

# Presentation

## Operator

Welcome to the Fourth Quarter Fiscal Year 2015 Microsoft Corporation Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded.

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

## Chris Suh

*General Manager of Cloud & Enterprise Finance*

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

On our website, [microsoft.com/investor](http://microsoft.com/investor), we have posted our financial summary slide deck, which is intended to follow our prepared remarks and provide the reconciliation of differences between GAAP and non-GAAP financial measures. The non-GAAP measures exclude the impact of the impairment, integration and restructuring charges and are included as additional clarifying item to aid investors in further understanding the company's fourth quarter and fiscal year performance and the impact of these items and events has on the financial results. The non-GAAP financial measures provided above should not be considered as substitute for or superior to the measures of financial performance prepared in accordance with GAAP.

Unless otherwise specified, we will refer to non-GAAP metrics on the call. All growth comparisons we make on the call relate to the corresponding period of last year, unless otherwise noted. For selected metrics on the call and in other earnings materials, we have provided growth rates in constant currency. We present constant currency information to provide a framework for assessing how our underlying business is performed, excluding the effect of foreign currency rate fluctuation.

Additionally, any mention of operating expense refers to segment operating expenses as defined in the footnotes of our Form 10-K and includes research and development, sales and marketing and general and administrative, but excludes the impact of impairment and integration and restructuring charges.

We will post the prepared remarks to our website immediately following the call until the complete transcript is available. Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript and in any future use of the recording. You can replay the call and view the transcript on the Microsoft Investor Relations website until July 21, 2016.

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.

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

## Satya Nadella

*CEO & Director*

Thank you, Chris. Good afternoon, everyone. Today, we will share the results of the final quarter of the year and our optimism for the year ahead. We delivered \$22.2 billion in revenue this quarter and \$93.6 billion in total revenue for the fiscal year '15, an increase of 8% year-over-year. We pushed forward in our transformation by focusing our investments in areas where we have differentiation and significant opportunity for future growth in large, addressable markets. We galvanized around our mission and

ambitions. We aligned our structure to deliver better products at a more rapid pace. We focused our advertising business on search, we focused our mapping efforts on higher level experiences and developer services. We restructured our Phone portfolio so that we can operate more efficiently near-term while driving reinvention long-term. We invested more in new mobile applications like Wanderlust, Acomplia and Sunrise. We also strengthened our enterprise cloud platform by acquiring Revolution Analytics, Datazen and BlueStripe in this quarter alone, and we are at the threshold of the Windows 10 launch.

I'm proud of these steps and I'm proud of the results we delivered in tandem. In cloud alone, our annualized Commercial cloud run rate surpassed \$8 billion this quarter and the revenue grew 88% year-over-year. We're on a strong trajectory towards our goal of \$20 billion in fiscal year '18.

With that as the backdrop, I want to walk you through the progress we are making in each one of our 3 ambitions.

Let me start with reinventing productivity and business processes, including our efforts across Office 365 and Dynamics. We continue to see strong demand for Office 365 and Dynamics products. We now have more than 15 million Office 365 customers -- consumer subscribers, and customers are signing up at a pace of nearly 1 million per month. In addition, we surpassed 150 million downloads of Office Mobile on iOS and Android and have introduced a new version of Office for the Mac.

In the Commercial space, the number of Office 365 users continues to climb with seats growing 74% year-over-year. Office 365 now is in 4 out of 5 Fortune 500 enterprises and more than 55% of the installed base is on premium workload. It is clear that we have success moving customers to the cloud. Even half of all the Enterprise Agreement renewals were for Office 365 this quarter.

Small and medium businesses offer one of our best opportunities for new growth in the cloud. In fact for more than one year now, we have seen 50,000 new SMB customers adopt Office 365 every month. Last week at our Worldwide Partner Conference, we announced our new Office 365 premium SKU for business, E5. Now our customers will get rich, new voice functionality in Skype for Business with Cloud PBX and PSTN Conferencing, deep analytics with Dell World analytics and Power BI Pro and advanced security features such as Lockbox and Advanced Threat Protection. With E5, we've expanded our market opportunity for Office 365 by more than \$50 billion. This new E5 SKU and the launch of Office 2016 will drive one of the biggest new businesses for us.

Let's now turn to CRM. This market alone is \$20 billion-plus and has massive opportunity for reinvention. Mainstreaming Dynamics into our engineering, sales and marketing efforts gives us the ability to participate in this large and growing market in a more meaningful way. Last week, we announced the acquisition of FieldOne, which helps strengthen our Dynamics CRM customer service offering. This quarter, total paid seats for Dynamics CRM Online increased 140% year-over-year, and we have more than 8 million paid Dynamic seats across CRM and ERP in total, up 25% year-over-year. This creates a great foundation for future growth in our Dynamics business.

Next, I want to share our progress in building the intelligent cloud platform with Azure. Again, this quarter, we have seen proof that preference for our cloud SaaS services creates a flywheel of growth for our cloud platform services. In Azure, both revenue and compute usage increased by triple-digits year-over-year. We tripled our revenue from Azure premium services this quarter. In the Enterprise Mobility services, we now have 17,000 customers. Appeal for Visual Studio tools has grown to include developers beyond our traditional base, with some of the decisions we make to embrace open source with .NET and support across platform development. Since November, we have seen more than 5 million downloads of Visual Studio community, the fastest-ever adoption of a Visual Studio product. Visual Studio Online continues to gain momentum with over 3.1 million registered users.

Business intelligence and analytics is another large, rapidly growing market for us with an opportunity of more than \$15 billion. We are focused on strengthening our offers in this space. Just last week, we announced the availability of Cortana Analytics Suite, a fully managed big data and advanced analytics solution. We are not only building the tools but are also delivering the insights customers need to transform their businesses.

Security is a key priority for our enterprise customers and another \$30 billion market opportunity for us, and we are building capability to meet customers' needs. For example, we made significant investments in security with Azure Key Vault, enabling our customers to protect data in the cloud with secure key management and encryption customers in control. We have 4 new certifications for Azure, bringing our certification and attestation total to 22 globally, more than any other cloud platform today.

Our third bold ambition is to create more personal computing experiences with Windows and our devices. I'm thrilled we are just days away from the start of Windows 10. It's the first step towards our goal of 1 billion Windows 10 active devices in the fiscal year '18. Our aspiration with Windows 10 is to move people from needing to choosing to loving Windows. Based on feedback from more than 5 million people who have been using Windows 10, we believe people will love the familiarity of Windows 10 and the innovation. It's safe, secure and always up-to-date.

Windows 10 is more personal and more productive with Cortana, Office, universal apps and Continue. And Windows 10 will deliver innovative new experiences, like inking on Microsoft Edge and gaming across Xbox and PC and also opens up entirely new device categories such as HoloLens.

Windows 10 will deliver significant value to enterprise customers as well. Windows 10 provides advanced security capabilities with additional features for hardware-based security, mobile work and data protection. It also provides a single device management platform across all devices from phones to laptops to Internet of Things devices. And Windows 10 helps enterprises stay up-to-date with Windows Update for business and Windows Store for business.

While the PC ecosystem has been under pressure recently, I do believe that Windows 10 will broaden our economic opportunity and return Windows to growth.

First, we have an OEM ecosystem that is creating exciting new hardware designs for Windows 10. In fact, our OEM partners have over 2,000 distinct devices or configurations already in testing for Windows 10 upgrade, as well as hundreds of new hardware designs. We are delighted that the first of these exciting new devices will start to be available on Windows 10 launch day. And by this holiday, we will be selling the widest range of Windows hardware ever available.

Second, we will generate new growth through gross margin on our own differentiated first-party, premium-device portfolio. We will also significantly reduce our losses on the phone by operating more effectively and efficiently with a more focused portfolio.

Third, we will grow monetization opportunities across the commercial and consumer space. In the enterprise, customers will continue to value our unparalleled management, security, appdev and servicing capability. And for consumers, Windows 10 creates monetization opportunities with store, search and gaming. We are confident that these are the right levers to revitalize Windows and restore growth. The progress we made this quarter, and the forward-looking guidance that Amy will share, shows the opportunity for renewed growth is real.

In hardware, both Surface and Xbox had an incredible Q4. We more than doubled Surface revenue to nearly \$900 million this quarter, capping off a year in which it delivered more than \$3.6 billion in revenue. Both consumers and enterprise customers love this device. Surface is clearly a product where we've gotten the formula right, earned fans and can apply this formula to other parts of the hardware portfolio.

Gaming is an important scenario for Windows 10 and our success with Xbox this quarter gives us a strong starting position heading into launch. Xbox LIVE users grew 22% this quarter and logged nearly 3.5 billion hours of game play. Our growing fan base is excited for the best games lineup in our history. All of this comes together with Windows 10 when fans can connect with each other, stream all of their Xbox One games to Windows 10 and experience the best virtual reality platform given our partnership with Oculus Rift and Valve.

In search, Bing will now power both differentiated experiences on Windows 10 such as Cortana, as well as search and search advertising across the AOL portfolio of sites, in addition to the partnership we already have with Yahoo!, Amazon and Apple. With advertising revenue growth of 21% year-over-year, Bing will transition to profitability in the coming fiscal year.

It's been a strong year of progress. Above all else, I'm optimistic about our future. Our cloud services are accelerating fast and Windows is positioned for renewed growth.

With that, I'll hand it over to Amy to talk about this quarter's results in more detail. I look forward to rejoining you after that for questions. Thank you.

**Amy E. Hood**

*Executive VP & CFO*

Thanks, and good afternoon, everyone. Our fourth quarter results demonstrate the strong progress that we've made as a company over the past year. Key strategic initiatives such as cloud, first-party hardware and consumer services delivered significant growth as well as improved profitability.

Commercial customer renewals remained healthy, with strong adoption of cloud services and a higher mix of annuity than we expected. And our disciplined approach to resource allocation has allowed us to increase investment in the growth initiatives Satya mentioned while reducing the company's operating expenses. This allows us to better compete in markets with structural growth, where we feel we have unique competitive advantages.

With that said, I will start with an overview of our financial performance before moving into a more detailed discussion of the results.

This quarter, we recorded an impairment charge related to our Phone Hardware business and incurred integration and restructuring expenses. Additionally, like most multinational companies, the strengthening of the U.S. dollar continues to have a significant impact on our reported results. Accordingly, when applicable, I'll give results and growth rates adjusting for the impairment, integration and restructuring expenses but also in constant currency to help you better understand the underlying business fundamentals.

Revenue was \$22.2 billion, down 5% and down 2% in constant currency. As a reminder, last year included \$382 million of revenue that we recognized at the conclusion of our commercial agreement with Nokia. Significant gross margin improvement across commercial cloud, Surface and our consumer services helped to mitigate the impact on gross margin from the decline in the D&C Licensing. Total gross margin declined 7% and 3% in constant currency.

Operating income declined 3% and 1% in constant currency. Earnings per share was \$0.62, growth of 11% and growth of 8% in constant currency. Unearned revenue grew 1% to \$25.3 billion and 7% in constant currency. Commercial unearned was better than expected as we saw a higher mix of annuity in the quarter.

From a geographic perspective, the majority of markets performed in line with our expectations. The notable exception was Brazil, where inflation and macroeconomic volatility weighed on our performance. Overall, macro conditions remain a challenge in some large opportunity markets like China, Russia, Japan and Brazil. There was slightly less impact from currency than our expectation. With that backdrop, I'll move to a detailed discussion of our results.

Q4 last year effectively marked the end of the XP refresh cycle. It impacted our Windows OEM and non-annuity volume licensing as well as our Office non-annuity volume licensing results. During that time, OEM revenue exceeded that of the underlying PC market driven by a higher attach of Pro, particularly within the developed markets. This quarter Pro declined by roughly 21% and, similar to last quarter, we saw Pro attach remain at pre-XP level, even with the underlying softness in the business PC market. The annuity portion of Windows volume licensing grew again on a constant currency basis with non-annuity revenue declining due to XP.

Windows non-Pro revenue declined 27% as OEMs tightly managed PC inventory ahead of the Windows 10 launch, particularly in developed markets. In our view, this is a healthy state for the channel as we head into a transformational launch that starts next week.

Consumer Office 365 had another strong quarter of net subscriber growth. Overall, Consumer Office revenue results reflected the decline in the underlying driver of that business, developed market consumer PC sales. Within D&C Licensing, the transition to Office 365 accounted for 13 points and the impact of Japan's PC market accounted for another 19 points.

We had another impressive quarter in search, with revenue growth of 21% and 25% in constant currency, driven by increases in both volume and revenue per search. As Satya said, revenue from Surface more than doubled this quarter, with continued strength of Surface Pro 3 and the launch of Surface 3.

Enterprise sales accelerated this quarter and sales of Surface 3 were particularly strong to educational customers. Our differentiated products, as well as improved discipline and execution, helped to improve gross margin by over \$450 million this quarter and \$1.3 billion in fiscal '15.

Within Xbox, strong growth at consoles, online transactions and first-party game helped to drive revenue growth of 27%. This progress, as well as the excitement that we generated at E3, with Xbox exclusive gaming content and backwards compatibility, demonstrates the building momentum that exists within the Xbox ecosystem.

In phones, we sold 8.4 million Lumias, which is an increase over last year's full quarter sales. ASPs, however, have continued to decline. Gross margin declined this quarter driven by lower per unit margins on Lumia devices as well as reduced volumes in non-Lumia phones. As announced on July 8, we are changing that approach in this business and are focused on delivering differentiated experiences for our targeted customer segments while improving our operating results.

Moving to our commercial results. Total revenue across our 2 segments grew slightly in USD [ph] and grew 4% at constant currency. Our contracted not billed balance, which is a key indicator of customer commitment, reached an all-time high of over \$24.5 billion and it reached this level even with the significant appreciation in the U.S. dollar. Constant currency bookings were flat to the prior year. Though, as a reminder, last year, commercial bookings grew 23% on the strength of a large renewal base as well as the end of XP discussed earlier.

Our Office Commercial business continues to transition to Office 365. We, again, grew the installed seat base of Office, Exchange, SharePoint and Skype for Business. Office 365 allows us to have a deeper ongoing relationship with all of our customers which, in turn, provides us with the opportunity to expand and grow our business over time.

Because of this transition, as well as weakness in Japan and the impact of XP, Office Commercial products and services grew 1% in constant currency, quite similar to Q3. Dynamics revenue grew 15% on a constant currency basis, driven by the strong CRM results Satya talked about and our ERP business, which saw 35% growth in customers this quarter. Server products and services grew 4% and 9% in constant currency, continuing to outperform our peers in the enterprise software sector. SQL Server share growth continues as customers value its high performance and lower cost of ownership. Revenue and licenses of Windows Server grew against the backdrop of a declining server hardware market. And in the public cloud space, we had another quarter of significant Azure usage growth. Additionally, we significantly grew the gross margin percentage in our Commercial Other segment, increasing 13 points to over 43%.

Moving to operating expenses, which declined 9% or 4% in constant currency. Our continued disciplined approach has allowed us to incrementally fund strategic initiatives without having to increase our expense base. Other income was favorable to our expectation, driven by gains on foreign currency and sales with investment. Our non-GAAP effective tax rate was 24% and was at the high-end of our guided range due in part to strong performance in our Computing and Gaming Hardware segment in the U.S.

We returned \$6.7 billion to shareholders this quarter, nearly double the amount from last year. With that overview of the current quarter, let me turn to our outlook, starting with a few overall comments.

As we have communicated, over the past couple of months, the accounting for Windows 10 will change. We will be deferring a portion of Windows 10 revenue, primarily OEM, and recognizing it over time, generally 2 to 4 years. As shared previously, the initial deferral and the subsequent recognition of those deferrals will be netted in Corporate and Other in our segment reporting. Most importantly, underlying

billings and cash flow won't change. Therefore, our commentary in this and subsequent earnings calls, including our guidance, will focus on results prior to the net deferral impact, which we believe is the best reflection of business health. With that background, let me share some thoughts on fiscal '16.

The strengthening of the U.S. dollar will continue to have a significant impact on our results over the course of FY '16. Assuming rates across our largest currencies: the euro, Japanese yen and the British pound stay in line with current rates and that the geographic mix of revenue stays as forecasted. In our non-annuity businesses, the impact is immediate as the revenue is recognized in quarter. In our annuity business, revenue is deferred and the impact is delayed as we earn the revenue off the balance sheet. In total, we expect that FX will negatively impact total revenue growth by 5 points in each quarter of H1, with 7 points of negative impact in our Commercial segment. H1 would be the peak of the FX headwinds. And in H2, we expect FX to have 3 points of negative impact in total and roughly 4 points of negative impact on our commercial revenue.

With Windows 10, we expect momentum to build throughout the year as we and our partners bring new devices, applications and services to market. We expect this to benefit our business results in the second half of the fiscal year. With the strength in Xbox and Xbox LIVE, along with the launch of Halo 5 in October, Xbox will continue to grow both fans and profitability.

With the recently announced changes in phones, there will be significant revenue declines year-over-year in the Phone segment each quarter. With the proactive measures we've taken to reduce our cost structure, overall losses will also decline for the fiscal year. We would expect the majority of that improvement in the second half of the year once the restructuring efforts are materially complete.

Bing will be profitable in FY '16. And assuming the macro environment is stable, we expect our commercial momentum will continue, highlighted by growth in our commercial cloud. We remain on track to achieve our \$20 billion commercial cloud ambition in fiscal 2018.

We now expect operating expenses to be \$32.1 billion to \$32.4 billion, which is lower than the guidance we provided in April. The lowered guidance reflects the savings from our restructuring of the Phone business as well as important investments to drive top line growth as we support Windows 10, our first-party hardware effort as well as sales headcount to accelerate our leadership position in the Commercial cloud.

We expect our full year tax rate to be 24%, plus or minus 1 point, excluding the net impact from the Windows 10 deferrals.

Now to Q1, starting with Devices and Consumer. In licensing, we expect revenue to be \$3.4 billion to \$3.6 billion. This range reflects Windows revenue roughly in line with the PC market. Within Consumer Office, we expect the transition to Office 365 subscriptions to continue.

In Computing and Gaming Hardware, we expect revenue to be \$2.0 billion to \$2.1 billion. As a reminder, we launched Surface Pro 3 in late June last year, with launch benefits extending into Q1.

In Phone Hardware, we expect revenue to be approximately \$900 million reflecting our change in approach. We expect gross margin in Phone to improve sequentially in Q1.

In Devices and Consumer Other, we expect revenue to be \$2.2 billion to \$2.3 billion, with continued growth in Bing, Consumer Office 365 and Xbox LIVE transactions.

And in commercial, as I discussed previously, we expect a significant FX headwind this quarter. Our constant currency growth is expected to be about 7% in Q1, which assumes we continue to take share in key markets and build momentum in the new areas we have entered. With the negative impact of FX, we expect revenue to be roughly flat.

On Commercial Licensing, we expect revenue of \$9.1 billion to \$9.2 billion with a continued shift to annuity; and in Commercial Other, with the significant growth in our cloud, revenue of \$3.1 billion to \$3.2 billion.

We expect COGS to be \$7.0 billion to \$7.2 billion with the variability being driven by the hardware segment. We expect operating expenses to be \$7.6 billion to \$7.7 billion. As a reminder, other income and expense includes dividend and interest income, offset by interest expense and the net cost of hedging. Given the current FX environment, we expect our net cost of hedging to increase and other income and expense to be negative \$200 million.

Excluding the Windows 10 deferrals and the impact of foreign currency, we expect the sequential decline in unearned to be slightly better than historic seasonality, driven by the growing mix of annuity revenue.

In closing, I'm proud of the tremendous amount of progress that our company has made over the past year. We've improved how we operate in virtually every sense. These changes have allowed us to aggressively invest in areas that will drive future growth for the company. And looking forward, we're better positioned to capitalize on the significant opportunities ahead of us.

With that, let me turn it back over to Chris for the Q&A.

**Chris Suh**

*General Manager of Cloud & Enterprise Finance*

Thank you, Amy. We'll now move to Q&A. Operator, please repeat your instructions.

# Question and Answer

## Operator

[Operator Instructions] Our first question comes from Phil Winslow from Crédit Suisse.

### **Philip Alan Winslow**

*Crédit Suisse AG, Research Division*

I just wanted to double click on Office 365. You guys showed another huge quarter of growth in terms of your consumer seat count, and I think it was 86% growth on the Commercial Other side for Office 365. Wondered if you could just drill into both the consumer and then the enterprise side, just the trends you're seeing there. And obviously, the guidance you all just provided. It looks like those -- you expect those trends to continue in Q1. So any color there would be great.

### **Satya Nadella**

*CEO & Director*

Yes, I'll take that. Overall, we are very excited about the growth we are seeing in Office 365. On the consumer side, as you noted, we're growing 1 million subs a month, and that's fantastic growth for us. The consumer value, especially now that we have even all the endpoints covered with Office, the definition of Office and where all it's present is also changed and that all accrues to consumers being willing to have this subscription relationship with us. On the enterprise side, the growth remains very exciting for us. And the growth comes in multiple forms. It comes in the form of just the EAs renewing more to Office 365. It also comes in the form of some of the more comprehensive suites, the E3 and the new E5, that's the commitment we are seeing. And we also see small businesses. I talked about the 50,000 businesses, small- and medium-sized businesses, each month signing up for Office 365. That's pretty unprecedented. Having been in the server business all my life, I've never seen a lot of the small business customers adopt some of the rich capabilities like it's possible now, and that's great growth as well. And that cloud revenue number, that is the 88%, is all up cloud revenue. It's inclusive of Office 365, EMS and Azure. And it's good to see that kind of growth at that kind of scale now with \$8 billion.

### **Amy E. Hood**

*Executive VP & CFO*

And one thing I would add, Phil, to that is an important dynamic that we're seeing in Office 365 is as we are having this momentum build, and Satya talked about some of the new customers we're adding, and the way we see that is the installed base growing. And we were able to see that this quarter across all the core workloads in Office. And when you think about why that's so critical long-term is our ability to sell some of the workloads Satya actually referenced that will be in E5 when it launches, we could -- we have the capability of upgrading on a more consistent basis using more of these premium services. So when you can both add to your installed base and add overall market opportunity, we do feel good about our line of sight in that business to our long-term goal.

## Operator

Our next question comes from Brent Thill from UBS.

### **Brent John Thill**

*UBS Investment Bank, Research Division*

Satya, the server business continues a steady outperformance and, as Amy pointed out, better growth than your peers. I guess a couple of questions as it relates to the Windows 2003 retirement and any impact you're seeing there. And then secondarily, if you could just comment on some of the new product launches. It seems like there's a stack of new solutions that are coming on the server side that look pretty exciting and your partners are excited about it. If you could highlight what you see is the most interesting from your perspective over the next several quarters.



**Satya Nadella***CEO & Director*

Yes. Overall, I'd start even with the bold view that my server business is not some legacy business. We fundamentally think about servers as the extension of the cloud. I even described it architecturally as the edge of our cloud. Every server, for example, have things like disaster recovery, backup and tiering with the cloud. And so we will continue to push that differentiation because I think that view architecturally and the delivery of it is what makes us pretty unique. And you see it in the numbers. Our servers, even this quarter, grew 9%. And compared to the industry peers, we're obviously gaining share on Windows Server, on SQL Server and pretty much all of our management and security products as well. And going forward, we have a fantastic lineup of servers, not just the infrastructure, but even SharePoint, Exchange, Lync server continues to have significant on-premise deployment. So as our cloud continues to grow, obviously, we are getting where there is more capability in the cloud. We're incenting customers and our partners to move to the cloud. But at the same time, we are going to have a great server wave. I'm excited about our SQL product. I think it goes into the first preview next -- in fact, tomorrow. And that product, I think, is a pretty revolutionary product because, for the first time, you can take a single table in a database and even tier it with the cloud. At that kind of capability only we can provide, and that's something that I'm looking forward to.

**Amy E. Hood***Executive VP & CFO*

And Brent, to your specific question on Windows Server 2003, we did have a good quarter as we talked about in Windows Server. But in general, that business unlike the client upgrade that we see, just because so much of the business is already on annuity, you don't see that type of incremental impact in an in-quarter release. That isn't to say there isn't ample opportunity for us to make sure we upgrade customers to the higher-value prop and more secure and more manageable offerings we have in the server business.

**Operator**

Our next question comes from Mark Moerdler from Bernstein Research.

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

I want to drill in, in terms of the move to the cloud. This quarter, the year-over-year server product and services revenue growth was slower than it was in the past quarters. How much of that is because you're seeing now some revenue shift to Azure? Or is it not yet seeing any revenue shift? And then I have a follow-up question.

**Amy E. Hood***Executive VP & CFO*

Well, why don't I take that one and we'll see what Mark's follow-up is. At 9% growth and continuing to take share, I feel like our performance in this continues to be sort of a positive outlier to the peer group. And for me, that type of performance and double digits for the year, I still feel quite good about. In general, what's interesting, I think, as you're getting to the crux of it is, do we have incremental workloads that are unique to the cloud, that we continue to see that. The very best example, frankly, Satya mentioned in his comments, which is our EMS performance, Enterprise Mobility Suite offerings. It's just -- it's taking something that's very unique, built off of our core in the server business and allows us to us to both grow and add new perspective there. So I don't think of it as reflecting a bigger shift than we've seen, in particular, this quarter. Also, if you'll remember, a year ago, we had a very big base of expirations in Q4 and had very strong performance a year ago. So I don't look at it as a direct trend line.

**Satya Nadella***CEO & Director*

Yes. The only thing I'd add is when you look at the total growth of Azure, the growth that's coming now from some of the premium services, this is sort of businesses that we actually did not ever participate

on-premise at all. Even EMS, when I think about our management, our management was just about Windows management. But we now have management, data protection and identity systems that cross all devices in the enterprise, including Internet of Things, and that makes it pretty exciting and that growth is great to see. Same thing will be on the server management, we have a new suite called the Operations Management Suite, which also spans all the cloud units as well as on-premise units. Cortana Analytics, we never participated in any of the advanced analytics workloads at all, in spite of all the success we had in the database business. So I'm excited about built new workloads that, in many cases, are borne in the cloud workloads, where we are expanding our market opportunity and continuing to outperform our peers and grab share when it comes to on-premise.

**Mark L. Moerdler**

*Sanford C. Bernstein & Co., LLC., Research Division*

That's very helpful. Switching gears a bit. On Windows, obviously, you're seeing some amount of delay due to Windows 10 on the OEM side. Can you give maybe a little more color in terms of how you're thinking about that, how big a delay is it, how much we could see that starting to be replaced next quarter and beyond?

**Satya Nadella**

*CEO & Director*

Yes. I'll take that and, Amy, you can add to it. And the way I -- the Windows ecosystem works is there are phases to it. And in fact, if anything, this release of Windows 10, just the way we built it with the Insider Program, everything is, of course, speeding up because, in some sense, we've taken a very different approach with this Windows as a Service even when it comes to OEM relations and how they're able to co-create the products with us. But that's -- and there are 3 distinct phases. The first phase is what I'll describe as the upgrade phase, that's what starts in a week's time, and that is more of retail execution and upgrades. Then come the fall, you will see the devices from all the OEMs going into the holiday quarter. And then the enterprise upgrade, in fact, we have a release of enterprise features which I mentioned in my script, which will ship in that time frame. And I expect piloting to start and deployments to start in the second half of the fiscal year. So that's how we think about the OEM as well as enterprise adoption. So I would -- if -- my bullishness for Windows 10 is more in the second half of the fiscal year. And of course, it will build. It will build starting in a week's time in retail and in the upgrades, but I sort of see this in 3 phases.

**Amy E. Hood**

*Executive VP & CFO*

And to your specific question, Mark. Before every launch, we tend to have a tightening in the channel as they prepare and run reasonably lean, this is a healthy state, it's within the range of normal. So I don't think of it as a delay in the way you're talking about it. It is pretty standard, as Satya has talked about, in terms of the dynamic. And he mentioned we are feeling, I think, a lot of excitement from the ecosystem about what's possible with some of the new devices that will come. And so I don't really think of it in that way. I think about it as an encouragement that they want to fill the channel as quickly as they can over the coming quarters with new machines.

**Operator**

Our next question comes from Keith Weiss from Morgan Stanley.

**Keith Weiss**

*Morgan Stanley, Research Division*

I wanted to drill into sort of the new strategy around the Phone business a little bit. The revenue expectation for Q1, it was below our expectations, I think, quite below what the Street was looking for. Can you give us a sense of how you see that business trending over a longer period of time? Because if there's a significant restructuring going on, I think -- I don't think a lot of guys have a good view in their head of what your expectation is for the business on a revenue run rate basis or what do you expect to be selling this year and on a going-forward basis right now?

**Satya Nadella***CEO & Director*

Let me start and then, Amy, you can add to this. The big shift that we are making when it comes to phones is to not think about phones in isolation. That's perhaps the biggest shift because I think about Windows 10 in its entirety, the Windows ecosystem in its entirety. We clearly are going to have premium first-party portfolio. And you've seen some of the numbers, some of the progress we have made in Surface. I feel that we have a formula there that I would like to apply more broadly in terms of growing -- just delivering innovation, growing our own economic return for it, stimulating demand, creating categories, all of that is what I want to do broadly. And it applies to phones, it applies to Surface hub, it applies to HoloLens. And that's how I view it. I believe our participation in the Phone segment by itself, so the Windows phones and Lumia phones being there, is important. And that's why we picked the 3 areas where we have differentiation and we want to focus on it. We want to have great flagship phones for Windows SaaS. That's actually a segment we don't today have good devices, and we hope to change that with Windows 10. We have, in fact, good traction in the business segment. So this is business customers who are actually buying phone devices, which is basically a radio with -- essentially a smartphone to be able to deploy their line of business applications. That's where we have pretty unparalleled value, which is we have the Visual Studio Online and some of the tools I talked about. So you can generate these apps at a low cost of ownership, manage them, secure them and deploy them to our phone endpoints and then, of course, management and security. So that's the place where we are going to continue to focus. And in the value smartphone, that's the place where I want us to be much more efficient. We clearly have some value to add there because of the uniqueness of Office and Skype and our services. But at the same time, I think we want to be smart about how many of these phones do we want to generate, how many -- which price points do we want to participate. That's where you will see the most significant operational changes from how we operated last year to the coming year.

**Amy E. Hood***Executive VP & CFO*

And so, Keith, the way that I think about it, and I tried to outline it in my comments, is that the significant revenue declines quarter-over-quarter for the year are a reflection of the focused approach we're going to take in phone. It's an approach that we've executed in other hardware segments that I feel is a proven model for us. Our profitability will also improve. More of that comes in the second half of the year structurally as we complete some of the restructuring efforts and those costs come out of our operating expense run rate. But I think that's probably the way to more appropriately think about, over time, you would expect to see gross margin improvement and operating profit improvement as opposed to focusing on the revenue line.

**Keith Weiss***Morgan Stanley, Research Division*

Okay. Got it. And if I could sneak one more just on the security side of the business. I think a lot of guys have thought traditionally about security, it's something that Microsoft does to make your platform more secure and to provide more confidence in users using your platforms and your tools. On a going-forward basis, is there more of an opportunity for you guys to sell security as more of a standalone opportunity? I mean, it's something that's in very high demand as you are looking for more secure solution. Is that something that could potentially be more of a standalone opportunity for Microsoft on a go-forward basis?

**Satya Nadella***CEO & Director*

In fact, we are adding significant value in security. It's much better for us, for example, to add capability around 24/7 in security and that's all in, for example, the new suite that we have just announced called E5, the secure lockbox. That's actually a pretty -- a very cool set of features that allow both regulators and businesses to have, for example, auditability and control over their movement to the cloud. Similarly, Azure, where we launched a whole set of security offers around how people can encrypt and manage keys, so those are all security features. We bought a company in Colorado that's essentially a firewall on all your identity management. So when we talk about enterprise management suite growth, a lot of it is just,

obviously, management growth but it's also security and data protection growth. So the approach we're taking is we're essentially creating, to your point, security value around our products, which -- it allows us to participate in essentially a security market that we never did in the ways that we are. So it's more than just launching one point security product. It's much more broadly participating in the security market, and you have seen some of that in the inorganic moves and the suites we have created.

**Operator**

Our next question comes from Walter Pritchard from Citi.

**Walter H Pritchard**

*Citigroup Inc, Research Division*

Amy, just for you on the annuity, it looks like annuity is about 82% of the commercial revenue the last 2 quarters. How high do you think that goes? It sounds like you do expect that to continue to go up, although probably never gets to 100%?

**Amy E. Hood**

*Executive VP & CFO*

I do think our -- over the long term, you're right, that is how I think about it and, frankly, inherent in the conversation around moving to the cloud with the aggressive targets we've given, that is sort of implied to your point. And so I think 100% is not the logical answer, there will always be somebody who chooses to purchase on a one-time basis -- or there's a logic to it. But I do think, over time, we do expect that to trend in that general direction.

**Walter H Pritchard**

*Citigroup Inc, Research Division*

And then, Satya, you mentioned CRM in your comments, your prepared comments, which we haven't really heard you talk that much about as an area of interest in the past. I'm wondering what changed in your view? Or how do you look to sort of bring that into -- it sounds like more of the core productivity scenario that you deliver.

**Satya Nadella**

*CEO & Director*

Yes. I mean, overall business process collaborations, communication, these category boundaries are things that I believe are going to change. I've always felt that in some sense, most of the time, we even automate business processes where we spend really getting our business done in our communication and collaboration tools. And this impedance is something that I've always dreamt of sort of how do we go solve? And CRM has taken -- our own Dynamics product has taken some pretty unique approaches. And quite frankly, I was -- I want to open up our communication and collaborations for other CRM vendors. So one of the things that I'm very explicit about is we will have an open platform for other business process applications because this is a very fragmented market the world over, especially if you add SMB. And so we want to be having a platform play as well as our own business applications play, and both of them should be high growth for us. And in the last year, we've just added more focus and we put more selling capacity around it, more marketing capacity and now, of course, mainstreamed it across Microsoft because I'm a big believer in this, because I think we have something unique to add. As opposed to driving our own top line/bottom line growth, I think we can bring real innovation. And that's what is exciting to see. And it's not just CRM, I'm actually excited about our ERP business. Some of the numbers that Amy talked about is growth in the seats. And when I think about data as the new currency, we have lots of managed seats and a lot of data, which all will move to the cloud. And so things like Power BI and Cortana Analytics can help customers transform. So in fact, that's one of the reasons why I'm even sort of very optimistic about some of our new data capabilities is we have the attach capability to our even installed base of Dynamics.

**Amy E. Hood**

*Executive VP & CFO*

And Walter, just quickly, this is one of the areas that we invested in actually leading into this past fiscal year, FY '15, and the results have actually been better than we anticipated when we first made the investment. So I think we both feel very good about the momentum that's built through the year.

**Operator**

Our next question comes from Karl Keirstead from Deutsche Bank.

**Karl Emil Keirstead**

*Deutsche Bank AG, Research Division*

A question for Amy on the cost control front. Looks like you once again came in below your OpEx guide. But I think the COGS number came a little bit above what you had guided to 3 months ago. And I'm just wondering if you could talk through that. Obviously, it affects everybody's gross margin calculations. Was it the hardware mix shift? Was it the challenges with the Phone business? Perhaps a little color there might help us.

**Amy E. Hood**

*Executive VP & CFO*

Sure, Karl. Because of the performance in Xbox and in Surface, you're right, it is a hardware mix shift a bit. We outperformed significantly in both those products in Q4, and that does -- took us a little bit outside the COGS range but not as much as our revenue outperformed. So actually, margins structurally were better than I thought they would be. And so I actually feel quite good with that outperformance, in our ability to see that outperformance fall to the bottom line through stronger execution on gross margin percentage, particularly in that segment.

**Operator**

Our next question comes from Raimo Lenschow from Barclays.

**Raimo Lenschow**

*Barclays Bank PLC, Research Division*

I wanted to go back to Azure. You obviously have strong momentum there. Can you talk a little bit about the use cases you see from your enterprise and SMB customers? Is this kind of very much a test and development situation? Or are you seeing kind of a broader adoption there besides, obviously, Office 365, et cetera?

**Satya Nadella**

*CEO & Director*

At this point, I would say it's pretty broad even use cases for even enterprise customers. There's definitely dev test happening, there is production IaaS, Infrastructure as a Service, deployment given some of the new high-performance SKUs and storage options that we have. And we are seeing significant adoption of SQL services, Azure DB. Machine learning as a service, one of the things that we realized is that every company out there becomes a software company beyond even our traditional reach through IT. Everyone has a digital office inside the company. They are, in fact, doing things in advanced analytics and using machine learning, and that's the place where we have some very unique capability. So that's another place where we're seeing wide adoption. We are seeing adoption in the building of new front-end -- or back-ends for new front-ends. So essentially using Azure as the cloud back-end for their mobile apps across Android, iOS and Windows as well as their web. That's another use case that's high growth for us. And of course, Cortana Analytics. This is the big data side of it. This is happening in IT, it's happening in, as I said, in digital offices within each one of the customers. So we have a pretty broad spectrum of use cases that some of the customers have talked about even in the recent set of conferences. From our Partner Conference to our Ignite Conference, we have been, in fact, showcasing. Even our ad campaign showcases some of these use cases.

**Operator**

Our next question comes from Heather Bellini from Goldman Sachs.

**Heather Anne Bellini**

*Goldman Sachs Group Inc., Research Division*

Great. I just had 2 questions, pretty quick ones. Just to follow up on Azure, I was wondering if you could share with us what you're seeing in the mix between IaaS and PaaS and kind of how you've seen that shift evolve over the last few quarters. And then secondly, just to follow up, I think, on Walter's question. Yes, you definitely have been focusing on the Customer Relationship Management opportunity and the financials market more. But given the big SaaS incumbents already competing in that area, can you share with us -- do you think you have the assets you need internally to execute against your long-term goals?

**Satya Nadella**

*CEO & Director*

Sure. On the IaaS versus PaaS, it's an interesting question. I've not looked at it in isolation because what happens is, at least the use cases, what starts off as IaaS suddenly will start using Azure AD for identity management, will use a little bit of our Media Services, for example, just doing content encoding. So there's a mix always. So there's nothing pure PaaS, nothing pure IaaS. That's the trend I see. But it's a split that we should go take a look at and then off-line maybe even talk about it. But overall, we see significant amount of IaaS in the last year because that's probably the place where we had more of a weakness, which we have now overcome. And so we're seeing significant growth of IaaS in the enterprise. But the place where we continue to have significant differentiation is in some of these managed services and PaaS. And that I think is the mix on it. And then on the Dynamics side, I absolutely believe we have a huge opportunity. Having sort of worked in business applications for a long time, first of all, the market is very fragmented. I think people like to talk about leaders. And there are, clearly, leaders when you go to the very top of the enterprise customers and segments. But the way the market splits into verticals and into horizontals and then the platform effect, there's plenty of opportunity. For sure, you've got to be one of the players. It will be 3 players, 4 players, whatever. But in every technology paradigm, you want to be one of them. We already have a \$2-plus billion Dynamics business, I talked about the total number of seats and now we have this triple-digit CRM Online growth. So I feel that we are in a good position and I feel that we'll look at even in some of the inorganic means to keep growing it. In fact, the Field service acquisition I talked about in my script is an example of that. So that's my bullishness on our business process prospects.

**Operator**

Our next question comes from Ross MacMillan from RBC Capital Markets.

**Ross Stuart MacMillan**

*RBC Capital Markets, LLC, Research Division*

First, on OpEx, the guidance, Amy, is impressive. I presume that fully accommodates the restructuring announced 2 weeks ago. And then, last year, you said core Microsoft at NDS will be down slightly in OpEx. I wondered if you can provide a similar comment for fiscal '16 for core Microsoft ex phone.

**Amy E. Hood**

*Executive VP & CFO*

Sure. Look, I talked a little bit about it but let me go into a bit of detail on that. I think the first half of your question was does the \$32.1 billion to \$32.4 billion full year OpEx guide reflect the timing of the implementation of our restructuring. And it certainly does. And so what you can then see as it relates to the second half of your question is that we are taking some of those savings and investing them back into the business, in some of these key growth areas we've seen. I outlined 3 on the call. The third one, I probably could have expanded more on. The first one is Windows 10. The second is the first-party hardware, where we just had such terrific performance again this Q4. And then finally, the third bucket was about accelerating our Commercial cloud lead. And I do feel like in that area, we could invest in Office 365, some of the new E5 capabilities. I look forward to adding sales capacity to take advantage of that.

We'll also add sales capacity across some of the other opportunities we've seen broadly. And so I look and see that as an opportunity to accelerate top line growth.

**Satya Nadella***CEO & Director*

And one thing I'll just add because a lot of folks even asked about our business process and business applications. I want to build a long-term, profitable business. In other words, one of the keys in biz apps is you can always get into the trap of overspending in sales and marketing and not having long-term leverage at all. One of the things I feel very good about our position is how do you really build a long-term, profitable business. That's front and center to me. So we will not overspend there in sales and marketing because we do believe the products -- in fact, there's a different way to sell even business process applications because of the cloud, and that's something that we want to take advantage of.

**Ross Stuart MacMillan***RBC Capital Markets, LLC, Research Division*

And I had one quick follow-up, if I could. That's helpful. At Analyst Day, you did talk about -- I think it was 8% unit growth in the Office ecosystem over the last 2 years. And it sounds like you continue to see nice unit growth in Office. How should we think about that going forward? Are you fully expecting to continue to see unit growth? And then also just a clarification, I think your customer lifetime value was based on existing SKUs. So as you introduce E5 and others, does that open up the potential for even higher customer lifetime value?

**Amy E. Hood***Executive VP & CFO*

Great. I do think the work we showed at the Analyst Meeting on the importance of increasing the installed base across Office and Exchange, it did occur again this quarter, so I feel good that we're staying on the trajectory that we showed in the projection. Do continue to expect that to happen as we shared it back that last week in April. And on your -- on the second half of your question, I tend to think -- you're right. Generically, each of the examples look quite different. There were people that were upgrading from x to y, there were people that were just simply moving to the cloud. But one of the things that the cloud, to your point, makes fundamentally possible is the opportunity for us to quickly iterate the opportunities, build value and deploy it more quickly to customers. And generally, I do think that they will pay us for that, to your specific question. I also think the importance of it is that it tends to also come with higher margin. So our improvement and continued improvement in our Commercial cloud gross margin portfolio, I think this is a key criteria of that. So I associate it, yes, with life time value. I also associate it with our ability to move our gross margin percentage up.

**Chris Suh***General Manager of Cloud & Enterprise Finance*

We'll have time for one last question, please.

**Operator**

Our last question comes from Daniel Ives from FBR Capital.

**Daniel Harlan Ives***FBR Capital Markets & Co., Research Division*

Just one last one, just on M&A. Maybe you can just talk through any change in your strategy obviously given what's happened with the Nokia write-down, the security acquisition going to pivotal fiscal year. How you're thinking about M&A in the scheme of everything, especially as you guys have been pretty tight on cost controls and everything else.

**Satya Nadella***CEO & Director*

Overall, Dan, the way I look at it is where -- first of all, I'm most focused on, obviously, our organic growth. And in there, Amy alluded to this, we have made significant changes in how we have allocated our own organic dollars, both in R&D as well as in sales and marketing, and we'll continue to do that. Because I think there is significant new opportunities for us to go after, and that will require us to just reallocate aggressively, and that to me is core. But beyond that, we will look at inorganic means. When I look at all the acquisitions that we have made over the course of the last year, and our OpEx guidance for next year shows how disciplined we are in bringing new talent in, be it in R&D, be it in sales and marketing. So we are not afraid to bring in new capability, but then also questioning what is the allocation we have. Of course, we have done smaller acquisitions, but they add up. They are pretty significant when you add up all the things that we have done in the Office 365 space, all the things that we did in the Azure space. So we'll continue to do that. And if anything comes up in M&A, which allows us to pursue our strategic vision that we will need to even allocate more to on an OpEx basis, post-acquisition, we will look at that. So I won't shy away from it because what's important to us is growth in areas where we have something unique to contribute and long-term profitability.

**Chris Suh***General Manager of Cloud & Enterprise Finance*

That wraps up the Q&A portion of today's earnings call. We look forward to seeing many of you in the coming months at various investor conferences. For those unable to attend in person, these events will generally be webcast and you can follow our comments at the [microsoft.com/investor](http://microsoft.com/investor) website. Please contact us if you need any additional details, and thank you for joining us today.

**Amy E. Hood***Executive VP & CFO*

Thank you.

**Satya Nadella***CEO & Director*

Thank you.

**Operator**

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