NASDAQ OMX Investor Program

Company Participants

- Chris Suh, General Manager, IR

Other Participants

- Keith Weiss, Analyst, Morgan Stanley

Presentation

Keith Weiss {BIO 6993337 <GO>}

So we will get started here. And I thank everyone for joining us early in the morning. I am Keith Weiss. I run the US Software Group at Morgan Stanley. And we are very pleased to have with us opening up this morning Chris Suh, General Manager, Investor Relations, from Microsoft.

So Chris, maybe an opening question just about the overall environment. If we look at the last two quarters from Microsoft -- June quarter, which was perhaps a little bit below all your guys' expectations; a really nice rebound in September quarter. How much is that talking about the overall spending environment? How much is that talking about Microsoft was operating better in the September quarter?

Chris Suh {BIO 17955231 <GO>}

It's a good question. But before I get to that, I think I need to cover our forward-looking statement just real quick, if you don't mind. So during the course of our conversation, I may make some forward-looking statements, which are predictions or projections about future events. Those statements are based on current expectations and assumptions, which are subject to certain risks and uncertainties, obviously. Microsoft doesn't take -- actual results could materially differ and Microsoft doesn't undertake any duty to update that forward-looking statement. So sorry, I had to cover on that.

So I think your question was sort of Q4 to Q1, some of the business trends that we are seeing. So yes, I think you stated it right. Q4 did come in below where we were expecting. And then, conversely, Q1 came in a bit stronger than we were expecting.

I think if I reflect back on sort of those two quarters and what happened, Q4 we saw to be a bit of a low point in terms of what we saw in our Windows business specifically related to OEMs. So if you recall, in Q4, our OEM business finished declining 15% year-over-year. And we saw particularly a declining portion of the business in the consumer side of our OEM business. At that time, we set

expectations for Q1 to be similar Q4 to Q1 trend along the PC market, because that was the indicator that we were seeing.

As we proceeded into Q1, the PC market specifically actually finished a little bit better. We finished Q1 OEM revenue down 7% year-over-year versus 15%. And as you know, that OEM business is a highly profitable portion of our business. So 8 points of improvement relative to our expectations on OEM results and a lot of EPS uplift relative to expectations.

Now, again, we saw the two different trends. We saw our business Pro SKU -- what we call the Windows Pro SKU, which attaches to PCs that typically go into businesses -- we saw that business growing 6% in Q1, the second consecutive quarter of growth. So a positive trend. And I think we're feel pretty good about the trajectory there. Then we saw the consumer side finish about negative 22% -- that is the non-Pro SKUs -- in Q1. Again, a little bit better than we expected. But really that was the biggest difference, I think, Q4 to Q1. And I think it is a trend that we think will generally persist for the time being.

Keith Weiss {BIO 6993337 <GO>}

Got it. Excellent. Bigger picture. So you stepped into the role of General Manager of Investor Relations pretty much at this time last year.

Chris Suh {BIO 17955231 <GO>}

It was January, right around our January earnings call.

Keith Weiss {BIO 6993337 <GO>}

And you stepped in ahead of what turned out to be a pretty significant year of change for Microsoft in terms of a significant reorganization that you guys announced, a new CFO, Steve Ballmer announcing he was going to step down. And the announcement of the Nokia acquisition.

Should we look at -- looking ahead, a lot of moving pieces in calendar year 2013. Calendar year 2014, are you expecting more stability, more sort of building out on those pieces? Does Microsoft have what it needs -- outside of a CEO right now -- but outside of a CEO have what it needs to move forward with the devices and services strategy?

Chris Suh {BIO 17955231 <GO>}

Yes. It's a great question. And, yes, it was right at -- right before our January earnings call that I stepped into it. I have been around the Company for about 17 years. So I have had a good sort of perspective of Microsoft from the inside. But certainly didn't expect the amount of change that I have seen over the last 10 months that I have been in this role. It has been super fascinating, actually. And I keep telling people

that my boss and my boss's boss quitting has nothing to do with me. But it has been fascinating.

And we are actually quite enthused about the changes that are in process and the changes to come and the opportunity ahead. I think there are a few different categories, as you sort of mentioned. The organizational change, the realignment, the what we call One Microsoft, that has only been in place for a couple of months now, actually. But we are already starting to see a lot of the benefits of that change. And I think there is a lot more benefit to come.

If I think about -- what we effectively did was we moved from five distinct divisions, what we call product groups, which had their own divisional president, which had their own P&L and their own CFO and their own marketing organization, which was put into place almost 10 years ago. At that time, the product groups were functioning as almost distinct, separate products. But as we move forward into the future, as you think about cloud devices and services, along the backside, we share data centers, we share resources, we share a lot of operations, it made a lot of sense to bring those together and help those teams work together more closely.

And so by moving to a more functional model where we have the R&D organizations collaborating across the Company well, we brought all five marketing organizations into a single marketing organization to tell a more integrated, cohesive story about our offerings and services. And we took out some of the P&L incentives that existed across five different divisions that were based on their own division's performance versus the Company in total.

So I think you are already starting to see -- we are internally already starting to see the benefits of that. And externally, even some of the messaging that we did around some of the new product launches at holiday have been, I think, better as a result.

Obviously some big changes yet to come, the biggest one being the next great leader for Microsoft. We are a unique Company in that we have only had two CEOs in our history. And both gentlemen. I think -- I think you can't argue that they are two people that were incredibly passionate about Microsoft and still are. And so I think they are taking the time -- the Board is taking the time to find the right next leader, make sure the Company is in the right hands.

Do we have all the -- I think your last question was do we have all the pieces in place. I think we do. I think the devices and services strategy is well underway. Obviously, the next CEO of Microsoft will have a great impact on how we proceed from here. And we are all eager to see what comes with that.

Keith Weiss {BIO 6993337 <GO>}

And just maybe too mark-to-market on some of those initiatives, how should we think of -- in terms of the transition or sort the work to be done towards Microsoft One, how far into that initiative is Microsoft, how much more change is on the come?

And maybe if you could dig into -- just give us some examples of some of the benefits that you guys are already seeing internally.

Chris Suh {BIO 17955231 <GO>}

Sure. It is early. I mean, in the grand scheme of things, I think it is early. I think it really is a deep integration. It is not just about -- I will use the OS team as an example of that. So previously -- so under Terry Myerson now, he runs all of our operating systems groups, which is operating systems for phone, operating systems for PC and tablets, operating systems for Xbox. It is operating systems that go into embedded devices. So all flavors of OS. Those previously sat in different parts of the organization. So we had a phone OS team building the Windows phone OS. And we had the Windows PC teams that were building in a different organization. And they really were built independent of each other in many ways.

So what Terry has done isn't just to take those organizations and put them side by side and put them under the same umbrella. But there is actually a single engineering team now across the whole OS, a single R&D leader, a single test dev PM lead, which is sort of the three-headed leadership in an R&D organization, that has responsibility for all the OSes and they are going to rationalize the thinking across do three, four, five OSes make sense. Ultimately, when we think about Microsoft's strategy of having sort of this unified experience across devices, maybe you don't need as many OSes as we currently have. But those are the types of things that are currently under development.

So I would say it is still early because you don't make those type of decisions quickly. But we are a couple months in and I think we are making progress along those lines.

Another area that I will point to is marketing. So we had, like I said, five different marketing organizations. At the end of the day, it is the same customer. So we would have an office marketing team that is creating marketing materials for the same enterprise customer that the server and tools team was creating marketing for. And creating messaging and the whole go-to-market strategies.

What we have done now is put all those marketing organizations into a single team. There is effectively one team that focuses on the enterprise and there is one team that focuses on consumer. And they are doing a lot better job already aligning some of those things. Like even some of the Surface messaging that you see today, I think when we first initially launched Surface, a lot of it was -- a lot of the marketing was targeted toward raising awareness of the product itself. But I think the marketing that you see today focuses a lot on the differentiated features and functionality, the productivity, the fact that you can have Office and the fact that you can use USB. And all these things that sort of articulate the value proposition differently than a year ago.

Keith Weiss {BIO 6993337 <GO>}

Got it, got it. Then just the latest update on how you guys are messaging the CEO search and the timing that investors should be expecting there.

Chris Suh {BIO 17955231 <GO>}

Yes. I think the most recent public statement was actually made by Bill Gates himself at our annual meeting of shareholders, which we held in November. So Bill gave an update. And that is still available on our replay on our website, the Microsoft IR website, if you want to go take a look.

Largely talked about the progress that is being made. Just to recap a little bit, we have a four-person CEO search committee, a subset of the Board. That is Bill Gates; that is our lead independent director, John Thompson; it is Chuck Noski; and it is Steven Luczo. Those 4 gentlemen have effectively been working with internal candidates as well as external candidates to ultimately come up with a short list. And that short list will then be vetted and interviewed and the entire Board will vote on the selection of the next candidate.

As Bill said in his update, the Board has been working very hard to come up with -- and met with a lot of internal and externals and are coming up with that short list. They are aware that everyone would like them to move expeditiously. At the same time, as Bill stated, he cares so deeply about this Company he is going to make sure that it is the right next leader and they are going to take the time to do so.

So we didn't provide any sort of updated timeline. But at the time of Steve's announcement, we said 12 months. I don't think it will go 12 months. But the Board is working very, very hard on it right now.

Keith Weiss {BIO 6993337 <GO>}

Got it. Got it. Excellent. There has been a lot of speculation on what could happen potentially under a new CEO. One of the ideas that we hear a lot about is the potential of spinning out some divisions. Specifically, what you hear about most often is the potential of perhaps spinning out Xbox, perhaps spinning out the Bing division.

I doubt you are going to comment on whether anyone is going to be spinning out the Xbox division or the Bing division. But maybe to just help investors think about it in context, maybe you can walk through how you guys think about today of Xbox in terms of the integration and how that relates to other parts of the consumer business, what the overall vision is for Xbox. So we get an understanding of what it would mean to actually spin that out.

Chris Suh {BIO 17955231 <GO>}

Sure. I have seen some of the headlines as well. It is interesting. I think we have been pretty consistent with our stated strategy statements, which is to become a devices and services company. I think our actions have also been consistent along with that

in terms of moving from a pure software company to both software, services and devices.

When I think about the two specific assets that you mentioned, Bing and Xbox, I do think they are an integral part of how we think about how we are successful in the future. So when we think about how Microsoft continues to grow and deliver the next wave of growth, it is important -- it is important for us that we stay relevant with users. And those aren't just users that are quote, unquote, business users, or quote, unquote, consumers.

I think in today's world, the way people engage with technology and the way people use technology, it is more evident that there aren't specific experiences that they do at work and then they leave all those behind, or vice versa, at play and then they leave those behind as well. Skype is a great example of that. And I think even iPhone -- well, not even -- but iPhone is a great example of people that bring their consumer -- what started as a consumer device into the workplace. And now we are certainly seeing that phenomenon.

So I think Xbox and Bing both fit into that category. When I think about Bing, for example, there is Bing.com the search engine. There is also deep, deep integration of Bing into phone, into mobile, into Windows 8. So if you have used Windows 8 and 8.1, if you swipe in from the right you come up with the search charms. And that search is really deeply integrated with Bing.

With Xbox, you got integration of Bing there. Then you can also imagine in the future a lot of scenarios for productivity and enterprise that involve deep integration with search. So Bing is both the Bing.com search engine. But there is also a back-end asset that we share across the portfolio that accrues a lot of value to the rest of the portfolio.

Xbox is along the same lines. Xbox -- at the end of the day, I talked about at the beginning Microsoft wants to provide that unified experience across devices, from a four-inch phone to an 80-inch TV and everything in between. And increasingly, we see sort of blurring the lines of difference between the tablet and a PC and a tablet and a phone. And ultimately a tablet and a desktop and we have got 27-inch all-in-ones now. That and the TV, those experiences are starting to blur.

With Xbox One, you see that there is a great gaming experience that we launched when we launched Xbox One a couple of weeks ago. But you also see that there is a deep -- the deep roots in Windows. You see the Windows UI there. You see deep integration with Skype and SkyDrive. You have all your stuff there, the native interaction with the TV through voice and gestures. It is quite a seamless set of experiences across the whole stack. And we think that is important, again, to win the minds of consumers, in a sense. And have that engagement and stay relevant across the whole portfolio.

Keith Weiss {BIO 6993337 <GO>}

And it seems like Xbox One has gotten a really nice initial reception. Some of the initial sales figures that at least we are seeing from retail suggest a really good market reception thus far.

So maybe digging in a little bit into some of the divisions, talk about Windows. Around this time last year, Microsoft released Windows 8. Initially, I think the distribution and the reception of Windows 8 didn't really reinvigorate the PC market as expected. Pulp was kind of pushed forward to 8.1, to the emergence of new touchscreen devices.

How has that progression been going? How are you guys viewing the holiday season? Do you think we are there yet with the sort of ecosystem, the chipsets, the touchscreen devices?

Chris Suh {BIO 17955231 <GO>}

You know, I think at the highest level, we are pleased with the progress from the last year to where we are today. You are right. I mean, it is an incredibly broad and complicated, complex ecosystem. And that is not just a statement about OEMs. But the whole supply chain, as you talked about, from chips to retail all the way through, end to end.

And I think about a lot of the improvements that we have made from a year ago. I think just starting with the OEMs. I think the selection of PCs that you are seeing on the shelves today or this holiday is vastly improved. Better battery management, a lot of really good price points that are available either online or through retail. We are seeing sort of the whole complement of equipment fill in nicely and we are really happy about that.

You know, with Windows 8.1, what we have done by releasing Windows 8.1 less than a year after Windows 8, which is a first for us, quite honestly, shows I think a little bit of the faster cadence in terms of delivering innovation that we have been working on. Windows 8.1 takes a lot of the feedback from Windows 8, a lot of learning that we got ourselves from doing Surface. We touched on that briefly a little bit ago. But just by doing our own hardware, where we are really working to integrate the software with the hardware and understanding that at a deeper level than we ever have before, I think there was some learning that certainly got into Windows 8.1.

So when I look at the ecosystem broadly, we have done a lot of stuff at retail. In the US, we have these store-in-stores at Best Buys, which is our big retail presence. So on the retail side, on the supply chain side, on the distribution side, on the product side; so everything is moving in the right direction.

Now that said, I think it still takes a little bit of time and I think Windows 8.1 and the adoption and deployment across is still a work in process. And we are more optimistic certainly.

Keith Weiss {BIO 6993337 <GO>}

Got it, excellent, excellent. And maybe shifting gears a little bit to Surface, it has been out over a year now. You have Surface 2 on the market. How do you guys feel about the momentum behind that tablet? I don't know if it is a tablet. How you feel about the momentum behind Surface 2?

And the corollary question, I think one of the initial goals of Surface was to show the other OEMs what you can do with Windows 8. So how you could extend the form factor. How have the OEMs responded (multiple speakers)?

Chris Suh {BIO 17955231 <GO>}

Yes. It is a great question. And you are right. I think -- it was interesting, when you sort of called it a tablet, then you sort of tried to say, well, is it a tablet or not, because I think that is part of the interesting thing of what Surface is.

When we first did Surface -- or really when the first idea of Surface came to be, which came in sort of side-by-side with the development of Windows 8 in many ways, it was meant to be, as you said, sort of a stage for all the great things that Windows 8 could do. It was meant to show that it could be a great productivity tool. But also -- when you attach the keyboard to it. But when you take it away, it is a great -- it comes with the simplicity of a tablet and all the work and play combined in one great device.

I think to a large degree, I think with the first Surface we did learn a lot about that. I mean, I talked about the learning of just building a piece of hardware and making it work with our software ourselves. Which is -- in the past, we have never -- we've had teams that worked closely with OEMs. But it is different when you actually build a piece of hardware optimized for a piece of software.

So I think we learned a lot from that. That has gone into the second generation of Surface products. I think the new Surface -- they are lighter, they are better power management with Windows 8.1. It is a little more optimized with the hardware/software experience. So I think, again, it tends to be a work in process. But we are really happy with the direction that we have made and the improvements that we made in the product.

It is a little early to have any sort of momentum yet on the second product. I think it is really targeted for this holiday, the second generation of Surface. But we are happy with the direction that we have gone.

You know, as I said, we are seeing a lot of innovation from OEMs. Whether they are two-in-ones, which are kind of like the Surface -- they are tablets and they are hybrids, Ultrabooks and touchscreen -- the OEM partners have been great. And we are certainly working together with them closely to help invigorate the whole ecosystem in total. So our OEM relationships are good and solid (multiple speakers).

Keith Weiss {BIO 6993337 <GO>}

So I think the fear was that you guys coming out with your own hardware devices would perhaps change relationship with OEMs, they'd feel a little bit more threatened by, well, of course, you could do the hardware and software better than they can do. You don't think you saw any of that kind of (inaudible)?

Chris Suh {BIO 17955231 <GO>}

No. I think it is interesting. And I think it always -- there is a healthy amount of partnership and there is also a healthy amount of collaboration across various types of devices and product families. End-to-end, I think we have a good relationship with OEMs. I think that we are partnering well together for this holiday for sure.

Keith Weiss {BIO 6993337 <GO>}

Excellent. I have a ton more questions. But I want to make sure we take time to take questions from the audience. Any questions from the audience before I continue?

Excellent. So Microsoft is a big Company to cover in half an hour. So I am going to skip around a little bit. And I want to make sure we focus -- or talk a little bit about the enterprise. In particular some of the activities that you guys have been doing in the cloud. One of the, I think, most interesting aspects of what Microsoft has been doing on the enterprise is Azure.

Chris Suh {BIO 17955231 <GO>}

Yes.

Keith Weiss {BIO 6993337 <GO>}

Can you walk us through sort of how Azure has been tracking? Number one, there are some really interesting data points you guys have been putting out about some pretty rapid adoption. And two, how should investors think about Azure in terms of a competitive environment between Azure and AWS and now Google in the marketplace and maybe IBM with SoftLayer coming into the market. How do you guys see that competitive environment evolving?

Chris Suh {BIO 17955231 <GO>}

Azure is an exciting part of our overall cloud strategy. So Microsoft is -- we have been investing in cloud for a long, long time. We took a very -- I guess an ambitious approach with our platform-as-a-service offering with Azure. But our cloud initiatives across Azure. But also Office 365 and various other parts of the businesses, we're sort of all into the cloud I guess in that sense.

I think of Azure in a couple different ways. First of all, I think we do have a differentiated solution vis-a-vis an AWS in a couple ways. I think of our -- with Azure, what you get is really what we call a hybrid cloud approach. So you have the ability to run your platform on your data center, on our data center, on a partner's data center. And it is sort of -- we are sort of agnostic to that. It works well across all of it with a common management and security layer. And so I think that differentiated approach, whether you want to host it or whether we do, provides a unique value proposition.

I would also say that Microsoft has a deep, deep history with working with enterprise companies, with CIOs, with data centers; we have 30-plus years working well with enterprise companies. I think a lot of that sort of the credibility that we have built over many, many years is helping us with our progress in terms of building Azure and our customer adoption in that sense.

I would say if I look across our entire cloud portfolio, you have got Office 365, which is probably a little bit further along the maturity curve versus an Azure. But Azure is growing very, very quickly. This last quarter, we talked about the growth in our total commercial cloud revenue, which is Azure and Office 365 together, being up 103% year over year. Azure customers were up over 200%. And we are adding a lot of new customers daily.

It is a business that is on a fast trajectory. We are also investing in those businesses, as you know, continuing to build out our data centers ahead of the anticipated demand curve for Azure. But really, I mean, cloud is probably the most exciting thing that we have going at Microsoft across both of the Office and Windows server -- I mean the Azure -- Windows, Azure divisions.

Keith Weiss {BIO 6993337 <GO>}

One of the things you talked about at the Investor Day was there is a very fast pace of growth in both the cloud offerings. And it takes some CapEx investment. How should investors think about sort of the level of CapEx investment that we are going to see in the coming year? But more so, how does that sustain over time? Is it an arms race between you guys and AWS and IBM of where it's really going to be about building out significant capacity over the next several years?

Chris Suh {BIO 17955231 <GO>}

I mean, I do think that there is a bit of an arms race, as you said, to build a bigger, better, faster data center, I guess. We are certainly making investments in our data center. It really started in FY13, where we -- our historical CapEx spend was closer to -- or under $3 billion in some cases. But closer to $3 billion. In FY13, we went a little bit north of $4 billion. And the current fiscal year, we are anticipating spending about $6.5 billion. So it is a big step up. And most of the difference -- if I sort of take the historical run rate of CapEx to now, I think most of the differential is in the data center side, is in networking equipment as well as some of the plant to host those servers.

We are investing in three areas primarily. You saw -- and I am going back to the start of the ramp in FY13 -- Office 365. And that is coming up to scale; we talked about that business being over a $1.5 billion run rate at the end of fiscal 2013. So that is now a pretty sizable business coming to scale and we are starting to see the benefits of that.

The two other areas of investment are actually the two businesses we have talked about, which is Bing and it's Azure. And people say well, Bing -- they are not surprised at the Azure one. But they are curious about what we are investing in Bing. And the way to think about Bing in terms of the investment is that we have a good presence in the US with Bing.com, the search engine. We have 18% share now. But the global footprint for Bing is still growing and so we want to invest in Bing.com globally.

At the same time, the growth in mobile, we talk about Bing being the back-end search engine for Windows 8, for mobile, for Xbox, all those things require more investment in the data center on the Bing side.

Then Azure, now Azure is interesting, because we do think that we are investing a little bit ahead of the curve in terms of what we expect the revenues and scale to come. So when you asked about what is the right sustained level of investment, I think investors often think about CapEx as a percentage of the revenue. So when I look at FY14, I would say that the CapEx is probably on an absolute dollar sort of at a level where I could foresee us continuing to invest in. At the same time, the revenue scale isn't there yet. So the revenue on Azure specifically will increase over time, where we may not necessarily need to invest more. It will just depend on how quickly -- how accurate we are in forecasting the demand curve on Azure.

So I would say that right now we have investment without revenue on Azure, or less revenue; I think it is out of scale. But in the future, that should normalize a little bit more.

Keith Weiss {BIO 6993337 <GO>}

Got it. Then one last question on perhaps bringing together a couple of these (inaudible) the margin impact. When we think about an elevated CapEx investment for all the cloud activities, we think about Surface, which is now selling hardware as well as software. And an Xbox release, Xbox One release, how should investors be thinking about the gross margin impacts of these investments throughout this fiscal year (multiple speakers)?

Chris Suh {BIO 17955231 <GO>}

Sure. I think this fiscal year is interesting, because we do have an Xbox One launch. And that is having a weight -- probably a heavier weight. And as you know, in the gaming business, the lifecycle of a gaming console is you tend to have low or negative margins upfront and then those improve over time. And so FY14 is probably overweighted a little bit with the Xbox One launch.

But I think that your general point is right. As we evolve from a higher-margin software business to services and hardware, we are going to have margin percentage impacts of those things. I think over time, we are confident that we can deliver more gross margin dollars, absolute gross margin. But the percentages will change.

I think the way that I would recommend folks look at it is you look at the new reporting segments that we have started in FY14. And you really have -- there is five segments. But there is really three categories of gross margin profiles within those five segments. There is two segments that are called licensing -- device and consumer licensing and commercial licensing. And both of those have more historic software-type gross margins. You have an entire segment devoted to hardware. So you can really track the progress in hardware segment within the segment. Then you have a segment that we call commercial other, which houses all of our Azure and Office 365 revenue and gross margin.

And so again, you could see sort of the margin profile, like-to-like, year-over-year within those segments. And I think in some years, the mix of the business will be different, like we will have more Xbox this year. But in some cases, the mix -- so the mix will affect the overall gross margin. But you can really see within those segments how we are doing from a gross margin perspective.

Keith Weiss {BIO 6993337 <GO>}

Excellent. Unfortunately, that takes us to the end of our half-hour. But thank you very much for joining us, Chris.

Chris Suh {BIO 17955231 <GO>}

Thank you, Keith.