Presentation

Operator

Welcome to the Microsoft third quarter earnings call. (Operator Instructions) I would now like to turn the meeting over to Colleen Heally, General Manager, Investor Relations; ma'am you may begin.

Colleen Heally

Good afternoon everyone. This afternoon I am joined by Chris Liddell, Senior Vice President and Chief Financial Officer, Frank Brod, Corporate Vice President and Chief Accounting Officer and John C. Top, Deputy General Counsel.

Today's call will start with Chris providing key takeaways for the third quarter of fiscal year 2008 and an overview of expectations for what remains of the fiscal year. I will then provide detail around our third quarter results and then turn it back to Chris for a more detailed discussion of our guidance for the fourth quarter and a preliminary outlook for fiscal year '09. After that we'll take your questions.

We filed our 10-Q today in conjunction with our earnings release, therefore you have available the earnings release, MD&A, financial statements and 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 10-Q and quarterly financial summary slide deck at 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 this same site through the close of business on April 24, 2009.

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Because we will be discussing on this call our proposal to purchase all of the outstanding shares of Yahoo we are providing the following statement. This conference call does not constitute an offer to sell or the solicitation of an offer to buy any securities or a solicitation of any vote or approval. The material covered in this conference call is not a substitute for the prospectus or proxy statement Microsoft would have to file with the Securities and Exchange Commission if an agreement between Microsoft and Yahoo is reached or for any other documents with Microsoft may file with the SEC and sent to Yahoo stockholders in connection with the proposed transaction. Investors and security holders of Yahoo are urged to read any such documents filed with the SEC carefully in their entirety when they become available because they will contain important information about the proposed transaction.

Statements in this communication are forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings press release and the comments made during this conference call and in the risk factors in the MD&A sections of our Form 10-Q, our 2007 Form 10-K and other reports and filings with the SEC. Actual results also could differ materially because of factors such as Microsoft's ability to achieve the synergies and value creation contemplated by the proposed transaction with Yahoo, Microsoft's ability to promptly and affectively integrate the business of Yahoo and Microsoft, the timing to consummate the proposed transaction and any necessary actions to obtain regulatory approvals and the diversion of management time on transaction related issues. You may obtain copies of Microsoft's SEC reports and filings by contacting our Investor Relations Department at 1-800-285-7772 or at our website at www.microsoft.com/msft.

All information in this conference call is as of today April 24, 2008. We do not undertake any duty to update any forward-looking statements, to conform the statements to actual or changes in the company's expectations.

Okay with that, let me now turn it over to Chris.

Chris Liddell

Thanks Colleen and good afternoon everyone. The sense of our third quarter results demonstrates the benefits of our diversified business model. As you will see our broad span across geographies, product categories and customer segments is a tremendous asset in any economic environment and produced third quarter results of 14% revenue growth normalized for the tech guarantee and 27% earnings per share adjusted for the tech guarantee, legal charges and tax benefits beating our earnings per share guidance by $0.02 to $0.04.

Let me mention a few highlights about third quarter performance before turning to guidance. When looking at the drivers of revenue growth this quarter it's clear that we are reaping the benefits of the diversification of our business. In the first two quarters of the year our core business of client and the Microsoft business division significantly outperformed our expectations and this quarter entertainment and devices division drove our results.

Despite the tough economic environment this has allowed us to deliver consecutive earnings per share growth of 29%, 32% and 27% this year adjusted for the tech guarantee, legal charges and tax benefits. Revenue growth in the client and Microsoft business division businesses were normalized for the prior year results for the impacts of the tech guarantee and retail launch spikes had combined growth of $700 million or 9%.

Server and tools had yet another quarter of double-digit revenue growth while kicking off our largest enterprise product launch in the company's history. Our consumer businesses of entertainment and devices division and online service business grew revenue of combined 57% or over $850 million. And the treasury department continued to take some work delivering investment income exceeding our forecast and managing to avoid any significant write-offs in our portfolio despite the [massive] dislocation in the financial markets.

In the fourth quarter we expect a strong finish to what has been an excellent year. Revenue, operating income and earnings per share guidance for the year remain largely in line with our January guidance and significantly above our expectations upon entering the year. Since this time last year our revenue outlook for fiscal year '08 has increased by about $3 billion, operating income margins are expected to expand by over a point and earnings per share guidance is higher by $0.18.

On a more macro level there has been some uncertainty regarding the strength of the IT spending environment but our business has remained robust in the face of that uncertainty. While clearly no business can be immune from the impact of an economic slowdown, we remain confident in the benefits of our diversified business model and the investment approach we have taken in recent years.

We've delivered earnings per share results above the high end of our guidance every quarter this year and have raised our full year earnings per share guidance in each quarter. We are not expecting earnings per share growth of 33% to 35% this year normalized for legal charges and tax benefit which is an outstanding achievement in the current economic environment.

With those high level themes I'm going to turn over the call to Colleen for more details of our third quarter performance.

Colleen Heally

Thanks Chris. It was an excellent quarter with normalized revenue and operating income growth of 14% and 15% respectively. Normalized EPS growth at 27% was five points above high end guidance. Revenue growth was driven by continued enterprise customer demand for our core products as well as consumer demand for products and services in the entertainment and devices division and our online services business. Let me provide you with details of our financial performance starting with revenue. I'll discuss top line financial and business momentum points and then follow with revenue performance for each of the business units. Then I'll review the rest of the income statement. All growth comparisons relate to the comparable quarter of last year unless otherwise specified.

Revenue was $14.5 billion. Adjusting the year-ago quarter by the $1.7 billion of revenue recognition primarily related to the technology guarantee programs from Windows Vista and Office 2007 total revenue grew 14%. We estimate PC unit growth rates moderated from our January expectations by a couple of points in mature markets partially offset by an extra point of strength in emerging markets resulting in an estimate of approximately 8% to 10% for the entire PC market during the quarter.

Our mix of product billings for the quarter was approximately 30% from OEMs, 30% from multi-year agreements, 25% from license only sales and the balance from our other businesses. Annuity sales mix continued to increase on both a year-over-year and sequential basis while enterprise agreement renewal rates were in line with historical trends. As we guided our unearned revenue balance was consistent with historical seasonality patterns and remained roughly flat on a sequential basis at $12.1 billion up 18% year-over-year.

Our contracted not billed balance remains above $11.5 billion and increased sequentially up well over $1 billion from where we started the fiscal year. When taken together with reported revenue total bookings for the company grew 14%. Now I will provide revenue highlights by business segment starting with clients.

Client revenue of $4 billion was down 24% or down 2% adjusted for the tech guarantees. Adjusting that further for a retail launch bump from last year client revenue would have been up 4%. Let's break down the main drivers behind client revenue first for OEM license units and then for OEM revenue. During the quarter our OEM license units increased by 5%, about four points than the overall hardware market. We believe this reversal of the OEM unit trend outpacing that of the PC market was primarily driven by three factors. One, last year OEMs particularly in the system builder channel rebuilt inventory levels following the launch of Windows Vista driving OEM unit growth over 20% during that quarter and making it a tough comp. Two, inventory levels at our OEM partners this year were higher than normal exiting fiscal Q2 impacting this quarter's purchases. Three, we believe there was an increase in shipments of unlicensed PCs particularly in Asia. While we generally feel good about the gains we are making in piracy for the year, piracy is a tough battle in an area where we will need to continue investing in order to make progress.

Looking past the individual quarters, PC market growth was up 12% to 14% year to date with OEM license units growing about a point faster which is in line with our historical rate of progress against piracy. OEM revenue declined 25% but grew a point when normalized for the tech guarantees in the prior year. The four percentage difference between OEM license unit growth and revenue growth was caused by two roughly equivalent factors; mainly the increasing volume in emerging markets and a channel shift to large OEMs from the system builder channel. Partially offsetting these impacts was in increase in premium mix. Premium mix grew five points during the quarter to 76% driven by an increase in the consumer element of the mix while the business portion was unchanged.

The remaining roughly 20% of client revenue comes from the commercial and retail licensing portion of the business which declined 18% or was down 13% after adjusting for tech guarantees. Normalizing last year's Windows Vista launch bump at approximately $225 million growth would have been up 23%. We continue to see healthy growth in the commercial portion of the business as sales of software assurance were once again strong as evidenced by the 29% in the client volume licensing portion of the unearned revenue balance. Since the launch of Windows Vista revenue for the client business has grown 16% with a license growth rate of one to two points above that of the PC hardware market. Over 140 million licenses of Windows Vista have been sold to date and Service Pack 1 was released in the quarter.

Moving to server and tools, revenue of $3.3 billion represented an increase of 18% marking its 23rd consecutive quarter of double-digit growth. Customers continue to gravitate towards premium versions of Windows Server and SQL Server as well as to annuity contracts. The increased billing mix of annuity contracts drove the unearned revenue balance for the division up by over 35% versus last year. Our consulting and support services revenue increased 24% as we've experienced high demand following the recent launches across our product lines. The third quarter also marked the launch activities of the new versions of our flagship products in the server and tools division, namely Windows Server 2008, SQL Server 2008 and Visual Studio 2008. These products bring powerful new tools to our customers and partners looking to turn their IT departments into a strategic asset.

For example Windows Server 2008 with virtualization technology will help customers increase reliability and flexibility of their server infrastructure, reduce costs and increase security.

Online services business grew revenue 40% to $843 million this included $143 million from the addition of aQuantive. Online advertising grew 39% or was up 29% excluding the $47 million of ad revenue from aQuantive. Our online audience continues to grow. Live IDs increased to 18% to 448 million while usage deepened with search queries and page views up from the prior year. In the quarter we announced a number of acquisitions including Caligari for collaborative 3D modeling, YaData for customer micro segment management, and Rapt for behavioral targeting. And of course in February we proposed to purchase Yahoo. Chris will go into more detail about Yahoo later in the call.

Microsoft business division revenue was $4.7 billion down 2% but up 9% adjusted for tech guarantees in fiscal year 2008. Adjusted for last year's retail launch bump of about $150 million revenue would have grown 13% with business customer revenue growth of 17%. Our expanded portfolio of productivity products are thriving with share point revenue up over 35%, unified communications up over 20% and dynamic customer billings up 13%. On the strategic front we announced the acquisition of FAST Search and Transfer to enhance our enterprise search offerings. During the quarter we also held our SharePoint and Convergent conferences which both saw record attendance by customers and partners. And we expanded on our software plus services vision by announcing that the Beta of SharePoint online and exchange online will be opened to companies of all sizes.

Entertainment and devices division grew revenue of 68% to $1.6 billion over $300 million above our high end guidance driven by the sale of 1.3 million Xbox 360 consoles. High holiday demand for Xbox 360 consoles during the preceding quarter in which Xbox 360 outsold PlayStation 3 by over 1 million units in the US led to a short channel inventory for much of this quarter. However according to US MPG data by March Xbox 360 had reclaimed its monthly console sales lead over the PS3. With retail inventory restored to more healthy levels Xbox 360 is well positioned as the industry anticipates next week's launch of Grand Theft Auto 4. During the quarter we announced the acquisition of Danger which closed last week and announced the November target release date for Gears of War the highly anticipated sequel to the fastest selling video game of 2007.

Now for the rest of the income statement. Cost of revenue increased by $370 million primarily driven by higher Xbox 360 console sales, growth in our consulting business, and expansion of data center operations and the addition of aQuantive costs. After adjusting the year-ago quarter for the impact of tech guarantees cost of revenue held flat at 17% of sales. Operating expenses increased almost $1.9 billion or up 33% primarily due to $1.4 billion of legal charges relating to the European commission fine assessed in February. Adjusting for that charge in the current quarter and $150 million of legal charges in the same quarter of last year, operating expenses increased $600 million, up 11%.

This is favorable to our expectations due to lower headcount driven costs and some shift of marketing expense into the fourth quarter. Operating income was $4.4 billion. After adjusting for the impact of tech guarantees and legal charges, operating income grew 15%, one point faster than revenue growth. Investment income and other totaled $401 million for the quarter as the treasury team continued to do an outstanding job in challenging capital markets. Our effective tax rate for the quarter was 9%. During the quarter we settled a 2000 to 2003 examination with the IRS. As a result we reduced our previously accrued tax provision by $1.4 billion which was partially offset by the non-tax deductibility of the European commission fines resulting in our adjusted effective tax rate for the quarter of 29%.

During the quarter we repurchased 30 million shares or $1 billion of company stock and paid out over $1 billion in dividends to shareholders. Diluted shares outstanding for the quarter were 9.4 billion down 4% from the prior year as a result of share repurchases. Earnings per share for the quarter were $0.47 which was $0.02 to $0.04 above our guidance after adjusting for the offsetting impacts of the $0.15 EPS charge from the European commission fine and the $0.15 benefit from the resolution of the tax examination.

So in summary our diversification across geographies, product lines, customer segments and product life cycles produced 14% top line and 27% bottom line growth. This allowed us to generate over $7 billion of operating cash flow, the second highest level in the history of Microsoft.

With that let me turn it back to Chris who will provide you with our fourth quarter guidance and our preliminary outlook for fiscal year 2009.

Chris Liddell

Thanks Colleen, I'm going to spend my remaining time on the call giving you a view of our expectations for the fourth quarter followed by a preliminary view of fiscal 2009. I also note that we have about twice the number of people on the call as normal so for some of the newcomers I'll also make some brief comments on our proposed acquisition of Yahoo.

Let me begin by outlining some of our key assumptions for the fourth quarter. We'll assume the following macroeconomic conditions for the remainder of the year; we expect the software spending environment to remain mixed but positive overall on a global basis especially for the positioning of our products and the value they offer. Like you we are cautious on the reported economic softness in the US but at this point we have not seen any significant spillover to our businesses. We continue to benefit from strong underlying growth in non-US and emerging markets which has also been assisted by stronger international currencies.

For the fourth quarter we expect PC hardware unit growth of 9% to 11%. Growth will continue to be driven by strength in emerging markets while we are tempering our forecast to growth rates in mature markets. [inaudible] fourth quarter guidance and year-over-year growth rates, we expect revenue of $15.5 billion to $15.8 billion representing excellent growth of 16% to 18% over fiscal 2007. Revenue guidance by business unit is as follows: for client we expect revenue growth of 7% to 11% for the fourth quarter. The guidance of [power] units, OEM units will grow in line slightly ahead of the PC hardware market and underlying PC market dynamics in the consumer and emerging market segments will drive OEM unit growth in excess of OEM revenue.

Sever and tools revenue should 18% to 20% in fourth quarter. We expect corporate demand for our server products to remain strong which will drive double-digit growth across the [bricks] of our server platform products and services. In the online services business we forecast revenue to be up 37% to 41% for the fourth quarter. Microsoft business division revenue should grow 15% to 16% on continued demand for the 2007 Office Suites, SharePoint and Office communication server. Lastly entertainment and devices division revenue is expected to grow 32% to 34% driven by strong demand for Xbox 360 consoles and games.

Turning back to company wide performance operating income for the fourth quarter is expect to be between $5.8 billion and $6.2 billion representing 46% to 54% growth over the prior year which included the Xbox 360 warranty charges. Excluding those charges operating income should grow a very healthy 15% to 22%. Fully diluted earnings per share expected to come in at $0.45 to $0.48 for the fourth quarter and this guidance assumes an effective tax rate of 30%.

So with that fourth quarter guidance we arrived at the following expectations for the full fiscal year 2008. Revenue of $60.1 billion to $60.3 billion representing year-over-year growth of 17% to 18%; operating income of $22.6 billion to $23 billion, excluding the European commission fine of $1.4 billion in the quarter, operating income would have been $24 billion to $24.4 billion; and for fully diluted earnings per share we expect $1.87 to $1.90 representing growth of 33% to 35% when normalized for legal charges and tax benefits.

So with the close of the FAST Search and Transfer acquisition since the last time we provided you with guidance in January we've updated our fiscal '08 guidance to include and estimate of about $50 million of in process R&D and integration costs related to the acquisition.

From a balance sheet perspective we are maintaining our previous forecast of total unearned revenue balance to finish fiscal 2008 up 14% to 16% over prior years. Contract but not billed should also finish 2008 up from current levels.

With that let's turn our current thinking about the next fiscal year. Remember this represents our preliminary view prior to completing our internal budgeting and planning process which occurs during the fiscal fourth quarter. This guidance does not include any impacts from our proposed acquisition of Yahoo. Our current forecast for fiscal 2009 revenue is $66.9 billion to $68.0 billion which represents growth of 11% to 13%. On an absolute basis that represents an increase of approximately $7 billion to $8 billion of incremental revenues. We expect operating income to be between $26.7 billion and $27.4 billion or growing 18% to 19%. Excluding the European commission fine in fiscal 2008 operating income is expected to grow roughly in line with revenue growth. Although [inaudible] about costs and operating expenses [inaudible] is still preliminary we expect operating income margins to remain generally flat year-on-year which includes the impact of about $0.50 billion of additional expenses related to recently announced acquisitions including FAST and Danger which were not in our forecast when we saw many of you in New York in February.

We look forward to providing more detail on the fiscal '09 investments on our fourth quarter earnings call and our fiscal analyst meeting on July 24th. So for the rest of the income statement we expect investment income to be lower in fiscal '09 due to lower yields on the investment portfolio as a result of lower interest rate environment but we are also modeling a decline in our tax rate to 28% in fiscal 2009 driven by continued shift in our earnings mix towards lower tax rate jurisdictions. We expect fully diluted earnings per share of $2.13 to $2.19 representing growth of 14% to 15%.

As always I'll remind you to think about the guidance that we provided. You must also consider the risks. These included competitors, legal, execution and general market risks such as foreign exchange for instance, fluctuations in PC and server hardware growth rates, IT spendings, changes in the piracy rates of our products and customer acceptance of our new and existing products. Additionally changes in the mix of our sellings between the new [inaudible] and license only can have an impact on revenue, operating income and earnings per share by delaying revenue recognition into future periods.

I'd like to wrap up with a couple of final comments. First as you consider the performance we're delivering in fiscal 2008, and the preliminary view of fiscal '09, they are great examples of the growth model we've had for the company which I outlined previously. It begins by focusing on the growth opportunities where we can differentiate ourselves through software and in particular business IT spending but also increasing the online advertising and consumer entertainment.

Add to that a truly global approach to our sales, two-thirds of our revenue driven from users outside of the US and about 15% in high growth emerging markets. These opportunities set the stage for healthy broad based revenue growth across our businesses. That revenue growth allows us to reinvest into our existing business, pursue both organic and inorganic growth opportunities while continuing to grow operating profits. Operating profits combined with reductions in our share count and improvements in our tax rate drive earnings per share growth.

If we achieve the guidance we have outlined today over the three year period through fiscal year '09 during one of the most difficult economic environments we have faced we will grow earnings per share approximately 80%.

Lastly before handing the call back to Colleen, I wanted to provide a brief update on our proposal to acquire Yahoo. With or without a Yahoo combination Microsoft is focused on the online advertising market which is expected to double by 2010 to $80 billion. Although Yahoo would accelerate our efforts we have an existing strategy that is already centered on three key pillars; drive innovation and search, increase value to advertisers and publishers through innovation and scale and grow user engagement across our MSN and Windows Live properties. We have an extremely talented engineering team, a great portfolio of advertiser and publisher tools and key assets in information content, communications and social networking. Lastly we are committed to compete in online advertising through organic investments, partnerships and acquisitions such as aQuantive and Rapt.

With respect to Yahoo we have been as evidenced in the size of our offer premium that speed is of the essence for the deal to make sense and get folded into our online strategy. Unfortunately the transaction has been anything but speedy as is being characterized by what would appear to be unrealistic expectations of value. Our initial offer was an extremely generous more than 100% premium fee [inaudible] core business. And our view on value is shaped by the long-term value of the company and we intend to remain disciplined in our approach. The strongest argument that I've heard on why we should increase our bid, simply that we can afford to, is not one that I favor. We've yet to see tangible evidence that our bid substantially undervalues the company. In fact we see the opposite. Yahoo continues to lose search share and profitability continues to decline year-on-year. The results that they announced on Tuesday were in line with the guidance that they gave on their last earnings call on January 29, after which their stock price closes at $19.05 and Wall Street analysts' consensus on value was significantly decreased.

As outlined in our recent letter to the Yahoo Board, unless we make progress with Yahoo towards an agreement by this weekend, we will reconsider our alternatives. We will provide updates as appropriate next week. These alternatives clearly include taking the offer to Yahoo shareholders or to withdraw our proposal and focus on other opportunities both organic and inorganic. With that being said I'd like to remind you that we're here today to discuss our earnings and we hope you understand that we can't go beyond in the Q&A session what I've just said.

With that I'll hand the call back to Colleen so we can get started taking your questions.

Colleen Heally
Thank you 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

Your first question comes from Charlie DiBona - Sanford Bernstein

Charlie DiBona
Sanford Bernstein

I know it's early but I was wondering if we could maybe dive a little bit into your fiscal '09 guidance, in particular you're calling for something around 12% revenue growth here. With the US economy looking like its getting weaker, it doesn't sound like you've included any kind of recession in your forecasting but can you maybe characterize your view of your business and how insolated it would be from a US based downturn and how solid that number looks if the economy starts to get weaker?

Chris Liddell

The first thing to comment on is in line with some of the prepared remarks that we made. One of the great things about our business from my perspective is the diversification and the diversification across geographies and across business types. So clearly we like everyone else would be impacted by an economic downturn if one was to get worse than where it is, but we have built in what we consider to be an appropriate level of conservatism at this stage for next year. And I'll just remind you that two-thirds of our business is now out the US and some we've seen some very strong growth from emerging markets. So a very good geographic spread and also fairly a weak US dollar helps us in that perspective.

The other thing to mention is this year would be one year that most people would say has been one of relatively difficult economic conditions so this is a year where if we finish out along the guidance that we have talked about we will have grown revenue by 17% to 18% and earnings per share by 33% to 35% so if we can turn in a performance like that in what a lot of people are finding to be a particularly difficult year, then that gives me a lot of confidence in our business model going forward.

Operator

Your next question comes from Sarah Friar - Goldman Sachs

Sarah Friar
Goldman Sachs

Chris the FY09 EPS guidance is quite robust so could you give us a sense for what does that assume in terms of the investment required for your goals in the online services business and if for whatever reason you don't get Yahoo do you have to come back and revise down the margin for a build versus a buy decision?

Chris Liddell

There's a reasonable amount of additional growth in our expense line for the online and is already imbedded into fiscal year '09 so we'll obviously give you more detail in three months because we haven't completed our internal budgeting but if you look at the makeup of the expense growth then it's around 20% to 25% of that growth will be to drive our online services division with those final numbers to be determined in the next three months. The balance will go into other high growth areas in the other divisions into things like building our sales force and in particular outside of the US and then we're getting other impacts like FX and so forth coming in as well. But there is already a reasonably high proportion of expense growth allocated to the online services area and also in terms of CapEx we're expecting to spend more next year and that's imbedded in our numbers as well than this year. So clearly if Yahoo was to happen we'd have to overlay that impact. We would still think about spending I would think virtually all of that money in terms of organic growth anyway. If Yahoo wasn't to happen, could we consider other investments, yes but we'll cross that bridge when we come to it.

Sarah Friar

Goldman Sachs

Great, the currency impact on the quarter, could you just give us a sense for that?

Chris Liddell

Yes, around 3% benefit both on the revenue and the expense side so if you like in the expense it's a negative but a 3% impact broadly speaking in both revenue and expenses.

Operator

Your next question comes from Heather Bellini - UBS

Heather Bellini
UBS

I know piracy is a difficult thing to solve for each quarter but I know your comps here are getting tough in the second half of calendar year '08, so how should we think about your progress - the progress you made in the second half of '07 how much of a tough comp does that give you for the client business than in the second half of '08 and then just about the buybacks, I believe I read in your Q you cut them to about a billion dollars this quarter, should we expect that level to stay until we know the outcome of the Yahoo transaction?

Chris Liddell

Starting with piracy, you're right on a quarter-by-quarter basis and I'll talk to you and other investors about this its difficult to look at piracy on a quarter-by-quarter because we can see individual enforcement actions make a big difference in any one quarter so we had a very good performance in the first two quarters of the year. The first and second quarter of our fiscal year a relatively weak performance, in fact it was a negative in this quarter so overall for the year, we still think that we will drive unit growth 1% to 2% higher than underlying market growth as a result of our combating piracy but relative to the first couple of quarters when we had very good performance that's a little lower. So we still think it's a positive trend overall but you are correct it does get progressively harder. In this particular quarter we had a couple of distributors had a particularly high distribution of unlicensed PCs in China due to some market conditions there. You can have that sort of one-off impact so it's much better to look at it on a year by year rather than a quarter by quarter.

Heather Bellini
UBS

Just to understand that topic just because that means that in the September and December quarter of calendar year '08 you've got pretty tough comps, is that the situation where we should expect your OEM to be below PC shipments for your revenue to grow less than PC shipment?

Chris Liddell

Are you talking about for the fourth quarter?

Heather Bellini
UBS

No I'm talking about for September and December given the tough comps you have September and December of '08, you've got tough comps in piracy versus September and December of '07.

Chris Liddell

Yes I think for next year but I just don't want to get into too much guidance. We still think that we will grow units more than PC demand but for the same, you'll get the same impact that you've seen for this year which is the extent that it grows faster in emerging than mature markets et cetera then revenue will be slightly lower than unit growth and that will probably wash out to mean that revenue will be broadly in line or just slightly below overall market growth but we still think that our unit growth will be higher than market growth.

Heather Bellini
UBS

Okay and then just the buyback question.

Chris Liddell

On the buyback, yes you are correct it was low this quarter in particular because of the Yahoo transaction. I want to maintain the most amount of flexibility for that transaction in terms of our cash buildup and how the final transaction might work if it does. Therefore I don't intend to get into quarter by quarter and I don't want to give specifics but also just from a legal perspective, its difficult for us to be too active in the buyback market so I would expect us to be relative modest from a buyback perspective until we get clarity on Yahoo one way or the other.

Operator

Your next question comes from Kash Rangan - Merrill Lynch

Kash Rangan
Merrill Lynch

If you just look at the guidance philosophically Chris compared to the last couple of years the same time of the year when we you were giving guidance for the upcoming year I think guidance has been generally below consensus or bracketing consensus - mainly conservative giving you the opportunity to outperform as you execute on your model. I'm just curious this time around I think the guidance tests certainly as Charlie indicated assumes some US - actually a reasonable level of execution on the revenue side range of 12% growth but I'm wondering on the earnings side if you're not giving enough flexibility for potential spending in the online business if the Yahoo transaction were not to come through just philosophically I guess my question is how do you think about guidance relative to the trend - it seems like there's a bit of a change here and I'm just curious what your thought process there is.

Chris Liddell

There's a few trends here, from a revenue point of view, as I mentioned to Charlie I feel very good about our revenue forecast 11% to 13% for next year. I think that's very good in the current economic environment and as I said I think that is a testament to the strength of our particular investment business model and also the fact that we have made a lot of investments in the past. We have talked to investors about the benefits of those investments and I think that is starting to pay. Clearly in this year where we've driven revenue by over 16% and next year 11% to 13% feels very good. So I feel good on the revenue side. On the operating expense side I think we're making at this stage plenty of provisions for what I consider to be appropriate OpEx not just in the online services but across the whole business. So I don't feel bad that we are leaving anything out there. Clearly if we were to make another acquisition or to acquire Yahoo that does change the game but in terms of allowing us to do what we want to do organically and through some level of acquisition not only in online services but in other businesses I feel good about the level that we have built in at this stage. And overall earnings per share growing 14% to 15% I guess some assumptions there about buybacks and investment income, I mentioned the tax rate is starting to come down and I talked about this at the last couple of financial analyst meeting that we are now in a period where you can expect to see our tax rate start to go down year after year not only in fiscal year '09 but in fiscal year '10 as well as a result of the changes in our business models. So if you look at the individual parts of guidance for fiscal year '09 at this stage I feel we are hanging together very well.

Kash Rangan
Merrill Lynch

and also the bookings growth rate, coming in at 14% do you think that is more indicative of what we should expect over the few quarters because I think and right after the product launches you had 30%

and then it looks like we've seen some deceleration but is this the real run rate going forward given that we're entering a more mature aspect of the product cycle?

Chris Liddell

You would expect over the long-term that bookings growth and overall revenue growth to be broadly both the same as each other so if we can continue to get bookings growth excluding Vista unearned impact but general bookings growth in the mid teens that would support low to mid teens revenue growth. If that's the mature part of the cycle then that's pretty healthy from my perspective.

Operator

Your next question comes from John Difucci - Bear Stearns

John DiFucci
Bear Stearns

I have a follow-up to Heather's question and it has to do with the anti piracy efforts. The September to December quarters we saw some big benefits from that and actually seemed to take us by surprise and you by surprise and this quarter that looks to have reversed. Chris you mentioned I guess government crackdowns and we had heard some of those in the second half of last year, is there any other color you can give us on that because trying to understand this and obviously its going to be a fight as you move along but if its always going to be you get a foot and you give up a yard kind of thing, I'm just trying to figure out what you see and in Asia this quarter why would it sort of reverse and then secondly on that I'm just curious why you expect an acceleration in PC growth into the next quarter especially given the macroeconomic backdrop.

Chris Liddell

On piracy or more particularly on license shipments which become pirated, you are true that on a quarter by quarter basis it can move around quite a lot and hopefully you recall in particular in the first quarter that I said don't take too much from this positive number. You can get an aberration like this on a quarterly basis and you could have a negative one by implication and that's what we have seen this quarter. So again I'll just reinforce you really need to look at things like piracy on a long-term basis and average them out to really get a sense of how it's happening. In the first quarter in particular we saw a very strong performance in our Russian subsidiary which helped enormously when you spread that volume over the total business. In this quarter in China because of some specific market dynamics that happened in that country you saw a relatively negative performance. You have got to wash those things out. You have got to look at it on the course of the year. We still think for the year we are going to have PC unit growth of 11% to 13%. We think we are going to ship our units of 12% to 14%. So we still think we are going to pick up one maybe two percent of shipment growth relative to overall market growth and that washes out the unders and overs and that's how I prefer to think of it.

Colleen Heally

And just to put that into a little more context too on the unlicensed PCs aspect, just keep in mind that when we were looking at the PC units to OEM units that was one of three factors that we talked you through in bridging that, so that is one of three factors.

Chris Liddell

In terms of overall PC demand what I would say is we started the year believing that we were going to have about 9% to 11% in terms of unit shipments. The third quarter came in at 8% to 10%. So broadly speaking it was in line with where we started the year. It was a little bit weaker in mature markets which I think picks up some of the economic issues that we are seeing particularly in the US but it was stronger in emerging markets. So the mix was different to what we thought but the overall market was about in line, 1% lower which is [around the area] really to where we started the year. What we saw really was a particularly strong performance in Q1 and Q2 so it's difficult to continue to extrapolate an out performance, 8 to 10 I don't feel bad about. And if we can end the year at 11 to 13 which is how we feel relative to a starting point of 9 to 11 we still feel that's a good robust year but obviously on a quarter by quarter basis again you can read too much into an individual quarter if you look at the year it looks pretty good.

John DiFucci
Bear Stearns

Yes but how could you I mean given the macro backdrop it just seems kind of odd that you would assume that PC sales would increase in this current quarter versus the 8 to 10.

Chris Liddell

Well we're talking about 9 to 11 for the fourth quarter relative to 8 to 10 for the third quarter. So it's a 1% change. And don't forget the third quarter, this quarter [lept] Vista launch last year so you've got some aberrations on a year on year basis but accelerating from 8 to 10 to a 9 to 11 third quarter to fourth quarter doesn't feel like its - we haven't got the foot on the accelerator very hard to achieve that.

Operator

Your next question comes from Robert Breza - UBS Capital Markets

Robert Breza
UBS Capital Markets

I was wondering if you could talk a little bit about the integration of aQuantive and I guess where does that sit relative to your estimates and how is that tracking to your plan?

Chris Liddell

There's a number of ways of looking at how it's integrated. The first and most important is from an employee integration point of view given that the real revenue potential is some years out. From the employee point of view we couldn't have been happier. All of the key executives have remained. Brian [Makendries] is doing a great job leading that and is taking a broader role inside Microsoft in terms of driving that part of the strategy. We've integrated in my view the cultures very well and we've got people from aQuantive taking a broader role and Microsoft people from the previous Microsoft working inside and helping drive aQuantive strategy and they're very active and thinking the way in which they can not only build aQuantive as it was but use the financial and other resources of Microsoft to make aQuantive go faster. So if you take that as the sort of first determinate of how well things have gone, I'm extremely happy with that. In terms of the underlying business, leading indicator would be just number of publishers we're getting on board again that's going very healthy. We've talked through the quarter I think we've made a few announcements. There are 96 I believe new publishers of various sizes have switched on to the Atlas Publisher Suite in the last quarter, since we announced sorry. So very good growth in the underlying dynamic in the business. From a profitability point of view, we're carrying the costs of the acquisition but we are managing to achieve the results that we talked about despite the fact that at this stage its early days for aQuantive and we're carrying in particular some of the non-cash charges associated with the acquisition. So the revenue growth is still ahead of us, from a cost point of view we're in line but it's a negative. From a publisher business point of view good early indicators and from a people point of view it's excellent.

Operator

Your next question comes from Kirk Materne - Banc of America Securities

Kirk Materne
Banc of America Securities

Operating margins for the fourth quarter appear to be going down just a tad versus the third fiscal quarter, could you just explain some of the dynamics around that. I realize you have just made some acquisitions. Is it mainly headcount related? Is there some mix shift going on between the businesses? Anything to do with E&D, obviously its going to have a strong quarter with Grand Theft Auto, I'm just trying to get the dynamics about that.

Chris Liddell

The problem looking at margins for the business overall is you inevitably get quite a lot of difference between the individual businesses and how they make up one quarter. So that's the first statement and its best to look at the year overall where you're looking at margin expansion but if you look at the trends through the quarters. I think quarter one was 43%, quarter two was 39.6, quarter three was 40.3, and quarter four was 37.6, overall 40. So in any one quarter you can get quite different movements and that reflects (a) the mix of businesses and (b) if you have a strong Xbox quarter you get a lot of the [cogs] associated with that that tends to decrease the margins. Fourth quarter we get a lot of marketing and signup costs associated with our enterprise businesses which generally are buying annuities. So we don't get a lot of the revenue associated with it, we get some of the costs and we get the benefits of that revenue flying through for the next year. So the short answer to your question is there is nothing unusual in the fourth quarter. We typically see it if you look back in previous years it's a low margin quarter relative to the first, second and third. There's nothing unusual about this fourth quarter. Its part of the normal cycle.

Kirk Materne
Banc of America Securities

If I could just follow-up on John's question just on the acceleration in PCs into the fourth quarter, one of the comments you had about the last quarter was just the inventory levels being a little bit higher heading into the third quarter, I assume those have been drawn down to levels you feel more comfortable with heading into the fourth quarter?

Chris Liddell

Yes, although just to be clear I think John's question was PC units overall and inventory levels tend to be a comment about our shipments to OEM so those are very tightly related to each other clearly but in answer to your question, yes they are [inaudible] more normal. Although I will say it's quite early in the quarter. Sometimes we get that information over the next few weeks but there's nothing that we're seeing that's unusual going into this quarter and that's embedded in our guidance.

Operator

Your final question comes from the line of Brent Thill - Citigroup

Brent Thill
Citigroup

Chris just drilling into the client line item, that was clearly probably the biggest disappointment relative to all of our models and understanding the licensing change but when you drill into what's happening with Vista and XP are you still happy with what you're seeing in the Vista upgrade cycle or are you still seeming more units of XP going than you like and that wouldn't obviously have an impact on the pricing?

Chris Liddell

Yes, with respect to the quarter, the third quarter in particular there's really no Vista-related issues at all. In terms of the impacts, firstly the overall PC market, unlicensed PCs which is not a Vista issue. Emerging markets growing faster than mature markets, that's not really a Vista issue. A bit of a channel shift to larger OEMs again not a Vista issue. And obviously if we sell a unit of XP rather than selling a unit of Vista we're still relatively happy because of the realization and so there's nothing in the third quarter that is specific to Vista in terms of the walkthrough from the overall PC market down to overall client revenue. I guess the only Vista impact really is the launch last year and the very strong comparables that we have but that's not really a comment about this quarter its more a comment on the year-ago quarter and the comparable.

Colleen Heally

Yes I think if you look at whether it's Vista, [inaudible] or from a mix standpoint we can let you know we're up a bit sequentially in terms of Vista -- shared with you 140 million licenses sold so you know I think things are tracking well and as expected from our perspective.

Chris Liddell

So with that I'll thank you all, I'll hand it back to Colleen to finish but I look forward to talking to a number of you in three months and in particular seeing a number of you at the financial analyst meeting a few days later.

Colleen Heally

Thanks everyone for your participation in today's call. If you have any further questions, please feel free to call me or my team directly. As I mentioned at the beginning of this call, this conference call will be available on replay at our Investor Relations website through close of business April 24, 2009. In addition, you can hear the replay by dialing 1-800-756-0715 or for international calls dial 203-369-3427; the dial in replay will be available through the close of business May 2, 2008. Thanks again for joining us today.