Credit Suisse Technology, Media & Telecom Conference

Company Participants

- Rajesh Jha, EVP of Experiences & Devices

Other Participants

- Brad Alan Zelnick, MD, Crédit Suisse AG, Research Division

Presentation

Brad Alan Zelnick {BIO 16211883 <GO>}

Excellent. Well. Good morning, everybody. Welcome back. I'm Brad Zelnick, Software Analyst and Equity Research here at Crédit Suisse. And we are truly delighted to be joined by Rajesh Jha of Microsoft. He is the enterprise -- excuse me, Executive VP. I see E and I get confused sometimes. Executive VP of Microsoft's Experiences and Devices Group.

The format of this presentation is a fireside chat. And I think we've -- in the scope of Microsoft, we've got a lot of things to talk about today. But maybe just for introductions sake, maybe we could start with a brief bit of background. Rajesh, you've been with Microsoft now since the early days, since 1990.

Rajesh Jha {BIO 20129196 <GO>}

Thanks for dating me, Brad. Okay.

Questions And Answers

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

You're welcome. But I think it's important to recognize the perspective that you have over time. And again, now is leading up Experiences and Devices that includes Office, Devices, Windows client, new experiences and technology and enterprise mobility management. I mean these are things we touch every day. These are part of all of our lives.

Can you give us a sense of your journey over the years? I don't want to say all those years. But you clearly have seen a lot of Microsoft in that time.

A - Rajesh Jha {BIO 20129196 <GO>}

Yes, sure. I mean, it's been a privilege to be on this journey. I came to Microsoft straight out of school and have worked with now all the 3 CEOs, Bill and then Steve and, more recently, with Satya. And my experience mostly has been on the enterprise side, though, I have also worked in consumer products. And I would say, the most formative years have been in the last 10, perhaps even 15, where we started on this vision of productivity in the cloud. Even though the Office 365 journey, of which I was in a very early member, started about 10 years ago, Bill had really pushed us to think about productivity in the cloud. We had a project called (mad docs) about 15, 16 years ago. And some interesting technology came out of that. We didn't take it to market. So I've been on the cloud and what does productivity really mean in the world of the cloud for the last 10 or 15 years. And so today, I -- beyond just Office 365 and productivity and collaboration, I have Surface and I have Windows client, I have management, security and compliance. So really thinking about the modern workplace for our customers.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Excellent background. And maybe to speak more about the cloud tailwind. Over the last 5 or so years, the company has undergone a significant shift. And it's proven to be a significant tailwind for Microsoft as a whole. And Microsoft's really embraced a more collaborative relationship with competitors and open source of like, things that, I don't know, a decade plus ago we may never have imagined.

Can you talk about how your group specifically has evolved during that time? And what that means for connecting with customers and sales functions, all the way down to your engineering and product teams.

A - Rajesh Jha {BIO 20129196 <GO>}

No. It's a great question. I mean, I do think that the cloud has enabled us to really rethink the way we build products. From an end user perspective, if you go back five years ago, we were very application focused. We used to think about mail and calendar and office and collaboration and real-time communications. Today, we start with a very strong sense of the user at the center.

All of us live in a world surrounded by devices, surrounded by applications, working in multiple platforms. And so we started the user at the center. And then we have this notion called the Microsoft Graph that encapsulates the users' goals, their projects, who they work with, the documents they work on, the devices that they use. And so we start with that as a core. And then we build our applications, whether it be Office or Teams or video with stream, we make them work cross-platform.

Then finally, for the Enterprise, we think about management, security, compliance and identity and knowledge management. So that's the vision, starts with the user at the center. And it goes from there. Whereas in the past, it really was around application silos.

So if people ask me what are we doing, how does this help users, it helps because no matter what application you're on, no matter what device you're on, we

understand your context, we can be intelligent on your behalf. So that's definitely the user-centricity.

The cloud has also helped us to be much more customer-centric in the pre-cloud world when we had packaged software. We used to build stuff for multiple years, hand it to customers. And too often, the customers would, because our products are mission-critical, they would take multiple years to deploy it. And so the feedback signal for customers would often be years and years after we initially built a product. Now we get to co-develop with our customers. So when we build new security capabilities or new knowledge management, we have this Project Cortex that we talked about last month, which is how do you lock/unlock the enterprise intellectual property and connect people to people and projects and skills. We are co-developing that with customers.

And now my product team today takes full accountability, not only to build stuff, ground in the customer needs. But how do we help customers be successful in deploying it.

So I run a team called a Fast Track team. That's part of the Office and the Microsoft 365 team. These are engineers who work with customers. We fund it to help our customers get to deploy. But deployment isn't enough. So we work with our counterparts in sales to do -- to help customers successfully deploy this value through customer success managers. So the entire life cycle, ideation, deployment, adoption feedback.

Now it's meant changing our sales, too, where our sales force now has to be much more outcome-driven, much more about the business value and less about licensing. We are -- our sales force is increasingly starting to think about role-based productivity. They're starting to think about industry relevance.

And on the partnership front, our customers are going to use multiple vendors, multiple solutions. And you've seen us work with Apple and Google when we build our applications on their platform. And of course, I think you've seen the recent announcement from Salesforce and Adobe on how our clouds connect where it makes sense. And we have a rich API through the Microsoft Graph that allows other ISVs to connect to it and add value to customers. So yes, it's been quite the journey. I mean, the cloud has really accelerated the rate at which we're able to deliver value and see our customers realize that value than in the business model, the delivery model of the past age.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

A quick follow-up in terms of the development process and development team. It would seem that the cloud and other factors have served to compress the development life cycle today, where things are so much more iterative and having a -- so much more of a collaborative design and iterative process. I mean, this is a very different model than maybe 5 or 10 years ago.

A - Rajesh Jha {BIO 20129196 <GO>}

I completely agree.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

It's obviously in the end for the benefit of your customers. But just in terms of how you run the organization and think about engineering, how does that change the world and the way that you go about it?

A - Rajesh Jha {BIO 20129196 <GO>}

That's a great question, Brad. I mean, culturally, it was a big transformation. When innovation has a long lead cycle, what you end up having is lots of functional depth because in -- what I mean by that is you have a product management arm and an engineering arm and a consulting arm and a sales arm and a support arm because there's such discrete life cycles in the value delivery chain.

But when you're in a faster pace, these start to compress. So my customers today on the cloud, they don't care if their issue is a product issue or was it a support delivery issue or was it a misconfiguration during deployment. They are buying a service from us. And so that forces us internally to be much more cross-functional in how we work and work in a much tighter loop. Whereas in the past, the collaboration between the different functions was really not a core scenario, now it is the core scenario.

My engineers are on-call now. My engineers talk to customers far, far more than ever before because they must. And actually, to be perfectly honest, they won't have it any other way now. It was a big shock in the beginning. But I think any time you make the innovations cycle 10x faster, every process that we have, every process that any organization has, has to be completely rethought. And we've gone at least 10x faster in terms of the innovation, if not, on that order of magnitude.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Excellent. Can we dive into some of the products?

A - Rajesh Jha {BIO 20129196 <GO>}

Yes, sure thing. Yes, of course.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

So earlier this year at your Build conference, Satya talked about Microsoft 365 as the world's productivity cloud. Why are we hearing so much about Microsoft 365 lately?

A - Rajesh Jha {BIO 20129196 <GO>}

Our vision with Microsoft 365 is to really have an integrated service that powers a modern workplace, that powers modern education, that powers a small business, nonprofit. And we want to bring the same vision to consumers we always have. And

let me just talk a little bit about what our investment pillars are for Microsoft 365, maybe that will help concretize it.

So first, of course, is the delivery of productivity and collaboration services, whether it be Office or the newer services like Microsoft Teams, Microsoft Stream. So that's where the users work together to generate together, to collaborate together, to communicate together. Another investment pillar for us is how do we take these systems of engagement, which is Office and Teams. And how do we help people automate their business process, connect to their business process. How do we take systems of records and connect them to this systems of engagement?

So we have a lot of thrust on automation and business process connectivity with Microsoft Teams and Power Apps. Then from an enterprise perspective, it's about securing, complying with the regulations, managing your real estate, managing your data, identity. So that's kind of the investment pillar for us.

But in the end of the day, as the digital transformation is just picking up speed. But it's still early days, the most important database for most organizations to this graph of people, their skills, where they work on, the project. How do you connect people to these relevant business process? How do we get them in the context with their colleagues who have the right skills? How do we connect them to the relevant projects? The knowledge management is another core thrust for us. So that is Microsoft 365.

Now to be honest, about 2, three years ago, what it was, was a licensing construct. It allowed our customers to buy Office 365, management and security and Windows 10 as one construct instead of 3 products. Here you had 1 licensing construct. But now, today, it is an integrated product and increasingly so.

If I'm an end user and I'll launch the Edge browser and I do a search on the browser. I should -- the search of my enterprise knowledge, the search of my documents, search with the Internet, should all be the same search well, the same natural language interface, should work across all of that data.

Today, from a security perspective, the signals that come out from my endpoint, the signals that come out from my IoT, the signals that came out from my applications, our identity are integrated. No longer do we have 3 threat protection stories, we have 1 Microsoft 365 threat protection. It's integrated from an admin perspective, no longer do you have to go administer the different apps and different workloads. It's a Microsoft 365, you go to admin microsoft.com. It's a one way to administer itself.

So Microsoft 365 is really an integrated product or service that underlies the dial tone for modern work, from communication collaboration to automation, business process, connectivity, knowledge management and, of course, security management.

Now financially, of course, as you would expect, customers who buy into our vision of Microsoft 365 tend to use more of our services. They tend to have higher revenue per user, they churn less. And what we offer to our customers is integration, best-of-breed. But also integrated well together.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

It sounds like a tremendous value proposition for your customer. If we look at the trends in terms of who's adopting Microsoft 365, what would we notice by industry, by vertical, by customer size, what have you? And what from what you shared with us and what was once a licensing construct or go-to-market bundle to today, which is so much more integrated, what's maybe at the tip of the spear, specific to that demographic, driving the value prop for them and the catalyst to adopt?

A - Rajesh Jha {BIO 20129196 <GO>}

Yes. Today, as you know, with Office 365, we have a lot of customers in the Enterprise are on Office 365. So many of those customers take a look at that service and then we have opportunity now to have them take our management or security or Windows 10 commercial integration points. And so customers like Goodyear, they were Office 365 customers. They are now choosing to be a Microsoft 365 customer. So that's one path that I see our customers

(technical difficulty)

Microsoft 365.

But there are customers who today are using Microsoft 365. The one thing I may not have talked about enough on Microsoft 365 is Office traditionally has been about information workers, the people like us. But with Microsoft 365, we are bringing productivity and collaboration to who we call first-line worker.

There are 2 billion people on the planet who are often the first to touch a patient, to touch somebody on a retail floor or be on manufacturing. And they work with knowledge better than knowledge shifts or how to do a process, how to communicate with colleagues. And so we also see customers broadening their coverage with Microsoft 365 beyond information workers.

So for example, Air France is using that for the first-line workers in the transportation industry. We have Marks & Spencer using Microsoft 365 to get the retail employees connected with the information workers. And they're connected with each other as they use Microsoft Teams, which is a configurable app that brings all the modules together as a means to go do that.

And so that's another path we see. So Office to Microsoft 365. We see broadening of the coverage of the employees that are covered with Microsoft 365. Then we still have customers continue to move at a healthy clip from on-prem to the cloud directly into Microsoft 365, from older versions of Office or Windows.

We are excited about the Microsoft 365 beyond just the enterprise, the SMB value proposition where you give them integrated security, integrated collaboration, productivity is as compelling. And traditionally, with Office, we haven't had that much share in emerging markets. But we are excited about what we can do with Microsoft 365 in emerging markets too because Microsoft 365 has great set of applications in mobile devices. And so there are economies that are mobile-first, mobile-only. And we get to with Microsoft 365 extending to them as well.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

You talked about some of the innovation that's driving this integrated solution already. But I had in my notes to ask you more about how this is driving the combined value proposition. One of the topics, I mean, I have written down was AI and Microsoft Graph to ask you about. But the other was just edge computing. Can you maybe talk about how that is part of the overall design construct and how you guys are thinking about Edge as it relates to the overall proposition for the offering?

A - Rajesh Jha {BIO 20129196 <GO>}

Yes. Sure. I mean, first, let me just talk about the AI part. I'd like -- we go back to what I was saying, which is we are now user-centered. While user-centered, we are no longer about applications. So we are able to compute or deliver AI for you, centered on you, your calendar, your tasks, your projects, your documents. Then different applications will manifest that differently.

So for example, in Word, if I'm in the health care industry, the spellcheck or the grammar check or the critiques know the vocabulary, they know the acronyms, they know the project names in your organization based on the purpose of the graph. So it is giving you AI, contextual to you, your job, your industry, your specific company.

And so today, if you take a look at PowerPoint, the ability for it to recommend so many of the decks that we create so much of the presentations we create are often -- we have some original ideas. We want to take some ideas from some relevant decks, we want to bring it all together. The AI helps you, suggests, "Hi. if you -- we see the slide you're working on. And we recommend what are the documents and your purpose that you have access to may be relevant that you take slides from." And we measure our success in AI not based on how many ideas we gave to users, how many times did they choose to keep our ideas. And that relentlessly gets better and better.

And in Microsoft Teams, for example, if we were in a meeting, automatic transcription and translation. When Satya does a townhall, we have AI that's able to split the video into bite-size chunks. So when somebody is searching for a given topic, they don't get an hour-long video. They get the specific snippet that is relevant to their search terms.

I talked about security and compliance. I think, our unique value proposition on security and compliance, one of the pillars, is the fact that we have 6.5 trillion, 7 trillion signals coming every single day in the graph. Then we have AI that actually really is trying to think about threat and protection on those signals. So AI permeates

in the Project Cortex and knowledge management is all about applying AI to these signals.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Got it.

A - Rajesh Jha {BIO 20129196 <GO>}

So that permeates everything. To your point, Brad, on Edge, the Edge computing. I think we architected that way, both on the Azure Cloud and M365, where we will run compute on the client where necessary. So our models can run on a client when you disconnect it or run the service, where it makes sense to overlay your enterprise models on top of your personal models.

And Office, Office has the ability to both be served from the cloud directly in the browser. But also run as a native application, whether it be on your Windows PC or your Mac or your iOS or your Android devices. So we'll take compute right where ever we get it.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Got it. If I can dig into Office 365 Commercial. At this point, it's a material portion of the total Office Commercial installed base, over 65% at the end of fiscal '19. But seat growth is still very strong at 21% year-on-year, at least the most recent quarter. How should we think about the installed base of O365 Commercial going forward? And how do you focus on migrating those that are still on-premise versus adding new seats and balance those 2 growth drivers?

A - Rajesh Jha {BIO 20129196 <GO>}

Yes. I don't think it's a balance as much as an and. I talked about the seat growth, the seat growth continues to come. I feel our growth opportunity here in terms of going beyond information worker in existing customers. Information workers, connecting them to the first-line workers, connecting the first-line workers to themselves and to the information worker to the business process. That is a driver of future growth in seats and existing customers.

Then with small businesses, I think we have an opportunity to reach our share in small business. And we have a lot of room to grow there. I talked about emerging markets and our ability to have these productivity and collaboration experiences in the mobile devices. We see that as another growth opportunity.

Then in terms of the customers that are still on-prem or moving to the cloud. We continue to have enterprise-grade security and compliance features for them. And we continue to add those. And you've seen recently Bank of Canada has moved over, as a recent example, as a couple of the capabilities they were looking for is now available in the cloud.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Got it. Just to switch topics to cybersecurity. Recently, we've just been hearing so much about security from Microsoft. Obviously, a huge area of opportunity in a large and expanding market. And in fact, in the last earnings call, Satya talked about Sentinel and Microsoft Defender, Threat Protection and over 100,000 organizations using Azure AD Premium. And I recall hearing that Microsoft spends over $1 billion a year on security-related R&D, which is, for context, is more than 2x a significant security company, like a Palo Alto Networks, which is amazing. How does Microsoft think about security today across what is a very competitive landscape?

A - Rajesh Jha {BIO 20129196 <GO>}

Yes. It's a good question, Brad. So let me just start by telling you what we see as the customer context today. First, I feel there's -- today, I was just talking to a customer prior to this meeting. And they were telling me they have over 150 security solutions. And that's not atypical, where if you have these many solutions, it doesn't make you more secure. You have 150 different applications telling you about incidents and alerts and threats. I mean who's going to stitch it together? Which one is important, what do you really look at? And so the fragmentation of the signals, the fragmentation of the different lenses doesn't make you more secure, even as the need continues to grow.

The intellectual property creation, which is really what's happening with the digital transformation, whether it be code or data, whether it be documents, whether it be business processes. That is what needs to be protected. It's too fragmented to be protected today.

Most of the -- I think that one of the statistics I remember was 80% of the content that exists in the organization today is not even classified. So you don't even know what the risk profile is on those things. We're in the early days of this transformation.

The other thing that we see is where the rate of change is incredibly fast right now in our organization. But still the early days where the traditional perimeter is disappearing, the network perimeter. People bring their own devices, there's IoT proliferation. The data generation, code generation of an organization continues to grow.

Then the -- you take a look at the talent that is available with our customers. So actually reason why these signals do drive security, there's a huge shortage of people who can do security incident management, who can do this kind of analysis.

So our vision with security, I would say, first, we want to make sure we build best-of-breed. They're well-known categories, whether it be endpoint management, whether it be (STEM), whether it be identity. We want to be best-of-breed in these core categories. But we also want to be deeply integrated because you go back to the fragmentation. It's not just enough to be best-of-breed. We want to be best-of-breed and integrated.

Second thing is we want to build security close to the data, close to the applications. But we want to also extend that to the fact that there is heterogeneity in a customer's

environment. So for example, data leakage protection is built in the core workflows in Office. But we allow connectors to bring in non-Office data to apply the same policy for data leakage protection. The same thing we do on threat protection. So built-in. But extensible.

The third thing, which I feel is like, I was saying earlier, we have 6.5 trillion signals every single day from identity, from endpoints, from applications that we can run cloud-scale AI on. And so again, with connectors, we can have customers bring their other signals into this graph that we can reason over.

And finally, we are not going to solve it all, our customers are going to have multiple solutions. So we have something called the Intelligent Security Graph, where we allow customers to plug their other signals in, others ISVs. We have over 50 partners today that enter off with the Security Graph.

So we are taking a holistic look at security. But I would say, security is just one dimension. There's security, then there's compliance. And by compliance, I mean privacy, I mean insider threat risk management. 80% of big breaches tend to be insider risk, insider threats rather than outside in. And so how do you classify data, how do you then protect it, how do you overlay the right policies. So security and compliance. And of course, identity is a core plane that enables these things.

And finally, management and security have to integrate, too. Because if you get signals from the securities, the security signals tell you about some exposure across a vast range of the devices, the enterprise, the management plane should be able to take those signals and how to remediate those things. So we have an expansive view.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Rajesh, a half hour goes by pretty quickly when having an interesting conversation. I want to sneak in 1 or 2 more quick topics here with a few minutes left.

A - Rajesh Jha {BIO 20129196 <GO>}

Yes.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Just in terms of Teams, Teams has seen significant success with deep integration with your office products. And you're now larger in daily active usage terms compared to your main competitor, what's the end game here and why is collaborations so important?

A - Rajesh Jha {BIO 20129196 <GO>}

Maybe 10 years ago, the atomic unit of productivity was what we, as individuals, could go do. Not true anymore. The atomic unit of product right now is group. None of us do anything meaningful just by ourselves. We do this in the context of working with others. So the Microsoft Teams -- our vision with Teams is like a meta operating

system is (fish). It's something that is centered on a group and the applications come to the group, the right applications come to the group.

Today, the way we compute is we -- whether on your phone or your tablet or your desktop, you pick an application, you're trying to get your job done there then you collaborate from within the application. You jump from applications to applications. The Teams' vision is you go to the group that you're trying to do a project on, whether the group is -- an org group, whether it's a project group. And then the right application should come into the group. So Teams, we think of that as the shell that brings in chat, that brings in meetings that brings in telephony, that brings in Office, that brings in third-party applications, that brings in business process. Because if you take a look at the UI for Teams, you can extend, just like the browser-over-the-tab metaphor, you can bring external applications, the right applications for the right group. And that also carries over to the mobile device.

The mobile device, today, an IT can configure what module -- say, if I'm a first-line worker in Marks & Spencer, perhaps the application that show up in Teams, that shell -- if Teams is a shell, I have chat, I have my scheduling module, I have the module that will take a look at my task list. But I don't need to see the meetings module. The Teams is like a shell that brings productivity oriented at a group.

Our vision with Teams is it's as applicable to information worker as to first-line worker. It is about productivity. But it's also connecting to business process. And we are very committed to making Teams a powerful platform that allows third-party applications to connect in, just as we've connected Office into Teams.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Very helpful perspective with just a little bit of time left. We are financial analysts at the end of the day or at least I am. Wanted to ask a question about margins, Office 365 margins in particular. We've heard you talk about O365 margin moving towards steady state with moderating improvement once the business hits low-70s gross margin percentage. Where are we in that journey? And can you talk about the differences in margin structure that serve O365 versus a more typical born-in-the-cloud SaaS offering.

A - Rajesh Jha {BIO 20129196 <GO>}

First of all, I'll just say O365 is born-in-the-cloud SaaS offering. But I have a couple of thoughts on that. First, if you take a look at the scale of O365. I think last quarter, Amy and Satya talked about us having more than 200 million active users. Now if you take 200 million active users, a service that has that many users. And you find a sliver, which is even in our service, the 200 million, you pick some service with 2 million users, its margin profile is going to be different than the margin profile of something like mail or documents where the storage, there's a real cost of the storage. So O365 or M365 is such a broad set of services across so many users, that it's -- I don't think you can compare SaaS services with a couple of million users against that aggregate of usage patterns.

With that, I feel very -- I feel we are hard at work on the engineering side, with our Azure colleagues to continue to drive the COGS down and increase the margin. But there's counter pressure. Our customers are using more and more of our workloads. AI is a resource-intensive investment. But we are ready to make that investment to give value back to our customers.

Now as you know, E5, our premium offering for customers where we have security and compliance in the phone system, we're going to continue to add new value into that with analytics and knowledge management and Project Cortex, that increases the ARPU and gives us higher margins.

So there's a lot of things at play here. Some workloads have a different COGS profile than others. We continue the engineering work. AI and consumption is a counter pressure. Then we have premium offerings that continue to increase the margins.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

Makes perfect sense. With that, I think we're out of time. Rajesh, thank you immensely for joining us this year at the conference.

A - Rajesh Jha {BIO 20129196 <GO>}

It was my pleasure. Thank you.

Q - Brad Alan Zelnick {BIO 16211883 <GO>}

It's been great.

A - Rajesh Jha {BIO 20129196 <GO>}

Yes. Thank you, Brad. Thanks for having me.