Presentation

Operator

Welcome to the Microsoft 2007 fiscal year third quarter earnings conference call. (Operator Instructions) I would now like to turn the call over to Ms. Colleen Healy, General Manager, Investor Relations. Please go ahead.

Colleen Healy

Good afternoon, everyone and thank you for joining us today. 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 Seethoff, Deputy General Counsel.

Today's call will start with Chris providing some key takeaways for the third quarter of fiscal year 2007, 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, as well as a preliminary outlook for fiscal year 2008. After that we will 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. This 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 the 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 April 26, 2008.

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We will be making statements during this call that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the Risk Factors section of our 10-Q, our 2006 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.

With that, let me now turn it over to Chris.

Chris Liddell

Thanks, Colleen. Good afternoon, everyone. Thanks for joining us today. We're going to use our prepared remarks this afternoon to share our third quarter results, discuss our outlook for the fourth quarter, and provide a preliminary view of fiscal 2008.

I'm extremely pleased with the company's financial performance during the quarter, as revenue, operating income and earnings per share exceeded our expectations and each grew at strong double-digit rates. Our results were primarily driven by strength in our core products. Windows Vista and 2007 Microsoft Office System will have a multi-year impact, and both are off to a very good start.

Revenue growth in the third quarter was 32% and even if you were to exclude the $1.7 billion in recognition of previously deferred revenue associated predominately with our Technology Guarantee Programs for Windows and Office, our revenue growth would have been an extremely good 17%. Four of our five businesses delivered double-digit growth and we saw forward strength across all customer segments and channels.

Excluding $0.01 in legal charges and a $0.02 tax benefit in the quarter, the revenue upside flowed through to operating income and earnings per share, which came in at $0.03 to $0.04 higher than our guidance in January. Cash flow from operations was also over $7 billion, indicative of the underlying strength of our business, and was a record for the company.

Lastly, we continue to execute on our financial strategy. During the quarter we repurchased over $6.7 billion in company stock, and paid out just under $1 billion in dividends. This brings combined year-to-date repurchases and dividends to over $22.5 billion, which represents over 150% of our cash flow from operations over that same period.

Moving now to the full fiscal year, we expect a strong finish to what has been an excellent year. We are increasing our revenue, operating income and earnings per share guidance for the year on the strength of our new product launches. Excluding certain legal charges and tax benefits in the prior and current years, we expect revenue growth in excess of 15% and earnings per share growth in excess of 16%.

For both high level themes for the quarter and for the full year 2007, I'm going to turn the call over to Colleen for more details on our third quarter performance.

Colleen Healy

Thanks, Chris. As Chris mentioned, the results for Q3 were excellent. Let me provide you with details on our financial performance, starting with revenue. I will discuss top line financial and business momentum points, and then follow-up with revenue performance for each of the business units. All growth comparisons I mention relate to the comparable quarter of last year, unless otherwise specified.

Revenue for the quarter grew 32% to $14.4 billion, which includes $1.7 billion in recognition primarily from the Technology Guarantee Program. Excluding the recognition of these deferrals, revenue growth would have been 17%. Growth this quarter was driven by sales in our Client and Microsoft Business Division, following the general availability of Windows Vista and the 2007 Microsoft Office System in January. Server and Tools had another solid quarter. These three core businesses turned in notable performance, each growing at a double-digit rate, and collectively growing revenues 22%, or over $2 billion in absolute growth before the recognition of the Tech Guarantees.

We saw continued strength in the underlying PC hardware market, which we estimate grew 10% to 12% during the quarter, a bit faster than we had expected. Growth in emerging markets continues to outpace that of mature markets, and the consumer PC shipment growth outpaced business shipments. Europe, Asia excluding Japan and Latin America maintained double-digit growth rates, while the remaining regions grew at single-digits.

Our mix of product billings for the quarter was approximately 30% from OEMs, over 25% from multi-year licensing agreements, over 20% from license only sales, and the balance from our other businesses. The mix this quarter versus the same period in the prior year is higher in license only sales, primarily due to retail sales following the consumer launches of Windows Vista and the 2007 Microsoft Office System, and lower in our other businesses due to our core product making up a higher mix of revenue this quarter, as you would expect given where we are in our various product lifecycles.

Our field sales force saw broad strength across our customer segments and regions. Our small, midmarket and retail sales group actively engaged with our customers and partners, readying the market for the product launches. The entertainment sales force drove robust volume license sales, and entertainment and enterprise agreements renewal rates at the high end of our historical range of 66% to 75%. We are delighted that the benefits and value proposition offered in the recent releases of our flagship products are resonating with customers.

As a result of a strong annuity licensing results, our unearned revenue balance ended the quarter at $10.3 billion, up 16% over the same period in the prior year. Our contracted not billed balance at the end of March was sequentially higher and continues to exceed $9.5 billion. Taking into account reported revenue and changes in the unearned and contracted not billed balances, bookings growth totaled 20%, with bookings in our core business of Client, Microsoft Business Division and Server and Tools growing 25%.

Before closing out the revenue overview, let me add that changes in foreign exchange rates added about 2 percentage points to our overall revenue growth rate in the quarter, and was generally in line with our expectations going into the quarter.

Now I will provide revenue highlights by business segment. Client revenue of $5.3 billion, an increase of 67%, includes the recognition of $1.2 billion from Tech Guarantees and pre-shipments. Adjusting for this impact, Client revenue would have been $4.1 billion, up 30%, driven by growth in all channels due to the successful consumer launches of Windows Vista during the quarter.

OEM revenue increased 24%, excluding the recognition of the Tech Guarantee deferrals, driven by 20% growth in OEM license units. The 8 to 10 point difference between OEM license unit growth and the overall PC market growth during the quarter is a result of a normal spike in license sales on the launch of a new operating system in our system builder channel, restocking of retail inventory levels by OEMs as a result of the consumer launch, and continued progress on unlicensed PCs under our existing program.

Consistent with the results we saw last quarter and the relative strength in the Consumer segment following the launch, we continue to see a change within the mix of sales of our Premium Edition operating system. OEM Premium mix was 71%, an increase of 18 percentage points from the prior year, driven by sales of Windows Vista Home Premium, while our other business editions of Windows declined a few points in the overall mix.

As we shared with you previously, Windows Vista business generates over five times the pricing of our Windows Vista Home Basic and of Windows Vista Home Premium. So the net result is that the increase in Premium mix added about 1 percentage point of growth to OEM revenue.

Client, commercial and retail licensing grew 63%, excluding the recognition of pre-launch revenue deferrals, driven by strong sales to the retail channel following the consumer launch of Windows Vista and a very healthy commercial business.

Server and Tools revenue of $2.7 billion grew 15%, primarily driven by double-digit growth in Windows Server, SQL Server and Visual Studio, as well as growth in our consulting and Premier services. Also, during the quarter we launched Systems Center Operations Manager 2007, which provides end-to-end management for the monitoring and reporting of Windows environments.

In our Online Services business we saw continued improvement in our advertising platform monetization, which resulted in advertising revenue growth of 23%. Revenue for our Online Services business overall increased 11% to $6.2 million, driven by the growth in advertising revenue, partially offset by an expected decline in access revenue. Search revenue benefited from a higher number of search queries, and increased revenue per search on both a year on year and consequential basis. We are now monetizing more effectively in the U.S. on our own Ad Center platform than we had under third-party Overture at this time last year. Our display growth was in line with what is a healthy market, driven by an increase in page views. This quarter we forged content partnerships with Newscorp, NBC and CBS to enhance MSN's premium video inventory.

Microsoft Business Division revenue of $4.8 billion grew 34%, or 20% after adjusting for the Tech Guarantee. Growth was driven by both consumer and business sales of the 2007 Microsoft Office system following the recent launches. The performance for the quarter was highlighted by a strong consumer response to the 2007 Microsoft Office system, which drove better than expected retail sales. We are also pleased with the results of our Dynamics business which showed healthy performance across both the ERP and CRM product lines, driving a 20% increase in customer billing.

During the quarter we announced plans to acquire TellMe Networks, bringing this industry-leading expertise and voice services to our existing speech platform and unified communications offering.

Consistent with our guidance, Entertainment and Devices revenue decreased 21% as a result of lower Xbox 360 sales. We sold over 5,000 Xbox 360 consoles during the quarter, bringing our life-to-date sell-in to approximately $11 million. Software and accessory attach rates remain at record levels in the U.S. per MPV, and we have passed the 6 million member mark for Xbox Live.

Our Mobile and Embedded Devices business continued to turn in strong performance, with revenue growth in excess of 30%. During the quarter we unveiled Windows Mobile 6, the next version of our Windows Mobile software platform. We expect to see an increasing number of Windows Mobile 6 powered devices coming to market through the rest of this year.

Now for the rest of the income statement. Cost of revenue increased 6%, primarily driven by data center costs, product costs associated with the launch of Windows Vista, and the growth in consulting services, partially offset by a decline in Xbox 360 console sales. Other operating expenses increased $928 million, or 20%, excluding legal charges of $154 million in the current quarter and $397 million in the same quarter from the prior year. This is favorable to our expectations, due primarily to shifting some marketing and product development costs into the fourth quarter.

Operating income of $6.6 billion, or $5.1 billion after adjusting for the impact of the Tech Guarantee deferrals and legal charges, is up 18% from the prior year, driven by the 22% revenue growth in our core businesses of Client, Microsoft Business Division, and Server and Tools.

Investment income and other totaled $382 million for the quarter. Our effective tax rate for the quarter was 29%, and was lower than expected due to a $195 million one-time tax benefit. Cash flow from operations increased 60% to $7.3 billion. During the quarter we repurchased 237 million shares, or $6.7 billion of company stock, and paid out $976 million in dividends to shareholders. Diluted shares outstanding for the quarter were 9.9 billion, down 5% from the prior year as a result of execution against our share repurchase program. Earnings per share for the quarter were $0.50, which includes the following non-recurring items: $0.12 related to the impact of the Tech Guarantees, a tax benefit of $0.02 offset by $0.01 in legal charges.

So in summary, the third quarter broadly exceeded our expectations, driven by the extremely positive consumer response to the launches of our flagship products.

With that, let me now turn it back to Chris, who will now provide you with our expectations for the fourth quarter and a preliminary outlook for fiscal year 2008.

Chris Liddell

Thanks, Colleen. Let me now outline some key assumptions that we have used in putting together the outlook for the fourth quarter. Firstly, we estimate that PC unit growth for the quarter will be 10% to 12%. Within the overall PC market we expect current trends to continue, with a consumer segment growth exceeding that of the business segment, and emerging market growth exceeding that of mature markets. In contrast, third party analysts have lowered their full year server hardware growth estimate to 4% to 6% and although Server and Tools revenue is impacted by many additional factors, we have incorporated that into our guidance. Lastly, our guidance for the fourth quarter assumes that changes in foreign exchange rates will not have a significant impact on revenue growth rates for the quarter.

So now for our detailed guidance. We expect fourth quarter revenue of $13.1 billion to $13.4 billion, growing 11% to 14%. Revenue guidance by business group is largely consistent with what we provided in January and so in the interested time I will simply provide you with the numbers. For Client we expect revenue growth of 14% to 15% for the fourth quarter. For Server and Tools, 16% to 17%. For Online Services, 10% to 15%, although excluding access subscription and transactions revenue, this implies advertising growth of 19% to 27%. For Microsoft Business Division, 13% to 14%. Finally, Entertainment and Devices revenue is expected to be down 2% to 11% in the fourth quarter.

Now moving on to operating income. For the fourth quarter we expect to generate between $5.0 billion and $5.2 billion of operating income, representing 28% to 33% growth over the prior year. Well, 17% to 22% when legal charges of $351 million from the year-ago quarter are excluded. This was lower than the implied guidance from January due primarily to two factors. The first is a shift in operating expenses from the third quarter, as our full year total remains consistent with what we said in January. The second is higher COGS related to Xbox console and Windows Vista retail sales.

We now estimate a fourth quarter effective tax rate of 31.5% due to a greater mix of forecasted earnings in higher tax rate jurisdictions. For diluted earnings per share, we expect $0.37 to $0.39 for the fourth quarter.

So with that fourth quarter guidance we arrive at the following expectations for the fiscal year. Revenue between $50.9 billion and $51.2 billion, representing growth of 15% to 16%. Operating income of $19.5 billion to $19.7 billion, or excluding certain legal charges, $19.7 billion to $19.9 billion, representing growth of 12% to 13% and for fully diluted earnings per share of $1.48 to $1.50 or adjusting for certain legal charges and tax benefits, $1.47 to $1.49, and representing growth of 16% to 17%.

We are clearly pleased that our strong performance in Q3 has allowed us to raise our revenue, operating income and earnings per share estimates for the full year. From a balance sheet perspective, we expect unearned revenue to finish the year up 8% to 10%, an increase of 2 percentage points from our January guidance. This increase reflects our growing confidence in multi-year contract billings in Q4, where the revenue opportunity and undoubtedly risk, is the largest we have seen in two years. The deal pipeline is robust. The value proposition for multi-year contracts are strong and the product portfolio is broad and deep.

With that, let's turn to our fiscal year '08 preliminary outlook. As is always the case at this time of year, we are providing you with our first look at the next fiscal year prior to finalizing our internal budgeting and planning process. Reflecting where we are in the planning cycle and consistent with our past practice, we're not currently in a position to give specific business group detail. I should also highlight that this guidance provides you with a view that balances both the risks and opportunities as we currently see them.

For context, our expectations are based on a stable IT spending environment. 2007 IT spending has been generally healthy and although we may see softening in select areas such as server hardware growth, we're not expecting any significant changes on a regional basis in fiscal 2008. Also, we're not modeling any significant impact to year-over-year revenue growth from changes in foreign exchange rates.

The continuous product innovation we have been stressing for two years is driving our expected growth and our product cycle continues in the next 12 months with the launches of, for example, Longhorn Server, the next version of our CRM software and live CRM service, Halo 3, the next version of Visual Studio, new Windows Live Search and Communication Services, Office Communications Server, Expressions Studio, Office Performance Point Server, Forefront Client Security, and many other products and services from across the company.

We expect our product line ought to generate revenue of $56.5 billion to $57.5 billion in fiscal '08, representing growth of 11% to 12%. On an absolute basis, this translates into an increase of over $5.5 billion, an amount larger than the total annual revenue of some Fortune 500 companies. As we have previewed with you since October, this guidance reflects the requirements for Windows Vista revenue recognition, which results in a relatively faster revenue recognition as compared to Windows XP, where we have stood at 5% to 25% of license revenue.

We are committed to transparency on this, so I would like to provide you with our revenue guidance adjusted for the impact of Windows Vista revenue recognition. We have included slide 20 in our earnings slide deck, which provide you with detail on the associated underlying balance sheet and P&L adjustments.

Had we never deferred some delivered elements on Windows XP sales, our expected accounting revenue would be approximately $220 million lower in fiscal '07 and $660 million lower in fiscal '08. These figures represent the near annual amount of revenue we expect to recognize from the undelivered elements accounts on the balance sheet. From a year-over-year growth perspective, this impact represents approximately half a percentage point of consolidated corporate revenue growth in fiscal '07, and approximately 1 percentage point of consolidated corporate revenue growth in fiscal '08.

Applied specifically to the Client business in fiscal '08, we expect a 3 percentage point impact in year-over-year Client revenue growth as a result of the Windows Vista revenue recognition methodology. Of course, the magnitude of revenue impact varies with the underlying sales mix between Windows Vista and Windows XP. Our fiscal '08 guidance numbers assume a unit mix of 85% Windows Vista, and 15% Windows XP. The amount of impact we have highlighted today could differ materially to the extent that transition to Windows Vista from Windows XP differs from our forecast. In other words, the faster the transition to Windows Vista, the bigger and more positive the impact will be in fiscal '08.

While on the subject of Client revenue, we recognize there's a lot of interest in our outlook for fiscal '08. Although we won't be providing specific Client business guidance on the call today, I would like to briefly provide you with some directional expectations. For your convenience, we have laid these out for you on slide 21 of our earnings slide deck.

The starting point for any analysis in our Client business should begin with PC sales in mature markets, which we expect to grow in mid single-digit range. We expect to get a modest uplift from emerging markets, where the underlying market growth is higher and we have the opportunity to reduce piracy. Offsetting this uplift is the successful launch of Windows Vista in 2007, which creates a difficult retail comp in fiscal '08. Adding these together, our expectation is that Client organic revenue growth in fiscal '08 will be in line with, or slightly better than, the mid single-digit growth rate for PC sales in mature markets and that Client's GAAP revenue growth will be 3 percentage points higher than the organic growth rate, due to Windows Vista revenue recognition methodology. We will provide our specific Client revenue guidance for fiscal '08 in July, but I hope this provide you with some insight into how we're thinking about our forecast, and assist you with your modeling.

Now moving on to operating income. Operating income is expected to be between $22.0 billion and $22.5 billion. Excluding certain legal charges in fiscal '07, operating income growth of 12% to 14% is slightly faster than revenue growth. This guidance implies incremental year-over-year COGS plus OpEx spending of between $3.3 billion and $3.6 billion, when you exclude legal charges in fiscal '07. Of these amounts, somewhat less than $2.7 billion is operating expenses, which is consistent with our commentary at the February analyst meeting in New York.

I would like to take time here to provide you with some of the key drivers behind our COGS and OpEx spending in fiscal '08. First, let's cover COGS. Incremental COGS spending will be in excess of $600 million, driven primarily by two factors. One, higher network infrastructure costs and delivering online services such as Windows Live, Office Live, CRM Live and Xbox Live. Two, increased scale of our consultant services business. Higher overall revenues and greater unit sales of Zune and Xbox 360 will have some impact as well.

In terms of incremental operating expenses, I would like to describe the underlying drivers using the same four categories we used for fiscal '07. The largest category remains our broad array of investments in high growth areas. As we continue to stress, innovation drives long-term growth, and we intend to continue to invest in the best opportunities. This makes up over one-third of the incremental OpEx in fiscal '08.

The second largest category is our investment in services, which makes up about a quarter of the incremental OpEx in the business. The online services area is also critical to our future success, and we have built up an appropriate level of potential future investment that reflects our current thinking.

The third category is marketing and field sales costs, which makes up about 25% of the total. The remainder of the incremental operating expenses are driven by general increases in costs, as well as unallocated spending related to small acquisitions that we may do during the year.

Now for the rest of the income statement. We expect investment income to be lower in fiscal '08 due to lower cash balances resulting from our stock repurchases in fiscal '07. We're also modeling a 30.5% tax rate in fiscal '08, driven by a higher mix of earnings in lower tax rate jurisdictions. Our forecast for fully diluted earnings per share is therefore $1.58 to $1.72, representing growth of 14% to 15%, excluding legal charges and tax benefits in fiscal '07. Similar to fiscal '07, we expect to grow earnings this year at a rate faster than revenue and operating income.

As always, I will remind you that as you think about the guidance we have provided that you also consider the risks. Those risks include competitive, legal, execution and general market risks, as well as PC and Turbo hardware growth rates and customer acceptance of our product. Also, our emerging businesses are harder to forecast when compared to our mature businesses and as they become a larger part of the overall financial mix, they may contribute to increased volatility in our performance.

I would like to wrap up today with two final and brief observations. The first is that if we take a step back and look at the results we have delivered, as well as the guidance provided for fiscal '08, you find that we're growing revenue, profits and earnings per share at impressive rates on both an absolute and relative basis for a company our size. For example, excluding legal charges and tax benefits, our fiscal '08 guidance implies earnings per share growth of $0.41 to $0.45, or 32% to 35% over two years.

The second observation is that I believe the third quarter results and the guidance we have provided are indicative of how we build long-term shareholder value in the company. We do so by driving robust revenue growth for our established cores in the desktop and server markets, as well as by building new cores in online services and entertainment. By translating that revenue growth into strong operating profits and cash flow, allows us the flexibility to make significant investments to drive future growth, and finally by returning capital to shareholders through repurchases and dividends.

We believe this is an optimal model for delivering long-term shareholder value and I'm pleased that our third quarter and our forward-looking outlook reflect our execution against this.

Thank you for your time today and I will now hand the call over to Colleen so we can take your questions.

Colleen Healy
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 yourselves to just one question. Operator, will you please repeat your instructions?

Question and Answer

Operator

(Operator Instructions) Your first question comes from Heather Bellini - UBS.

Heather Bellini
UBS

Thanks Rick and Colleen. I actually had a question about the premium mix that you reported. It seems to be coming in much better than what you guys had forecasted prior to Vista launching. I just wanted to get your sense for how you think this is going to track over time, and should we hold constant this type of Vista Premium mix adoption?

In terms of the 85/15 mix that you're forecasting between Vista and XP, how would that have compared to your expectations of what actually happened when XP launched? Thank you.

Chris Liddell

In terms of the Premium mix, you're right, it is coming in above our expectations and are good. Within that obviously you do have a shift between Pro and what was previously Media standard. There's a mix shift within the mix. We think that we are going to see in fiscal year '08 a continuation of the trend that we saw in fiscal year '07 so the numbers from a Premium point of view will be broadly the same.

What we're thinking of doing probably for next year is to start to give you some more visibility into how that Premium mix is made up, because, as we have talked about on previous calls, this is quite a different economic impact, depending on in this case whether it is Vista Premium or Vista Business, one being five times the economic benefit relative to the other. So we'll continue to give you the Premium mix as we see, which you can think of as being broadly equal to fiscal year '07 a lot of the benefit that we are seeing. But will also start to give you some visibility into the split of that Premium mix going forward as well.

What was the second half of your question?

Heather Bellini
UBS

You commented about a 85% Windows Vista mix, 15% XP. What did you see during the last cycle when XP launched, what was the mix?

Colleen Healy

It is not going to be terribly comparable just because of also the SKUs structure.

Chris Liddell

But generally speaking it is faster. So 85/15 is very healthy. Now it obviously may vary on that, it is going to depend on the consumer versus the business.

Heather Bellini
UBS

Are you forecasting faster adoption of Vista than what you saw for adoption of XP, is the question?

Chris Liddell

We don't think of it that way. We don't do a comparison back to that. But if you look at the math of it, that is likely to be the result. What we are looking at is the underlying trends we see in the business relative to Vista, regardless of what might have happened four years ago. As we see the mix in consumer versus business, and as we see the overall growth rates and as we see the current adoption, we think 85% is a reasonable starting point for next year.

Colleen Healy

You know, obviously, the variable there that people look to is on the business side and how quickly they're adopting. We feel like because this version, as you'll remember when was in beta was very widely tested, we feel like the tools and costs associated with it and ease of images, we are optimistic but we still don't want to get ahead of ourselves.

Operator

Your next question comes from Charlie DiBona - Sanford Bernstein.

Charlie DiBona
Sanford Bernstein

Chris, you spent a lot of time clarifying client guidance and accounting, but I'm wondering if I could maybe change gears for a second and look at my favorite group, the Online Services group? It seems like from your financial results this quarter and from some of the external metrics that you maybe stopped some of the deterioration there. Certainly any metrics more that you want to share there would be appreciated.

Going forward, now that you have sort of stabilized the patient, can you maybe talk strategically about how you want to get him up off the table and move in the right direction? Maybe also how you're going to build share and community and how OSG relates in that process to the other business groups, both in building its business and then feeding back into those ones?

Chris Liddell

Lots to digest in that one. But let me cover the ground, and then get back on any particular aspect. You're absolutely right. From a quarterly point of view this was a much better quarter for OSB. If you exclude the Access and Subscription business, the advertising revenue, which is probably the single best metric to look at in terms of growth year on year, was up 23%. If you look at the guidance that we're talking about for next quarter, we're looking at greater than 20% again in the fourth quarter as well.

That is a reflection of a number of factors. One is display growth revenue growing broadly in line with market. The second is the benefits now of Ad Center are coming on stream. So we have talked with you about this a lot. We said that we would lap our previous monetization rate on Ad Center at some stage in this fiscal year. Well, we did that in that third quarter. So we're a little ahead of ourselves. We were expecting more like fourth quarter, but we did it in the third quarter. So we are ahead of where we were on the Overture platform of a year ago now and obviously on an appreciating trend. When you look at the number of advertisers that we are getting on the platform, we're getting at or above the rates that we were expecting and with considerably less advertisers than on the Overture platform, we're getting a higher monetization.

So we are feeling very good about the rates that we are seeing in terms of Ad Center overall. That is feeding through to the revenue growth numbers that you see, if you exclude the Access. Again, we will try quarter by quarter to give you that advertising number to give you a sense of the health of the underlying business.

To your broader question about strategy, from our point of view it is a continuation of what we have talked about, which is we are going to invest in this business because we see it as a long-term one. We like a lot of the growth that we are getting on the display side. We are happy with it. On the communication side, you have the growth in Hotmail and Messenger accounts, which we don't currently monetize to any great extent, but it still is extremely healthy and we're very happy with, for example, some of the relevancy in the underlying product in our search. We aren't happy, clearly, with the market share we have.

So some things we are happy with, some things that we're not happy with, or I would like to see a lot better but we are going to continue to invest. We're going to continue to invest in the infrastructure of the business, we will continue to invest in new products, we will continue to invest in the search relevancy side of things. And in terms of the infrastructure, that will support not only the online business, but it will support Office Live. It will support Xbox Live. That is another healthy statistic from our point of view, with greater than 6 million customers now on Xbox Live. So that is a very good platform. The platform will support that area.

In terms of accounting, to a large extent we bear the costs inside the Online Services area without trying to change accounting around. We may try and give you more visibility into how it helps some of the other businesses, but certainly strategically it helps them quite a lot.

Operator

Your next question comes from Adam Holt - JP Morgan.

Adam Holt
JP Morgan

My question is about the underlying strength in the Office business or the MBD category. If you strip out the one-time events in the quarter, it looks like you still had about 20% growth in MBD. I guess what I'm trying to understand is what was the mix between what came off the balance sheet relative to what was new business? And understanding there's a little bit of retail spike here, how should we think about the Enterprise business feathering in over the next couple of quarters, particularly in the context of how you compare that to Vista?

Chris Liddell

I think it is great. We tend to get 90% of our questions about Client, and to a large extent the MBD business is a real success story in the third quarter. We exceeded our revenue expectations by around $200 million and that was on the back of, to a large extent, just very good retail sales, so sales of units out the door. We feel like that is a direct customer acceptance of a very good product.

It didn't result from any balance sheet movements. In fact, we are slightly penalized because of the change in revenue recognition inside that division but to a large extent, very good customer acceptance, very good retail sales inside the quarter.

In terms of annuities going forward, which is probably more of the case; obviously we're not going to at this date give you fiscal year '08 numbers, but for the fourth quarter a continuation of very good revenue growth numbers inside that division. Embedded inside fiscal year '08 we think the business will continue to do well.

I am happy, very happy with the retail acceptance of the product. From an annuity point of view and a business point of view at this stage it is early days, but it is good as well.

Colleen Healy

Just in terms of that housekeeping matter, we had about $0.5 billion of Tech Guarantee. Your 20% year on year is the normalized growth, and we think it speaks to the strength of the business and the launch in the quarter.

Chris Liddell

But to be clear, 20% is excluding the Tech Guarantee impact.

Adam Holt
JP Morgan

If I could just ask a follow-up on that, if you were to look at this business adding into the next quarter with respect to the small business segment of it, are you seeing small businesses gravitate towards long-term contracts, or do you think the small business activity is going to be principally more like licensing and more like the consumer?

Chris Liddell

We aren't seeing any marked difference in the pick up to any great extent. The same split that we have seen in terms of 40% annuity, 40% license only is, broadly speaking, what we are expecting going forward.

Colleen Healy

Just to add to that, the metrics, certainly the 20% billings growth does speak to the Dynamics business, which targets more of that segment that you're talking about. And then on the CRM side, we did announce in March reaching that milestone of 10,000 customers and 400,000 users. We're continuing to work the value proposition there.

Operator

Your next question comes from John DiFucci - Bear Stearns.

John DiFucci
Bear Stearns

Chris, you told us what the impact of the Technology Guaranteed Program was on the Client business, but you also mentioned a couple of other events that are different this quarter versus previous quarters. There was a revenue recognition change and also the channel preparation for the launch. Can you tell us what the growth would have been if you excluded both of those?

Along the same lines, just to follow, on the revenue rec change, the numbers you threw out there seemed a little low to me, looking at the rest of this year and next. Are you going to give us what the impact has been on a quarterly basis?

Chris Liddell

We will certainly give you the Vista revenue recognition impact on a quarter-by-quarter basis. That is what we can do right at the start. We are very happy to do it. If you look at the chart that I referred to, I'm not sure you had a chance to as I was speaking, it gives you it in black and white. It is $220 million in fiscal year '07 and $660 million in fiscal year '08.

Of that $220 million in fiscal year '07, it was broadly equal in Q3 and Q4. That would have had about 0.5% impact from a growth rate point of view. That is just for the Vista revenue recognition impact. For the company overall and for Client it was around 3%. We are certainly happy to work through the math. I know there's a lot of moving parts, but we will give you total transparency to the extent we can.

John DiFucci
Bear Stearns

Even though in Q3 there was only two months out of the three that really had the impact, you think it will be evenly split? If you included that impact, plus the channel preparation for the launches, I think either you or Colleen mentioned generally usually you see a spike in the revenue due to that. During a launch quarter what would the Client growth have been?

Chris Liddell

If I work through the math, if you start with PC unit growth in the quarter, it was around 10% to 12%. We saw OEM unit growth of 20%. So the units grew in excess of PC units and that is people stocking obviously or restocking, and some of the system builder channel impacts as well, so unit growth of around 20%. If you exclude the Vista and the Tech Guarantee, the OEM revenue grew broadly in line to 21% relative to 20% growth.

The commercial and retail, which was obviously the retail spike, grew 53% and Client revenue overall would have grown 27%. So if you exclude all the accounting impacts, that is probably the easiest way to work through it. But it is still a very healthy quarter, up 27%.

Operator

Your next question comes from Sara Friar - Goldman Sachs.

Sara Friar
Goldman Sachs

Maybe you could switch to just the Entertainment and Devices division. Could you just give us some clarity, Chris, on whether you are still expecting profitability for that division in FY’08? Obviously that has been a big milestone.

I think last quarter it seemed as if you were managing that inventory, but I assumed that was somewhat ahead of a price cut, so any further color you could give us there would be great. And then just one more on the Halo 3 launch. What are you expecting in terms of impact from Halo 3, and just overall attach rates as the cycle gets a little bit more mature?

Chris Liddell

The sales during the quarter in terms of sell-in were around 500,000 consoles. The sell-through, that is what the retailers sells, was higher than that, so our inventory levels did come down to more around normal levels we would expect. We did a good inventory movement during the course of the quarter.

In terms of profitability for next year, that is certainly the target. We're working through our budgeting process now, but from my point of view anyway, that is the starting point going into next year. Obviously, there's a lot of moving parts there in terms of our ability to take COGS of the system, how many units we sell and factors like that. But that is certainly the starting point.

In terms of Halo 3, that is clearly going to have a positive impact in two senses. One, it gives us more confidence with the number of consoles that we think we are going to be able to sell next year. In terms of a direct impact, obviously it is a third-party product, so it is reasonably profitable from our point of view. It will be several hundreds of millions of dollars in revenue next year.

Sara Friar
Goldman Sachs

Terrific. No change competitively this quarter in terms of Sony and Wii and so on?

Chris Liddell

I'm sorry, what was that?

Sara Friar
Goldman Sachs

Any changes competitively from the other two big game vendors, Sony and Nintendo?

Chris Liddell

No, nothing of significance. We are obviously very happy from a competitive point of view with the response in the marketplace, but nothing of significance.

Operator

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

Kirk Materne
Banc of America Securities

Chris, you mentioned going into your fourth quarter you have a number of large multi-year deals up for renewal. Can you just give us some color perhaps around how many of those deals involves say upselling a large enterprise from the Business version to get them on the Enterprise version, which would also take them into a longer-term agreement with you guys around software assurance?

I'm just trying to get a sense on how many of those type of deals are still out there where a customer might be on software assurance for Office but not for Vista, for example. Any color around that would be helpful.

Chris Liddell

I can't give you a proportion, but I think if I talk about it the way the field thinks about it, every license that comes up for renewal is an opportunity to sell additional products. When you think about it, it is a three-year anniversary, generally speaking. So in the last three years if you think about the products we have launched, it is not just the obvious ones of Vista and Office. There's a significant amount of additional products that the field now has the ability to sell as part of an enterprise agreement. So there is a significant number of contracts coming up and clearly, there is some risk to the extent those people now have an entitlement to Vista and Office, but there is an opportunity because of all the other products.

I don't want to say there is an X percent where we think we will be successful but we certainly feel good about maintaining the renewal rate of two-thirds to three-quarters, and in some instances they would be additional products as well.

Operator

Your next question comes from Kash Rangan - Merrill Lynch.

Kash Rangan
Merrill Lynch

I just want to clarify on the EPS guidance for fiscal '08, that does include the positive impact from the rev rec rate, so how would you quantify that if you look at the $1.68 to $1.72, does $0.04 to $0.05 positive impact from the rev rec seem like a reasonable assumption?

Chris Liddell

We give the specific number, so depending on how you treat it. But if we look at the GAAP unearned income that comes off our balance sheet and we expect to flow through the income statement next year, it is $660 million. So that will equate to around $0.04 a share, if you take an after-tax and divide it by our number of shares. So that number may go up or down slightly depending on our actual sales and the mix of Vista and XP. But if you just take our guidance as it sits, it would be around $0.04 a share.

Kash Rangan
Merrill Lynch

What is the confidence level at this early point in the cycle, Chris, with 85% Vista, 15% XP assumption? What we hear from our surveys is that a lot of the Enterprises seem to want to do an implementation of Vista in 2008. So how are you thinking about the confidence level in the 85/15 mix between Vista and XP?

Chris Liddell

It is early days, so the standard deviation is quite high. But I will just say that our fiscal year '08 picks up the first six months of calendar year 2008. So to the extent that some people are on the sidelines waiting, they may well be looking at a position of early next year and that would pick up our fiscal year.

It could be a relatively high swing between 85/15. From a revenue recognition point of view that might move around from an accounting perspective. From a cash flow point of view, it is not really going to have a significant impact.

Kash Rangan
Merrill Lynch

Finally, the units on Vista you disclosed, I think one month after the launch, was 20 million. Any update on that during the quarter how many units of Vista? If you could break that out between OEM and retail, that would be useful.

Chris Liddell

No, I don't have a number to give you today. I'm happy to talk to the Client people, and if there's a number they would like to give out, we will follow-up with that.

Operator

Your next question comes from Brent Thill - Citigroup.

Brent Thill
Citigroup

Thanks, good afternoon. Chris, next year for fiscal '08 on operating margins, I believe that implies roughly flat with '07. Can you help us reconcile, considering that you're headed in probably the strongest point of your product cycle in a number of years, how you expect that operating margin to play out with regard to what your long-term model looks like and where you were at a couple of years ago at much higher operating margins?

Chris Liddell

Sure. I will start with just the guidance we have given you, at least on a GAAP basis. So we talk about revenue growth of 11% to 12%, and operating income growth of 12% to 14%. So you see a slight margin expansion based on that, although some of that is obviously the Vista accounting impact, and obviously earnings per share growing at 14% to 15%, so higher again; so a little bit improved margins in that respect.

When I look at next year, we are still in investment mode in Online Services. We are looking at year-on-year growth on expenses broadly in line with what we have talked about. We're talking about growing the company's revenue base 11% to 12%. So if we can get margin expansion, I think that is tremendous. I think you have to look at the underlying businesses and look at them one by one. But if we can grow the company top line 11% to 12% and maintain or possibly slightly enhance our margin structure, I think that is a good starting base for a company of our size.

Brent Thill
Citigroup

I would just be curious to get your thoughts. A number of the hardware companies have mentioned a sluggish March. It appears that you're not seeing that. Maybe offer some thoughts in terms of what the difference is there. As a follow-up on the business segment, you mentioned the consumer segment is tracking ahead of the business. When do you expect the business segment to really start to kick in?

Chris Liddell

Obviously we have a lot of different cycles from a hardware manufacturer, given the number of businesses that we're in. You have to look at it across the whole suite of our businesses. The thing that I would say is we are not seeing any significant slowdown in aggregate across our businesses. Individual businesses may have some, but certainly for the company overall, given the multiplicity of businesses we're involved in, we are seeing healthy demand.

We have a good international business as well, which helps as well. I assume your question was mainly around North America, but a large number of our sales are outside North America and the economies are doing very well there and we're certainly seeing growth rates that are very good there as well. So no particular aspects there.

What was the second part of your question?

Brent Thill
Citigroup

Just in terms of when do you think the business segment starts to maybe eclipse the consumer segment, when you see that strength kicking in?

Chris Liddell

I think the business segment is probably going to continue to be broadly equal to what it is at the moment. So it is really around consumer growth and whether that changes or not. But if the business growth continues in the sort of mid single-digits, the consumer growth is probably growing in excess of 10%. I don't necessarily see that inverting for the foreseeable future. I think customer growth would have to slide down quite a lot in order to dip below business growth, which I think is going to remain relatively healthy.

Colleen Healy

Thanks so much. Thanks to 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 26, 2008. In addition, you can hear the replay by dialing 866-479-2456, or for international calls dial 203-369-1531. The dial-in replay will be available through the close of business May 4, 2007. Thanks again for joining us today.