics you can help us to understand better what the effect of your revenues is from the shift to the cloud? I think on Office, it's more of a net delta that I think you'd said it hurts you about $150 million in the previous quarter. Is there any way you can give us a sense of what the net impact is on the business from the shift to the cloud?

Chris Suh
General Manager of Cloud & Enterprise Finance

Rick, it's Chris. I think I talked about this a little bit. The place where you can see the most direct impact is in the Consumer Office business. We talked about the business on a traditional license basis being down 24 points, but our estimate is approximately 16 points of that decline is accounted for by the shift to Office 365 Home Premium. So that gives you sort of a good estimation of the impact -- the direct impact we're seeing, particularly on the consumer side.

Richard G. Sherlund
Nomura Securities Co. Ltd., Research Division

That implies it would only be down about 8% were it not for the shift to the cloud?

Chris Suh
General Manager of Cloud & Enterprise Finance

That's one way to look at it, yes. The net number would be about 8%.

Operator

Our next question comes from the line of Ed Maguire with CLSA.

Edward Everett Maguire
CLSA Limited, Research Division

I wanted to ask about Phone because you had not discussed Windows Phone on the call so far. Just how it's tracking based on your expectations, whether you are planning on continuing to invest with non-Nokia OEMs, and also, Amy, whether any of your expectations or investment plans for the integration with Nokia have changed in any meaningful way since you announced the deal.

Amy E. Hood
Executive VP & CFO

Thanks, Ed. That's a good point. We didn't have a chance to discuss the Phone results. We did see growth in Windows Phone, both in the licensing and in the mobile phone IP revenues. Both grew this quarter.
I think regarding Nokia, we continue to see the growth in many places that we've seen historically: so unsubsidized markets, as well as with entry-level smartphone devices. So I think many of those dynamics haven't really changed. Do I have any updates to how to think about Nokia other than we continue to expect it to close in the quarter? I don't. We mostly remain focused on working hard to get to the point. We're working together as 1 team to drive that business forward.

Operator

Our next question comes from the line of Kash Rangan with Merrill Lynch.

Kasthuri Gopalan Rangan
BofA Merrill Lynch, Research Division

Amy, I appreciate the fact that you're trying to improve the margins in each of the Commercial and the Consumer businesses. But the margin differential between these 2 businesses is still is a pretty wide one. It looks like the Consumer business is growing. The 2 dynamics that I can see are that the Consumer business -- the 3 are [ph] : one is the margin differential is too wide. You try to improve it. The margin differential is still wide. The Consumer business, trend-wise, is growing faster than commercial. And third

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is that you have the shift to the cloud. So unless you do something like an Adobe or Autodesk where you force the transition to happen very quickly, there is the risk that you get a lot of growth, which is fantastic, and there's a lot of progress to share. But the margin inflection point could be delayed for several years, so I think that was one of the questions, that was the spur behind, I think, presumably, Heather's question. That's what I'm trying to get at. So how long are you going to get this shift to result in a way that we may not see the earnings growth rate but we may have to wait until some point in time? Or are you at the point where you can actually force this shift to happen much quicker?

Amy E. Hood
Executive VP & CFO

Thanks, Kash. I think the way I think about it is we are -- we have a broad portfolio, and we address customers of all types. And in many ways, our biggest goal is to meet the needs of our customers, whether they be CIOs or consumers, and setting our business model to support the products, and the adoption curve that we want needs to be married with the adoption curve and timing of our customers. I feel like we've done a very good job of balancing the pace of that. I've been encouraged by the pace of adoption of many of our cloud services. You heard the Home Premium numbers today, as well as talking about the commercial cloud. And so for me, it's hard to say -- they're too big of a delta. It's really about managing each of these things toward absolute growth and absolute improvement and having customer adoption. So I probably just have a different perspective on that than you have.

Operator

Our next question comes from the line of Ross MacMillan with Jefferies.

Ross Stuart MacMillan
Jefferies LLC, Research Division

Amy, you said that Office 365 Home Premium was more than 15% of total Consumer Office licenses sold. And I wonder, if you think about your Commercial business and we either think about it as a percentage of total Office 365 or as a percentage of maybe what's traditionally being transactional, whether you have a similar metric in terms of percentage of total Office licenses sold.

Amy E. Hood
Executive VP & CFO

It's actually -- it's a good question. We only recently started selling the Office client in our volume licensing agreements through a subscription. So that is actually good feedback for us to think going forward about talking about the Office-specific business that way because, in general, we think of Office 365 as being a broad set of assets, including Exchange, SharePoint, Lync and Office in the Commercial business. And we haven't really talked about it, given the newness of the model in the enterprise as being as meaningful as it has been in the consumer. The shift is far faster there on the client.

Ross Stuart MacMillan
Jefferies LLC, Research Division

Yes, I just think that would be helpful, especially if you think about it with respect to your traditional commercial transactional business. Maybe if I could slip in one other one, just to go back on the contracted not billed. I just want to be clear in my own mind because I've heard 2 things. One thing I heard you say was we had stronger transactional business late in the quarter, but I also heard you say that there were, frankly, more renewals on multi-year that would have resulted in that balance going up, especially if those were late in the quarter. So am I right to think it's those 2 factors that are at play here, both stronger transactional and a larger pool, if you will, of multi-year renewals? And is it relatively evenly balanced between the 2?

Amy E. Hood
Executive VP & CFO

Thanks. Actually, transactional execution in the quarter is recognized all in quarter. That's not annuity. It doesn't go to either the unearned balance or the contracted not billed balance. So that's not an impact

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that results in a change to your unearned or CNB. The latter, which is the absolute size of the expiration days, frankly, could or couldn't impact CNB. It can impact things like unearned growth, but it also can impact CNB, depending on if it's contracted and quartered but not billed until after the end of the quarter.

Operator

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

Brad Robert Reback
Stifel, Nicolaus & Company, Incorporated, Research Division

So, Amy, in the Q, you talked about the Surface still losing money even at the almost $900 million run rate of revenue in the quarter. Can you give us any sense of what type of volume you need for that business to have the scale to make some money?

Amy E. Hood
Executive VP & CFO

Thanks, Brad. When we launched Surface just a year ago, our goal was really to create a product that showcased what can happen when you innovate in hardware, in the service and in the software. And as you know, we've learned a lot over the course of this journey, and we have to make more meaningful progress. But I think for us, we've remained focused as we launch the second version of Surface to be -- to stay focused on those price points and gross margin. And I think we've made a big leap from B1 to B2, and I look forward to making leaps as we go forward in our product roadmap. But I do think it's more to think about it as a goal we absolutely have as we continue to innovate the line.

Operator

Our next question comes from the line of Gregg Moskowitz with Cowen and Company.

Gregg Steven Moskowitz
Cowen and Company, LLC, Research Division

Amy, despite the healthy gross margins, your Xbox platform revenue grew $1.2 billion year-over-year, but your related cost of goods sold went up by $1.6 billion. And I realize there may be additional costs related to launch, but just wondering if you could talk to your expected profitability levels for Xbox over the balance of fiscal '14.

Amy E. Hood
Executive VP & CFO

Thanks. We'll continue to be in launch mode for Xbox One, especially many people are excited about the launch of Titanfall in March. And we'll continue to add and expand markets over the course of the year. So I would continue to think about our investments in being the leading next-generation console certainly extending.

Operator

And our last question comes from Brendan Barnicle with Pacific Crest Securities.

Brendan John Barnicle
Pacific Crest Securities, Inc., Research Division

Amy, you mentioned briefly in your comment some of the strengths you'd seen in SQL Server, and that seems to be taking market share. You highlighted a couple of the features, but what do you think is driving that market share gain? And a similar question over on the Server side, where you seem to have better server numbers than what we've seen in units. What would be accounting for that additional strength?

Amy E. Hood
Executive VP & CFO

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Thank you. You're right, I only pointed out a few of the value props of SQL Server. And actually, dating back years, the real value prop of SQL has been the breadth of its offering: analytics, reporting and core database functionality. And so over the years, I think the balance of those things and continuing to add and innovate at very good value has continued to be appealing. And I -- as we move forward and add some cloud capabilities into our hybrid model and continue to add features into the premium levels, when you're the established, and I think in many ways, unit leader, then you can focus on continuing to move up the stack, adding value and increasing your premium mix. And the team has really done a terrific job of doing that. So it's nice to be asked so that I can talk about it. And I think, I mentioned it briefly, that System Center is another where we've gained share in virtualization. And I think we're quite proud of the progress we've made, especially in that area, and that's enabled a lot of growth as well. So I actually appreciate the question. It's good to be able to talk so positively about those assets.

Chris Suh
General Manager of Cloud & Enterprise Finance

Okay. So that wraps up the Q&A portion of today's earnings call. Just a quick reminder, that Build, our developer conference, will kick off the morning of April 2 in San Francisco. We encourage investors to watch the keynotes live via webcast. We'll also look forward to seeing many of you at the coming months in various investor conferences. For those of you unable to attend in person, these events will generally be webcast, and you'll be able to follow our comments at the microsoft.com/investor website. Please contact us if you need additional details. Thanks again for joining us today and take care.

Amy E. Hood
Executive VP & CFO

Thank you, everyone.

Operator
This concludes today's teleconference. You may disconnect your lines at this time, and thank you for your participation.

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