Presentation

Operator

Greetings, and welcome to the Microsoft Fiscal Year 2018 Third 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 of Investor Relations. Thank you. You may begin.

Michael Spencer

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; Frank Brod, Chief Accounting Officer; and Carolyn Frantz, Deputy General Counsel and Corporate Secretary.

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 reconciliation of differences between the GAAP and non-GAAP financial measures. Unless otherwise specified, we 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 third quarter performance, in addition to the impact that these items and events had 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 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, view the -- 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, in the comments made during the 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, and thanks to everyone on the phone for joining. It was another strong quarter, the result of picking the right secular trends, delivering differentiated innovation and focused execution that results in increased engagement and usage.

The intelligent cloud and the intelligent edge era is already upon us. It represents a tremendous opportunity. We took significant steps this quarter to put this at the forefront of everything we do, realigning our entire engineering organization to accelerate innovation and better serve the needs of customers and partners. With that as the backdrop, I want to highlight key areas of innovation and growth across our customer solutions.

Creating a modern workplace where people can do their best work requires the right culture and the right technology. Microsoft 365 helps every organization empower their employees with AI-backed tools that unlock creativity, increase teamwork and fuel innovation, all the while ensuring compliance and protecting data from new cyber threats.

Microsoft is a clear leader in cloud security. Advanced AI [releases] over hundreds of billions of signals each month to identify anomalies, automate detection and help customers respond to cyber threats. Just last week, we announced new value for customers, Microsoft Secure Score, Attack Simulator and Windows Defender ATP automatic detection and remediation capabilities as well as a new open API for the Intelligent Security Graph.

We've also built compliance capability directly into our cloud services. Thousands of organizations are using the recently launched compliance manager with new information protection scanner and built-in classification capability to help prepare for GDPR. Our comprehensive approach and proactive protection are one reason Coca-Cola chose Microsoft Cloud for their digital transformation.

One year in, Teams has rapidly become the hub for teamwork. More than 200,000 organizations in 181 markets use Teams, from Maersk to General Motors. Teams is now enabled for a broad spectrum of calling and meeting room devices. We're also building AI-powered services into Teams. We've integrated Microsoft Stream, our enterprise video service, into Teams for transcription and time coding of recorded meetings. We've added new facial recognition capabilities, which will attribute remarks to specific meeting attendees. And we are adding new Cortana capability to make calls, join a meeting or initiate 3-way calling just using your voice.

All this innovation is driving customer usage. Windows 10 continues to gain traction in the enterprise, with Windows 10 commercial monthly active devices up 79% year-over-year. Office 365 commercial now has more than 135 million monthly active users and Office 365 consumer subscribers increased to 30.6 million.

Now I'll turn to LinkedIn and business applications. From the start, we recognized the opportunity for LinkedIn and Microsoft to combine forces to create economic opportunity for every member of the global workforce and enable professionals to be more productive and successful. A little over 1 year in, we feel great about the value we are delivering for members, customers and shareholders.

Our integration model has enabled LinkedIn to accelerate growth while retaining its member-first ethos. Results are ahead of expectations across all lines of business, with revenue growth of 37% year-over-year. We saw record levels of engagement again this quarter with sessions growth of more than 30% year-over-year, driven by innovation across the platform. This increased engagement is driving strong demand for sponsored content and marketing solutions and record levels of job postings and job visitors again this quarter in Talent Solutions.

Shifting to business applications. Dynamics 365 is gaining traction as our third commercial cloud growth engine, up 65% this quarter. We unleashed a wave of AI innovation in Dynamics with hundreds of new capabilities to transform sales and automate marketing, with Office 365 embedded inside Dynamics for productivity. Relationship analytics for sales and marketing leverage the Microsoft Graph and data from social networks to improve customer relationships, and predictive lead scoring help sellers identify and focus on high-quality leads.

We're investing in our business applications platform capabilities across Power BI, Power Apps, Flow and a Common Data model. Now customers can extend Dynamics 365 and Office 365 and quickly build applications using data from across the organization as well as third-party data with minimal custom code. The new power platform enables customers like Inter Cars, a leading European auto parts company, to go from paper to digitized workflows within days versus months. With the rapid growth of Power BI, we are now the leader in business analytics in the cloud.

Now I'll turn to infrastructure and AI platforms. Our architectural advantage of a consistent stack from the cloud to the edge is resonating with customers, with Azure revenue growth of 93% this quarter.

Recent CIO surveys affirm our leadership position in hybrid, developer productivity, trusted security and compliance and new workloads such as IoT and AI at the edge.

We have made the right investment decisions and they're having an impact, increasing our overall share in an expanding market. Our recent data center expansion, including the United Arab Emirates and Switzerland, brings our total number of regions to 50, more than any other cloud provider, and the additional availability zones provide the most comprehensive resiliency in the industry.

We also continue to see strong customer demand for Azure Stack across industries, and it's unlocking new workload scenarios across hybrid and edge. Industrial IoT is transforming the rules of manufacturing, fueling cloud and edge innovation, accelerating the evolution of digital factories and enhancing supply chain performance.

Azure IoT and Azure Stack enable customers and partners to build industrial IoT solutions that run at the edge, so operators on the factory floor can manage devices and analyze data in real-time. And HoloLens is quickly becoming an indispensable tool as we take digital twin technology to the next level.

We're also innovating in silicon to help customers realize the promise of a connected world of devices and things. Our just announced Azure Sphere is a first of its kind, highly secure edge solution that combines chip design and IoT operating system and a cloud service to secure more than 9 billion microcontroller-powered devices entering the market each year.

And we're already seeing rapid customer adoption of IoT scenarios. Toyota Material Handling in Europe is using Azure as well as HoloLens to create a factory of the future. Using AI, drones learn complex processes to automate the flow of a factory, increasing supply chain and warehouse efficiency. And Microsoft and ABB are partnering to push the boundaries of smart manufacturing for industrial automation.

We're investing to make Azure the best cloud for enterprise data estates. In less than a year, Azure Cosmos DB, the first globally distributed multi-model and multi-model database, exceeded $100 million in annualized revenue. Azure database for MySQL and PostgreSQL makes it even easier to bring open source powered applications to Azure, expanding our opportunity in this space. We are seeing a rapid adoption of Azure Databricks for data preparation, advanced analytics and machine learning scenarios.

We continue to innovate to democratize AI. More than 1 million developers have already used cognitive services to quickly and easily create AI applications, and we have more services than any other cloud provider. Our Azure Bot Service has nearly 300,000 developers, up more than 150% year-over-year.

Microsoft Translator brings AI-powered translation to developers where their data is, whether that's in the cloud or on the edge. And just last month, we reached human parity in language translation, a new milestone, in addition to our previous human parity achievements in object recognition, speech recognition and machine reading comprehension. We're also gaining traction in machine learning tools adoption with tens of thousands of customers using Azure ML.

Finally, we are innovating with new GPU and FPGA-based offerings to lead in AI infrastructure for both training and inference. I'm excited to share more about our cloud and AI innovation at our developer conference next month at Build.

Now to gaming. We continue to pursue our expansive opportunity in gaming from the way games are created and distributed to how they are played and viewed. We had one of the best quarters in gaming with strong revenue performance and record levels of engagement. Software and services revenue grew 24% as we continued to attract, retain and deepen user relationships across Xbox Live, Game Pass and Mixer.

Xbox Live monthly active users grew to 59 million, up 13%. Our new first-party game, Sea of Thieves, drove gameplay across Windows 10 and Xbox One, in addition to nearly 10 million hours of viewing on services like Mixer in its very first week. Our results speak to the strength of our platform and services for both first-party and third-party experiences. And we'll continue to invest in our platform, enhancing our cloud services with AI capabilities for developers to quickly build and monetize games across PC, console and mobile.

In closing, intelligent cloud and intelligent edge represents a tremendous opportunity for our customers. It comes with a responsibility to ensure trust in technology. We are working to instill this trust in 3 key areas. The first is privacy. We recognize that privacy is a fundamental human right, and we have consistently acted accordingly. Our success is grounded in our customers' success. We have been working towards the May 25 GDPR implementation date since 2016, with hundreds of engineers across the company working on end-to-end privacy architecture, and we'll ensure that all our products and services are GDPR compliant.

For customers, we will provide robust tools backed by a contractual commitment to help them comply with GDPR. In fact, for most customers, it will be more effective and less costly to host their data in Microsoft's GDPR-compliant cloud than to develop and maintain GDPR compliance tools themselves.

Second, cybersecurity. In response to escalating cyber attacks around the world, we are leading a bold initiative to defend and protect our customers. We recently led a coalition of 34 global technology and security companies in signing the Cybersecurity Tech Accord. The accord is an important first step by the industry to help create a safer and more secure online environment for everyone.

Finally, we recently established the AI in Ethics and Engineering and Research Committee at Microsoft to ensure we always advance AI in an ethical and responsible way to benefit our customers and the broader society. This includes new investments in technology to detect and address bias in AI systems.

Microsoft stands for trust and this will continue to be a differentiating focus for us moving forward.

With that, I'll hand it over to Amy to cover our financial results in more detail and share our outlook, and I look forward to rejoining for your questions.

Amy E. Hood
Executive VP & CFO

Thank you, Satya, and good afternoon, everyone. Our third quarter revenue was $26.8 billion, up 16% and 13% in constant currency, with better-than-expected performance across all segments.

Gross margin increased 16% and 13% in constant currency. Operating income increased 23% and 20% in constant currency. Earnings per share was $0.95, increasing 36% and 31% in constant currency. From a geographic perspective, we saw broad-based strength across markets of all sizes, benefiting from the positive global corporate IT spend environment.

Growth in cloud services increased our commercial annuity mix, up 2 points year-over-year, to 89%. Along with healthy renewals, our sales teams and partners drove a higher volume of new business, leading to commercial bookings growth of 26% and 18% in constant currency. Commercial unearned came in slightly above our expectations due to FX, growing 20% and 17% in constant currency.

Commercial cloud revenue was $6 billion, increasing 58% and 55% in constant currency, highlighted by healthy growth in the U.S., Western Europe and the U.K. We again improved commercial cloud gross margin, now at 57%, up 6 points, with improvement in each cloud service, most notably Azure.

We outperformed our expectation on company gross margin, finishing the quarter at 65%. We are up slightly year-over-year with improvement in our Productivity and Business Processes segment from Office 365 commercial and LinkedIn, offset by a decline in our Intelligent Cloud segment, driven by a greater mix of Azure revenue.

FX positively impacted revenue growth by 1 point more than expected. 3 points of the company and Productivity and Business Processes level and 2 points on both Intelligent Cloud and More Personal Computing. FX added 2 points of growth to COGS and operating expenses, 1 point more than expected.

Operating expenses grew 10% and 8% in constant currency as we continued to invest in commercial sales capacity, cloud engineering and LinkedIn. Even with this accelerated pace of spend, we increased operating margin 2 points year-over-year, a direct result of our focused investments to drive top line growth.

Now to the segment results. Revenue from Productivity and Business Processes was approximately $9 billion, increasing 17% and 14% in constant currency, with better-than-expected results from Office 365 commercial and LinkedIn.

Office commercial revenue grew double digits again this quarter, up 14% and 12% in constant currency, including a couple of points from a greater mix of contracts with higher in-period recognition.

Office 365 commercial revenue grew 42% and 40% in constant currency, with continued installed base growth and ARPU expansion, driven by customer migration to our premium workloads in E3 and E5. Office 365 commercial seats grew 28%, in line with the expected trend, given the increasing size of the installed base.

Office consumer revenue increased 12% and 9% in constant currency, driven by recurring subscription revenue and a growing overall installed base.

Our Dynamics business accelerated this quarter, growing 17% and 14% in constant currency, driven by Dynamics 365 growth of 65%, 62% in constant currency.

LinkedIn revenue grew 37% and 33% in constant currency, with more than $1.3 billion in revenue. We continued to see outperformance across all segments, with record levels of engagement.

Segment gross margin dollars increased 18% and 15% in constant currency. Gross margin percentage increased, with margin improvements in Office 365 commercial and LinkedIn, offsetting the increased mix of cloud revenue.

Operating expenses grew 14% and 12% in constant currency as we continued to strategically invest in LinkedIn, commercial sales capacity and cloud engineering.

Operating income increased 23% and 19% in constant currency. The Intelligent Cloud segment delivered $7.9 billion of revenue, increasing 17% and 15% in constant currency, exceeding expectations due to our on-premises server business.

Server products and cloud services revenue grew 20% and 17% in constant currency to $6.3 billion, driven by continued strong Azure revenue growth of 93%, 89% in constant currency, on a significant revenue base. Our on-premises server business grew 3% and 1% in constant currency, driven by customer demand for hybrid solutions as well as increasing virtualization needs, resulting in the uptake of premium versions.

Enterprise Services revenue increased 8% and 5% in constant currency, with growth in premium support services and Microsoft consulting services more than offsetting the continued decline in custom support agreements for Windows Server 2003.

Segment gross margin dollars grew 16% and 14% in constant currency, and gross margin percentage declined with a growing mix of Azure IaaS and PaaS revenue, mostly offset by another quarter of material improvement in Azure gross margin.

Operating expenses increased 9% and 7% in constant currency, driven by our continued investment in sales capacity and cloud engineering. Operating income increased 24%, up 21% in constant currency.

Now to the results of More Personal Computing. Revenue from the segment was $9.9 billion, up 13% and 11% in constant currency, with significantly better-than-expected results in gaming, Windows commercial and Surface.

Windows OEM revenue increased 4% this quarter. OEM Pro revenue grew 11%, in line with a strong commercial PC market.

We continued to see healthy enterprise demand for Windows 10 benefiting our OEM partners. OEM non-Pro revenue declined this quarter by 8%, below the consumer PC market, driven by a higher mix of lowerpriced licenses and continued pressure in the entry-level price category. Inventory levels were within the normal range.

Windows commercial products and cloud services increased 21% and 17% in constant currency from strong double-digit billings as well as a higher mix of in-quarter recognition from multiyear agreements. The fundamentals of this business remained healthy, with installed base growth and adoption of our security solutions. As a reminder, under Accounting Standard 606, the Windows commercial growth rate will have significant variability quarter-to-quarter due to its relatively high mix of on-premises licensing revenue.

Search revenue ex TAC grew 16% and 14% in constant currency, with higher revenue per search and search volume driven by Bing performance in the U.S. and international markets.

Surface revenue grew 32% and 27% in constant currency with better-than-expected performance from Surface Book as we continued to transition to the latest products in our portfolio and against the prior year comparable impacted by product end-of-life cycle dynamics.

Gaming revenue increased 18% and 16% in constant currency due to Xbox software and services revenue growth of 24% and 21% in constant currency.

Momentum in digital distribution as well as record levels of engagement, driven by a third-party title, contributed to better-than-expected software and services revenue. We grew Xbox Live monthly active users by 13% to 59 million, with user expansion across Xbox One, Windows 10 and mobile platforms.

Segment gross margin dollars increased 13% and 11% in constant currency, in line with revenue growth. Segment gross margin percentage was relatively flat year-on-year.

Operating expenses increased 5% and 3% in constant currency from investments in engineering across gaming, search and AI. Operating income grew 24% and 20% in constant currency.

Now back to total company results. In line with our expectations, we increased capital expenditures on a sequential basis, with $3.5 billion invested to support current and future growth of our cloud offerings. Cash paid for property and equipment was $2.9 billion.

Cash flow from operations was up 14%, driven by collections from strong billings growth. Free cash flow of $9.2 billion grew at a slower rate, 3%, due to an increasing cash use for property, plant and equipment.

Other income and expenses was approximately $350 million from net recognized gains on investments and income from dividends and interest, partially offset by interest expense. Our effective tax rate came in at 14% due to a benefit from an R&D tax credit.

We returned $6.3 billion to shareholders through dividends and share repurchases, increasing total shareholder return by 37%. We nearly doubled our year-over-year amount buyback, accelerating our pace from the prior quarter and now have roughly $30 billion remaining of our current $40 billion share repurchase authorization.

Now let's turn to next quarter's outlook.

First on FX. Assuming current rates remain stable, we expect FX to increase revenue growth by 3 points, COGS by 1 point and operating expenses by 1 point.

Second, we again expect strong performance from our commercial business with solid execution in our largest quarter of the year. We expect commercial unearned revenue to be up 38% to 39% sequentially.

Third on CapEx. We expect sequential growth in capital expenditures on an accrual dollar basis as we continued to see strong demand signals globally.

Finally, we expect commercial cloud gross margin to be roughly flat to Q3, representing another quarter of material year-over-year improvement even with increasing Azure revenue mix.

Now to the segments. In Productivity and Business Processes, we expect revenue between $9.55 billion and $9.75 billion. We expect Office commercial growth rates to normalize as we do not expect the same level of in-quarter recognition on multiyear contracts as we saw in Q3. Dynamics should see another quarter of double-digit revenue growth, driven by Dynamics 365 and LinkedIn growth should remain high.

In Intelligent Cloud, we expect revenue between $8.95 billion and $9.15 billion, with another quarter of server products and cloud services revenue growth in the high teens as our hybrid cloud leadership continues to be a differentiator for customers.

We expect the total Azure revenue growth to reflect the balance of our continued strength in infrastructure, data and application services and a moderating growth in our per user base services like EMS.

In More Personal Computing, we expect $10.3 billion to $10.6 billion. Across both OEM Pro and non-Pro, we anticipate trends in Q3 to continue into Q4.

In our devices business, we expect Surface revenue growth in the high teens as we continued to transition to the latest products in our portfolio. Search ex TAC should see another mid-teens revenue growth quarter as it has the entire year.

In gaming, we expect a higher revenue growth rate in Q3 as we continue to benefit from third-party game title performance and user engagement on our platform.

We expect COGS between $9.6 billion and $9.8 billion, including 1 point of growth from FX. We expect operating expenses of $9.8 billion to $9.9 billion, with 1 point of growth from FX. This would place us slightly above the high end of our prior range for the full year operating expense growth due to the impact from FX and incremental revenue-driven expenses that support our continued strong top line growth.

In Q4, we expect other income and expense to be approximately $350 million as we continue to take gains on our equities portfolio and earn dividend and interest income, as we have in prior quarters. We expect our effective tax rate in Q4 to be approximately 16%, with some volatility in the final quarter of our fiscal year.

Finally, I want to offer a few early thoughts on FY '19. Assuming the macro environment remains consistent, many of the key drivers of our business should remain intact. Revenue growth will continue to be driven by the transition to cloud services. And within our commercial business, strong execution and our differentiated hybrid position should drive continued high teens growth in our server product and cloud services revenue KPI. Office 365, Dynamics 365 and LinkedIn should also continue to drive double-digit revenue growth in our Productivity and Business Processes segment.

The gross margin percentage of every commercial cloud service will continue to improve, with more improvement in Azure IaaS and PaaS consumption-based services and less improvement in our per user SaaS services. While we expect continued improvement in the overall commercial cloud gross margin, the revenue mix shift to Azure will moderate the rate of improvement relative to FY '18.

We'll continue to grow our investment in capital expenditures to meet the growing demand for our cloud services. With the business results we delivered and the tremendous opportunities we see ahead, we will continue to see growth in operating expenses in key areas we discussed, including LinkedIn. We expect other income and expenses to be slightly negative in FY '19 as we don't expect to have any significant equity gains.

And lastly, we continue to expect the full year FY '19 effective tax rate to be slightly below the new U.S. corporate tax rate of 21%, with variability across the quarters due to the mix of cloud versus license revenue and the timing of equity vests.

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

Michael Spencer
Thanks, Amy. We'll now move over to Q&A. Operator, can you please repeat your instructions?

Question and Answer

Operator

[Operator Instructions] Our first question is coming from the line of Heather Bellini with Goldman Sachs.

Heather Anne Bellini
Goldman Sachs Group Inc., Research Division

Great. You guys are seeing a really nice acceleration in Intelligent Cloud gross profit growth. And with 15 straight quarters now of triple-digit premium services growth in Azure, I know you mentioned some comments directionally about the gross margin ramp. But how do we think about the pace of the ramp in gross margin expansion from here for this -- for Azure, in particular, as you approach what we estimate to be roughly an $8 billion business in annualized revenue? And I guess, what -- the other thing that would be helpful is when you think of the COGS of commercial cloud, can you give us a rough ballpark of what percentage of COGS comes from CapEx depreciation?

Satya Nadella
CEO & Director

So maybe I'll start and then I'll have you, Amy, go into some of the numbers. One of the things, Heather, that's happening is there is growth in Azure across each of the layers. And I think I've said this before. Sometimes, when you have new workloads and new customers onboard, they start with, in some sense, the IaaS and the data, more at a Blob Storage, but then scale to higher-layer services, like our Cosmos DB or even some of our compute higher-level services like in AI. So that, I think, will continue because we're still in the early innings of the cloud transition. We're investing aggressively, whether it's on the field side or on the CapEx side to attract more customers and more workloads per customer. So they will have that same profile, which is lower-margin services first, higher-margin services over time. That's just inside of Azure. And of course, you combine that with the rest. One of the things that, I think, should be fairly clear is the high correlation between our services in Office 365 as well as Dynamics 365 around data, in particular, with Azure. So that's why we think of this as one cloud play, but that should give you a feel for how the customers are looking at it.

Amy E. Hood
Executive VP & CFO

And I think to your specific questions, there were a couple in there, Heather. If you think about the portion of our commercial cloud gross margins that come from depreciation, it's best to think of it as roughly half. And actually, it's been going up as we begin to get scale through these services over time, actually. Some of the fixed costs, frankly, even in COGS, tend to come down as a percentage over time. So that should help you roughly to think about how much depreciation is to that number. Now if you think about sort of the dynamics that we've been going through in the Intelligent Cloud segment, in particular, the way I tend to think about that, as you've seen, our 20% growth this quarter in that server and product services KPI, 17% on a constant currency basis and are sort of confident that you should continue to see that, as I said, into Q4 and then into FY '19 as well. I tend to think about that as we'll have significant revenue growth in that segment. We'll have significant gross margin dollar growth in that segment, and you'll actually continue to see operating margin dollar growth as significant in that segment even as we reinvest into it, given the top line signal. If you think about gross margins, in particular, what you'll see is Azure continuing to be a growing percentage of the total revenue growth. So even with significant improvement again and what Satya was talking about, some of the lower level IaaS and PaaS services within Azure on the gross margin side, you'll see some gross margin percentage pressure in that segment through '19, but with significant dollar growth.

Operator

The next question is coming from the line of Mark Moerdler with AllianceBernstein.

Mark L. Moerdler

Sanford C. Bernstein & Co., LLC., Research Division

CapEx increased significantly this quarter, $2.9 billion, you said, in cash and property and equipment. We know that you build out -- you significantly invested in the data center footprint ahead of demand, but you don't build out the equipment itself that far in advance. Is there a large corporate or government requirement or is it the acceleration in new data centers that ended up causing that lift? Or is there something else driving it? And as a follow-up, how should we think about that for the next couple of quarters?

Amy E. Hood
Executive VP & CFO

Thanks, Mark. I actually didn't think of it as a significant change in trajectory from what we expected. A year ago, Q3 was actually a little low. So on a year-over-year basis, I think it pops a little bit, Mark, when on really a sequential basis, I actually don't think, to me, it looks out of sorts especially with the type of demand we're seeing not just for Azure but across all of the cloud components. Those growth rates, really at 58% on that total cloud number, it's pretty good demand signal on a global basis. So I hear you on a year-over-year basis, but Q3 was a little funny a year ago on that front.

Satya Nadella
CEO & Director

And we continue to really monitor the actual equipment in that supply chain and what-have-you, and if anything, there's a lot of automation and demand sensing capability we have there.

Amy E. Hood
Executive VP & CFO

And I would say, Mark, while I appreciate your point that it takes -- and we do build data centers in advance, the majority of the cost obviously in a data center is in the equipment inside. And so while this really is -- the majority of this spend is servers.

Operator

The next question is coming from the line of Keith Weiss with Morgan Stanley.

Keith Weiss
Morgan Stanley, Research Division

And really nice quarter across the board. There's really not much to pick on in this quarter. One of the highlights from my perspective was definitely LinkedIn and what seems to be an acceleration in the revenue growth in LinkedIn. So 2-parter here. One, where are we in terms of that acquisition? Is this still just LinkedIn operating better as an independent company? Are we starting to see some of the synergies, specifically revenue synergies, come to bear from maybe broader distribution channel that they get from Microsoft or product integration? So have synergies started to kick in, number one? And number two, given where we are in terms of the M&A process on LinkedIn, what's the appetite for further, like large M&A, for Microsoft on a going-forward basis?

Satya Nadella
CEO & Director

Thanks, Keith, for the question. Let me start and then, Amy, you can add to this. First of all, it is very important for us to ensure that we did everything to enable LinkedIn to keep their product and cultural ethos of putting members first and innovating on their behalf. I mean, that was sort of priority 1, 2 and 3. And that's what you see in their sessions growth, engagement growth, their quality member growth. And obviously, that all translates into the revenue growth as well across all of the marketing solutions, talent solutions and sale solutions. We also, during that 1 year, done integrations. You see it -- I see it every day in my Outlook mobile. I see it in Sales Navigator and Dynamics. And so you will see us -- and with Windows 10. So you'll see us continue to do these integrations that add value again to both the Microsoft 365 and Dynamics users as well as LinkedIn members. And clearly, that's increasing engagement as well.

And that obviously then translates into revenue growth of those business solutions we mentioned. So yes, revenue synergies are showing up, but mostly because product synergies are showing up, and that's because of the product ethos of LinkedIn around member-first is what we have maintained throughout this integration.

Amy E. Hood
Executive VP & CFO

And I will also add, Keith, the LinkedIn team has really done a tremendous job. So let me also say, after a year of working with them closely, my appreciation and frankly a lot of inspiration that I think you've seen at our own product development has been their focus on users and how important it is and how focused they are on it. In some of the products, I would urge people to look at the Outlook Mobile experience and how really meaningful the experiences for the user and the member. And I think sometimes it's harder for us to measure exactly what a revenue synergy means. But I think I look at this and say, "At a 37% growth rate plus some of the integrations we've seen and the growth in usage and users of things like Outlook Mobile, I believe that we're probably a little bit on the front end of the revenue synergies you'll see in product over time." When it comes to our appetite for M&A, I think it actually -- it has remained unchanged, which is when things meet our criteria and when we feel like it's in core areas for us, where markets are expanding, where the companies have a unique asset, I think that we -- our ability to both execute on those and see them both execute on their own and execute inside Microsoft, I actually feel quite good that our -- we don't worry about our ability to do them, but I wouldn't say that's new this quarter.

Satya Nadella
CEO & Director

Yes. And I think just to add on that, which is whether it's Minecraft or LinkedIn or many other acquisitions we've done as part of Azure, I think the key thing that we are very, very focused on is how do we make this culturally accretive, management times accretive as well as revenue. And that's where we're building good muscle and we'll continue on that.

Operator

The next question is coming from the line of Karl Keirstead with Deutsche Bank.

Karl Emil Keirstead
Deutsche Bank AG, Research Division

And just to start, Satya and team, congrats on getting Microsoft to over 10% organic growth. That's a big achievement for a company at your scale, and it looks like you're expecting the same for the June quarter, so congrats. So I guess, my question is in the spirit of this, to Amy, on the overall growth margin trade-off as you look into fiscal '19. Amy, when I go back to the Analyst Day you had almost a year ago, I left thinking that your messaging was really that you were going to press on revenue growth and not on big margin leverage. So I'm just wondering as we look into fiscal '19, is it correct to assume that, that's a similar framework with the focus on top line growth and not to expect much in the way of overall improvement in gross margins?

Amy E. Hood
Executive VP & CFO

Thanks, Karl. Yes, I think that's a fair interpretation of my commentary both last year and this, which really speaks to consistency. I do believe that the market that which we are operating, the set of assets we've picked, the team we've built, the investments we made in our sales force, even to some extent, the acquisitions we've done, these are all showing up as top line revenue growth for us. You see it this quarter. You see it, frankly, in the guide. And I think your interpretation that our focus on being a growth company, even at our scale, is certainly the right interpretation.

Operator

The next question is coming from the line of Walter Pritchard with Citi.

Walter H Pritchard
Citigroup Inc, Research Division

I'm wondering, I guess, a combination of Amy and Satya, if you could talk about the forward kind of view of Azure growth and how we should think about the drivers of that as we go into '19. New customers, existing consumption, premium services and we're growing at eye-popping rates right now. We saw that with Office 365 in the early days. How should we expect this business to sort of level out over time as I think it inevitably will as we look to next year?

Satya Nadella
CEO & Director

Yes, and I'll start qualitatively. And it's true that we are, at this point, at scale on Azure and with very, very high growth rates. But as I said, I think the key things that we think about is differentiation of Azure at each level because that's what is super important for us as we compete in this marketplace, and more importantly, double down on areas of differentiation we have. So the first thing is on the infrastructure side itself with the combination of the edge and the cloud, I believe, between Azure Stack and Azure as well as inclusive of our servers, we have the best cloud platform for what is going to be hybrid computing and we'll continue to push on that, so you'll see growth that just got a different margin profile. The layer about that is the place which we are very excited about. You've seen lots of consecutive quarters of growth in our high-level services but we're now seeing some good scale. I, for the first time, talked about Cosmos DB. This was actually a database we just launched last year. I mean, I've been around databases for a long time. I've never seen a product that's gotten to this kind of scale this quickly. And so we're very bullish about what can happen in the higher-level services and we'll continue to build on that piece. But as I said, one of the key things is architecturally, the way we build Azure, the way we build Office 365, the way we build our gaming cloud and the way we build even Dynamics are all pretty much one architecture. And you see that even in the way customers use it. So overall to your specific question on Azure, the growth will moderate as the numbers become big, and they've already become very big. But that said, we see plenty of opportunity for total gross margin growth in terms of dollars just because of the number of markets that we participate in, which we, by the way, never participated in the old server world.

Amy E. Hood
Executive VP & CFO

And Walter, I think the way you see that show up is really in my conversation on FY '19, to Satya's point, really we talked about that server product and KPI being high teens through FY '19. We're really confident in double-digit growth in that PBT segment with the components of Office 365, Dynamics 365 and LinkedIn. So if you think about that as the primary components of our commercial cloud, overall, we're certainly saying that it's a big business growing very fast at $6 billion, not counting LinkedIn. At 58% growth, it certainly speaks to having a big base and a big growth number. On Azure, you're right. It will moderate through next year. But because of the scale at which it's operating, that's why you still see that server KPI remain at that high level even as the base grows. And so you will see also some different dynamics within that Azure revenue number. Satya mentioned the layers of Azure. If you think about the IaaS and PaaS numbers, I would expect to be on the higher end of growth rates. And some of the services that are more per user like, like EMS within the Azure frame, you would expect that growth to moderate somewhat more quickly just because it's a per seat business. You will actually, over time, see us be able to continue to add ARPU and growth in those segments. Think of it almost like an Office business. Internally, we call that component part of our Microsoft 365 value. That's how we sell it externally even. And so hopefully, that helps give a little context to the number as well as our overall ability to continue to grow the sort of hybrid cloud opportunity high teens.

Operator

The next question is coming from the line of Phil Winslow with Wells Fargo.

Philip Alan Winslow
Wells Fargo Securities, LLC, Research Division

Satya, you touched on the synergies that you're seeing between applications businesses and LinkedIn helping the 2 out. Wonder if you can talk just sort of high level and strategically about applications and enterprise applications in Azure and how you kind of see the synergy of potentially coming up between those, especially when you think about Azure AI, ML services sort of -- kind of questions is how important or how critical are applications like the growth that we're seeing in Dynamics, et cetera?

Satya Nadella
CEO & Director

Yes, I mean, one of the things that I talked about in my remarks this time was this power platform. One of the areas of, in fact, real breakout growth in differentiation as being in Power BI, Power Apps and Flow. For the first time, in fact, in our own Microsoft history, we have an extensibility model that is the same for Office 365 and Dynamics 365. This has been a dream of mine for, I don't know, for 15 years probably. And we are finally here and we are executing super well. But the interesting thing is it's not just even for our own SaaS applications. It is the extensibility model for every SaaS application out there, including a common data model. So I think that, that's where the synergies lie because AI starts with having a data estate that can really bring data from all of your applications, silos, in some sense, together so that you can start doing, building an analytical power that you can then visualize and put in the hands of people using Power BI or run an AI model that does some prediction that you can deploy in your system, whether it's forecasting, sales lead scoring, what have you. So that workflow, we have every layer of it. We have the best deployment tools and development tools in Azure. We have this common data model. On top of this, we have the best BI visualization technology. So that's what you're seeing increasingly as the synergy. But most importantly, architectural benefit for customers because by having incoherence around these layers is where you may feel like you're making some great best-of-breed sort of choices in individual layers, but you'll bear that expense in your overall agility as well as your overall management of your data. And that's where I think we will be very differentiated.

Operator

The next question is coming from the line of Ross MacMillan with RBC Capital Markets.

[Technical Difficulty]

Okay. We'll move on to the next question, which is coming from the line of Brad Reback with Stifel.

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

Maybe Amy, quick question. The Windows OEM Pro business has been extraordinarily strong the last few quarters. Can you maybe give us a sense of how penetrated you guys are in the Windows 10 corporate upgrade cycle and the sustainability of that growth?

Amy E. Hood
Executive VP & CFO

Thanks, Brad. Let me -- first, I wouldn't say penetration is the word for this. Let me talk about this in 2 or even a couple of components because when you think about Windows 10, what we've seen over the past couple of years is you're right, a very strong enterprise deployment cycle and real pull for that product inside enterprises because of the security value prop of the product itself. When you see that deployment for security reasons, an externality of that is people often choose to upgrade machines in that process. We've seen good demand inside commercial entities for and when they make those upgrades to buy Windows PCs and often Surface devices in that choice. I think it's benefited our OEM partners and us. The portfolio of devices that are available are incredibly compelling. I think our partners have done a terrific job on that as well. The overall economy is certainly also quite good. And the installed base had actually gotten older. And so I think what you're starting to see is a process whereby there's a great product, there's a good macro environment. And you've got customers who really want to move to a modern infrastructure. A modern infrastructure has to both be secure at its very core and that can result, as you're seeing through that confluence of events, in a very strong PC market with very strong Pro performance. And I -- and certainly, the guide for Q4 continues to imply all those factors.

Operator

Our next question is coming from the line of Michael Nemeroff with Credit Suisse.

Michael Barry Nemeroff
Crédit Suisse AG, Research Division

Satya or Amy, can you help us understand the large revenue outperformance and guide for continued strong growth in gaming? And Amy, could you please give us a sense of the margin profile of the areas of gaming that exceeded expectations? And if you could also comment on the strength of the MPC margin in the context of the gaming margin as well, that would be helpful.

Satya Nadella
CEO & Director

Yes, I can start and then [indiscernible] even on gaming, very much like how we talk about some of our commercial segments. We've gotten a strategy, which sort of really helps us articulate both the growth opportunity as well as our investments across all of the various layers. So first is the console itself is the highest engagement console out in the marketplace. So anytime a new game, whether it's first-party or third-party releases, the fact that Xbox is where the best engagement is driven, benefits us. So as a platform owner, that's a great growth area for us. But we don't stop there because now we have, whether it's Xbox Live, whether it's Game Pass or Mixer, these are all additional opportunities to really serve the gamer as they play more games or watch games on different platforms. So that's the other big opportunity. But the last one, which I think is new and is something which is already paying its dividends on the Azure growth side, is we've taken all the knowledge of what it means to go to any one of these first-party titles of ours and building it as a PaaS service in Azure for game developers, and the PlayFab acquisition speaks directly to that. So those are all the various levers we have in gaming. And you'll see it in the MPC segment and you'll see it, as I said, increasingly over time even on Azure.

Amy E. Hood
Executive VP & CFO

And I think, Michael, if you don't mind, I'm going to expand your question a little bit because I don't think the increase in the MPC guide is simply gaming. So let me talk a bit about the components and which ones, I think, are a bit more sustainable and which ones may have a temporal nature to them. The performance in Q3 and the guidance for Q4 shows actually strong performance in a number of places that we expect to continue. OEM Pro is a terrific example for the reasons I just gave in Brad's question. Windows commercial, which is really the business inside the enterprise of selling much of the security value on a far more annuity like basis. We've seen strong double-digit billings growth there and we expect that to continue into Q4 as well. The next piece that I would say is a part of that sort of uplift in Q4 is our Surface device. The reception to Surface Book 2 as well as Surface Pro with LTE has been quite good. And you see us reflect that again in Q4, even as the comparable gets a little bit more difficult than it was in Q3 for us when you saw a very large growth rate. We're still expecting high teens there. Then you get to that gaming component and specifically what Satya was talking about, the Xbox software and services component is where I would expect to see the impact of the continuation of Q3. Part of that, I want to be very clear, is consistent, even going back a few quarters. That has been a double-digit grower. It will be a double-digit grower. There'll be some volatility in the number like anything else. And third-party hit games will move it higher as they did this quarter and we're expecting in Q4, but there's also a really strong base to that business that is the result of what Satya is talking about in terms of having a vibrant platform with fans that believe in it and come to it with all the value that's been added. So that's how -- okay, great.

Operator

The next question is from the line of Ross MacMillan with RBC Capital Markets.

Ross Stuart MacMillan
RBC Capital Markets, LLC, Research Division

Hopefully, the line is clear this time. So Satya and Amy, I wanted to ask about server products because striking growth this quarter, given the comp. And Amy, you talked about expected strength into fiscal Q4 and all of that, I guess, is testament to the strength of the kind of hybrid leadership you have. The 2 questions, though, were really, is that strength in server products broad-based across Windows Server, SQL Server, System Center, et cetera? Or is there any sort of bias in the mix, if you will, in terms of what's driving that strength? And then Satya, you mentioned Cosmos DB and that was a striking number to me as well. And I was just curious, do you think, now you have the multi-model database in market, that, that can help you take market share within the data management database space?

Satya Nadella
CEO & Director

Yes. I mean, I'll take the second one. I think that yes, I mean, Cosmos DB's pretty unique capability, in combination with everything else we do in both the data layer, the AI layer and the infrastructure layer, I think we have a tremendous opportunity because, as I said, the AI era is mostly first data era. And that's where I think the opportunity lies. But to your previous question, even there, there are multiple trends, and Amy referenced it in her remarks, which is, for example, virtualization still continues to be a growth driver of server products. The other growth driver of server products is cybersecurity and the security value in our servers. So that's one. The fact that we now have SQL and, for example, when you think about SQL itself, it's a hybrid product. You can tier SQL databases with the cloud. SQL is an AI product because we are the one database that actually allows you to write Python and R in situ, store procedures right in your database. So for example, when we talk about data and AI close to data because computation will always go wherever data is, and a lot of data shows up in relational databases and we have a growth driver there as well. And then there is the hybrid choices where somebody's building a smart factory, they're now looking and saying, "What is the server I deploy in the factory to manage the millions of sensors that are there across the factory?" And that's where Azure Stack shows up. So multiple drivers of what is essentially the server and cloud number in combination.

Amy E. Hood
Executive VP & CFO

And to your point on the component, the on-prem component even with tough comparable doing well, let me break Satya's comment into sort of 2 drivers that have been actually more sustaining. And it's across both Windows in particular, but also SQL, which are obviously the largest products within our server portfolio. The first, exactly with hybrid demand. We have something called hybrid -- Azure Hybrid Benefits. What it does is really provide confidence to our committed customers, buying on-prem servers that their transition to a hybrid, to cloud over a period of their agreement, is really about their choices, their time lines and their confidence. And so with that right, it lets them easily transition between Windows or SQL to those same benefits in Azure with a small uplift in price. I think that has actually been a core component. The second one was the virtualization drive or data center modernization, another one, do move the premium mix up a bit. So that's -- if you wanted to break it down into 2 more sustaining things, those are the types of things we're seeing in that number.

Operator

Our final question is coming from the line of Kash Rangan with Bank of America Merrill Lynch.

Kasthuri Gopalan Rangan
BofA Merrill Lynch, Research Division

Last question will be the longest one, really, really long. Question for you, Satya. As you meet with CEOs of large companies, this is a recurring theme that we've been hearing from other software company CEOs, the theme of digitization. Can you help us understand just -- especially given that Microsoft's growth rate is accelerating, whereas the GDP growth rate is the GDP growth rate. So obviously, tech spending or IT spending as a percentage of GDP or revenue, average company revenue is going higher. So can you help us, given your perspective, which is pretty unique, help us understand, what is the baseline of IT that we've been operating in? When it comes to digital business transformation, what are the Phase 1, Phase 2, Phase 3 initiatives like? Where are companies likely to spend more? And what kinds of products and services that are new and upcoming or maybe you sell them today that comprise that incremental swing factor over the baseline of what IT is today versus wherever we're likely to go with the digitization of business processes?

Satya Nadella
CEO & Director

Yes, I mean, I think when we talk to customers and CTOs, CEOs, what have you, we talk about 4 digital transformational outcomes. In fact, everything that we do across our solution areas are all ingredients to helping our customers achieve digital transformation objectives on. For example, how do they engage their customers? When I talked about Cosmos DB growth, Cosmos DB happens to be one of the best database products to be able to capture the signals that you want around your customers from a variety of different sources. That's one example of it. The second piece is, of course, around empowering your employees. I mean, one of the things that now has increasingly become #1 priority for every CEO is to make sure that the right tools, the right products are in front of their own employees so that they can do their very best work and collaborate. So teams grow. That's a great example of how companies are modernizing their workforce with things like Microsoft 365. The third one is operational efficiency. When we see the Dynamics 365 growth or Azure IoT growth, that's -- taking every IoT project, it ends up as a field service project. So that's a classic way somebody says, "Let me sense something, predict something and then actually fix using field service." So that's a transformational outcome that we're very well positioned. And lastly, people are changing their business models. You take somebody like Nalco Water. You could say they're a water company, but now they're pure water service company. In other words, they put sensors that allow them to actually deliver a very differentiated business model to their customers. And so that's the transformational outcomes we see. And we feel we -- at Microsoft, we're well positioned both with the technology but also with our front-line sales capability, service capability and partner capacity to best address the digital transformation needs.

Kasthuri Gopalan Rangan
BofA Merrill Lynch, Research Division

Wonderful. It seems like CRM, HCM, ERP, IoT, these are the predominant themes that are going to be driving your growth. Very useful, insightful.

Michael Spencer

That wraps up the Q&A portion of today's earnings call. Thank you for joining us, and we look forward to speaking with all of you soon. You can find additional details at the Microsoft Investor Relations website.

Amy E. Hood
Executive VP & CFO

Thanks, everyone.

Satya Nadella
CEO & Director

Thank you, everyone.

Operator
Ladies and gentlemen, this does conclude today's teleconference. Again, we thank you for your participation, and you may disconnect your lines at this time.