Presentation

Operator

Welcome to the Microsoft fiscal year 2009 first quarter earnings call. At this time, all participants are in a listen-only mode. (Operator Instructions). Today's conference is being recorded. If you have any objections, you may disconnect at this time.

I will now hand off the call to Microsoft's Chief Financial Officer, Chris Liddell. Mr. Liddell, please go ahead.

Chris Liddell

Well, thank you and good afternoon, everyone and thanks for joining us today. I want to start the call by introducing Bill Koefoed, as the new General Manager Investor Relations. Bill was previously the General Manager for Finance our IT organizations Supporting our CIO here internally at Microsoft. I'm just delighted to have him on the team and I'll now turn the call over to him for our normal introduction.

Bill Koefoed

Thank you for the welcome Chris. I'm excited to have this role and I'm looking forward to meeting with our analysts and investors in the coming weeks and months. We're also joined today on this call by Frank Brod, Corporate Vice President and Chief Accounting Officer, and John (inaudible) Deputy General Counsel.

The format for today's call will be relatively unchanged from recent earnings calls. Chris will summarize some of the key takeaways for the quarter. I'll then provide details around our first quarter results and then hand it back to Chris for a more detailed discussion of our guidance for the second quarter and for the remainder of fiscal year 2009. After that, we'll take your questions.

Please be aware that we filed our Form 10-Q today in conjunction with our Earnings Release. Therefore, you have available the Earnings Release, MD&A, financial statements and footnotes.

We have also posted our quarterly financial summary slide deck, which is intended to follow the flow of our prepared remarks in order to assist you. The slide deck offers highlights from the quarter, outlines our guidance, and provides a reconciliation of differences between GAAP and non-GAAP financial measures that we will talk about today. You can find the Earnings Release, the Form 10-Q and a quarterly financial summary slide deck on the Investor Relations website at www.microsoft.com/MSFT.

Today's call will be recorded. Please be aware that if you decide to ask a question it will be included in both our live transmission as well as any future use of the recording. As always shareholders and analysts can listen to a live webcast of today's call at the Microsoft Investor Relations website. A replay of the call will be available at the same site through the close of business on October 23, 2009.

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

And now, I'll return the call over to Chris.

Chris Liddell

Thanks, Bill. I'll begin with highlights from our first quarter performance and outlook for the rest of the fiscal 2009. We delivered strong first quarter financial results with revenue, operating income and earnings per share all meeting or exceeding the high end of our guidance despite what was obviously a very challenging environment.

Let me just mention a few key items of our first quarter. Revenue from Microsoft Business Division and Server and Tools segments grew a combined $1.3 billion, or 19%, driven by healthy demand from enterprise customers. Client revenue grew 2% with growth impacted by the expected reduction of Q4 channel inventory and a shift of the sales mix to lower price netbooks and the units sold in emerging markets.

Consumer demand for the Xbox 360 resulted in the outperformance by Entertainment and Devices division. Our Online Services Business grew revenue of very good 15% in a challenging online advertising environment. We refreshed our product lineup with several important releases and we also increased the dividend by 18% and announced a new $40 billion share repurchase authorization.

While we're pleased with the overall results, the macroeconomic environment clearly weakened throughout the quarter. Like many other companies we experienced deterioration in the spending environment over the last few weeks of the quarter, which has continued into October.

Accordingly, we're updating our business outlook to reflect the increased risks and the likelihood of continued economic slowdown. In July we indicated that our guidance was based on an expectation that economic conditions would improve in the second half of our fiscal year and this clearly now appears unlikely to occur.

We're not economic forecasters, and there is a high degree of uncertainty in outlook based on the state of the economy. As a result we've adjusted our guidance approach as follows. At the top end we're assuming a mild recession, and a relatively modest growth rate for all IT-based products. While at the bottom end we're assuming a deeper recession in the economy an end-season lower growth for IT.

Clearly there is a possibility that the economy recovers faster than we predict or that it deteriorates more severely. In all scenarios we're focused on maintaining the positive delta in growth rate between our revenue and the overall IT environment.

We feel extremely good about our relative competitive position, our ability to continue growing faster than general IT spending and our ability to deliver value to our customers in this environment. We believe our exceptionally strong cash flow, high unearned revenue and $25 billion in cash and investments on hand will allow us to weather any economic contraction in relatively better terms than most.

It's also clearly important to keep perspective. We still foresee an increase in demand for our products and the potential to drive revenue and earnings per share growth from high single to low double-digits for this financial year, which will be an exceptional performance in this environment.

With those high-level themes I'm going to turn the call over to Bill now for more details on how we closed out the first quarter.

Bill Koefoed

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

In the first quarter we met or exceeded our high end guidance for revenue, operating income, and earnings per share. Revenue grew over 9% to $15.1 billion, approximately $150 million above our high end guidance.

Our annuity sales mix which is approximately 25% of our billed revenue grew over three percentage points year-over-year. Enterprise agreement renewal rates were in line with historical trends. The remainder of our product to the (inaudible) of quarter was approximately 35% from OEMs, about 20% from license only sales and the balance from our other businesses.

Our unearned revenue grew over 16% to $13.5 billion, but was down sequentially from the prior quarter. The sequential decline was in line with our guidance and followed normal seasonal patterns. Our contracted not billed balance increased both sequentially and year-over-year to over $13 billion.

When taken together with reported revenue, total bookings for the company increased 6% this quarter on top of our over 30% total bookings growth reported in Q1 FY '08. Overall, changes in foreign exchange rates added about three percentage points to our revenue growth.

Now I will provide revenue highlights by business segment starting with Windows clients. The Client revenue grew 2% to $4.2 billion, missing guidance by four percentage points. I'll review the main drivers behind Client revenues that contributed to this performance beginning with PC unit growth.

We estimate that the PC unit growth rate for the quarter was between 10% and 12%. While this tracks to the overall forecast we provided in July, the underlying mix was different than we expected entering the quarter. Specifically, growth of traditional PC units was several points lower than we expected. This was offset by growth in the new low end, netbook segment.

From a geographic perspective, we estimate mature market traditional PC growth of flat to low single-digits with netbooks adding about eight points to the growth. In emerging markets we continued to see strong double-digit growth across all segments.

During the quarter, our Windows OEM license units increased by 8%, a few points lower than the overall hardware market. The shortfall between OEM unit growth and hardware growth was primarily driven by inventory reductions in the OEM channel. As we mentioned in the last earnings call, we exited the fourth quarter with OEM channel inventory above historic norms, which were worked down during the quarter.

Despite healthy unit growth, OEM revenue declined 1% year-over-year as the average selling price declined. This was primarily the result of two factors. The mix shift in netbooks and continued mix shift to emerging markets, both of which have lower average selling prices than our historical average selling price.

At this stage it is too early to determine the extent to which the new netbooks segment is cannibalizing the traditional consumer PC market sales or simply capturing a new market opportunity, so we believe that there are likely aspects of both.

That said, customers are increasingly opting for the value, diversity and choice that Microsoft Windows provides. We have increased attach rates on these form factors to mirror the traditional PC market, so we are well positioned to participate in this segment.

The remainder of Client revenue comes from commercial and retail licensing. This portion of the business grew over 20% driven by continued strength in client annuity licensing as business customers recognize the value of our Windows Vista enterprise offering, including those to help them reduce costs by more efficiently managing their desktop infrastructure.

Our Server and Tools revenue grew 17% to $3.4 billion, marking the business 25th consecutive quarter of double-digit growth. Annuity licensing grew faster than non-annuity licensing driving Server and Tools unearned revenue up over 28% from the prior year. This reflects continued customer commitment to our long-term product road map and underscores the increasingly critical role our server products perform in transforming customers IT departments into strategic assets.

The releases during the quarter of Sequel Server 2008 and Microsoft Hyper-V Server 2008 demonstrated our ongoing commitment to help customers create more cost effective and flexible data centers. Meanwhile, demand for our consulting and support services to deploy Microsoft technology remained strong, driving revenue growth of 19%.

The Online service business grew revenue 15% to $770 million. Online advertising revenue also grew 15% with search revenue growing faster than display revenue. We continue to see healthy growth in our traffic to page views and query searches both up on sequential and year-over-year basis.

During the quarter we partnered with NBC to make the 2008 Beijing Olympics the largest ever media event on the web, showcasing Silverlight as it served up 70 million video streams and 600 million minutes of video content on NBColympics.com. As new online advertising model strived to increasingly differentiate based on user experience. Microsoft technologies like Silverlight become even more pivotal to our partners success.

Microsoft Business Division revenue was up 20% to $4.9 billion exceeding our high end guidance by four percentage points. Business revenue grew 16% driven by strong sales of enterprise agreements and Client access license suites. Microsoft Office, SharePoint, Dynamics and Unified Communications all continued strong sales momentum.

Consumer revenue grew 36% driven by higher than expected sales into the retail and OEM channels resulting from well received promotional pricing programs for the 2007 Microsoft Office system.

Entertainment and Devices division revenue declined 6% to $1.8 billion, but exceeded our high end guidance. The anticipated revenue decline due the comparison to the quarter a year ago that included the launch of Halo 3 was milder than expected due to stronger Xbox 360 console sales into the channel.

We sold 2.2 million Xbox 360 consoles representing over 20% growth, as retailers stocked inventories throughout the holiday season. Based on US MPD numbers released last week, Xbox 360 outsold PS3 by over 100,000 consoles during the quarter while achieving an industry leading game attach rate of 8.1.

Also, earlier this month at the Tokyo game show we announced that Xbox Live has over 14 million members, roughly doubling in membership for each of the last two years. In spite of console price cuts taken in the quarter and the absence of Halo 3, the Entertainment and Devices Division increased operating income by 7%, expanding its operating margins by over a percentage point.

Now for the rest of the income statement. Cost of goods sold was $2.8 billion and operating expenses were $6.2 billion. Cost of goods sold as a percentage of revenue declined half a percentage point to 18.9%. This gross margin expansion was driven by lower console manufacturing, warranty and component costs, as well as a mix shift towards the lower cost Xbox 360 arcade console.

Operating income was $6 billion, up 3% from the year-ago period. Other income and expenses was an $8 million loss for the quarter as dividend was offset by asset revaluations. It should be noted that we continue to be pleased by our treasury team's performance in a very challenging capital market environment.

Our effective tax rate for the quarter was 27%, a percentage point lower than expected, driven by an earnings mix increase in lower tax jurisdictions. During the quarter, we repurchased 223 million shares or almost $6 billion of company stock and paid out a billion dollars in dividends to shareholders.

Of the $6 billion in share buybacks, approximately $3.3 billion was made under the new repurchase plan that we announced in September. Diluted shares outstanding were 9.2 billion, down 3.5% from the prior year as a result of the share repurchases.

Earnings per share were $0.48, at the high end of our guidance, representing growth of 7%. So, in summary, we had a good quarter with revenue above expectations, operating income in line with guidance, and earnings per share at the high end of guidance.

With that, let me turn it back to Chris who will provide you with our second quarter and full year guidance.

Chris Liddell

I'm going to spend my remaining time on the call talking about what we're seeing in the market and providing additional details on the second quarter and the full year. Our guidance now assumes an outcome between a mild and a deeper recessionary environment. It's important that we give you some background therefore to what we're seeing in the marketplace.

Over the first two months of this quarter we experienced much the same economic conditions as we saw during the second half of fiscal 2008, with demand actually a little better than our historic seasonality.

However, in September, as the credit crisis unfolded, many partners and customers were faced with market uncertainty and credit restrictions which impacted the rate at which they purchased software.

We've seen this behavior continue into October and while we're optimistic about the actions the governments have taken to unfreeze the financial markets there will be some spillover into the real economy. However, even in this environment of softening demand, recent third party research continues to call for growth in overall technology spending, with the enterprise software portion of the spending expected to be up in the high single-digit range.

Our approach will be to tailor our business to whatever the economy brings, focusing on outperforming our competitors and in doing so, to outgrow the overall IT market. We will be agile, not only to customer demands in the changing environment but also to our own patterns of spending.

Given that, we have three main areas of focus. First, our philosophy of providing high value products at low total ownership costs as a competitive advantage in these times. Most IT leaders today are looking at their budgets and determining how to do more while spending less. We expect Microsoft's low cost, standardized platforms and solutions will be particularly strong in the time when enterprises are unwilling to embark on complex customized IT solutions.

We believe we have some compelling products that will reduce our customers' costs. We expect these to be particularly competitive in this environment. For example, virtualization with Windows Server Hyper-V and System [sender] Management Tools, which allow customers to reduce hardware costs, increase server utilization rates and simplify system maintenance while lowering power and facility costs.

We offer the lowest PCO in the industry with our solution about one-third the cost of our largest competitor. This value proposition is already successful as evidenced in IDC's recent report which shows that in the second quarter Microsoft's share of the X86 server virtualization market climbed to nearly 25%.

Additionally, with our help customers can experience general cost savings and improved efficiency across their organization. For example using unified communication software and services including Office Live Meeting, which help us improve collaboration and increase productivity while reducing travel and telephonic expenses.

SharePoint improves the coordination across organizations, enables people to find and act on information anywhere within and across organizations and decreases IT support costs by empowering end users.

The second area we're focused on in the current economic environment is internal operational efficiency and expense management. In the near term, we're reassessing our business plan and pulling back spending in lower priority areas. As a result, better than our guidance is a $400 million to $500 million decrease in operating expenses.

This saving can be categorized as follows. Lower headcount related costs as we review the hiring plans, making adjustments to our headcount growth. Lower marketing expenses as we're adjusting our spending plans to correspond to our updated economic outlook. Lower CapEx spend on data centers and other general savings including travel expenses and vendor services.

These savings will progressively layer in, translating to economic savings particularly later this year and carrying forward into the next fiscal year as well. We are also putting in place other initiatives on a contingency basis that we can either dial up or down as we see economic changes unfold. If macroeconomic conditions worsen then we will endeavor to reduce our operating expenses accordingly.

Third, we'll focus our investment dollars in key strategic opportunities. Continue to manage our business for the long-term in anticipation of the eventual economic recovery. While our short-term results will be impacted by the current economic environment, our long-term technology outlook remains strong. Long-term trends, which power our business including the development of IT infrastructure and growing IT penetration in places like China and even other emerging markets remains intact.

So with those comments, let's move to guidance. Looking to the second quarter we expect revenue of 17.3 to $17.8 billion, which represents a year-over-year increase of 6% to 9%. For the full year, we're providing updated guidance for revenue of $64.9 million to $66.4 billion, growing 7% to 10%.

Let me provide you with some of our revenue guidance by segments and some additional details of and the assumptions underlying it. Beginning with our Client division, we see second quarter growth of 7 to 10%, and full year growth of 2% to 6%. Underlying this guidance we see significant variability in the potential PC hardware demand. As a result, we made some adjustments to our forecast of PC units and now expect PC unit growth of 10% to 12% for the second quarter and 8% to 12% for the overall fiscal year.

You can see that we've widened our forecast range in the second half of our fiscal year as variability in the market demand clearly becomes more pronounced. The forecast also reflects continuation of the trends we saw in the first quarter, and assumes the following. Traditional mature market PC units will grow in the low single-digits, but with high potential variability. Emerging markets units will continue to grow mid to high teens. Sales in Xbox led about five percentage points of growth to the overall PC market.

Moving on to our Server and Tools segment, we're now foreseeing revenue growth of 16% to 17% for the second quarter and 15% to 17% for the year. Despite a more cautious IT spending outlook, and in particular lower forecast for non-annuity license sales to small and medium businesses, we continue to expect revenue to grow strong double-digits across our Server platform products and services, reflection of the strength of the product portfolio and its relative value to customers.

Microsoft Business Division revenues should be up 7% to 8% in the second quarter and 12% to 13% for the year. We expect to see continued healthy consumer and enterprise demand for our Office, SharePoint, Dynamics and Unified Communications offerings.

We forecast revenue in the Online Services businesses to increase 6% to 10% in Q2 and 10% to 13% for the year. This includes online advertising growth of about 15% for the year. Still healthy in a more difficult advertising spending environment we expect.

Our display advertising business is probably the most economically sensitive of our revenue stream and therefore has the highest potential to either under or outperform depending on the state of the economy.

The Entertainment Devices division we're forecasting revenue to be down 5% to up 1% for Q2 and down 3% or flat for the full year. Revenue growth is impacted by our recent Xbox 360 pricing cuts, buts offset by increases in console volumes and lower costs. As I outlined in July, we still expect the division to continue its profitability throughout this year.

Taken together, we still expect to grow revenue faster than market. For example we're forecasting MBD and Server and Tools to grow revenue a combined 14% to 15%, about six points above Gartner's recent forecast for overall IT software spending of around 9%.

As a result of the changes to our revenue and operating expense forecast, the operating income for the second quarter is expected to be between $6.1 billion and $6.4 billion, and for the year we expect operating income to be between $24.4 billion and $25.5 billion. For the second quarter, we expect EPS, earnings per share of $0.51 to $0.53 and for the fiscal year we have updated our EPS guidance to be between $2 to $2.10, still achieving double-digit growth of 12% at the top end. These earnings assume effective tax rate of 26.5%, a point and-a-half lower than we expected in July.

From a balance sheet perspective, we expect total unearned revenue to finish fiscal 2009 up 2% to 5% and when talking sequential changes on unearned revenue Q1 to Q2 we expect the balance to be down sequentially. Contracted not billed should also finish 2009 up from current levels.

I'm also pleased with our continued progress on capital structure and dividend policy. During the quarter as you've seen, the Board authorized $40 billion share repurchase program. We issued debt in the form of commercial paper for the first time and we've been issuing that at an interest cost of less than 1% and increased our dividend by 18%.

Given the uncertainty surrounding the current environment, it's important that you clearly consider some of the risks of this forecast, which includes the normal competitive legal, mix and execution risks, however in addition there is also a high degree of uncertainty as to the path and economic demand and that's reflected in a somewhat wider guidance range.

So, before closing and taking your questions, I'd like to offer the following long-term perspectives. We cannot control the economy, but we can control our relative performance versus the economy and versus overall IT spend. We continue to forecast outgrowing the market regardless of the economic conditions.

On the spending front, we're carefully examining all of our businesses for opportunities to manage expenses and have already implemented some initiatives as I detailed earlier. We will adapt our cost base to the evolving economy while simultaneously making appropriate investments to position ourselves for continued long-term success when the economy recovers.

On balance, I am happy that we're managing the company with the right balance of short-term earnings performance and driving long-term shareholder value. So with those comments I'll hand the call over to Bill so we can get started taking some of your questions. Thanks.

Bill Koefoed
Thanks, Chris. Let's now proceed to questions. We want to accommodate questions from as many people as possible. So please avoid multi-part questions and limit yourself to just one question. Operator, will you please repeat your instructions?

Question and Answer

Operator

Okay, thank you we will now begin the question-and-answer session. (Operator Instructions). Our first question comes from Heather Bellini with UBS.

Heather Bellini
UBS

Great, thank you. Good afternoon Chris and Kevin. I had two quick questions for you, Chris. What is your assumptions for premium mix in the Client business for the December quarter and for fiscal year '09. That's been moving around a lot and obviously being impacted by the netbook trend. And then the other question would be how should we expect Client margins to be impacted by the trend going forward? Thank you.

Chris Liddell

On the premium mix, it's in the mid-70s, Heather and for Q2 and for the rest of the year we expect that to be about the same. So somewhere in the 70% to 80% region, probably on balance, in the low 70s to mid-70s. That premium mix, based in the netbook sales as well. So that has both low end Vista and netbook sales in it.

In terms of margins, it's a difficult one to answer because you've got the weighted average of lots of growth factors in there. Clearly, the realization that we get from netbooks are lower than what we traditionally get from the consumer segment. And to the extent that they are relatively high growth and it does impact our overall revenue per license.

But to the extent that it is growth that we wouldn't otherwise have had and that's the phenomenon that I don't think any of us really know at this stage, how much of it is cannibalization of higher revenue per licenses and how much of it just simply new sales, then it's incremental sales, even though it drags down the average.

So, clearly some of it is partially cannibalization, some of it is a new phenomenon. If you look at the price points of the some of the netbooks they are $300 to $400, clearly that is attractive for a lot of people in terms of adding a third or fourth PC to their homes. So it's not just transparents of higher end PCs as well. So it will affect the margins but some of that will be incremental growth that we wouldn't otherwise have had.

Heather Bellini
UBS

So will we start thinking of this business like we do your overall operating profit as growth in operating income and Client are supposed to focusing on the absolute margin percentage?

Chris Liddell

Yeah, I think that's a good way of thinking about it, and what we really have now is quite different segments inside the PC market. It's becoming more interesting in that sense but you have quite different dynamics in the business market, the consumer, non-netbooks market, the consumer netbooks market and the emerging country version of all of those as well. Quite different growth rates, quite different realizations and quite different dynamics driving that. So it becomes, if you like more complicated from a forecasting point of view but a more interesting marketplace.

Heather Bellini
UBS

Okay, thank you very much.

Chris Liddell

Thanks.

Operator

Our next question comes from Brent Thill with Citi.

Brent Thill
Citigroup

Thanks. Chris, just on the operating margin side, can you just walk through some of the metrics you're putting in or procedures you're putting in to control the costs. I think you mentioned CapEx and headcount. Are you still on track to do $4 billion on CapEx this year and I guesses just from a headcount perspective I think you ended last year at 91,000 employees, up 15%. Do you expect to freeze or significantly slow that number.

Chris Liddell

On the CapEx side I would expect us to spend upwards of $300 million less than what we were anticipating, so we were talking about 4 before [237] and probably a better number at this stage. That will all be in the data sense side. We will probably also slow our growth in some of the facilities that we have the people just by virtue of not having as many people as were expected as well. But that's likely to be more of an FY '10 phenomenon.

In terms of, sorry what was the second part of your question.

Brent Thill
Citigroup

Just as it relates to headcount you ended the year at 91,000 heads, up 15%. Do you expect to heir or slow that pace?

Chris Liddell

I don't see any scenario where we'll grow by that much this year, by 15%. So it would certainly be less than that and it will be less than what we expect them to grow in the year coming into the year. So what we've done is, since we have gone right across the company, every division and looked at areas where we can if you like to have lower priorities spending taken out.

So some of that is headcount growth that we might have otherwise had, some of its in marketing spend in areas where there's not the demand that we're expecting. Some of it's other, so it's non-people related costs, window spend, travel and things like that. So we're really cutting back on all of the areas which I consider as to I'll call it non-priority or low priority.

In terms of where we might go further, you know we'll keep looking at those areas as the year develops. From my point of view, in terms of the margin structure, for our core business as a result of the cuts that we will see and what we would have otherwise spend, the margins for our core business overall will stay broadly flat year-on-year. Entertainment and devices always teach you to have their own dynamic, but all of those divisions will spend little less than what they would have otherwise.

Brent Thill
Citigroup

Thanks, Chris.

Operator

And our next question comes from Charlie DiBona with Sanford Bernstein.

Charlie DiBona
Sanford Bernstein

Hi, Chris. I was wondering if we could turn maybe to unearneds here. They were down sequentially sort of by an unusually large amount from Q1 to Q4 and you're guiding to down sequentially next quarter which is different than your historic seasonality and even to regarding even to sort of a weak increase year-over-year by the end of the year. I understand there's an issue around undelivered elements also be sort of systemically coming down here. But even the VLA unearneds are down so its an unusual amount.

How should we interpret this? What should we infer about your ability to sort of replenish those balances in this environment? And second as you are pulling those revenues down they should be extremely high margin. Maybe you can give us some light color on sort of what that means for controlling for that what apples-to-apples margins really look like?

Chris Liddell

Good question, Charlie. In terms of quarter one relative to quarter four it was down, that's certainly true, but obviously quarter four is a big billings quarter for us. So you would expect it to be down year-on-year, it's down about the same as what we would normally expect.

During the course of the year in unearneds you've also got the Vista impact and undelivered elements. So you need to net that out to look at the unearned part that is not sister associated with that. So there is a couple of factors there that you need to build in. In terms of how we think about it going forward, and better than our guidance is clearly some sense that we will have a more difficult economic environment and that's going to have to feed into the billings overall.

In the first quarter, interestingly, we continued our EA renewal rate of sort of traditional two-thirds or thereabouts. So the first quarter we saw very good. But there's just going to be pressure. All of our customers are clearly going to be looking for opportunities to cut costs and so also we're just being more cautious in terms of the rate at which we might have renewals or the rate at which we may sell to our new customers.

Now all of that sales force, I sat in for half a day with our sales force yesterday going through area-by-area and segment-by-segment, all of them are committed to their budgets but you have to be realistic and say in this environment, we may not get the growth that we would have liked to have seen otherwise.

So I'm just generally more cautious and that will feed through to our unearned over time. One of the benefits we have is in the areas like MBD and Server and Tools, about 40% of our revenue this year is from unearned coming through from last year.

So it's going to be an FY '10 impact as much as an FY '09 impact that I'm concerned about Charlie, and as we get through the second quarter and get much more visibility into that I think we'll have to cut our costs for FY '10 depending on how we see the billings approach in the December period, which is much more significant and then also going into potentially into the June resignings as well.

So it's an emerging issue. I don't see it that significant just at the moment. It's going to depend enormously on the environment that develops over the next three to six months and that's going to be an FY '10 sort of issue and upside, depending on where we get to.

Charlie DiBona
Sanford Bernstein

And on the margin side, though, you're pulling this high revenue, these billings you're pulling them down a little faster than you did last year. Is that going to give you some cushion on the margin side?

Chris Liddell

I don't see if cushions the margin side. It will help give us an underpinning on the revenue growth and to the extent that that revenue is effectively 100% margin that's already paid. So, as it comes through, it's just revenue that's there. It will help us with, if you like, the underwriting the revenue. I don't see it as high margin, per se.

Charlie DiBona

Sanford Bernstein

Thanks, Charlie.

Bill Koefoed

Let's move to the next question, please. Operator?

Operator

Yes. And the next question comes from Sarah Friar from Goldman Sachs.

Sarah Friar
Goldman Sachs

Good afternoon, everyone. Two quick ones. Chris, just on the margin, back to margins, I know you don't like to guide to a margin, but I think you made the comment that margin is broadly flat year-over-year, given the cost focus that you have.

Why shouldn't Microsoft be thinking about margin expansion, just given your size, the fact we're going into a downturn, it really gives companies an ability to go back in and cut not just kind of semi discretionary, but really kind of cut back and think what a new operating model could look like with a slower top-line growth for a couple of years.

And then just if I could, a follow-up on the EPS side, what buyback assumptions if any have you got within your EPS guidance as you think about the next couple of quarters. I think normally you say you don't want to give it, but it seems like there's not a lot in there just based on how the guidance stacks up.

Chris Liddell

Yes. The way that we spend and the way that our revenue is recognized, really are two quite separate trends and we have talked about this before. So, when I think about how much we should save, I think about it in the context of what are the opportunities to save against the expense base that we have. Not as against the revenue base that we have.

So, the revenue are adjusted both in terms of the economic conditions that we think for this year. The expense base we've adjusted to try and retain margins as much as possible, but more against the opportunities set of where we can take expense out.

In terms of our ability to expand margins in an environment like this, again, I would say that's an FY '10 and further. That's the sort of discussions that we have and the strategy reviews as opposed to how we run the business in the short-term. I made the comment in the commentary that I think we're making the right balance of taking cost out in the short term, but still investing for the future.

As we start to put our forecasts for how we see the environment in fiscal year '10, '11 and so forth, then we have to start making some divisions about more structural change on the expense side as opposed to saving what we have already budgeted for this year. So, the two are clearly mathematically connected to each other but in terms of the way that we manage them are really quite separate.

On buyback, as you know, we don't forecast about buybacks. We did $6 billion in the quarter. Clearly, we have a new authorization in place now, and we have the economic ability to continue the buybacks and share prices are certainly relatively attractive. But we don't forecast, what we will do in any one particular quarter.

Sarah Friar
Goldman Sachs

Okay. I will get back in queue.

Bill Koefoed

Thanks, Sarah. Operator, next question, please.

Operator

Our next question comes from Kash Rangan from Merrill Lynch.

Kash Rangan
Merrill Lynch

Hi, thank you very much. Two questions for you, Chris. One is looking at the cash flow statement there is an unusual deduction in current liability, and I was wondering if you could offer some perspective on that.

Secondly, at a very high level, just doing some rough back of the envelope math here. Your revenue guidance now compared to where it was three months back is about 300 basis points lower and when I flow through that incremental impact at a 70%, 75% contribution margin, which is what I would expect given that most of your core business products are at that margin.

I would expect that a lot of that negative impact to earnings can be offset through your share buybacks and even if you slowed down your pace of share buybacks to let's say 3 billion to 4 billion per quarter for the next three quarters. I would imagine the EPS impact, the negative EPS impact should be largely offset, yet we do have cautious guidance. You should completely understand and appreciate, given the economic environment. But I just wonder as I go through this tradeoff, if there is a little bit more cautiousness that is built in than what meets the eye. That's it. Thanks.

Chris Liddell

Okay. Fine. In terms of the unusual amount that you talked about, we did settle a past IRS exam for the years 2000 to 2003. So, that was a large one-off payment to the tax department. And it was actually lower than what we were expecting, and we recall that we released some of the provisions last quarter. So, that was the large payment that you're alluding to from a cash flow point of view.

Secondly on the margin side, you are correct that buybacks will certainly offset some of the loss of margin that we have at an operating income level. One of the things that will dampen that, to some extent is the investment income that we have. We're more cautious in what we expect to get from our investment income line. You saw it was essentially zero for this quarter and it's just a difficult environment, clearly, to make high returns or any significant returns from our investment portfolio.

So, that will offset a little bit of the buyback impact that you talked about. The other thing to point out is that as we lose sales and most of our businesses, last you applied our average margin, the marginal margin, if I can call it that, is probably higher than that. So, some of the sales that we have really are 90% plus, given the relatively low COGS associated with them.

So if we lose revenue, our ability to take cost out in the short-term equal to that, to keep our margins intact, is very challenging. Now, we're looking to do that, and as I mentioned before in those three core businesses, I think we can retain margins year-over-year. But that's pretty difficult to make up from either cost reduction or from buyback overall. And it will certainly offset it and we have the benefit of both strong cash flow and a strong financial position which helps us. But I don't see it being a total offset.

Kash Rangan
Merrill Lynch

Got it. Thanks a lot.

Bill Koefoed

Thanks, Kash. Operator, next question please.

Operator

Next is John Difucci with JPMorgan.

John DiFucci
JPMorgan

Thank you. Chris, you saw your Client revenue go up about 2% this quarter and your guidance is for 2% to 6% growth for the year. But you expect 7% to 10% for the December quarter, and you've talked about at the beginning of this quarter seeing some weakness overall, you didn't specifically mention this business. Just curious, though, what gives you the confidence in this 7% to 10% growth for this quarter?

Chris Liddell

It's really around as we go further out in the year we just get more uncertain. So, we've widened the range in particular in the back half of the year. So we think, particularly with Christmas coming up, that overall sales will be relatively good. We have reasonably good visibility into this quarter in terms of the inventory positions. We feel pretty good about some of the initiatives that we have in the unlicensed area. We've got channel inventory down to where we would like to see it.

So, our visibility is better in this quarter than it is in some of the later quarters. So, it's simply as we go further out in the year, we just become more cautious.

John DiFucci
JPMorgan

Okay. And if I might just a quick follow-up, I just wondered if there's any potential for any channel issues, Entertainment and Device really strong this quarter, but two years ago was really strong, and then later on we found out there was, that channel was over full, I guess. And I don't think it's related but you had a big jump in inventory on the balance sheet probably like over 60%. Are those two things related or can you just address those two?

Chris Liddell

Yeah. We are feeling good about the overall level of inventory going into the Christmas period. We had a strong sell-in quarter you're correct and we have got a reasonable amount of inventory on our balance sheet in terms of our own boxes.

Having said that, the price points that we're looking at for this Christmas, at 199 for Arcade, 299 Pro, 399 Elite are very good. So none of us know exactly how, this economic situation is going to play out in terms of Christmas purchases. But when you look at those relative price points, either relative to our competition, sort of an absolute dollars relative to other things you people might purchase, it's nowhere near as significant as it was, say, last Christmas.

So clearly, we don't know what Christmas will look like. But given our relative position, I think we're in pretty good shape from an inventory perspective.

Bill Koefoed

Thanks, John.

John DiFucci
JPMorgan

Thanks.

Bill Koefoed

Operator, next question, please.

Operator

And our next question comes from Adam Holt from Morgan Stanley.

Adam Holt
Morgan Stanley

Good afternoon. I had a couple questions about currency. I believe a lot of your non-US business is actually billed in US dollars, like some of the OEM business and some of the emerging markets. Roughly, what percentage of your revenue, if you have a number, is actually in US dollars and what are your assumptions around currency for the rest of fiscal '09?

Chris Liddell

The easiest way to think about it is three, lots of one-third. About a third of our business is in US dollars in North America. About a third of our business is in US dollars, but sold in countries outside of the US. And about a third of our business is sold in international currency and countries outside of the US.

So, you correct, a large part in particularly the OEM sales is for units that are sold outside the US, but we bill in US dollars. That's the easiest way of thinking about it. So, around a third is directly impacted by foreign exchange movements.

In terms of the assumptions going forward, we are pretty much fully hedged for this year so regardless of the FX rate that you assume, the revenue guidance that we're giving is pretty solid, it won't change much depending on the currency. It will start to impact us more in fiscal year '10 as some of those hedges roll off. But we went into the year a 100% hedged and so at the moment we're benefiting from a lower exchange rate, in terms of those hedges being valuable.

Adam Holt
Morgan Stanley

Terrific. In fact if I could just ask a follow-up on the Office business. Obviously, good quarter in MBD with particular strength in the consumer side. Now the comparisons are easy for consumer for the next couple of quarters. You did mention some incentive programs this quarter. What are your expectations around the consumer growth and any further incentives there? Thanks.

Chris Liddell

That doesn't seem to certainly help drive growth in the first quarter. To the extent they're not evident or they're not in existence in the second quarter, we're more conservative, embedded in the guidance in MBD for the second quarter. We still think the overall customer proposition is very good, but we certainly saw a volume lift from some of those incentives in the first quarter. So, you're correct there. But we don't think it's going to be a significant phenomenon in the second quarter.

Bill Koefoed

Thanks, Adam. Operator, next question, please.

Operator

Next is Phil Winslow with Credit Suisse.

Phillip Winslow
Credit Suisse

Hi, guys. Just had a question on the PC outlook for the rest of the fiscal year and Q4. I think you mentioned 10% to 12% year-over-year growth, so just your PC shipment expectations. Just kind of looking at what that is sequentially, that's about 10% to 12% sequential uplift, which is basically what we've seen in the past several December quarters. Just wondering what you see on the outlook there that gives you the confidence that we have a similar type of uplift heading into the December quarter here.

Chris Liddell

Sure, what I actually said was our outlook for the year is 8 to 12. So, I think I talked about 10 to 12 for the second quarter and 8 to 12 for the full year. Now, to the extent that the front half is around 10 to 12 and the year is 8 to 12, the implication just on simple average is that the back half of the year we're saying 6 to 12.

So, that's a lot wider range and it's also on average lower. So, we are more cautious as the year goes on about not only the overall level of growth, but also the variability in that growth. So, if you take the average of that number, let's say 9% on the back half, that's a couple of points lower on average than the first half of the year and also with a much wider spread.

So, we're pretty conservative on what the back half of the year might look like. And in particular, where the growth might come from. So, we think certainly netbooks growth will continue to be relatively robust, emerging markets will be. But in the back half of the year, we're feeling pretty cautious about in particular mature markets, core PC growth. That could be flat to single digits. That could be flat to single digit.

Phillip Winslow
Credit Suisse

And then just for the December quarter, just with the Holiday season so forth, just the outlook heading into that, that's why I mentioned the 10% to 12%, sort of just what that implies sequentially?

Chris Liddell

Sorry, 10% to 12% for the December quarter. And that would be, again, single to mid-digits for the mature markets, solid double digits for the emerging markets and then probably about a five percentage point uplift as a result of netbooks. Is that the question you were asking?

Phillip Winslow
Credit Suisse

That's perfect. Thank you.

Chris Liddell

Okay, great.

Bill Koefoed

Thanks, Phil. Operator, this will be our last question.

Operator

Our last question comes from Israel Hernandez from Barclays Capital.

Israel Hernandez
Barclays Capital

Good afternoon, everyone. Chris, how should we be thinking about Microsoft's M&A strategy as we move through this down cycle? Do you see an opportunity to perhaps accelerate the pace as valuations come in? I'm not talking necessarily specifically around the Yahoo! situation, but its more generally with respect to enterprise software.

Chris Liddell

Clearly, the benefit this environment has to us, if there is one is in lower asset prices and we continue to be a net acquirer of businesses. Last year, as we bought around 24, so two a month. And we will continue to buy in particular in the sort of small or medium size businesses which are our real sweet spot.

I see our real constraint is not being capital in that, but its simply our ability to integrate. So, I don't see us necessarily increasing the volume of acquisitions and in fact a lot of people will see this as a difficult time to sell, because they'll see their prices as being depressed. But to the extent that we do buy, which I think we'll continue then it's likely to cost us less than it would have otherwise.

So generally, it's going to be a good environment for us and clearly relatively speaking we're still very cash rich. So, we are certainly not constrained from a capital point of view in buying companies. It's very much around, do they set the product road map and do we have the people and management capability to integrate them.

Israel Hernandez

Barclays Capital

Great, thank you.

Bill Koefoed

Great. That will wrap up our Q&A portion of today's earnings call. Remember that you can access this call on the Microsoft investor central website at www.microsoft.com/MSFT.

Chris Liddell

Thank you, everyone.

Operator

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