Presentation

Operator

Greetings, and welcome to the Microsoft Fiscal Year 2021 Second Quarter Earnings Conference Call. [Operator Instructions] As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Mike Spencer, General Manager, Investor Relations. Thank you, sir. You may begin.

Michael Spencer
General Manager of Investor Relations

Good afternoon, and thank you for joining us today. On the call with me are Satya Nadella, Chief Executive Officer; Amy Hood, Chief Financial Officer; Alice Jolla, Chief Accounting Officer; and Keith Dolliver, Deputy General Counsel.

On the Microsoft Investor Relations website, you can find our earnings press release and financial summary slide deck, which is intended to supplement our prepared remarks during today's call and provides a reconciliation of differences between GAAP and non-GAAP financial measures.

Unless otherwise specified, we will refer to non-GAAP metrics on the call.

The non-GAAP financial measures provided should not be considered as a substitute for or superior to the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the company's second quarter performance in addition to the impact these items and events have on the financial results.

All growth comparisons we make on the call today relate to the corresponding period of last year, unless otherwise noted. We will also provide growth rates in constant currency when available as a framework for assessing how our underlying businesses performed, excluding the effect of foreign currency rate fluctuations. Where growth rates are the same in constant currency, we will refer to growth rate only.

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

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

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

Satya Nadella
CEO & Director

Thank you, Mike. It was a record quarter driven by our commercial cloud, which surpassed $16 billion in revenue, up 34% year-over-year. What we are witnessing is the dawn of a second wave of digital transformation sweeping every company and every industry. Digital capability is key to both resilience and growth. It's no longer enough to just adopt technology. Businesses need to build their own technology to compete and grow. Microsoft is powering the shift with the world's largest and most comprehensive cloud platform.

And now I'll briefly highlight how we are innovating across every layer of the modern tech stack, starting with Azure. We're building Azure as the world's computer to support organizations' growing cloud needs. We're investing to bring our cloud services to more customers, announcing 7 new data center regions in Asia, Europe and Latin America and adding support for top-secret classified workloads in the United States.

We've always led in hybrid computing, and we are accelerating our innovation to meet customers where they are. Azure Stack HCI, now broadly available, helps businesses extend the power of the cloud to sovereign workloads. More than 1,000 customers now use Azure Arc to simplify hybrid management and run agile services across on-premises, multi-cloud and at the edge. And with Azure Digital Twins, organizations like Bentley Systems, Honeywell Industries and Johnson Controls can bridge the digital and physical worlds, creating simulations of factories, cities to optimize their operations.

We are seeing momentum in every industry. Deutsche Telekom will rely on Azure to modernize its IT infrastructure through a partnership with Broad Institute of MIT and Harvard as well as Verily, our cloud will be used to help more researchers analyze biomedical data. Cruze and GM chose Azure as their preferred cloud as they work to make autonomous driving mainstream. And just last Friday, we announced an expansion of our partnership with SAP to accelerate the adoption of SAP workloads on Azure. In the past 6 months, we have seen Tier 1 ERP migrations from companies such as Bayer, Carhartt, Coats and Pepsico to Azure.

At the data layer, Azure is the only cloud with limitless data and analytics capabilities that enable organizations to build the predictive and analytical power required to digitally transform. Azure Synapse brings together big data, data warehousing and data integration all into one powerful solution. Leading companies like FedEx, Grab and P&G are using Synapse to generate immediate insights from massive amounts of structured and unstructured data, and we are seeing strong overall growth in our analytics business as companies accelerate their data initiatives to build competitive advantage.

Data governance is top of mind for every business leader and will grow into an important category on its own as critical as any AI or analytics category today. We are investing to participate in this growth. New Azure Purview provides an end-to-end view of an organization's data estate across on-premise, multi-cloud and SaaS apps that previously was impossible.

In AI, we offer the most comprehensive portfolio of tools, frameworks and infrastructure, enabling

[Technical Difficulty]

teams calling globally to 42,000 employees in just 4 weeks. The pandemic has shown the importance of empowering the 2 billion frontline workers around the world with the right technology. 390,000 associates at Home Depot will use Microsoft 365, including Yammer, to foster connection and engagement across the organization. And more than 500,000 employees of the U.S. Department of Veterans Affairs, including health care workers, use Teams to collaborate.

In education, more than 200 million students and educators worldwide rely on Microsoft education products for remote learning. And leading customers in every industry, including Amgen, AT&T, Daimler, GSK and IKEA are increasingly turning to our premium offerings for advanced security, compliance, voice and analytics capabilities. Microsoft 365 E5 revenue has grown triple digits for the past 4 quarters.

Now to security. The recent SolarWinds attack are a stark reminder of how critical security is to our customers. We are focused on ensuring organizations deploy and maintain a zero-trust architecture. Our end-to-end security capabilities, inclusive of identity, security, compliance and management across all clouds and all client platforms have been key as we help customers strengthen their security posture and mitigate impact.

Beyond our products, our operational security posture and threat intelligence, which analyzes 8 trillion signals each day, help customers defend themselves. Over the past 12 months, our security business revenue has surpassed $10 billion, up more than 40%. This milestone is a testament to the deep trust organizations place in us, and we will continue to invest in new capabilities across all our products and services to protect our customers.

We see strong momentum in usage of our products. In identity, Azure AD has more than 425 million monthly active users. In security, Microsoft Defender blocked nearly 6 billion threats last year alone. In management, we saw triple-digit growth in the number of devices managed by Microsoft Intune; and in compliance, we've seen 90% increase in our customer base year-over-year.

Now on to gaming. We surpassed $5 billion in revenue for the first time in this quarter as we expand our opportunity to reach the world's 3 billion gamers wherever they play. The launch of Xbox Series X and Series S was the most successful in our history, with the most devices ever sold in a launch month. Game developers are benefiting too as they turn to us to reach more players and scale their games using the power of our cloud. We exceeded $2 billion in revenue from third-party titles this quarter for the first time.

We're gaining console share as gamers recognize the value of our broader ecosystem. Xbox Live has more than 100 million monthly active users while Game Pass now has 18 million subscribers. And we are transforming how games are distributed, played and viewed, bringing cloud gaming and Game Pass to iOS devices and Windows PCs over the next few months.

We are pleased with the overall growth in our consumer subscriptions with Game Pass and more than 47 million Microsoft 365 personal and family subscribers, we have a large and growing consumer subscription business. And we see significant opportunity in both of these segments as they move to services and on-demand models.

In closing, I'm energized by our increasing momentum and the expanding opportunity fueled by the structural change brought about by the rapid adoption of digital technology. We're investing to meet these needs in the coming decade, and I'm optimistic about what's ahead.

With that, I'll hand it over to Amy, who will cover our financial results in detail and share our outlook; and I look forward to rejoining you after for questions.

Amy E. Hood
Executive VP & CFO

Thank you, Satya, and good afternoon, everyone. This quarter, revenue was $43.1 billion, up 17% and 15% in constant currency. Earnings per share was $2.03, increasing 34% and 31% in constant currency. Across our business, results exceeded expectations, driven by strong execution and improving trends across industries, customer segments and geographical markets, resulting in double-digit top and bottom line growth.

In our commercial business, customers prioritized their digital transformation, which drove healthy demand for our hybrid and cloud offerings with material growth in the number of $10 million-plus Azure and Microsoft 365 contracts. We saw stronger Azure consumption as well as higher usage of Teams, Power Platform and our advanced security and compliance offerings. And within our small and medium business customer segment, transactional licensing trends continued to show some improvement.

[Audio Gap]

our Windows OEM, Office Consumer and Surface businesses. The advertising market continued to show improvement, benefiting our Search and LinkedIn businesses. And in gaming, we saw record engagement and monetization across our platform as well as console demand that significantly exceeded supply following the Xbox Series X and S launches.

Moving to our overall results, even with the declining expiration base and a strong prior year comparable, commercial bookings increased 19% and 11% in constant currency. Strong execution across our core annuity sales motions, including the Azure and Microsoft 365 momentum noted earlier, drove a better-than-expected result. Commercial remaining performance obligation increased 24% and 22% in constant currency to $112 billion, with a roughly equivalent split between the revenue that will be recognized within and the portion beyond the next 12 months. And our annuity mix increased 4 points year-over-year to 93%.

Commercial cloud revenue was $16.7 billion as growth accelerated to 34% and 32% in constant currency. Commercial cloud gross margin percentage expanded 4 points year-over-year to 71%, driven by the change in accounting estimate for the useful life of server and networking equipment assets. Excluding this impact, commercial cloud gross margin percentage was up slightly.

As a reminder, revenue mix shift to Azure, increased customer usage of our productivity and collaboration solutions and continued strategic investments to support customer success, and the deployment of our solutions will continue to impact gross margin. With the weaker U.S. dollar, FX increased revenue growth by approximately 2 points, about 1 point more favorable than anticipated. FX had no impact on COGS growth and increased operating expense growth by approximately 1 point, both in line with expectations.

Gross margin dollars increased 18% and 16% in constant currency. Gross margin percentage was 67%, up slightly year-over-year with roughly 2 points of favorable impact from the change in accounting estimate noted earlier. Excluding this impact, company gross margin percentage was down driven by the sales mix shift to cloud and gaming.

Operating expense increased 3% and 2% in constant currency, lower than anticipated, driven by greater-than-expected COVID-related savings, reductions in retail store expenses and investments that shifted to future quarters. Overall, company headcount grew more than 10% year-over-year with our focused investment in key areas such as customer success, cloud engineering and sales.

Operating income increased 29% and 26% in constant currency, and operating margins expanded 4 points year-over-year to 42%, including roughly 2 points of favorable impact from the change in accounting estimate and nearly 1 point of favorable impact from COVID-related savings.

Now to our segment results. Revenue from Productivity and Business Processes was $13.4 billion, increasing 13% and 11% in constant currency, ahead of expectations, primarily driven by Office Commercial and LinkedIn. On a strong prior year comparable that included roughly 3 points of benefit primarily from transactional strength in Japan, Office Commercial revenue grew 11% and 9% in constant currency. Office 365 Commercial revenue grew 21% and 20% in constant currency. Results were driven by installed base expansion across all workloads and customer segments as well as higher ARPU.

The strong demand for Microsoft 365 noted earlier, particularly for our security, compliance and voice components, drove E5 revenue growth acceleration again this quarter. Paid Office 365 Commercial seats increased 15% year-over-year with strong conversion of our free trial offers. We also saw a steep growth improvement in our small and medium business and first-line worker offerings.

Office Consumer revenue grew 7% and 6% in constant currency on a strong comparable that included roughly 7 points of benefit from transactional strength in Japan. Microsoft 365 Consumer subscriptions grew to 47.5 million, up 28% year-over-year. Dynamics revenue grew 21% and 18% in constant currency, driven by Dynamics 365 revenue growth of 39% and 37% in constant currency. The number of customers adopting multiple Dynamics 365 workloads accelerated again this quarter.

LinkedIn revenue increased 23% and 22% in constant currency, significantly ahead of expectations. Growth in our marketing solutions business accelerated to 53%, benefiting from the stronger advertising market noted earlier. Segment gross margin dollars increased 13% and 11% in constant currency, and gross margin percentage was relatively unchanged year-over-year with roughly 2 points of favorable impact from the change in accounting estimate. Operating expense increased 4% and 3% in constant currency, and operating income increased 19% and 17% in constant currency, including 5 points due to the change in accounting estimate.

Next, the intelligent cloud segment. Revenue was $14.6 billion, ahead of expectations, increasing 23% and 22% in constant currency. Server products and cloud services revenue increased 26% and 24% in constant currency. Azure revenue grew 50% and 48% in constant currency driven by strong growth in our consumption-based business that benefited from improvement across industries and customer segments noted earlier. Our per-user results were also better than expected driven by accelerated growth in our enterprise mobility and security installed base, up 29% to over 163 million seats. And on a strong prior year comparable that included roughly 4 points of benefit from the end of support for Windows Server 2008, our on-premises server business increased 4% and 3% in constant currency with strong annuity performance driven by continued demand for our hybrid and premium offerings.

Enterprise services revenue grew 5% and 4% in constant currency, again driven by premier support services. Segment gross margin dollars increased 29% and 27% in constant currency, and gross margin percentage increased 3 points year-over-year, with roughly 3 points of favorable impact from the change in accounting estimate. Operating expense increased 12% and 11% in constant currency, and operating income grew 43% and 41% in constant currency, with roughly [10 point] favorable impact from the change in accounting estimate.

Now to More Personal Computing. Revenue was $15.1 billion, increasing 14% and 13% in constant currency and better-than-expected performance across all businesses. In Windows, the stronger PC market resulted in overall OEM revenue growth of 1% despite a strong prior year comparable in OEM Pro from the end of support for Windows 7. OEM non-Pro revenue grew 24%, and OEM Pro revenue declined 9%. Inventory levels ended the quarter in the normal range.

Windows Commercial products and cloud services revenue grew 10% and 8% in constant currency driven by continued demand for Microsoft 365 and our advanced security solutions. In Surface, revenue grew 3% and 1% in constant currency. Search revenue ex TAC increased 2% and 1% in constant currency, benefiting from the improved advertising market noted earlier. And in gaming, revenue increased 51% and 50% in constant currency. Xbox hardware revenue grew 86% driven by the new console launch as well as the benefit from lower price promotions on our prior generation consoles. Xbox content and services revenue grew 40% and 38% in constant currency with strong growth in third-party transactions, Game Pass subscribers and first-party titles.

Segment gross margin dollars increased 11% and 9% in constant currency, and gross margin percentage decreased 2 points year-over-year driven by sales mix shift to gaming. Operating expense decreased 10%, and operating income grew 25% and 22% in constant currency.

Now back to total company results. Capital expenditures, including finance leases, were $5.4 billion, up 20% year-over-year to support growing global demand and customer usage of our cloud services. Cash paid for PP&E was $4.2 billion. Cash flow from operations was $12.5 billion and increased 17% year-over-year as strong cloud billings and collections were partially offset by payments related to a tax audit settlement. Free cash flow was $8.3 billion, up 17%.

Excluding the impact of these tax payments, cash flow from operations and free cash flow grew 33% and 41%, respectively. Other income and expense was $440 million, higher than anticipated, primarily driven by net gains on investments, including mark-to-market gains on our equity portfolio as well as net gains on foreign currency remeasurement. Our effective tax rate was approximately 16%, in line with expectations. And finally, we returned $10 billion to shareholders through share repurchases and dividends, an increase of 18% year-over-year.

Now let's move to our outlook. My commentary for both the next quarter and any remarks for the full year does not include any impact from the ZeniMax acquisition, which we still expect to close by the end of the fiscal year. In our Commercial business, consistent execution, focus on customer success and a compelling solution portfolio in high-growth markets should drive another strong quarter. In our Consumer business, we expect to see healthy demand for PCs and productivity tools continue, though growth rates will again be impacted by the end of support for Windows 7 last year. In gaming, we expect continued strong engagement on the Xbox platform and significant demand for the Xbox Series X and S that will still be constrained by supply. And our Search and LinkedIn businesses should benefit from the improving advertising market.

In Commercial bookings, we have a growing Q3 expiry base and a low prior year comparable, so strong execution across our core annuity sales motions and increased commitment to our cloud platform should drive healthy growth. As a reminder, an increasing mix of large long-term Azure contracts, which are more unpredictable in their timing, can drive quarterly volatility in the growth rates.

Commercial cloud gross margin percentage to increase by approximately 3.0 over year, again driven by the change in accounting estimate. Excluding this impact, continued improvement in Azure, IaaS and PaaS gross margin will be offset by revenue mix shift to Azure and continued investments to support our customers' success. We expect a sequential increase on a dollar basis to our capital expenditures as we continue to invest to meet growing global demand for our cloud services.

Now to FX. Based on current rates, we expect FX to increase total company revenue, COGS and operating expense growth by approximately 2 points. Within the segments, FX should increase Productivity and Business Processes revenue growth by approximately 3 points and Intelligent Cloud and More Personal Computing revenue growth by approximately 2 points.

Now to segment guidance. In Productivity and Business Processes, we expect revenue between $13.35 billion and $13.6 billion. In Office Commercial, revenue growth will again be driven by Office 365, with continued upsell opportunity to E5. In our on-premise business, though we anticipate continued improvement in transactional purchasing trends, we expect revenue to decline in the mid- to high teens range, consistent with the ongoing customer shift to the cloud.

In Office Consumer, on a strong prior year comparable, revenue growth should be similar to last quarter with continued growth in Microsoft 365 subscription revenue. In LinkedIn, we expect continued strong engagement on the platform to drive revenue growth in the low 20% range. And in Dynamics, continued momentum will drive revenue growth similar to last quarter.

For Intelligent Cloud, we expect revenue between $14.7 billion and $14.95 billion. In Azure, revenue will again be driven by strong growth in our consumption-based business. And in our per-user business, we expect continued benefit from Microsoft 365 suite momentum. In our on-premise server business, we expect revenue growth to be in the low to mid-single digits driven by continued demand for our hybrid and premium annuity offerings on a strong prior year comparable that included the benefit from the end of support for Windows Server 2008. In enterprise services, revenue growth should be roughly in line with last quarter.

In More Personal Computing, we expect revenue between $12.3 billion and $12.7 billion. In Windows, overall OEM revenue growth should be in the low single digits on a strong comparable mentioned earlier. Windows commercial products and cloud services growth should be in the low to mid-teens, driven by continued demand for Microsoft 365 and our advanced security solutions. And in Surface, good demand against the low prior year comparable should drive growth in the mid- to high teens range. In Search ex TAC, growth should be driven by improvements in the advertising market. And in gaming, we expect revenue growth of approximately 40%, driven by next-generation console sales as well as Xbox content and services revenue in the mid-20% range.

Now back to the company guidance. We expect COGS of $13.1 billion to $13.3 billion and operating expense of $11.9 billion to $12 billion. In other income and expense, interest income and expense should offset each other. We expect our Q3 tax rate to be approximately 15%, slightly lower than our full year rate of approximately 16%.

And finally, for FY '21, with our strong performance in the first half of the fiscal year and our outlook for Q3, we expect to deliver another full year of double-digit revenue and operating income growth as well as healthy operating margin expansion, even after excluding the impact of the change in accounting estimate and COVID-related savings.

In closing, we have executed well in the first half of our fiscal year in a challenging and changing environment. Investments made over quarters and often years, coupled with focused execution by our teams, are the drivers behind a compelling portfolio that is delivering value today for our customers and creating optimism in our road map for tomorrow.

Satya discussed our unique, comprehensive and integrated set of products earlier on the call, products and services that span large growth markets, and we will continue to invest broadly and boldly against the significant opportunities ahead of us.

With that, Mike, let's go to Q&A.

Michael Spencer
General Manager of Investor Relations

Thanks, Amy. We'll now move over to Q&A. As respect to others on the call, we request that participants please only ask one question. Operator, could you please repeat your instructions?

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Mark Moerdler with Bernstein Research.

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

Satya and Amy and the whole team, congratulations on the great quarter. It seems like almost every part of the business beat. There did not seem to be any meaningful impact from COVID or tougher comps. Two parts to the question: one, should we feel that the COVID impact is basically behind you?; And two, is the tougher comps or are we now seeing the demand as such that allows you to build on those larger numbers?

Satya Nadella
CEO & Director

Thanks, Mark. Maybe I'll start, and Amy, you can add to it. I think one of the things that we're seeing is the COVID impact has put a lot of constraints on all our customers, but the one structural change is the digital technology is becoming critical even for core resilience and business continuity and to deal with what is going to be a structurally changed customer behavior and expectations.

So as a tech company with that comprehensive differentiated portfolio, all the way from business applications, industry solutions to infrastructure, I think we benefit from that and that's what you saw this quarter. But more importantly for me, Mark, when I look at the next 10 years of what compute and digital technology will do across industries, that's the opportunity that we are obviously staying very, very focused on and investing in.

Amy E. Hood
Executive VP & CFO

And Mark, maybe to the second half of your question on being passed some tougher comparables, I don't think we are and it's why I mentioned a couple of them, most particularly, I think the OEM number with the Pro end of support in Q3; and we did have another strong end of support for the server on-prem number. And so those are the 2, for Q3 in particular, that I would make sure to call out.

Operator

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

Brent John Thill
Jefferies LLC, Research Division

Azure putting up a great accelerating quarter. Could you just talk to what you're seeing in terms of the breadth and maybe the size of the transaction? And anything else that you think is important to highlight why you're seeing this reacceleration in the business?

Satya Nadella
CEO & Director

Thanks, Brent. Maybe again I'll start. Amy, you can add. I would say, again, with Azure, some of the core differentiation we have, whether it comes to our hybrid leadership, some of the new data products that are highly differentiated and competitive in the marketplace as well as the integration with every other layer of our stack, whether it's the dev layer with Power Platform or GitHub or with Teams to Power Apps to Azure DB, the industry solutions we now have in health care and in retail are all leading to that time to value, the price differentiation and cost advantage to customers and most importantly, agility in that -- in their ability to build their own digital capability. So that's what you see in the acceleration around Azure.

But when we think about Microsoft Cloud, we think about all the parts coming together to deliver value and differentiation to our customers.

Amy E. Hood
Executive VP & CFO

And maybe just to add a couple of thoughts on the shape, Brent, and to make sure that we're clear on some of the important drivers there, really, the Azure consumption comments are not about size of transactions, right, being signed. And you obviously saw we had a good quarter in bookings, which is far more reflective of future commitment.

In quarter, what we saw is really fundamental consumption growth and some reacceleration of growth curves, particularly in maybe industries that had been more hard hit in Q4 and Q1. And so I would describe it a little bit that way and including, frankly, even some mid-market and some segment-based recovery on that front. So as I look forward, obviously, it's about what Satya talked about, which is you -- there's differentiation. There's usage. There's looking forward to making sure that we continue to have great bookings numbers; but in the quarter itself, it was usage growth, not the contracting that made a difference.

Operator

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

Karl Emil Keirstead
UBS Investment Bank, Research Division

Amy, I wanted to ask you about the PBP guide for your third quarter or the March quarter. It was comfortably above where everybody, I think, is modeling. And in particular, I wanted to ask you about Office 365. Of all the businesses, the larger ones in Microsoft, most saw upside in this recent quarter except perhaps for Office 365, where, despite the migration to E5 and despite the free-to-paid seat conversion, we really didn't see an acceleration in Office 365. I'm wondering if you could perhaps unpack that and describe why.

And part 2 to the question is your guide for that segment is so good in the March quarter that one would infer that the Office 365 growth is likely to accelerate in March. I'm wondering if you could confirm whether that's a reasonable assumption.

Amy E. Hood
Executive VP & CFO

There's a couple of things, Karl, in the PBP guide, and let me break them down a little bit. As you heard, actually, almost all the components in Q3 have sort of consistent to slightly better execution, right? So there's upside that we saw in LinkedIn. There's upside in Office Commercial. There's upside that's reflected in the stronger subscriptions number we saw in Consumer. And there's good execution in Dynamics. So for me, it's a bit more. And then we'll come back and talk about Microsoft 365 all up in a second.

Each of those pieces, there's really consistent performance into Q3, which is good. And so when you think about Office 365, interestingly, what we're seeing is a lot of the things we have seen before, but remember, we had a pretty tough comp a year ago in Office Commercial. And so for me, I look and say, gosh, we did great execution. We saw some improving trends in seat growth in the frontline; improving trends in SMB that won't yet be reflected, of course, in revenue; seeing good trial conversion, which again, speaks to forward revenue more than in-quarter revenue given that's all subscription. And we saw -- so you see better seat growth, good conversion and good E5 selling. So I actually feel pretty good leaving Q2 and entering Q3 in terms of value that customers are getting out of the subscriptions that they've got and the conversions that we're seeing in market.

Satya Nadella
CEO & Director

Yes. I mean just one quick thing I would add is when you look at Microsoft 365, I think one of the things that -- one of the best things I've seen recently is when a customer talked about all the things that they're using compared to even just last year to now, that is new value from Office 365 and the usage depth and increase. That's, I think, really the real power of that franchise going forward. And so I hope you, as shareholders, look at what's the depth and breadth of the offering and the usage -- and the usage depth by account, which I think is what at least we are investing and tracking closely.

Operator

Our next question comes from the line of Keith Weiss with Morgan Stanley.

Keith Weiss
Morgan Stanley, Research Division

Satya, I wanted to dig into one of the topics that you mentioned in your introduction. And that's kind of Teams working as a framework across all of your solutions and sort of connecting more and more people into the Microsoft framework. I was doing some calls this quarter and asking about a competitor's acquisition of a Teams competitor, and a lot of people in the channel talk to me about how Teams was pulling through Dynamics CRM, right? And they understood that acquisition as a defense against that. And I was surprised to hear that, that there would be a linkage between the 2.

Can you help us, one, kind of understand the -- how Teams pulls in additional products behind it, number one? And number two, the connection between kind of Teams and how they get a broader base of frontline workers into the story for Microsoft? Because I think most people think about Microsoft as like an information worker story, but frontline workers is another huge kind of area for you guys to go after.

Satya Nadella
CEO & Director

No. Thanks much, Keith, for the question. That is absolutely right. And I think I've commented on this earlier as well in our calls, which is we built Teams as essentially this tool that brings together multiple capabilities. It brings together chat. It brings together meetings, collaboration that is office collaboration as well as business process workflow all into one scaffolding. That's the biggest breakthrough of teams.

In the past, obviously, we had suites of tools, but this is the first product, more so than Outlook was even, in terms of being able to integrate communications, collaboration and business process. And that's what you see. When we talked about it in my comments, that's why one of the things I stressed was what was happening with just line of business applications.

Before any SaaS application, ours or others, the reality is the most usage in any enterprise is line of business applications that were built custom by their enterprise and their IT organizations for all the departments, whether it's HR or finance or operations. That is really one of the bigger drivers of Teams usage as a platform capability, right?

So you -- you brought up first line. There's some shift scheduling application, some inventory counting application that the frontline person is using on a mobile phone with Teams, but the inventory management app was just a power app built using Power Apps. So that is what you're seeing. And then, of course, the integrations into Dynamics, integrations into all SaaS applications, whether it's Workday or whether it's SAP or whether it is ServiceNow and even Salesforce, all of these applications are getting integrated into Teams very rapidly. And so that's the power of Teams as a platform capability that we are seeing.

And you're absolutely right that this is no longer about just knowledge workers collaborating. In fact, if anything, it's about knowledge workers collaborating and enabling frontline workers with more of these work to participate with digital tools in the workflow versus being disconnected.

Operator

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

Mark Ronald Murphy
JPMorgan Chase & Co, Research Division

I'll add my congrats as well. Amy, do you see a sustainably different post-COVID expense profile for Microsoft as it relates to real estate footprint and T&E levels or -- and maybe, Satya, you could perhaps comment on this as well. Are you expecting a fuller return to the office and fuller resumption of business travel over time such that, that expense profile wouldn't look very different?

Satya Nadella
CEO & Director

Maybe I'll just talk about broadly how I think both at Microsoft as well as what we are seeing as this return to work. I think the key thing, Mark, we just think about is there will be more flexibility in terms of time, where they work, even the sites people work because I think the expectations have changed. We obviously are not going to have the same constraints going forward, so I'm not at all assuming that we just remain as is all the way going forward. But at the same time, there's no return to January of 2020.

But -- so therefore, what I think is key for us is to really maintain flexibility. And that's why even going back to the conversation around Teams, it's not like the work only happens in online meetings, right? Work happens before meetings, during meetings, after meetings, and especially in hybrid work, you need that sophisticated set of tools that really track workflow irrespective of who is where. And so that's what we are focused on.

And in our own policies, we have laid out our policies, which give more flexibility, and it'll be different by function, different by geography, different in time. So that's how we expect essentially work to evolve. I don't know, Amy, if you want to add a little more on the expense side.

Amy E. Hood
Executive VP & CFO

Yes. I think what I would add is maybe to take a step back from the narrowness, in some ways, of the question, Mark, and expand it to say the overall expense logic that we have going forward and in many ways, that's why I talked about we've seen headcount growth of over 10% in the past year as we invest in the significant opportunities we see and having customers be successful.

And that's at a time when, frankly, we're coming upon the anniversary across many spots of the world of where we've been working remotely for close to a year. And so it's about continuing to invest in those places, looking and learning about the types of flexibility that we're able to provide our own employees, what travel patterns need to look like. And of course, we'll do what it takes to deliver success to customer, which should be the driving force behind how we invest in that segment.

And finally, there's obviously lots of opportunity for us to continue to be flexible in how we work specifically, which is where Satya talked about. But this is a pretty broad conversation and, in many ways, I think, talks to a broader rethink of what productivity means across every industry and every role, which I actually think is a very exciting time, both for Microsoft 365 and lots of the tools we're developing.

Operator

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

Walter Herbert Pritchard
Citigroup Inc., Research Division

Question for Satya and how you're thinking about the $200 billion enterprise applications market. Your market share in that area is fairly low in aggregate. You've got Dynamics that's performing really well and sounds like is accelerating. Just wondering how you're looking at that market more broadly as an opportunity for the company.

Satya Nadella
CEO & Director

Yes. We are very, very focused on what we think is modern business process applications, Walter. The way I look at it is there's a complete rethink on, even if you take the previous conversation around what are the workflows that need to get integrated into a communications tool such that there's real continuity between frontline to knowledge worker to business process. I think that opens up even a ton of opportunity.

I mean take something like even digital twins and the level of automation that one can bring even into manufacturing. So the combination of an Azure PaaS service to SaaS capabilities in Dynamics 365 can be very transformative to digital manufacturing, which is probably going to be one of the bigger trends going forward. Same thing in supply chain.

So it's a pretty important area. For us, business process and business applications participation, if you will, will be both on the Azure side, on the data side, on the AI side and the biz apps side as well as Power Apps. So it's not one narrow category because I think most people, the way you measure business applications and the categories of business and applications is pretty narrow. But business process is much broader than that. And so that's, I think, at least what we are building towards.

Amy E. Hood
Executive VP & CFO

And maybe just to add a bit to that, Satya. Just I think, for us, one of the exciting parts about Dynamics and for shareholders is the expansiveness of that redefinition by industry. And even the terms and categorization today that define biz apps, I think we'll see, are quite large and will be addressed not just with our Dynamics product portfolio but partially with our LinkedIn portfolio, with our Power Platform portfolio, with Microsoft 365 as well as Azure. And I think that -- and thinking about it holistically is why it's so important for us and why we keep coming back to the commercial cloud as our frame. It's how customers see the solution. It's how we sell. It's how solutions are actually implemented for business process change.

Operator

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

Raimo Lenschow
Barclays Bank PLC, Research Division

Congrats from me as well. I wanted to talk a little bit about gaming. Obviously, you had a very strong quarter, but we also saw a few months ago the launch of Xbox Game Pass Ultimate so -- or the xCloud as we knew it. Can you talk a little bit about some of the early experiences there and the importance that you see emerging for that?

Satya Nadella
CEO & Director

Yes. Maybe I'll start. Amy, you can add to this. On xCloud, it's very early days, but we are very excited about, fundamentally, the expansion opportunity it provides. So the service today really allows us to take our catalog and not be limited to any of the traditional end points, in particular, the console and the PC and expand beyond that.

And so as you can imagine, that, I think from a reach perspective, is very exciting to us. And the fact that we now have a technology solution to do so, we are in the very early innings of it while at the same time, ensuring that we are doing a fantastic job for all our console gamers and PC gamers, is going to be how we'll approach the value of our subscriptions.

Operator

Our final question comes from the line of Brad Reback with Stifel.

Brad Robert Reback
Stifel, Nicolaus & Company, Incorporated, Research Division

Amy, the cash flow in the quarter ex the audit settlement was far ahead of everyone's expectations, and I know you talked about strong billings in the quarter. But as we look forward, are there any puts and takes that we should be aware of? Or should we just focus on cash flow growing pretty much in line with net income?

Amy E. Hood
Executive VP & CFO

Yes. In general, Brad, it's a very good question because the things you tend to watch that can move it quarter-to-quarter are things like you mentioned, whether it's the settlement this quarter, whether it's for free cash flow, the timing of cash capital expenditures versus on an accrual basis.

But overall, it really should move in line with operating income generally and really reflect the fundamentals of our business execution. We've -- it's been something we focused on. And I do feel like strong sales, improving margins, particularly in the cloud, have all benefited us on those lines.

Michael Spencer
General Manager of Investor Relations

Thanks, Brad. That wraps up the Q&A portion of today's earnings call. Thank you for joining us today, and we look forward to speaking with all of you very soon.

Amy E. Hood
Executive VP & CFO

Thank you all, and stay safe.

Satya Nadella
CEO & Director

Thank you very much.

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