Presentation

Operator

Greetings, and welcome to Microsoft's Fourth Quarter Fiscal Year 2016 Earnings Call. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Mr. Chris Suh, General Manager, Investor Relations. Thank you, you may begin.

Chris Suh
General Manager of Cloud & Enterprise Finance

Thank you. Good afternoon, and thank you for joining us today.

On the call with me today are Satya Nadella, Chief Executive Officer; Amy Hood, Chief Financial Officer; Frank Brod, Chief Accounting Officer; and John Seethoff, Deputy General Counsel and Corporate Secretary.

On our website, microsoft.com/investor, you can find our earnings press release and financial summary slide deck, which is intended to supplement our prepared remarks during today's call and provide the reconciliation of differences between GAAP and non-GAAP financial measures.

Unless otherwise specified, we will refer to non-GAAP metrics on the call. The non-GAAP financial measures provided should not be considered as a substitute for or superior to the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the company's fourth quarter performance in addition to the impact that these items and events had on the financial results.

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

As a reminder, in May, we announced plans to further streamline the Phone Hardware business. During the fourth quarter, restructuring and related impairment expenses were $1.1 billion. All growth comparisons we make on the call today relate to the corresponding period of last year, unless otherwise noted. We will also provide growth rates in constant currency, when available, as a framework for assessing how our underlying business has performed, excluding the effect of foreign currency rate fluctuation.

At the segment level, we provide constant-currency growth for both revenue and gross margin. However, due to recent changes to our segment reporting groupings, we're not able to provide segment level constant-currency operating expense growth and, consequently, cannot derive constant-currency segment operating income either. We do provide constant-currency operating expense and operating income growth at the company-wide level.

We'll post our prepared remarks on our website immediately following the call until the complete transcript is available. Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript and in any future use of the recording. You can replay the call and view the transcript on the Microsoft Investor Relations website until July 19, 2017.

During this call, we will be making forward-looking statements which are predictions, projections or other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings press release, in the comments made during this conference call and in the Risk Factors section of our Form 10-K, Form 10-Q and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

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

Satya Nadella

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CEO & Director

Thank you, Chris, and to everyone on the call for joining. I want to thank all the Microsoft team members and partners who contributed to a successful year. We are proud of what we achieved and particularly how we are positioned for new growth. Today, Amy and I will share our fourth quarter results and our perspective on the year ahead.

We delivered $22.6 billion in revenue this quarter, an increase of 5% for the quarter in constant currency. This past year was a pivotal one in both our transformation and in our partnerships with customers who are also driving their own digital transformation. Our progress is best captured in the results of our 3 ambitions, starting with Productivity and Business Process. In a world of infinite information but finite attention and time, we aim to change the nature of work with digital technology.

In pursuit of this ambition, we continue to add value to our products, grow usage and increase our addressable market. Along these lines, let me start with Office 365 and then move to Dynamics 365. In the last quarter, we advanced our collaboration tools. We launched Microsoft Planner, which helps teams manage operations as well as Skype meetings, which is aimed at helping small businesses collaborate. In June, we further strengthened our security value proposition with the release of Advanced Security Management.

Lastly, we continue to add intelligence and machine learning to Office to help people automate their tasks and glean insights from data. These advancements help to drive increased usage across enterprises, small and medium businesses and consumers. In the enterprise, Office 365 commercial seats grew 45% year-over-year, and revenue grew 59% in constant currency. Also, 70% of our Office Enterprise Agreement renewals are in the cloud. Innovative companies like Facebook, HERSHEY'S, Discovery Communications, Cushman & Wakefield, all adopted Office 365 and now see how transformative this service can be for their own business. We are enthusiastic about the early feedback and growth opportunity from companies using our newly released Office 365 E5, which includes powerful security controls, advanced analytics and cloud voice. These customers tell us that they love the simplification that comes with standardizing across all of our productivity workloads.

We see momentum in small and medium businesses, with a growing number of partners selling Office 365, now up to nearly 90,000, a 25% increase year-over-year. We continue to grab share and adding over 50,000 customers each month for 28 consecutive months. We also see momentum amongst consumers with now more than 23 million Office 365 subscribers. Across segments, customers increasingly experience the power of Office on their iOS and Android mobile devices. In fact, we now have more than 50 million iOS and Android monthly active devices, up more than 4x over last year.

Now let's talk about progress with the other pillar of this ambition, Dynamics 365. We're removing any impedance that exists within productivity, collaboration and business process. This month, we took a major step forward with the introduction of Microsoft Dynamics 365 and Microsoft AppSource. Dynamics 365 provides business users with purpose-built SaaS applications. These applications have intelligence built in. They integrate deeply with communications and collaboration capabilities of Office 365. Dynamics 365, along with AppSource and our rich application platform, introduces a disruptive and customer-centric business model, so customers can build what they want and use just the capabilities they need.

The launch of Dynamics 365 builds on the momentum we're already seeing in this business. Customers around the globe are harnessing the power of Dynamics in their own transformation, including 24 Hour Fitness and AccuWeather. Overall, Dynamics now has nearly 10 million monthly paid feeds, up more than 20% year-over-year, and Q4 billings grew more than 20% year-over-year. Overall, business processes represent an enormous addressable market projected to be more than 100 billion by 2020. It's a market we are increasingly focused on, and I believe we are poised with both Dynamics 365 and Microsoft AppSource to grow and drive opportunity for our partners.

Across Office 365 and Dynamics 365, developers increasingly see the opportunity to build innovative apps and experiences with the Microsoft Graph, and we now have over 27,000 apps connected to it. Microsoft AppSource will be a new way for developers to offer their services and reach customers worldwide.

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Lastly, with Office 365 and Dynamics 365, we have the opportunity to connect the world's professional cloud and the world's professional network with our pending LinkedIn deal.

Overall, the Microsoft Cloud is winning significant customer support. With more than $12 billion in commercial cloud annualized revenue run rate, we're on track to achieve our goal of $20 billion in fiscal year '18. Also, nearly 60% of the Fortune 500 companies have at least 3 of our cloud offerings, and we continue to grow our annuity mix of our business. In fact, commercial annuity mix increased year-over-year to 83%.

Now let's get into the specifics of the Intelligent Cloud, an area of massive opportunity as we are clearly one of the 2 enterprise cloud leaders. Companies looking to digitally transform need a trusted cloud partner and turned to Microsoft. As a result, Azure revenue and usage again grew by more than 100% this quarter. We see customers choose Microsoft for 3 reasons: they want a cloud provider that offer solutions that reflect the realities of today's world and their enterprise great needs; they want higher-level services to drive digital transformation; and they want a cloud open to developers of all types.

Let me expand on each. To start, a wide variety of customers turn to Azure because of their specific real-world needs. Multinationals choose us because we are the only hybrid and hyperscale cloud spanning multiple jurisdictions. We cover more countries and regions than any other cloud provider, from North America to Asia to Europe to Latin America. Our cloud respects data sovereignty and makes it possible for an enterprise application to work across these regions and jurisdictions.

More than 80% of the world's largest banks are Azure customers because of our leadership support for regulatory requirements, advanced security and commitment to privacy. Large ISVs like SAP and Citrix as well as startups like Sprinklr, also choose Azure because of our global reach and our broad set of platform services. Last week, GE announced it will adopt our cloud for its IoT approach.

Next, Azure customers also value our unique higher-level services. Now at 33,000, we nearly doubled in 1 year the number of companies worldwide that have selected our Enterprise Mobility solutions. The Dow Chemical Company leverages EMS along with Azure, Office 365 and Dynamics to give its thousands of employees secure, real-time access to data and apps from anywhere. Just yesterday, we announced Boeing will use Azure IoT Suite and Cortana Intelligence to drive digital transformation in commercial aviation with connected airline systems optimization, predictive maintenance and much more. This builds on great momentum in IoT, including our work with Rolls-Royce, Schneider Electric and others. This is great progress, but our ambitions are set even higher.

Our Intelligent Cloud also enables cognitive services. Cortana Intelligence Suite offers machine learning capabilities and advanced predictive analytics. Customers like Jabil Circuit, Fruit of the Loom, Land O'Lakes, Liebherr, already realize the benefits of these new capabilities.

Lastly, central to our Intelligent Cloud ambition is providing developers with the tools and capabilities they need to build apps and services for the platforms and devices of their choice. The new Azure Container Service as well as .NET Core 1.0 for open source and our ongoing work with companies such as Red Hat, Docker, Mesosphere, reflects significant progress on this front. We continue to see traction from open source with nearly 1/3 of customer virtual machines on Azure running Linux.

On the server side, premium server revenue grew double-digits in constant currency year-over-year. New SQL Server 2016 helps us expand into new markets with built-in advanced analytics and unparalleled performance. More than 15,000 customers, including over 50% of the Fortune 500 have registered for the private preview of SQL Server for Linux. And we're not slowing down. We will launch Windows Server 2016 and Systems Server 2016 later this year.

Now let's talk about the progress in More Personal Computing. We have increased Windows 10 monthly active devices, and they're now at more than 350 million. This is the fastest adoption rate of any prior Windows release. While we are proud of these results, given changes to our Phone plan, we changed how we will assess progress.

Going forward, we will track progress by regularly reporting the growth of Windows 10 monthly active devices in addition to progress on 3 aspects of our Windows strategy. First, deliver more value and

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innovation, particularly for enterprise customers. Second, grow new monetization through services across a unified Windows platform. Third, innovating new device categories in partnership with our OEMs. Let me walk through each.

We continue to pursue our goal of moving people from needing Windows to choosing Windows to loving Windows. In 2 weeks, we will launch Windows 10 Anniversary Update, which takes a significant step up in security. We are also extending Windows Hello to support apps and websites and delivering a range of new features like Windows Ink and updates to Microsoft Edge. We expect these advances will drive increased adoption of Windows 10, particularly in the enterprise in the coming year. We already have strong traction with over 96% of our enterprise customers piloting Windows 10.

Next, as we grow our installed base and engagement, we generate more opportunity for Microsoft and our ecosystem. Bing profitability continues to grow with greater than 40% of the search revenue in June from Windows 10 devices. Bing PC query share in the United States approached 22% this quarter, not including volume from AOL and Yahoo!. The Cortana search box has over 100 million monthly active users, with 8 billion questions asked to date.

We continue to drive growth in gaming by connecting fans on Xbox LIVE across Windows 10, iOS and Android. Just this quarter, we launched our Minecraft Realms subscription on Android and iOS. Overall, engagement on Xbox LIVE is at record levels with more than 49 million monthly active users, up 33% year-over-year. At E3, we announced our biggest lineup of exclusive games ever for Xbox One and Windows 10 PCs. And we announced Xbox Play Anywhere titles where gamers can buy a game once and play it on both their Windows 10 PC and Xbox One. We also announced 2 new members of the Xbox One console family, the Xbox One S and Project Scorpio. The Windows store continues to grow with new universal Windows apps like Bank of America, Roku, SiriusXM, Instagram, Facebook, Wine, Hulu and popular PC games like Quantum Break.

Finally, we are innovating in new device categories in partnership with OEMs. Our hardware partners are embracing the new personal computing vision, with over 1,500 new devices designed to take advantage of Windows 10 innovations like Touch, Pen, Hello and better performance and power efficiency.

Microsoft's family of Surface devices continues to drive category growth, and we are reaching more commercial customers of all sizes with the support of our channel partners. We recently announced new Surface enterprise initiatives with IBM and Booz Allen Hamilton to enable more customer segments. Also in the past year, we grew our commercial Surface partner channel from over 150 to over 10,000.

Lastly, this quarter, more and more developers and enterprise customers got to experience 2 entirely new device categories from Microsoft Surface Hub and Microsoft HoloLens. While we are still in the early days of both of these devices, we have seen great traction with both enterprise customers and developers making us optimistic about future growth.

In closing, I want to reflect on the opportunity ahead of us. Simply put, businesses will not just use digital technologies, but they will become digital companies. This generates enormous opportunity for Microsoft and our partners. We are the ones who can empower digital transformation across all industries, companies and geographies with our technology and platforms.

With that, I'll hand it over to Amy to go through this quarter's results in greater detail and share our outlook. And I look forward to rejoining you after that to answer questions.

Amy E. Hood
Executive VP & CFO

Thank you, Satya, and good afternoon, everyone. This quarter, revenue was $22.6 billion, up 2% and 5% in constant currency. Gross margin was flat but up 4% in constant currency. Operating income this quarter declined by 3% and grew 6% in constant currency. And earnings per share were $0.69, increasing 11% year-over-year or 27% in constant currency.

Across most markets, our execution and results were generally as expected, with some strength in the U.S. But we did see additional softness in Brazil, the Middle East and Africa, which were impacted by

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macroeconomic headwinds. From a seasonality perspective, the fourth quarter is always an important one for our commercial business. Our results were strong as our sales teams led with our cloud offers. Healthy renewal helped to drive double-digit annuity performance in constant currency. Our total annuity mix reached 83%, up 1 point year-over-year. While our commercial cloud continued to drive a higher annuity mix overall, we also had better-than-expected transactional revenue performance as products like Office 2016 and SQL Server 2016 generated more deal volume.

The dollar volume of expiring enterprise agreements was smaller this quarter than last year. On that base, our commercial bookings increased 4% in constant currency, driven by customer preference for our cloud offers. Commercial unearned revenue slightly beat our expectations at $24.6 billion or 8% growth in constant currency. Our contracted not billed balance exceeded $25.5 billion.

As Satya called out earlier, our commercial cloud annualized revenue rate exceeded $12.1 billion, growing more than 50% year-over-year. Additionally, more than 70% of customers who signed Enterprise Agreements this quarter attached cloud offerings. Our commercial cloud gross margin was 42%, declining year-over-year, driven by investments for cloud capacity, deployment and support.

Now let's turn to company gross margin performance. We were above our COGS expectations due to approximately $200 million of inventory adjustments from the change in our Phone Hardware business. And, as expected, our mix of cloud services revenue continued to increase, resulting in gross margin percentage declines in the Productivity and Business Processes and Intelligent Cloud segments. Importantly, gross margin dollars expanded year-over-year in constant currency.

In Q4, the FX impact on total and segment level revenue was in line with expectations. FX had a 3-point negative impact on Productivity and Business Processes and Intelligent Cloud results and a 2-point negative impact on More Personal Computing results. As we've noted in previous quarters, we're not able to provide constant-currency impact at the segment level for operating expenses and, therefore, segment operating income. This quarter, total operating expenses grew 1% in constant currency, above our expectations due to legal settlements and revenue-driven sales cost. At the company level, our operating income grew 6% in constant currency as FX had a 9-point impact on our results.

Now let's turn to each segment. This quarter, our Productivity and Business Processes segment delivered results above our expectations, with nearly $7 billion in revenue, an increase of 5% and 8% in constant currency. In Office Commercial, revenue increased by 5% and 9% in constant currency as Office 365 growth outpaced the shift from our on-premises business. Our seat growth was driven by broad-based momentum across commercial customers of all sizes. While we generally expect transactional purchasing to continue to decline, results across all products came in higher-than-anticipated this quarter.

Office consumer revenue increased 19% and 18% in constant currency, outperforming the consumer PC market, driven by seat growth, recurring subscription revenue and 6 points of growth from Japan, which had a particularly weak quarter a year ago. And our Dynamics business grew 6%, up 7% in constant currency with strong billings and seat growth. Segment gross margin dollars were flat and up 4% in constant currency. The gross margin percentage declined on a higher cloud revenue mix within the segment, coupled with an increase in cloud investments. Operating expenses grew 6% from investments in commercial cloud sales programs and engineering. As a result, operating income declined 5%.

The Intelligent Cloud segment delivered slightly more than $6.7 billion in revenue, growing 7% and 10% in constant currency. Demand and use of our hybrid cloud offerings led to another quarter of double-digit annuity revenue growth within server products and cloud services, partially offset by a decline in our transactional on-premises server business.

Enterprise services revenue grew 12%, 14% in constant currency, as customer demand for Windows Server 2003 and the support agreement and premier services continued this quarter. Gross margin dollars grew 1% and 5% in constant currency, and gross margin percentages declined as cloud mix accelerated. This quarter, operating income declined 17%, driven by investment in sales resources and engineering.

Now to our final segment, More Personal Computing. Revenue was $8.9 billion, down 4% and 2% in constant currency. First, our OEM results. Our total OEM business grew 11% this quarter outperforming

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the overall PC market, which was better than we expected in most markets, including the U.S., the U.K. and Germany, partially offset by incremental weakness in India and Russia. OEM non-Pro revenue increased 27% and, similar to last quarter, was driven by a higher mix of premium devices. OEM Pro revenue grew 2%, reflecting a stabilizing commercial PC market and a higher mix of business PCs sold with Windows Pro.

Inventory, across both OEM Pro and non-Pro remained at normal levels. Windows volume licensing grew 3% and 9% in constant currency with ongoing annuity growth. IP licensing declined, impacted by both a decrease in total unit volume and lower revenue per unit.

We continued to execute well in our search business this quarter. And as we committed, Bing was profitable for the full fiscal year, driven by increasing revenue per search and search volume. As expected, devices revenue significantly decreased this quarter. Revenue declined 35%, also 35% in constant currency, due to Phone, where revenue declined 70% in constant currency. Surface revenue increased 9% in constant currency as Surface Pro 4 and Surface Book growth was partially offset by unit declines in our prior-generation Surface 3.

And in gaming, revenue declined 9% or 8% in constant currency, driven by lower Xbox 360 unit volume and reduced Xbox One pricing. Our overall gaming ecosystem showed healthy growth with 49 million monthly active Xbox LIVE users or a 33% increase and 4% Xbox LIVE revenue growth. Segment gross margin dollars declined 3%, or roughly flat in constant currency, as decreases due to Xbox consoles and the Phone inventory adjustment were partially offset by our OEM and search results. Operating expenses decreased this quarter by 13% based primarily on reduced Phone spend and the transition of display advertising sales to AOL, resulting in segment operating income growth of 59%.

Now back to our overall company results. We invested $3.1 billion in capital expenditures, consistent with our plan for accelerated investment as we added both commercial and consumer global cloud capacity to meet near-term and longer-term customer demand. During the quarter, we continued to rebalance our investment portfolio, which resulted in other income and expense of $267 million from net recognized gains on investments, partially offset by interest expense.

Our non-GAAP effective tax rate was 15% this quarter, lower than we expected. Our income tax expense reflected a favorable mix between U.S. and foreign currencies, as well as benefits associated with distributions from foreign affiliates.

This quarter, we returned $6.4 billion to shareholders through stock repurchases and dividends.

Before turning to next quarter's outlook, I want to share our view on the shape of next fiscal year. My commentary, both on the year and next quarter, does not include LinkedIn. However, we still expect the transaction to close in the second quarter.

For the full year, we expect the FX impact to lessen throughout the year, assuming current rates remain stable. In H1, we expect the total impact of 1 point, reducing to 0 in H2. The fundamentals of our commercial business remain strong, and we anticipate that cloud services and healthy renewals will continue to drive high annuity mix. As I've noted before, our Commercial transactional business is influenced by different dynamics. Most important, it's impacted by a structural transition to the cloud across all workloads, but it's also more sensitive to overall macroeconomic conditions and changes in corporate budgets. We expect volatility as we saw in both Q3 and Q4 this year to continue in the next fiscal year.

Before discussing our total company gross margin expectations, let me first address commercial cloud gross margin. We expect the commercial cloud gross margin percentage and dollars to materially improve next fiscal year. We have invested heavily to build share, expand geographically and ensure world-class support and reliability for our commercial customers. Going forward, we expect those investments to provide benefits of scale. We also anticipate our cloud capital expenditure growth curve will slow. Given seasonality and revenue mix, commercial cloud gross margin will see variability quarter-to-quarter but an overall trend of material improvement.

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At the company level, at each cloud service continues to grow and improve its gross margin percentage, our company gross margin should only decline roughly 1 point in FY '17. We now expect our full-year operating expense will be $31.1 billion to $31.4 billion, as we continue to prioritize spend on strategic growth opportunities.

Lastly, our effective tax rate. Our tax rate is impacted by 3 factors: the proportion of services revenue versus licensing revenue; the geographic mix of revenue; and the timing of equity vests. As our cloud continues to gain momentum, we expect our tax rate to increase. With quarterly variability based on these factors, we anticipate our non-GAAP tax rate to be 20% for the full year, plus or minus 2 points.

Now to the outlook for the next quarter. Based on current currency rates and forecasted geographic mix of revenue, we expect 2 points of negative impact on total revenue in Q1. By segment, the negative impact is 2 points in Productivity and Business Process, 2 points in Intelligent Cloud and 1 point in More Personal Computing. We expect commercial unearned revenue to be within the range of $21.8 billion to $22 billion, in line with historic seasonality. In Productivity and Business Process, we expect revenue to be $6.4 billion to $6.6 billion. We will continue to grow our installed base and drive premium mix through offers like Office 365 E5. We anticipate continued transactional decline as customer migration to the cloud accelerates.

In our consumer business, we will outpace the consumer PC market. But the benefit from Japan's improved results over a weak prior period and the benefit from last year's Office 2016 launch are not expected to repeat.

For Intelligent Cloud, we expect revenue between $6.1 billion and $6.3 billion, driven by continued annuity strength across Azure and our hybrid cloud offerings, offset by ongoing declines in our transactional on-premises server business and moderating growth from support agreement and enterprise services.

In More Personal Computing, we expect revenue between $8.7 billion and $9 billion. We anticipate that our OEM revenue will be more in line with overall PC market trends. Devices revenue will decline again from more actions in Phone. Gaming revenue will be driven by the same factors as in Q4. And in search, we expect Bing's growth trajectory to continue.

We expect COGS to be $7.5 billion to $7.6 billion with variability due to device sales. We expect operating expenses between $7.35 billion and $7.45 billion. We expect other income and expenses to be approximately 0 as realized gains on investment should offset debt expense.

And with that, Chris, let's go to Q&A.

Chris Suh
General Manager of Cloud & Enterprise Finance
Thanks, Amy. We'll move now to the Q&A section. Operator, can you please repeat your instructions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Keith Weiss with Morgan Stanley.

Keith Weiss
Morgan Stanley, Research Division

I wanted to dig into Azure. I may have one question for Satya and one question for Amy. Satya, you mentioned the Boeing agreement. What was interesting about that is not just a large company moving significant workloads onto Azure, but from my reading, it sounds like there's a distribution side to this agreement that you guys are going to help them distribute some of those applications on a going forward basis. I was wondering if you could touch a little bit on that. Is that a onetime thing? Or is that something that you look to do more often with some of these large companies, moving workloads onto Azure? And then for Amy, thank you for the additional detail on sort of the cloud risk margin profile on a going-forward basis. When we dig into just Azure, you said in the past that you sort of -- you expect to match the gross margin profile of what we're seeing in Amazon Web Services. Does that commentary still hold? And maybe you could give us a sort of mark-to-market on how you're doing in terms of matching up Azure's gross margin profile to what you're seeing from your top competitor there?

Satya Nadella
CEO & Director

Thanks, Keith, for those questions. So let me start on the first one. You're absolutely right that one of the phenomena now is that pretty much anyone who is a customer of Azure is also, in some form, an ISV, and that's no longer just limited to people who are "in the classic tech industry" or the software business. That's the same case with GE, it's the same case with Boeing, it's the same case with Schneider Electric or ABB or any one of the customers we are working with, because they all are taking some of their assets and converting them into SaaS applications on Azure. And that's something that we will, in fact, have distribution agreements with. And AppSource, it's a pretty major announcement for us because we essentially created, for SaaS applications and infrastructure applications, a way to distribute their applications through us and our channel. And I think it makes, in fact, our cloud more attractive to many of them because of that. So we look for -- I think going forward, we will -- you'll look to see -- or you'll see us do much more of this with many other customers of ours.

Amy E. Hood
Executive VP & CFO

And to your question on Azure gross margin specifically and how we think about that in comparison. Let me first say the additional color I gave in terms of comments, in terms of material improvement, clearly also apply to our Azure portfolio as well. We're encouraged by the improvements we've seen year-over-year, and we do expect a material improvement in FY '17, both from the benefits of scale and the investments we've made, but importantly also, in the revenue trajectory we're seeing and the makeup of that revenue. Boeing's agreement is one such agreement in terms of embedding a sort of premium service at a premium gross margin. We signed many of those this quarter that we feel quite good about. We -- I think I have a strong line of sight to AWS' margin profile and still feel good about the progress we're making not just on the workloads that are relevant, apples-to-apples with Azure, but also in our broader cloud portfolio and our ability to have very healthy margins across Dynamics 365 as well as Office 365 in conjunction with many of the innovations we're doing across Azure. So while I am focused on both the workload improvement, I'm also focused on what's possible across the entirety of the cloud. Thanks, Keith.

Operator

Our next question comes from the line of Karl Keirstead with Deutsche Bank.

Karl Emil Keirstead

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Deutsche Bank AG, Research Division

So Satya or Amy, last quarter, the stock was hit in part on a deceleration in your on-premise server product business. And I think your commentary around the transactional part of that suggested it softened a little bit. I think your tone on this call is a lot better around the transactional performance, and it looks like that business accelerated a little bit. Perhaps you could explain what changed in the course of the 3 months to make the transactional piece, at least, if I'm hearing you correctly, feel a little bit better.

Satya Nadella
CEO & Director

Yes. Let me start, and then Amy you can add to it. Overall, Karl, the focus for us is in what I would describe as this hyperscale plus hybrid approach when you think about the cloud approach, which is pretty unique to us. And the way we track progress is to see how is our annuity growth of our server business and how is our cloud growth. And if you look at this last quarter, we -- our annuity grew double digits and our cloud grew triple digits, and that's a pretty healthy growth rate and that's something that, by design, both in terms of the technical architecture as well as the traction we have in the marketplace and our sales efforts and so on, are playing out well and we are very bullish about that going forward. The transactional business is much more volatile because of the macro environment, IT budgets and also the secular shift to the cloud. The question again that gets asked is about the cannibalization. But if you look at Boeing or you look at any of the other examples that I talk about when it comes to the cloud, our servers never did what these customers are now doing in our cloud. So at a fundamental long-term secular basis, we have new growth, new workloads, and that's what we are focused on and that's a much bigger addressable market than anything our transactional server business had in the past.

Operator

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

Brent John Thill
UBS Investment Bank, Research Division

Amy, in Q3, the transactional business was weak, and you said that the business bounced back in Q4. Was that just a mere fact of you cleaning up some of the flip business? Or did you see additional strength on top of some of those closed transactions on the transactional business in Q4?

Amy E. Hood
Executive VP & CFO

Thanks, Brent. I -- let me split your question into 2 components. The first thing really that I think Satya and I both focus on every quarter, every month is how much of our business are we continuing to shift to annuity and, specifically, to the cloud. We structure all of our motions at this company, from how we engineer to how we do our go-to-market to how we think about sales engagement to how we do our investments, fundamentally toward that long-term structural transition in the market. And so to your question on transactional performance, there were some deals that didn't get done in Q3 that got done in Q4. And there were some deals done in Q4 on the Office side with large companies that I'm thrilled by. But at the same time, we still will focus on those deals moving to the cloud over time. And so this volatility that we are going to see because of macro and because of budget constraints, especially on transactional, we will focus on because we expect excellent execution and have accountability to do that in the field. But our first priority every time is to make sure we are focused on annuity growth and digital transformation at our company, which is best done through that motion.

Brent John Thill
UBS Investment Bank, Research Division

Just to be clear, Amy, in terms of the sales motion, are they incented more towards cloud versus transactional going into this year?

Amy E. Hood
Executive VP & CFO

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Yes.

Satya Nadella
CEO & Director

Absolutely.

Operator

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

Heather Anne Bellini
Goldman Sachs Group Inc., Research Division

Great. Satya, I had a question for you on Azure. I was just wondering if you could talk about the percentage of Azure revenue coming from ISVs. And then how do you see this helping you compete with AWS? And can you talk about why these partners may be choosing you over the competition?

Satya Nadella
CEO & Director

Sure. Let me take that second part in terms of what is our differentiation. And in my remarks, I sort of pointed out the couple of dimensions. But overall, I believe this hyperscale plus hybrid architecturally helps us a lot with enterprise customers because we meet them where the realities are today and also the digital transformation needs going forward. So that's one massive advantage we have. And the second area for us is also the nexus between what's happening in Office 365, Dynamics 365, AppSource and, in fact, this last quarter, some of the most strategic announcements were all around our application platform. At our Partner Conference, there was significant amount of excitement with the tools that we announced like Power Apps and Power BI, Azure Functions and Flow. These are tools that our developers and system integrators and solution partners will use in order to be able to customize applications around Azure. And so to me, that's another huge advantage and a competitive differentiation for us. And then, lastly, we have the best support for what I would say is the most open platform for all developers, not only is .NET first-class, but Linux is first-class, Java is first-class, Azure Container Service cuts across both containers running on Windows, running across Linux, so, again, speaks to the enterprise realities. So those would be the places where we are fairly differentiated, and that's what you see us gaining, both for enterprise customers and ISVs. The question you asked is an interesting one, which is if I had to sort of slice it by classic ISVs, it would be 1/3 or so of our revenue. But the thing that -- the first question that Keith asked is probably more indicative of what's happening, which is every customer is also an ISV. So every customer who starts off consuming Azure is also turning what is their IP in some -- most cases, into an ISV solution, which ultimately will even participate in AppSource. So at least the vision that we have is that every customer is a digital company that will have a digital IP component to it, and that we want to be able to partner with them in pretty unique ways.

Amy E. Hood
Executive VP & CFO

And I would also add, Heather, the importance of the motion in our field organization and go-to-market with ISVs is incredibly high in terms of selling with and along with those ISVs, both making them successful and thereby helping us build very important scale through the platform. And we've seen a lot of improvement in the past 4 quarters on that front.

Operator

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

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

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Amy, how much of the weakness in transactional has been caused by clients that otherwise would have bought a license now under annuity? In other words, are you driving the transactional weakness to some extent by driving the growth in on-prem? And then I have a quick follow-up for Satya.

Amy E. Hood
Executive VP & CFO

It's probably not exactly how I would say it, Mark. I do believe that every conversation that we're having with customers is cloud-led. That cloud-led conversation and making a plan for customers to best change and perform their own business is certainly a far more in-depth one than on occasion is required by long-time transactional purchasers especially in Office, as an example, because what we're talking about now is really pivoting your business for the long-term. And so I'm sure there are examples where that has elongated the sales cycle for good reason, but I would generally point back to say that most of these are driven at the structural level, which is structurally, over time, on-premises transactional business will move to the cloud or to a hybrid structure through an annuity revenue stream. Now over any short-term period, the majority of what we have seen is really budget -- is either budget constraint, a macroeconomic economic change or people, to the question you've laid out, maybe in the midst of making their cloud transition plan and maybe that has elongated the sales cycle to an extent. But again, I don't view that as negative performance, I view that as a strategic relevance long-term inside of digital accounts.

Operator

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

Walter H Pritchard
Citigroup Inc, Research Division

Amy, I'm wondering, you're seeing -- you saw very strong unearned revenue in the quarter, but I note that you saw contracted backlog that grew sequentially below what a typical June quarter does, and commercial bookings that were up about 4% off of a fairly easy comp. And I'm wondering if you could just help us understand the dynamics between -- in new and renewal signings that drove that combination of really strong unearned but somewhat weaker trends in the bookings.

Amy E. Hood
Executive VP & CFO

Sure. Strong unearned, in particular, was actually better-than-expected Azure billings in the quarter that drove unearned above the high end of our guide. And I think we were quite pleased by that performance. In terms of C&B, that's the reference I made in my comments to the lower expiry base. Quarter-to-quarter and year-to-year, we just have different amounts of contracts expiring. And so this was one of our lower contract bases and was lower than a year ago. So the fact that we were able to grow on that low expiry base is actually very good structural performance.

Operator

Our next question comes from the line of Raimo Lenschow with Barclays.

Raimo Lenschow
Barclays Bank PLC, Research Division

Two questions on the Office side. First of all, you're obviously, really reaching the very large numbers in terms of the numbers of seats that you have. Can you talk a little bit about towards the seat growth because both for consumer and for commercial, it seemed to be coming down? Is that kind of the law of large numbers coming in? Or is there anything else? And then in Consumer Office, so the Consumer Office performance was very, very strong and almost needs to be stronger from transactions because otherwise, I don't get to the numbers. Can you talk a little bit about the source of the strength there?

Amy E. Hood
Executive VP & CFO

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Thanks, Raimo. Let me start with the Office Consumer question. We haven't had a chance to touch on that, and then we'll talk about commercial seat growth. You're right; the Office Consumer growth still has quite a bit of transactional business to it, even though we have moved. And you saw that growth of the subscriber base sort of materially. The growth in quarter versus our expectations was really 2 things that are transactionally focused. One, the PC market was a little better than we thought and, particularly, in developed markets, the PC growth was better than we thought. And developed markets are where we see the most transactional business with Consumer Office that impacts in quarter. So the strength from that outperformance or better market in consumer PCs in developed markets is a direct correlation to our performance in Office Consumer, and so that's how to think about that big delta. The other thing was Japan was a little better. And when Japan is better, it's why you also see the interesting relationship in constant currency. We have a lot of yen exposure in that segment, so the Japan performance being better also helped. And that is a purely -- it's more transactional than even our rest of world business. So you're right, Raimo, in terms of what impacted that number in quarter versus the underlying market dynamics. On commercial seats, listen, we're very proud of that big number -- growth number. But you're right; we're also getting a very big base. And so while we feel great about continuing to add seats at that type of rate, converting and adding net new into our installed base, you will see that growth rate come down just because the business is getting quite big.

Operator

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

Gregg Steven Moskowitz
Cowen and Company, LLC, Research Division

Amy, you spoke about a slowdown in the cloud CapEx growth curve in fiscal '17. I assume you're referring to the growth in absolute dollars moderating and not just the rate of change in percentage terms, but any additional color that you could provide on the company's CapEx requirements over the course of the next year would be appreciated.

Amy E. Hood
Executive VP & CFO

Thanks, Gregg. You're right; my comments are more pivoted toward the absolute dollar amount, which is what I intend to focus on in my comments, so that's a good clarification, and thanks for asking. In terms of how we think about the absolute numbers, first, I should say, I think most people assume, and it is true to a certain extent, so much of this is the growth in our commercial businesses across Azure and Dynamics and Office 365, and that's true. But we're also seeing quite good growth in some of the consumer businesses, which also are built on our cloud infrastructure: Search, some of our gaming assets, our Xbox LIVE business going forward. And so many of these assets, including increased usage of our consumer properties inside our Productivity business and Office, do require capital spend. And so the growth is pretty broad-based to support. And so as I think about moderation, it is the absolute dollar. It's from -- it's not due to any change in our aspiration or belief in the growth curve of revenue. And I want to be clear on that, it really is about continuing to benefit from scale and engineering improvements that will allow us to do that even as we see broad-based growth.

Operator

Our next question comes from the line of Ross MacMillan with RBC Capital Markets.

Ross Stuart MacMillan
RBC Capital Markets, LLC, Research Division

Amy, I had one on the same lines on CapEx, and I just wondered if you could provide some insights. We're at 26 data center regions today. I think you have 34 planned, so that would imply we're about 3/4 of the way through that spending cycle. But should we view 34 as a ceiling? Or is it possible that we could see further data center regions built out beyond that 34? And then I had one follow-up.

Satya Nadella

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CEO & Director

Sure. Let me start, and then, Amy, you can add to this. In some sense, Ross, you're sort of trying to ask us to project forward and say what is the legitimate digital security and digital sovereignty needs of all the different types of businesses that we want to serve using the cloud all over the world. The position that we have taken is that we want to serve customers where they are and not assume some very simplistically that, that digital sovereignty needs of customers can be met out of a fewer data center approach because, right now, given the secular trend to move to the cloud across all of the regulated industries across the globe, we think it's wiser for us and our investors long-term to be able to meet them where they are. And that's what you see us. We were the only cloud that operates in China under Chinese law; the only cloud that operates in Germany under German law. And these are very critical competitive advantages to us. And so we will track that, and we will be very demand-driven. So there is -- in this case, we're not taking these positions of which regions to open and where to open them well in advance of our demand. If anything, I think our cycle times have significantly come down, so it will be demand-driven. But I don't want to essentially put a cap because if the opportunity arises, and for us it's a high ROI decision to open a new region, we will do so.

Amy E. Hood
Executive VP & CFO

And I would add, in addition to the number of regions, which Satya is talking about, it's also the capacity inside a region. Much of our spend is, as you note, on some of the infrastructure to put in place when you pick a location. The rest of it is continuing to build out in that location the number of servers and networking equipment required. So there's really 2 components. And I think Satya talked about why you would enter a region, and it's ROI and there's also their correlation to how many servers and that spend and pace over time based on demand.

Ross Stuart MacMillan
RBC Capital Markets, LLC, Research Division

Maybe just one quick follow-up, the server products business that Karl talked about did rebound this quarter, and I think it was up about 4% constant currency for the year. I know you're not guiding to that number specifically, and you talked about potential volatility. But is there any sort of range of outcomes that you're thinking about for that business? Will it grow? Is it not clear that it will grow? I'd just love any additional color there.

Amy E. Hood
Executive VP & CFO

In terms of server products and services, I tend to think of it as the all-up growth. It's really about growing the cloud, growing the hybrid and then whatever happens in the transactional business happens. And we -- I'm very proud, actually, of the growth this quarter. I think our guide for Q1, given some of the headwinds we expect in terms of support agreements that we talked about in enterprise services, continues to expect very healthy double-digit annuity growth, driven fundamentally by Azure in that segment.

Operator

Our next question comes from the line of Michael Turits with Raymond James.

Michael Turits
Raymond James & Associates, Inc., Research Division

Satya, around the LinkedIn announcement, there was a lot of discussion about some of the opportunities to use the assets and information there to help build your HCM and CRM capabilities. And then we fairly shortly afterwards got the announcement of Dynamics 365 and AppSource. So maybe given the amount of discussion here, you could comment on the evolution of the strategy and your thought process around broad enterprise application.

Satya Nadella

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CEO & Director

Thanks for that question. So I sort of look at what we are doing with Office 365, Dynamics 365, AppSource, LinkedIn as all being part of one strategy. So the move to the cloud for our customers and for us is not just about a new way of delivering the same value just to the service. It's really the transformation from having applications that are silos to becoming more services in the cloud where you can reason about the activity and the data underneath these services to benefit the customers who are using these services. So that's what this notion of a graph represents. So when somebody moves to Office 365, their graph, their people, their relationships with other people inside the organization, their work artifacts all move to the cloud. You can connect them with all the business process data that's in Dynamics 365. But not just in Dynamics 365, but all the applications in AppSource because business process will always be a much more fragmented market as opposed to just one market share leader by industry, by vertical, by country. And so that's our strategy there. And now the professional cloud or the professional network helps usage across all of that professional usage. Whether it's in Office 365 or whether you are a salesperson using any application related to sales, you want your professional network there. Of course, it's relevant in recruiting, it's relevant in training, it's relevant in marketing. So that's really our strategy with LinkedIn as the professional network meeting the professional cloud. And so you're right to point out that these are all part of one overarching strategy and, ultimately, it's about adding value to customers.

Chris Suh
General Manager of Cloud & Enterprise Finance

Thanks so much. We'll have time for one more question, please.

Operator

Our final question comes from the line of Mark Murphy with JPMorgan.

Mark Ronald Murphy
JP Morgan Chase & Co, Research Division

Yes. So Satya, we noticed Office 365 commercial seat growth of 45% produced Office 365 commercial revenue growth of 59% in constant currency, so a favorable spread of about 14 points, suggesting ASP growth. I'm wondering if you could help us understand the drivers, both now and into the future, particularly in terms of the initial response to the E5 plan and also, which products you think are driving the strength as you consider across Exchange, Skype for Business, Power BI, Yammer, SharePoint, et cetera.

Satya Nadella
CEO & Director

Yes. Let me start. And, Amy, you can add to it. Overall, I would say, even in this last year, even just a broader spread of E3 has driven a lot of the growth. And then, of course, we are very excited about E5, but they're very, very early days of E5. And E5 value proposition across all 3 of the areas, whether it's cloud voice or analytics or security, are all 3 massive areas for us. And I would say, if anything, the initial data from customers around security is very -- is gaining a lot of traction. But we're -- at the same time, one of the things that customers are looking for is making an enterprise-wide architectural decision across all of the workloads. So E3, E5 and higher penetration of this is what's going to drive ASP growth. And you will look to -- you can see -- you'll see us add more value to these packages as time goes on as well because our R&D is focused on that, which is how do we take these buckets of value creation and reinforce them with all of the future R&D as well.

Chris Suh
General Manager of Cloud & Enterprise Finance

Thanks, Mark. So that wraps up the Q&A portion of today's earnings call. We look forward to seeing many of you in the coming months at various investor conferences. For those unable to attend in person, these events will be webcast, and you can follow our comments at the Microsoft Investor Relations website. Please contact us if you need any additional details, and thank you for joining us today.

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Amy E. Hood
Executive VP & CFO

Thanks, all.

Satya Nadella
CEO & Director

Thank you.

Operator
This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.

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