Jefferies Software Conference

Company Participants

- Jared Spataro, Corporate Vice President, Modern Work and Business Applications

Other Participants

- Brent Thill, Analyst, Jefferies

Presentation

Brent Thill {BIO 1556691 <GO>}

Thanks for joining. My name is Brent Thill with the Research group at Jefferies. Jared is with us today. He has been at Microsoft for over 17 years. He started the stock was $24, [ph] and during his tenure, the stock's up a modest at 1,200%. He started in SharePoint and was the GM of Office, and then in charge of M365, and now in charge of Modern Work and Business Apps. Jared, thanks for being here today.

Jared Spataro {BIO 17854733 <GO>}

My pleasure to be here.

Questions And Answers

Q - Brent Thill {BIO 1556691 <GO>}

And maybe just to kick off, give us a sense of your role in creating this modern environment. What you're spending the bulk of your time on Microsoft today?

A - Jared Spataro {BIO 17854733 <GO>}

Well, right now, I'm responsible for two of what we call our customer solution areas, Modern Work, which is our productivity business and then Business Applications which is essentially is Power Platform and Dynamics. Most of my time, Brent, is spent right now in AI. We introduced a new set of products that go into the moniker of Copilot and demand is kind of I've never seen anything like it in my career. So very busy with that right now.

Q - Brent Thill {BIO 1556691 <GO>}

You brought it up, so we'll keep pulling the thread on Copilot. 99.5% of the questions I get are on this, and everyone asks. I know you haven't availed everything, maybe not all the pricing's out, but what does this look like in five years in terms of, does everything have a Copilot? Are we going to have a Copilot across every

application and it's going to be all fueled by AI? I mean just share your vision of what this looks like.

A - Jared Spataro {BIO 17854733 <GO>}

(inaudible) and here I go. Get ready. There's a lot to say. First, we're in early days. I'll start there. This is very early. But if I take a step back and paint a big-picture of what we're seeing right now, there are basically two broad scenarios that we see within my portfolio for AI. One is what we would call in-app assistance, and this is the one that people understand the best. This is a Copilot in Word, a Copilot in Excel, a Copilot in Teams.

It's the one when I introduced the product that everyone kind of gravitates toward because it's easy to explain and people can see an immediate benefit in terms of productivity for them personally and often in terms of a group. That's very interesting to us. We think it has long-term potential. We do think that most applications will end up having a Copilot, and over time, many applications we think will start to have natural language as one of their primary user experiences. That's important. But while that's getting a lot of the attention, the second really big scenario for us is something that we call cross-app intelligence.

It's just a moniker that we would use to say, hey, independent of any particular app, you can essentially have a ChatGPT like experience for your business. So you can ask this experience, what were Q4 sales, what are the trends on this product line, what are my competitors doing, how do I compare versus competitors in this category or sector?

This is a brand-new set of scenarios, and over the long term, I'd say, Brent, this is the place that we actually think we'll be most disruptive because it's brand-new. It's the hardest one for me to explain to customers. I typically have to demo it. I have to bring the product up and say watch this. But when they see the concept of ChatGPT against their company data, against their financial data, against their graph data, then they start to realize, wow, that could be a very big inflection point for how we think about productivity. That's the one that we're most excited about.

So we are going to pursue both. Again, I think that first one is easy to sell. It's easy to build. It's easy for people to understand. But that second one probably has the most disruptive opportunity over time.

Q - Brent Thill {BIO 1556691 <GO>}

Back then, you haven't seen anything quite like this.

A - Jared Spataro {BIO 17854733 <GO>}

Yeah, sure.

Q - Brent Thill {BIO 1556691 <GO>}

How do you keep up? Like how are you guys keeping up with this? Are you having to hire a lot more people? Are you -- like what's the -- how do you stay in front of it? Or is it, hey, get in line and there are seven bodyguards and there's a line out the door? How are you?

A - Jared Spataro {BIO 17854733 <GO>}

It's busy. You know, it's busy, I'd say that. It's a strange time at Microsoft, but I mean strange in a good way. In that, on the one hand, macroeconomically you have all this pressure from our customers of what we would call an initiative of do more at less that we do very well. When there is consolidation in the industry, we do very well. In this productivity space, everybody has a million vendors for everything from video conferencing to chat, all of sudden Teams becomes really interesting.

So we already had this foundation that we are operating in. But I would say probably the biggest change is the cycle time like it's just faster right now. This Copilot thing did not exist in -- at the end of January in terms of us having a product by any stretch. And we made the product, came up with the concepts, came up with kind of the basic ideas over the course of end of January until we announced it on March 16. That's how fast we're moving and then we've continued to be fast since then, adding new capabilities to it.

So how do we keep up? I would say kind of radical prioritization. There's only so much we can do and more than anything, I'm spending a lot of time with customers. That's where I'm focused. I don't personally build the product any longer. We have teams that do that, but I want to stay plugged into customers and what they're thinking. And that's where I'm spending most of my time is in those discussions.

Q - Brent Thill {BIO 1556691 <GO>}

And so for the rest of the year, I would assume we're going to see a lot more announcements soon.

A - Jared Spataro {BIO 17854733 <GO>}

Yeah, we have a lot coming, I'd say, for sure. Although, I would also say that just getting the world to digest what we have announced is a big piece of work, and we're very focused on that. And we just opened the preview program for this Copilot to 600 enterprise customers, so we're very focused on those customers. We've been way, way oversubscribed on that. So we just opened the list and had as many customers as wanted to sign up and we're just kind of starting to chop through that list and get them using the product. And so both kind of helping the market digest what we announced and at the same time continuing to innovate, that's what we're up to.

Q - Brent Thill {BIO 1556691 <GO>}

The monetization strategy, we can see it in GitHub at a pretty nice price uplift. I mean, when you think about kind of what's baked in at the core versus what's the incremental add-on, how do you think about this? I know you can't avail the pricing

right now, but how do you think about this? And how should we think about is, we're all going to be probably evaluating the soon as customers what --

A - Jared Spataro {BIO 17854733 <GO>}

Yeah. Everyone wants me to utter things that will help you build models, I'm sure of it. It's early days. Here, let me look at the competitors and we can talk about public things. So competitors typically do a per user per month in this space of productivity space, $10 -- between anywhere of $10, $70, $80 per user per month. We don't know where we'll fall. What we're really focused on is trying to understand kind of a couple different dimensions.

Number one, where is the value? Where do people really see value? We have home runs in the product right now in AI in the context of Teams. Every time I demo that like actual product, the people are like, wow. We've got really, really solid technology in the context of things like writing in Word or processing email Outlook. So those are quite strong as well. We've got other places where we're still developing, and so we're trying to figure out the value.

I'd also say that when you think about this technology, it is expensive to run. This runs on GPUs. As you're seeing the coverage right now, that was something that people are starting to understand and there are costs associated with it, for sure. So we're trying to understand the economics of usage, you know, what do usage patterns look like, what does that cost us, and what can we do to drive costs down? So the reason I keep saying it's early is the value and what people perceive the value to be. We're still understanding that and then our own ability to run this efficiently. We're still getting the hang of that.

So right now, it's not like I'm hiding some sort of like monetization model that I'm just not telling the room. We're still working on it. We look at a couple of different things. We also have to look at things like making sure that we don't open the door to unlimited usage. We do that, and you've seen us from OpenAI. So you have again a comparable that's public right now, wherewith their GPT-4 model, they limit the number of essentially prompts that you can give it over an amount of time.

So we're playing with all those types of variables right now. Again, it's you just have to understand the cost model and understand the value model, and somewhere in there we'll get to a monetization model.

Q - Brent Thill {BIO 1556691 <GO>}

I'm not saying you're doubling the price per seat -- per user per month, but if you did, it would be because of value productivity and then the cost to run. It's just -- so we see --

A - Jared Spataro {BIO 17854733 <GO>}

All those factors, yes, that's right.

Q - Brent Thill {BIO 1556691 <GO>}

But we've seen 2X lift on pricing on some of your original products so that's --

A - Jared Spataro {BIO 17854733 <GO>}

GitHub is a really good example if I probe into that for a moment of us I think doing the right thing where we're able to run studies on productivity uplift, so that we can tell you, for instance, that developers who are using Copilot say they have just about 50% of their code now written by the Copilot. Then we can do calculations and say what's that look like and what would we charge you.

So you can imagine, we're doing the same types of things now. As we move to the 600 customers, we're looking at, okay, talk to me about your average day, talk to me about time save, talk to me about where you put those minutes. What percentage of writing do you do differently? Analysis do you do differently, all those types of things? So we're using the same methodology we did with GitHub as a way of evaluating the value here.

Q - Brent Thill {BIO 1556691 <GO>}

One of the biggest questions we get is if you're successful with this, then inevitably, are there just less actual users but your pricing goes higher. And so -- I mean, when you think about the volume of users that can use versus pricing, I think most of our clients are defaulting to, well, this X, Y assistant need to be here, or you're seeing a lot of companies saying we're reducing jobs because of AI. How do you address that? What do you think happens there?

A - Jared Spataro {BIO 17854733 <GO>}

Yeah. Let's take a step back and just talk about Myspace for a moment. A couple of quarters ago, I think it was -- a couple of quarters ago, 382 -- we announced 382 million users of the Microsoft 365 constellation of things. In the grand scheme of things, we actually think there are over 600 million information workers in the world, and on top of that, another 2 billion frontline workers.

So when we look at do we have opportunity to continue to grow seats for the business, we would say, yeah, we feel pretty good about that. Will there be some consolidation of jobs over the mid to long term, we say, yes. Over the short term, I think most CEOs are using AI as an excuse to get leaner. To be honest with you, I can't imagine they're really using it in ways that are cutting jobs. So I'm not too worried in the short-term about reducing the number of sockets that I have to sell into.

Over the mid to long term, yeah, I think there will be some changes. But generally speaking, our position is we're very tech optimist. We don't think that this all of sudden automates people out of jobs. We think they go on to do higher-value jobs within the functions that they run. And I'd also say that it gives us an opportunity with AI that we're very excited about with some products that are public to also start to move from just a plain per user type of charge to more consumption-based charges.

And that combination could be pretty interesting for the productivity space that I'll give one concrete example.

We have a product out now called Syntex. Syntex essentially is AI applied to content management in bulk. And of course, you can do that on an individual basis, but you can do this on a repository basis, so on contracts at large or on those types of kind of documents. And here, the industry already is charging on essentially a consumption basis. And that's pretty interesting to us because on top of what we can do on a per user basis, we can add a different economic model.

So right now, my biggest problem as I talk to the Board or to our senior leadership team is not, oh, my gosh, I think AI is going to reduce the number of seats that I can sell to. My biggest issue is, hey, there's a lot of demand. How do I turn that demand into money and then how do I continue to grow the value I deliver through that demand?

Q - Brent Thill {BIO 1556691 <GO>}

We don't have a demo build here, but when you said there was a wild factor-in Teams. I'm a huge Teams user. My team hates me using Teams as much because they can always find them, but we use it a lot. What's the wow? Can you explain the wow factor like? What is with AI-infused? What's different about us using Teams today that it's kind of look different at the end of the year or next year when you launch it?

A - Jared Spataro {BIO 17854733 <GO>}

Yeah. There are just -- there is a wow factor. And one of the first demos I often do is go back to a recorded meeting and use Copilot to essentially query the meeting, was my name mentioned, were the action items given to me, were decisions made, and the -- if you think --

Q - Brent Thill {BIO 1556691 <GO>}

I like, hey, Microsoft 10 million map showed up at the highway. [ph]

A - Jared Spataro {BIO 17854733 <GO>}

Yeah, exactly. I mean, it is amazing to not attend the meeting and feel like in five minutes of prompting a GPT-based engine that you can understand exactly what happened. We've done a nice job of doing things like recordings and transcripts, but nobody goes to take through tough things. It takes us long and dig through as if you just attended the meeting. So not attending a meeting, but getting something out, there is a wow factor there. It is immediate. GPT like these, you know what it looks like because you're using ChatGPT, very sophisticated. But then that's not all.

Typically when I demo to customers, I'll ask them if I can transcribe the meeting, and I'll start then I'll let it go for about 15 minutes, and then, I'll say, hey, can I show you something. And I pull-up Copilot and I say, ask any question about what we've talked, or any question. And first they start typically with tentative kind of basic

questions like what did Jared ask? What did Bob answer? But then they start to realize that the thing is very, very good at analyzing sentiment you can ask.

The other day I was in a meeting and my boss asked me a question. I answered it and then I thought this is a great chance. And so I asked Copilot, did Jared know what he was talking about when I answered to Kashi? And it came back and said, it didn't seem like Jared really did know what he was -- and I was making the answer up, so -- and my boss, he was like, wow, that's very impressive. You can ask it anyway, tell a joke, and it can say, yes, there were three jokes told. How good were they and rate them in order of how good they were, who laughed. I mean it's its ability to understand the human dynamics of a situation is incredible.

So during a very complex meeting, for instance, you can ask it things like can you parse out for me the different arguments people are making, and who agrees with what sides? Tell me what is still left to be decided. Tell me what we did decide. I mean, it's ability to just do those types of things is amazing and it changes human interaction in real-time and that's kind of one of those wow factor demos.

Q - Brent Thill {BIO 1556691 <GO>}

You love all your apps equally, but if there's kind of one that you're really excited about in the next three years, what would that one be?

A - Jared Spataro {BIO 17854733 <GO>}

We talked about Copilot, so I'll put that to the side unless you want to ask me more questions about that in a moment, but there are two that are top of mind. One won't surprise you and one may. The one that won't surprise you would be Teams. We have over 300 million monthly active users now. We've been able to get to a point where it has a really nice position within the communications infrastructure of enterprises and increasingly smaller down market businesses, and the opportunity we have is to monetize that.

The questions you will ask me, it's great, Jared. What you're going to do with that 300 million? Can you further monetize? We see an incredible opportunity. We already see phone [ph] taking off and becoming a very big opportunity for us. That is really growing very nicely. We see Rooms growing very nicely. We see something that we call Teams Premium growing very nicely, even though we just introduced it.

So I think Teams is very interesting for us as a platform for monetization and serving up more value. And then the other one that I flag for you that I think you'll understand a little bit better if you tuned into our Build conference is Windows. I actually think Windows has a moment of revival coming as AI really changes what operating system can be in personal computing. And I'm happy to talk more about that if you'd like to or we can just skim over it.

Q - Brent Thill {BIO 1556691 <GO>}

Yes, please.

A - Jared Spataro {BIO 17854733 <GO>}

But Windows I think is really something that you should watch because the combination -- kind of the confluence of tech trends right now could make the operating system very interesting again.

Q - Brent Thill {BIO 1556691 <GO>}

Why is that?

A - Jared Spataro {BIO 17854733 <GO>}

Well, let me take the two big ones that are on my mind right now as I'm really trying to drive the team. The first is the move to the cloud. We have seen tremendous success with a product that we introduced called Windows 365. It essentially has taken some of the backend virtualization technology, wrap it up and turn it into a Software-as-a-Service offering. You can spin up a Windows kind of environment in the cloud within literally a matter of minutes, and it becomes your personal environment, you can stream that down to any device.

People who are starting to use this, the signal we're getting from customers is very strong. First, first we pilot it and I'll start with five, 10, 20, now we see people go into hundreds, thousands and tens of thousands of Windows 365 licenses. So we've got a really good signal there that this kind of Windows in the cloud is very interesting. I see people starting to now use it on their iPads. I use it on my iPad. It's transformative as you see, Windows can be anywhere. It really can be my most productive environment.

So there's one trend there. And then the second trend that we're very excited about is Windows Copilot. If you think about what Windows Copilot can do, we demoed it at our conference call Builds last week. But Windows Copilot essentially can really bring together agent and assistant that understands everything that you're doing in your digital life. It can watch where you're browsing on the web. It can see the applications that you're using way outside the scope of M365 which is what the M365 Copilot is limited to. And it can bring all those things together and what again would be a very personal assistant type of scenario knows every keystroke.

So we think there's really something there to make personal computing more personal than it's ever been to follow you across any device, it's big or small and to essentially called that the evolution of Windows. And as companies are starting to catch that vision, they're very excited about what it could do to-end user computing. So we think there's something there.

Q - Brent Thill {BIO 1556691 <GO>}

Everyone has been super surprised by Office. I mean to put up 17% to 21% constant-currency growth consecutively, it's like Jimmy Butler or Steph Curry, or you go through like it's just the consistency is insane, like how do you do that.

A - Jared Spataro {BIO 17854733 <GO>}

It's -- I mean, first, I won't take credit for it. I mean there are kind of two components to it. Let's say, we have a very good product team and under Satya's leadership, they have not become complacent. They have tried to understand customers and say what's the core value that we're providing, how do we improve that. And you see that in both improvements to the core apps where something like Excel is more loved than it's ever been. Like despite the competition, Excel still is incredibly loved, and then with things like Teams that have added kind of breath new life into the suite.

So it starts with product. We think from our perspective, value is number one, but it's not just product. I love the people who work on my go-to-market team who helped to turn what we have into a machine -- a machine of execution. In fact, if you look at our Q3 results, it's not that the macroeconomic kind of conditions changed. It's just that the go-to-market team really executed for us. And so we have really worked hard and have been very focused on two aspects of the business, both driving the Q and the P. So we both drive kind of seat growth and we try to drive the price up, and we have some really interesting ways of doing that as we move through E3, E5 kind of our SKU lineup.

Q - Brent Thill {BIO 1556691 <GO>}

I think you mentioned Power Apps earlier.

A - Jared Spataro {BIO 17854733 <GO>}

Yeah.

Q - Brent Thill {BIO 1556691 <GO>}

We wrote a dive on Azure way back when and that was like AWS has already taken off, no room and here we go kind of an interesting opportunity. Do you think Power Apps could be the next Azure?

A - Jared Spataro {BIO 17854733 <GO>}

I'm very bullish on Power, and Power for us is Power Apps, Power Automate, Power BI, so it's all of those. And we actually now have Power Pages and Power Virtual Agents. They're kind of our some up and coming shoots of growth as well. And yes, if I were to cut to the chase, we would simply say, the world is starting to move so fast that this idea of low-code solutions or easy automation managed incredibly attractive to the market.

So we're just getting to a really big business milestone for us. We would say we're starting to see Power Tip from this early part of the market into what we call a majority buyer. So what used to be BDM type buyers where it'd be like we do pockets within the enterprise. Now that buying habit has switched over very clearly for us over into IT. That's good because IT typically will do these broad wall-to-wall type purchases. So we're definitely seeing kind of an opportunity right now as the

technology is maturing and the market itself is maturing across all of those different categories right now. So it's a space to watch for sure.

Q - Brent Thill {BIO 1556691 <GO>}

Dynamics?

A - Jared Spataro {BIO 17854733 <GO>}

Yeah, Dynamics. I'm very excited. People kind of gives us one up for dead, but let me tell you, I've been in the midst of -- I took it over last quarter -- well, two quarters ago, and I've been in the midst of it kind of really trying to understand what's going on. First half, the products have gotten good. It's hard to take someone like a Salesforce straight on -- head-on in what you call a static market where the structure of the market is set, they're so far ahead, you know, that could feel like a slog. But the products have gotten good.

There's a lot of DSAT quite frankly on some of the leaders like Salesforce. We're doing a lot of work in trying to understand the market and there's a lot of unhappy Salesforce customers out there in terms of how they feel about the commercials and the product. And the big game changer goes back to, Brent, AI. We think AI is a tremendous game-changer. And whether you're doing kind of like Salesforce enablement, so you're helping your sellers be more productive or like service centers or call centers, et cetera, like, man, AI really changes the game.

So it has been growing nicely for us, but we really see an opportunity here for us to kind of pounce on what we think will be a new structure of the market. So as the game changes, as the playing field tilts, we see an opportunity.

Q - Brent Thill {BIO 1556691 <GO>}

Do you envision A, I can walk into my desk and say show me the last 10 customers of Microsoft stock on our trading desk and pull up their name and I get an automated call feature and I could just start calling people or send an email? It seems like there is so much between Salesforce and it doesn't give me anything back and sucks everything in, which is okay. That's where we're out with it. But this ability to then give you back your time is this -- this seems like the direction this is going.

A - Jared Spataro {BIO 17854733 <GO>}

I'll go back to the beginning and say, the most strategic thing you should take out of what we're doing is that cross-app Intelligent scenario. At the end-of-the-day, your ability to walk into essentially a ChatGPT interface and say whatever question you have, hey, tell me the last 10 customers that bought Microsoft, pull up their profile, tell me what else they bought, and tell me what your recommendation do next that -- nothing exists like that today. And what we see essentially is people bopping around from application to application essentially kind of trying to piece together really what are the meta goals of their job, which is how do I serve my customers better, what should I do next, what's the next most high-value action I should take. And we really think that these natural language interfaces can change. And we do anticipate that people spend less time in biz app-type scenarios -- interfaces, we think that people

spend less time frankly in other apps, even Outlook or Excel as well. But the race is on we think for this opportunity to have this interface that is an interface to your business, not to any particular app.

Q - Brent Thill {BIO 1556691 <GO>}

I mean, I'm hearing a theme of faster innovation.

A - Jared Spataro {BIO 17854733 <GO>}

That's for sure. Yes.

Q - Brent Thill {BIO 1556691 <GO>}

I mean with AI, it feels like we may get it to a more efficient R&D organization, faster dev times like the innovation comes.

A - Jared Spataro {BIO 17854733 <GO>}

We definitely see that. It's not like these things come for free, but I'll use an anecdote to give you a sense of what that looks like. And one of the reasons we could move so fast on this Microsoft 365 Copilot is we had been working behind the scenes on a scripting language for all the apps. Think of a scripting language that allow you to do anything you can do in the ribbon in Excel, or PowerPoint or Word. And the coolest thing happened in January, essentially when we took the GPT foundational model and we exposed it to that scripting language.

Now remember, at GPT model, what it can do is it can understand the syntax, the vocabulary, the structure of a language, and scripting language is nothing more than a language. It learned how to speak the scripting language for those apps. So the reason that we could introduce Copilot and it could command the apps, do this in bold, add a slide, take a picture of this and put it here was because it simply learn how to speak Microsoft app, and it did so within a matter of about 10 days. So is that fast R&D, we think so. Will everything go that fast, no, but we do think it's kind of a sea change in what's happening.

Q - Brent Thill {BIO 1556691 <GO>}

Jared, exciting times. Thanks for joining.

A - Jared Spataro {BIO 17854733 <GO>}

Yeah, my pleasure. Great to be here.