Microsoft Corporation (MSFT) Management Discusses F4Q 2013 Results - Earnings Call Transcript

Executives

Chris Suh - General Manager, Investor Relations

Amy Hood - Chief Financial Officer

Analysts

Walter Pritchard - Citigroup

Mark Moerdler - Sanford Bernstein

Phil Winslow - Credit Suisse

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Rick Sherlund - Nomura

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Karl Keirstead - BMO Capital Markets

Microsoft Corporation (MSFT) F4Q 2013 Results Earnings Call July 18, 2013 5:30 PM ET

Operator

Welcome to Microsoft's Fiscal Year 2013 Fourth Quarter Earnings Conference Call. All lines have been placed in a listen-only mode until the question-and-answer session. Today’s call is being recorded. If anyone has any objections, please disconnect at this time.

And I would now like to turn the meeting over to Chris Suh, General Manager of Investor Relations. Chris, you may begin.

Chris Suh

Thank you, Operator. On our website microsoft.com/investor is our financial summary slide deck, which is intended to follow our prepared remarks and provides a reconciliation of differences between GAAP and non-GAAP financial measures. As a reminder, we will post today's prepared remarks to our website immediately following the call until the complete transcript is available.

Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript and any future use of the recording. You can replay the call and view the transcript at the Microsoft Investor Relations website until July 18, 2014.

During this call, we will be making forward-looking statements that 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 this conference call, and in the Risk Factor section of our Form 10-K, Form 10-Q, and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

Before I hand the call over to Amy, I'd like to remind you that all growth comparisons we make on the call today will relate to the corresponding period of last year. Also, unless specified otherwise, all impacted numbers for the current quarter have been adjusted for the cumulative effect of the revenue deferral and recognition related to the Office and Windows upgrade offers, the $900 million charge for inventory adjustments primarily related to the new Surface RT pricing we announced earlier this week and the goodwill impairment charge from last year. You can find the details of the adjustments and reconciliation of differences between GAAP and non-GAAP financial measures in our financial summary slide deck.

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

Amy Hood

Thanks Chris and good afternoon everyone. Thanks for joining us today. In many ways, our fourth quarter results reflect the trends we saw developing throughout the fiscal year. The consumer x86 PC market declined as users continued to prioritize devices to touch and ability. At the same time we saw continued strength in our enterprise product and cloud solution and increased adoption of our consumer services.

This quarter our Windows business declined as the device market continued to evolve beyond the traditional PC. We are working to transition the business into this modern era of computing taking advantage of the new scenarios enabled our Windows 8. As we said before, given the complexity of the ecosystem this journey will take but we continue to make incremental progress.

In June, we released the public preview of Windows 8.1. It blends the desktop and modern experience. It has new features and improvements in areas such as personalization, search, built-in app and cloud connectivity. Windows 8.1 will be a free update to existing Windows 8 users and will be made available to OEMs in August, less than one year since launch.

To increase and improve retail distribution, we entered into a strategic partnership with BestBuy to create a Windows store in over 600 BestBuy locations. These store-within-a-store locations provide a large scale hands-on consumer experience that showcases Microsoft devices and services. The percentage (inaudible) devices available at retail continues to improve. The first 8x Windows tablet became available at retail a few weeks ago. It has legacy application compatibility, includes Microsoft Office and retails for less than $400. We expect additional compelling small screen devices to be available in the coming months.

Less than a year ago, we launched Surface RT and Surface Pro, each with a unique value proposition. Surface is one part of our journey to bring innovative, compelling Windows devices to market in a modern era of computing. (Inaudible) analyze our progress and fine-tune our action plan as needed.

Hear what we did this quarter. We reduced the price of Surface RT by $150 to $349 per device. As a result of this price change as well as inventory adjustments for related parts and accessories we recorded a $900 million charge to our income statement. While this resulted in a negative $0.07 impact on earnings, we believe this pricing adjustment will accelerate Surface RT adoption and position us better for long term success.

We also increased retail distribution in the quarter. Surface is now available in 29 markets and 10,000 retail locations.

We expanded the availability of Surface to our business and institutional customers. Through our new channel expansion program, commercial customers are able to purchase Surface devices from authorized resellers in the U.S. Over the next few months we will authorize commercial distributors and resellers in more countries.

So in summary on Windows, we are working hard with our partners to gain share in the evolving and growing device markets. I want to be very clear, we know we have to do better and that's one reason we made a strategic and organizational changes we made last week. With over 1.5 billion Windows users around the world, a transition of this magnitude takes time. We are confident we are moving in the right direction.

Now on to our enterprise business which continues to be strong. We closed out the year with record on our revenue up $22.4 billion as businesses continued to make long term commitments to the Microsoft platform. Within our server and tools business, we continue to make significant improvements in performance reliability and scalability with SQL server. As a result, customers are increasingly moving mission critical and BI workloads to the platform. Our SQL Server has been the unit share leader in the market for some time. It has consistently outgrown in the market over the past 12 months and is now the second largest database in revenue share.

We recently announced the next versions of Windows Server and System Center which will continue to deliver on our Cloud OS vision. With new features and enhancements in virtualization, storage and networking, we are empowering our customers to more officially manage their application services and their private, hosted and public cloud infrastructures.

In Windows Azure, we continue to innovate and broaden our cloud platform offering. We recently announced an important enterprise partnership with Oracle. It will enable customers to our Oracle software on Hyper-V and in Windows Azure. In June, we announced the public review of Windows Azure in China, operated by 21Vianet making Microsoft the first multinational organization to offer public cloud services in China.

As a result of the greater choice and flexibility, we are seeing increased customer tractions, those in terms of an increase in Enterprise customers but also the average deal size. Our productivity solutions continue to be a top priority for CIOs. As Enterprise customers look to modernize their productivity infrastructures, they are increasingly turning to Office 365.

We recently announced the expansion of commercial availability into several new markets, making Office 365 available in over 125 markets worldwide. I’m pleased to share that momentum is accelerating. An Office 365 is now on a $1.5 billion annual revenue run rate.

During the quarter, we saw ongoing momentum for our consumer services such as Office 365 Home Premium, SkyDrive, Xbox LIVE, Skype and Outlook.com. By giving consumers rich, high value experiences across productivity, litigations and entertainment, these services can help you about products and our overall ecosystem, our strategic advantage in today’s marketplace where the line between home and work is boring for many customers.

Our unified communication offering of Skype and Lync are great example of our customer enterprise products can be mutually reinforcing and create more opportunity for Microsoft. In summary, the third quarter contains many of the trends we saw developing throughout the fiscal year.

We continue to make important stride for our strategy, to create a family of devices and services for individuals and businesses, to empower them for the activities they value the most. Some of our investments are already paying off while others reinforce the foundation that positions us for future growth and profitability.

With that, I’ll hand it over to Chris to get more details about this quarter before I come back to share thoughts on the first quarter of fiscal 2014.

Chris Suh

Thanks Amy. First, I’m going to review our overall results and then I'll move onto the details by business segment. Revenue was up 3% to $19.2 billion and operating income declined 11% to $6.2 billion. Earnings per share declined 19% to $0.59. Foreign exchange had $257 million or 1 percentage point negative impact revenue this quarter and $177 million or 3 percentage point negative impact to net income.

From a geographic perspective, revenue in the U.S. was strong relative to other regions. Annuity revenue continued to be strong growing 13%. We have record unearned revenue of $22.4 billion and our contracted-not-billed balance was approximately $21 billion.

Now, to the result of the Windows division, our revenue declined 5% this quarter. The x86 PC market continued to decline while business PC showed modest growth. We estimate consumer PCs declined more than 20%. As a result, OEM revenue declined 15%.

OEM revenue lagged the PC market primarily due to market dynamics in China and lower ASPs reflecting the introduction of our small screen touch offering in the current period incentive program. Non-OEM revenue grew 22% driven by sales of Surface and continued double-digit growth in volume licensing as businesses across all areas and segments continue to value the Windows platform.

This quarter we saw continued progress in the transition from Windows XP and today almost three-quarters of enterprise desktops are running Windows 7. Volume licensing of Windows delivered more than $4 billion in revenue this year.

Next, I'll walk through our Server and Tools business which posted another solid quarter with 9% revenue growth and double-digit bookings growth. Product revenue grew 9%, driven primarily by growth in premium versions of Windows, Server and SQL Server .Our cloud momentum continues with strong customer adoption, upsell the higher level services and increased innovation. We released a number of Azure services, including mobility, media and website services and a growing number of customers who are already using multiple services for the cloud platform needs. We added 25% more enterprise customers this quarter and now over 50% of the Fortune 500 are using Windows Azure.

In the data center, system center revenue grew 14% and the premium version of Windows Server continued to see significant revenue growth. Hyper-V, our virtualization product, continued to gain market share over the past year. Companies such as Aston Martin and Grant Thornton continue to look to Hyper-V and System Center to deliver their critical business application.

In the data platform business, SQL Server revenue grew 16% and again outpaced the broader market. Last month, we announced SQL Server 2014, the next version of our data platform which has in-memory capabilities built right into the core database. We also announced Power VI for Office 365, a cloud based BI solutions that combine power of SQL server with the familiarity of Office.

Now I'll move on to the Microsoft Business Division where revenue grew 2%. Within that, business revenue grew 7%, driven by 10% growth in annuity revenue. Consumer revenue declined 27%. Results in our consumer business were driven by declines in the consumer x86 PC market and the shift to subscription, offset in part by attach gains. As our customers transition to the new subscription model, there is a short term impact to revenue due to the changes in the timing of revenue recognition but over time we expect our revenue to grow and become more recurring and predictable.

With the subscription model, we are providing greater value to our customers with the frequent product updates, new cloud services and attractive pricing. We saw strong early adoption of the subscription offering and now have more than 1 million Office 365 Home Premium subscribers. It's been a big year for Office 365 and as Amy said, it's now on a $1.5 billion annual revenue run rate. This was our strongest quarter ever with more net fee adds in the quarter than all of fiscal 2012. We are seeing strong upsell with one in three Office 365 now running premium workloads.

In terms of our productivity offerings, we continue to see strength of Exchange, SharePoint and Lync each growing double-digits. Lync revenue grew over 30% driving our enterprise communication business to deliver more than $1 billion revenue in this fiscal year. Additionally, we met a key milestone in the Lync and Skype integration and users can now seamlessly communicate in voice and IM across the two services.

Next, I'll move on to the Online Services division where revenue grew 9% and operating performance improved by $107 million or 22%. Online advertising revenue was up 11% driven by both rate and volume improvements in our search business.

In the Entertainment and Devices division, revenue grew 8%. Xbox LIVE transaction revenue grew nearly 20% and is providing economic opportunities for publishers in the soft console market. This quarter we announced our next generation gaming and entertainment console Xbox One and at E3 we showcased in impressive line of games that will be coming to the new platform.

Progress with Windows Phone continues as our partners, including Nokia, Samsung, Huawei and HTC are delivering new phones at a broader range of price points. Telefonica also recently announced an enhanced marketing effort to promote Windows Phone 8 devices and with the recent Sprint announcement, Windows Phone 8 devices will now be available on all major U.S. operators.

Now I'll cover the remainder of the income statement. Cost of goods sold increased 14% principally driven by Surface and growth in cloud infrastructure. Operating expenses grew 9% primarily related to sales and marketing for Surface and Windows 8. This quarter, our CapEx increased as we continued to invest in our cloud infrastructure and expand our geographic footprint to support the growth in our online businesses. And finally we returned $2.9 billion to shareholders in buybacks and dividends.

Now, I'll turn the call back to Amy for our outlook.

Amy Hood

Thanks Chris. Before I discuss our expectations for the first quarter, I'd like to spend a few minutes discussing last week's announcements on One Microsoft. If you haven't already done so, I encourage you to read out strategy memo and Steve Ballmer's email to employees. Microsoft is rallying to hide a single strategy. As a part of this, we implemented a new organizational structure that will allow us to advance our strategy more quickly and more efficiently.

We are currently in the process of determining what changes, if any, will be made to our reporting segment. In late September, we will host an analyst event, here in Redmond, at which point we will discuss our strategy, our new organizational structure and any changes to our reporting segments. We will also give more thoughts on our full-year outlook at that time. Please look for additional details from Chris over the coming weeks.

Now, moving on to our expectations for the first quarter. In Windows, we expect revenues to continue to be negatively impacted by the decline in the consumer x86 PC market. Excluding the impact of the Windows upgrade offer in the prior year, OEM revenue should account for approximately 65% of the division's revenue and should decline mid teens. Non-OEM revenue should account for approximately 35% of the division's revenue primarily reflecting revenue from volume licensing and Surface including Surface RT at new price points.

While updating your model, please keep in mind that in the first quarter of fiscal 2013, prior to the launch of Surface, OEM accounted for 75% of the division's total revenue. Within Server & Tools, product revenue including transactional and multi-year licensing is about 80% of the division's total. Our Enterprise services is the remaining 20%.

We expect both product and enterprise services revenue to grow high-single digits. In the Microsoft Business Division, we expect business revenue to account for approximately 85% of the division's total. Our consumer revenue should account for the remaining 15%. Business revenue should grow mid-single digit reflecting low double-digit growth in annuity and the shift from transaction licensing to Cloud services.

With the ongoing shift to subscription, consumer revenue will lag the x86 consumer PC market by approximately 5 percentage points, even as the tax continues to grow. This excludes the impact of the Office upgrade offer in the prior year. As a reminder, business revenue accounted for 80% of total revenue in the prior year.

In the online services division, we expect revenue to grow low double digits reflecting growth in service revenue partially offset by lower display revenue. With the Entertainment and Devices divisions, we expect revenue to decline low-single digits as the industry waits the next generation console.

For the first quarter, cost of goods sold will reflect surface as well as the impact of the capital expenditures we made in fiscal 2013. As a result, COG should grow over 20%. Other income and expense includes dividend and interest income offset the interest expense and the net cost of hedging. In the current low interest environment, we expect these items to generally offset.

For the first quarter regarding CapEx, we expect continued growth in our investments and our global data centers. Excluding the impact of the Windows and Office upgrade offers, unearned revenue should roughly follow historical seasonal pattern.

Now, turning briefly to the full fiscal year, we are reducing our operating expense guidance. We now expect fiscal year 2014 operating expenses to be $31.3 billion to $31.9 billion with growth in the low teens for the first quarter. We expect our tax rates to be between 18% and 21% for the full fiscal year.

In summary, as we look back on the year, fiscal 2013 was a pivotal time for Microsoft. With Windows 8, we increased our addressable market. Our OEM partners have started capitalizing on the new opportunities delivering a wide range of new Windows hardware, from phones, the tablets to new PCs.

We extended our first party devices through Surface and the announcement of Xbox One. We modernized productivity with Office 365 changing our business model. For the first time, both businesses and consumers can now access Office through subscription. We took share from key competitors and key enterprise markets. We added several new features, including infrastructure as a service capabilities for Windows Azure. With Azure we are fundamentally changing the way businesses manage their IT infrastructure and we continue the expansion of our data center footprint which enables us to deliver high value services and experiences globally.

As we look to fiscal 2014, we are focused on a single strategy. With our new organizational structure, we believe we'll be able to execute more quickly and more efficiently driving long term growth profitability and shareholder value.

With that I'll turn it back to Chris and we'll take some questions.

Chris Suh

Thanks Amy. We want to get to question from as many of you as possible, so please just stick to one question. Operator, please go ahead and repeat your instructions.

Question-and-Answer Session

Operator

(Operator Instructions) And we do have our first question from Walter Pritchard from Citigroup.

Walter Pritchard - Citigroup

I am wondering if you could talk a little bit about -- you talked about COGs in Q1 and you don’t mention COGs, obviously you have Xbox One launch in the second quarter. Could you give us some guidance about how we should think about that product having an impact on margins, maybe comparing it to 360 or anything else you could do to help us directionally with the COGs impact on Q1?

Amy Hood

So as we transition to a device services company, I think you need to keep in mind that we expect CapEx continue to grow throughout our business, specifically the Xbox One and the new generation of consoles and launches I think you should think about that, as to think about all console life cycles, and so keep that in mind as you model COGs and seasonality throughout the year.

Operator

Our next question comes from Mark Moerdler with Sanford Bernstein.

Mark Moerdler - Sanford Bernstein

Can you give us some color on the short term revenue impact of the move to the cloud, is it just MBD, is it also server and tools, how does the license revenue convert to cloud revenue?

Amy Hood

Mark, thanks for that question. It is primarily an MBD where we had a higher percentage of our revenue, that was accounted for transactionally both on the business side and in the consumer side. So I think that’s why you’ve seen us in our outlook for Q1 try to start to explain that transition to consumer by saying that we expect to lag the PC market by approximately 5 percentage points while attaching pieces.

Mark Moerdler - Sanford Bernstein

Is there a similar lag on the transactional side on the enterprise?

Amy Hood

Yes, you can see it when we gave the guidance for the business segment. We said 10% growth on the annuity and so that would clearly say that part of that is a transactional move from recognize upfront revenue to multi-year licensing agreement.

Operator

Our next question comes from Phil Winslow with Credit Suisse.

Phil Winslow - Credit Suisse

Just a follow up on (inaudible), first, Amy, obviously you go to a subscription model, you have less upfront, lower billing versus license, why don't you give us a sort of a backdoor, a dollar of cloud or 365 revenue would have been, and that for sure should have been $3 relative to license, so just we can turn it back on to help with that transition and also actually to Walter's question about Xbox COGs, maybe you could add a sense for -- if this cycle really should be any different than previous cycles when you thought about pricing relative to the cost of the console?

Amy Hood

I will try to remember both of those questions. Let me take the second question as it's the most recent in my mind. I would not think about this console cycle being any different from prior cycles. So let me go back to the first question, which is can I give examples, I believe we probably think about the transition front, we used to recognize revenue when we bought something upfront transactionally versus buying a subscription from us. I will give an example. If you used to buy a license from us as a consumer and paid up for example $100 for (inaudible), we recognize $100 in the period in which it was purchased.

Now if that same person went and bought Office 365 Premium, and once it's activated, we recognize the revenue over the period of the purchase which is 12 months, we recognize it ratably.

Chris Suh

Yeah, thanks. Next question please.

Operator

Our next question comes from Keith Weiss with Morgan Stanley. Your line is now open.

Keith Weiss - Morgan Stanley

Excellent. Thank you guys for taking my question. I was wondering focusing on the Server & Tools division you guys came in with high single-digit growth versus the guidance of low double-digit growth. Also can you walk us through some of the elements that perhaps transpired during the quarter than caused that gap of why it came in slightly below expectations there and to what extent was the shift towards subscription a part of that.

Amy Hood

Let me start by saying Server & Tools had a very good quarter. We continue to win share in virtualization, the SQL Server and could continue to go faster than both Oracle and IBM. Revenue did grow 9%, which importantly far outpaced the underlying hardware market. And over the period of the quarter, we did see the hardware market fundamentally coming a bit lower than we had expected.

Keith Weiss - Morgan Stanley

Okay.

Chris Suh

Great. Thanks Keith. Next question please.

Operator

Our next question comes from Heather Bellini with Goldman Sachs. Your line is now open.

Heather Bellini - Goldman Sachs

Great. Thank you very much. Amy, I was wondering if you could talk a little bit about the incentive pricing you've been doing, not just on your own devices like Chris mentioned in his prepared remarks but also in the OEM market. And if you haven't done incentive pricing at the OEM level, is there a chance we could see the strategy going forward at a way to help lower the price points of consumer PCs and then hence trying to spur demand? Thank you.

Amy Hood

Thanks Heather. I think it's a great question. I do think that we should think about incentives and all of our programs, including a Small Screen Touch view that we've launched, as a way to increase the breadth of our Windows devices available across all price points.

Chris Suh

Thank you, Heather. Next question please.

Operator

Our next question comes from Rick Sherlund with Nomura. Your line is now open.

Rick Sherlund - Nomura

Thanks. I wonder if you have any perspective for us on you got Intel's Haswell chip shipping now 8.1 coming in probably October. Are you sensing that OEMs are trying to manage inventories down for the time being and waiting cautiously Intel suggested that maybe you're seeing some inventory liquidation. So I wonder if you could just give us a sense of what you're hearing from the OEMs?

Amy Hood

Thanks Rick. I think like the rest of the ecosystem, we are excited about the advances Intel has made with the fourth-generation core processor. And we're also looking forward to the next ADAM chip but was launched a little less than a month ago. I think it's little bit too early for me to say and like to wait and see how the quarter plays out.

Chris Suh

Rick, next question please.

Operator

Our next question comes to us from Brent Thill with UBS. Your line is now open.

Brent Thill - UBS

Amy, on the expenses you are realizing next year down and it looks like your expense growth will materially slow from what it was this year. I'm just curious if you could just help us understand where that's coming from and how you're thinking about that for next year.

Amy Hood

Well, actually I think this is I feel good because I think in some ways the re-org we announced last week along with our increased focus and our new single strategy has allowed us to really look and say what are the things we're going to put behind and focus to improve our execution. And so I feel quite good about our ability to do that and you heard us say before many of the reasons we did this re-org are about doing things better and more efficiently.

Chris Suh

Thank you. Thanks Brent. Next question please.

Operator

Our next question comes from Ed Maguire with CLSA. Your line is now open.

Ed Maguire - CLSA

Hi. Good afternoon. Amy, you had discussed your increased CapEx this quarter and I was wondering if you could address the margin profile of your cloud services. In the comments, you discussed how you have higher datacenter cost and what I'd like to understand is whether this is temporary as you are ramping up this transition towards subscription business or whether this actually changes the growth margin profile of these revenues. Thanks.

Amy Hood

Thanks Ed. It’s a good question. Every transition to device and services company that is a multiyear commitment to evolve our business. You should expect the CapEx will continue to grow as we ramp that business. With the expansion of Azure service offerings and the continued momentum and Office 365 as well as our consumer services, investing in this global footprint to meet customer demand is incredibly important and quite strategic. And really the question is, our ability to feel smart way and that will create an advantage for us, we can pass along to our customers. And so I look forward to being able to move these datacenters globally to reach more people with more services.

Chris Suh

Okay. Thanks, Ed. Operator next question, please.

Operator

Our next question comes from John DiFucci with JPMorgan. Your line is now open.

John DiFucci - JPMorgan

Thank you. Amy your CapEx this quarter was about $700 million, greater than $700 million, greater than you guided just 90 days ago. Why was there such a sudden change, I know, Chris I think explained why it was high -- higher and why it’s going to be higher going forward? But why was it such a sudden change so dramatically just in this quarter and will this planned increase going forward affect your ability to do things like buyback shares?

Amy Hood

Yeah. Our -- in Q4 really as we continue to add Azure services, in fact we added over 80 this quarter and with this increase demand of Office 365 and then $1.5 billion annual run rate, up from just a $1 billion in Q3. I would think about that as our ability to increase demand and meet demand globally with our services, and so doing that in Q4 was important, because you want to be ahead of demand there.

John DiFucci - JPMorgan

So was that something that was unexpected, you just said, higher demand in Q4?

Amy Hood

We are accelerating.

John DiFucci - JPMorgan

Okay. Okay. And will this affect your ability to buyback shares going forward, this increase in CapEx?

Amy Hood

No. I mean, our cash returned $2.9 billion this quarter, I recall for the year and we’ll continue take a balanced approach to capital allocation with those investments, acquisition really make sense and return the capital to shareholders.

Chris Suh

Okay. Next question, please.

Operator

Our next question comes from Kash Rangan with Merrill Lynch. Your line is now open

Kash Rangan - Merrill Lynch

Hi. Thank you very much. Amy congrats on your first conference call as CFO. My question had to do with Windows side of the business. I know that you had a impairment charge for the inventory clearance. But even if I backed, if I add that back, it looks like the operating margin of the Windows business were sequentially lower, quite materially just wanted to get some insights into what drove that from the March quarter into the June quarter?

As you look further out into the operating margins of the Windows business, given that you are going to be focusing on Surface? How should we think about the margin structure, I guess you have a volume threshold to clear before you can start to make a margin, given that it's more of a product? But really two parts to that question, love to get your answers? Thank you so much.

Amy Hood

Thanks Kash. Let me address, I think were the two components. The first component, like a general question about margins this quarter for Windows, as you said they were impacted by Surface. And the second one is, by the marketing investment we continue to make in the ecosystem to move forward.

Overall, I think, as you think about the Windows division as we reported, obviously since there was mix between hardware and software, you should continue to expect margins to reflect that mix.

Kash Rangan - Merrill Lynch

Okay.

Chris Suh

Thank you, Kash. Next question please.

Operator

Our next question comes from Ross MacMillan with Jefferies. Your line is now open.

Ross MacMillan - Jefferies

Thanks a lot. Amy, I just wanted to drill into the billings growth, where we adjust for the unearned and it's a lot higher for the server and tools business, which is obviously going through a condition towards more a subscription arrangements then it a lot higher there in the MBD segment?

I'm just wondering if you can compare and contrast why that might be, I understand the consumer piece in MBD. But is the other piece of it just that there are more sort of conditional licensing arrangements in MBD with enterprise customers and so the impact from the transition is all the greater and that's why you see that more subdued billings growth rate in MBD? Thanks.

Amy Hood

Ross, thank you. It's always terrific when someone answers their own question. You actually have it exactly correct.

Ross MacMillan - Jefferies

Great. Thank you.

Chris Suh

Thanks. Thanks Ross. Next question please.

Operator

The next question comes from Gregg Moskowitz with Cowen. Your line is now open.

Gregg Moskowitz - Cowen

Hi. Thank you very much and good afternoon. Just a follow on a bit on Kash's question. With Windows revenue coming in where it did. We are getting a few questions from investors about how Windows fared this quarter relative to the PC unit? If we were to exclude tablet revenues both Surface and otherwise. Just wondering Amy if you might be able to say roughly on year-over-year basis how Windows PC revenue compared to the low double-digit PC unit decline cited by the IDC's and Gartner's?

Amy Hood

Yeah. Chris actually covered that a bit in his comment but let me reiterate, because I do understand the question I think, which is relate to our OEM revenue 15%, down 15%. It was related, I believe to China, lower ASPs on the small stream SKU that we mentioned, as well as some of the incentive programs that we had in place during the quarter.

Gregg Moskowitz - Cowen

Thank you.

Chris Suh

Thanks Gregg. Next question please.

Operator

Our next question comes from Raimo Lenschow with Barclays. Your line is now open.

Raimo Lenschow - Barclays

Yeah. Thank you and Amy welcome on the first earnings call. And I had a question on the business PC side, that was an area of strength for the Windows division and you saw some growth there? Can you talk a little bit about that, if that's kind of, if you see that as a sustainable number or is that still driven by the end of life for Windows XP? Thank you.

Amy Hood

As we mentioned, our Windows business didn't make incremental progress in the business side. We expect that to continue in Q1. And with the end of life for Windows XP next year, we expect continued migration and today in the Enterprise about three quarters of desktops already run Windows 7.

Raimo Lenschow - Barclays

Okay. Thank you very much.

Chris Suh

Yeah. Thank you. Next question please, operator?

Operator

All right. Our next question comes from Brendan Barnicle with Pacific Crest Securities. Your line is now open.

Brendan Barnicle - Pacific Crest Securities

Thanks so much. Amy contracted-but unbilled was down sequentially from Q3, the first time we have seen that in the last two years, what is attributing to that shift?

Amy Hood

Thank you. Actually I think our strong annuity growth, as well as our record unearned balance, I do believe -- support our belief that the strong performance of our multiyear license agreement is in place.

Chris Suh

Thank you, Operator. I think we have time for one more.

Operator

Okay. The next question is going to come from Karl Keirstead with BMO Capital Markets. You line is open.

Karl Keirstead - BMO Capital Markets

Thanks. I just wanted to ask a question about the mix shift multiyear licensing across Microsoft that's been a big part of the story. It has been up about 5 percentage points year-over-year each quarter in fiscal 2013? Amy, I'm just wondering as we look forward to fiscal '14, can we expect it to increase at that cliff or is the software assurance attach rates now getting high enough that that mix shift should start to moderate?

Amy Hood

We have -- I continue to believe we will have double-digit annuity growth next year, so I think that shift you have seen especially if we continue to move people to our Cloud services, will continue.

Karl Keirstead - BMO Capital Markets

Okay. Thanks

Chris Suh

Thanks, Karl. Okay. So that will wrap up our Q&A portion of today's earnings calls. We look forward to seeing many of you in the coming months at various investor conferences and at our financial analyst meeting to be held in late September where we will share more details about our long-term strategies, the organizational structure and outlook for the rest of the fiscal year. Thank you again for joining us today.

Operator

This concludes today's conference. Thank you for your participation. You may disconnect at this time.

Executives

Chris Suh - General Manager, Investor Relations

Amy Hood - Chief Financial Officer

Analysts

Walter Pritchard - Citigroup

Mark Moerdler - Sanford Bernstein

Phil Winslow - Credit Suisse

Keith Weiss - Morgan Stanley

Heather Bellini - Goldman Sachs

Rick Sherlund - Nomura

Brent Thill - UBS

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John DiFucci - JPMorgan

Kash Rangan - Merrill Lynch

Ross MacMillan - Jefferies

Gregg Moskowitz - Cowen

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Brendan Barnicle - Pacific Crest Securities

Karl Keirstead - BMO Capital Markets

Microsoft Corporation (MSFT) F4Q 2013 Results Earnings Call July 18, 2013 5:30 PM ET

Operator

Welcome to Microsoft's Fiscal Year 2013 Fourth Quarter Earnings Conference Call. All lines have been placed in a listen-only mode until the question-and-answer session. Today's call is being recorded. If anyone has any objections, please disconnect at this time.

And I would now like to turn the meeting over to Chris Suh, General Manager of Investor Relations. Chris, you may begin.

Chris Suh - General Manager, Investor Relations

Thank you, Operator. On our website microsoft.com/investor is our financial summary slide deck, which is intended to follow our prepared remarks and provides a reconciliation of differences between GAAP and non-GAAP financial measures. As a reminder, we will post today's prepared remarks to our website immediately following the call until the complete transcript is available.

Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript and any future use of the recording. You can replay the call and view the transcript at the Microsoft Investor Relations website until July 18, 2014.

During this call, we will be making forward-looking statements that 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 this conference call, and in the Risk Factor section of our Form 10-K, Form 10-Q, and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

Before I hand the call over to Amy, I'd like to remind you that all growth comparisons we make on the call today will relate to the corresponding period of last year. Also, unless specified otherwise, all impacted numbers for the current quarter have been adjusted for the cumulative effect of the revenue deferral and recognition related to the Office and Windows upgrade offers, the $900 million charge for inventory adjustments primarily related to the new Surface RT pricing we announced earlier this week and the goodwill impairment charge from last year. You can find the details of the adjustments and reconciliation of differences between GAAP and non-GAAP financial measures in our financial summary slide deck.

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

Amy Hood - Chief Financial Officer

Thanks Chris and good afternoon everyone. Thanks for joining us today. In many ways, our fourth quarter results reflect the trends we saw developing throughout the fiscal year. The consumer x86 PC market declined as users continued to prioritize devices to touch and ability. At the same time we saw continued strength in our enterprise product and cloud solution and increased adoption of our consumer services.

This quarter our Windows business declined as the device market continued to evolve beyond the traditional PC. We are working to transition the business into this modern era of computing taking advantage of the new scenarios enabled our Windows 8. As we said before, given the complexity of the ecosystem this journey will take but we continue to make incremental progress.

In June, we released the public preview of Windows 8.1. It blends the desktop and modern experience. It has new features and improvements in areas such as personalization, search, built-in app and cloud connectivity. Windows 8.1 will be a free update to existing Windows 8 users and will be made available to OEMs in August, less than one year since launch.

To increase and improve retail distribution, we entered into a strategic partnership with BestBuy to create a Windows store in over 600 BestBuy locations. These store-within-a-store locations provide a large scale hands-on consumer experience that showcases Microsoft devices and services. The percentage (inaudible) devices available at retail continues to improve. The first 8x Windows tablet became available at retail a few weeks ago. It has legacy application compatibility, includes Microsoft Office and retails for less than $400. We expect additional compelling small screen devices to be available in the coming months.

Less than a year ago, we launched Surface RT and Surface Pro, each with a unique value proposition. Surface is one part of our journey to bring innovative, compelling Windows devices to market in a modern era of computing. (Inaudible) analyze our progress and fine-tune our action plan as needed.

Hear what we did this quarter. We reduced the price of Surface RT by $150 to $349 per device. As a result of this price change as well as inventory adjustments for related parts and accessories we recorded a $900 million charge to our income statement. While this resulted in a negative $0.07 impact on earnings, we believe this pricing adjustment will accelerate Surface RT adoption and position us better for long term success.

We also increased retail distribution in the quarter. Surface is now available in 29 markets and 10,000 retail locations. We expanded the availability of Surface to our business and institutional customers. Through our new channel expansion program, commercial customers are able to purchase Surface devices from authorized resellers in the U.S. Over the next few months we will authorize commercial distributors and resellers in more countries.

So in summary on Windows, we are working hard with our partners to gain share in the evolving and growing device markets. I want to be very clear, we know we have to do better and that's one reason we made a strategic and organizational changes we made last week. With over 1.5 billion Windows users around the world, a transition of this magnitude takes time. We are confident we are moving in the right direction.

Now on to our enterprise business which continues to be strong. We closed out the year with record on our revenue up $22.4 billion as businesses continued to make long term commitments to the Microsoft platform. Within our server and tools business, we continue to make significant improvements in performance reliability and scalability with SQL server. As a result, customers are increasingly moving mission critical and BI workloads to the platform. Our SQL Server has been the unit share leader in the market for some time. It has consistently outgrown in the market over the past 12 months and is now the second largest database in revenue share.

We recently announced the next versions of Windows Server and System Center which will continue to deliver on our Cloud OS vision. With new features and enhancements in virtualization, storage and networking, we are empowering our customers to more officially manage their application services and their private, hosted and public cloud infrastructures.

In Windows Azure, we continue to innovate and broaden our cloud platform offering. We recently announced an important enterprise partnership with Oracle. It will enable customers to our Oracle software on Hyper-V and in Windows Azure. In June, we announced the public review of Windows Azure in China, operated by 21Vianet making Microsoft the first multinational organization to offer public cloud services in China.

As a result of the greater choice and flexibility, we are seeing increased customer tractions, those in terms of an increase in Enterprise customers but also the average deal size. Our productivity solutions continue to be a top priority for CIOs. As Enterprise customers look to modernize their productivity infrastructures, they are increasingly turning to Office 365.

We recently announced the expansion of commercial availability into several new markets, making Office 365 available in over 125 markets worldwide. I'm pleased to share that momentum is accelerating. An Office 365 is now on a $1.5 billion annual revenue run rate.

During the quarter, we saw ongoing momentum for our consumer services such as Office 365 Home Premium, SkyDrive, Xbox LIVE, Skype and Outlook.com. By giving consumers rich, high value experiences across productivity, litigations and entertainment, these services can help you about products and our overall ecosystem, our strategic advantage in today's marketplace where the line between home and work is boring for many customers.

Our unified communication offering of Skype and Lync are great example of our customer enterprise products can be mutually reinforcing and create more opportunity for Microsoft. In summary, the third quarter contains many of the trends we saw developing throughout the fiscal year.

We continue to make important stride for our strategy, to create a family of devices and services for individuals and businesses, to empower them for the activities they value the most. Some of our investments are already paying off while others reinforce the foundation that positions us for future growth and profitability.

With that, I'll hand it over to Chris to get more details about this quarter before I come back to share thoughts on the first quarter of fiscal 2014.

Chris Suh - General Manager, Investor Relations

Thanks Amy. First, I'm going to review our overall results and then I'll move onto the details by business segment. Revenue was up 3% to $19.2 billion and operating income declined 11% to $6.2 billion. Earnings per share declined 19% to $0.59. Foreign exchange had $257 million or 1 percentage point negative impact revenue this quarter and $177 million or 3 percentage point negative impact to net income.

From a geographic perspective, revenue in the U.S. was strong relative to other regions. Annuity revenue continued to be strong growing 13%. We have record unearned revenue of $22.4 billion and our contracted-not-billed balance was approximately $21 billion.

Now, to the result of the Windows division, our revenue declined 5% this quarter. The x86 PC market continued to decline while business PC showed modest growth. We estimate consumer PCs declined more than 20%. As a result, OEM revenue declined 15%.

OEM revenue lagged the PC market primarily due to market dynamics in China and lower ASPs reflecting the introduction of our small screen touch offering in the current period incentive program. Non-OEM revenue grew 22% driven by sales of Surface and continued double-digit growth in volume licensing as businesses across all areas and segments continue to value the Windows platform.

This quarter we saw continued progress in the transition from Windows XP and today almost three-quarters of enterprise desktops are running Windows 7. Volume licensing of Windows delivered more than $4 billion in revenue this year.

Next, I'll walk through our Server and Tools business which posted another solid quarter with 9% revenue growth and double-digit bookings growth. Product revenue grew 9%, driven primarily by growth in premium versions of Windows, Server and SQL Server .Our cloud momentum continues with strong customer adoption, upsell the higher level services and increased innovation. We released a number of Azure services, including mobility, media and website services and a growing number of customers who are already using multiple services for the cloud platform needs. We added 25% more enterprise customers this quarter and now over 50% of the Fortune 500 are using Windows Azure.

In the data center, system center revenue grew 14% and the premium version of Windows Server continued to see significant revenue growth. Hyper-V, our virtualization product, continued to gain market share over the past year. Companies such as Aston Martin and Grant Thornton continue to look to Hyper-V and System Center to deliver their critical business application.

In the data platform business, SQL Server revenue grew 16% and again outpaced the broader market. Last month, we announced SQL Server 2014, the next version of our data platform which has in-memory capabilities built right into the core database. We also announced Power VI for Office 365, a cloud based BI solutions that combine power of SQL server with the familiarity of Office.

Now I'll move on to the Microsoft Business Division where revenue grew 2%. Within that, business revenue grew 7%, driven by 10% growth in annuity revenue. Consumer revenue declined 27%. Results in our consumer business were driven by declines in the consumer x86 PC market and the shift to subscription, offset in part by attach gains. As our customers transition to the new subscription model, there is a short term impact to revenue due to the changes in the timing of revenue recognition but over time we expect our revenue to grow and become more recurring and predictable.

With the subscription model, we are providing greater value to our customers with the frequent product updates, new cloud services and attractive pricing. We saw strong early adoption of the subscription offering and now have more than 1 million Office 365 Home Premium subscribers. It's been a big year for Office 365 and as Amy said, it's now on a $1.5 billion annual revenue run rate. This was our strongest quarter ever with more net fee adds in the quarter than all of fiscal 2012. We are seeing strong upsell with one in three Office 365 now running premium workloads.

In terms of our productivity offerings, we continue to see strength of Exchange, SharePoint and Lync each growing double-digits. Lync revenue grew over 30% driving our enterprise communication business to deliver more than $1 billion revenue in this fiscal year. Additionally, we met a key milestone in the Lync and Skype integration and users can now seamlessly communicate in voice and IM across the two services.

Next, I'll move on to the Online Services division where revenue grew 9% and operating performance improved by $107 million or 22%. Online advertising revenue was up 11% driven by both rate and volume improvements in our search business.

In the Entertainment and Devices division, revenue grew 8%. Xbox LIVE transaction revenue grew nearly 20% and is providing economic opportunities for publishers in the soft console market. This quarter we announced our next generation gaming and entertainment console Xbox One and at E3 we showcased in impressive line of games that will be coming to the new platform.

Progress with Windows Phone continues as our partners, including Nokia, Samsung, Huawei and HTC are delivering new phones at a broader range of price points. Telefonica also recently announced an enhanced marketing effort to promote Windows Phone 8 devices and with the recent Sprint announcement, Windows Phone 8 devices will now be available on all major U.S. operators.

Now I'll cover the remainder of the income statement. Cost of goods sold increased 14% principally driven by Surface and growth in cloud infrastructure. Operating expenses grew 9% primarily related to sales and marketing for Surface and Windows 8. This quarter, our CapEx increased as we continued to invest in our cloud infrastructure and expand our geographic footprint to support the growth in our online businesses. And finally we returned $2.9 billion to shareholders in buybacks and dividends.

Now, I'll turn the call back to Amy for our outlook.

Amy Hood - Chief Financial Officer

Thanks Chris. Before I discuss our expectations for the first quarter, I'd like to spend a few minutes discussing last week's announcements on One Microsoft. If you haven't already done so, I encourage you to read out strategy memo and Steve Ballmer's email to employees. Microsoft is rallying to hide a single strategy. As a part of this, we implemented a new organizational structure that will allow us to advance our strategy more quickly and more efficiently.

We are currently in the process of determining what changes, if any, will be made to our reporting segment. In late September, we will host an analyst event, here in Redmond, at which point we will discuss our strategy, our new organizational structure and any changes to our reporting segments. We will also give more thoughts on our full-year outlook at that time. Please look for additional details from Chris over the coming weeks.

Now, moving on to our expectations for the first quarter. In Windows, we expect revenues to continue to be negatively impacted by the decline in the consumer x86 PC market. Excluding the impact of the Windows upgrade offer in the prior year, OEM revenue should account for approximately 65% of the division's revenue and should decline mid teens. Non-OEM revenue should account for approximately 35% of the division's revenue primarily reflecting revenue from volume licensing and Surface including Surface RT at new price points.

While updating your model, please keep in mind that in the first quarter of fiscal 2013, prior to the launch of Surface, OEM accounted for 75% of the division's total revenue. Within Server & Tools, product revenue including transactional and multi-year licensing is about 80% of the division's total. Our Enterprise services is the remaining 20%.

We expect both product and enterprise services revenue to grow high-single digits. In the Microsoft Business Division, we expect business revenue to account for approximately 85% of the division's total. Our consumer revenue should account for the remaining 15%. Business revenue should grow mid-single digit reflecting low double-digit growth in annuity and the shift from transaction licensing to Cloud services.

With the ongoing shift to subscription, consumer revenue will lag the x86 consumer PC market by approximately 5 percentage points, even as the tax continues to grow. This excludes the impact of the Office upgrade offer in the prior year. As a reminder, business revenue accounted for 80% of total revenue in the prior year.

In the online services division, we expect revenue to grow low double digits reflecting growth in service revenue partially offset by lower display revenue. With the Entertainment and Devices divisions, we expect revenue to decline low-single digits as the industry waits the next generation console.

For the first quarter, cost of goods sold will reflect surface as well as the impact of the capital expenditures we made in fiscal 2013. As a result, COG should grow over 20%. Other income and expense includes dividend and interest income offset the interest expense and the net cost of hedging. In the current low interest environment, we expect these items to generally offset.

For the first quarter regarding CapEx, we expect continued growth in our investments and our global data centers. Excluding the impact of the Windows and Office upgrade offers, unearned revenue should roughly follow historical seasonal pattern.

Now, turning briefly to the full fiscal year, we are reducing our operating expense guidance. We now expect fiscal year 2014 operating expenses to be $31.3 billion to $31.9 billion with growth in the low teens for the first quarter. We expect our tax rates to be between 18% and 21% for the full fiscal year.

In summary, as we look back on the year, fiscal 2013 was a pivotal time for Microsoft. With Windows 8, we increased our addressable market. Our OEM partners have started capitalizing on the new opportunities delivering a wide range of new Windows hardware, from phones, the tablets to new PCs.

We extended our first party devices through Surface and the announcement of Xbox One. We modernized productivity with Office 365 changing our business model. For the first time, both businesses and consumers can now access Office through subscription. We took share from key competitors and key enterprise markets. We added several new features, including infrastructure as a service capabilities for Windows Azure. With Azure we are fundamentally changing the way businesses manage their IT infrastructure and we continue the expansion of our data center footprint which enables us to deliver high value services and experiences globally.

As we look to fiscal 2014, we are focused on a single strategy. With our new organizational structure, we believe we'll be able to execute more quickly and more efficiently driving long term growth profitability and shareholder value.

With that I'll turn it back to Chris and we'll take some questions.

Chris Suh - General Manager, Investor Relations

Thanks Amy. We want to get to question from as many of you as possible, so please just stick to one question. Operator, please go ahead and repeat your instructions.

Question-and-Answer Session

Operator

(Operator Instructions) And we do have our first question from Walter Pritchard from Citigroup.

Walter Pritchard - Citigroup

I am wondering if you could talk a little bit about -- you talked about COGs in Q1 and you don’t mention COGs, obviously you have Xbox One launch in the second quarter. Could you give us some guidance about how we should think about that product having an impact on margins, maybe comparing it to 360 or anything else you could do to help us directionally with the COGs impact on Q1?

Amy Hood - Chief Financial Officer

So as we transition to a device services company, I think you need to keep in mind that we expect CapEx continue to grow throughout our business, specifically the Xbox One and the new generation of consoles and launches I think you should think about that, as to think about all console life cycles, and so keep that in mind as you model COGs and seasonality throughout the year.

Operator

Our next question comes from Mark Moerdler with Sanford Bernstein.

Mark Moerdler - Sanford Bernstein

Can you give us some color on the short term revenue impact of the move to the cloud, is it just MBD, is it also server and tools, how does the license revenue convert to cloud revenue?

Amy Hood - Chief Financial Officer

Mark, thanks for that question. It is primarily an MBD where we had a higher percentage of our revenue, that was accounted for transactionally both on the business side and in the consumer side. So I think that's why you've seen us in our outlook for Q1 try to start to explain that transition to consumer by saying that we expect to lag the PC market by approximately 5 percentage points while attaching pieces.

Mark Moerdler - Sanford Bernstein

Is there a similar lag on the transactional side on the enterprise?

Amy Hood - Chief Financial Officer

Yes, you can see it when we gave the guidance for the business segment. We said 10% growth on the annuity and so that would clearly say that part of that is a transactional move from recognize upfront revenue to multi-year licensing agreement.

Operator

Our next question comes from Phil Winslow with Credit Suisse.

Phil Winslow - Credit Suisse

Just a follow up on (inaudible), first, Amy, obviously you go to a subscription model, you have less upfront, lower billing versus license, why don't you give us a sort of a backdoor, a dollar of cloud or 365 revenue would have been, and that for sure should have been $3 relative to license, so just we can turn it back on to help with that transition and also actually to Walter's question about Xbox COGs, maybe you could add a sense for -- if this cycle really should be any different than previous cycles when you thought about pricing relative to the cost of the console?

Amy Hood - Chief Financial Officer

I will try to remember both of those questions. Let me take the second question as it's the most recent in my mind. I would not think about this console cycle being any different from prior cycles. So let me go back to the first question, which is can I give examples, I believe we probably think about the transition front, we used to recognize revenue when we bought something upfront transactionally versus buying a subscription from us. I will give an example. If you used to buy a license from us as a consumer and paid up for example $100 for (inaudible), we recognize $100 in the period in which it was purchased.

Now if that same person went and bought Office 365 Premium, and once it's activated, we recognize the revenue over the period of the purchase which is 12 months, we recognize it ratably.

Chris Suh - General Manager, Investor Relations

Yeah, thanks. Next question please.

Operator

Our next question comes from Keith Weiss with Morgan Stanley. Your line is now open.

Keith Weiss - Morgan Stanley

Excellent. Thank you guys for taking my question. I was wondering focusing on the Server & Tools division you guys came in with high single-digit growth versus the guidance of low double-digit growth. Also can you walk us through some of the elements that perhaps transpired during the quarter than caused that gap of why it came in slightly below expectations there and to what extent was the shift towards subscription a part of that.

Amy Hood - Chief Financial Officer

Let me start by saying Server & Tools had a very good quarter. We continue to win share in virtualization, the SQL Server and could continue to go faster than both Oracle and IBM. Revenue did grow 9%, which importantly far outpaced the underlying hardware market. And over the period of the quarter, we did see the hardware market fundamentally coming a bit lower than we had expected.

Keith Weiss - Morgan Stanley

Okay.

Chris Suh - General Manager, Investor Relations

Great. Thanks Keith. Next question please.

Operator

Our next question comes from Heather Bellini with Goldman Sachs. Your line is now open.

Heather Bellini - Goldman Sachs

Great. Thank you very much. Amy, I was wondering if you could talk a little bit about the incentive pricing you've been doing, not just on your own devices like Chris mentioned in his prepared remarks but also in the OEM market. And if you haven't done incentive pricing at the OEM level, is there a chance we could see the strategy going forward at a way to help lower the price points of consumer PCs and then hence trying to spur demand? Thank you.

Amy Hood - Chief Financial Officer

Thanks Heather. I think it's a great question. I do think that we should think about incentives and all of our programs, including a Small Screen Touch view that we've launched, as a way to increase the breadth of our Windows devices available across all price points.

Chris Suh - General Manager, Investor Relations

Thank you, Heather. Next question please.

Operator

Our next question comes from Rick Sherlund with Nomura. Your line is now open.

Rick Sherlund - Nomura

Thanks. I wonder if you have any perspective for us on you got Intel's Haswell chip shipping now 8.1 coming in probably October. Are you sensing that OEMs are trying to manage inventories down for the time being and waiting cautiously Intel suggested that maybe you're seeing some inventory liquidation. So I wonder if you could just give us a sense of what you're hearing from the OEMs?

Amy Hood - Chief Financial Officer

Thanks Rick. I think like the rest of the ecosystem, we are excited about the advances Intel has made with the fourth-generation core processor. And we're also looking forward to the next ADAM chip but was launched a little less than a month ago. I think it's little bit too early for me to say and like to wait and see how the quarter plays out.

Chris Suh - General Manager, Investor Relations

Rick, next question please.

Operator

Our next question comes to us from Brent Thill with UBS. Your line is now open.

Brent Thill - UBS

Amy, on the expenses you are realizing next year down and it looks like your expense growth will materially slow from what it was this year. I'm just curious if you could just help us understand where that's coming from and how you're thinking about that for next year.

Amy Hood - Chief Financial Officer

Well, actually I think this is I feel good because I think in some ways the re-org we announced last week along with our increased focus and our new single strategy has allowed us to really look and say what are the things we're going to put behind and focus to improve our execution. And so I feel quite good about our ability to do that and you heard us say before many of the reasons we did this re-org are about doing things better and more efficiently.

Chris Suh - General Manager, Investor Relations

Thank you. Thanks Brent. Next question please.

Operator

Our next question comes from Ed Maguire with CLSA. Your line is now open.

Ed Maguire - CLSA

Hi. Good afternoon. Amy, you had discussed your increased CapEx this quarter and I was wondering if you could address the margin profile of your cloud services. In the comments, you discussed how you have higher datacenter cost and what I'd like to understand is whether this is temporary as you are ramping up this transition towards subscription business or whether this actually changes the growth margin profile of these revenues. Thanks.

Amy Hood - Chief Financial Officer

Thanks Ed. It's a good question. Every transition to device and services company that is a multiyear commitment to evolve our business. You should expect the CapEx will continue to grow as we ramp that business. With the expansion of Azure service offerings and the continued momentum and Office 365 as well as our consumer services, investing in this global footprint to meet customer demand is incredibly important and quite strategic. And really the question is, our ability to feel smart way and that will create an advantage for us, we can pass along to our customers. And so I look forward to being able to move these datacenters globally to reach more people with more services.

Chris Suh - General Manager, Investor Relations

Okay. Thanks, Ed. Operator next question, please.

Operator

Our next question comes from John DiFucci with JPMorgan. Your line is now open.

John DiFucci - JPMorgan

Thank you. Amy your CapEx this quarter was about $700 million, greater than $700 million, greater than you guided just 90 days ago. Why was there such a sudden change, I know, Chris I think explained why it was high -- higher and why it's going to be higher going forward? But why was it such a sudden change so dramatically just in this quarter and will this planned increase going forward affect your ability to do things like buyback shares?

Amy Hood - Chief Financial Officer

Yeah. Our -- in Q4 really as we continue to add Azure services, in fact we added over 80 this quarter and with this increase demand of Office 365 and then $1.5 billion annual run rate, up from just a $1 billion in Q3. I would think about that as our ability to increase demand and meet demand globally with our services, and so doing that in Q4 was important, because you want to be ahead of demand there.

John DiFucci - JPMorgan

So was that something that was unexpected, you just said, higher demand in Q4?

Amy Hood - Chief Financial Officer

We are accelerating.

John DiFucci - JPMorgan

Okay. Okay. And will this affect your ability to buyback shares going forward, this increase in CapEx?

Amy Hood - Chief Financial Officer

No. I mean, our cash returned $2.9 billion this quarter, I recall for the year and we'll continue take a balanced approach to capital allocation with those investments, acquisition really make sense and return the capital to shareholders.

Chris Suh - General Manager, Investor Relations

Okay. Next question, please.

Operator

Our next question comes from Kash Rangan with Merrill Lynch. Your line is now open

Kash Rangan - Merrill Lynch

Hi. Thank you very much. Amy congrats on your first conference call as CFO. My question had to do with Windows side of the business. I know that you had a impairment charge for the inventory clearance. But even if I backed, if I add that back, it looks like the operating margin of the Windows business were sequentially lower, quite materially just wanted to get some insights into what drove that from the March quarter into the June quarter?

As you look further out into the operating margins of the Windows business, given that you are going to be focusing on Surface? How should we think about the margin structure, I guess you have a volume threshold to clear before you can start to make a margin, given that it's more of a product? But really two parts to that question, love to get your answers? Thank you so much.

Amy Hood - Chief Financial Officer

Thanks Kash. Let me address, I think were the two components. The first component, like a general question about margins this quarter for Windows, as you said they were impacted by Surface. And the second one is, by the marketing investment we continue to make in the ecosystem to move forward.

Overall, I think, as you think about the Windows division as we reported, obviously since there was mix between hardware and software, you should continue to expect margins to reflect that mix.

Kash Rangan - Merrill Lynch

Okay.

Chris Suh - General Manager, Investor Relations

Thank you, Kash. Next question please.

Operator

Our next question comes from Ross MacMillan with Jefferies. Your line is now open.

Ross MacMillan - Jefferies

Thanks a lot. Amy, I just wanted to drill into the billings growth, where we adjust for the unearned and it's a lot higher for the server and tools business, which is obviously going through a condition towards more a subscription arrangements then it a lot higher there in the MBD segment?

I'm just wondering if you can compare and contrast why that might be, I understand the consumer piece in MBD. But is the other piece of it just that there are more sort of conditional licensing arrangements in MBD with enterprise customers and so the impact from the transition is all the greater and that's why you see that more subdued billings growth rate in MBD? Thanks.

Amy Hood - Chief Financial Officer

Ross, thank you. It's always terrific when someone answers their own question. You actually have it exactly correct.

Ross MacMillan - Jefferies

Great. Thank you.

Chris Suh - General Manager, Investor Relations

Thanks. Thanks Ross. Next question please.

Operator

The next question comes from Gregg Moskowitz with Cowen. Your line is now open.

Gregg Moskowitz - Cowen

Hi. Thank you very much and good afternoon. Just a follow on a bit on Kash's question. With Windows revenue coming in where it did. We are getting a few questions from investors about how Windows fared this quarter relative to the PC unit? If we were to exclude tablet revenues both Surface and otherwise. Just wondering Amy if you might be able to say roughly on year-over-year basis how Windows PC revenue compared to the low double-digit PC unit decline cited by the IDC's and Gartner's?

Amy Hood - Chief Financial Officer

Yeah. Chris actually covered that a bit in his comment but let me reiterate, because I do understand the question I think, which is relate to our OEM revenue 15%, down 15%. It was related, I believe to China, lower ASPs on the small stream SKU that we mentioned, as well as some of the incentive programs that we had in place during the quarter.

Gregg Moskowitz - Cowen

Thank you.

Chris Suh - General Manager, Investor Relations

Thanks Gregg. Next question please.

Operator

Our next question comes from Raimo Lenschow with Barclays. Your line is now open.

Raimo Lenschow - Barclays

Yeah. Thank you and Amy welcome on the first earnings call. And I had a question on the business PC side, that was an area of strength for the Windows division and you saw some growth there? Can you talk a little bit about that, if that's kind of, if you see that as a sustainable number or is that still driven by the end of life for Windows XP? Thank you.

Amy Hood - Chief Financial Officer

As we mentioned, our Windows business didn't make incremental progress in the business side. We expect that to continue in Q1. And with the end of life for Windows XP next year, we expect continued migration and today in the Enterprise about three quarters of desktops already run Windows 7.

Raimo Lenschow - Barclays

Okay. Thank you very much.

Chris Suh - General Manager, Investor Relations

Yeah. Thank you. Next question please, operator?

Operator

All right. Our next question comes from Brendan Barnicle with Pacific Crest Securities. Your line is now open.

Brendan Barnicle - Pacific Crest Securities

Thanks so much. Amy contracted-but unbilled was down sequentially from Q3, the first time we have seen that in the last two years, what is attributing to that shift?

Amy Hood - Chief Financial Officer

Thank you. Actually I think our strong annuity growth, as well as our record unearned balance, I do believe -- support our belief that the strong performance of our multiyear license agreement is in place.

Chris Suh - General Manager, Investor Relations

Thank you, Operator. I think we have time for one more.

Operator

Okay. The next question is going to come from Karl Keirstead with BMO Capital Markets. You line is open.

Karl Keirstead - BMO Capital Markets

Thanks. I just wanted to ask a question about the mix shift multiyear licensing across Microsoft that's been a big part of the story. It has been up about 5 percentage points year-over-year each quarter in fiscal 2013? Amy, I'm just wondering as we look forward to fiscal '14, can we expect it to increase at that cliff or is the software assurance attach rates now getting high enough that that mix shift should start to moderate?

Amy Hood - Chief Financial Officer

We have -- I continue to believe we will have double-digit annuity growth next year, so I think that shift you have seen especially if we continue to move people to our Cloud services, will continue.

Karl Keirstead - BMO Capital Markets

Okay. Thanks

Chris Suh - General Manager, Investor Relations

Thanks, Karl. Okay. So that will wrap up our Q&A portion of today's earnings calls. We look forward to seeing many of you in the coming months at various investor conferences and at our financial analyst meeting to be held in late September where we will share more details about our long-term strategies, the organizational structure and outlook for the rest of the fiscal year. Thank you again for joining us today.

Operator

This concludes today's conference. Thank you for your participation. You may disconnect at this time.