Presentation

Operator

Welcome to the Microsoft second quarter earnings call. At this time all participants are in a listen only mode. During the question and answer session, please press star one on your touchtone phone. Today's call is being recorded. If you have any objections you may disconnect at this time. I would now like to turn the meeting over to Colleen Healy, general manager investor relations.

Colleen Healy

Thank you and good afternoon everyone. Thanks 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 C. Top, Deputy General Counsel.

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

We filed our 10Q today in conjunction with our earnings release, therefore you have available the earnings release, MD&A, financial statements and footnotes. We have also posted our quarterly financial summary slide deck which is intended to follow the flow of our prepared remarks in order to assist you. The slide deck offers highlights from the quarter, outlines our guidance and provides a reconciliation of differences between GAAP and non GAAP financial measures that we will talk about today. You can find the earnings release, the financial highlights 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 January 25, 2009.

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We will be making statements during this call that are forward looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in today's earnings press release and the comments made during this conference call and in the risk factors section of our 10Q or 2007 form 10K and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward looking statement.

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

Chris Liddell

Thanks Colleen and good afternoon everyone. I'll begin today's call by providing you with the highlights from our second quarter results and discuss our outlook for the remainder of fiscal 2008. Results for the quarter were outstanding. Revenues surpassed our previous record high by $2 billion and at $16.4 billion that exceeded the high end of our expectations by over $300 million.

We are benefitting from the investments we've made over recent years plus excellent execution performance from our field sales force. Revenue in the quarter grew 30% or 15% adjusted for the technology guarantees in the comparable period last year. Besides just the sheer size and pace of growth, the breadth was notable as we saw strength across all customer segments, divisions, channels and geographies.

For example, demand from enterprise customers combined with healthy holiday consumer spending for Windows Vista and the 2007 Microsoft Office system drove revenue for the business group a combined 18% for the quarter. Server and tools, once again delivered double digit revenue growth in the quarter, the 22nd in a row. Healthy enterprise agreements signings across the company drove our unearned revenue balance up over $0.5 billion, $500 million above our guidance.

The successful integration of our eQuantive acquisition plus good organic growth helped our online business grow 38% and a compelling lineup of Xbox games drove our performance for our entertainment and devices division. E&D had its second consecutive quarter in the black, on its way to our target of full year profitability.

From a geographic perspective, over 60% of our sales are from users in regions outside of the US. Revenue in those regions continue to drive growth for the company with non-US mature markets up over 20% for the first half of the year and emerging markets up nearly 30%.

During the quarter we combined revenue growth with cost efficiencies resulting in operating income growth of 27%, even adjusted for the tech guarantees of last year. Operating margins during the quarter were a healthy 40%. Lastly, earnings per share growth of 32% after adjusting for last year's tech guarantee continued to benefit from the accommodation of strong operating performance and execution of our share repurchase program.

So overall the quarter and half one performance demonstrates that we're realizing the benefits from our expanding business lines, product SKUs and global presence. The investments we've made, including in our sales force and new product offerings have positioned us well to offer the right product in the right markets worldwide. And during the quarter we refreshed and bolstered our product line up with releases of Microsoft Dynamic CRM, Visual Studio 2008, new Zune devices and progress towards the upcoming server offerings, including release candidate one of Windows Server 2008 and a beta of our server virtualization technology, Hyper-V.

In light of the strong second quarter, we are increasing our revenue, operating income and earnings per share guidance for the year. We now expect revenue growth of 17-18% and operating income growth of 31-32% and finally we're raising our earnings per share forecast by $0.07 for the year to $1.85-$1.88, a growth of 30-32%. With those high level themes, I'm going to turn the call over to Colleen for more details on our second quarter performance.

Colleen Healy

Thanks Chris. The strong momentum that kicked off our fiscal year continued in our second quarter. As Chris mentioned, revenue exceeded the high end of our expectations by $300 million during the quarter. This was driven by demand for our flagship product of Windows Vista and Office 2007 as well as a good holiday season for our Xbox franchise. This revenue outperformance combined with decreasing Xbox 360 console costs flowed through to operating income and earnings per share.

Let me provide you with details of our financial performance starting with revenue. I'll discuss top line financial and business momentum points and then follow up with revenue performance for each of the business units. Then I'll review the rest of the income statement. All growth comparisons relate to the comparable quarter of last year unless otherwise specified.

Revenue is $16.4 billion, an increase of 30%. Adjusting the year ago quarter by the $1.6 billion of revenue deferrals primarily related to the technology guarantee program for Windows and Office, total revenue grew 15%. With business and consumer PCs each experiencing double digit growth rates, the underlying PC hardware market increased an estimated 14-16% during the quarter, about 3 points higher than our expectations. PC growth rates in emerging markets continue to outpace that of mature markets. Europe led the mature markets and we again saw significant improvement in the US and especially in Japan.

Our mix of product billings for the quarter was approximately 30% from OEMs, 30% from multi-year agreements, 20% from license only sales and the balance from our other businesses. Annuities sales were robust, particularly for server and tools in anticipation of the major product releases scheduled for the second half. This combined with enterprise agreement renewal rates, consistent with historical trends, drove our unearned revenue balance over $0.5 billion above our guidance to $12.2 billion, up 20% year over year normalizing for the impact of the tech guarantee deferrals.

Our contracted not billed balance increased sequentially to over $11.5 billion, up well over $1 billion from where we started the fiscal year. When taken together with reported revenue, total bookings for the company were almost 20%.

Now I will provide revenue highlights by business segment, starting with clients. A robust personal computer market and progress against software piracy drove client revenues to $4.3 billion, up 68%, or 16% after adjusting for tech guarantees. Over 80% of client revenue comes from our OEM business. During the quarter, we grew our OEM unit shipments at 18%, approximately 3 percentage points faster than the overall hardware market. Curbing software piracy has been a significant investment area for the company over the last several years and those investments are paying off.

OEM revenue grew 80% or 18% when normalized for the tech guarantee and in line with our OEM unit growth rate. In terms of premium mix, three out of every four Windows customers adopted premium versions during the quarter. Consumer premium units grew over 50% while business premium units grew 12%. As a result, the OEM premium mix increased by 8 points to 75%, driven by an 11 point increase in the consumer element of the mix and offset by a 3 point decline in the business portion due to the pricing differences between business premium and consumer premium SKUs, these changes in the premium have largely offsetting impacts to revenue.

The commercial and retail licensing portion of the business increased 18%, up 8% adjusted for tech guarantees as business customers continue to add client products to their annuity agreements. Next week will mark the one year anniversary of the general availability of Windows Vista. We feel extremely good about the performance it has driven this first year. Specifically, client revenue is growing on average over 40%, up over 20% adjusted for tech guarantees. Client volume licensing portion of the unearned revenue balance has increased 29% year over year. And sales of Windows Vista have surpassed 100 million licenses.

Server and tools revenue increased 15% to $3.3 billion, driven by double digit revenue growth in each of the Windows Server and SQL Server businesses. Coupled with the significant shift in our billings to annuity licensing in advance of the upcoming product releases, this resulted in the server and tools portion of the unearned revenue balance increasing by over $1 billion, up by over 35% year over year.

License growth for Windows Server and SQL Server grew at healthy double digit rates in the quarter. Our premium SKU Windows Server Enterprise Edition with its virtualization capabilities grew 35%. Our consulting revenue increased 28% as we've experienced higher demand following the recent business product launches across the company.

Online services business revenue grew 38% to $863 million, including $154 million from the addition of aQuantis. Online advertising growth for the quarter was also 38%, up 26% excluding aQuantis. Our online audience continues to grow. Windows Live usage broadened as Live IDs increased over 20% to $427 million and the Windows Live Suite was downloaded 45 million times since its launch in November.

We also continue to expand our advertising and content partnerships. During the quarter, we became the exclusive third-party advertising partner on a worldwide basis for Facebook and we announced strategic alliances with Viacom and CNBC. Since we announced our acquisition of aQuantis, 60 new publishers have switched to the atlas publishers suite offering.

Microsoft business division revenue was $4.8 billion, up 37% or 20% normalized for tech guarantees. Returns on our investment in field sales specialists were evident as they contributed to double digit revenue growth across a broad range of productivity offerings. Revenue from business customers was up

23% in the quarter on continued broad based demand for not only versions of Office 2007 but also for Sharepoint Exchange, Office Communications Server and the Dynamic product.

Sharepoint and Office Communications Server had a great quarter with each experiencing growth in excess of 50% and Dynamic's customer billings were up 26%. Consumer revenue grew 10% adjusted for tech guarantees.

Entertainment and Devices revenue grew 3% to $3.1 billion, over $90 million above our high end guidance, driven by an abundance of high demand game titles which contributed to setting a record lifetime to date software attach rate of 7.0. In addition to normalized for the impact, in order to normalize for the impact of retailers advancing some of their holiday console purchases into Q1, spurred by the September launch of Halo 3, performance of the two quarters should be assessed together. With that in mind, entertainment and devices revenue grew 25% in the first half of the fiscal year.

Exiting the calendar year, life to date sales of Xbox 360 consoles hit 17.7 million units. Based on US and PD data released last week, Xbox 360 sold over 1 million more consoles than PS3 in the holiday quarter. From a shared wallet perspective, consumers spent 27% more on Xbox 360 consoles, games and accessories than on the Wii and twice as much than on the PS3. Xbox 360 had four titles that sold over 1 million copies in the quarter, compared to three for the Wii and none for PS3. Xbox Live rapidly achieved its 10 million members goal six months ahead of schedule.

On the music scene, we are pleased by the favorable editorial reviews received by the second generation of Zune. 1.5 million people joined the Zune social online community during the holiday season and music downloads from our marketplace approximately doubled from last year.

Now for the rest of the income statement. Cost of revenue decreased by $75 million, primarily driven by more Xbox 360 component costs that were partially offset by growth in our consulting business, expansion of data center operations and the addition of aQuanits cost. After adjusting prior year second quarter for the impact of tech guarantees, cost of revenue decreased by 4 points to 22% of sales.

Operating expenses increased 16%, expense growth was slightly higher than head count growth due to legal charges taken in the quarter. Operating income grew at a faster rate than revenue to $6.5 billion, adjusting for the prior year for the tech guarantee, cost of revenue improvement drove margin expansion, increasing our operating margin by 4 points to 40%.

Investment income and other totaled $339 million for the quarter. Our effective tax rate for the quarter was 31%, half a point higher than what we previously guided. Cash flow from operations increased 124% to $4.6 billion. During the quarter we repurchased 120 million shares or $4.1 billion of company stock and paid out over $1 billion in dividends to shareholders. Diluted shares outstanding for the quarter were 9.5 billion, down 4% from the prior year as a result of share repurchases, but flat sequentially primarily due to stock options exercise in the quarter.

Earnings per share for the quarter was $0.50 which was $0.04 above our high end guidance, driven by the revenue outperformance. So in summary we are extremely pleased with this quarter's revenue performance. When combined with decreasing cost of revenue, operating income and EPS growth were also impressive. With that, let me turn it back to Chris who will provide you with our third quarter guidance and outlook for the remainder of fiscal 2008.

Chris Liddell

Thanks Colleen. So let turn to the details of our forecast for the third quarter and the full year, beginning with some of the key underlying assumptions. For our fiscal 2008 forecast we'll assume the following macroeconomic conditions for the remainder of the year. As I mentioned before, over 60% of our business originates from countries outside of the US and we expect the overall software spending environment to remain healthy on a global basis.

In US markets, although clearly the risk of an economic slowdown exists, we have not seen any significant spillover to our businesses and lastly we continue to benefit from strong underlying growth in non-US and emerging markets which has also been assisted by stronger international currencies.

No company is immune from macroeconomic factors but overall we believe our business is extremely well positioned in the technology industry with diversification across a broad set of products, channels, geographies, currencies and customer segments, supported by excellent product value and sales execution.

For PC hardware units, we expect growth of 11-13% for the fiscal year, an increase of one percentage point from our prior outlook, reflecting the upside we saw in the quarter. Third quarter growth is forecasted to be 9-11%, slightly lower than the year because of the difficult prior year comparables from the launch of Windows Vista. We expect PC hardware shipment units to decline sequentially from the first half to the second half of the fiscal year, in line with historic seasonality.

Growth will continue to be driven by strength in emerging markets and we expect growth rates in the consumer segment to outpace that in the business segment. In terms of our detailed guidance, we expect fiscal year revenue to be in the range of $59.9-$60.5 billion, growing 17-18%, which is an increase of over $700 million from our prior forecast, based on the strong exit from Q2. We expect revenue in the third quarter of $14.3-$14.6 billion, up 12-15%, excluding the impact of the technology guarantee deferrals in the prior year.

And with that I'll provide details of this guidance by segment. Starting with client, we expect full year growth to be 13-14% with OEM revenue growing roughly in line with the PC market. The third quarter, growth should be 3-5%, excluding the impact for tech guarantees. When thinking about the third quarter revenue growth for client, keep in mind that the strong customer sections for launch of Windows Vista in the year ago period makes it a difficult comparable.

Server tools revenue should grow 17-18% for the full year and 17-19% for the third quarter. We expect continued corporate demand for our server products which will drive double digit growth across the breadth of our server platform, products and services. We're forecasting the billings mix of server and tools to continue to shift towards annuity agreements ahead of the upcoming releases.

Next month marks and important milestone to the group with the commencement of the joint launch activities for Windows Server 2008, SQL Server 2008 and Visual Studio 2008. Together these products will allow IT departments to be more productive by providing them with a secure, trusted and manageable platforms and which will underpin growth in the server and tools business over the next several years.

With the online services business, we forecast revenue to grow between 37-40% for the year and to be up 40-45% in the third quarter. Online advertising is expected to grow approximately 35% for both the quarter and the full year.

Microsoft business division continues to be truly outstanding financial performance. We've raised our full year revenue guidance to 16-17% for the year and 11-12% for the third quarter, we're normalizing for last year's tech guarantee. Growth in the second half of the year will be largely driven by the same factors that made the first half a success. We expect to see continued demand for the 2007 Office Suite and Sharepoint and Office Communication Server should continue to grow double digits. When thinking about growth in the second half of the year for the business division, bear in mind the growth of retail demand for the Office 2007 last year created the tough comparable.

Our [unintelligible] does not include the any impact on the recently announced acquisition of FAST which we anticipate to close during our fourth quarter of the fiscal year and is not expected to have a material impact on earnings per share during this fiscal year.

For the entertainment and devices division, expect revenue growth of 21-24% for the full year and 25-30% for the third quarter. We've raised the full year second half revenue forecast to reflect the record software attach rates and strength in Xbox console sales we experienced in the first half of the year.

Turning back to companywide performance, operating income for the year is expected to be between $24.2-$24.4 billion, up 31-32% for the year, an increase of 3-4 points from our outlook in October. Our higher revenue forecast is responsible for the increase in operating income as we expect greater than 75% of the incremental revenue to flow through to operating profit. For the third quarter, we expect operating income to be between $5.6-$5.7 billion.

As a result of the higher operating income guidance, we're increasing our full year earnings per share results to be $1.85-$1.88, an increase of $0.07 from our previous guidance. For the third quarter we expect earnings per share of $0.43-$0.45. This guidance assumes an effective tax rate of 30.5% for the full year.

From balance sheet perspective, total unearned revenue should finish fiscal 2008, up 14-16%, 6 points or about $750 million above our October guidance, driven by strong annuity billings in our core businesses of client MBD and server and tools as well as an increase in an annuity licensing mix. Excluding deferred revenue for undelivered elements, the remaining portion of the unearned revenue should increase 20-23%.

When thinking about sequential changes in unearned revenue from Q2 to Q3, we expect the balance to follow historical patterns and remain roughly flat. Contracted not billed should also finish 2008 up from current levels.

As always, I'll remind you to think about guidance we're providing, you must also consider risks. These risks include competitors, legal, execution and general market risks, such as foreign exchange rate movements, fluctuations in PC and server hardware growth rates, IT spending and customer acceptance of our new and existing products.

Additionally, changes in the mix of our billings between annuity and license only can have an impact on revenues, operating income and earnings per share by delaying revenue recognition into future periods.

Before moving on to questions, let me mention a few things. Firstly I'd like to welcome Stephen Elop to Microsoft. Stephen has a wealth of experience from both an operational and leadership perspective and he will add a new dimension to our leadership team. However I will also personally will miss working with Jeff Raikes who will retire from the company in September. He's done a fantastic job over the years and leaves us not only with a strong Office franchise, but he has redefined the role of business productivity software at Microsoft by expanding the business into new areas of productivity offerings to collaboration, unified communications, business intelligence, DRP and CRM, resulting in a near doubling of MBD annual revenues since the year 2000. It's notable that MBD is now the largest division of Microsoft in size of revenue.

Lastly I will look forward to seeing a number of you a week from Monday in New York where Steve Ballmer and I will provide you an update on the strategic direction of the company. For those of you who are unable to join us for this, we'll make available a live webcast as well as on demand replay of the presentation. So with those comments I'll hand the call back Colleen so we can get started taking your questions.

Colleen Healy
Great, thanks Chris. Let's now proceed to questions. We want to accommodate questions from as many people as possible so please avoid multiple part questions and limit yourself to just one question. Operator, will you repeat your instructions please?

Question and Answer

Operator

Thank you. We will now begin the question and answer session. If you would like to ask a question, please press star one. If you need to withdraw your request, press star two. Our first question comes from Heather Bellini with UBS.

Heather Bellini
UBS

Hi, thank you. Excuse my voice, good afternoon everybody. Chris, I was wondering, you've shown a lot of impressive top line performance over the last few quarters and in particular some nice upside in operating income. I guess my question is after the past few years when we've seen operating margins contract, do you feel now you're in a position where you've made some of the big catch up investments you discussed in April of '06 and now looking forward the spending will be more incremental in nature and then I just have a follow up for that when you're done.

Chris Liddell

Sure, as I've said in previous calls and certainly at financial analyst meeting, I think you have to look at the company in three parts. The core businesses, the entertainment and devices business and the online business because the dynamics from a margin perspective are quite different in each of those and obviously the company is an amalgam of the three.

In the core businesses, if you put them together collectively, certainly the operating margin has remained an impressively constant, in fact slightly up over the last few years and so we see revenue growth sort of broadly in line with operating income growth, operating [unintelligible] in those.

The entertainment and devices division has moved from a loss to a profit so clearly the margins have improved there. On the online business, it has been and will continue certainly for the foreseeable future to be in investment mode so that has a different dynamic altogether. When you put those three together then the operating margin for the company will be very good this year and you can see that in our guidance for the year. So overall we're not making any predictions including on the call at the moment about past the next couple of quarters but the operating margin performance as an average of those three trends is good for this year.

Heather Bellini
UBS

Okay, that was my follow up is really you've been in operating margin contraction mode for the past few years, you finally seem to be kicking it into high gear there where you're going to have well over 100 basis points, so should we expect Steve, when he's in town in two weeks to kind of discuss an operating plan for the company going forward where we might hear more about the increased leverage in the business?

Chris Liddell

I want to qualify the purpose of the February call, we've always seen that as a good chance to talk about the strategic direction of the company. So you can certainly expect to hear the investment themes, but as you know we're a quarter ahead of most companies in terms of giving out fiscal year guidance by doing it in April, and what I don't want to do is raise expectations that suddenly we're going to start doing that in February and then maybe we'll start doing it in November and we'll do it a year ahead of time. It is a time to talk about the strategy of the company and the strategic themes and at a very high level that will give some indication of our thoughts about where we will invest, but it's not going to be a financial guidance exercise.

Heather Bellini
UBS

Okay great, thank you.

Colleen Healy

Thanks Heather, we hope you're feeling better than your voice sounds. Next question please.

Operator

The next question comes from Sarah Friar with Goldman Sachs.

Sarah Friar
Goldman Sachs

Good afternoon guys, good quarter. So following on that ending comment there Chris about areas where you'll invest, if you look at the online services business, it's still relatively small, the growth kind of ex-aQuantive is still not quite at the levels you might see from competitors. How are you thinking about strategically where you need to go with that business and what are some of the big milestones we should be looking for over the next couple of quarters, maybe over the next year?

Chris Liddell

Well we certainly see it as a multi-year journey that we're going on and so we're investing with an expectation of hoping to be at a critical mass in several years. I'm happy if you look at the quarter [unintelligible] if you like the incremental progress we've made, revenue growth of 38%, ex-aQuantive in the mid 20's, it certainly very respectable. You are right in the sense it's not at the size of critical mass we'd like to see and we are building a business we believe and hope will be at critical mass in the next few years.

But I come back to the theme that we have talked about on several quarters and certainly at financial analyst meetings, we make decisions on investments now which have multi-year implications and when you look at the revenue performance over the last couple of quarters, that didn't happen by accident. That happened as a result of investments that we made several years ago so you have to look back two or three years to look at the leading indicators of how we've been able to drive revenue growth at extremely good levels and higher than most people's expectations than the last couple of quarters.

So when you look forward in the online business, you have to think about the revenue, several years out and the infrastructure we are building for that. Unfortunately from a financial perspective, that means investment now, but that's the way that we think about the company and that's the way we'll continue to run it.

Sarah Friar
Goldman Sachs

And just a follow up on that. So that has been an area where you've definitely been willing to look for inorganic growth, successfully with aQuantive and so on. Is that also part of the ongoing strategy there, could we expect to see some more acquisitions go on for OSB that are of size?

Chris Liddell

We obviously don't speculate on acquisitions in any particular area. We've been willing to drive inorganic growth really across all of the divisions. It probably gets a little more attention than the online business because of its nature, but in fact when you look at the acquisitions we've made, they're across a broad spread, server and tools, the FAST acquisition that we made in the enterprise search area, some of the ones we've made in the entertainment and devices division. So, we have been willing to use our balance sheet to drive inorganic growth right across the company.

I don't expect that to not continue, I think that trend will continue and again we've signaled, I think Steve and I, our willingness to do acquisitions over the last couple of years. I don't think you'll necessarily see some dramatic increase in the number that we do, they've been going along at about a couple of months for the last couple of years and where we see opportunities where the situation is right, we'll look to use acquisitions.

Sarah Friar
Goldman Sachs

Great, thanks very much.

Operator

Our next question comes from Charlie Di Bona with Sanford Bernstein.

Charlie di Bona
Sanford Bernstein

Hi, Chris, for the last two quarters you've called out anti-piracy as a driver in the client business. Could you maybe give a little more color on the sort of specific impact that that's had an how you see that playing out as a driver for client going forward. And then maybe also touch on some of the other divisions, I'm thinking particularly the MBD division with Office where anti-piracy has some potential to effect results as well.

Chris Liddell

Sure, it is an interesting trend Charlie and it's a good one to call out. Historically we've seen the difference between the unit shipments that we have relative to the overall PC market. A benefit in our anti-piracy of 1-2%, so our sales if you like grow 1-2% faster than the market as a result of taking piracy away. Over the last couple of quarters that's picked up, it was around 5% in the first quarter and around 3% in the second quarter.

So that's giving us the confidence to raise in terms of our expectations that to the 1-2%, more like 2-3% going forward. If you say, why is that happening, there's a few factors. Firstly, better enforcement, so we've had a significant enforcement activity over the last few quarters, something like 74 legal actions in 22 countries, so working with local governments who are becoming much more sensitive to this as an issue and very strong government partnerships from us. We've seen some of the technology advances in Vista helping us, relative to previous additions of Windows. Also we've seen a shift to laptops and in particular sales through multi-national OEMs who typically have a lower piracy rate.

Now, not all of those factors are beneficial from a revenue point of view, you know the average selling price through large multi-national OEMs is typically lower than in the smaller entities, but overall from a unit perspective it's helping us about 3% and it's offsetting some of the mix shift that we see and some of the other factors and so it's just been a very good trend and it certainly in the last two to three quarters has picked up from what we've seen in previous two to three years.

Colleen Healy

And then I would say as a broader theme, the company is focused on piracy really across all of our software offerings, including Office and MBD as you also asked about. With Office it's tougher to quantify than we can with client because with Office we sell through so many different channels, volume licensing retail as well as OEMs. We estimate about half of the worldwide base out there is pirated, so there is opportunities to make gains there as well. And we're doing a lot of those same sort of partnering with governments and educating people on the value of buying genuine software and keeping an eye really on retail sales of Office to see how that's progressing. And you know it's been really robust since the launch of Office 2007, but unlike client we can't give you a specific of a number in terms of how we're doing on piracy.

Charlie di Bona
Sanford Bernstein

Okay, thank you.

Operator

Adam Holt with J.P. Morgan, your line is open.

Adam Holt
J.P. Morgan

Good afternoon. I wanted to drill down on the strength in MBD and Office which has been a consistent theme over the last several quarters. Another quarter of better than 20% revenue growth in business office and related. I wanted to see if that is primarily unit driven at this point or whether you're actually starting to see an ASP uplift on the Office side and how long do you think you can sustain better than 20% growth for business revenue?

Chris Liddell

Yeah, firstly, specifically, it is very much around units, it's not ASP driven. And I'd pick out a couple of themes in particular. One is just customer acceptance of the Office product itself which has been extremely good, you know it's right at the top end of our expectations. So when you talk to people, their like of the product is extremely high and we're seeing that manifest itself from a financial perspective and very strong license sales right across the board. So from consumer to small business to large businesses, the underlying office business and the office product has been a real success since launch.

That's number one, number two is some of the other products are starting to become significant in their own right, so when you look at Sharepoint, growing over 20-30% year on year, that's over $1 billion business now, so it's a significant business in its own right and it's incredibly successful again in terms of customer acceptance in rollout through the enterprise.

Unified Communications a similar story. Some of the Dynamics products, CRM and ERP which don't get a lot of attention because we focus on the big parts but also growing at 30-40% growth. So you're seeing a very strong portfolio of products anchored around the Office product but with some extremely good secondary ones as well making a big contribution. How long can that last? Well we will start to lap the launch of Office 2007, so that impact won't be necessary be a significant going forward, but if you look at the second half guidance we certainly see a lot of the same factors for the first half continuing to the second half.

Adam Holt
J.P. Morgan

If I could actually just ask a follow up on that. You mentioned in your prepared comments that you're taking a little bit more of a conservative view on spending in the US for the second half. As we think about the back half guidance, how should we or where do you think that's being reflected, it looks like you're being conservative against a tough comp on the PC growth expectations, where else are you reflecting that conservatism in the guidance?

Chris Liddell

Well I don't think, when you look at the growth rates, they're still very healthy in the second half so when we think about product portfolio we actually feel very optimistic for the second half. Certainly, if there's you know a substantial economic slowdown you could see PC growth rates come down but we're guiding for the second half in 11-13% or thereabouts so it's still very healthy growth from an overall perspective. You look at individual verticals, probably we can find a couple of soft spots, but each of those individual verticals represents less than 5% of our sales and they're made up for by strength in other areas. So when you look at the combined portfolio of our products, what we're being, it's just like everyone else about what might happen in the US economy, when you look at the overall suite of product we have and the overall growth rates we have, we actually feel very optimistic.

Adam Holt
J.P. Morgan

Thanks very much.

Operator

And the next question comes from Kash Rangan with Merrill Lynch.

Kash Rangan
Merrill Lynch

Hi, thank you very much, when I look at the double digit operating profit percentage of the reported in the entertainment and devices business, despite having a record Xbox unit quarter, how should we think about the margin profile of this business going into the next fiscal year. Are you at the point that console costs have been driven low enough and you're getting a healthier mix of software due to rising attached rising attach rate. It looks to me that the business [unintelligible] for a breakout on operating margins but how do you think about that looking into the next two to four quarters?

Chris Liddell

Yeah, well the first thing to note is as we've talked about before the first time we start talking about fiscal year '09 is in April, so happy to make some comments about it then. In these calls we're really trying to focus on this fiscal year, it's the main purpose. In terms of some of the underlying drivers though that you can think about when you start populate your model, you know one of the things to point out is a very, very good attach rate for Xbox.

So we're looking at a life to date average attach of 7 games per console. You know, interesting when you look at that now people on average are spending more in terms of the software and accessories than they are on the underlying console itself, so that model of selling the console as a way of generating future revenue is really paying off. That 7 on average is well above anything historically were on on previous consoles. So that's a very healthy leading indicator.

But the entertainment and devices division is much more than just the Xbox, there's obviously a music player in there, Windows for Mac and various other parts of it as well, so there's other dynamics when those mobile that are going to play in terms of our investment in the future. We're not making any long term predictions about the margins structure, the one thing that is positive is its clearly profitable and we believe on target to be profitable for the year which is the commitment we made some 18 months ago.

Kash Rangan
Merrill Lynch

Thanks and also one metric that you gave last quarter was the bookings growth rate in the core business being 25%. What was the same number this quarter, I do see that overall bookings growth rate was 20% but I was just curious about the core business? That's it thanks.

Chris Liddell

Yeah, greater than 20%. I'll look if I can give you a more detailed number after the call but certainly off my head it's greater than 20%.

Operator

John Difucci from Bear Stearns, your line is open.

John DiFucci
Bear Stearns

Thank you. Chris, you talked a little bit about US risk and I think you were quoted in Routers I think after the close today saying something similar. Did you see any of it this quarter, I mean the aggregate results were obviously pretty impressive, but the server and tools division was a little bit below your expectations and that's really enterprise infrastructure software in aggregate, did you see it and is that what you're seeing now, is that an area where you might be seeing a little more pressure than perhaps some of the other areas?

Chris Liddell

Actually you have to look really hard to find any weakness in our results in the first half. So, in terms of server and tools, there was actually a shift to an annuity mix, so that may be what you're looking at, in fact that's a positive trend because it means our unearned is up significantly which we reported as you know over $500 million higher than expectations and it's a reflection of our company's commitment to our products as a platform in anticipation of some of the server products coming up. So from an accounting point of view you notice a difference, from an underlying business point of view that's an incredibly positive trend.

But if you look at the first half of the year, I mentioned over 60% of our sales come from customers outside the US. If you look at non-US, it grew over 20%, non-US mature markets, if you look at emerging markets, it grew at almost 30%, but the interesting factors that I didn't say which I'm happy to say is that US markets are up 15%. So that's a total our sales in the US for the first half grew by 15%. Now, clearly if the softness going forward, that would impact that, but that's still a very healthy growth rate from our point of view.

John DiFucci
Bear Stearns

Yeah but I would think you would expect that shift to an annuity at the beginning of the quarter when you gave guidance and it was a little bit shy there but are you saying you just didn't expect that and it was customer driven?

Chris Liddell

Yup, absolutely. There's a vast number of contracts that come up for renewal every quarter and the nature of how those renewals flow through to annuity mix quite significantly quarter on quarter. But yes it was an unexpected positive surprise.

Colleen Healy

You're seeing on the low end on server and tools as revenue is about a $20 million miss and on the unearned balance you're talking 100's of millions, net-net on a bookings point, server and tools although the mix was different, the business was just healthier actually than we had expected.

Chris Liddell

Thank you.

Operator

The next comes from Ben Thill with Citi Investment Research.

Ben Thill
Citi Investment Research

Thanks, Chris can you characterize any meaningful differences in consumer versus enterprise demand. Are you seeing any changes in patterns in each of those two divisions?

Chris Liddell

No, they're broadly in line with our expectations and in terms of the enterprise, as I mentioned and Colleen just referred to, the unearned balance is extremely good and so we're feeling good about the relative commitment of our enterprise customers to multi-year agreements, so that's good. On the, I mentioned about Office and the strength there.

A lot of very good license earnings sales in the Office area right across the spectrum of businesses from small medium and large businesses. And lastly on the Xbox side, you know the consumer sales are very good, that's a good leading indicator of consumer acceptance and I guess the last one would be PC sales overall which poured in to 16% in the quarter was a hit of our expectations. So really everything was slightly better than what we had hoped for but there wasn't any significant mix change if you like, all those factors were good.

Ben Thill
Citi Investment Research

And just as a quick follow up, just as you look at the second half of this calendar year, how would you characterize your visibility and I guess the confidence of this macro overhanging the US, doesn't catch up, I think you mentioned there were a couple soft spots, what gives you confidence that this doesn't spillover into some of the other sectors in the US and catch up with you later in the year?

Chris Liddell

Well we've just gone through our mid-year reviews with where we go country by country and segment by segment across the world and the sales force, so the people who are in charge of delivering. Their results, sitting in on all of those and listening to them certainly is factored into our guidance. And you know at this state we're obviously not giving fiscal year '09 guidance but again you have to take a step back and look at the overall environment we're selling into.

The next six months we feel very good about. In terms of more general factors, we're a global company, I talked about the sales mix, I feel good about global GDP over the medium to long term, I think software spending is going to be faster than global GDP and I think we're going to grow faster than overall global software spending. So could we be impacted by global slowdown, of course we could, but if you look at the overall growth rates from the products we have and the markets we compete, we still feel very good if we think about our business on a multiyear basis.

Ben Thill
Citi Investment Research

Thanks Chris.

Operator

Our next is Jason Maynard with Credit Suisse.

Jason Maynard
Credit Suisse

Hey good afternoon guys. I had a little different tact on the questioning. I'm just curious to get your opinion on how you expect the recent EU commission new investigations to play out and what impact you think that may have on not only Vista but I guess perhaps the not yet released Windows 7 product that's being talked about?

Chris Liddell

Yeah, overall obviously we'll cooperate fully with the commission's investigation and provide any and all information necessary. We're committed to insuring that we're in full compliance with their law and our obligations as established by the court. So I don't really have a sort of general business comment, happy to leave it at that.

Jason Maynard
Credit Suisse

Is this, post the settlement I guess was like three or four months ago, is this is any way shape or form impacting perhaps your M&A strategy or maybe decisions to do something bigger within the online services area?

Chris Liddell

No, not at all.

Jason Maynard
Credit Suisse

Okay, thank you.

Operator

And the last question comes from Brendan Barnicle with Pacific Crest Securities.

Brendan Barnicle
Pacific Crest Securities

Thanks so much, Chris I had a quick follow up question on the online business. Specifically, where is it you're spending the money for the investment you're making now. Is that around infrastructure or R&D, sales, and then secondly, where do you envision that going, is it just always going to be an online advertising business or do you see a point where you charge for content or applications, music, any of these other potential revenue streams? Thanks.

Chris Liddell

Yeah the investments are across a broad spectrums o we believe to be successful in that business you really need to commit substantially across the whole gamut of investments, so we're investing in search, improving the relevancy of our search results, focusing on some key verticals like commerce, local entertainment, health. We're obviously investing in the advertiser and publisher tools. You know after our aQuantive acquisitions that's given us a substantial leg up in the advertising platform area, so we're continuing to build on that.

We're investing in content and services through Windows Live and other Live services through the MSN portal and then lastly but not leastly in operational infrastructure. So a lot of [tapics] going into data centers to improve performance and reliability and generate global sales for the business and some of those costs are feeding through in terms of depreciation. So there is no one particular area that we're focused on, we are focused on all the areas and we think to be successful in that business going forward, that's the approach you have to take.

Brendan Barnicle
Pacific Crest Securities

And then second question in envisioning where it goes?

Chris Liddell

Yeah, just go over that one again.

Brendan Barnicle
Pacific Crest Securities

Yeah, I mean do you ever see a point where you may charge for content, charge for applications or are you always going to be basically in online advertising and advertising driven type model?

Chris Liddell

Well we're obviously moving to a software plus services world, so there are certainly areas of products that we have where you can see us moving from a license only to a on demand situation. We already are, in terms of the basic online advertising business as you think about OSB, to a large extent that's going to be an advertising driven, advertising supported business. But there will be other parts of the business you know as we already are with CRM, delivered online and charged for on a subscription basis where it won't be advertising driven. So we'll live in a multi-business model world going forward.

Colleen Healy

Great, thanks a lot Brendan and thanks everyone for your participation in today's call. If you have any further questions, please feel free to call me or my team directly. As I mentioned at the beginning of this call, this conference call will be available on replay at our investor relations website through close of business January 26, 2009. In addition, you can hear the replay by dialing 1-800-297-0771 or for international calls dial 203-369-3238, the dial in replay will be available through the close of business February 1, 2008. Thanks again for joining us today.

Operator

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