

Presentation

Operator

Welcome to the Microsoft Earnings Conference Call. [Operator Instructions] I would like to turn the call over to your host, Bill Koefoed, General Manager, Investor Relations. You may begin.

William A. Koefoed

Former General Manager, Investor Relations

Thank you, Holly, and thank you, everyone for joining us this afternoon. As usual, with me today are Peter Klein, Chief Financial Officer; Frank Brod, Chief Accounting Officer; and John Seethoff, Deputy General Counsel. Today, we filed our Form 10-Q. In addition, we posted our earnings release and financial summary slide deck to our Investor Relations website at microsoft.com/investor. The slide deck is intended to follow the flow of our prepared remarks and provides a reconciliation of differences between GAAP and non-GAAP financial measures. As a reminder, we will post today's 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 any future use of the recording. You can replay the call and use the transcript at the Microsoft Investor Relations website until January 27, 2012.

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During this call, we will be making statements that are forward-looking. 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, in the comments made during this conference call and in the Risk Factors section of our Form 10-K, Form 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.

Okay, and with that, I'll turn the call over to Peter.

Peter S. Klein

Former Chief Financial Officer

Thanks, Bill. Good afternoon, everyone. I'm extremely pleased with our performance this quarter. We delivered excellent top line and bottom line results. Business and consumer response to our latest wave of innovation, including Office 2010 and Kinect, helped drive yet another quarter of healthy revenue growth, resulting in revenue of nearly \$20 billion.

Our solid revenue performance, combined with cost controls and continued prioritization of investments into the highest growth opportunities, enabled us to deliver record earnings per share and our sixth consecutive quarter of operating margin expansion.

On our last earnings call, I commented that we were looking forward to an exciting holiday quarter, especially from consumers. Kinect, in particular, exceeded our expectation. The controller-free entertainment experience is revolutionizing the living room. Kinect is the fastest-selling consumer electronics device in history. We couldn't be more proud of what the team has accomplished. But importantly, it's just our first step in delivering on the opportunity to fundamentally change the way people interact with technology.

The Microsoft Business Division also had a terrific quarter. Office 2010 is the most successful consumer version we have ever shipped, and the product is also performing extremely well in the Business segment. Companies are purchasing Office 2010 as well as our entire productivity platform, including SharePoint,

Exchange and Lync. Businesses are also deploying Windows 7. According to IDC, nearly 90% of enterprise companies worldwide have already started their formal migrations to Windows 7.

In addition to healthy enterprise deployment of our Business Desktop, we saw a strong momentum for our business infrastructure offerings. Windows Server and SQL Server premium revenues grew double digits, and this quarter marks the one year anniversary of Windows Server 2008 R2. Since its launch, we have grown our share of the overall server market every quarter.

During the quarter, we continued our product launch momentum. In November, we delivered Microsoft Lync 2010, a next-generation communications platform that incorporates instant messaging, presence, audio, video, Web conferencing and voice into one interface that integrates with the applications businesses are already using today, including Microsoft Office, SharePoint and Exchange.

For the consumer, I already mentioned Kinect. Also during the quarter, we launched Windows Phone 7, which is now on nine devices with 60 operators in 30 markets. We said all along that our first priority was to make a phone people love, and to that end, we're pleased with the initial response. Customer satisfaction data indicates 93% of customers worldwide are happy with the product, and we're also seeing strong developer engagement. While we're encouraged by the early progress, we realize we still have a lot of work ahead of us, and we remain focused and committed to the long-term success of Windows Phone 7.

We continue to deliver sustained innovation and releases for Bing. In addition to transitioning Yahoo!'s paid search in the U.S. and Canada during the quarter, we also entered into a strategic partnership with Facebook. Bing now provides much more personalized experiences by allowing users to bring their Facebook friends into their Search experiences.

So in summary, our record performance for this quarter rounded out a very successful calendar year for Microsoft. We delivered strong financial results and invigorated the market with our product innovation.

With that, I'll hand it back to Bill to provide more details on the quarter's results.

William A. Koefoed

Former General Manager, Investor Relations

Thanks, Peter. I'll start today by noting that all of my comments are adjusted for the \$1.7 billion of deferred revenue, which was recognized in the second quarter of last year. The deferral was related to the Windows 7 Upgrade Program and Windows 7 licenses sold in advance of general availability. We've reconciled the difference between GAAP and non-GAAP results in our earnings slide deck. All growth comparisons I make on the call today will relate to the corresponding period of last year, unless I specify otherwise.

Okay, now to our results. This quarter's performance continued the momentum we've seen over the past year. Total revenue for the company was up 15% to nearly \$20 billion. Operating income grew 20% and earnings per share grew 28%. Bookings grew 21%, which marks the fourth consecutive quarter of strong double-digit bookings growth.

We continue to see strong momentum with Windows 7. As Peter mentioned, nearly 90% of enterprise companies worldwide have started their formal migrations to Windows 7 and many have already recognized material savings as a result.

Office 2010 is the fastest-selling consumer version of Office in history, with license sales over 50% ahead of Office 2007 for the equivalent period following launch. Office clearly remains the world's most popular productivity platform for both home and work.

We've experienced an incredible consumer response to our latest products. Kinect, in particular, was the hottest gift this holiday season and has been mentioned by a number of publications as the most innovative product of 2010.

Businesses of all sizes continued to commit to Microsoft's platforms. This quarter, we saw a better-than-expected increase in transactional licensing and Enterprise Agreements renewed in the historical range.

Our unearned revenue balance grew 7% year-over-year to \$13.4 billion. On a sequential basis, after adjusting for the \$224 million of Office Tech Guarantee recognition, our unearned revenue balance declined \$278 million. Our contracted-not-billed balance grew to over \$16.5 billion, a \$700 million increase from the prior quarter. This growth in our customer's multiyear commitment, combined with our strong transactional sales, resulted in a solid 21% growth in year-over-year bookings. Geographically, emerging markets continued to outperform mature markets.

Now turning to the PC market, we estimate close to 90 million PCs were sold globally, the biggest quarter ever, representing growth of 2% to 4%. Business PCs grew faster than consumer PCs as companies continued to refresh hardware and has opt to Windows 7. Within consumer PCs, netbooks declined from their peak last year while notebook growth remained healthy.

With that PC backdrop, I'll move on to the results for the Windows and Windows Live division. Last quarter, we noted that there would be a \$600 million headwind to Windows comparables for the second quarter due to the Windows 7 launch spike last year. Adjusting for this dynamic and the prior-year Tech Guarantee recognition, Windows and Windows Live revenue growth was in line with the PC market.

As usual, you'll find an OEM revenue bridge in our earnings slide deck. The revenue per license benefit from a higher business mix was offset by emerging markets growing faster than developed market.

This quarter marks the one-year anniversary of Windows 7. Today, we are announcing that we have sold over 300 million Windows 7 licenses to date, continuing its momentum as the fastest-selling operating system in history.

Looking ahead, we are excited about the partner innovation underway in the PC and Windows 7 ecosystem as seen at CES. The PC hardware dynamics are incredibly strong, with innovation in new ultra-portables, all-in-ones and other form factors, including tablets, plates and convertibles. The new Intel Sandy Bridge and AMD Fusion chip architectures substantially improved performance, graphics and battery life.

In addition, we announced at CES that the next version of Windows will support System on a Chip architectures, including ARM-based systems from partners NVIDIA, Qualcomm and Texas Instruments and x86-based systems from partners Intel and AMD. Windows on System on a Chip architectures will fuel significant innovation across a spectrum of devices. We are enthusiastic about the future of device innovation and the role Windows is playing.

Now let's move to Server & Tools, which posted 10% revenue growth. Non-annuity revenue grew roughly in line with the underlying server hardware market, which we estimate grew high-single-digits. Multi-year license revenue growth was roughly 11% and Enterprise Services revenue grew 9%. In the data center, we continue to be pleased with our progress in virtualization and systems management. The virtualization trend is driving double-digit System Center and Windows Server premium revenue growth while significantly lowering our customers' costs. In the database, premium offerings are also a core focus of our strategy, and this quarter, we saw a double-digit growth in SQL Server premium revenue.

Among other customer wins this quarter, Dollar Thrifty Auto Group migrated their mission-critical pricing system from Oracle to a Microsoft data management solution, a strategic move that supports the company's goal to standardize on high-value cost-effective technologies. We are excited about SQL Server and our opportunity to drive Tier 1 customer wins.

In the cloud, we continued to see developer interest and application development on the Windows Azure platform. Earlier in the quarter at PDC, we unveiled a number of additional platform enhancement and showed how leading companies like Pixar Animation Studios and ADP with NVoicePay were able to develop innovative solutions with Azure.

Next, I'll move to the Online Services division which grew 19%. Online advertising revenue, including both Search and Display, grew 23% and now includes revenue-driven by our Search partnership with Yahoo!, which is implemented in the U.S. and Canada during the quarter. We continue to make progress on the partnership, and earlier this month, we transitioned to algorithmic search traffic in Mexico, Brazil and Australia.

Bing's U.S. market share continued to grow, ending the quarter at 12% and our Search revenue growth rate again outperformed the market leader.

During the quarter, we announced the significant expansion of our partnership with Facebook, where Bing will provide more personalized experiences by allowing users to Search Facebook profiles and incorporate their friend's like into search results. We believe the addition of these new social features is another way to deliver innovation and valuable enhancements to the Bing experience.

Next, I'll move to the Microsoft Business Division, which continues to show solid launch momentum with revenue growing 24%. This includes \$224 million of recognized revenue pertaining to the Office Tech Guarantee. We've seen enthusiastic consumer response to Office 2010 and business demand has also been strong with the transactional components of MBD sales up over 40%. The multi-year licensing portion of the business grew 9%. CIOs are investing in the new productivity scenarios enabled by SharePoint, Exchange, Lync and Dynamics CRM, which are enhanced when deployed with Office 2010.

Lync grew over 20% this quarter while SharePoint 2010 and Dynamics CRM both continue to grow double digits. This quarter, we reported a number of cloud productivity wins, including the State University of New York, the U.S. Department of Agriculture, DuPont and the state of California among others. We have seen an immediate customer and partner response to the Office 365 announcement, with the beta oversubscribed within its first day.

Just two weeks ago, we launched Dynamics CRM online in 40 markets. We're already seeing customers switching from Salesforce.com to Dynamics CRM online. It saves money, it's more flexible and it's easy to use with the familiar Microsoft Office experience for increased productivity.

Let's move on to the Entertainment and Devices division, where revenue grew 55% and operating income has now surpassed \$1 billion year-to-date, which is a major milestone for this division. Kinect exceeded all expectations with 8 million stand-alone and bundled sensors sold in just 60 days. And since we updated the consoles last June, Xbox 360 has had tremendous momentum. We sold a record 6.3 million consoles this quarter, a unit increase of 21%. This helped drive Xbox Live membership up 30% to 30 million active members.

In addition, at CES, we announced a number of upcoming feature enhancements, including Kinect support for Netflix, Hulu Plus and Avatar Kinect, which will advance how people communicate and enjoy their television experiences.

Windows Phone 7 is off to a solid start as handset manufacturers purchased over 2 million licenses in the quarter. Windows Phone 7 is making progress in its early days as user satisfaction is extremely high, and developer momentum has continued to build to now over 24,000 registered developers. As we announced at CES, we are looking forward to adding more features including support for CDMA.

Now let me cover the remainder of the income statement. Cost of goods sold increased 33% to \$4.8 billion, driven primarily by increased Xbox hardware volume and online costs. Operating expenses were \$7 billion in the quarter, an increase of 1%. Our effective tax rate for the quarter was 22%, below our guidance of 23% to 24%, due primarily to the one-time benefit of the retroactive extension of the R&D tax credit from January 1, 2010. In the second quarter, we repurchased \$5 billion of shares and declared \$1.3 billion of dividends, continuing to deliver on our commitment to return cash to shareholders.

In summary, it was a strong quarter both for our product momentum, as well as for our financial results.

And with that, I'll hand it back to Peter, who's going to discuss our business outlook for the remainder of this fiscal year.

Peter S. Klein

Former Chief Financial Officer

Thanks, Bill. For the remainder of the call, I'll discuss our expectations for the third quarter and the remainder of fiscal 2011. According to various surveys, enterprise IT spend is forecast to grow in 2011,

and Windows 7 and Office 2010 remained among the highest priorities for CIOs. We remain confident in our ability to continue to grow our share of the IT spending market.

We expect the business PC refresh cycle to continue. In terms of PC growth, we expect business to outpace consumer and emerging markets to outpace developed markets. With that backdrop, let me turn to segment expectations.

Windows division revenue should grow roughly in line with the PC market for the third quarter and the full year when excluding the revenue attributable to the prior-year launch spike and Tech Guarantee. As we said previously, when looking at year-over-year growth, you should exclude \$100 million from Q3 of fiscal 2010 for the launch spike. And for full fiscal year 2010, you should exclude \$700 million of revenue for the launch and \$300 million for the Tech Guarantee.

Moving on to Server & Tools. From Q3 and the full year, we expect non-annuity revenue, approximately 30% of the total, to generally track with the hardware market. Multi-year licensing revenue, which is about 50% of the total and enterprise services the remaining 20%, should grow high-single-digits for the third quarter and low double-digits for the full fiscal year.

Turning to expectations for the Microsoft Business Division, consumer and business non-annuity revenue, approximately 40% of the division's total revenue, will continue to exceed PC shipment growth rates for the third quarter and the fiscal year due to the Office 2010 launch. We expect revenue associated with multi-year agreements representing approximately 60% of total revenue, to grow mid- to high-single-digits for the third quarter and the fiscal year. When updating your models, remember that in Q3 of fiscal 2010, we deferred approximately \$300 million related to the Office Tech Guarantee.

Moving on to our Online Services division. While we feel great about the progress we have made with the partnership, we recognize that there has been some market place disruption. We are working diligently to address any issues, and we expect the benefits of the integration to occur gradually over the next several quarters. We expect online advertising revenue, including organic revenue and new revenue associated with our Yahoo! partnership, to outperform the overall online advertising market in Q3 and for the full fiscal year. When updating your models, keep in mind that roughly 75% of Yahoo!-related revenue will be recognized net of traffic acquisition costs.

Moving on to the Entertainment and Devices division. Considering the enthusiastic response to the Xbox 360 platform, including the Kinect Sensor, we now expect this division's revenue to grow roughly 50% for the third quarter and roughly 40% for the full fiscal year.

Switching to cost of goods sold. As was the case this quarter, the biggest factor impacting COGS going forward will be the growth of the Entertainment and Devices division. Xbox consoles and Kinect Sensors have higher COGS than the rest of our products, and due to our growth expectations for these products, we remind you to consider this impact in your models.

Turning to operating expenses. We are reconfirming our guidance of \$26.9 billion to \$27.3 billion for the full fiscal year. We continue to expect capital expenditures for fiscal year 2011 to be about \$2.5 billion and our effective tax rate to be 23% to 24% for the third quarter and the remainder of the fiscal year. Finally, at the end of the third quarter, we expect unearned revenue to roughly follow historic seasonal patterns.

In summary, we're extremely pleased with the strong financial performance and continued product innovation we delivered this quarter. Heading into calendar year 2011, our product portfolio has never been stronger, and this combined with our continued prioritization of investments into the highest growth opportunities, will help us drive long-term revenue and earnings per share growth.

With that, I'll turn the call over to Bill and we'll take some questions.

William A. Koefoed

Former General Manager, Investor Relations

Great. We want to get the questions from as many of you as possible so please stick to just one question and avoid long or multi-part questions. Holly, can you please go ahead and repeat your instructions?

Question and Answer

Operator

[Operator Instructions] And our first question comes from Adam Holt with Morgan Stanley.

Adam Hathaway Holt

Morgan Stanley, Research Division

My question is about the corporate upgrade cycle and the impacts on where you are on Windows 7. Would you expect to see the business premium mix increase from the 30% level as you get a little bit deeper into the cycle? And can you update us on where you think you are in terms of any improvements around software insurance attach?

Peter S. Klein

Former Chief Financial Officer

Yes. In general, as we talked about the seeing the business refresh and the sort of intent to deploy the enterprises, obviously to the extent their strength in the business PC market, that will be helpful for the mix that you indicated. So given our outlook that, that will continue to outpace consumer markets, that's a good thing. To your point on SA, you think about the commercial side of the business and the volume licensing part the business, that has been strong, reflecting all those numbers that we talked about. So that has sort of -- as we've talked about that a relatively smaller portion of the OEM portion but it's having a favorable impact on the overall growth of the division.

Operator

Walter Pritchard with Citi.

Walter H Pritchard

Citigroup Inc, Research Division

Bill and Peter, I'm wondering if you can talk about, in MBD we saw really strong transactional business that make up 40% or so, and I think you sort of pulled it to expect that to grow more in line with PCs. And I'm just wondering if you saw any of the business that maybe would have been annuity in nature that showed up in the quarter and transactional, explain part of that strength?

Peter S. Klein

Former Chief Financial Officer

No, not really. We're seeing strength both in the annuity side and in transactional side, so it's really incremental which led to their high growth. It's probably helpful to frame that so you can understand the complete picture. We talked a little bit about the strong growth in contracted not billed, because really the funnel where that multi-year licensing revenue really comes into Microsoft. And ultimately, that will flow through to the balance sheet and the income statement so we saw a strong contracted not billed, a lot of that was Office, and obviously, Server & Tools. And so what we're seeing is strong contracted not billed, strong transactional reflected the bookings growth that Bill talked about. So really what we're seeing is better-than-expected uptake, particularly in small and mid-sized companies, who typically buy transactional licenses, not enterprises who typically buy the multi-year agreements. So it really is increased strength in the Office business.

Operator

Heather Bellini with ISI Group.

Heather Anne Bellini

ISI Group Inc., Research Division

I just have a follow-up to Walter's question about the strength in MBD. I mean, you made the comment that non-annuity revenue will exceed PC growth, and obviously, you did a phenomenal job at that this quarter. But this is a much wider gap than what we've seen in the past. So I guess what I'm trying to ask is, do you expect the gap that you've normally been outpacing PC shipments to kind of the gap to widen similar to what we saw this quarter versus what historicals might tell us?

Peter S. Klein

Former Chief Financial Officer

Well, the only thing I could say, Heather, as the outlook that we gave is the outlook that we gave. We continue to be certainly very pleased with the customer response to Office 2010. We thought we had a great product coming into the cycle, and that has proven to be true from the customer response. Not only to the suite of applications themselves but how they integrate with SharePoint and Exchange and Lync. So I would just lead you to the outlook that we gave, and we remain incredibly pleased with the customer reaction to the product.

Operator

Brent Thill with UBS.

Brent John Thill

UBS Investment Bank, Research Division

Peter, just on the multi-year licensing pick-up that you're seeing, can you just give us a typical term length in terms of what those contracts are renewing at? And the contracts that are coming back, are they now renewing above the original contract values? Is that a trend that you're seeing as things are improving?

Peter S. Klein

Former Chief Financial Officer

They are typically three-year contracts. They sort of vary in length but that's the most common length of our multi-year agreements. In many cases, we are adding new products and services to our multi-year agreements. We talked about some of the products that are showing growth that are some of the newer enterprise products like Lync, like SQL Server Premium Editions. We're starting to get those migrations from Oracle, Tier 1 applications over to SQL. And so as we continue to do those things and people invest in our platform, I think you'll see some opportunity there.

Operator

Phil Winslow with Crédit Suisse.

Philip Alan Winslow

Crédit Suisse AG, Research Division

Just a question on the Windows division. Obviously, PC shipments globally solid, pretty significantly this quarter. Just looking at your KPIs, Windows license shipments were actually down 5% year-over-year. Just wondering if you could give us a sense of how much you think since obviously, the PC data is in selling as this relates to sort of launch of Oak Trail, Sandy Bridge and so forth in Q1 affecting, you call it, inventory levels but in sort of the channel but also Windows license inventories inside OEMs and how that should maybe change when you think about the calendar Q1?

William A. Koefoed

Former General Manager, Investor Relations

Yes. In looking at the OEM license growth, keep in mind that there was a spike from the launch last year in Q2, which makes that, exacerbates that issue as people booked up some inventory there. But in general, I wouldn't characterize what we saw in this fiscal quarter as sort of having anything to do with Q1 and some of the new chipsets. I think we saw some macro things on the consumer side but business remains very strong, and I don't think that played a big part in it.

Peter S. Klein

Former Chief Financial Officer

I would say we just see the opportunity for Sandy Bridge and Fusion as an opportunity for businesses to improve their refresh outlook as you start to get into 2011. They were super bullish on the chipsets from both of those manufacturers.

Operator

Katherine Egbert with Jefferies.

Katherine R. Egbert

Jefferies LLC, Research Division

You always say that emerging PC market is going faster than the mature market. Can you give us some color on that? And then also talk about PC pricing, especially in consumer. And then finally, any comment on tablets and cannibalization?

Peter S. Klein

Former Chief Financial Officer

Sure. Emerging markets are growing faster than developed markets. Probably 2x is not a bad sort of ballpark for how to speak through that. Obviously, China played a big part in that and that's the important issue to think through and certainly an opportunity for us going forward.

Katherine R. Egbert

Jefferies LLC, Research Division

Pricing?

Peter S. Klein

Former Chief Financial Officer

Pricing on?

William A. Koefoed

Former General Manager, Investor Relations

Emerging markets versus developed markets.

Peter S. Klein

Former Chief Financial Officer

Yes, we've always said that there's about half of what you'd see in developed markets.

Katherine R. Egbert

Jefferies LLC, Research Division

But there seems to be reports that pricing has bottomed. Have you seen that?

William A. Koefoed

Former General Manager, Investor Relations

We really haven't changed our prices much at all.

Katherine R. Egbert

Jefferies LLC, Research Division

And then finally, just tablets and cannibalization.

Peter S. Klein

Former Chief Financial Officer

I think that as Bill talked a little bit in his comments about netbooks and how netbooks were, they hit their peak last year in Q2, and I think what we've seen is over the course of this year in the consumer space,

some of that volume being replaced with newer devices like ultra-portables and tablets. And largely, these are second devices, not primary devices. And that's caused a little bit of a drag on the consumer side.

Operator

Brad Reback with Oppenheimer.

Brad Robert Reback

Oppenheimer & Co. Inc., Research Division

Just a quick question, Peter. You had talked about the SQL Server Premium business being up double digits in the quarter. I know earlier this week, I think as you announced some appliances with HP. Do you think that type of relationship could further accelerate that growth?

Peter S. Klein

Former Chief Financial Officer

Yes. I mean, I think partnerships with some of our key partners are very important for helping us to continue to grow in that part of the market, and HP is a perfect example of somebody who's a very important part -- a partner when it comes to some of this infrastructure and database platforms, and even more broadly, in the cloud pertaining to the market. So yes, I think that can be a real benefit.

Operator

Kash Rangan with Merrill Lynch.

Kasthuri Gopalan Rangan

BofA Merrill Lynch, Research Division

It looks like you're talking of the business PC versus consumer PC and also, implicitly, the premium mix should also go up yet you're talking about client revenues more or less in line with the PC unit growth rate for fiscal year. I'm trying to reconcile the contradiction there because it would seem like your client revenue should grow faster than PC units, given what we're talking about, especially coupled with Windows 7 enterprise upgrade cycle. Any comments?

Peter S. Klein

Former Chief Financial Officer

It's the emerging markets growing faster than developed markets. So we have offsetting dynamics going on. Business PC is growing faster than consumer. It's good for attach and good for pricing and emerging markets growing faster than developed markets has the opposite effect. And so what you're seeing is largely those two things offsetting each other.

Operator

Colin Gillis with BGC Financial.

Colin William Gillis

BGC Partners, Inc., Research Division

Just real briefly, Search is now basically a duopoly and a lot of the Search marketers are looking pretty favorably, if anything. Is now the time to increase the outreach marketing efforts?

Peter S. Klein

Former Chief Financial Officer

Well, we're extremely focused on doing what we need to do to be successful in that business. And we've been laser beam focused on what that is. One is growing our Search share and the other is growing our revenue per search. And we continue to grow our share every quarter. We're going to continue to focus on that. We're going to do a lot of things, a lot of the same things that we're doing to that. Bill talked about some of the product enhancements. I think that's probably the most important thing we can do to really differentiate the product experience because I think that's really what drives usage and

share in Search. And then of course, on the revenue per search side, the Yahoo! integration is the key component of that, and we're excited to move forward in that. But really on the share side, I mean, we'll do interesting marketing things like we have been doing. But I think what I'm really get excited about is product enhancement with some of the partnerships we've got there.

Operator

Gregg Moskowitz with Cowen.

Gregg Steven Moskowitz

Cowen and Company, LLC, Research Division

I wonder if you could update us on where the thing stands with regards to Kinect supply and how should we be thinking about units in the Q3. And relatedly, the E&D operating margin of 18% was up three points year-over-year and a little bit of then would have expect to give the marketing launch around Kinect. If you could talk about the prospects for margin expansion over the next couple of years?

Peter S. Klein

Former Chief Financial Officer

Well, to your first question on supply, I think you should just go to the outlook framework that we gave you to have a good sense of what we expect for the Xbox business in E&D sort of over the next coming quarters. And in terms of margin, the long-term story is a good one, right? As we build our installed base -- the business model for that is build an install base that really engage users and then you'd attach lots of software and services to has been part of the strength of the Xbox Live service. And of course, as we build the installed base of Kinect, we have a whole new generation and evolution of games that we can sell into our installed base. So all of those things are very positive long term for that business. In the short term for this quarter, we obviously prioritize and allocate our resources very carefully against the launch of that, and so we're able to have a successful launch and still improve the profitability profile of the business.

Operator

John DiFucci with JPMorgan.

John Stephen DiFucci

JP Morgan Chase & Co, Research Division

Peter, I think you said that IDC said that 90% of enterprise companies had started to form a migration to Windows 7. Can you tell us how penetrated you think even roughly corporations are at this point? And when I say corporations, exclude small business. Really talking mid-market to enterprise.

Peter S. Klein

Former Chief Financial Officer

I don't know exactly. It's very early. I could give you some of anecdotal feedback in certain conversations that we have with our sales folks and directly with customers. The majority of the people I talk to are either in the middle of doing it or at the last stages of evaluating and have a specific plan to do it. And in fact, most of them have said, we want to go faster because once they get started, they realize the productivity benefits and the cost savings are really compelling. But it is early in terms of getting those migrations done.

Operator

Robert Breza with RBC Capital Markets.

Robert Paul Breza

RBC Capital Markets, LLC, Research Division

Peter, I was wondering if you could talk to us about really the cloud momentum I saw in the slide in the slide deck. But really as you look at Office 365 launching from a beta perspective and to oversubscribed, can you maybe just walk us through how you see cloud revenue 12, 24 months out?

Peter S. Klein*Former Chief Financial Officer*

Yes, I'm really excited about roadmap and the opportunity. We obviously haven't given any guidance on the revenue of that and how fast it's going to ramp up. Certainly, excited both about the customer wins that we talked about for our existing product and then the conversations we're having about the roadmap off of Office 365 are really exciting. So in addition to just the beta being oversubscribed, it's not part of the conversations we're having with all of our customers. And it's one of those things where it's going to happen and the exact sort of speed of the ramp is uncertain. I do believe that once it starts to accelerate, it's going to accelerate pretty fast.

Operator

Ed Maguire with CSLA.

Edward Everett Maguire*CLSA Americas, LLC, Research Division*

I just wanted to follow up on Rob's question around the Online Services and Azure. Could you talk about some of the conversations that you're having and the criteria? As customers are deciding whether to stay on premise or adopt the Software-as-a-Service solution, what that means in terms of their economics and ultimately, what it may mean for you and the business model as it becomes a bigger part of the business?

Peter S. Klein*Former Chief Financial Officer*

Yes. There's really two dimensions to the conversation. One is about economics and one is about capabilities. The talk about sort of the applications, the Office 365 types of services. People are very interested in that for two reasons. One, ultimately, if the economics are very good for them once they migrate over. But probably even the stronger driver, especially now in the conversations, is the ability to more quickly take advantage of the latest capabilities that we have. So it's a very easy way to deploy the latest versions of our software and increasingly, that's really the biggest piece of the dialogue. And for that, on the Office 365 side, on the Azure side, the conversation's really about moving up from thinking about infrastructure-as-a-service to platform-as-a-service and what they get with Azure in terms of management and security and sort of the developer ecosystem. So that's really what excites them in talking about the platform of the service of Azure, if you will.

William A. Koefoed*Former General Manager, Investor Relations*

Okay, so that will wrap up our Q&A portion of today's earnings call. We look forward to seeing many of you at the numerous conferences in which we'll be participating in this quarter. For those of you who are unable to attend in person, you will be able to follow our comments at microsoft.com/investor. Please contact us if you need additional details. Thanks again for joining us today, and have a good day.