Presentation

Operator

Welcome to the Microsoft first quarter earnings conference call. (Operator Instructions) I would now like to turn the meeting over to Colleen Healy, General Manager, Investor Relations. Madam, you may begin.

Colleen Healy

Thank you very much and good afternoon, everyone. Thanks so much for joining us today. This afternoon I am joined by: Chris Liddell, Senior Vice President and Chief Financial Officer; Frank Brod, Corporate Vice President and Chief Accounting Officer; and John [Setok], Deputy General Counsel.

Today's call will start with Chris providing some key takeaways for the first quarter of fiscal year 2008 and an overview of expectations for the rest of fiscal year. I will then provide details around our first quarter results and then turn it back to Chris for a more detailed discussion of our guidance for the full year and second quarter of fiscal 2008. After that, we'll take your questions.

We filed our 10-Q today in conjunction with our earnings release. Therefore, you have available the earnings release, MD&A, financial statements, and footnote. We have also posted our quarterly financial summary slide deck which is intended to follow the flow of our prepared remarks in order to assist you. The slide deck offers highlights from the quarter, outlines our guidance, and provides a reconciliation of differences between GAAP and non-GAAP financial measures that we will talk about today.

You can find the earnings release, the financial highlights, and the quarterly financial summary slide deck on the investor relations website at www.microsoft.com/msft.

Today's call will be 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. As always, shareholders and analysts can listen to a live webcast of today's call at the Microsoft investor relations website. A replay of the call will be available at the same site

through the close of business on October 25, 2008.
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is not allowed without express permission of Microsoft.
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 10-Q, our 2007 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 statement.
With that, let me turn it over to Chris.
<TAG>Christopher P.
Liddell</TAG>
Thanks, Colleen, and good afternoon, everyone. Thanks for
joining us. I'll start today's call with highlights from our first quarter
performance and how we see the rest of fiscal 2008 shaping up.
The first quarter represented an outstanding start to the
fiscal year, with every part of the company performing at or above
expectations. In particular, we are very happy the consumer demand across our
total product range propelled revenue, operating income, and earnings per share
growth by 27%, 32%, and 29% respectively.
Also, we successfully closed aQuantive and a number of
smaller acquisitions, and we continued setting the platform for future growth with
the availability of products and services, such as an updated live search, BizTalk
Server, Silverlight, Performance Point Server, Halo 3, and Office Communication
Server.
In terms of our financial performance, there are some key
trends that I would like to highlight. On the revenue side, the benefits of our
multi-year product cycle are obvious. Q1 was our fastest growing first quarter

in seven years, with revenue up 27%, or $3 billion, over Q1 of last year. The performance was across all positions, customer segments, channels, and geographies.

Looking specifically at the growth coming from our various geographies, emerging markets continued to be a strength. The nations that make up the G7 grew 29% for the quarter, but even better was an over 40% increase turned in by the combined group of Brazil, Russia, India, and China.

A quarter like this demonstrates how enlarging our geographic presence has positioned us to benefit from the continued worldwide economic expansion.

We also did a good job this quarter of converting revenue growth into profit growth. Operating income grew five percentage points faster than revenue, expanding our operating margin from 41% to 43%.

Solid marketing and sales execution, combined with efficiency on operating expenses, kept costs in line with expectations.

Earnings per share was up 29% over last year, up to $0.45, assisted by our ongoing share buy-back program. Given the start in the first quarter, the acquisition of aQuantive, and an improved outlook, we are increasing our revenue, operating income, and earnings per share guidance for the year.

We now expect revenue growth of 15% to 17%, and this would put the top end of that revenue approaching nearly $60 billion, representing a $2 billion increase over our guidance in July.

We are also increasing our operating income and earnings per share guidance, the latter to a range of $1.78 to $1.81, $0.08 to $0.09 higher than our previous outlook.

With those high level things for the quarter and 2008, I am going to turn the call over to Colleen now for more details on how we closed out the first quarter.

Colleen Healy

Thanks, Chris. As Chris mentioned, we are off to the fastest start for revenue and operating income growth of any recent fiscal year. Let me provide you with details of our financial performance, starting with revenue.

I'll discuss top line financial and business momentum points and then follow up with revenue performance for each of the business units. Then I'll review the rest of the income statement. All growth comparisons relate to the comparable quarter of last year, unless otherwise specified.

Revenue increased 27% to $13.8 billion, significantly exceeding our expectations by over $1 billion. Every business grew at double-digit rates, with particular strength in client, the business division, and server and tools, which grew in excess of 20% combined, as well as growth of over 90% by our entertainment and devices division.

The underlying PC hardware market was strong, with estimated growth of 14% to 16% during the quarter, about three points higher than our expectations. From a customer segment standpoint, the business PC shipment growth rate increased almost three times to over 12%, while continuing to be outpaced by the consumer segment.

From a geographical point of view, PC growth rates in emerging markets continued to outpace that of mature markets, driven by robust growth in Brazil, Russia, India, and China, which grew a combined 20%. Europe and Canada led the mature markets, while we began to see recovery in the U.S. and Japan.

Our mix of product billings for the quarter was approximately 35% from OEMs, 25% from multi-year agreements, 20% from license-only sales, and the balance from our other businesses.

Non-annuity sales were particularly robust, which is consistent with the post product launch stage for Windows Vista and the 2007 Office system. Strong annuity licensing performance with enterprise agreement renewal rates consistent with historical trends drove our unearned revenue balance 15% higher to $11.6 billion.

Our [contracted and not billed] balance increased sequentially to over $11 billion. When taken together with reported revenue, total booking for the company grew an impressive over 30%.

I will close out the revenue overview by adding that changes in foreign exchange rates added about two percentage points to our overall revenue growth and was slightly above our forecast heading in to the quarter.

Now, I will provide revenue highlights by business segment, starting with client. Since Windows Vista became available for consumers, client revenue has grown over 20% on average. This quarter, a rapidly expanding personal computer market, progress against software piracy, and three quarters of Windows customers adopting premium versions drove client revenue to $4.1 billion, an increase of 25%.

OEM revenue, which makes up over 80% of client revenue, grew 25%.

After adjusting for three points of revenue recognition from deferred revenue, OEM revenue increased slightly faster then OEM unit shipments of 20%, due to a higher mix of Premium Windows SKUs.

Consumer premium units grew over 150%, while business premium units grew closer to 11%. As a result, the OEM premium mix increased by 16 points to 75%, driven by a 19-point increase in the consumer element of premium mix, and partially offset by a three-point decline in the business element.

Because business premium SKUs have a five-to-one pricing impact over consumer premium SKUs, these changes in the premium mix have largely offset any impact to revenue.

Client, commercial and retail licensing, which makes up about 20% of client revenue, increased 23%, as business customers continue to add client products to their annuity agreement.

During the quarter, we saw a 27% increase in the client volume licensing portion of the unearned revenue balance. We view this to be a positive leading indicator of intent by businesses to deploy Windows Vista.

Server and tools revenue increased 16% to $2.9 billion, driven by strong annuity license growth in Windows Server and SQL Server, which we are happy to see ahead of the upcoming new releases.

More specifically, we saw healthy unit growth in our Windows Server business, particularly in our premium enterprise edition SKU, which grew by over 35%. And SQL Server unit and revenue growth each exceeded 15%.

During the quarter, we release Silverlight, a Windows home server. We also gained significant product development momentum with beta releases of Visual Studio and SQL Server. Since the availability of the initial release candidate of Windows Server about a month ago, it has been downloaded over 1 million times, indicating high interest in the coming final products.

Our consulting revenue increased 32%, as we've experienced higher utilization rates following the recent business product launches across the company.

Online services business revenue grew 25% to $671 million, including $80 million for the half quarter of aQuantive revenue since close. Excluding aQuantive, consistent with the way we guided you back in July, growth was in line with our expectations. Online advertising growth for the quarter grew 33%, or 25% before aQuantive.

Microsoft Business Division revenue grew 20% to $4.1 billion. As a result of our focus on delivering greater desktop value to business customers, we achieved double-digit revenue growth across a broad range of products within our Office system, unified communications, and business solution areas.

Looking at how the various customer segments performed, revenue from business customers jumped 25% over the prior year. We benefited from strong, mid-market transactional sales and good Enterprise demand for business productivity infrastructure, such as SharePoint and enterprise [COW].

Healthy sales through retailers for the back-to-school season helped drive consumer growth in the quarter.

Entertainment and devices revenue grew over 90% to $1.9 billion, driven by higher-than-expected console sales and Halo 3, which achieved the biggest entertainment launch day in history. The strong demand for Halo 3 generated approximately $330 million of Microsoft revenue in the quarter, as well as significant consumer interest for the X-Box 360 console.

X-Box 360 console units increased over 90%, with over 1.8 million units sold. This was driven by our August price cut, excitement around Halo 3 generating console demand, and an earlier ramp-up to the holiday season in anticipation of the most compelling line-up of game titles available on any platform.

In addition to the success of Halo 3, X-Box 360 continues to lead third-party games sales against all current generation platforms, which is not only good for us and our gaming audience, but also good for our game developer partners in the X-Box ecosystem.

For example, according to NPD for the U.S., all four of the current generation third-party titles in the top 10 last month were for the X-Box 360. In fact, over the last year, game developers have seen their titles hit the top 10 list 27 times for X-Box 360 compared to only twice for the PS3 and only once for the Wii. This helps X-Box 360 software attach rates remain at record levels for any console at this stage in its lifecycle.

Now for the rest of the income statement. Cost of revenue increased three points to 19% of sales, primarily driven by the high volume of X-Box 360 unit sales, increased consulting business, and expanded online services operations.

Operating expenses increased 11%, dropping from 43% of sales to 38% of sales. Expense growth was largely in line with headcount growth and is tracking to our expectations, despite the higher-than-expected revenue as generated during the quarter.

Operating income grew faster than revenue at 32% to $5.9 billion, exceeding high-end guidance by $750 million and expanding our operating margin by two percentage points.

Investment income and other totaled $298 million for the quarter. Our effective tax rate for the quarter was 31%, half a point higher than we previously guided. Cash flow from operations increased 45% to $5.9 billion. Cash flow from operations outpaced operating income due to collections on the large volume of business close at the end of the fiscal year.

During the quarter, we repurchased 81 million shares, or $2.3 billion of company stock. $2.9 billion settled in the quarter due to the high volume of repurchases at the end of fiscal year 2007, and we paid out $938 million in dividends to shareholders in the quarter.

Diluted shares outstanding for the quarter were 9.5 billion, down 5% from the prior year as a result of share repurchases. Earnings per share for the quarter were $0.45.

So in summary, we are extremely pleased with this quarter's performance. Revenue for the fiscal year is off to the fastest start in recent history, fueled by strength across our products launched over the last nine months. Operating expenses came in line with expectations while generating significantly higher-than-expected revenue. This resulted in operating income growing faster than revenue at an impressive 30% clip.

With that, let me turn it back to Chris who will provide you with our second quarter guidance and outlook for fiscal 2008.

<TAG>Christopher P.
Liddell</TAG>

Thanks, Colleen. Before we get into the specific guidance, let me outline some of our key underlying assumptions. First, our fiscal 2008 forecast assumes stable macro economic conditions through the remainder of the fiscal year. We remain optimistic about the overall outlook for the IT industry. In mature markets, we haven't seen a spillover from problems in other areas of the economy, although clearly the risk of an economic slowdown has increased.

Emerging markets in particular appear healthy to us. Not only are we getting the benefits of strong growth offshore, but it is assisted by stronger international currencies. The FX impact alone we believe will add about one point to our yearly revenue growth.

Overall, our business is benefiting from our diversification across products, channels, geographies, and customer segments.

We are increasing our expectations for PC unit growth for fiscal 2008 by one percentage point to 10% to 12% for the year, and 11% to 13% for the second quarter. Growth rates in both the Asia-Pacific and EMEA regions appear to be stronger than we thought coming into the year. We estimate that the growth rate will continue to be higher in the consumer segment and the business segment, and recent regional trends should continue with growth in emerging markets outpacing that of mature markets.

Now let me go through our detailed guidance. For the full year, we expect our revenue to come in between \$58.8 billion to \$59.7 billion, growing 15% to 17%, up four percentage points from our last guidance.

The full year forecast now includes revenue from aQuantive, which contributes approximately one point of revenue growth. The remaining three point increase from July is driven by an improved outlook for our three businesses of client, the business division, and server and tools.

For the second quarter, we expect revenue of $15.6 billion to $16.1 billion, which represents a year-over-year increase of 25% to 28%.

With that, revenue guidance in our divisions is as follows: for client, we expect full-year growth to be 12% to 13%, and second quarter growth to be 62% to 64%, or 13% to 14% excluding certain revenue deferrals in the prior year. For the full year, we expect OEM revenue to grow in line with the PC hardware markets.

On the commercial and retail side of the business, we expect double-digit growth for the year from continued demand through our volume licensing channels. The client growth rate benefits by two percentage points for the full year and by four percentage points in Q2 from recognition of undelivered elements, consistent with our guidance in July in both percentage and absolute dollars.

Server and tools revenue should be up 16% to 18% for the year, and 16% to 17% for the second quarter. We expect double-digit growth across our server platform products and services. The division is completing the new releases of Windows Server, SQL Server, and Visual Studio in preparation for the upcoming launch event starting in February. These products will allow IT departments to be more productive by providing them with a secure, trusted, scalable and manageable platform that will underpin growth in the server and tools business over the next several years.

We forecast revenue in the online service business to increase 33% to 37% for the year, and 32% to 35% in Q2. This implies online advertising growth in excess of 30% for the quarter and for the year.

This guidance includes the revenue from aQuantive, which adds approximately 25 points of growth for Q2 and for the full year. Organic revenue guidance for the fiscal year is unchanged for both the business group and advertising.

We’re aiming to become one of the major players in the online advertising space, and we are pleased by the progress we are making in putting the building blocks in place. For example, the launch of our new search product with much stronger relevance, using industry standard measurement methodology; our core algorithmic relevance is now on par with the market leader and better than all other search engines in the U.S. market today; we saw solid growth, 23%, in our display business; we saw rapid growth in our live IDs, growing 19% to over 400 million; our partnership, which we announced yesterday with Facebook; and the acquisition and successful integration of aQuantive during the quarter.

We will continue to invest in this business, as we've told you before. For example, in building a differentiated search experience in the four high value verticals of commerce, local search and mapping, entertainment and health, which collectively represent 40% of all global searches.

Microsoft Business Division revenue should be up 14% to 15% for the year and 31% to 33% in the second quarter. Normalizing for the impact of the technology guarantee and pre-shipment deferrals in the prior year, the second quarter growth should be 15% to 16%.

Looking at the applied growth rate from the second half, I'll remind you that due to last year's strong sales of the 2007 Microsoft Office system, we will have tough comparisons but are predicting double-digit growth nevertheless.

2008 is another important product launch year for the business division, as we roll out our offering in the important investment areas of business intelligence and unified communications. These two areas are projected to have a combined addressable market size of about $65 billion in 2009, representing sizable growth opportunities for the division.

Performance point server, which is our business intelligence offering, had over 10,000 customers on its CTP program, an amount larger than some competitors' installed bases.

In unified communications, Office Communication Server also has been gathering interest, with over 80,000 beta downloads of the software.

The entertainment and devices division, we're forecasting revenue growth of 15% to 20% for the full year, and flat to down 8% for Q2. Our

Q2 revenue growth, however, should be viewed in conjunction with the earlier-than-expected ramp-up of console sales in Q1 in preparation for the coming holiday season.

If you look at our overall, for the first six months -- that's the first quarter and the second quarter combined, growth would have been about 15%.

[inaudible] has historically comprised almost half of industry hardware and software sales. With competitively priced console bundles and accessories, combined with a great first and third-party software title line-up, we feel very good about our position heading into the holidays.

We also look forward to bringing more choice to digital music consumers with our expanded families of Zune devices and updated music marketplace and new software updates, such as podcasting support, new wireless send and sync functionalities, and an attractive user interface. And in appreciation of our early Zune adopters, the new software features will be updateable to current owners' devices as well.

Turning back to company-wide performance, operating income for the year is expected to be between $23.3 billion and $23.7 billion, increasing 26% to 28%. Our higher revenue forecast is responsible for the improvement versus our July guidance, as we expect over half the incremental revenue to flow through to operating profits.

For the second quarter, we expect operating income to be between $5.9 billion and $6.1 billion.

As a result of the higher operating income guidance, we are increasing our full year earnings per share results to $1.78 to $1.81, including a $0.01 impact from integration and deal costs associated with aQuantive. This is an increase of $0.08 to $0.09 on a GAAP basis, or $0.09 to $0.10, excluding deal costs.

For the second quarter, we expect $0.44 to $0.46. These earnings then assume both for the year and for the quarter an effective tax rate of 30.5%.

From a balance sheet perspective, we expect total unearned revenue to finish fiscal 2008 up 8% to 10%, in line with our prior guidance.

Excluding deferred revenue for undelivered elements, the remaining portion of unearned revenue should increase 14% to 16%.

When thinking about sequential changes in unearned revenue from Q1 to Q2, we expect the balance to follow historical patterns and remain roughly flat. Contracted not billed should also finish 2008 up from current levels.

It is clearly important, especially in the current environment, that you consider some of the risks of this forecast. These risks include competitors, legal, execution, and general market risks, such as foreign exchange rate movement, fluctuations in PC and server hardware growth rates, and consumer acceptance of our new and existing products.

Additionally, changes in the mix of our billing between annuity and license only can have an impact on revenue, operating income, and earnings per share by delaying revenue recognition in the future periods.

So to wrap up, the first quarter was an outstanding start for the year. A strong PC hardware market, healthy demand by business customers for our product, and overwhelming consumer response to the launch of Halo 3 helped propel us to the fastest Q1 revenue growth in seven years.

To put that in context, our revenue base is about 2.5 times larger than it was the last time we grew this fast. The fact that we can beat the law of large numbers is a tribute to our products and sales teams.

Good execution and cost discipline allowed the majority of our revenue upside to flow through to operating income, and for the balance of this year, we will continue to deliver the strategies for shareholder value we outlined at our financial analyst meeting in July, in particular, driving our top line growth, continuing to invest in technology offerings that will provide the platform for future growth, and using our strong cash flow and balance sheet to benefit shareholders through dividends and share repurchases.

With that, I will hand the call over to Colleen so we can get started taking some of your questions. Thank you.

Colleen Healy

Okay, great. Let’s proceed to questions. We want to accommodate as many questions as we can from as many of you, so please avoid multi-part questions and please limit yourself to just one question. Operator, can you please repeat your instructions?

<TAG>Question-and-Answer Session</TAG>

Question and Answer

Operator

(Operator Instructions) Our first question comes from

Heather Bellini with UBS.

Heather Bellini
UBS

Congratulations on the quarter. I was wondering if you could

give us an update on your view of Vista adoption thus far, and in particular,

how the uptake of premium SKUs, both on the consumer side and also with Vista

Enterprise, are tracking versus your original expectations, and how should we

think about that going forward?

<TAG>Christopher P.

Liddell</TAG>

Clearly we are very happy with the client division overall.

As you've seen since we launched Vista, the revenue growth has been in excess

of 20% three quarters in a row, so the overall [headline] number, very good.

In terms of the premium mix, also very happy about that.

Now, in this case, premium mix brings in both Vista and XP premium sales as

well, and that's tracking in the mid-70s, so 75% for the quarter, and that

compares to I believe 59% in the equivalent quarter last year, so up 16 points

year over year. So we're very happy with the adoption of Vista Premium and also

happy with the old XP Media sales as well.

The other thing I'll point to is on the client annuity

agreements, which is probably the best leading indicator we can think of of

people's intention to adopt, that's still very early in the adoption cycle for

businesses, but the volume licensing portion of our business was up 27% in the

client area, so that's a very good leading indicator from our point of view.

And sort of finally, as a wrapper, year-to-date sales are

now 85 million units for Vista. That compares to about 45 million for XP over

the same period, so almost twice as much.

So it's still early days but progress, we're very happy with

so far.

Heather Bellini

UBS

And just on the premium SKUs, would you say that they are

tracking above what you guys had expected when you originally launched the

product?

Christopher P. Liddell

Yes.

Heather Bellini
UBS

Great. Thank you.

Colleen Healy

Next question, please.

Operator

Our next question comes from Adam Holt with J.P. Morgan.

<TAG>Adam Holt - J.P.

Morgan</TAG>

Good afternoon, and I'll also let go the congratulations. I

have two questions on the business uptake. In particular, you had a meaningful

acceleration on the client side in terms of business units and I was hoping maybe

you could detail what you thought was behind that acceleration.

And then on the Office front, still another quarter of

better than 20% Office growth on the business front. Where do you think we are

on the enterprise upgrade cycle for Office? Thank you.

<TAG>Christopher P.

Liddell</TAG>

Sure, Adam. We'll start with client. The business sales

were, to be honest, a function of underlying demand, so the PC unit came in at

14% to 16% for the quarter overall, compared to our expectations of around 10%

to 12%, so we saw a good uplift in overall PC units, and that was both on the

consumer and the business side.

I think the benefit that we saw on the business aspect was

probably most particular in some of the emerging markets, so we saw good

strength in business and that really helped us with the anti-piracy and

legalization aspect of our growth. So if PC units grew by 14% to 16%, our

shipped units that we were paid for grew by 20%, and all of that delta was effectively a fight against unlicensed PCs, so the growth that we saw in the business segment, in particular internationally, really helped us in terms of overall unit sales. So felt very good about that and we still think that consumers will grow faster than businesses, but overall a very good story on the client side.

In terms of the Office, that has a slightly different impact, mainly because it's a much stronger impact from annuity there rather than non-annuity sales, although interestingly, non-annuity sales, which typically go to smaller businesses, were strong as well, which is a very direct impact with Office.

In the annuity sales, which tend to have a multi-year impact, you recall I talked last quarter about how we saw a very strong sign-up for maturing agreements right at the top end of our expectations, and that was really a very good leading indicator of people's acceptance of or expectation that they would roll out Office, but also the other products in MBD. So it's clearly strong from our point of view that people are seeing not only a value in Office, but products that are related to Office, for example, in the unified communications and business intelligence area.

So overall, we're feeling good about the rollout.

<TAG>Adam Holt - J.P. Morgan</TAG>

Terrific. Thank you.

Colleen Healy

Great. Thanks a lot, Adam. Next question, please.

Operator

Our next question comes from Sara Friar with Goldman Sachs.

<TAG>Sara Friar - Goldman Sachs</TAG>

Good afternoon, everyone. I think everyone is going to say congratulations, but it is quite an amazing quarter you put up. Following on one more comment on the client Vista adoption side; I think a lot of folks had thought SP1 would be the catalyst. Why do you think we saw it a little bit ahead of that and do you have a timing update on SP1? And then I just have a quick follow-up question, if I may, after that.

<TAG>Christopher P.

Liddell</TAG>

Vista adoption, as I say, it is still early and I talked

about intention to adopt rather than actual adoption. I think you are right

that certainly some businesses will be waiting for SP1 to roll it out, but in

terms of their willingness to sign up for the client element of the multi-year

agreements, their intention to roll out is I guess signaled by that. So it is

still early days as to what the actual adoption numbers are, and we think it

will increase during the year and obviously will be helped to some extent by

SP1. But some of the leading indicators are what we feel good about.

<TAG>Sara Friar - Goldman

Sachs</TAG>

And then just turning to the EDD division, great quarter. It

seems like you do think there was some pull forward on consoles just based on

your guidance. Is there anything implied in your guidance on broader commentary

about health of consumer spending in the fourth quarter? Are you leaving

yourself a little bit more cushion there?

<TAG>Christopher P.

Liddell</TAG>

No, it’s principally around the pull forward, as you

mentioned. And as I said in my prepared remarks, I tend to look at the business

for the first six months rather than the quarters. In particular in the first

quarter, console sales were 1.8 million units, which is relatively small. So it

was ahead of our expectations, but it’s a quarter where you can beat

expectations because the volumes are small. I mean, Halo was obviously a clear

beat but in terms of consoles, I’d rather think that the volume over that six

months, because there’s a lot of stocking in anticipation of Christmas going on,

and movements like that. So I feel good about it. There’s no particular

signaling on weakness for Christmas. In fact, we feel very good about the

line-up we’ve got, not only from the box itself but obviously the games

associated with it as well.

<TAG>Sara Friar - Goldman

Sachs</TAG>

Terrific. Okay, well, thanks a lot.

Colleen Healy

Thanks a lot, Sara. Next question, please.

Operator

Charlie Di Bona with Sanford Bernstein, your line is open.

<TAG>Charles Di Bona -

Sanford Bernstein</TAG>

I guess no surprise here, but I'm going to go back to the well on OSB. It was probably the only division that didn't really outperform significantly, only about 10% growth, excluding aQuantive, and the comScore share is back down to sort of the lows that they were in your fiscal Q4. Especially in light of yesterday's announcement around Facebook, maybe you can give us a little insight into the strategy and execution here, and is there any shift towards sort of buying traffic and community rather than building it internally? And in general, how do you go balancing those two alternatives and valuing those two alternatives?

<TAG>Christopher P.

Liddell</TAG>

First thing to note obviously is we met expectations, so it wasn't a beat, I agree, but it was a meet, so start with that. Underlying business growth or revenue growth, you mentioned the 10%, which is correct. Clearly in this case it's a negative from the Access business going away, so -- if you look at underlying revenue growth, underlying advertising revenue growth, it grew in the mid 20s, around 25% for the quarter year on year, which we think is acceptable. It's nor certainly stellar. We'd like to see it higher but it's acceptable and it is higher than where we guided at the start of the year, roughly speaking. So I think reasonable progress on the organic side of the business.

In terms of putting the building blocks in place and how we trade off organic growth through inorganic growth, it's both. The strategy has been both and will continue to be both, so we are investing heavily in the organic aspects of the business, so a lot of investment in particular has gone into the search product itself, and we clearly are extremely happy with the improvements we are seeing on aspects like relevance, which are critical going forward. We are putting a lot of investment into things like data centers, which are creating the platform of the future and the experience, so we are increasing CapEx quite considerably there. We are looking at CapEx overall for the year of $3.2 billion to $3.3 billion, about half of which is going into the OSB area. And we are putting investment in some of the verticals that I talked about on search organically and all the other areas as well, content on the display side.

So there’s a strong organic side, there’s a strong inorganic side, but clearly aQuantive is the most obvious representation of that and we’re particularly happy that we not only closed aQuantive but we’ve retained all of the employees. We think that integration has gone extremely well and we believe that’s going to generate some significant benefits going forward.

We also did some other smaller acquisitions, ones which we think are important for the ad platform, like AdECN during the quarter, and then the announcement yesterday on Facebook, which is a willingness on our part to make a commitment to a multi-year agreement with a partner who we think has got some tremendous growth opportunities.

So we are willing to do both. We are quite clearly willing to suffer an operating loss in that position as a result of those commitments, and we’ll share that there I think both in our financial analyst meeting and in our guidance.

But to date, in terms of underlying financial metrics, we’re on track. In terms of some of the other things that we wanted to do, if anything we are slightly ahead of where we would like to be.

Colleen Healy

Thanks, Charlie. Next question, please.

Operator

Our next question comes from Brent Thill with Citigroup.

<TAG>Brent Thill -

Citigroup</TAG>

Thanks. Good afternoon. Chris, I think your guidance for the fiscal year implies roughly a 40% operating margin, and clearly with Q1, it was higher than 40%. Why do you expect the operating margin will drift to that lower level for the year?

<TAG>Christopher P.
Liddell</TAG>

Overall for the year, we feel very good about the operating income growth relative to revenue growth and it will still be an increase year-on-year. So there's some COGS impacts, for example, the mix of COGS during the course of the year and we just saw an outstanding performance in the first quarter, some really, really strong growth in particular in client and MBD.

We think that out-performance is going to continue, but not at the same rate, so operating margins improve but I think quarter one was just an outstanding one in terms of our ability to take the revenue out-performance and drive it to the bottom line, and as I say, there is a different COGS mix to the rest of the year, which impact it as well.

But overall margin, we are going to grow operating income faster than revenue growth this year, which means our margins are going to expand, and the other impact which you know I've talked to you about is we expect earnings per share to grow very fast as well, backing out all of the one-offs, if you like. We think EPS is going to grow faster than 20% this year, which is the benefit of the operating margin expansion and also the benefit of things like share buy-backs flowing through.

So at this stage of the cycle for the company and for a company that started to grow earnings per share greater than 20%, up significantly from where we were, we feel good about it.

<TAG>Brent Thill -
Citigroup</TAG>

And just one quick one, if I could; relative to enterprise demand, it sounds like it's improved slightly over the past couple of quarters. Do you think it stabilizes from here or has room to improve even from here?

<TAG>Christopher P.
Liddell</TAG>

It's just the renewals. It was back to more traditional levels in the first quarter and that's about two-thirds of the three-quarters ramp that we talked about, so we saw a particularly good renewal rate in the fourth quarter and we are back down to more traditional levels, but levels which we feel obviously very good about, so I don't think -- we're not expecting an out-performance or an increase back to the very, very good levels that we saw in the fourth quarter, but if we can maintain traditional levels and obviously start to sell the new product range that we have coming through to our existing clients, and hence get the benefits of all of the additional products that we've either launched or are going to launch, [that is up] very well from a business point of view in terms of overall billings growth.

<TAG>Brent Thill -

Citigroup</TAG>

Thanks, Chris.

Colleen Healy

Thanks a lot, Brent. Next question, please.

Operator

Our next question comes from John DiFucci with Bear Stearns.

<TAG>John DiFucci - Bear

Stearns</TAG>

Thanks. Just a follow-up question I guess to Brent; the

margins were really impressive here, Chris, and even next quarter, you have a meaningful increase in revenue and a pretty I guess meaningful decline in operating margin. Is there any reason for us to think that you can't do a lot better than what you are saying here? I mean, I understand what you are saying about the COGS, but it looks like it is something that can continue.

<TAG>Christopher P.

Liddell</TAG>

Probably the first thing to do is to normalize of aQuantive,

so that may be distorting the numbers. But we are bringing that in for the first time and that's bringing in revenue but no operating income -- in fact, with amortization of intangibles, it will be a slight loss for the year. So that's probably a drag on the margins that you might want to normalize for, or at least give us the benefit of.

If you take that out, the way that I look at it is what is
our ability to meet our operating expenditure guidance and potentially
outperform on the revenue side, as opposed to drive the business on a margin
basis. And I would say I'm particularly happy with the fact that we delivered
increased revenue in the quarter whilst keeping operating expenditure literally
right on guidance. You'll recall from last year, I was certainly happy that we
delivered the whole year right on operating expenditures, so I feel really good
about the business groups, discipline, the sales force discipline to a large
extent keeping operating expenses under control, which will allow us to, the
extent that we beat revenue, to drive it to the bottom line.
I can't promise this is necessarily going to significantly
increase margins, but it will increase margin every dollar that drops through,
and perhaps if you back out aQuantive, that will give you a better comparison.

Colleen Healy

From a fiscal year on fiscal year, I mean, if you are
looking at organic, fiscal year '07 you were see us sort of a bit above the
mid-30s. You pull out aQuantive and legal charges and tax, guaranteed bonds and
the rest of it, for the year you are sort of in that 40% range, and then of
course, with Q2, given that X-Box with the hardware is such a big driver for
holiday, Q2 for the year, in terms of for the year, you'd probably see a dip,
but year on year, when you look at the true underlying organic, pulling out
aQuantive and some of those other things, you are going to see I think pretty
good margin there, John.
<TAG>Christopher P.
Liddell</TAG>
aQuantive will -- to help you, and obviously we'll have to
give more detail as we go on, but aQuantive will add $500 million of revenue
for the year. We will pull out deal costs and IP R&D that we write off of
close to $100 million, but we'll still leave in things like amortization of
intangibles, which we know other companies tend to call out. We'll leave those
in, which means that will be a drag on the operating income of close to a
couple hundred million towards this year. So perhaps that will help you
normalize for that.

<TAG>John DiFucci - Bear

Stearns</TAG>

Thank you.

Colleen Healy

Thanks a lot, John. Next question, please.

Operator

Our next question comes from Kash Rangan from Merrill Lynch.

<TAG>Kash Rangan - Merrill

Lynch</TAG>

Thank you very much. Good to see a quarter like that and more particularly, the stock break out to a multi-year high. That's got to look good. I just have a question on the online business, Chris. It looks like you've done a good job restoring or bringing profitability, let's say, to the entertainment and devices business. At what point are we in making similar progress on the profitability of the online business, especially with aQuantive being integrated into the operations of the company?

And as a follow-up, I was also curious to get your thoughts on the client side. I know you do [inaudible], and correct me if I'm wrong, and there's some concerns in certain segments of Wall Street that there might be an inventory issue on Wall Street, especially on the PC side. Intel had a good quarter, you guys had a good quarter, but with retail sort of weakening or at least suspected to weaken during the holiday season, who knows, I'm just wondering if you share that concern and if you don't, what specifically makes you feel that this inventory build-up could actually lead to sell-through in the Christmas holiday season? Thanks.

<TAG>Christopher P.

Liddell</TAG>

Entertainment and devices and OSB are really at different parts of their business cycle. It was a very strong commitment from our point of view to try and drive profitability in the entertainment and devices division this year, and we feel like we are on track for that. So they are on, if you like an upswing to a part of their business cycle where we believe we can be profitable.

In the OSB case, there isn't a primary driver of the business at the moment. The primary driver is to invest in the right areas and create the platform for a very strong growth in economic value over the next few years. So it's not one where we are the [clearly the] -- but if we were profitable, but it is one where it is not going to be our primary determiner of success this year.

I will be keen to ensure that the expenses come in where they are. I'll obviously be keen to see that our revenue growth is in line with expectations, but assuming we meet those two things, it is going to be a loss for the year.

So they are just different -- the businesses are at different parts of their business cycle, and so we have different tests against them.

On the client side, we are not seeing any significant inventory issues that we are aware of, and so from our point of view, if you look at the guidance, we feel good about PC unit growth guidance of 11% to 13%. Anything in double digits or greater we think is good and that's like a sell-in number, using your terminology. So we think that's good and we think we should be able to drive OEM units in our area around that same level. So there's no particular issues of significance that we are aware of.

<TAG>Kash Rangan - Merrill Lynch</TAG>

It just looks like the emerging markets and the [inaudible] countries, perhaps business there is accelerating and that's why your OEM units are looking better than they have in the last few quarters?

<TAG>Christopher P. Liddell</TAG>

That's absolutely right. Those countries really did an outstanding job -- countries like Russia, the business overall grew there by greater than 100% in the OEM area and client grew by something like 50%. So some of those countries are growing at a tremendous rate, which is a function of the underlying economies growing well, but as we see business growth in those areas and a greater desire to obviously have legitimate PCs, we are seeing good progress on piracy as well, and that’s really helping us with our overall OEM unit.

<TAG>Kash Rangan - Merrill Lynch</TAG>

Great. Thanks a lot.

Colleen Healy

Thanks a lot, Kash. We have time for one, maybe two more questions, please.

Operator

Our next question comes from Kirk Materne with Banc of America.

<TAG>Kirk Materne - Banc of America</TAG>

Thanks very much. Chris, I might be jumping ahead a little bit here, but clearly you guys haven’t seen any slowdown in terms of demand around either SQL Server or Windows Server 2008 in front of those launches. What is your expectation in terms of the impact of those launches on the growth rates? Do you think that we’ll see demand come in at a steady pace? Or do you expect that as we get into the back half of the year, that can help accelerate the growth rates in that division? Thanks.

Christopher P. Liddell

I think it will help continue the growth rates that we’ve seen, to a large extent. You have to realize that the structure of our business really has matured significantly to one that’s driven much more around multi-year expectations. So people are -- to the extent we’re seeing strength in annuity agreements now, it’s an anticipation of those products. The fact those product launch won’t in itself drive an enormous amount of accounting activity. We’ll see that over a slow -- to a large extent, that’s the same phenomena we talked about with Vista. These things will happen over time as people adapt and adopt the particular systems.

But from a revenue and economic point of view, our relationship with our customers, our ability to continue to sign them up and drive growth is much more of a multi-period rather than a single event based phenomena, and we just think a continuation of very strong products rolling out continuously quarter after quarter, year after year, is the best way of driving that business.

<TAG>Kirk Materne - Banc of America</TAG>

Just a really quick follow-up on Windows Server 2008, the beta for Veridian is still expected to be released with that, with the full-blown version released 180 days afterward? Is that still on track?

<TAG>Christopher P. Liddell</TAG>

Yes, that's correct.

<TAG>Kirk Materne - Banc of America</TAG>

Thanks very much.

Colleen Healy

Great. Thanks so much, and our last question, please, Operator.

Operator

Our last question comes from Brandon Barnicle from Pacific Crest Securities.

<TAG>Brandon Barnicle - Pacific Crest Securities</TAG>

Thanks so much. I just have two quick ones. Chris, first on premium edition, obviously a great move, year over year up 75%. As we have SP1 come, where we potentially get more enterprises pulling in, can we see that premium edition even move up higher still?

And then secondly, over on aQuantive, have you given any thought again to the agency business and whether that's something that stays within the business or needs to be divested? Thanks.

<TAG>Christopher P. Liddell</TAG>

Yeah, we are very happy with XP business. That's continued to do a great job. I mentioned before, I think the integration has gone extremely well. As far as we can tell, the employees are very happy, who are running the XP business in particular on a standing independent basis and really letting them continue getting on with their life. We think it is a very good business and no intention to do anything other than continue to run it. On the client side -- just go over your question again, sorry.

<TAG>Brandon Barnicle - Pacific Crest Securities</TAG>

Premium edition, 75%, very impressive. Can we see it go to 85%?

<TAG>Christopher P. Liddell</TAG>

We’re just looking -- in terms of our guidance and our thoughts and what’s embedded with, we believe we can continue to drive that at over 70%, but too early to predict anything higher than that.

<TAG>Brandon Barnicle - Pacific Crest Securities</TAG>

And would SP1 have any impact on accelerating that?

<TAG>Christopher P. Liddell</TAG>

It might help but those rates of 70% are very high, so -- it might assist but it may just simply just help us continue at that sort of rate. So we are not [anticipating] a particular pick-up as a result of that alone.

<TAG>Brandon Barnicle - Pacific Crest Securities</TAG>

Thank you very much.

Colleen Healy

Thanks, Brandon, and thanks everyone for joining us today. If you have any further questions, please feel free to call me or my team directly. As I mentioned at the beginning of this call, this conference call will be available on replay at our investor relations website through close of business October 25, 2008.

In addition, you can hear the replay by dialing

800-835-8067, or for international calls, please dial 203-369-3354. The dial-in replay will be available through the close of business November 2, 2007. Thanks again, everyone, for joining us today.

Operator

And that concludes today's call. Thank you for joining.