Presentation

Operator

Welcome to the Microsoft fourth quarter 2009 fiscal year conference call. (Operator Instructions) I would now like to turn the call over to Mr. Bill Koefoed, General Manager, Investor Relations. Sir, you may begin.

Bill Koefoed

Thank you, Barb and thanks everyone for joining us today for our fourth quarter earnings call. As usual, here with me are 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 Chris will start with takeaways for the fourth quarter and our 2009 fiscal year. Then I will get into the details of our fourth quarter and then hand it back to Chris, who will discuss our business outlook. After that, we'll take your questions.

Our earnings release today includes an addendum of financial highlights which contains more detailed information about revenue, operating expenses, and other items. We have also posted our quarterly financial summary slide deck, which is intended to follow the flow of our prepared remarks, as well as provide a reconciliation of differences between GAAP and non-GAAP financial measures that we will talk about today. You can find these documents at the investor relations website at www.microsoft.com/msft.

Today's call will be webcast live and recorded. 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. You can replay the call at the Microsoft investor relations website until July 23, 2010.

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We will be making statements during this call that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the risk factors section of our Form 10-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.

Okay, now let's hear from Chris.

Christopher P. Liddell

Thanks, Bill, and good afternoon, everyone. The fourth quarter marks the end of one of the most difficult but in some ways encouraging fiscal years in the company's history. Our absolute results were disappointing due to the poor macroeconomic environment and as you've seen, revenue in the fourth quarter was down 17% year over year and down 3% for the full year.

However, I do feel better about our relative performance in fiscal 2009 than I did in fiscal 2008. We actually executed much better than in preceding years across almost all aspects of our business, we had great product shipments, strong sales execution, and a new level of internal discipline shown by the speed and efficiency with which we cut costs.

So in my mind, we are a stronger company than we were a year ago -- however, the economy continues to be challenging and we need to lift our game to another level in fiscal 2010.

As I said a quarter ago, we see the economy making its way through a [reset] and we expect tough year-over-year comparables for the rest of this calendar year. Having said that, there are some signs that we have at least seen the worst. We began to see sequential stabilization in some of our key businesses; for example, we saw sequential unit increases in both Windows and Windows Server for the first time in a year.

I am also very pleased with the way in which we are responding to the environment. In the fourth quarter, for example, we cut costs an additional $800 million below the low-end guidance we provided in the third quarter and ended up spending $900 million less than the prior year, adjusted for certain charges. Overall, we pulled back over $3 billion of spending from our original fiscal 2009 guidance.

Despite cutting costs this year, we also brought to market a strong wave of products in full and on time. Notably, we released SQL Server 2008, Office Communication Server R2, Exchange Online, SharePoint Online, and Bing, our major advance search product offering. Over the next 12 months, we will deliver releases in each of our core franchises of Windows, Windows Server, and Office.

So in summary, our market conditions were clearly difficult in the quarter but we successfully offset most of the impact by focusing on factors inside our control.

Looking forward, we do not expect trading conditions to improve much but neither in the short-term do we expect them to worsen. They should remain difficult for the balance of this calendar year with the potential for improvement as we look ahead to calendar year 2010.

With that, I'll turn the call over to Bill for more details on the fourth quarter.

Bill Koefoed

Thanks, Chris. I will start with the company all-up view and then go through revenue performance for each of our business units. All of the growth comparisons relate to the corresponding quarter of last year unless I tell you otherwise.

Overall, revenue declined 17% because of continued weakness in global demand, especially in the business PC and server hardware markets. On top of the economic reset we've all experienced this year, remember that we had especially high prior year comparables for our client and entertainment and devices segment.

The foreign exchange impact on overall revenue was a negative $220 million, or about 1 percentage point in the fourth quarter.

Revenue for the quarter was also impacted by $276 million in deferrals for the Windows 7 technology guarantee program, which is near the high-end of the guidance we provided in June.

The weak hardware markets continue to weigh heavily on OEM and license-only revenue, while multi-year annuity licensing revenue grew single digits, in line with the outlook we provided last quarter.

Our product mix continued to shift toward our annuity licensing, which was up a few points from last year to about 45%. OEM billings accounted for about 25%, license only sales were about 15%, and the balance came from other businesses.

Within our customer segments, we generally saw last quarter's trends continue. Specifically, small and mid-market customers are still the hardest hit by the economy and as a result, we are seeing lower overall buying activity.

In the consumer segment, we are still seeing healthy volumes in our lower priced offerings with softness in our premium offering.

Our enterprise customer segment remains relatively healthy with EA renewal rates in line with our historical range. As you might expect, the average deal size has been pressured by reduced IT budgets and enterprise employment levels, though we haven't seen any unnatural discounting.

We also experienced some sales cycles which pushed deals out of the fiscal year.

Our sales force closed many of these deals a few days after our fiscal close but in line with our normal deal calendar, which differs slightly from our fiscal calendar. Taking into consideration the impact of these bookings, our unearned revenue and contracted not billed balances were roughly flat year over year. We are very happy with this result, considering the economy relative to a year ago.

Okay, now let's move on to the revenue and business drivers by segment, beginning with our thoughts on the PC market. We estimate the overall PC hardware market declined 5% to 7% from last year. Within that, we estimate traditional or non-netbook PCs were down 16% to 18% compared with the year-ago quarter. We've seen substantial weakness in the business PC market as reduced IT budgets have delayed hardware purchases and refresh cycles.

The netbook category remains strong, representing about 11% of the total PC market this quarter. With the growth of netbooks, we estimate the consumer PC market was flat to down slightly year over year.

On a sequential basis, we estimate the PC market was up low-single-digits. From a geographic perspective, the market was strong in Asia-Pacific, particularly China, as a result of the stimulus programs. In North America, demand appears to have normalized, with sequential sales in line with historic seasonality and in EMEA, we saw demand continue to deteriorate.

With that backdrop, let's look at Windows Client. Client revenue was down 22% from last year when adjusting for the Windows 7 tech guarantee. The decline was primarily driven by the underlying PC market dynamics I discussed, combined with the impacts of a difficult comparable to last year.

Overall OEM unit sales declined 10%, a few points under the overall PC market due to year-over-year inventory fluctuations. If you'll recall, our fourth quarter of 2008 represents tough comparables as OEMs built inventory above historic levels.

Attach rates were relatively stable year over year. Strong attach rate gains on netbooks were offset by some attach rate pressure on traditional PCs due to the geographic mix of the PC market, particularly in China where attach rates are lower.

Again here, I want to note some sequential trends. Sequentially, our OEM units grew slightly ahead of the underlying PC market, mainly driven by netbook growth. This was the first sequential unit growth since the September quarter, so we are pleased to see some stabilization in the market, even though it's in lower priced units.

Overall OEM revenue was down 24%, adjusting for the tech guarantee, driven by the PC market dynamics and the mix shifts toward our lower priced netbook offerings.

Specifically, sales of premiums SKUs declined over 25%, mainly due to the lower sales of business PCs I covered earlier.

The commercial and retail portion of the client business was down 16%, driven by declines in retail sales prior to the Windows 7 launch. We saw an exciting level of interest in Windows 7 during the pre-order period, although revenue for these sales won't be recognized until Windows 7 general availability.

We continue to have healthy growth in our client enterprise annuity business, which was up single digits in the fourth quarter.

Yesterday Windows 7 was released to manufacturing. This is an exciting milestone for our R&D teams and our partners, delivering not only a terrific product but one that's nicely ahead of the schedule we committed to almost three years ago. As we've announced, Windows 7 general availability will be October 22nd.

Now let's move to server and tools, where revenue declined 6%. Our license only and OEM business declined slightly less than the estimated 24% drop in the underlying X86 server hardware market. On a sequential basis, we were pleased to see that Windows server units were up after falling the prior two quarters. Annuity revenue was up single digits, in line with the guidance framework we gave last quarter. FX rate changes were a two-point headwind to revenue during the period.

We are still seeing great adoption of our virtualization solution, which drove growth of the premium editions of Windows Server and system center to healthy double-digits.

On a product front, yesterday we announced the Windows Server 2008 R2 release to manufacturing, which builds on the value of Windows Server with live migration and high availability, and together with Windows 7 Enterprise edition provides new capabilities, including direct access and branch cash.

In addition, during the quarter we released Silverlight 3, which adds new functionality to run Silverlight applications offline.

Moving on to the online services business, revenue declined 13%. Online advertising revenue was down 14%, mainly due to the significant decline in display advertising rates across the industry. Partially offsetting this was continued growth in page views.

Search revenue for the quarter was flat year over year despite industry-wide monetization declines. FX rate changes were a headwind of five points to online advertising revenue and three points to total OSB revenue.

Most significantly for this business, during the quarter we launched Bing, our new search engine which has had positive early momentum. Unique users of Bing.com grew 15% in [Q4]. We've seen particular strength in the areas of shopping and travel as visitors to Bing shopping almost tripled and Bing Travel traffic was up 90% month over month since launch.

It's still early but we are executing and we are optimistic about the future of this business.

The Microsoft business division revenue was down 13% due to declines in consumer and business purchasing. Our consumer OEM and retail portions of the business continued to be impacted by slower PC sales, as well as lower ASPs. Pricing promotions drove higher attach rates but overall consumer revenue declined 30%.

Business revenue was down 10%, driven by an over 35% decline in our license only sales. The annuity portion of this business was up single digits, in line with the outlook we provided last quarter.

Within the MBD products, we continue to see double-digit growth in our SharePoint, Office Communications Server, and CRM products. CRM achieved the 1 million seed milestone this quarter.

Our notes conversions remain strong. For the year, we converted 4.7 million notes users to exchange and SharePoint. We've seen more and more customers choosing our online business services, which include hosted communication and collaboration solutions like Exchange Online and SharePoint Online. For example, during Q4 we had significant customer wins of over 200,000 seats moving to Exchange and SharePoint Online.

In the entertainment and devices division, revenue decreased 25%. The Xbox 360 business had a solid quarter, selling about 1.2 million consoles, which is down on a year-over-year basis due to inventory restocking last year. Overall this year, we've sold approximately 11 million consoles, 28% above last year.

Xbox attach rates are still the best in the industry, growing to 8.6 software titles for each console sold. For the year, Xbox Live grew over 50% to more than 20 million members and in the last six months, the number of paid Xbox Live downloads has jumped 73% year over year.

Now for the rest of the income statement, cost of revenue was down 10% or $280 million, driven by lower Xbox 360 console costs and reduced costs from our consulting and support services, partially offset by increased online distribution costs.

Operating expenses decreased $760 million, or 11%. This quarter's results were impacted by $193 million of legal charges and $40 million of additional employee severance charges. Expenses were reduced by the capitalization of $105 million of certain R&D costs related to Windows 7 technical feasibility.

Adjusting for these items, operating expenses were down about $900 million for Q4. The savings were driven by a combination of strong operational execution, the impacts from lower revenue driven expenses and rigorous cost controls across the company.

For the year, as Chris mentioned, we took out over $3 billion of operating expenses compared to our original guidance.

Other income and expenses was a gain of $155 million and includes $108 million of impairments on investments as a result of the market declines earlier this year.

Our effective tax rate was 26.5% for the quarter, in line with the guidance we provided.

Diluted shares outstanding for the quarter were 8.9 billion, down 5% from the prior year.

Earnings per share were $0.34. After excluding the net impacts from the legal charges, severance charges, and capitalization of R&D costs, and investment impairments, EPS was $0.36.

The Windows 7 tech guarantee revenue deferral resulted in an additional $0.02 per share impact on EPS.

So to wrap up, while the environment clearly remains challenging, we are executing diligently on the areas we can control and in the fourth quarter, we delivered meaningful cost savings and outstanding progress on our product pipeline.

Lastly, one housekeeping item before I turn the call back over to Chris -- we have included an additional slide in our earnings presentation to help you model some recent organizational and reporting changes we have made which are effective for fiscal year 2010.

With that, I will hand it back to Chris who is going to discuss our business outlook.

Christopher P. Liddell

Thanks, Bill. So the rest of the call, I will cover our broad expectations for the first quarter and trends for fiscal 2010.

So let’s begin with some of the key assumptions on the industry and the economy. We generally expect the economic conditions we saw in the third and fourth quarter of fiscal 2009 to continue through the first and second quarters of fiscal 2010. We believe the spending environment is stabilizing on a sequential basis but remained substantially below year-ago levels.

We see the potential for improvement in calendar year 2010 and acceleration there afterwards, but clearly exact timing is uncertain.

Regardless of the macroeconomic conditions, we feel extremely good about our relative position and our product delivery plans. Macroeconomics may be the winner in the short-term, but product quality will drive medium term growth.

So in my view, the shape of the year will therefore be probably the most interesting of any year in recent memory. While I remain cautious overall, particularly in the short-term, we expect to exit the fiscal year with the combined momentum of an improving economy, potentially improving business spend, and an outstanding product lineup.

With those background themes, I’ll turn to segment expectations. In the first quarter, client revenue is expected to align to traditional PC shipments, excluding the impact of the tech guarantee program. We expect those traditional PC shipments to decline on a year-on-year basis in the first quarter but be up sequentially, continuing the trend we saw in the fourth quarter of last year.

In the first quarter, we expect to defer between $1.1 billion and $1.3 billion from the Windows 7 tech guarantee program and presales, the majority of which will be recognized in the second quarter of the fiscal year.

For the full year, we expect client revenue to align with the total PC market, which factors in the launch of Windows 7 and the resulting impact to retail sales, combined with the anniversary of netbooks in the year-ago comparison. This implies that we could see client revenue growing faster than PC shipments by the end of the fiscal year.

Microsoft business division revenue, which is approximately 20% consumer and 80% business, is correlated to both the underlying PC market and IT spend.

We expect consumer revenue in the first quarter to lag traditional PC shipments by several points, continuing the trends in the third and fourth quarters, but also impacted by [higher] inventory levels in the year-ago period.

For the full year, we also face a normal cyclical slowdown in advance of the next version of Office, which will release to manufacturing in the second half of the fiscal year.

The business portion of the Microsoft Business Division includes non-annuity and annuity licensing. Business non-annuity sales, approximately 20% of the division, will lag business PC shipments by several points both in the quarter and full year, as a result of the general market weakness of small and mid-market customers, as well as headwinds in advance of the next product cycle.

The dynamics of the remaining annuity business will be broadly flat for the full year and for the quarter. This helps us buffer through the resale. However, it will be a transition year for MBD and I don't believe we will see overall revenue growth until we start to see a recovery in the small and medium business and consumer sectors, combined with the impact of Office 2010.

The server and tools business includes non-annuity components, long-term contractual agreements, and our enterprise services business, which represents approximately 30%, 50%, and 20% of revenue respectively.

In the first quarter, we expect non-annuity revenue to continue to reflect weakness in the server hardware market, which external analysts expect to decline on a year-over-year basis through the calendar year and then improve in calendar 2010.

We expect server and tools annuity revenue to be mid to low single digits in the first quarter and in the full year. Enterprise services revenue should be broadly flat this coming year.

Online service business revenue excluding our [inaudible] business should mirror the online advertising market, which we expect to remain weak in the first quarter and potentially through the year. Display monetization rate should reflect the headwinds seen in broader industry trends but volumes from increased usage should be healthy.

We also hope to see progress in the search market share as the year proceeds.

The entertainment and devices division has been resistant to the declines in the gaming industry to date and clearly was a standout in fiscal 2009. Looking forward, weak consumer markets means that we expect industry console sales and attach revenue to moderate in both the first quarter and the full year. These segments represent 60% to 65% of revenue. The balance of the non-gaming business will be impacted by continuing weakness in the underlying PC market.

Turning to COGS, which next year should increase as a result of three factors -- firstly, we are changing our business model in a number of areas as we transition to the cloud. This means an investment up-front to build out the infrastructure necessary to win in what is clearly a significant area of opportunity. We are also paying for increased distribution in our online offerings. We also expect increases as a result of increased unit volume from the product launch cycle next year.

Offsetting these increases, we've identified and expect to achieve several hundreds of millions of dollars of savings through an internal program focused on efficiencies. The combined impact of these factors will increase COGS as a percentage of revenue by a couple of percentage points.

I will now turn to our expectation of full year operating expenses -- full year operating expenses we believe will be between $26.6 billion to $26.9 billion, down from the $27.4 billion I communicated in April. And next year, we remain committed to expense control.

Our effective tax rate next year we expect to be between 25% to 26%, depending on the final mix of revenue, and reflecting the downward trend we've seen in recent years.

Our balance sheet remains extremely strong despite the economic turmoil this past year. This quarter we utilized our Triple A credit rating and issued $3.75 billion of long-term debt and extremely low after-tax cost of 2.3%. We also remain focused on customer credit issues and to date have had an extremely good collection experience.

We expect fiscal 2010 CapEx to be about $2 billion, down from the $2.1 billion in fiscal 2009, and to stay at or below that level for fiscal 2011 as we continue to focus on cash flow.

In fiscal 2010, CapEx spend will be below depreciation expense for the first time in years, helping continue the recent trend of free cash flow being greater than net income.

As I called out in April, capital strength and flexibility will continue to be a focus area for fiscal 2010 but we remain committed to returning capital to shareholders through share repurchases and dividends.

So in summary, like all customers we are adapting to a new and more challenging economy. We remain extremely optimistic about the long-term outlook of our industry and our relative position and we have taken significant actions to strengthen the company while at the same time investing in critical areas and delivering on a significant wave of new products.

The company is in, in my belief, the best shape that I've seen.

With that, we look forward to seeing many of you next week at our financial analyst meeting where Steve and our senior leadership team will provide more details about our long-term strategy.

And now I'll turn it over to Bill so we can start taking your questions.

Bill Koefoed
Operator, let's get going on questions. Can you please hold people to just one question and let's go ahead and go.

Question and Answer

Operator

(Operator Instructions) Our first question comes from Adam Holt with Morgan Stanley.

Adam Holt
Morgan Stanley

Good afternoon. My question is about average selling prices as we head into the upcoming Windows cycle. You know, the premium mix of 59% in the quarter was obviously down quite a bit. As you head into next year, Chris, I believe you talked about the potential to outpace the PC market, which would suggest average selling prices can actually start to go back up. How do you get there? Do you expect to see mix improvement on the consumer side? Are you expecting to see a corporate upgrade cycle? Maybe walk us through A, what you are expecting and B, how you get there?

Christopher P. Liddell

Sure, it's a great question. On the downside, if I start there and then talk about the upside, on the downside, as we are seeing weak markets in the last couple of quarters and the last year and in particular, the last quarter average PC sales were down sort of in the traditional market 16% to 18% and business was disproportionately badly affected. And because business is typically our highest ASP from a mix point of view, that hurt us on the downside.

On the upside, as we go into next year, if we start to see, which is certainly my hope, if we start to see the economy improve, business spending improve, and we start to see a refresh cycle in the business PC side of things, which Windows 7 should obviously help facilitate, then you start to see the reverse impact, so hopefully business PC growth will be at or greater than consumer, and so what you will start to see is that our higher average selling price units will have a higher growth rate and hence, ASPs will go up. So hopefully we'll see a double impact of a better PC market year over year and a better mix in terms of the types of PCs that we are selling relative to average selling prices.

Adam Holt
Morgan Stanley

Terrific. If I could just ask a quick follow-up, the commentary on expenses for next year, do you anticipate the incremental OpEx cost controls to offset the increase in cost of goods sold?

Christopher P. Liddell

No, they are two different dynamics. We certainly have taken some money out of OpEx and relative to where we started from, certainly quite considerable. I certainly see the focus continuing in that area but we are managing OpEx to a large extent different from COGS. Now, we do actually have a project going looking at COGS opportunities and as I mentioned, I think we have the opportunity to take several hundreds of millions of dollars out of our cost of goods sold through that project. But then we have the dynamic of the changing business models going on and also volume related activities, so that's really a different dynamic from OpEx, which is driven around, for example, people costs in particular.

Adam Holt
Morgan Stanley

Thank you.

Bill Koefoed

Operator, next question.

Operator

The next question is from Brent Thill with Citigroup.

Brent Thill
Citigroup

Chris, just on the margins coming into the mid-30s, do you feel that margins have now bottomed, considering the ASP expansion as well as your strict operating expense controls for next year?

Christopher P. Liddell

It comes back to some of the commentary I mentioned in my prepared remarks, Brent, which is really around the shape of the year. So I still will see a relatively different difficult economy for certainly the balance of this calendar year and despite the fact that I think we have done a great job on expenses, it’s hard with the margin structure we have to take expenses out proportional to the revenue that we lost. So I would like to think that the expense controls were at the top end of people’s expectations but we still saw margin compression because of the macroeconomics.

That’s going to be probably a continuation of that trend in the short-term. In the medium term, I certainly think the discipline that we are showing on costs as we continue through the next calendar year and beyond with an improving business cycle with all the products coming on-stream and some of the ASP factors that I mentioned, and certainly we’ve got the promise of margin expansion there afterwards, but I wouldn’t promise that in the short-term.

Brent Thill
Citigroup

Okay, and just a quick follow-up -- the buy-back, you now have a cash position above $30 billion again. Can you just comment on why the last two quarters, you’ve chosen not to buy back stock?

Christopher P. Liddell

Basically look to -- obviously relatively conservative because in the last couple of quarters, we felt we couldn’t necessarily see the bottom. I think that at least we are seeing signs now of the bottom, so we are feeling more confident looking forward in the outlook, even though as I see it, I -- I see it going along the bottom for some period of time.

I was more conservative from a financial point of view six months ago and even three months ago, if you’ll recall my remarks. I said it was going to be tough for the rest of the calendar year and we are really still not sure we are out of the woods. Now, I’ll still say that but I guess we are feeling better about the economic environment but unless, in that last six months, conservatism won over the natural desire to buy back shares, and we did accelerate the buy-back to some extent in the first six months of the year, so even for this fiscal year in total, we bought back around $8 billion of shares, which was close to our net free cash flow. So we front-ended it a bit in the first six months of the year and then just took a very conservative stance in the second half.

Bill Koefoed

Okay, Operator, next question and guys, let’s stick to one question, please.

Operator

The next question is from Sara Friar from Goldman Sachs.

Sara Friar
Goldman Sachs

Could you give us a little bit of commentary on what you have heard from customers in terms of both their willingness to start a Windows 7 upgrade? So you are clearly signing a lot of ELAs this quarter. They must have been talking about that.

And then secondarily, in server and tools, do you also feel like there was any pent-up demand ahead of the new product upgrade cycle in the June quarter, and now you have that launched as we look into September?

Christopher P. Liddell

I'll start with server and tools first, Sara -- the market is still very weak and Bill mentioned server shipments were down, I think it was 24% for the quarter. So I don't think we are yet seeing too much pent-up demand in the server area.

As it turned out, even though our results were relatively weak, they were better than the server shipment numbers, so the division lost 6% in revenue but that 6% is relative to a 24% decline in server shipments. So we are certainly feeling good about our relative position but I would contrast that and say we don't yet see a lot of pent-up demand in that area.

Going into next year, sure. But it's really macro conditions are going to continue to trump everything. We really need to see an increase in IT spending before I feel confident that we are really going to see an acceleration back in the server and tools area.

Now, I've seen your forecasts and everyone else's, and I think most people are saying we're probably at about the bottom in the server area. We are probably going to be that way for a quarter or two and then things improve next year. That's internally consistent with the way that we see things as well, plus then we start to get the benefit of the new server product and the new SQL product, so it's a consistent story in the server area as it is in the PC area.

When you go to PCs, we haven't heard a lot of early discussion about how people are going to put Windows 7 in but again, it's that same general sense of optimism that once we get through this year, people start to reset their budgets for next year, clearly a lot of businesses have extended their refresh cycle because of overall economics. They can only do that for so long. As they start to look into next year, hopefully a slightly better economic outlook, they start to look at refreshing their PCs and they have Windows 7 availability, then you start to get into a much more virtuous cycle.

So there's similar commentary to what we see in server and tools -- nothing immediately on the horizon but potentially start to see some positives next year.

Sara Friar
Goldman Sachs

Got it. Great, thank you.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Brad Reback with Oppenheimer.

Brad Reback
Oppenheimer

Chris, just to clarify a point -- as you talk about the economic rebound or the expected rebound and volume rebound in the back half of the fiscal year, just to be clear on the expense side of the equation, is the organization at a place where we can be fairly confident that the upside is not reinvested into the business as we've seen in other cycles?

Christopher P. Liddell

Yes, certainly for this fiscal year, I don't see any potential for us to significantly vary from the numbers that I gave you. The only reason why it would would be something outside our control, like foreign exchange, so some of our expenses are outside the U.S., if we saw a significant change in the FX rate, then I can't influence that. And things like some of our volume related expenses, so if we saw a really strong pick-up in some of our enterprise sales, some of our revenue driven expenses might increase.

But in terms of things, which is the great bulk of the expenses which are totally inside our control, I don't see any potential for us to [inaudible] this year.

Brad Reback
Oppenheimer

Great. Thanks very much.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Brendan Barnicle with Pacific Crest Securities.

Brendan Barnicle
Pacific Crest Securities

Chris, you had talked about September client revenue growing in line with traditional PCs and in the most recent quarter, we saw that you guys declined about 600 basis points more than traditional PCs. What accounts for the difference from this quarter to next quarter that would I guess raise you back up to the decline in the traditional PC rate?

Christopher P. Liddell

The biggest single factor is just inventory changes. We still saw inventory contraction in the fourth quarter, the one we just finished, relative to a year ago. So some of the other parties out there saw positive inventory. We were relatively late in the cycle so we saw inventory contraction and that cost us a lot of that 600 points that you mentioned year over year.

As we start to go into this year and clearly Windows 7 is just around the corner, then we start to see that inventory position stabilize and even potentially over the course of the year start to actually get better on a year-over-year basis, which is one of the reasons why I feel better not only about the first quarter but how we might exit the year as well.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Phil Winslow with Credit Suisse.

Phil Winslow
Credit Suisse

I have a question back on expenses again -- if you guys ex out some of those one-time charges, you know, the legal charges, severance, et cetera, FX, R&D costs, you ran an OpEx about 25.5 this year and obviously you are guiding 26.6, 26.9 next year. Just given the fact that most of the headcount reductions occurred in the second half of the fiscal year, how should I think about that increase in OpEx that you are guiding towards? Is it just a little bit of conservatism or is it because [inaudible] product launches that you do have coming out, you know, marketing investment, sales, et cetera. How should I just think about that increase?

Christopher P. Liddell

Sure. We set our budgets a month or two ago before we saw some of the savings that we had in the fourth quarter, so that's the first point to make.

In terms of the year-over-year, the factors that are likely to see an increase are, as you mentioned, we've got some fairly significant product launches next year, so we do have some marketing associated with those that we are intending to spend. We are seeing some other factors, like non-cash charges associated with depreciations, so even though CapEx is going down next year, some of the deprecation [inaudible] from the increasing CapEx is starting to feed through.

Stock comp, which is also non-cash, is going up as we layer investing. Acquisition amortization, if we do any acquisitions, which we provide for, some of the non-cash amortization will impact expenses next year as well, and then we have [inaudible] from pay raises last year, so we've got no pay raises this year but we did have some pay raises last year, so the full year impact of those.

So there's a series of relatively small items which add up to the increase that you are seeing. But we did, as I mentioned, we did actually cut back expense to for next year, despite all of those things which are likely to happen. We did cut them back from where we originally were.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Todd Raker with Deutsche Bank.

Todd Raker
Deutsche Bank

I just wanted to dig back into unearned revenue. I didn't quite understand the discussion in terms of timing -- that was flat year over year. So if you could just touch on that, and if you just talk about the annuity business in general, are you seeing any indications that the annuity business is decelerating, even ahead of a Win 7 product cycle?

Christopher P. Liddell

We have a slight difference in timing with our field year relative to our fiscal year. Our fiscal year is clearly June 30 but our field year can be either a day or two short of that or a day or two longer than that, just in terms of -- depending on whether they -- when they close their books.

So from a fiscal year point of view, unearned was down but if you include the couple of days after the fiscal year to when the field closes their books, then it was basically flat and that's how we tend to look at it internally because that's the -- the field cycle is what essentially drives customer behavior.

So essentially flat is either half full or half empty, depending on how you look at it. Half empty is zero is down from the double-digits that we were getting in previous years; the half full is getting flat bookings in the current environment, which is the worst economic contraction of our lifetime, is actually heroic effort in terms of our field sales. So inside that flat bookings or flat billings, you are basically seeing two dynamics. The renewal rate is similar to what we have been receiving traditionally, so that -- from two-thirds to three-quarters renewal rate that we have quoted in previous years actually held true this year, which was a very good performance from the field.

What we are seeing that is different which is meaning that we are flat rather than double-digit increase, is that the people aren't increasing the number of seats that they are taking, so clearly an environment that we've got, most businesses are flat in headcount or even contracting, so you are not seeing that uplift from the increased number of seats. And people are much more conservative with what they are buying, so we are getting certainly good growth from things like SharePoint but that's really just holding the line in terms of keeping them dollar for dollar with the rate at which they are coming off.

So average level of -- you know, on a contract by contract basis, the number that we renewed in line with history, what's changing is the dollar value of those contracts, which is leading to sort of flat year-over-year performance.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Kash Rangan with Merrill Lynch.

Kash Rangan
Merrill Lynch

Thank you very much. When I look at the deferred revenues, it looks like we definitely got a sequential improvement, so that's got to give you some visibility. And Chris, you also talked about the transactional revenues which I think you quantified to be down 20% year over year in the March quarter. I was wondering how that metric faired in the June quarter and should we think about that metric in the June quarter as potentially the bottom, because the other pieces of your business are fairly coming off the balance sheet, if you will? So I'm just wondering if -- whatever that transactional growth was in the quarter or contraction was in the quarter, do you really think that this could be the bottom and that that transaction growth could actually pick up in the September quarter and beyond?

Christopher P. Liddell

The transactional business, it depends on whether you are talking about client, server and tools, or MBD --

Kash Rangan
Merrill Lynch

Combined, everything combined.

Christopher P. Liddell

Yeah, it's in the 20% to 25% contraction if you do all of those combined. So if you think about overall PCs down sort of that 18, 16%, 18%, you see server and tools, server hardware down 24%. Then the transactional business really follows those quite closely, adjusted for things like inventory, that I mentioned before. So if you think on average that our underlying hardware shipment decreases were in the 20% to 25% range on average, then that's what the transactional business was as well, plus or minus a little bit.

So do I think that's the bottom? Yes, I do think that's the bottom but as I probably said in my prepared remarks, I think it's probably going to continue to be tough for a quarter or two so I wouldn't necessarily promise that it's going to be significantly better but if you look at a combination of say the first and second quarter, that's the first half of the year, then that's probably a good surrogate for the transactional business for the second half of the calendar year, the first half of this fiscal year and the confidence of that is really in terms of that sequential trend that we mentioned in our prepared remarks.

Bill Koefoed

Doe that help, Kash?

Kash Rangan
Merrill Lynch

Yes, and just a clarification on the COGS, you said you were working on some internal initiatives to drive COGS down, and you also said that given the transition of the cloud, that COGS was going to go up by 200 basis points. Were you talking net or gross? That is, in other words, COGS goes up by 200 basis points but you also have these internal initiatives that could drive COGS down by hundreds of millions of dollars, so should the net number then be lower than the 2% of revenue hit?

Christopher P. Liddell

The 2% is net of the initiatives that we've seen. Now clearly if we outperform on that, we will offset it by more but that was a net figure that I was giving you, so the combination of the infrastructure costs associated with that, some of the distribution deals that we've done, the volume related, because clearly with the Windows 7 launch, that has a lot of COGS associated with it, is offset by the things I talked about to give the 2% decrease.

Kash Rangan
Merrill Lynch

Got it -- increase, you mean?

Christopher P. Liddell

Increase, decrease in gross margin .

Kash Rangan
Merrill Lynch

Okay, got it. Thanks.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from John DiFuca with J.P. Morgan.

John DiFuca
J.P. Morgan

Thank you. I have a follow-up to Brendan's question earlier -- a question on the channel effect on client. Chris, a few quarters ago, you said that client was negatively affected by I think 2 percentage points and then last quarter I think you said there was a slight negative effect. Now this quarter it sounds like it's the majority of that six percentage point delta between OEM and PC shipments. I guess two things here -- well first, I would think that this is a cumulative effect, so when it comes back and it does reverse, how would you think this will come in? Will it come in over a long period of time when inventories build? Or is this going to come in relatively quickly in one or two quarters? I know you are not suggesting it is coming in anytime soon, the economy is weak out there.

And the second point, why wouldn't it happen, you know, soon? Like next quarter? It does sound like some of the component vendors benefited from inventory restocking this quarter, so why wouldn't -- you do say you guys are later and you lag but why would it be a long lag?

Christopher P. Liddell

All great questions -- so first to start with the underlying math, assuming inventory went down three quarters ago and stayed down, then year over year you are always going to have a negative, so the fact that it's negative quarter after quarter doesn't mean that it's continuing to contract. It just means it contracted and stayed down.

Having said that, in the fourth quarter contracted a bit more and you're right, the two or three basis points of slippage that we saw in the second and third quarter were more like 3% or 4%, so the majority of that 6% in the fourth quarter. So it was a little bit higher there but also we are always talking about year over year, so just recall that.

To the second half of your question, you are correct, it could come back quite quickly and in our modeling is likely to in the first and second quarter. So we will see a positive impact on that.

The reason why I say that in the first quarter revenue is more likely to be close to underlying market growth is that even though we will start to get a positive inventory, I don't think we'll start to get the positive ASP benefit from business sales that I talked about, so that will still potentially be a slight negative, and that won't start coming back until let's say the first half of next year. Then you get into the first half of next year, you get the positive inventory impact because it will go back up and hopefully stay back up and you start to get the business cycle as well, so you start to get both of them being positive rather than offsetting. Does that make sense?

John DiFuca

J.P. Morgan

Yeah, it does. That's very helpful, thanks.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Tim Klasell with Thomas Weisel Partners.

Tim Klasell
Thomas Weisel Partners

Good afternoon, everybody. My question has to do with the Office 2010 launch and actually, I think you've got the entire productivity stack launching next year. Can you sort of guide us through how you think that will affect revenues? Will there be a burst afterwards like we see in Windows 7 or can you help us sort of think about our models going into next year with the business division?

Christopher P. Liddell

Given that it's going to launch in the fall of next year, I don't really see a significant impact in 2010 as a result of it. In fact, again, we could start to -- it could be a headwind for the first half, then start to turn around in the second half and you start to see a very good situation in terms of 2011, but if you're just trying to model 2010, it's not going to be a significant positive.

It will certainly help in terms of annuity sale and help mitigate some of the negative transactional impacts that we are seeing, so some of the signing up annuities that I mentioned, people are looking forward to Office 2010, some of the new business that we are signing, as well as some of the other products that are coming up in that division, for example, SharePoint and Office Communication Server.

So it will be a slow burn in terms of MBD. I think we'll see a more positive earlier trend than server and tools and client but MBD to my mind is pretty much a 2011 story, not a 2010.

Tim Klasell
Thomas Weisel Partners

Very good. Thank you.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Katherine Egbert with Jefferies.

Katherine Egbert
Jefferies

Good afternoon. Chris, you've given a pretty tight range of guidance for operating expenditures for fiscal '10, especially give how much cost you took out in the back half of fiscal '09, I mean, I'm struggling a little bit with -- I mean, is revenue going to grow next year and can you handicap why that range is so tight? What happens if revenue is significantly better or worse -- will it still stay there?

Christopher P. Liddell

As I mentioned, we have a very -- what I described as a very tight rein on costs and I think you saw that in the performance this year. So I am feeling very good about the organization's ability to keep a tight control on costs across the board in terms of things like headcount, which we look at on a month-by-month basis, in terms of cost per head, salary increases, which are zero this year -- it's going to be hard to vary much from zero. Costs per head in terms of travel and entertainment, the things that we can control through a very good cost control mechanism, I think we have a good handle on and therefore I don't feel exposed in terms of it peaking or troughing much from it.

In terms of some of the areas where we don't control our revenue driven expenses, you know, for example, money that we might pay our partners if they outperform on revenue, yes, those could go up and therefore that number could go outside that range as a result of that. I guess I would say if that's the case and revenue outperforms and it costs us a little bit more expense, it's probably a positive thing and we'll explain it at the time. But in terms of the great bulk of expenses which are very much around our people internally, I feel good that we have handle on those.

Katherine Egbert
Jefferies

Okay, very good. Thanks.

Bill Koefoed

Operator, next question, please.

Operator

The next question is from Sandeep Aggarwal with Collins Stewart.

Sandeep Aggarwal
Collins Stewart

Thanks for taking my question. Chris, I have one platform related question -- as you know, Google announced the launch of Chrome OS for netbook in 2010. In your view, is there really a need for an OS that can handle online services and cloud client computing better than Windows and how [inaudible] Microsoft is to respond to that kind of competitive move? Thank you.

Christopher P. Liddell

Sure, I mean, we've been fighting free OS in the client area for quite some time, as you all know, and I would point to the general value that we think Windows has and in particular around Windows 7, which we think is going to be our best ever operating system, and we still believe that the very, very, very large majority of people are going to want both a client and an Internet based experience on their PC, so of course people want to surf the Internet and access. They can do that quite freely with Windows and all the Internet Explorer and choices that they have, so a browser only based like software may have applicability as it does with Linux based systems already, but we don't see that significantly changing just because of Chrome OS coming out.

Bill Koefoed

All right, Operator, let's have one final question.

Operator

The last question is from Robert Breza with RBC Capital Markets.

Robert Breza
RBC Capital Markets

Chris, I just wanted to get your thoughts as you look out here -- do you see much change from a geographic perspective? I mean, I would love to just get your thoughts from an economic perspective as you are looking out across the different geographies -- do you see much variance between North America, Europe, and maybe how we should think about that going from the first half to the second half of the year? Thanks.

Christopher P. Liddell

Sure. If I cluster the areas into I guess four -- let's do it in four, which would be Europe, North America, Asia non-Japan, and Japan, I would say that we are most encouraged in Asia in general developed markets, so we are starting to see reasonable growth in those areas. Now, that tends to be our lowest ASP market, so it's not helping us enormously but nevertheless, when we look out, we would say that to the extent that there's a -- we come out of a global recession, those are the areas that are going to be the first to come out of it and we see positive growth.

Next in line would be North America, which is still obviously very tough but relative to say Europe and Japan, is just looking in better shape and that's as much anecdotal as it is macroeconomic, just in terms of our sales force and talking to them and looking at our budgeting for next year.

So I've rank ordered them emerging markets, North America, and then [inaudible], Western Europe and Japan.

Robert Breza
RBC Capital Markets

Thank you.

Bill Koefoed

Okay, so that will wrap up our Q&A portion of today's earnings call. Remember that you can access this call on the Microsoft investor central website at www.microsoft.com/msft. Thanks again for joining us today and we look forward to seeing you next week at our financial analyst meeting here in Redmond. Thanks and have a good day.

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