

Barclays Global Technology Conference

Company Participants

- Kirk Koenigsbauer, Corporate Vice President
- Unidentified Speaker, Analyst

Presentation

Unidentified Speaker

(audio in progress) part 01. Welcome to the second software session. I'm really happy to have Kirk Koenigsbauer here from Microsoft. Kirk, in a second, I'll let you introduce yourself a little bit more. But I'm reading the first harbor statement, which I'll have my glasses out now. So before we begin, Microsoft may make some forward-looking statements during this presentation and you should refer to their SEC filings for the risk factors relating to their business and that is true whether you are here in person or listening on the web. That's a much shorter one than we (inaudible) actually by the way. I like that.

Kirk, great to have you here. Maybe start a little bit to introduce yourself and then about your role at Microsoft a little bit.

Kirk Koenigsbauer {BIO 5905758 <GO>}

Okay, yes, great. First, thanks for having me, I appreciate it. It's fun to be here. So I've been at Microsoft, I guess, since early 1990s. So the reading glasses thing is relevant to me as well. I had a bit of a sabbatical at Amazon.com for a few years. But I have been at Microsoft since. And I currently run the Office product marketing and product management group. So responsible for essentially our go-to-market strategy, packaging, pricing, all those elements. I had a bunch of different roles in Office and have been around for a while. I ran the Office client engineering team for about four years. So been in a bunch of different parts of our business.

Questions And Answers

A - Unidentified Speaker

Okay. Since you've been at Amazon as well, you mentioned, I spent some time at the (inaudible) Conference last week and 40,000 people that don't fit into some (inaudible) hotels. It was pretty amazing to see just from the cloud team (inaudible). How do you guys at Microsoft think about the whole cloud opportunity? What it does to kind of IT and whole IT landscape?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes. Clearly, probably not surprised. Cloud is a huge (inaudible) for us. We think about the Microsoft cloud as being really a platform for this cloud technology. It has common identity and in terms of this Microsoft graph and a bunch of different components. Of course, there is workloads, like Office 365, like Azure, like Dynamics, like our project Online service. It is the center of the company at this point in terms of our push. Speaking specifically from an Office lens, we really have a very optimistic view of what the future looks like in terms of our growth opportunities. I think, right now, we feel like we've been in this phase essentially of I would call it maybe phase 1 where we were in this -- we've been in this journey of moving our on-prem base essentially to the cloud. And essentially, these are customers that we're fans and using our technology and that's great and certainly not minimizing the amount of hard work we have to go through. But that I feel like has been really the phase 1 approach. I think we're entering a phase 2, which is the cloud offers so much opportunity, both to grow stock and grow ARPU by going after underserved segments. There are segments that we couldn't go after before or our customers even couldn't serve their own users, for example, in emerging markets or people that work at desks all day, they have PCs and laptops, they are mobile-only types of workers, software workers, retail employees, travel professionals. So there's many different kinds of folks that we think about it (inaudible), even small business. The capital of that we require to reach those types of users for productivity and collaboration in the past, it was just too expensive, too complicated. But in this cloud and mobile world, we're able to reach into those new segments. And so, we think there's quite a bit of opportunity ahead.

A - Unidentified Speaker

I mean, if you think about the issue for the legacy voice is always (inaudible) to make that transition into the cloud and first to realize there is something important and then kind of take the right step, the altered stories are real success story in that respect. Can you talk a little bit about the journey there and then you (inaudible) start to kind of elaborate a little bit on that one like -- so where do you start thinking about it like what you have to do to make it kind of happen and then you started to talk about (inaudible).

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes. No. The journey has been a really interesting one and I remember our first customer, Energizer. Essentially, the conversation went along the lines of "Hey Microsoft, we think you'll do a better job of running exchange and share points than we will". And frankly, we want to put our effort, our resources into differentiating our own products and our own services and that sort of started this thing called the BPOS, the business productivity online suite. And I think last quarter, we announced what we feel are some -- we're really proud of the results, 85 million active users commercially of the service, over 50 million people using our mobile apps on iOS and on Android, license growth, usage growth of 40% year-over-year. So it's been good. I think that it has seen a lot of work, kind of bunch of different dimensions. I mean, there's no question, it starts with product value. And so we recognized early on that we had a well-established brand, a trusted brand with a notion around collaboration productivity and so we thought, okay, great and got that. But we also recognized, particularly in the social space, that hey, if we're going to really drive hard, we're going to have to invest in the infrastructure to make it really enterprise

grade. And so we focused early on with the customers, with regulators, with lawmakers to really understand what it takes to build a truly hyper-scale, global, compliant, secure infrastructure. And I think that's been a very, very important part of our differentiation over the last years as companies have moved to the cloud. Every customer I talk to wants to talk about digital transformation. They want to move with a trusted partner. I think that's benefited us immensely. And so, with that sort of the humble beginning with the product, I do think there has been other work too that has been really, really important. We had to reboot the GTM. It's one thing to go sell licenses to customers. But then get deployed through IT or through partners, it's different in a service relationship. And so whether it's retooling our sales force, whether it's building out the partner ecosystem to be able to sell our cloud products and services our cloud products. Being a subscription company is different. When you just sell licenses and again you're sort of a bit of an arm's reach to the customer, now we have to think about churn and renewal rates. And we have to think about like for every single customer in their channel, what's the LTV, what's the CAC associated with it, what's the most efficient way to go to market. So we had to really think differently about that piece. Then, I guess I just the last big chunk of the journey has really been retooling our own product development process. And so gone are the days of -- these sort of three-year long drawn out product cycles. We ship much more rapidly, we've re-architected our products, we've changed our build systems, our deployment systems. We literally have new roles that we didn't have four, five years ago. And the efficiency that we have now and the agility, the feedback with the customers, it's just so much more tight than it's ever been. And so, those are some of things I guess I think about when I think about this journey.

A - Unidentified Speaker

Okay. The other thing like -- look, I'm a financial analyst. So I apologize for the questions in advance. If you think about it, we want to bring it down to numbers again. If you think about the opportunity around office, can you talk a little bit towards the number of seats that -- you mentioned how many seats you've filled already around the subscription like. But what's the total opportunity for you and me to differentiate between commercial and consumer a little bit?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Okay. Yes. No. I think we don't actually quote specifically for Office 365 numbers. We do provide guidance typically every other quarter on monthly active users. I mentioned the 85 million. We did grow licenses year-over-year 40%, as well as the usage growth. So we feel really good about that. For me, this comes down to p x q sort of a question in the sense of -- and I talk a little bit about some of the queue. We do feel this continuing to (inaudible) opportunity. With Office 365, of course, there's more on-prem to cloud that we feel like we have to go through. But we also feel like again, opportunities in emerging market, opportunities in small business, opportunities serving customers we've not served for the desk-oriented workers. We think there's a big opportunity for us to expand our stock base. And so, we're bullish about that. Work to (inaudible), we're bullish about it. Then on the pricing side. And this is something we've been doing really since the beginning of the business productivity Online Suite, the first versions of Office 365. There is opportunity to continue to drive mix shift. And so I think about it from the perspective of originally, when we first started, we feel a lot of (inaudible) essentially with exchange online,

that was the predominant workload that people were moving into. But now, we sell the suite of Office 365. We have this plan called E1, which is the certain base level collaboration capabilities in our web-based versions of Word, Excel and PowerPoint. We introduced this thing called E3, which was a really great mix shift for us. We really recognize a lot of the ARPU benefits in last 12 to 24 months, I would say. That product includes some higher in value on the collaboration side, things like discovery capabilities is just one small example or archiving. But there also we introduced the Office Client in that package. And customers love the notion of getting the office client in a per user model, one that will work across platforms, one that was always up-to-date like their traditional cloud services and so turning Office Client into a cloud service was a big driver in ARPU growth for us. Then, we have this new tier that we introduced just about a year ago. We call it E5. And there's a bunch of different workloads there where we feel like with these advanced workloads, we can continue to drive again a premium mix shift. And you ask for a number, I mean, all of our premium skews, we're at about 60% mix right now. And so, it's really fantastic to see that side of business doing well as opposed to just socket expansion.

A - Unidentified Speaker

If you think about different skews and where the customers are sitting, is there like -- do you think it's going to be like you try to push everyone to E5 or it's going to be E3 or is going to be one way you want to see most customers and E5 is going to be like for some that you can have one more functionality, how do you think about that (inaudible) SKUs?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes. Well of course, when we do our account planning, every customer is a little different. But at a really high level from a general perspective, we start with E1 again as a sort of real value-oriented highly competitive pricing, making sure that we feel good about that offer in the marketplace. Then, stepping up to E3, it has its differentiation around the Office Clients and advance workloads and that sort of super valuable. Right now, I would say E3 is s our hero SKU. It's the one we lead with the most. And it's the one -- there was always a question, long-term vision around E5 most recently. And there we got these new advance workloads. And E5 really has a value proposition on three core pieces. Those are the hottest, I would say, the one that's getting the most amount of attention from customers right now, not surprisingly, its security. We can't have a conversation and not talk about security and whether its advance threat protection, the work we're doing with this thing called customer lockbox against discovery. There's a bunch of really great capability there that the customers are super interested in. Another work we have in E5 is around the analytics. And so Power BI is sort of a hero product that we have there. Power BI Pro, I should say. And then we also have this product called Mind Analytics, which really is an interesting learning and artificial intelligence to create these personalized productivity dashboards for customers. Then, there is a third workload around voice, voice services. And so, we're literally moving PDX into the cloud, a full multi-tenant oriented solution, great value proposition to customers from a cost and from a productivity perspective. Then, there is PSTN services around PSTN conferencing and PSTN calling services that can be added on to E5 as well. And so we feel really good about what the value proposition looks like. And we'll keep pushing upwards with the customer base.

A - Unidentified Speaker

Yes. And just switching gears a little bit on the consumer side, like how do you think about the whole situation there?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes. We haven't talked much about consumers. We feel really good about the consumer business as well in the sense that we similarly how we feel like we've been able to make this transition to the cloud and commercial, it's happening in consumer as well. And so, we announced in the last quarter just over 24 million active paying subscribers, which is great to see. There too, we have this notion of sort of a lower cost value SKU that we push called Office 365 Personal. Then we step up customers to a product we have called Office 365 Home, which you should think of providing essentially sort of family right, a terabyte of storage for every single person of the five in the family. And so, there is a bunch of step hearing that we do there as well. And so, again, we feel like we're transitioning that base from buying office with the PC device-oriented license to now being in the subscription business.

A - Unidentified Speaker

You mentioned earlier, the emerging markets as a big opportunity. How do you like to think about it, like on the one hand, I think like repeat connectivity might not be that good. So with that kind of more an office on-prem-type license. But you sound like you're actually more excited about it from a --?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

I'm definitely excited about it in the sense that I think similarly to what has happened in sort of develop markets, there is no question that the cost of connectivity is still expensive in emerging markets. But increasingly, big cities, big companies, you can expect it. And so more of a commercial statement I think I'm making here in terms of where we see the opportunity. But there's a lot of big companies in these emerging markets. There's huge populations (inaudible) two weeks ago. And you go to place like the Philippines and you're just blown away by the opportunity that's there, large population, GDP growing quite rapidly, 7% I think. And we see a bunch of opportunities. Those customers are now thinking, okay, it isn't the question of I'm going to move to cloud, it's when I am going to move to cloud. Well it may be behind developed markets or what we see here in North America, generally speaking, there is a lot of opportunity there. And so, we're quite bullish.

The other thing, I guess, I would mention is related to that is this notion of mobile-only customers, particularly in emerging markets, we think it's interesting. And there, I think, we have holistically due to a hole in our value proposition. But there's no question that we're going to be there and we see it as opportunity.

A - Unidentified Speaker

Yes. Okay. Shifting here again a little bit. You mentioned earlier artificial intelligence. It seems to me like the new password for every vendor. Last year, you had talked

about reimagining productivity, like how do you think about artificial intelligence? How does that fit into that overall scheme of reimagining how we work?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

You bet. Yes. It's a big focus for us and has been for several years. I think I actually credit Dr. Chivu, who came to Microsoft, the first (inaudible). And also was responsible for the Office business (inaudible). He really pushed the Company around many, many years ago. And we've benefited from it, I think, on the Office side in terms of not only insight. But for us, we think about artificial intelligence, machine learning around much of intelligence features and their capability. And I think there's a bunch of opportunity, whether it's helping you streamline your email box, which is cluttered and overcrowded. And you can use machine learning for that, whether it's helping you literally automate task and create content, like I talked about some of the work that we're doing there, whether it's around discovery of people and content and information, it can be a great (inaudible) sort of a vehicle. And so, it's a very important part of our value proposition. I'll give you a few examples. We just launched, a few months back, a feature in PowerPoint, (inaudible) PowerPoint called PowerPoint Designer. And literally, it'll take your presentation and it will make it beautiful, like having a designer and lighting the box. And it looks at your content and just templates. It does things like cropping pictures for you. It's a (inaudible) sort of blow you away sort of things, when you see it in action. I wish I could come on to your guys there. But it's a really great one. On Word, we've literally revised the grammar and spelling checking capability. But now, we're using machine learning around natural language. So literally, how people like better changing from, say, passive voice to active voice, being more inclusive. We will give these suggestions, not only to be a better writer so that when people go read your stuff, they can read it more comprehensively. Excel, we're using artificial intelligence, machine learning in Excel. We're using, for example, sentiment analysis tools actually as a service that we wired into Excel. There's some many examples. And by the way, it's not just end-user pieces, too. Machine learning and artificial intelligence, we use it for our security workloads as well. We believe it's a reason over threats and patterns and have a much more rapid response to be able to update our capability to protect our customers better. So there are many, many, -- it's a part of the life blood of what Office 365 is.

A - Unidentified Speaker

Yes. The artificial writing will probably need extra (inaudible). Just talk a little bit towards how Office and Office 365 kind of fits in with kind of the other big areas, Windows and Azure, like, how do you kind of interact with those two big parts of (inaudible)?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes. No. Increasingly, it's just so important those customers are -- of course, there's going to be heterogeneous environments. The customers (inaudible) and largely angling towards back-oriented solutions. And there is a bunch of different ways. For example, we (inaudible) about, again, as I started the discussion (inaudible) about the Microsoft cloud and so with Office 365, as an example, when a company goes and deploys our collaboration productivity workloads, they're going to want to

protect those workloads. And so (inaudible) services become a natural attachment to that or maybe they want CRM capability and so great, they can attach to dynamics or maybe they want project management, great, they can attach to project online. And so, there's really a lot of opportunity to take a socket like Office 365 and then up-sell other different SaaS-type workloads and other workloads that we have. From an infrastructure perspective, we're building on the Microsoft cloud. We use Azure services in our products. The PowerPoint designer service I referenced, that's actually a service that runs on Azure. I mentioned that Excel example. That's a service that runs on Azure. And so, increasingly, we're able to leverage members of the platform by infrastructure, the data centers and all that. Again, even with Windows, I mentioned we're doing quite a bit of work with Office and Windows, whether it's ink, whether it's better streamlining of notifications in the user experience. But even security. So Windows has a capability called Windows Events Threat Protection. We have one in exchange online also that's one of the parts of Azure. We take all that signal together and by being able to reason across that, we can better protect customers because we have so much input coming in from all these different services. So there's a lot of opportunity.

A - Unidentified Speaker

And you were sitting on Azure obviously like -- where is Azure on that global wallet? Are you kind of global enough (inaudible)? Office is already a global product. Is Azure (inaudible) to help you across the globe?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes. No. We think it's definitely -- we think -- we work very closely with the Azure team to think about our overall data center footprint. And our CFO is, of course, quite involved in those discussions as well, as you might expect. But we definitely think of it as a significant competitive advantage for us. I mean, just take Office 365 right now, we're in 150 markets worldwide. In the next few years, we'll do another 97 markets. We're localized in 44 different languages. When we introduced Microsoft team in early November, which is a new collaboration, sort of chat-based workspace, Office 365. That was immediately available to preview right now. But it was immediately available for millions and millions of customers for evaluation and trial and to be able to experience it. So we definitely think of this as a great share and opportunity with the Microsoft Cloud.

A - Unidentified Speaker

Okay, perfect. I know I only have three minutes. But I can't let you go without talking about profitability and margins. Gross margins, if you look at the scale that you have in Office, you were like a very, very big SaaS company already. But the gross margin seemed to yield a little bit lower than other guys in that space. Can you talk a little bit about factors that we need to consider when we think about profitability or gross margins?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes, no, sure. For productivity and collaboration space, (inaudible) all SaaS workloads aren't the same. And so, there are some that are going to have this point solutions in

the marketplace, there are some solutions that maybe have a heavy storage component, which are going to have obviously lower margins. There are suites like ours. We're offering a breadth of services. And so, I think it's a little bit tricky to compare them. But I would say in the productivity and collaboration space, we expect to be best-in-class. And we think we're actually doing relatively well. We announced a good quarter of growth in our margins improvement overall at Microsoft. And we expect that to continue. With Office, we talked a little bit about the ARPU opportunity to continue to improve our margin. We think there's an opportunity for sure. We also think there's an opportunity just with how we run the business, the notion of being more efficient as we do things like combine the same back-ends for our consumer email service, which, of course, was based on Hotmail originally, we have our exchange online service. Now, it's just (inaudible), it's just one service. And so that's one of the ways re-architecting by bringing these back-ends together, being much more efficient than we can improve our margins. The data center capability as we do go more globally -- grow more global, the capital efficiency we get out of driving 85 million users to Office, that helps our margins overall. So we expect to continue to see some growth. We think it'll be a little bit lumpy quarter-to-quarter. But generally speaking, we expect to be best-in-class. And we expect to improve over time.

A - Unidentified Speaker

And go one level down on OpEx, like if you -- I remember, when Amy started, she kind of, at least to me, introduced a notion like you don't have your \$100 budget for the year and you spend it the next, you get a \$105. It seems a lot more dynamic now. Can you talk a little bit about how that's impacting, how you're working in the office space?

A - Kirk Koenigsbauer {BIO 5905758 <GO>}

Yes, sure. There's no question that Amy and Satya, I think, has really taken so much of the company in terms of changing the culture. This is one area of the culture they have absolutely changed, I think, in a really positive way. We're much more agile about how we think about budgeting and managing OpEx. Amy does, I think, a great job of pushing all of us. We have -- when I say agile, I mean, we have a lot more flexibility and a real big push from them to reallocate as opposed to always asking for more. And so, I'll give you an example of that, where we do a lot more example that where we do digital market that we've ever done before, it's highly efficient for us, particularly in the small business and consumer space and also in enterprise to some degree. But literally, we're probably running 10 to 13 campaigns a month. We look at those, we look at the LTV, we look at the CAC, we see what the saturation looks like and every month, we're sort of shifting dollars around to go invest in what we think is going to deliver the highest value. And we don't have to be -- we're not stock on these long-term budget cycles. And I think, she's done an incredible job setting a great culture around reallocation, efficiency, discipline, that we hadn't always had.

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