Presentation

Operator

Welcome to the Microsoft Third Quarter 2009 Fiscal Year Conference Call. At this time, all participants are in a listen only mode. (Operator instructions) Today's call is being recorded. If you have any objections, you may disconnect at this time. I would now like to turn the meeting over to Mr. Bill Koefoed, General Manager, Investor Relations. Sir, you may begin.

Bill Koefoed

Thank you, Barb, and thanks everyone for joining us today on our third quarter earnings call. I am joined today by Chris Liddell, Senior Vice President and Chief Financial Officer; Frank Brod, Corporate Vice President and Chief Accounting Officer; and John Seethoff, Deputy General Counsel.

The format for today's call will be as follows. Chris will summarize some of the key take-aways for the quarter. I will then provide details around our third quarter results, and then hand it back to Chris for a more detailed discussion of our business outlook. After that, we'll take your questions.

Please be aware that we filed our Form 10-Q today in conjunction with our earnings release. We have also posted our quarterly financial summary slide deck, which is intended to follow the flow of our prepared remarks, as well as provide a reconciliation of differences between GAAP and non-GAAP financial measures that we will talk about today. You can find these documents at the Investor Relations website at www.microsoft.com/msft.

Today's call will be webcast live and recorded. Please be aware that if you decide to ask a question, it will be included in both our live transmission as well as any future use of the recording. A replay of the call will be available at the Microsoft Investor Relations web site through the close of business on April 22, 2010. This conference call report is protected by copyright law and international treaties. Unauthorized reproduction or distribution of this report or any portion of it without the express permission of Microsoft may result in civil and criminal penalties.

We will be making statements during this call that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially 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-Q, our most recent Form 10-K, and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statements.

And now, I'll turn the call over to Chris.

Chris Liddell

Thanks Bill. Our third quarter results reflect the combination of two forces, firstly the most difficult economic environment the company has faced in our 30 year history, about offset by company specific factors. On the macroeconomic front, we saw a broad-based slowdown across virtually all product lines and geographies. Our transactional revenues, for example, and our emerging markets, in particular, were impacted by the economic reset that we are all seeing with demand down as much as 15% to 20%.

Against that backdrop, while I can't be happy with any quarter where our revenue and earnings per share decreased, I was actually pleased with our relative performance. First, our annuity licensing held up well, reflecting the strength of our diversified business model. Second, we managed expenses significantly below our expectations going into the quarter, which is a credit to our employees' ability to adapt to a new reality. And third, despite all the distractions, including the first significant layoffs the company has ever implemented, we executed on our product development milestones.

Globally, overall IT spend, in particular, business hardware purchasing continued to slow from the levels seen in the second quarter and severely impacted transactional license sales in our client Microsoft business division and server and tools businesses. We did see some pockets of strength reflecting consumers' desire to purchase down the price points. For example, we saw healthy unit volumes at netbooks, office suites at retail and Xbox 360 consoles.

Geographically mature markets slowed noticeably, while emerging markets, which has historically been sources of strong revenue growth for us reported even deeper declines than mature markets. Our annuity business is clearly our bright spot. With strong sales execution, corporate customers are renewing their long-term commitment with us, which reflects both the value of our current product portfolio and anticipated future product innovation.

On the expense side, we executed against cost-saving initiatives with production down across the board, marketing, vendor costs, and other discretionary spend, as well as a reduction in headcount and headcount related costs, and lower capital expenditure. We ended the quarter with 800 less employees than we started the quarter with, and importantly, we're also seeing our people focus on efficiency and the need for fiscal discipline.

We accomplished this while also focusing on operational excellence. This quarter, we made significant product development progress towards the next wave of product and services. Over the next 18 months, we will be delivering updates to our core franchises, namely Windows 7, Windows Server and Office 2010, as well as bringing new services like Windows Azure to market.

So in summary, we remain cautious - more cautious than most about the state of the world economy. Our globally diversified business gives us insight into a world where economic pressures are both broad and deep. While we would all like to think that a recovery will be short and painless, we unfortunately believe that it'll be so and gradual. We expect trading conditions to remain very difficult through the next quarter and potentially through the balance of this calendar year.

Against that backdrop, we have to focus on our relative performance. We have the benefit of a strong annuity business, which partially insulates us. We can continue to be tight on costs. We can continue to focus on maximizing the strongest cash flow of any company in the industry, and we will continue to launch a counter cyclical wave of products over the next 12 to 18 months, which will help growth in fiscal year 2010 and beyond.

So with those high-level themes, I will turn the call over to Bill for some more details on the third quarter.

Bill Koefoed

Thanks. As Chris mentioned, our revenue results were impacted by a weak macro economic environment. However, strong execution on our cost initiatives helped to offset the impact to operating income. I'm going to provide you with details on our financial performance. I'll start with the overall company business and financial momentum points and then follow up with revenue performance for each of the business units. All growth comparisons I mention relates to the comparable year of last year unless otherwise specified.

Overall, revenue declined 6% to $13.6 billion, due to continued weakness in global demand, particularly in the business PC and server hardware market. Despite this revenue shortfall, excluding the $0.06 of charges related to severance and investment impairments, earnings per share for the quarter were $0.39, in line with expectations. Within the business results, the transactional portions of our business are down substantially as a result of weakness in the associated market while our annuity business remains healthy.

Within our customer segment, small and mid market customers remain the most severely impacted by the current economic conditions. In the consumer segment, we have seen healthy volumes in the lower-priced products, but experienced weakness in the higher -priced SKUs as can be expected in this environment. The enterprise customer segment has held up and renewal rates were stable and within our historical range.

Driven by these dynamics, our product billing mix continues to shift toward our annuity licensing, which is up five percentage points from the prior year to about 35%. The remaining billing mix is approximately 30% from OEMs, 15% from transactional license only sales, with the balance from our other businesses.

Unearned revenue grew 1% year-over-year to $12.3 billion. Our contracted not billed balance exceeds $12.5 billion and was also up year-over-year. Overall, total bookings for the company declined 15% driven by the declines in the transactional portions of our business. Foreign exchange rate fluctuations did not materially impact overall revenue growth this quarter.

Now let me move to the revenue and business drivers by segment beginning with Windows client. I will start with some commentary on the PC market. We saw continued deterioration in the overall PC hardware market, which we estimate to have declined 7% to 9%. Traditional or non-netbook PCs were down 15% to 17% compared with the year ago quarter. We have seen continued weakness in the business segment of the PC market as companies cut their IT hardware spending and extended hardware refresh cycles.

The small notebook PCs or netbook category in the market continued its growth and represented about 10% of the total PC shipments for the quarter. Unit sales in the consumer segment of the market benefited from the growth in the netbook category and were about flat year-over-year. So with that market context, let me move on to client.

Client revenue was $3.4 billion, down 16% from a year ago. This decline is consistent with the framework we provided to you last quarter with client revenue declining in line with the traditional portion of the PC hardware market. Overall OEM unit sales declined 6% performing slightly better than the overall PC market due to attach rate improvement. The particularly strong attach rate in netbooks illustrate that customers continue to prefer Windows.

OEM revenue was down 19% driven by the dynamics in the underlying PC market. Specifically, sales of premium SKUs were down over 20%, primarily due to the declines in the traditional business PC market, I mentioned. Partially offsetting the decline in premium units was strong growth in our lower price netbook software.

The commercial and retail portion of the client business grew 1%. The enterprise annuity business continued to have healthy growth. This growth was partially offset by lower retail sales attributable to general consumer spending softness, as well as some normal slowing ahead of a major product release.

Against the current economic backdrop, the client revenue remained - the client division remained focused on execution and delivering on the product pipeline. During the quarter, we released the public beta of Windows 7. We feel very good about the response we are getting to Windows 7 beta testers and our progress against the next milestone, which is the release candidate. We also delivered significant innovations to the browser with the release of Internet Explorer 8, which has also received strong press and analyst reviews. We remain very positive about the client product pipeline and its ability to drive long-term growth for the company.

On the marketing side, we have seen a measurable perception increase for Windows from our recent advertising campaigns. Specifically, our research shows that 10% increase in preference for Windows PC since these campaigns launched.

Now let us move to server and tools where revenues grew 7% to $3.5 billion. Revenue was driven by double-digit growth in our enterprise annuity business from sales of premium editions of Windows Server 2008 and SQL Server 2008 in addition to strong growth in System Center Management suite. The consulting and support services portion of server and tools revenue grew 6%. Revenue from the transactional and OEM portions of the business declined over 15% during the quarter in line with the estimates for the underlying x86 server hardware market.

Industry analysts continue to publish healthy market share performance for Windows Server 2008, a validation of the competitive benefit it provides the customers. On the product front, the server and tools division delivered the beta release of Windows Server 2008 R2, which builds on the value of Windows server, with new features like live migration. In addition, we released the beta version of Silverlight 3, which delivers new functionality to run Silverlight applications off-line.

Moving on to the online services business, revenue declined $122 million or 14%. Online advertising revenue was down 16% primarily due to the significant decline in display advertising rates across the industry. Partially offsetting this was continued growth in both page views and search queries. The

Microsoft business division had revenues of $4.5 billion, which declined 5% due to declines in non-annuity licensing. This transactional revenue was primarily impacted by the traditional PC market decline. We increased attach with pricing promotion, but due to lower prices and PC sales, overall transactional revenue declined more than 25%. This decline was partially offset by healthy 15% revenue growth from our annuity business.

In the quarter, we continued to see strong demand in our SharePoint, Office Communications Server and CRM products, which all grew more than 20%. On the product front, during the quarter, we released a new version of our unified communications offering, with Office Communications Server 2007 R2. Additionally, last week, we announced the timeline for our next release of Office 2010 and made available the beta version of Exchange 2010, which will be for sale in the second half of calendar 2009.

Moving to the entertainment devices division, revenue decreased 2% to $1.6 billion. The Xbox 360 business had a very strong quarter selling over 1.7 million consoles. This represents growth of almost 30% over the prior year. This fiscal year to date, we have already sold approximately 10 million consoles, about 15% more than we sold in all of last year. Attach rates for Xbox continue to lead the industry with software attach rates growing to 8.3 and accessories attach rates growing to 3.9.

In addition, Xbox Live is a key differentiator for our platform. For example, 1 million Xbox Live gold members have activated Netflix on Xbox Live. You'll hear more about our Xbox Live progress at E3 in June. During the quarter, we unveiled Windows Mobile 6.5, the next version of our Windows Mobile software platform. You can expect to see phones running Windows Mobile 6.5 by the fourth quarter of this calendar year.

Now for the rest of the income statement. Cost of revenue increased 12% primarily driven by increased distribution and data center costs. Operating expenses decreased $1.3 billion or 16%. This year's results were impacted by $290 million of employee severance charges, as a result of our announced plan to eliminate up to 5,000 positions. Prior year's results included $1.4 million in certain legal charges. Adjusting for these items, operating expenses were down 2% year-over-year and 10% sequentially, due to our focus on efficiency that Chris described earlier.

Operating income of $4.4 billion was up 3% but down 17% after adjusting for impacts of the employees' severance and legal charges from the current and prior years. Other income and expense was a net loss of $388 million and includes $420 million of impairment charges on investments, primary due to the continued declines in the market. Given the uncertainty and volatility of marketing conditions, we remain focused on cash and working capital management.

The company generated $5.4 billion or $0.61 per share in free cash flow this quarter, reflecting moderated operating expenses and capital expenditures. We have maintained our AAA debt rating and rebuild cash to over $25 billion while returning $1.2 billion in cash to shareholders through dividends. Our effective tax rate was 26.5% for the quarter in line with guidance we provided. Diluted shares outstanding for the quarter were $8.9 billion, down 6% from the prior year. As I mentioned earlier, excluding the severance and impairment charges of $0.06, earnings per share for the quarter were $0.39, meeting expectations.

So in summary, we remain focused in the areas we can control and in the third control delivered meaningful cost savings and significant progress on our product pipeline. With that, let me turn it back to Chris who will provide you with more insight into our business outlook.

Chris Liddell

Thanks. For the remainder of the call, I will speak to our broad expectations for the fourth quarter and our preliminary view of fiscal year 2010. As I mentioned in the opening remarks, we witnessed deterioration of spending levels through the third quarter as macro factors pressured hardware market's IT budgets and advertisement spend. In the fourth quarter, we expect the overall spending environment to remain difficult.

Given the numerous underlying trends though, rather than providing a static quantitative revenue and earnings per share guidance, we recommend that you look at the market drivers of our business using the following framework. In the client business, PC shipments remained the primary driver of revenue, and we expect traditional PC shipments, both excluding netbooks to remain weak. In the fourth quarter, we expect client revenue to be in line with or slightly below the growth rate in the traditional PC market, based on a year ago comparable which had higher than normal levels of inventory at OEM and at retail, and continued weakness of business PC demand, which has a higher associated selling price. We expect the netbooks mix of total PCs to follow the trends seem in Q3.

In the Microsoft business division, traditional consumer and business PC shipments remained the primary drivers of approximately 40% of the segment's revenue, which is transactional in nature. This revenue is the most susceptible to the volatile market conditions. In the fourth quarter, we expect this part of the revenue to lag traditional PC shipments by several points, the result of general purchasing power weakness from small and mid market customers, and continued inventory contraction and retail and our OEMs.

The remaining 60% of MBD revenue is from annuity licensing, which is being supported by the strength of new growth businesses like SharePoint and unified communications. In the fourth quarter, we expect positive annuity growth of single digits, slightly ahead of overall IT spend. The pipeline for annuity contracts in the fourth quarter includes a large renewal wave, which we are optimistic on closing given our year-to-date performance, but there are clearly risks from lengthening sales cycles.

Like MBD, the server and tools segment includes both transactional and annuity licensing components. We expect the transactional portion of the business, which is about 30% of the total, to generally align to the server hardware market. Third-party analysts expect both server hardware shipments to be consistent with the third quarter and therefore remain weak. The remaining annuity licensing and enterprise services portion of the server and tools segment will trend towards overall IT spend.

Our OSB revenue, excluding our legacy Access business, should mirror the online advertising spending market. Volume should continue to increase but monetization rates, in particular, the display advertising portion of our business will remain under pressure. The entertainment devices division primary driver remains consumer sentiment and spending. Our overall market position and volume remains very good, but console revenue, representing 30% of the segment should decline in the fourth quarter as a result of our earlier pricing actions and a mix shift to lower priced consoles.

Console attach rate of revenue representing another 30% of revenue should benefit on a year-over-year basis from the increased install base of consoles, partially offset by moderating attach rates. The other non-gaming portions of the business should be impacted by the underlying PC market and overall consumer spending behavior. In summary, the transactional, consumers and advertising revenue will remain under significant pressure until market conditions improve, offset by annuity revenue, which will start to converge with, but still outperform overall IT spend.

With those things on revenue, I will turn to our expectations of fourth quarter operating expenses. Given the progress made on cost reductions in the third quarter, we're further reducing our full year operating expense guidance by up to $1 billion from the guidance we provided to you last quarter of $27.4 billion. This is on top of the $1.5 billion decrease we forecast in our January call, so it totals up to $2.5 billion of savings from our original July guidance last year. We now expect fiscal 2009 operating expenses to be between $26.7 billion and $26.9 billion. This forecast includes the $290 million severance charges, which were not in the prior forecast.

We also now expect capital expenditure to come in at $3.1 billion, an additional $200 million below our January guidance, and some $900 million lower than our expectations at the beginning of the year. Moving to the other drivers of earnings per share, we continue to expect an effective tax rate of 26.5% for the fourth quarter. Other income will be largely dependent on market movements.

So I would like to spend a few minutes looking ahead to fiscal year 2010. Our planning expectation is that macro conditions remain very challenging through the remainder of this 2009 calendar year, which covers the first half of our fiscal year. Third-party analysts generally expect continued decline in the demand for PC and server hardware, which as I told earlier, will likely impact the non-annuity components of our Microsoft business division, client and server and tools segments. Growth in the annuity portions of our business should still outperform non-annuity or moderate reflecting the lower growth rate in bookings. We expect the volatility seen in emerging markets to continue.

In calendar year 2010, there is some potential for market conditions to improve, but it is clearly too soon to call. Many third-party economists are predicting the re-emergence of GDP growth, which should favorably impact IT spend, hardware markets and advertising spend. We will also begin to benefit from favorable year over year comparables in the second half of fiscal 2010. And finally, we will begin to see the impact from the next wave of new products coming to market. As to COGS, cost of goods sold, next year, we should expect to continued growth driven by increasing costs and the distribution deals we signed in fiscal year 2009 ramp and more of our business goes towards the software plus services model.

In January, we shared with you a preliminary estimate for operating expenses in fiscal year 2010 of $27.4 billion. We are currently in the process of finalizing next year's budget, and while we are looking for additional opportunities to save, we will provide you with an updated view of fiscal year 2010 operating expense in July.

The headcount, as I mentioned in last quarter's call, we are committed to eliminating 5,000 positions by July 2010. In addition, we said we would make cuts in our cost of goods sold stopping. We're making progress on that plan and remain committed to implementing it as soon as practical. As we also said in January, we will add 2,000 to 3,000 new jobs in new high-growth areas over the next 18 months. The vast majority of these will be US workers, but we are also committed to hiring the best employees from around the world. So we will continue our Visa program, albeit at a lower rate, with overall applications for H1B Visas down from 20% and new hire Visas down 40%.

Cash maximization will continue to be a focus area in fiscal year 2010, given our view of the economy. We are fortunate to have a business model that is exceptionally strong in cash generation. Despite the turbulent economic conditions, we are generating net cash flow from operations at an annualized rate of approximately $20 billion. We expect free cash flow to continue to exceed operating income, and this will be assisted by significantly lower CapEx spending in fiscal year 2010. Capital expenditures are expected to decrease from the $3.1 billion I mentioned earlier this fiscal year to approximately $2 billion next year.

We are very vigilant on customer credit issues and to date have had an extremely good collection experience. Finally, we remain committed on returning capital to shareholders, and while stock repurchases will vary from quarter to quarter, we remain a net purchaser of stock over the long-term and a committed payer of dividends.

So in summary, it was a tough quarter, but I'm pleased with the organization's response by managing costs and executing on our product portfolio. Over the next 18 months, we were bringing a large wave of products and services to market, and as such, while on the short-term, our results will be impacted by the current economic conditions, we believe the long-term outlook for technology and our relative position remains very strong.

So with those comments, what I am going to do is hand it back to Bill and very happy to take your questions.

Bill Koefoed
Thanks Chris. Let's now proceed to questions. We want to accommodate questions from as many people as possible, so please avoid lengthy and multipart questions, and I will strictly limit you to just one question. Barb, will you please repeat your instructions?

Question and Answer

Operator

(Operator instructions) And our first question comes from Heather Bellini with UBS.

Heather Bellini
UBS

Hi. Good afternoon guys. Chris, just to follow up on your COGS comment before, you said - I believe you said we should expect to see continued growth given the deals signed in fiscal year 2009 ramp. I'm just trying to get a sense, should we expect the - I mean gross margins I think were a little bit disappointing to people this quarter. I thought that was an area where Steve mentioned at the event that you could actually expect to get a little bit of an improvement there. So…

Chris Liddell

Yes, Heather. We are - relative to Steve's comment, we are looking for opportunities to make efficiency savings in that area, and in fact we have got a task force looking at that over the next quarter. Having said that, that efficiency is against a generally increasing trend as the mix of business shifts in that direction. So we have clearly been making some fairly significant investments in our data center, infrastructure, as we shift to a more online business and more software services. So that will start to flow through in terms of depreciation. And we will also be making some distribution transactions we've announced. So you'll start to see the costs…

Heather Bellini
UBS

So it is going to start growing faster than - it is going to be growing still faster than sales?

Chris Liddell

Yes. I would think in particular in this environment because we're going to see a relatively subdued environment certainly for the first half of the fiscal year. So yes, you can assume that is the case.

Heather Bellini
UBS

Okay, thank you.

Bill Koefoed

Thanks Heather. Operator, next question?

Operator

And next is Adam Holt with Morgan Stanley.

Adam Holt
Morgan Stanley

Good afternoon. I had a question about the client commentary heading into the fourth quarter. I believe you mentioned that we should expect units and revenue to be in line maybe with revenue a little bit below unit. And I guess I was wondering, given that the delta in this quarter between licensing and units being pretty wide, should we expect to see that similar kind of delta as average selling prices are under pressure, do you expect that to close as we get into the quarter? And then just as we look a little bit further towards Window 7, what would you expect to see with the commercial and retail licensing business as we get a little bit closer to the release? I would think it would probably drop off. Thanks.

Chris Liddell

Yes. Thanks Adam. Good point. In quarter four, I would say you're going to see broadly the same trends as we saw in Q3. I mean the introduction of netbooks makes it difficult for us to do our normal walk-through of units and revenue, but the rule of thumb that we gave you last quarter is, if you look at the non-netbooks growth, or in this case decline, that would broadly approximate the revenue in the client business. So the negatives we're seeing on our ASP will be made up for the positives that we get from netbooks growth.

I think that's a reasonable rule of thumb going forward, the same sort of trends we will see in terms of lower ASPs, netbook growth you can expect to see. The only thing that you I think we will see in the fourth quarter, that is probably slightly different from the third quarter, is a continued pressure on the business segment, which is the Pro, which is their highest revenue generator. So we might see a little bit of a gap there. And also in the finished goods area, which you asked about for fiscal year 2010, will just start with the fourth quarter. I think that will be a tough comparable because we had a good very good performance in the fourth quarter of last year. So that might be a - that my drag the overall growth rate down, attach as well. Going into next year then the finished goods area, in particular, FPP in the second half of the year when we start to see the Windows 7 impact, that will start to look more favorable. So we're going to see a declining trend for a while, improving as we get to the back end of next fiscal year.

Bill Koefoed

Thanks Adam.

Adam Holt
Morgan Stanley

Terrific, thanks.

Bill Koefoed

Operator, next question?

Operator

Next is Brad Reback with Oppenheimer.

Brad Reback
Oppenheimer

Hi guys. How are you?

Chris Liddell

Good, thank you.

Brad Reback
Oppenheimer

Chris, you had talked about annuity rates, renewal rates being pretty stable over the course of the quarter and the expectation that they remain that way. Could you give us any sense of what pricing trends look like and what you might expect them to be for the remainder of the fiscal year?

Chris Liddell

Yes. The first comment I will make is that the third quarter was a relatively quiet quarter for us, fourth quarter is a very big quarter. So this will be an important quarter for us in terms of renewals and that will feed through what happens in fiscal year 2010. The experience to date is that we have seen no - what we discovered is no unnatural discounting. We've certainly seen customers being very price conscious, but to date our renewals have been broadly in line with the revenue that is falling off from previous contracts being revenue renewed at about the same rate.

Now what we're losing is perhaps some of the upside that we saw in previous years, so typically when we renew a contract, we take the opportunity to up sales, put some of the new products into the mix.

Hopefully for most customers, we are seeing them with more seats at the end of three years than they started that with, more employees. Clearly that trend is more difficult, so we're seeing customers with the same or even less employees than where they were three years ago. And while we should be offering them new products, we might be losing some, picking up something from the new products, so overall awash.

The general sort of environment that we're seeing is good renewal rates, no unnatural price discounting, but we have lost some of the upside, so therefore our renewals and our billing is sort of trending down to low single digits from the sort of mid double digits that we are experiencing in the last years. So still overall what I would describe particularly in this environment as very healthy, but not sort of double digit rates we would have loved to have seen.

Brad Reback
Oppenheimer

Great, thanks.

Bill Koefoed

Operator, next question?

Operator

And next is Phil Winslow with Credit Suisse.

Phil Winslow
Credit Suisse

Hi guys. Just wanted to dig into cost of goods sold just a little bit for the count down next year, just wondering if you can give us a sense of quarter to quarter there, just what your expectations are? And that is it.

Chris Liddell

Yes sure. We're not giving out guidance on cost of goods sold. We will certainly give you some more color in July. But if you see the trends that have been happening in the last few quarters and extrapolate those, you can expect that to continue. Now you have to look a little bit deep into the underlying trend. So for example we have hardware cost of goods sold, they tend to move very much with Xbox sales, so that is one dynamic. Then you have the online cost of goods sold and that tending to go up as we depreciate some of the infrastructure we have put in that tends to follow the capital expenditure that we have been talking about over the last couple of years. And then you have got sort of general cost of goods sold and things like distribution deals which is starting to ramp up with the announcements that we have made over the last few months. So if we take these three trends and combine them together and extrapolate them, you get some sense of what fiscal year 2010 will look like.

Phil Winslow
Credit Suisse

Thanks.

Bill Koefoed

Operator, next question?

Operator

Next is Brendan Barnicle with Pacific crest.

Brendan Barnicle
Pacific Crest

Thanks so much. Chris, as you start to think about Windows 7 and how that may be released and we start to think about modeling that, should we look at that to have the same sort of tech guarantee program that we had with Vista and as a result that same impact on deferred revenue, or would there be any change, maybe more like was done in earlier OS releases?

Chris Liddell

Yes. We obviously haven't finalized all of those details. It is not unreasonable to assume that we would do a tech guarantee at some stage, but the exact timing of that will depend on clearly the release time of the product itself, and that could cause some inter-quarter accounting recognition issues, but not a significant issue. Obviously it will washout over the course of the year. So yes, you can assume that from a modeling point of view. I you're looking over the long-term, it won't have any impact.

Brendan Barnicle
Pacific Crest

Might it be - see its effect in the shorter period than we saw with Vista?

Chris Liddell

Too early to tell. I think that a similar period is how I would assume.

Brendan Barnicle
Pacific Crest

Okay great. Thank you.

Bill Koefoed

Operator, next question?

Operator

Next is Sarah Friar from Goldman Sachs.

Sarah Friar
Goldman Sachs

Good afternoon. Chris, if I could just take you back more to kind of a macro view, feel like you have given us more color than last quarter. Is there anything in the linearity of the quarter that made you feel a little bit better as you got towards the end of March? And in particular, if I kind of think of even just the guidance you have given us, you have clearly given us a lot more color this time around than you give us back in January. But it feels like you're signaling that maybe you still have your arms around it better, is that fair or unfair way to think about it?

Chris Liddell

A couple of comments. Firstly, this is the quarter we typically start to talk about fiscal year 2010, so I'm giving you a little bit more color, because I'm trying to give you some sense of the fiscal year the next year as opposed to what is just happening for the next quarter, so you are picking up that. The second, in terms of linearity, I guess (inaudible) learning things like second derivative, and what they mean. How do I feel about the shape of the quarter? I don't see any improvement at the end of the quarter that gives me encouragement that we are at the bottom and coming out of it. I think - I would like to think that trading conditions will not get any worse than where they were in the third quarter, but hopefully my commentary gives you some sense that we expect them to continue in the fourth quarter and second half of the year, a little bit early to tell, but probably continue to be tough as well. So if you like, during the quarter, they stopped getting worse, but that is different from they started getting better.

Sarah Friar
Goldman Sachs

Sure.

Chris Liddell

And I think that's a safe assumption for the fourth quarter.

Sarah Friar
Goldman Sachs

And US versus Europe, just the two very major geographies, any particular differences between the two?

Chris Liddell

Not between US and Europe, Western Europe anyway. Eastern Europe very weak, places like Russia, particularly weak. Japan, very weak; Brazil, very weak. So some of the areas where a year ago we were talking about extremely good growth rates, countries like Russia, particularly had extremely good growth rates a year ago, have gone the other way. So the US and Western Europe, very similar picture, weak, but not significantly. When you go into Eastern Europe and emerging markets, the picture is generally worse.

Sarah Friar
Goldman Sachs

Okay, thank you.

Bill Koefoed

Operator, next question?

Operator

And next is John DiFucci with JP Morgan.

John DiFucci
JP Morgan

Thank you. Chris, last quarter you said that clients saw 2% headwind because the channel inventories were below normal levels, and it looks like the OEM license G&A growth was about 2% better than PC unit growth. I'm just curious is that all - is that all inventory making up for the inventory of last channel, and where is the industry today, or is there something else happening there also?

Chris Liddell

It is a combination of factors. Inventory is one of them; attach rates were actually quite good in the quarter, so not only because of the netbooks impact. We have an exceptionally high netbooks attach now, about 90%, I believe. But we also saw good attach in the non netbook segment as well, so there's a few variables moving there, inventory being one of them, I think was a slight negative, to be honest, inventory but attach rate was particularly positive, and that led the impact that you are seeing.

Bill Koefoed

Operator?

Chris Liddell

Sorry? Yes.

John DiFucci
JP Morgan

So the - just to be clear there, so inventory has the 2% headwind last quarter and you saw another small headwind again this quarter as inventory levels actually got a little lower?

Chris Liddell

Correct.

John DiFucci
JP Morgan

Okay, thanks Chris.

Bill Koefoed

Operator, next question?

Operator

And next is Brent Thill with Citigroup.

Brent Thill
Citigroup

Chris, your expense controls are significantly ahead of your plan you just gave just two months ago. How do you think about the next phase of expense control, and I know you mentioned you are not going to give 2010 guidance? But I think the way you guys mentioned, to think about it is that would be flat in 2009 with 2010, so I think we are assuming that that number that you have given us now is flat for 2010? Can you just help us clarify if there is anything else that you plan to spend ahead of some of these major launches that would change that trajectory that you just give us two months ago?

Chris Liddell

Let me give you a bit of overall context about how I think about the savings in general and then I can answer your question specifically. I think you've probably heard me say that in this company and in the previous companies I've worked, I've always felt that the best cost savings programs are ones that are a combination of, I describe, a top-down and bottom-up. Top-down being basically, we're going to cut headcount by X, we're going to cut travel expenditure by Y, and these are the new rules.

The bottom-up is how then employees actually apply those rules to how they run the business. Now when I give you the numbers a couple of months, three months ago effectively, for this year, that was the sum total of our top-down initiatives. So if employees implemented them exactly how - implemented the rules exactly how we told them, effectively you would have had that number. The fact that we have been able to achieve operating expense savings in excess of that is really a credit to people implementing in an even more extreme fashion.

So they have even traveled even less than what we have asked them to, they have taken - been doing cost savings even more than what we have asked them, and we have ramped headcount even slower than what we were anticipating. So I don't bank the bottom-up on a continual basis. I only bank what I describe as the top-down, so my starting position for fiscal year 2010 remains where it was, in dollar terms, a quarter ago.

Having said that, if we get a cultural change and employees continue to have fiscal responsibility and implement the rules in a very efficient fashion, then we could see a lower number. So I'm not going to promise that to you this quarter. There will be part of what we do in the budgeting round, but I would be starting next year with the number I gave last quarter, and hopefully we can beat that when we talk to you about it in three months time.

Brent Thill
Citigroup

Thanks Chris.

Bill Koefoed

Operator, next question?

Operator

And next is Tim Klasell with Thomas Weisel Partners.

Tim Klasell
Thomas Weisel Partners

Yes, good afternoon everybody. Just wanted to go over to the Microsoft business division where you said on Office you had a higher tax rate but lower ASPs and lower units. Is that lower unit - excuse me, lower ASP and higher tax rate going to be something you want to do prominently, i.e. if units begin to pick back up, we can model it like that, or do you think we might see the ASPs begin to increase after the release of the next version or if the economy gets better?

Chris Liddell

There was two impacts last quarter that hit ASP and what (inaudible) talked about how you expect them going forward. The first was that we just had a price decrease. We took the opportunity to have a special price. We will - and that certainly we got a volume pickup as a result of that but a lower ASP. You won't see that as a permanent basis, that was something that we did for a quarter or so. That was one thing.

The second was that we generally saw a continued buying activity in the lower price points and less buying activity in the high price points because of the worse business PC growth. So if you like, you saw a mix change to a lower SKU. Again that is really going to be driven in the future by not our action, but by how PCs, business PCs recovered through next year. I think it is going to continue to be relatively weak for the foreseeable future, and I think I foreshadowed that in my overall comment. Going into the releases the next calendar year, I would like to think that business PC demand is hopefully going to be picking back up by then, plus we'll have the new release. So you'll start to see that trend come back the other way, but it is going to be some time.

Tim Klasell
Thomas Weisel Partners

Okay great. Thank you.

Bill Koefoed

Operator, next question?

Operator

And next is Kash Rangan with Merrill Lynch.

Kash Rangan
Banc of America Securities/Merrill Lynch

Hi, thank you very much. Chris, you made a comment earlier that you are looking forward to launching a counter cyclical wave of products in the next 18 to 24 months. I was wondering if you could expand upon that and also talk about, to the extent that you can on a quarterly earnings conference call, what kind of changes we should anticipate to the business model (inaudible) associated with that? Thanks.

Chris Liddell

Sure. I mean - it is difficult launching a massive wave of products into a weakening demand, so that is what I've described as the counter cyclical. But when you look across virtually all of our businesses, there is going to be a major release of some form of them in the next year, the most obvious is Windows 7 clearly which has been well foreshadowed. Office will be coming out with a new version, Exchange will be coming out with a new version. We have got potentially a new search product coming out in the foreseeable future. So you will see, in all of our major products, a significant release in the next let's say 12 months.

Now that is going to be into a soft demand environment potentially, but we think that is really the right thing to do. And clearly that is an investment that is driven around our product development portfolio, not the economic cycle. But once we start to get economic pickup, we think that we will outperform that economic pickup. So the moment it is really about the surviving the economic reset, going into a growth period, which we like to think is going to be around the corner at some stage. We will actually be going into that growth pickup with a very, very good set of new products, and so the environment, one to two years out, starts to look much more interesting.

Kash Rangan
Banc of America Securities/Merrill Lynch

And also Chris, the business model changes associated with that product rollout?

Chris Liddell

Well, the ones that I meant, and why it would be a significant business model are the ones that you will see, the Windows Azure also will be generally released over that period. So that will start to change the business model. You'll start to see more online driven version of some of our key products, so that will start to change the business model. But the revenue impacts of that are going to be relatively modest, certainly in fiscal year 2010. That is more of a fiscal year 2011 and 2012 impact in terms of significance.

Bill Koefoed

Operator, next question?

Bill Koefoed

And next is Robert Breza with RBC Capital Markets.

Robert Breza
RBC Capital Markets

Hi. Thanks for taking my question. Chris, just a follow up to Sarah's question about the geographic weakness that you mentioned in some of those countries, are you specifically talking about the transaction business, the annuity business or both, kind of follow up on that? Thanks.

Chris Liddell

Yes, I tend to look at the transactional business because it is probably more of an indicator of the instantaneous economic activity in that particular country, although the blended rate is also the same basic trend. But my comments were in particular around transactional. So you tend to obviously see in countries like Russia, it is more driven around transactional anyway. There isn't a strong enterprise agreement driven part of that economy yet. So the transactional tends to be a higher component and particularly when [ph] I was mentioning countries, I was thinking about that.

Bill Koefoed

Operator, let us take one more question.

Operator

And our last question comes from Katherine Egbert with Jefferies.

Katherine Egbert
Jefferies

Thanks. Chris, you didn't repurchase any stock this quarter. Can you talk about that, you approach to capital? I mean is this environment driven or is there another reason? Thanks.

Chris Liddell

It is generally environmental. I put that - foreshadowed that at the last call that we would be generally more cautious in this current environment in terms of building our cash reserves. I am happy on the flip side to lower share repurchases. We have built cash and investments back over $25 billion. So we have purchased back around $9 billion of stock this fiscal year and paid out around $3 billion of dividends. So we have returned about $12 billion.

Going forward, as I think I have said consistently, we still will be a net purchaser of our shares. We are still committed to paying dividends. So we are still committed to repaying cash as much as possible, but it is going to vary quarter by quarter, and is going depend enormously on the environment we find ourselves in, and things like our working capital management as well.

But overall one of the great positives of the company, which I mentioned briefly in my prepared remarks, is just the overall cash flow. We are generating free cash flow at around $20 billion annualized rate, which is tremendous in this environment. So there is no reason to suspect that over the medium to long-term we won't continue to be net buyers of our shares.

Katherine Egbert
Jefferies

Okay, very good. Thank you.

Bill Koefoed

Okay. So that will wrap up the Q&A portion of today's earnings call. Remember that you can access this call on the Microsoft Investor Central website at www.microsoft.com/msft. Again thanks for joining us and have a good day.

Operator
And that concludes today's call. Please disconnect your lines at this time.