Presentation

Unknown Speaker

Operator

Welcome to the Microsoft fiscal year 2009 second quarter earnings call. Today's call is being recorded. If you have any objections, you may disconnect at this time. I would now like to turn the call over to Mr. Bill Koefoed, General Manager, Investor Relations. Sir, you may begin.

Bill Koefoed

Thank you, operator, and thanks everyone for joining us a little earlier than normal today for Microsoft's second quarter 2009 earnings conference call. We decided to align the timing of the earnings release this quarter with the cost management initiatives that we announced this morning. We will talk further about these initiatives later on the call.

I am delighted today to be joined by Steve Ballmer, our Chief Executive Officer, as well as Chris Liddell, Senior Vice President and Chief Financial Officer, Frank Brod, Corporate Vice President and Chief Accounting Officer, and John Seethoff, Deputy General Counsel. The format for today's call will be as follows

Chris will summarize some of the key take-aways for the quarter, as well as address the announcement we made this morning. I'll then provide details around our second quarter results and then hand it back to Chris for a more detailed discussion of our business outlook, and then Steve will make some comments. After that, we'll take some questions.

Please be aware that we filed our Form 10-Q today in conjunction with our earnings release. We have also posted our quarterly financial summary slide deck, which is intended to follow the flow of our prepared remarks, as well as provided a reconciliation of differences between GAAP and non-GAAP financial measures that we will talk about today. You can find these documents on the Investor Relations website at www.microsoft.com/msft.

Today's call will be webcast live and recorded. Please be aware that if you decide to ask a question, it will be included in both our live transmission as well as any future use of the recording. A replay of the call will be available at the Microsoft Investor Relations web site through the close of business on January 22, 2010. This conference call report is protected by copyright law and international treaties. Unauthorized reproduction or distribution of this report or any portion of it without the express permission of Microsoft may result in civil and criminal penalties.

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

And now, I'll return the call over to Chris.

Chris Liddell

Thanks, Bill, and again thanks to all of you for accommodating our timing changes.

Our second-quarter results reflect a difficult environment as the global economy continued to deteriorate beyond our expectations, particularly during the month of December. Despite this economic backdrop, we were able to grow revenue and utilize accelerated cost reductions to offset the majority of the impact to the revenue shortfall on operating income. On a segment basis, our client business, being the most severely impacted by the softening economy, declining 8% due to the significant weakness in the traditional PC market sales, partially offset by the record growth of net books. Revenue from Microsoft business edition and server and tools divisions were a combined $500 million or 7% driven by healthy demand from enterprise customers while the transactional aspects of these businesses were impacted by lower PC and server hardware unit sales. Our online services business revenue was flat although online advertising revenue was up 7% in a tough environment, and entertainment and devices division delivered revenue above the high end of our guidance driven by a record number of consumers purchasing Xbox 360 consoles during the holiday season.

Against the backdrop of a deteriorating economy, we are focused on the need for fiscal discipline and on executing in the areas we can control by managing expenses while delivering on the next wave of our product pipeline. During the second quarter, as the economic outlook continued to slow, we accelerated our expense reduction plan. These actions allowed us to deliver operating expenses in the second quarter of $600 million below our October forecast. However, today we have also announced steps we will take to further manage our cost structure. These steps include a reduction in headcount related costs, including plans to reduce up to 5,000 positions in the areas of research and development, marketing, sales, finance, legal, human resources and IT over the next 18 months, of which 1,400 are effected today. There will be no pay raises next fiscal year. We have plans to significantly reduce our window and contingent staff expenses. We'll also be looking for reductions in marketing expenses, reduced capital expenditure and facility costs, as well as tighter discretionary spending, including significantly reduced travel related expenses.

The cumulative result of these actions taken during the quarter and those announced today will result in operating expense savings of $1.5 billion and capital expenditure savings of $700 million lower in this fiscal year 2009 than assumed in our July guidance. Lastly, we plan to manage operating expenses broadly flat in the fiscal year 2010 and capital expenditure to be lower year over year. While we are managing our expenses tightly, we continue investing in key strategic opportunities which will fuel the future growth of the company. We have a strong product pipeline and are bringing to market a number of significant product releases over the next two calendar years.

With those high level themes, I will turn the call over to Bill for more details on the second quarter.

Bill Koefoed

Thanks Chris. I will discuss top line financial and business momentum points followed by revenue performance for each of the business units. Then I'll review the rest of the income statement. All growth comparisons relate to the comparable quarter of last year unless otherwise noted.

Revenue grew 2% to $16.6 billion, which was below our low end guidance as the economic environment weakened further than we expected, particularly in the month of December. Our mix of product billings was approximately 30% from OEMs, 25% from multi year licensing agreements, 20% from license only sales, and the balance from our other businesses. Despite the broad economic weakness, the annuity portion of our volume licensing business remains healthy and increased one percentage point in our billing mix. Enterprise agreements renewal rates were in line with historical trends. Unearned revenue grew over 7% to $13.1 billion but was down sequentially. Our contracted not billed balance increased 10% year over year but was slightly down on a sequential basis remaining at over $13 billion. When taken together with reported revenues, total bookings for the company declined 10% this quarter, reflecting the general economic weakness, primarily in our non-annuity business. Overall, changes in foreign exchange rates added about 1 percentage point to our revenue growth.

Now I'll provide revenue details by business segment starting with Windows clients. Client revenue declined 8% to $4.0 billion. I will review the main drivers that contributed to this performance beginning with an overview of the PC market. We estimate that the PC market for the quarter was approximately flat year over year, well short of our forecast of 10% to 12% growth as the PC market weakened much more quickly and severely than expected. Adding a bit more color, traditional PCs declined almost 10% with weakness in both consumer and business PCs. This was partially offset by incremental growth in the new net books category. During the quarter, our windows OEM license units declined by 1%. OEM revenue was 12% lower year over year driven primarily by the dynamics of the underlying PC market. Specifically, the decline in traditional PC sales drove double digit declines in business and consumer premium SKUs.

This impact was partially offset by strong growth in our net books offering. Our attach rates were under pressure during the quarter, but we didn’t experience a material change versus historical rates. Our net book attach rate now exceed 80% as customers are clearly opting for the value Windows provides.

We estimate that we lost about two percentage points of growth due to the channel holding lower than historical level of inventory. The commercial and retail portion of the client business grew 19% as it benefited from continued adoption of Windows Vista in the enterprise. On the product front, our engineering team reached a major milestone with the delivery of the public beta of Windows 7, which has received great reviews today. We remain very positive about the client product pipeline and its inability to drive long-term growth. Servers and tools revenue grew 15% to $3.7 billion despite a decline in the server hardware market. This achievement marks the businesses 26th consecutive quarter of double-digit growth. Annuity licensing continued to grow faster than non annuity licensing. The momentum of SQL Server 2008 and our Hyper-V virtualization helped drive Windows server sales and increase our systems center management tools attach rate, thus allowing us to grow our revenue per server. As a result, servers and tools continued to grow faster than the hardware market.

Demand for our consulting and support services to deploy Microsoft technology remains strong, driving revenue growth at 16%. On the product side, the server and tools business division made significant product development progress. Released to beta, Windows Server 2008 R2 will add the Live migration feature to Hyper-V further enhancing our virtualization offering. At the Professional Developers Conference in October, we provided a preview to Windows Azure, our cloud based services platform. The Azure services platform hosted Microsoft data centers, provides an operating system, and a set of developers services that can be used to build new applications to run from the cloud or enhance existing applications with cloud based capabilities. This architecture gives developers the choice to build web applications, applications running on connected devices, PCs, servers or hybrid solutions, while using the same tools they use today.

The online services business revenue was relatively flat at $866 million. Online advertising revenue grew 7%. Search revenue grow double digits while display revenue grew slower in a weak ad spending market. We continue to see healthy growth in our traffic with page views and query searches both up on a sequential and year over year basis. In the online services business, we recently announced important partnerships with Dell, Verizon, and Sun Microsystems, and released a new suite of Windows Live services. We remain committed to the benefit that a strong online services business will bring to Microsoft.

Microsoft businesses division revenue was up 1% to $4.9 billion. Business revenue grew 7%, driven by continued strength of the annuity business across Office, SharePoint and Client Access licenses suites, and benefited from strong deferred revenue recognition. Non annuity revenue declined on the weakness in the mid market, small medium business and consumer segments. Specifically consumer revenue declined 23% driven by the weakness in the core PC market, a mix shift to lower price SKUs and inventory reductions from Q1. From a product perspective, SharePoint, Office Communication Server and CRM, all grew at double-digit rates. We made significant progress against the product pipeline by releasing final versions of Exchange Online and SharePoint Online.

In October at PDC we demonstrated our Office 14 web application which will enable the rich and familiar office experiences through the browser. Entertainment and devices division revenue grew 3% to $3.2 billion. A record 6 million consoles were sold in the quarter growing over 41%. In Europe, Xbox 360 sales nearly doubled those of previous holiday season. Based on US NPD numbers released last week, Xbox 360 outsold PS3 two one. We continue to lead the industry with out software attach ratio of 8.1. During the quarter, we also launched the new Xbox Experience which has been received extremely well. The software update has given our customers a new upgraded experience that broadens its appeal and increases the value and durability of the platform to customers and Microsoft. Xbox Live membership has grown 70% from last year to 17 million members.

Now for the rest of the income statement. Cost of goods sold was $3.9 billion, increasing as a percentage of revenue two percentage points to 23.5%. Cost of goods sold growth was driven by higher Xbox 360 console volumes, increased data center and traffic acquisition cost in the online services business and growth in enterprise services. Operating expenses were $6.8 billion, over $600 million less than was assumed in our low end guidance. This represents a significant slowing in the operating expense growth rate. Savings included marketing, vendor, people and general and administrative expense. As a consequence, operating income, which was $5.9 billion was only $174 million below guidance despite revenue being $712 million below guidance. Other income and expenses was a loss of approximately $300 million for the quarter, driven by currency valuations declines on unhedged portions of the balance sheet and investment impairments, offset by dividends, interest and net recognized gains on investments sold.

Our effective tax rate for the quarter was 26%, half a percentage point lower than guidance, driven by an earnings mix increase in lower tax jurisdictions. During the quarter, we repurchased 94 million shares or over $2.2 billion of company stock. We also paid out about $1.2 billion in dividend to shareholders. Diluted shares outstanding were 8.9 billion, down 6.2% from the prior year as a result of the share repurchases. Earnings per share were $0.47 representing a decline of 6%.

As Chris noted earlier, the business environment made for a challenging quarter, but we feel positively about our quick response in managing expenses to mitigate the impact as much as possible. With that let me turn it back to Chris, who will provide you with more insight into our business outlook.

Chris Liddell

I am going to spend my remaining time talking about the balance of fiscal 2009. Clearly the volatility in the macro economic climate created a great degree of uncertainty in the second half of our fiscal year, and in particular conditions progressively worsened throughout the second quarter, creating a broader the normal range of possible extrapolations looking forward. So given that we expect macroeconomic conditions to be the most important variable in predicting our results in the second half, we're not providing quantitative revenue or earnings per share guidance at this time.

We will however provide you with the framework to help you think about the drivers for our business. I'll start with revenue, beginning with clients. The PC market is clearly the key driver of client revenue and it is likely to remain weak over the second half of our fiscal year, with market trends similar to or potentially weaker than the second quarter, especially in the traditional PC market, excluding the Xbox. Offsetting that partially, the net books mix of total PCs will likely follow similar trends to Q2, with continued strong Windows attach on net books contributing to overall Windows revenue. However, as the economy slows, continued inventory contraction and pressure on attach rates would negatively impact revenue growth in the second half. So overall we expect client revenue to perform broadly in line with the traditional PC market.

The Microsoft business division, I will speak to the three main drivers for the business. Consumer revenue which makes up about 20% of the divisional revenue will be impacted by the declines of the traditional or non net book PC market, in addition to further channel contraction. Transactional licensing sales to business customers which make up about 25% of the divisional revenue should generally align to the business PC hardware market which may continue to decline in the second half. Finally, the remaining annuity licensing portion of MBD revenue which makes up approximately 35% is likely to remain somewhat insulated from macro trends and grow faster than IT spending due to the strength of the businesses like SharePoint, unified communications, while it could face pressure due to lengthening sales cycle.

The sever and tools segment has many of the same drivers as the business division. The OEM and transactional licensing business customers, which is approximately 35% of the business, should generally align for the server hardware market which at this time of the year and we expect will decline over the second half of the year. The remaining annuity licensing and enterprise services portion of the business will likely continue to grow faster than IT spending based on the strength of our product portfolio and business model but also could face some pressure due to lengthening sales cycle. Overseas revenue should followed similar trends to what was experienced in the second quarter with advertising spending will likely remain weak until the economy starts turning. This is particular for the display advertising portion of our business where we expect monetization rates across industry to continue to worsen. Also keep in mind that the ongoing expected decline is our XS business worldwide on the overall growth of the segment. Additionally, we would expect a head wind from the impact of foreign currency in the second half of the year, given the high proportion of revenue that comes from the international market.

The entertainment and devices division, is highly dependent on consumer spending and while we feel good about the first half results, a shrinking consumer spending environment would weight on the segment results in the second half. Consolidated revenue will likely decline as a result of really pricing actions. Attach revenue may also slow due to contracting consumer spending and moderating attach rates. The other software and virtual portions of our business should follow the underlying PC market in the second half.

With that primer to assess our revenue prospects, let me move to our outlook on expenses. The economy is clearly deteriorated more than we expected and we have responded to this environment by taking further actions to reduce expenses and to prioritize our efforts. We have initiated a number of cost savings which will layer in progressively over this fiscal year. As a result of these actions, we have now said fiscal 2009 operating expenses of approximately $27.4 billion. Going forward, we expect to maintain our operating expense broadly flat in fiscal year 2010.

Moving to the other drivers of earnings per share, we continue to experience - we continue to expect an effective tax rate of 26.5% for the year. Other income might be negatively affected by further market movements. We remain committed to returning capital to shareholders, through stock repurchases over the long-term, given the increased uncertainty in the current market, repurchase activity will slow in the second half of fiscal 2009.

With those overall comments and outlook, I would now like to hand the call over to Steve, so he can share his perspectives before we take your questions.

Steve Ballmer

Thanks Chris. We are certainly in the midst of a once-in-a-lifetime set of economic conditions. The perspective I would bring is not one of recession, what I would say rather is the economy is resetting to a lower level of business and consumer spending, that is based largely on the reduced leveraged in the economy. Consumers cannot refinance their homes, don't have that extra money to buy discretionary second and third PCs. Business in the business market, we certainly see a production in capital expense based upon lack of leverage in business conditions. IT spending represents about 50% of US business capital spend. And so neither the consumer nor the business side of the technology industry is immune to these economic conditions. As a participant in this market that at least in some areas like a client business has a very significant market share, you certainly feel the overall market impact most clearly.

In these times, I think there is three things to focus in on, and not surprisingly two of them are very similar to things we focusing in on everyday. The three things are, number one, innovation, which I will talk about; number two is market share, because even in the market that is suffering, share increases tried revenue growth. We are always focused on share but particularly now. And number three is efficiency and effective resource prioritization and allocation which is where I want to start and one where we perhaps spent a little less time with you historically.

We are long-term and I'll come back to this. We'll remain incredibly positive on Microsoft, the technology industry, the opportunity for innovation, and yet now it's certainly the time to ask critically, which of our investments should we prioritize, and how can we get more efficient? Is the same amount of work done, if you will, for less. We have been an exercise and continue through an exercise looking at work processes and driving that efficiency, rightsizing and prioritizing some of our investments, and we have got to take a number of actions, we are taking a number of actions to in some sense manage our cost base. Our cost base has grown. As many of you know significantly over the last few years. And while as Chris said, we don't plan on shrinking it in FT10, we are really putting the brakes on at a new level and quite significantly putting the brakes on. With that said, we're going to continue to invest in important areas of opportunity for the company and so even while we take out the 5000 jobs, we will also be adding a few thousand jobs back in areas like search, where we continue to see incredible opportunity to do good work. So we will take out, put back in, but in aggregate manage expenses consistent with the comments Chris had a chance to make.

In terms of market share, I think we have some great opportunities. Bill talked about the performance of the Xbox, sold over 5 million Windows mobile units this quarter, which was great, we have got a lot of opportunity in search, we are glad to have search volume up so significantly for us this quarter. Our server and tools business reflects our ongoing market share improvement basically in both Windows Server and in our Sequel business. You'll see us continue to invest particularly in Web Servers and technical computing as we move forward. In the client business, we sold north of 50 million units of Windows and that another big chunk. Unfortunately probably got used without pay, but not paid for, and yet we lost maybe a point of share of that, so 2.5 million during the same period. We have big plans there with Windows 7 and everything that we have coming forward. And certainly in this economic climate, with the kind of price premiums that people pay for Macintoshes versus PCs, I think will be looked at farmer critically by customers as a number of reviewers have started to note. In the case of net books, we have gotten from no share to as the guys said over 80% share and climbing. It is a fully interesting topic in and of itself. Our business with the consumer market, unit volumes up dramatically year-on-year, over 14%, which is the business people think where we have high share, we have a great opportunity. So a lot of focus in the enterprise space, in the online space, in the entertainment area, in the client area. There are a lot of opportunities to work market share, both from product development standpoint and from an sales and marketing perspective.

Our product pipeline and the work we are doing in innovation, I am excited about it. We have had first look on Windows 7, we had good market reaction to Windows Azure, a new version of Office, Office 14. I am excited to be out in next year or so. Windows Server 2008 Release 2 builds on the strength of Windows Server. We have certainly got our work cut out for us. There are businesses where we have got a lot of work to do, where we don't have leading positions, and there is some businesses where we've got leading positions, which have phenomenal new products to come. But we will continue to invest strongly in R&D, that get very well funded in the operating expense strategy that Chris talked about, but at the same time, we are prioritizing, we are focusing on the most important stuff as we go forward.

Certainly the size and scope of this economic dislocation is unprecedented and may delay some technology adoption in the industry at large. I don't think there is any stopping, forward march of our industry or Microsoft. And in the long run, let us call it the pause that the economy is imposing on our industry, it will certainly just be that. It is a pause and will be renewed strong growth in the technology industry overall, certainly at Microsoft. And we're focused, we are focused on efficiency, on market share, and on renovation as we drive forward.

And with that, I am going to hand things back over to Bill so that we can start taking some of your questions.

Bill Koefoed
Thanks Steve. Let's now proceed to questions. We want to accommodate questions from as many people as possible, so please avoid multipart questions, and I will strictly limit you to just one question. Operator, will you please repeat your instructions?

Question and Answer

Unknown Speaker

Operator

(Operator instructions). And our first question comes from Brent Thill with Citigroup.

Brent Thill - Citigroup

Thanks. Good morning. If your fiscal 2009 guidance holds, this will be the fourth consecutive year of operating margin decline. Do you think you're taking quick enough action to realign the business to this lower demand environment?

Chris Liddell

Yes, Brent. We believe certainly taking as you saw $600 million worth of costs out the second quarter, which is almost 10% of our cost base for the quarter, was very prompt action. And if you look at $1.5 billion dollars for this year as well, that we believed in the context of a deteriorating economic really accelerated December. So we're talking about reacting to the last and particular months to six weeks or so of economic data. We think the actions we took were actually quite very fast and appropriate for that now. I agree with the margin comment, but clearly also the mix of our business is changing quite significantly as well. So as we sit here today, based on the facts that we have seen in particular over the last few weeks, we think we have taken the right degree of action in terms of reducing the cost base but continuing to still invest against the revenue that we see coming forward.

Steve Ballmer

I think one thing you have to understand is with our margin structure i.e. with high margins as a percentage of revenue, we're going to be far more volatile both on the upside and on the downside due to fluctuations in revenue. And unlike a company that is sort of more about manufacturing where everything kind of scales with volume, we have a much larger fixed costs chunk. And on the upside, when revenue goes strong, it’s a chance to increase margins, but when revenue is weaker, it is likely that margin percentages will decline.

Chris Liddell

And when you look at the initiatives we have taken, depending on the item you are talking about, whether it's from people to things like travel expenses to Window cost, we're taking out somewhere between 5% and 15% of the cost line that we’re talking about, which we think in this environment relative to the reset in the economy is broadly the right level.

Bill Koefoed

Thanks. Next question?

Operator

And the next question comes from the Heather Bellini with UBS.

Heather Bellini - UBS

Hi, good morning. You mentioned that you are laying of 5,000 people. I'm wondering if all of those are Microsoft employees or there are also outside contractors that work at Microsoft that you're not including in that total? And I guess along that line, are you including cash severance charges that you are going to take for the reductions in force, are you including that in your operating expense guidance for fiscal year 2009? Thank you.

Chris Liddell

Yes, Heather. The outside contractors are not included in that number, and we will be certainly looking to reduce that cost line, probably in proportion by more than what we are talking about in terms of internal people. So the 5,000 jobs we talk about are entirely Microsoft related.

Steve Ballmer

It is not really five - I mean let me make sure the math is clear. We may eliminate up to 5,000 jobs, but we are also adding a few thousand jobs.

Heather Bellini - UBS

Yes. No, I think we all assumed that, that net-net it is going to be less than 5.000.

Steve Ballmer

and we're talking here now privately about operating expense head count as opposed to cost of goods, which varies in its own criteria. So on the operating expense line, I expect this to been down more like a net sort of 2,000 to 3,000.

Heather Bellini - UBS

Right. Then to Chris' point, it looks like you will end up cutting more outside contractors than the 5,000, or than the 2,000 to 3,000 you just mentioned?

Chris Liddell

Yes, those numbers all internal people, Heather. The external contractors I guess if we think about more in terms of the dollars that we spent overall, that's on top of the numbers that we are talking about and that could be down up to 15%.

Heather Bellini - UBS

Okay. And then the cash severance charge part?

Chris Liddell

The cash severance charge is not included in the operating expense that we are talking about. It will not - we are looking at the number and it obviously depends on the final number that we talk about with people, but we will call that out separately in the third quarter for the 1,400 people that we are talking about today, and then I guess that as other people leave the company, we will look at the charge at that time.

Heather Bellini - UBS

Okay, thank you.

Bill Koefoed

Let's go to the next question please.

Operator

Next is Adam Holt with Morgan Stanley.

Adam Holt - Morgan Stanley

Good morning. My first question is about the buyback, is the slowing of buyback activity principally related to just capital preservation, or do you see an opportunity to maybe be more aggressive on the M&A side given some of the depressed valuations? And then just secondarily can you walk us through maybe even some high-level thoughts on how you view the PC market? I know you are not giving explicit guidance, but what your expectations are for piracy, any just kind of guidelines for how we should be thinking about PC growth in the back half of the year? Thanks.

Chris Liddell

Sure. On the buyback, it is both the factors that you mentioned. Certainly capital preservation in this environment is more important than it's ever been. On the acquisition side, clearly the opportunity to buy shares is very good. And Microsoft, having said that, the opportunity to buy other companies has probably never been better relative to their prices. Having said that, I wouldn't expect M&A activity to be particularly significant in the second half of the year, simply because I don't think the market generally has yet lowered their expectations to the new level of prices we're talking about. So we will continue to buy some small medium-sized businesses as we normally do. Prices are certainly coming down and that's an opportunity from our point of view, but I think the level of activity will be relatively low, certainly in the next quarter or two. But the opportunity there afterwards to buy companies, again generally speaking the small and medium sized, I think is going to be very good and that's part of thinking about why we're trying to retain that capital and retain our powder as much as possible. On the PC market, you are right, we're not giving guidance. I gave some directional thoughts. We aren’t predicting any macro economic rather than Microsoft specific factors are really going to drive the PC market over the next six months. But you have so realistically the base cases for continuation or even possibly a slight deterioration from the second quarter in what we described the traditional PC market.

Steve Ballmer

It is worth remembering the market has let me just say broadly speaking four pieces to it. Business PCs, for which we receive our highest royalty, consumer PCs, net book, net book PCs, and then let's just say everything in emerging markets, of which China is half of that. And I mentioned that because we have different pricing in each and we have particularly in the last one we have some high piracy dynamics, which affect us. PC market overall is probably strongest today in emerging markets, second strongest in the net books, third strongest in home PCs, and weakest in business PCs, because that's where - it is a place where businesses will say, we will just extend the refresh cycle. So our economic drivers don't look like overall PC market, they look like the components, and unfortunately right now we are in let’s say tough win relative even to the mix.

Chris Liddell

And the other thing I would say, and I think this is generic to all the businesses, is we saw quite a different shape in the quarter. I mean December in particular was relatively weak inside the quarter. October trading conditions were generally speaking in line with our expectations, the first half of November was, and we like I think like most companies out there saw the weakness really started to set in in late November and through December. So to some extent, at the end of the year, we extrapolate quarter overall or the conditions that we and most companies saw in December, as to what sort of an environment we’d see in the first half, and that creates if you like the bookings of expectations, but those are quite wide. If you extrapolate the quarter overall, or extrapolate the December, you get quite different answers, and that's true of the PC market, also true for business overall.

Adam Holt - Morgan Stanley

Good color, thank you.

Bill Koefoed

Let's go to the next question.

Operator

And next is Sarah Friar from Goldman Sachs.

Sarah Friar - Goldman Sachs

Good morning. Thanks for taking my questions. Just a follow up there on the PC growth rate versus Microsoft growth rate. Steve, I understand your point about your oriented away from maybe some - or you don't make as much money on some of the segments that are growing fastest. The delta we saw this quarter of about 8%, is that a reasonable delta to think about going forward, particularly you have a

sense of how inventory noise was in the quarter? Does that dive back and maybe close the delta or should we keep thinking about it about an 8% delta?

Steve Ballmer

I don’t know that you can pick any magic number because the dynamic - unfortunately, the dynamics shift fairly quickly. My guess is, wherever businesses are going to reset, that will reset more quickly than where the consumer will wind up resetting to. The consumer will be more volatile. Our business customers will go through one round of thinking rethinking budgets, and then they will reset it at a new level. And so I think we are going to see more dynamism unfortunately in that number.

Chris Liddell

Yes, Sarah, if I add a little bit color on that, and there are more - as Steve say, there are more moving pieces this quarter than there are normally, but if I try and simplify it a little bit, if you take what we described as our traditional PC market, which is the mixture of the business and consumer that Steve just mentioned, and take that as one growth rate, net books will clearly grow in excess of that and give us a little bit of a revenue uplift. We will see probably some inventory contractions. Attach rates on average are probably going to be much the same, we might lose some in the traditional market but gain a bit on the net books side, and then we will see our traditional shift to emerging markets, although interestingly they have slowed more than traditional markets inside the quarter. You throw all those things together and we would next their revenue decline to be broadly in line with the growth rate from the traditional PC market, so all the other pluses and minuses will generally speaking cancel themselves out.

Sarah Friar - Goldman Sachs

But not as big a delta as we saw this quarter?

Chris Liddell

Relative to the PC market, in fact, we saw it’s about the same. So the traditional PC market we think shrinks somewhere between 7% and 10% in the quarter and our revenue for the client business was down around 8%, so in that range. So that sort of trimmed based on the set of factors which Steve mentioned are moving quite quickly, but if I hold relative to the second quarter, you're probably going to see that same overall trend in the back half .

Sarah Friar - Goldman Sachs

Thank you.

Bill Koefoed

Thanks. Operator, next question?

Operator

Next is Karl Sharingan [ph] from Bank of America.

Karl Sharingan - Bank of America

Hi. Thank you very much. Steve, since we have you on the line, just thought I’d ask you a question on the headcount reduction. You pointed out the consumer spending and business spending has contracted pretty sharply and yet we are talking about a 5,000 person headcount reduction here which still leaves the operating expenses from this fiscal 2009 up about 10% despite the revenue growth of what looks to be about a percent or so? So I'm wondering what your thoughts are, what are your assumptions? I mean it looks like you're factoring in some sort of a rebound, maybe on 12 months, 15 months? Certainly you don't want to lay -off a lot of people if you end up having to hire them back when the economy starts to turn. I'm just wondering if that's the way you are thinking about it, or are you actually open to revisiting the cost structure if indeed the economic conditions continue to act the way that you portrait, that is a vastly lower level of consumer and business spending on technology? Are you open to another round of cuts if you have too to bring the OpEx in line with net revenue growth that we are looking at in 2009 and 2010?

Steve Ballmer

Well, no. I would say actually a couple of things. I don't know about that. We are not used to down markets. So PC market is traditional market as Chris call them, is down 7, or whatever it is, 8% or so. But 8% is vast, something that's always grown a lot. But maybe some of your attributes, I would modify slightly. We are certainly dealing with unprecedented grounds. Our model is not for a quick rebound. Our model is things go down, as I said, and they reset. The economy shrinks and then it doesn't rebound, it builds from a lower base effectively. So that kind of building in our work on costs overall reflects that model. So no, I'm not expecting a balance. And when we did our resizing, we did our resizing with an eye both towards margin, total profit, shareholders short-term and long-term investment in the growth opportunities that we see. So no, I would say that if the economy stays down and then builds slowly, we're probably at about the expense base, we will stay at about the expense base that Chris talked about. You can't tell, the economy could also get a whole lot worse, it could get a whole lot better, but our basic view is that things go down, they are down for a while, a year or two years, I don't know what it will be, and then start to build back again. That's kind of the basic planning model behind this resizing of our cost base. You could say that means you could see lower total profit percent margin and that's certainly possible.

Bill Koefoed

Next question.

Operator

And next is Philip Winslow from Credit Suisse.

Philip Winslow - Credit Suisse

Hi, guys. I just wanted to dig into the severance charges for a minute, you mentioned that you are clearing those in your GAAP OpEx guidance, what level would you expect that to be in the second half of this year?

Chris Liddell

Yes. I said just to be clear, that it wasn't in the number of 27.4 that I mentioned, so it would be on top of that. And we'd expect it to be several tens of millions, but less than 100 million to give you an order of magnitude, and it's going to depend entirely on the number of people that we talk about, yes, the individual circumstances. So I can't give you an exact number, but that's the order of magnitude.

Bill Koefoed

Next question operator.

Operator

And next is Brad Reback with Oppenheimer.

Brad Reback - Oppenheimer

Hi guys. How are you?

Steve Ballmer

Good.

Brad Reback - Oppenheimer

I'm a little confused. If, Chris, as you talk about on the share repurchase side, slowing it down in the second half of the year, but on the other side when we are talking about $1.5 billion cost coming out over the next 18 months, clearly it is still a very valuable franchise with a lot of cash flow, why not take this opportunity to buy back probably the best investment there is at least from your perspective?

Chris Liddell

Yes. My comments were certainly from the - over the long term, we remain committed to the buyback activity. The buyback activity in the first half was actually very high. All I did was signal that we expect in the second half that will moderate from that level. We continue to be a net buyer of our shares absolutely. Do we think liquidity in the current environment, certainly until we get a clearer pattern on economic activity overall. Is it a premium? Yes, I do. Do I think there's going to be some outstanding opportunities over the medium term to potentially buy some other companies that we have looked at? I'll mitigate that by saying small to medium, yes, I do. So the opportunity cost of buying our shares has also gone up as well as the price going down. We are just trying to balance those factors, but we certainly are not talking about getting out of buyback activity as a general concept.

Steve Ballmer

I will remind you that there was a time when tendered our shares at 25 bucks because they looked super cheap for us. That we could - I mean it is hard to know what the underlying market is going to do, and asset values, and we just think it makes sense to keep a little bit more liquid for a while.

Chris Liddell

But also be consistent on this, we try not to tell you in advance what we are doing on the buyback activity. We do that in the quarter, all I'm doing is giving you a directional trend.

Bill Koefoed

Next question operator.

Operator

And next is John Difucci with JPMorgan.

John Difucci - JPMorgan

Thank you. Guys, can you just help me a little bit here in reconciling sort of a follow-up to some of the other questions, because you're talking about the declining environment actually meaning going down, and the uncertainty going forward, and you're resetting expense to reflect this. But your new guidance for operating expenses is still up meaningfully in the second half year over year when you adjust for the third quarter charge last year. And it just if you really think things are - and they obviously are, we all know they are tough out there, and today it looks like it's coming down, it is getting worse year over year, but your expenses, you're laying out some people, no one like to see anybody get laid of, I am sure you don't, we don't, but net 2,000 to 3000 out of 91,000 or whatever you have, are you really resetting expenses to reflect what is out there?

Chris Liddell

Bear in mind of course in the year, half of the year has already gone, and we are reacting to a situation, as I say, and in particular, it's in the back half of the quarter. So -

John Difucci - JPMorgan

This is year over year for just the second half, your expenses are still up, your operating expenses are still going to be if you exclude the third quarter last year that 1.35 fine, so it is - I'm sorry, go ahead, Chris.

Chris Liddell

Your point is valid, and I am very happy to address that. What I described act as changing the momentum of our expense base going forward, but clearly we already have things in the pipeline and people who are employed, who we have to bear the expense of. So we are talking about a plan that stretches out over the next 18 months as opposed to the next few months of which the first few stew steps were taken in the quarter, that's why we were able to reduce by 600 million, 1.5 billion over this year and flat the year afterwards, and a program to reduce not only people internally, but the balance of initiatives that we took. So these things are layering in over time and are in response - you remember I talked about it at the last call, we are taking a set of initiatives in that quarter, and we said - I said at the time that if things got worse, we will probably look to do more. Things did get worse, and we did do more. So we're talking about layering in as we see economic conditions change. So, yes, we would all like to be able to take things out instantaneously. The reality is that we can't do that as quickly as we would like, but you will see us take action that have an impact over the next few months.

Bill Koefoed

Operator, next question.

Operator

And next is Todd Raker from Deutsche Bank.

Todd Raker - Deutsche Bank

Thanks guys. Chris, I was wondering if you look at the overall corporation, could you give us a sense in terms of how kind of consumer versus transactional business versus annuity breaks out? And what's the risk as we look at this spending environment as the annuity business starts to show some dramatic impact over the next kind of six to 18 months?

Chris Liddell

The annuity business was good in the first quarter and the second quarter, so that’s certainly one of the strengths of that business model is the relative insulation of our results from as a result of the annuity business, that's a very good point. Non annuity business shrink during the second quarter, annuity business actually, the revenue associated with annuity business actually grew. So it is providing us some degree of insulation and we're talking about results obviously that are lower than expectations, but to just keep that in context, we still grew revenue 2% in probably the worst environment that we have seen. Part of the reason for that was the strength of annuity. Over the time, and in particular if we see the business environment deteriorate in the second half, clearly that annuity business will slow. Having said that, our re-signing rates inside the enterprises was broadly in line with historic rates. Billings were broadly flat in the annuity area year over year, so they aren’t growing as fast as they would, but they weren’t declining either. They were broadly flat. We have a very big second half from a billings perspective, so we have the opportunity actually to put some more money back in the bank. So on that side of the business, certainly stronger historically, and that will provide us some degree of cushion as we go through the next six months to 12 months.

Steve Ballmer

The way I would characterize it is it is a bit of a dance oscillation. We are actually recognizing now contracts signed two or three years ago. The contracts we are re-signing contracts - sometimes we're re-signing contracts with companies that have less blades, they have less PCs, so even if they are renewing their contracts, they may not be renewing at the same dollar value that the contracts expire at. The effect of that event shows up in other revenue and all that stuff in the books. But from a net income, it takes longer. So if we stay in this cycle and there is fewer people employed in the US, eventually that does ripple through to the annuity business also.

Chris Liddell

But non annuity is likely to be more volatile and more negative than the annuity which is likely to provide, as Steve says, it is likely to lower the oscillation of revenue overall.

Todd Raker - Deutsche Bank

And any rough -

Chris Liddell

Sorry, what was that?

Todd Raker - Deutsche Bank

I was just trying to get a rough sense for the percentage of the business that is annuity driven?

Chris Liddell

It changes a bit quarter by quarter because of things likes Xbox which is all clearly non annuity and move things. But it generally varies between 30% and 40% of our revenue.

Todd Raker - Deutsche Bank

Okay, thank guys.

Chris Liddell

That's the annuity side of 30% of 40%.

Bill Koefoed

Next question operator.

Operator

And our next question comes from Robert Breza with RBC Capital Markets.

Robert Breza - RBC Capital Markets

Hi. Thanks for taking my question. Maybe Steve, can you talk about as you look at the portfolio of business you have and obviously if you go through this economy the way it is, I mean when or if do you think you and the Board would take action to review your portfolio and made a strategic decision to possibly divest off certain assets or technologies, any color around the strategy in particular would be helpful? Thanks.

Steve Ballmer

I like our portfolio.

Robert Breza - RBC Capital Markets

Okay.

Steve Ballmer

The Board likes our portfolio.

Bill Koefoed

Operator, next question, and this will be our last question.

Operator

And the last question comes from Katherine Egbert with Jefferies.

Katherine Egbert - Jefferies

Hi, good morning. So you said you are slowing buybacks to preserve capital. You said no significant M&A in the back half because the sellers haven't reset their expectations and yet you're adding search jobs. What are you really telling us here? Are you saying basically it’s a status quo with Yahoo?

Steve Ballmer