Presentation

Operator

Welcome to the Microsoft Third Quarter Fiscal Year 2010 Earnings 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.

William A. Koefoed
Former General Manager, Investor Relations

Thanks, Barb, and thanks, everyone, for joining us this afternoon. With me today are Peter Klein, Chief Financial Officer; Frank Brod, Chief Accounting Officer; and John Seethoff, Deputy General Counsel. Today, Peter will start with overall takeaways from the quarter. Then, I'll give you the details of our performance before handing it back to Peter, who will discuss our outlook. After that, we'll take your questions.

Please note we filed our Form 10-Q this afternoon. In addition, we posted our quarterly financial summary slide deck, which is intended to follow the flow of our remarks as well as provide a reconciliation of differences between GAAP and non-GAAP financial measures. You can find these documents at the Microsoft Investor Relations Web site at microsoft.com/msft.

Today's call will be webcast live and recorded. If you ask a question, it will be included in our live transmission, any future use of the recording and in the transcript, which will be posted on our Web site. You could replay the call and view the transcript at the Microsoft Investor Relations Web site until April 22, 2011. This conference call is protected by copyright law and international treaties. Unauthorized reproduction or distribution of this call or any portion of it without the expressed written permission of Microsoft may result in civil and criminal penalties.

We will be making statements during this call that are forward-looking. These statements are based on current expectation and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings press release and 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 statements. Okay, Peter, it's all yours.

Peter S. Klein
Former Chief Financial Officer

Thanks, Bill, and good afternoon, everyone. Our third quarter results reflect our strong product momentum, continued focus on controlling costs and the beginning stages of a return in business hardware spending. This quarter, we generated record third quarter revenue and operating cash flow. In addition, as a result of revenue growth and our ongoing focus on cost management, when adjusting for the impact of the Tech Guarantee programs this year, we had our third consecutive quarter of year-over-year margin expansion.

Strong demand for Windows 7 was the primary contributor to our performance. As evidence of that strong demand, both internal and external check show that over 10% of all PCs worldwide are already running Windows 7. While reaching this level of penetration in six months qualifies Windows 7 as our fastest-selling operating system ever, it also illustrates how much opportunities still remain. As I have met with investors, I've commented on the tremendous product momentum we have, which was evidenced this quarter across all our business.

Bing achieved 10 consecutive months of market share growth since its launch. And both the U.S. Department of Justice and the European Commission cleared our search agreement with Yahoo! Azure, our cloud development platform, became commercially available in 41 countries. In the mobile space, we announced Windows Phone 7 KIN. And last Friday, we released Office 2010 to manufacturing and are looking forward to its launch in June. All of this was achieved while continuing to focus on managing costs and prioritizing our investments. As a result, we delivered operating income and earnings per share growth ahead of revenue growth, with earnings per share up 36% over last year. We also returned $3.1 billion of cash to investors through dividends and stock repurchases.

So in summary, I am pleased with our continuing performance this quarter. We have great momentum with current products in the market, we have a very exciting pipeline of new products to come and we continue to deliver strong financial results. I'll now hand the call back to Bill to give you some additional details on the quarter and then come back and provide some thoughts on our outlook for our fourth quarter and the next fiscal year.

William A. Koefoed
Former General Manager, Investor Relations

Thanks, Peter. As I review this quarter's performance, keep in mind that all growth comparisons relate to the corresponding quarter of last year unless I specify otherwise.

As Peter said, we had another strong quarter. Overall, GAAP revenue grew 6% to $14.5 billion. During the quarter, we deferred $305 million of revenue related to the Microsoft Office 2010 Technology Guarantee program. Adjusting for this amount, revenue would have been $14.8 billion, 8% growth over the prior-year period. GAAP operating income grew 17% year-over-year, while EPS grew 36%. Operating cash flow this quarter was $7.4 billion, an all-time record for the company. Foreign exchange had a positive impact to revenue of about $200 million this quarter.

In terms of overall revenue mix, geographically, emerging markets grew more than 20%, while mature markets grew mid-single digits. While consumer demand continued to be strong, we saw renewed strength from small- and mid-market customers with year-over-year growth of more than 15%. Within the enterprise customer segment, we saw the beginning of a recovery in IT hardware spend. But as we've discussed on past calls, we continued to see lengthened sales cycles. Enterprise Agreement renewal rates, taking into consideration the extended sales cycles, are within our historical range.

Unearned revenue was $12.3 billion, down sequentially as is typical, but better than last year's seasonal trend and roughly flat year-over-year. Our unearned revenue balance would have been up more than $100 million or 1% year-over-year when considering the recognition of undelivered elements, primarily associated with our prior Windows XP sales and the revenue deferrals from our Office 2010 Technology Guarantee program.

Multi-year annuity billings were up mid-single digits year-over-year. This quarter's growth from volume licensing is beginning to offset the unearned revenue declines we've seen over the past several quarters as we rebuild our unearned balance.

Now for the PC market. Windows 7 and the innovation from our OEM partners continued to fuel demand for PCs. We estimate the PC market grew roughly 25% year-over-year. Within that, we estimate consumer PCs grew almost 30%, while business PCs grew 14%. This quarter, netbooks represented approximately 10% of the total PC market.

Let's move on to this quarter's performance by business group, beginning with the Windows and Windows Live divisions, which had another exceptional quarter. We continued to see very strong consumer demand for Windows with consumer license growth of 35%. We also saw a return in demand for business PCs with licenses up more than 15%, leading us to believe the business PC refresh cycle has begun.

OEM units increased 30% year-over-year and outpaced PC shipments. OEM revenue increased 29% for the second quarter in a row and also outpaced the PC market. As with prior quarters, we have included a slide that bridges the difference between the PC market growth and OEM revenue growth. We experienced a nine percentage point headwind, primarily caused by emerging markets outpacing mature markets and consumer outpacing business.

Windows attach and inventory drove eight percentage point of OEM revenue growth. Conditions from the prior quarter remained largely unchanged with inventory exiting the quarter at normal levels. Windows 7 upsell and channel dynamics drove five percentage points of OEM revenue growth reflecting adoption of Windows 7 on netbooks and adoption of premium versions of Windows 7 on business and consumer PCs. The commercial retail and online portion of the Windows division grew 26%, primarily driven by retail sales of Windows 7.

Now let's move to server tools. We estimate server hardware shipments strengthened considerably with year-over-year growth in the high teens. The OEM and license-only revenue, which represents 30% of the business grew high-single digits, an improvement from prior quarters. Within that, Windows Server revenue grew mid-teens, while SQL Server and developer tools experienced slower growth in front of new product launches.

Annuity revenue, which is approximately 50% of the business, was roughly flat. Enterprise Services grew 5%. Our virtualization solutions continue to be strong. System Center server revenue grew over 20%, and Windows Server premium mix remains over 20% this year. Additionally, our share of new x86 virtualization licenses, which includes Hyper V and Virtual Server is now 25%, up three points year-over-year in the December quarter according to IDC.

We released to manufacturing Visual Studio 2010, announced a new partnership with Citrix that furthers our desktop virtualization offering, and yesterday, we released to manufacturing SQL Server 2008 R2. Clearly, there is very strong product pipeline in Server & Tools.

Now for the Online Services division. Online advertising revenue grew 19%, primarily driven by Search, which outperforms the market. We continue to be enthused with Bing's momentum, which includes 10 consecutive months of share gains in the U.S. We ended the quarter with U.S. query share of 11.7% according to comScore, 340 basis points higher than when we launched Bing last May. The Yahoo! Search partnership implementation is underway, and we are working towards U.S. completion by the end of this calendar year and global completion by early calendar year 2012.

Moving on to the Microsoft Business Division. In general, the conditions from last quarter remain unchanged. Revenue was down 6%, but when adjusted for the Office 2010 technology guarantee deferral of $305 million, revenue was up 1%. Within MBD business, revenue was down 1%. As we've discussed previously, the non-annuity component of business revenue has been pressured in advance of the next product cycle, while annuity revenue was roughly flat.

Consumer revenue, which includes the OEM and retail portions of this business, increased 11% when adjusting for the technology guarantee of strong PC shipments. Last Friday, we released to manufacturing Office 2010 and SharePoint 2010. We expect commercial availability in May, with general availability in June.

With respect to the $305 million Tech Guarantee deferral, it's important to note that due to varying international availability and fulfillment dates, there will be puts and takes to the unearned revenue balance throughout Q4. However, the Tech Guarantee deferral balance is expected to remain roughly unchanged at the end of Q4. We expect that substantially all of the Tech Guarantee unearned revenue balance will be recognized in the second quarter of fiscal year 2011.

During the quarter, we made terrific progress in our cloud offerings. Customers such as Starbucks, McDonald's, GlaxoSmithKline, Coca-Cola Enterprises, Aviva and Swedish Red Cross are all going to the cloud with Microsoft. We now have 40 million paid seats of our commercial online services. Clearly, companies are choosing Microsoft for their cloud productivity solutions, and we intend to build on this momentum.

Now let's move onto Entertainment and Devices division. Gaming revenue declined 4%, as we sold 1.5 million consoles, a unit decline of 12%, which was roughly in line with the overall market. While our software attach rate continued to lead industry at 8.8, first-party software revenue declined based on typical comparisons to the prior-year launch of Halo Wars. This was substantially offset by the continuing strong revenue and membership growth of Xbox Live. Non-gaming revenue was up 14% reflecting growth in the PC hardware market and increased Windows Embedded revenue. As Peter mentioned, we continued to have good momentum on the product side for Mobile. During the quarter, we announced Windows Phone 7, and last week we announced KIN, which will be available in the U.S. in May.

Now for the rest of the income statement. Cost of goods sold decreased to 2% to $2.8 billion, driven primarily by lower Xbox 360 volumes and console costs. These savings were partially offset by increased traffic acquisition and online costs. Operating expenses were $6.6 billion as we continued to manage our expenses and prioritize our investments. Headcount declined both year-over-year and sequentially.

G&A expenses grew due to contractual costs associated with our Yahoo! Search partnership and legal expenses. We repurchased $2 billion worth of shares and paid $1.1 billion of dividends.

So to wrap up, the Consumer segment continues to drive great results. In addition, we saw the beginning of the business PC refresh. This, combined with our strong product pipeline and our continued focus on execution and cost management, means we are well positioned for the future. With that, I'll hand it back to Peter who's going to discuss our business outlook.

Peter S. Klein
Former Chief Financial Officer

Thanks, Bill. Now I'll discuss our expectations for our fourth quarter and the next fiscal year. From a macro perspective, we expect the next quarter to be similar to the third quarter with continued strength in hardware shipments. We are encouraged by the recent uptick in business PC growth and expect that this business refresh cycle will continue over a couple of years.

Before I get into my commentary by division, remember that the June quarter is the close of our fiscal year. As such, it is historically a seasonal high for our enterprise sale, and we are entering it with a strong sales pipeline. While we've noted early signs of improvement, the business-spending environment and associated sales cycles remain challenging. We will be very focused on closing deals during the quarter, and we expect that unearned revenue will likely return to normal seasonal patterns.

Beginning with the Windows division. We expect revenue to grow slightly faster than the overall PC market in the fourth quarter. Attach, inventory and premium mix gains should more than offset macro trends, particularly that of emerging markets growing faster than mature markets.

Turning to the Microsoft Business Division. We are very excited about the launch of Office 2010 this June, as it will provide the best productivity experience across the PC, phone and browser. A combination of Office 2010, SharePoint 2010, Exchange 2010 and Office Communications Server will be the practical platform for IT, delivering anywhere access to your documents and unmatched collaboration.

For the fourth quarter, consumer and business non-annuity revenue, approximately 40% of the total, should track towards PC shipment growth, while we expect annuity revenue to be up low-single digits.

The Server & Tools business generally aligns to server hardware shipments and business IT spending. Similar to many observers, we expect server shipments to show healthy year-over-year growth. For the fourth quarter, we expect that non-annuity revenue should move generally in line with hardware shipments. Annuity revenue should growth mid-single digits, while enterprise services revenue should grow low-single digits.

For the Online Services division, the outlook for online advertising appears to be improving, and we expect the trends from the third quarter to continue. Excluding the impact of our legacy Access business, revenue should be in line with or better than the market for the fourth quarter.

In the Entertainment and Devices division, we maintain our view expressed last earnings call that full year revenue should be roughly flat relative to the prior year. This translates into a fairly robust growth rate for the fourth quarter, driven by the uplift from the strong PC market, increased gaming attach revenue and momentum in Windows Embedded.

Switching to costs. We continued to make good progress containing our cost of goods sold despite the upward pressure of increased traffic acquisition costs in our Search business and growth of our Online Services. As a result of our operational initiative, improved Xbox 360 console costs and a continuing favorable revenue mix, we now expect full year gross margin to expand 1% compared to the prior year.

With regard to operating expenses, we remain focused on diligently managing our cost structure and aligning resources to key priorities. For the full year, we are lowering our operating expense guidance, now expected to be between $26.1 billion and $26.3 billion.

We estimate that our capital spending for the year will be no more than $2 billion, and our effective tax rate should be approximately 25% for both the quarter and the year. We will continue to generate strong free cash flow and will return capital to shareholders through dividends and stock repurchases over the long run, though the amount of repurchases may vary from quarter-to-quarter.

Now I'd like to spend a few minutes looking ahead to fiscal year 2011, with more details to follow at our Financial Analyst Meeting in July. From a macro perspective, we expect the business refresh cycle, that I referenced earlier, will continue through fiscal year 2011. This, combined with strong momentum from Windows 7 and the launches of Office 2010, SharePoint 2010 and SQL Server 2008 R2, will be significant revenue drivers for our core businesses.

Switching to online. We expect the online advertising market to be better than fiscal year 2010. Our business should continue to grow faster than the market, excluding our legacy Access business, which will be less of a headwind, as it becomes a smaller portion of the mix. We expect our partnership with Yahoo! will begin to contribute to our revenue the second half of the fiscal year.

Lastly, the Entertainment and Devices division will be introducing an unprecedented wave of innovation in the first half of the year, including Natal and its launch title, as well as Halo Reach, Fable III and Windows Phone 7.

Now moving to cost of goods sold. It's important to consider the shift of revenue mix across software, services and hardware. While there are a number of factors to weigh for next year, the single largest variable driving cost of goods sold will be hardware demand in the Xbox business. Additionally, we will continue to pursue operational efficiency as we have throughout this year.

Switching to operating expenses. We are currently working through our budgeting process and maintain our outlook of $27.0 billion to $27.5 billion. All of this will allow us to continue to generate exceptional operating cash flow, which we will continue to return to shareholders through dividends and stock repurchases.

So in summary, we delivered very good financial results for the quarter with strong demand for Windows 7 driving revenue growth, and solid cost management enabling operating income and earnings per share to grow even faster. As we look forward, we are encouraged by improving market conditions taking shape as we continue to launch our strongest wave of products in the company's history. With that, I'll turn the call over to Bill and answer some of your questions.

William A. Koefoed
Former General Manager, Investor Relations
Thanks, Peter. We want to get to questions from as many of you as possible. So please stick to one question and avoid long or multi-part questions. Barb, can you please go ahead and repeat your instructions?

Question and Answer

Operator

[Operator Instructions] And first is Heather Bellini with ISI.

Heather Bellini

I was wondering if you could talk about your comment about a return to normal seasonality and unearned revenue. I guess what I'm wondering is, we had to the Tech Guarantee benefit Q3 deferred. So when we're looking, if normal seasonality were to happen in Q4, are we taking the Q3 ending balance and thinking about it that way? Or should we be thinking about adjustments for the Tech Guarantee?

William A. Koefoed
Former General Manager, Investor Relations

Yes, take it as it is.

Operator

Next is Walter Pritchard with Citigroup.

Walter H Pritchard
Citigroup Inc, Research Division

Could you talk about on the server side? It looks like non-annuity revenue grew a little bit slower than server units. And I guess you're seeing an uplift in version mix there, which should be helping the situation. Just curious to get some more detail on that as well is what you think we should see looking forward into June and beyond.

Peter S. Klein
Former Chief Financial Officer

Yes, you have to break it down into its components. There's actually two pieces of the Non-Annuity business or the Transactional business, the Windows Server piece and then the other piece of the business. The Windows Server non-annuity piece actually grew mid-teens. So track towards the hardware market. The other products, things like SQL Server and Visual Studio grew slower than that in anticipation of a product release [indiscernible]. So it tends to be less correlated, particularly in quarters where there is a significant growth year-over-year. So that was the issue there. In terms of looking forward, I think we gave the guidance on what we expect for the transactional business, particularly as we launch Visual Studio and SQL Server, tracking more towards the server hardware market.

Operator

And next is Adam Holt with Morgan Stanley.

Adam Holt

My question is about Office. As we near the release, I was hoping you could talk to us about how you're thinking about what the impact should be, what you think about with respect to the average selling price opportunity around Office. And in particular, also you mentioned transactional revenue for the next quarter. Should we assume the transactional revenue continues to accelerate as we get deeper into the Office cycle?

Peter S. Klein
Former Chief Financial Officer

Certainly, as we've said, we expect the largest part of the impact from the launch actually to happen in fiscal year '11. So typically what you see -- since we're launching it in the May/June time frame, typically what you see is several quarters after that, the impact of that. So you should see that in the first half of fiscal year '11. In terms of average selling prices, it's a little hard to talk about that now. So it's going to be a function of obviously mix. But I would just think about it the way the Office 2007 launch was. The one thing I would add to that, where you will see it is in the platform side of the business. So when you see the enterprise cow and how we monetize the enterprise versions of the productivity infrastructure for SharePoint on exchange is where you'll see opportunities for overall revenue growth from an ASP perspective for MBD all a lot [ph].

Operator

And the next question is from Sarah Friar with Goldman Sachs.

Sarah Friar
Goldman Sachs Group Inc., Research Division

Peter, on the cost side, I mean you highlighted this great expansion that you've seen as you're started to reap the benefits of those cost controls that you took about a year ago. As you look out to Q4, your guidance would suggest actually a sequential decline in the operating margin and yet you should be hitting pretty strong product cycles still on Windows and Office beginning to come into the mix. Why wouldn't we get more margin expansion in Q4? And then as you look at fiscal '11 costs, what are the puts and takes of why costs go up versus what other measures you can do to keep them down?

Peter S. Klein
Former Chief Financial Officer

Yes, the biggest thing driving the Q4 expenses is revenue-driven expenses that are associated with primarily our Enterprise Annuity business, which are going to be up a fair amount both sequentially and year-over-year. And so that's the biggest thing you'll see in Q4. The other thing you'll see in Q4 is, as I talked about, the wave of product launches that we've got coming, including Office 2010 and SQL Server. So just what's happening this quarter is sort of not unique, but those are the things that are really driving what you're seeing in Q4. And of course, those have been embedded in our guidance all year long and the fact of the matter is, we've been trying to manage our costs as softly as possible and bring it down whenever can, which we did this quarter. The dynamics in FY '11, as you know, there's a lot of puts and takes and we're always prioritizing and aligning our investments. But all up, you should think the things that are driving it are similar. There's some revenue driven as we continue to grow revenue. And there's also some sales and marketing associated with some key launches that we'll have particularly in the first half of the year related to the Consumer businesses like Natal and Phone. And I would say, keep in mind, that is a pretty measured increase of only 3% to 5% for the full year.

Operator

The next is Brent Thill with UBS.

Brent John Thill
UBS Investment Bank, Research Division

Peter, considering the strength of the product cycle and the uptick we're seeing in corporate spend, it's still surprising to hear about lengthening sales cycles and I think the unearned was below the Street estimates. What are customers citing the reasons why they're not pre-signing up? Are they just waiting for all these products to be launched before they're renewing? Just trying to get our hands around what you're hearing from the customer base.

Peter S. Klein
Former Chief Financial Officer

Yes, there's a couple of things. One, that is true, particularly when there's so many products that are launching. So there's a bunch of revenue that's going to come through on the non-annuity side that people are waiting for launches for. And I do think that hardware, if you think about sort of what's happened over the last year, the first thing that got hit and decreased earliest and fastest was hardware. And that's what's coming back first. And I think over time, as we've been saying, and I think most other people are saying, over the course of calendar 2010 and certainly into 2011, you'll start to see the growth in the overall IT spend. For us in particular, from a sales-cycle perspective, Q4 is just seasonally our biggest quarter. And so when you combine sort of the sales cycle and the product cycle, kind of converging on Q4 and beyond, as well as sort of where we are I think in the stage of what businesses are doing in terms of first refreshing their hardware. That kind of converges over the next two or three quarters probably.

Operator

The next is John Difucci with JPMorgan.

John Difucci

I have a question on the Windows business. It looks like on Slide 11, you got about 8% benefit from the Windows attach and inventory, and I'm assuming that's from less piracy and then inventory build in the channel. You also got about I think it was 10% last quarter. Now this is the second quarter into the new launch of Windows 7. I'm just curious, I mean how sustainable is that? I would assume that piracy is going to be less during a launch, even pirates have to buy legitimate copies at least for a while. And then also the inventory build in the PC OEM channel, I assume that would start to wane. If that happens, would you expect that benefit to start to wane here? And if it does, should we be thinking that the segment mix line up above that with a corporate refresh cycle that sounds like it's going to happen in the second half, you'd start to see less of a negative hit in that line? Or how should we be thinking about this?

Peter S. Klein
Former Chief Financial Officer

You're thinking about all of the right components of it. And certainly, attach and piracy are always going to sort of cycle up and down, depending on where you are. We're working through this year sort of a work down of the inventory from last year, and we're still working that. We're at sort of normal inventory levels. That's been a good year-over-year thing for us. And attach, correct, part of that is piracy related to the launch of Windows 7. All of those things -- so we've given you specific color for Q4, what to expect for the OEM business relative to the PC business. The other thing is just there's just -- overall, I think we've talked about it on prior calls, an overall secular change, which is the multinational OEMs are becoming a more significant portion of the total PC market. And that does good things for our attach relative to the prior mix of our revenue from different PC manufacturers.

John Difucci

Does that mean that you're seeing a little less piracy, and you expect to see that in some international markets?

Peter S. Klein
Former Chief Financial Officer

We are seeing that globally.

Operator

And next is Phil Winslow with Credit Suisse.

Phillip Winslow

Peter, you guys have talked about the last few quarters seeing a pretty significant uplift in Windows revenue from the retail channel, essentially consumers going out to the store to upgrade to Windows 7. Would you compare what you believe is sort of the corporate upgrade opportunity to be to what you've seen over the past couple of quarters to consumer? Which one is the larger of the two? And when would you expect to see the corporate side begin?

Peter S. Klein
Former Chief Financial Officer

Well, just in sheer numbers in terms of PC shipments, the consumer is a lot bigger than the business segment. Now the impact you get from the business segment, obviously is some ASP uplift. And you get the corporate refresh in two ways. You can get sort of buying licensing upgrades or you can get OEM when they buy the PCs, which is the largest piece of the revenue. And that's what we started to see happen and you saw some of that impact this quarter with business PC shipments up 14%. That's the sort of the shape of the opportunity going forward as that continues. And you can see that has an uplift on our OEM revenue relative to the overall PC market.

Operator

Next is Kash Rangan with Merrill Lynch.

Kasthuri Gopalan Rangan
BofA Merrill Lynch, Research Division

I just wanted you to talk a little bit more about the deferred revenue trajectory going into Q4. It looks like this year, compared to the start of the year, deferred revenue, long term to short terms is down a lot more than what it has been the past few fiscal years. So that would argue for a bigger than seasonal catch-up in Q4. So maybe you could talk about what is embedded in your, expectations. And what do you expect on the ELA side? And also I think you talked about booked but not billed portion of your bookings. So if you can just give us some color and how that's shaping up, that'd be great.

Peter S. Klein
Former Chief Financial Officer

Yes, just in terms of the numbers, I mean sort of the guidance that we said, we're looking for sequential increase in Q4 in a similar range that you've seen over the last three, four, five years, sequential growth. We're starting to rebuild the balance. You started to see that happen a little bit in Q3 with our multi-year annuity billing having positive growth. But I think that's sort of the essence of what we're expecting and what we're guiding to. What was your second question?

Kasthuri Gopalan Rangan
BofA Merrill Lynch, Research Division

The booked but not build portion on the -- you would talk about that in your presentations at prior times but just noted that we've not talking about that in recent times. Just wondering if you have an update there.

Peter S. Klein
Former Chief Financial Officer

I think that's actually a good thing that we'll talk about in July of the Q4 call just because it's such a bigger issue. The seasonality, in terms of our bookings in Q4, is so much more material than a Q3. I think that's when we'll talk about that.

Operator

Next is Brad Reback with Oppenheimer.

Brad Robert Reback
Oppenheimer & Co. Inc., Research Division

So Peter, just switching gears back to Server & Tools. As I look back at my notes from last quarter, I think you talked about the Annuity business being up mid-single digits, and I think it came in flat this quarter. Given my understanding that most of that's coming off the balance sheet, what would've caused that delta in that three-month period?

Peter S. Klein
Former Chief Financial Officer

The comment was for H2 not for Q3, up mid-single digits. And so if you look at our guidance again with the seasonality of our sales cycle, most of that comes from Q4, which was in our guidance that we gave today.

Operator

And next is Katherine Egbert with Jefferies & Co.

Katherine R. Egbert
Jefferies LLC, Research Division

Speaking of guidance, I mean there's a lot of moving parts right now, multiple product cycles, revenue deferrals and economic recovery. What are you looking for to become comfortable with providing more specific guidance? What are the triggers?

Peter S. Klein
Former Chief Financial Officer

Well, I'm not sure there are specific triggers. I actually [indiscernible] a driver [indiscernible] framework and having a really good qualitative discussion about all the factors that drive it is actually a great way to talk about the outlook and the environment of what we're seeing for our businesses. And so I think, there's no specific triggers that are going to change that. I think that the dialogue that we're having around these drivers and the framework is great.

Operator

And next is Brendan Barnicle with Pacific Crest Securities.

Brendan Barnicle

Peter, you talked about next year gross margins, obviously having an impact from the hardware cycle. And in the past, at times you've talked about as you change to more cloud computing that's taking a hit as well. Can you give us any range? I mean could we see as much as two percentage points in change there next year?

Peter S. Klein
Former Chief Financial Officer

No, we're not giving a range of that now. We'll definitely talk about that at a Financial Analyst Meeting in July.

Operator

Next is Rob Breza with RBC Capital Markets.

Robert Paul Breza
RBC Capital Markets, LLC, Research Division

Peter, just maybe as a follow-up to Brendon's question. You called in your prepared remarks the 40 million paid seats for the cloud initiative. I was wondering if you can talk about where you're seeing the strength there and how we might expect that to be 12 months from now?

Peter S. Klein
Former Chief Financial Officer

Yes, we're seeing strength across a variety of areas. You heard Bill talk about all the great customers we have, our commercial Online Services like SharePoint Online and Exchange Online. That's obviously a big growth there for us. The 40 million comes from things like Live Meeting and Exchange Hosted Services and CRM online. And so what you're seeing is really part of our strategy, which is sort of the broadest array of commercial services for businesses of all sizes. Some of these are really aimed more at mid-market customers, some are more at big enterprise customers, and we're getting growth from both. And then the last thing that we sort of touched on but didn't talk about in great detail was Azure, which is now available in 41 countries and what that will do really over the next couple of years.

Operator

The last question comes from Tim Klasell with Thomas Weisel Partners.

Timothy Elmer Klasell
Thomas Weisel Partners Equity Research

A question about the Windows 7 upgrade cycle. It appears to us that a lot of customers are going to attach a Windows 7 upgrade with maybe a Server 2008 R2 upgrade. Are you sensing that? And could that maybe delay the Windows 7 upgrade cycle a little bit more than we normally would but have a positive impact of pulling along some server sales as well?

Peter S. Klein
Former Chief Financial Officer

We really haven't seen that at all. As a matter of fact, when we talked to our Enterprise customers, there's a high degree of intent to deploy Windows 7 as soon as possible. There's a high percentage of our customers are already either in pilot or prelaunch mode for deploying Windows 7. We haven't seen that as a phenomenon at all, people waiting for Window 7. In fact, we see the opposite, that people are deploying it rather quickly.

William A. Koefoed
Former General Manager, Investor Relations

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 Relations Web site at microsoft.com/msft. Please keep in mind that we will be at a number of conferences in the next couple months. We'll be at the JPMorgan conference in May. The Bank of America-Merrill Lynch conference, the Cowen conference, the RBC and UBS conferences in June. In addition, we will be previewing Natal at E3 in L.A. in June. Please contact Microsoft Investor Relations if you need additional details. We hope to see there. Thanks again for joining us, and have a great day.

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