

JPMorgan Tech Forum

Company Participants

- Bill Duff, CFO

Other Participants

- John DiFucci, Analyst, JPMorgan Chase & Co.
- Unidentified Participant, Analyst, Unknown

Presentation

John DiFucci {BIO 4099352 <GO>}

Good afternoon. My name is John DiFucci. I cover software at J.P. Morgan. And welcome to the afternoon session of the J.P. Morgan Tech forum at CES. We are very happy to have with us here today Bill Duff, who is the CFO of the Operating System business at Microsoft. We also have Lisa Nelson, the Director of IR in the audience. Bill is going to open it up with some opening remarks. And then I'm going to ask some questions. About midway through the session, I will turn it over to the audience so please don't be shy. Ask whatever questions you like. I have enough questions to get us beyond more than the half-hour we have. But please this session is for you so if you have any specific issues you want to touch on, Bill will be the guy to talk about it. Bill.

Bill Duff {BIO 18415528 <GO>}

Thanks, John. I really appreciate you giving me the opportunity to be here. This is great. I wanted to briefly talk a little bit about the Operating Systems Product Group at Microsoft. So I'm the CFO of the Operating Systems Product Group. This product group is where we develop the platform software and services that power a lot of our devices across the Company. And so, we power -- we develop the operating systems for Windows PCs and Windows tablets, Windows Phone, our embedded operating system. And our embedded operating system business. And in addition, we are developing the underlying Xbox software and Xbox LIVE services in this product group as well.

So we have a broad diversity of products that we are developing in this product group. And there's a lot of exciting things that are happening across the board. This has been a very big year for us. On the Windows side, we recently launched Windows 8.1. We felt like we drove great improvements to the platform. We are seeing good uptake of Windows 8.1. We are getting excellent customer feedback on 8.1. And we were just overall very pleased with the product of the Windows platform.

We are also very excited about our hardware partners and the devices that they are bringing to the market. So it's been great from that perspective after launching it this fall.

On Windows Phone -- really 2013 was a big year for us on the Windows Phone side, as far as growth and momentum. We launched the Windows Phone 8 software a little bit over a year ago. And since that time, we've seen significant growth in the Windows Phone ecosystem. We are outselling iPhone in many markets. We've really solidified our position as the third global mobile software platform out there. And in many markets in Western Europe and other areas of the world we are exceeding 10% market share in those markets. So we feel good about the momentum on that business.

The embedded business -- I don't know if everybody in the room is familiar with that business. That's where we help our enterprise customers connect their industrial products to the Internet; get them connected; get them managed. There is a tremendous opportunity there. This is a business we have been in for a while but we, again, think that over the next three years this is a significant area for us to focus on. We think there is a big opportunity there.

Then finally, Xbox. We launched Xbox One in the fall. And we feel great about the product and great about our sales results thus far. Really we brought together the Operating Systems Product Group to drive a single platform that developers can target. And so, developers are incredibly important part of our ecosystem. And we're really bringing together our core software platform and services such that developers can really target the aggregate volume of Microsoft.

We have a lot of volume out there today. But generally developers have to target specific products. Going forward and where investments are going to go forward is to bring together that entire story from a developer ecosystem perspective. We are also very focused on delivering consistent, familiar user experiences across these different products. That doesn't mean that the same user experience is going to exist on the Xbox and on a large screen TV as on a Windows Phone. So we are going to focus on tailored, targeted experiences for those devices. But we are also going to invest in seamless experiences and familiar experiences across our entire device category.

Then finally we are going to invest a lot in our core platform services. We've invested a lot in Xbox LIVE and in Windows Live. And this product development team is going to continue to focus on those core platform services and make sure that those core platform services are delivered across our entire device family.

So there is a lot going on. There's a ton of new devices coming out. There's clearly a lot of energy and excitement in the device ecosystem from PCs to tablets to phones to embedded devices. And we feel good about the opportunity going forward. And so, we are pretty excited.

Questions And Answers

Q - John DiFucci {BIO 4099352 <GO>}

Great. Thanks, Bill. That's a great summary of a lot of things happening in your group. I guess at first I want to just focus a little bit on the PC OS. Windows XP end-of-life comes in April. We've seen more positive or more promising results out of PC shipments -- especially corporate PC shipments. How much of an impact do you think that the end-of-life support for XP has had on that? And do you think we will continue to see that at least through the next quarter? But after that, do you think we'll see perhaps a lull? Is Microsoft expecting -- if that is happening -- a lull after the end-of-life comes and goes?

A - Bill Duff {BIO 18415528 <GO>}

Business PCs have a relatively strong. It's been an area of growth for us over the last couple of quarters. And we feel good about the business. We feel good about the value we are delivering to enterprises. XP end-of-life certainly has had some impact on that overall business, although it's very difficult to parse apart. If you look at some of the usage stats they came out publicly, you saw the XP install base decreasing, whereas the Windows 7 and the Windows 8 install base increasing. And so, we feel good about moving our enterprise customers onto our most modern platforms. But it's really difficult to say a couple of quarters out what the over overall impact would be. There's other impacts that are going on in business PCs, the overall macro economy, business hiring, things like that. And so, it is difficult to sort of tease apart the relative impact of XP. So I would say there is some impact. But not necessarily -- it's not the driving force, we don't believe, behind our business PC performance.

Q - John DiFucci {BIO 4099352 <GO>}

Okay. Great. Turning to consumer PCs, are there any innovations because you have to work with them and keep track of PC hardware vendors that you think -- are there any new innovations that could perhaps renew the enthusiasm among consumers for PCs?

A - Bill Duff {BIO 18415528 <GO>}

It's a really interesting question. I feel like there is a ton of innovation going on right now in computing platforms in general, particularly on the hardware side. On the software side, there is a ton of innovation is happening. You can see it with Windows 8 and all the different form factors that are coming out and different use cases.

We are pretty excited about that innovation. We're excited about some of the devices that our partners brought to market for the holiday. We think they are great devices, particularly on the low screen-size or the small screen-size tablets. There is a number of devices, 8-inch tablets, that came out with Windows software on them that are great devices. I've been using the Dell; it's a fantastic device. And we are excited about the roadmaps going forward. In addition, touch is really interesting. We made a pretty significant bet on touch last year with Windows 8. And you are starting to see, particularly in the US -- I think the latest stats I've seen is about 40%

of the laptops that are being sold through the big-box retail channel in the US are touch-enabled devices. So you are starting to see this innovation become more mainstream. And we expect those types of continued innovations. And there's a lot going on in PC land that's sort of broader when you sort of take a step back and think what's happening with tablets with PCs with smartphones and just what's happening overall in the computing landscape.

Q - John DiFucci {BIO 4099352 <GO>}

Since you mentioned touch, Microsoft has talked about optimizing Office for touch, has been asked and talked a little bit about for iOS but also for Windows 8. Can you give us any kind of update about where you think that is? And also, once you come out with that and once -- because one of the things we've always looked at for Microsoft to get a foothold in the tablet world was this is -- Office is something that they own that makes them unique. But if you come out for touch and you also expand it to Apple, well that expands the Office business. But it also may have a negative effect on your tablet business.

A - Bill Duff {BIO 18415528 <GO>}

I think -- I don't have any update on timelines or anything. I think we've talked about how we are working on touch-optimized Office. Office, we believe, is in incredibly strong productivity offering and we are investing heavily in Office scenarios. I think that just as historically Office worked across a couple of platforms, Office going forward you should expect to work great on Windows devices. We don't necessarily think about it as hurting the Windows value proposition. We actually think that once we get a great touch-optimized Office experience on a great touch-optimized Windows experience that we will have the best productivity experience out there.

Q - John DiFucci {BIO 4099352 <GO>}

Okay. So Windows first? That's sort of the --

A - Bill Duff {BIO 18415528 <GO>}

Yes, I think that we will focus on ensuring that Office is a great experience on the Windows platform.

Q - John DiFucci {BIO 4099352 <GO>}

Okay. I guess moving to something a little bit different but also sticking with the PC OS, I guess, what impact if any of you think that Chromebooks are having on consumer and commercial businesses of Windows. We hear a lot of them. And I am actually starting to see them a little bit more, within the consumer community primarily. What impact -- has it been surprising to you to see some of the large PC OEMs introduce Chromebooks in their lineup?

A - Bill Duff {BIO 18415528 <GO>}

In Chromebooks overall, we are seeing them in the education markets, for sure. You are starting to see them a little bit in retail. You can see them at the big-box retailers if you go into Best Buy. On the retail side or on the consumer side, it's primarily a low

price-point device. We also are working with our hardware partners to create great low-cost devices in the channel. And we think we have a great value proposition competitively versus Chromebook to have the power of a full Windows PC versus a Chromebook. So we feel good about where we stack up competitively from a product perspective. And as far as the overall ecosystem, I think it's a time of experimentation. You are seeing it a lot at CES. You are seeing it pre-CES. It's a very dynamic market right now. And I think people in companies are experimenting a lot, along a lot of different angles. And for us, really, the core focus is figuring out how we can deliver the best Windows experience and the best Microsoft services experiences with Windows through our partners to consumers. And we are just laser focused on that aspect of the business right now.

Q - John DiFucci {BIO 4099352 <GO>}

Okay. But have you -- you are seeing them out there. But I guess it would probably be difficult to note if it is having any effect.

A - Bill Duff {BIO 18415528 <GO>}

You know, the statistics I've seen -- there's been a couple of reports that come out over the holidays that, I think, slice and dice the distribution channel in certain ways. I think from the numbers that I have seen, it's a single-digit share type thing when you are talking about the overall US PC market. Then when you are talking about the global PC market, even lower.

Q - John DiFucci {BIO 4099352 <GO>}

I have a couple of questions. I'm going to move on to phone, your phone OS. You mentioned Windows Phone has made some market share strides of late, especially overseas. And we have been following that. What you think it will take to get greater adoption and awareness in the US market? I noticed you had the 41-pixel camera.

A - Bill Duff {BIO 18415528 <GO>}

Yes. And the 1020, which was great.

Q - John DiFucci {BIO 4099352 <GO>}

It's a great device. But in the US -- but not only in the US but also another big market, China.

A - Bill Duff {BIO 18415528 <GO>}

We have seen strides in many areas of the world. And I think the last time that John and I talked we talked about the global smartphone market is obviously enormous. It's about in 800 million unit market. About 40% of the market is China. So when you look at some of the global stats, it distorts different platforms and how well they are doing and in which customer bases they are selling to and things like that. And so, whereas we have done very well outside of the US, in China, we are starting to get better in the US. We are seeing share gains in US. And I think it's primarily just getting the right devices out there, driving awareness. And making sure that we have the right value proposition to our customers in the US.

We are doing very well at the lower end of the market. So Nokia has a device called the 520 that they are selling. This is a lower-cost device. It's much, much less expensive than the latest iPhone or the latest Galaxy 4. And it's really hitting a sweet spot in terms of price-performance trade off. And we're seeing a lot of customers adopt that. So we are feeling pretty good about the sales growth and sales momentum in the US. We would like it to be faster. We are certainly investing heavily. We think the US is a critical market for us. And so, we continue to invest and drive awareness and try to work with our partners, whether they be the handset providers or the mobile operators, to get more devices out there.

China, the same type of issue. I think what we need to do there is we need to work very closely with local partners and work with local carriers to penetrate that market. It's complicated in different ways than the US market. It is certainly a priority for us and something that we are going to focus on. But I would say our highest priority right now, beyond maintaining the momentum in the rest of the world is to gain some momentum in the US market.

Q - John DiFucci {BIO 4099352 <GO>}

Have you been -- I guess the follow-up to that, have you been -- how has your satisfaction then in regards to introducing devices that, in my view anyway, are unique, with the camera. You are coming into a market that is dominated by two other players. And you are the number three player. And to gain share you have to do things that are somewhat different, other than just putting Microsoft on the box. How is that going? Because the cameras are certainly unique. And they are actually pretty cool. And even if -- I even remember looking at phones and almost -- I didn't buy a Windows Phone -- but realized that even the music system, the Zune system for Windows phone at that time was actually, I thought, better than what else was available. But it's hard coming in later. I guess how -- I do see the camera as something unique. Are there are other things that you can --

A - Bill Duff {BIO 18415528 <GO>}

You know, you bring up a good point, which is one of our biggest issues is continues to be awareness, particularly in the US market. I'm not so much talking about Western Europe or other markets right now. But in the US market, awareness continues to be an issue. People just aren't aware of the devices that we have out there, the value prop we provide. I think we have -- you mentioned music. Xbox games are an area where we think we are somewhat differentiated. And just productivity scenarios in general: our email client, our calendar client, our integration with Exchange, if you use Lync in your enterprise environment. All of these are great user experiences that are differentiated from our competitors. And we are chipping away.

You mentioned a hardware feature where we introduced the Nokia 1020, which was a 41-megapixel camera. It really blew away everything that was currently out there in the market. And it's a great product. But you know it's getting the awareness. It's getting the distribution channel to have enough critical mass where they are investing behind the Windows Phone. It is getting developers to focus on getting their best applications on Windows Phone. It's even as simple as having friends who

have Windows Phones so they can demonstrate to show you, hey, look, look what my phone does. It's valuable in this way or that way.

And so, we are still focused on awareness. We will still push on hardware innovation, on software innovation. There is certainly more to come on the Windows Phone side. But we think we just need to chip away.

What we found in Western European markets or other markets where we have crossed that 10% threshold barrier is once you get up to a level of critical mass, you get positive reinforcement and positive feedbacks, loops. And share gains begin to get easier. So I think we are just at a certain stage in the US market. We are seeing progress. We are going to continue to push on that progress.

Q - John DiFucci {BIO 4099352 <GO>}

Thanks, Bill. Any questions from the audience? There's one in the back here.

Q - Unidentified Participant

Staying on the theme of mobile phones, I would have two questions for you. Number one is can you give us an update as to where your market share in the US is currently? Then number two is I think you are about to close the Nokia deal. And I may not have been paying attention. But I am curious. I would like to hear, what is the strategy behind owning Nokia? Is it really critical for you guys to actually own the hardware and the software?

A - Bill Duff {BIO 18415528 <GO>}

On the first one, I am trying to think -- the latest stats, I think, are still in the mid-single digits in the US and continuing to make progress. But we would like to make more progress. With regard to Nokia, we entered into a commercial relationship with Nokia a couple of years ago. And they adopted Windows Phone as their primary smartphone platform. That was when we were shipping Windows Phone 7.

We worked deeply with them around those devices. And, really, once we started shipping Windows Phone 8 and once we started that collaboration and that was really a little over a year ago, that is when we saw more significant momentum in the marketplace. Both companies I think felt very good about where that business was headed and that we saw that early momentum in the marketplace. But both companies were also assessing their strategic objectives in mobile and where they were going to head going forward.

Nokia was clearly assessing how they felt about the partnership and where they wanted to take the business. We were doing the same thing. From a Microsoft perspective, we saw significant benefits for acquiring Nokia and bringing them internally. Part of it was to maintain existing sales momentum with Windows Phone, which is incredibly important to us. We believe that the mobile business in general and the phone business in general is important for us to have a strong position in.

We felt like we could simplify and focus our efforts as one company, as far as go-to-market, sales, investments in marketing, investments in brand. Delivering on the awareness that I had mentioned earlier was one of the things that we really needed to drive, how we felt we were going to make faster progress in the market. And so, that was certainly one element of it.

Then finally we saw an opportunity to work very closely with Nokia in technical collaborations. We were still operating as two different companies. You saw with the Nokia 1020, which was the camera that John talked about earlier, that was the fruit of a deep technical collaboration with Nokia. But there are things on both sides where they would not necessarily share with us at an early stage. We wouldn't necessarily share with them at an early stage where we can really move the needle on innovation between the hardware/software layer. And we felt like that was an opportunity. And so, over the summer we made the decision. And both companies made a decision to put forward with the acquisition. And as you mentioned, we are still in the period between announced and waiting for regulatory approvals and everything else for the deal to close.

Q - John DiFucci {BIO 4099352 <GO>}

I guess one follow-up to that because I think it's in an interesting topic. Microsoft -- and we are in the process of trying to figure out about what it is -- has done a really good job, I think, recently in trying to monetize your patent portfolio. And we are actually at this point trying to just figure out what the Android opportunity is. With the Nokia patent portfolio, is there an opportunity there to do something similar? IBM has done this fantastically for years. And it just seems like there's been a lot of great development that's come out of Microsoft. But getting this portfolio from Nokia, too, is there an opportunity to do that there?

A - Bill Duff {BIO 18415528 <GO>}

So the Nokia acquisition -- Nokia has one of the strongest intellectual property portfolios in the mobile industry and has been a leader, obviously, for a long time in developing their intellectual property portfolio. And in mobile, intellectual property and licensing is a very mature and well understood -- there's mature business relationships between all of the major mobile companies, as far as cross-licensing patents and everything else.

And so when we decided to move forward with the Nokia acquisition, we structured the deal such that we didn't acquire Nokia's patents or at least their core essential wireless patents. So their intellectual property portfolio is retained by Nokia Corporation and what's left behind with Nokia.

And really as part of the transaction, there were two things related to intellectual property that were important for us. One is a significant part of the value of the deal was us signing a license with Nokia in order to use their patents. And we have the use of their patents broadly across our product portfolio. This is something that we would have had to do anyway or we were already working with Nokia on licensing their intellectual property and their patents. And we already had financial

transactions with them. So as part of this overall acquisition, we have a license to Nokia's core wireless patents.

In addition, the Nokia handset division had negotiated cross licenses with other patent holders in the wireless space. Probably most notably, Qualcomm. But many others, as well. And they were able, through their use of their patent portfolio and through upfront cash payments, they were able to secure a very favorable -- what we felt were very favorable IP licensing rates with other players in the industry. And as part of our acquisition of the Nokia handset business, we are able to inherit those patent agreements. So we are able to inherit the fundamental economics of those patent agreements. Both of those pieces, as John mentioned, of the Nokia transaction were very important as we thought about the overall value of the deal and how we wanted to structure the transactions.

Q - John DiFucci {BIO 4099352 <GO>}

I guess on the first group, can you actually try to monetize those patents, or no?

A - Bill Duff {BIO 18415528 <GO>}

No. We are licensing patents from Nokia. And so, this is just a payment from us as part of the overall transaction for us to license their intellectual property. There is a certain number of patents we got as part of the deal that were design patents that were more related to the hardware and other aspects of the assets that we purchased. But I think the core of the way to think about the core of the Nokia IP position stays with Nokia.

Q - John DiFucci {BIO 4099352 <GO>}

Any other questions? Two. One here and then one over here. There's one right there on the way.

Q - Unidentified Participant

Just two questions. One, how do you incent other partners in ACC, Samsung, other guys in the environment to adopt Windows and Windows mobile in a bigger way? I know you have historically charged for a license. What can you do to incent people to do a few more designs of Windows over Android? Then secondarily on the cost side in terms of supporting the Microsoft Windows OS, I'm sure you cannot talk about be absolute levels. But what has been the trend? Has this been a business that demanded 15% or 20% increases in the OpEx support to run this business? Is it now at a stable level? What is the right way to think about that kind of going forward?

A - Bill Duff {BIO 18415528 <GO>}

Let me take the first one first. On the Windows Phone side, what we are seeing is increased momentum in market is going to drive -- it's the end-user customer demand that is going to help us continue to partner with other hardware partners around Windows Phone. And so when we look at over 2013, Nokia was by far our largest hardware partner. We have other hardware partners that continue to ship Windows Phone. And really what we need to do is continue to demonstrate end-user

demand for Windows Phone and work with them in ways that those hardware partners can make money with our devices. I wouldn't say -- I would say that our software royalty model and our software royalty strategy with Windows Phone is not significant friction in the overall scheme of things as they think about the opportunity to make money with Windows Phone. So we continue to work with other hardware partners besides Nokia. And we are looking forward to working with many more as well. And actually over the past year, there has been increased interest in Windows Phone because we are starting to see those market share gains. And they are starting to see that there is customer demand out there.

With regard to your second question about the overall level of the business, we restructured our financial statements. And I think the first -- I'm looking at Lisa -- the first time we reported with the new financial statements was last quarter. And we are really focused on we are going to have -- our financial statements, the way to think about them is we are going to have devices and consumer software licensing. And we are going to report that as a segment, overall, from the revenue and COGS. So revenue and gross margin perspective. And I think that that will give you a lot of visibility as far as how we think our software licensing business is evolving over time and what investments we need to support that going forward.

I think that over the past year we've invested more on the marketing front. You can see a lot more advertising in terms of Windows and thinking about Windows ecosystem broadly. That's a broad statement. That's not necessarily a specific -- one specific product statement. You can see that from our advertising. And I think we will continue investing in that marketing to draw that end-user demand into the Microsoft Windows ecosystem.

Q - John DiFucci {BIO 4099352 <GO>}

I'm sorry. I think we are out of time. But there was one last quick question, maybe.

Q - Unidentified Participant

I know there is a lot a focus on Windows Phone and the consumer side of the business. But the bulk of the business that you manage is really enterprise client devices. My understanding is also the vast majority of that revenue is really what we would consider recurring revenue or annuity-based. Can you just talk about what that looks like to you and how that grows over time with the base that you have?

A - Bill Duff {BIO 18415528 <GO>}

Thank you for pointing that out. There is a significant chunk of our business which is focused on enterprise and commercial licensing of Windows. We talk about in our financials we have the Windows Pro business which is generally software licenses sold for PCs that are used in commercial environment and Windows core. But in addition to those two licensing models, which are upfront licensing models where we get paid when the device is shipped, we have a software assurance model. And this is a recurring license that we sell directly to businesses that provide them enterprise features on Windows. And it is sold more as a subscription model; it's over a three-year period. We continue to see growth in that overall market. And so, as with our Windows Pro business where we've seen growth over a couple of

quarters, if you look at the Software Assurance business that has shown growth over a longer period of time. And it's been a very consistent grower. And we expect it to continue along that trajectory.

I think we announced in the past year that was about a \$4 billion business, the Software Assurance piece. Not in addition to the Windows licensing piece, the per unit Windows licensing piece.

Q - John DiFucci {BIO 4099352 <GO>}

Well thank you very much, Bill.

A - Bill Duff {BIO 18415528 <GO>}

Thanks, John. I appreciate it. Thanks.

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