RBC Capital Markets Technology, Internet, Media & Telecommunications Conference

Company Participants

- Ross MacMillan, Analyst
- Takeshi Numoto, VP Cloud

Presentation

Ross MacMillan {BIO 1994797 <GO>}

(technical difficulty) -- Microsoft to our conference today. From Microsoft, we have Takeshi Numoto. Takeshi is the CVP for enterprise and cloud; he runs the marketing function there. Then in the front row, we have Mat McBride. He works with Takeshi, a senior director of finance in the same business unit. And, of course, the omnipresent Zack Moxcey from investor relations.

And Zack asked me to read a little regulatory blurb. So I will do that. 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's true whether you are here in person or listening on the web.

So with that, Takeshi, let's just start. Maybe we can start with your role. First of all, help us to understand what you actually do in your day-to-day role. And as an adjunct to that, you've been at Microsoft for 20 years, would love to get your perspective on the Microsoft today relative to the Microsoft that you've seen over the last number of years.

Takeshi Numoto {BIO 21693553 <GO>}

So first of all, my name is Takeshi Numoto. I'm the Corporate Vice President for cloud and enterprise marketing. I'm responsible for basically going to market and driving worldwide marketing strategy for our Microsoft application platform and infrastructure services and server products.

So that includes products like Azure as a public cloud service, as well as on-prem server products, such as Windows Server, SQL Server, software tools like Visual Studio portfolio of products, as well as our business applications around Dynamics 365. So I get to work on a wide portfolio of products.

I've been at the Company just over 19 years, not quite 20 years yet. And I started out actually as one of the engineers on Windows NT. I've been around a while. But it's

truly inspiring to see what customers do with technology these days and the transformational impact that it has on their businesses. And it's really an exciting time.

Ross MacMillan {BIO 1994797 <GO>}

That's great. So let's start with Azure. By our math, it's about a $3 billion revenue run rate business. But it's actually accelerating, which is kind of amazing at that scale. And also pretty amazing when you think that probably five years ago this was pre-revenue. So an amazing business --

Takeshi Numoto {BIO 21693553 <GO>}

According to your math.

Ross MacMillan {BIO 1994797 <GO>}

According to my math. So maybe let's talk about the differentiators. We all know that Microsoft is a player here. We know that your friends at Amazon with AWS really kind of maybe were [ph] the catalyst for this market. But let's talk about what makes Microsoft different when you're talking to your customers.

Takeshi Numoto {BIO 21693553 <GO>}

I think that's a great question. Because I think in a lot of the cloud dialogues I see, people focus on specific properties, Azure or Office 365 or each of these individual portfolios that we have.

And each of that is important. But for us one of the key things that we are rallying behind is this whole notion of Microsoft cloud. And when we talk about Microsoft cloud, it's basically the handle representing our commercial cloud service offering. So that includes Azure and all the constituent services underneath Azure, as well as Office 365 and Dynamics 365.

And when we think about the differentiation at the highest level, not at the individual property level. But what does Microsoft cloud do that is differentiated, I think it really boils down to three things. One is the global scale and reach that we offer. So if you just take Azure regions as an example, one region -- when we talk about Azure regions, it's not one data center; it's essentially a logical representation of multiple data centers that are within sort of a network latency such that we can represent it as one logical construct to the customer.

So that's a large-scale thing that essentially spans multiple data centers most of the time. We have 38 of those. And that essentially offers more choice to our customers and partners in terms of how they can deploy their solutions closer to their market, closer to their customers, closer to their company -- partners or their employees. And that's a huge benefit that we offer. And that's -- we think of this as really sort of (inaudible) enterprise requirements, because for us one of the key design points for

Microsoft cloud is that we are really designing for the enterprise and not -- enterprise requirements are not an afterthought.

And that relates to the second point in the sense that the notion of really meeting enterprise-grade requirements, it's something we've had a privilege of working with many, many business customers of all sizes, large and small. And we really feel like we have a sense of going deep with customers and understanding their business requirements and investing in their needs. And is not just about technology. It's about how we engage with customers, how we support them through the lifecycle of their product consumption.

And part of that is really making sure we are helping them be comfortable with the uses of technology in the cloud. And trust is a huge element of it. And so, we've had a very, very deep investment all sorts of security capabilities, as well as compliance certifications. Everyone [ph] thinks about compliance certifications, we have more compliance certifications than any other global cloud vendor.

So that's not just a horizontal certification, whether you talk about the numerous certifications we have around ISO this, ISO that, as well as soft one, two [ph], also vertical ones like kitsa [ph] or PCI and whatnot. And we have the broadest portfolio of compliance certifications that essentially designed to reduce the increased comfort and confidence in trusting customers being able to use their cloud. And that's really paying off well.

Then, thirdly is really hybrid. When you think about our approach, we know that despite the fact that we have all these reasons giving more choice for customers to be able to deploy their application solutions closest to their targeted areas, we also do not want to build regions in every country and just every geography. And so the whole notion of being able to offer a solution that lets customers essentially use what they have on prem. And almost all enterprise customers have these investments on their on-prem assets. And building both a technology that's really deep and comprehensive. But lets them use what they already have on prem with the things they can do in the cloud. And taking that as synergistic copacetic sale is something that we feel like we are uniquely positioned to do because we not only provide a cloud service. But also deliver software that customers can use on premises.

And so, that enables us to go beyond just hybrid in the sense of just narrowly connectivity. Oftentimes, how we get talked about is it's just a connectivity thing where you connect on prem to the cloud. But it's so much deeper than that. Oftentimes, maybe if people talk about infrastructure, because hybrid in the sense that you may be able to move storage around or compute around.

But for us, hybrid is far deeper than that. It's really a platform consistency. So from the productivity, like Office 365, all the way down to things like application platforms and data platforms like SQL, identity management like -- all of that is baked in where we actually have a very deep hybrid all the way down from infrastructure, all the way

up to the application layer. And we feel like that's something that's really resonating with customers. So those are the three things, global, trusted. And hybrid.

Ross MacMillan {BIO 1994797 <GO>}

And just on that last point, it kind of dovetails a little bit with your commentary around higher tier services, because that's been a big message from Microsoft, which is as you think about the evolution of this Azure service, it's about continuing to add incremental value up the stack.

And I was just curious. When we think about a customer journey on Azure, is there a way for us to sort of think about how this is typically approached, where the customer starts. And if we look to some of the customers that are more advanced on the platform, where are they going with this?

Questions And Answers

A - Takeshi Numoto {BIO 21693553 <GO>}

I think there is a consistent pattern we see in the customers' journey to the cloud, regardless of their entry point. And what I mean by that is different customers start with the different assets of the cloud.

Some customers start with essentially consuming our SaaS services first. So they might go deploy Office 365 or they might deploy Dynamics 365. And that's their first entry into cloud consumption. Some cloud customers start with infrastructure. Okay, I want to drive some storage into the cloud or move some virtual machines into the cloud. And it's kind of an infrastructure-centric approach.

Or a third (inaudible) essentially customer saying I want to essentially do net new things in the cloud. So I have an on-prem investment, I'm going to continue to harvest it. But for net new applications, particularly the ones that extend the capabilities that I already have on premises, perhaps through to the Web, through to mobile devices, cloud provides a great leverage point to be able to do more of that. So think about it as application modernization, that new applications. And those are typical three entry points customers start using the cloud.

But the common pattern we see is no matter where you start amongst the three entry points, you end up needing all the elements, from SaaS to infrastructure to higher-level services. Whether it be machine learning or whether it be face detection or voice detection and things like that, the application and the cloud consumption patterns basically become increasingly more sophisticated and the customer needs a vendor that essentially addresses all the portfolio needs that they have for their business.

And this is why I think, again, sort of we feel we are very uniquely positioned with not just Azure. But the Microsoft cloud approach and being able to offer all the things they need in their journey to the cloud. And that includes also things like

management and security capabilities, or advanced analytics or data level -- data services that you would probably classify as higher-level services.

A - Ross MacMillan {BIO 1994797 <GO>}

The other thing is you've embraced open source in a way that Microsoft historically has not done. And you've made comments that as much as 30% of the workloads now, I think, are running on a Linux OS as opposed to a traditional Microsoft Windows OS. How important has that been for the messaging and how important is that to customers when you consider Azure?

A - Takeshi Numoto {BIO 21693553 <GO>}

I think it's been a huge boon for our cloud business, frankly, because we had become really clearer around our sort of core goal of all around driving Azure consumption from our end in furtherance of customers' business transformation in the cloud.

And so, of course we continued to invest heavily in our software IP assets. And it's great when customers use our software on top of our cloud. That's kind of the best combination from a software purview. But we are basically, more than any of our particular individual product goals, essentially driving cloud adoption. And helping customers transform their business by their broad consumption of cloud is our primary goal. And so in order to do that, we really deeply embrace the notion of basically all we want [ph] pursuing in kind, all IT pros (inaudible) kind so that they can bring their skill sets and consumer cloud based on the skill sets they already have.

So we invested heavily in not just the operating system where we support all Linux variants. But also a lot of open source-based frameworks, whether it be at the database level or the language level, you name it, low dev [ph], Python, PHP. We've invested deeply in being able to recruit developers of those skill sets being able to productively use Azure. And like you said, over one-third -- over a quarter of our Azure VMs and over one-third in some regions are running Linux (inaudible) in our cloud right now. And so that's a huge (inaudible) from our standpoint that's very exciting for us in driving new growth.

A - Ross MacMillan {BIO 1994797 <GO>}

Yes. It's about let's ingest the workloads regardless of the platform. And that's a good thing for Microsoft.

A - Takeshi Numoto {BIO 21693553 <GO>}

Yes.

A - Ross MacMillan {BIO 1994797 <GO>}

So last thing I just wanted to touch on Azure. And this is maybe a little esoteric. But there's something that Amazon has done. I guess it's called this nomenclature of services -- serviceless computing. They have this function lambda. Microsoft has something called Azure functions.

And we hear more about this. And I just wanted to spend a minute. Maybe you could just talk to us about what that is and why is it getting airtime? Why is it becoming something that we are hearing about more in the market?

A - Takeshi Numoto {BIO 21693553 <GO>}

Well it's basically what you sort of talked about as serverless compute, basically to where you're not essentially not having a server running all the time that may be idle. But actually being able to have that compute capacity on demand when something is invoked, a message comes in or signal comes in. So that then it does the right processing at that time right here and there. And then it actually shuts down once the job is done.

That's kind of the whole notion, whether it's lambda or Azure functions. That's just one -- another element of essentially cloud computing bringing more efficiencies into overall compute. If you think about the overall journey, you started with basically bare metal servers. And then you would virtualize them. That means you can actually virtualize and essentially pack more virtual machines into a given hardware box so that your overall hardware utilizations are higher.

So this is kind of another way to take it to the next step. But it won't address all customer scenarios. At best, you have to have sort of a fit for -- it's a purpose fit thing that you wouldn't initially use in every scenario. But it's certainly one of the scenarios that extends the cloud computing efficiency and something that we offer as Azure function as well.

A - Ross MacMillan {BIO 1994797 <GO>}

So boost efficiency from a vendor provisioning standpoint. And also from a customer standpoint. You are not prepurchasing compute capacity; you are not buying, if you will, reserved instances. You are just basically putting the app out there and it will consume what it needs as and when those demands arise.

A - Takeshi Numoto {BIO 21693553 <GO>}

Exactly. Yes.

A - Ross MacMillan {BIO 1994797 <GO>}

So let's talk a little bit about Office for a minute. So 85 million active users on the commercial Office 365 product now, really impressive. And the other thing that's really interesting is you see growth still at 40%. And I guess one question I have is, is it clear that Office 365 is actually driving new users to the platform? You held an analyst day maybe a year and a half ago where you talked about unit growth within the Office franchise. So I'd love to just talk about that for a minute. What is Office 365 able to do in terms of attracting new users to the platform for a product we think of as pretty mature?

A - Takeshi Numoto {BIO 21693553 <GO>}

Yes. The background, right, is actually I've been in this current role for about four years. And before that, I actually got about eight years of working in Office, including actually launching Office 365. So it's been great to see (technical difficulty) now that I'm in a different role how Office 365 is being -- just growing and seeing tremendous success with customers.

And you're right; 40% see [ph] growth and actually representing, I think, 56% revenue growth. So it's not just see growth. It's actually driving average revenue per customer up as well as we are growing.

One of the phenomenon's that's really encouraging for us to see is that the Office 365 momentum is actually resulting in increasing our install base for Office. So this isn't just pure substitution; it's actually adding to the overall install base of Office. So it's having a great impact.

And not only that, we are actually then moving from just selling pure essentially desktop applications, like Word, Excel. And PowerPoint, to actually selling a service that includes email, that includes collaboration so that you're seeing that reflected into essentially the upper uplift. So we are seeing install base increases and an upper uplift. So it's great to see.

A - Ross MacMillan {BIO 1994797 <GO>}

And you've been driving these higher tier SKUs, if you well, E3, E4, E5 now. And as you offer these, you're adding more whether it's business intelligence capabilities or unified communications capabilities. Is this something we should expect as a sort of -- is there a path, if you will, that we could see more and more value, higher tier SKUs. And we sort of, if you will, sit on a continuum of sort of higher ARPU over time?

A - Takeshi Numoto {BIO 21693553 <GO>}

I think it's a logical thing for us to continue to think about. Like if you think about the transition that we've been on for Office 365 from essentially a traditional license business where perhaps the highest economic case from a lifetime value standpoint is to take a transactional customer that may have bought a license once every few years to the subscription relationship. And that certainly increases the way that we can deliver value to the customer and therefore increases the lifetime value of the customer.

Then once we do that, we certainly also want to increase the aperture value that we deliver. So whether it be going from just pure desktop set of applications to that plus collaboration and communication. And then, okay, that's certainly seeing see growth and ARPU growth, like I talked about. And the next step is to continue to drive that. It's logical for us to say, hey, what are the additional values in the subscription relationship we can add.

And right now, I can't talk about what's the next. But right now we're really excited about the opportunity we have around this Office 365 eply [ph] offer, where certainly you are really seeing a lot of residents from customers on the security value

proposition that it represents. And we are also really liking the fact that that also lets us -- the offering essentially positions us to participate in additional adjacent market opportunity areas, like business intelligence or voice.

A - Ross MacMillan {BIO 1994797 <GO>}

And just on security, obviously in the last couple years there were a number of acquisitions that Microsoft did in the security domain. Maybe at a high level you can help us understand how you're weaving new security functionality both into Office and into Azure and into the on-prem products. It feels like that's become an elevated part of the strategy.

A - Takeshi Numoto {BIO 21693553 <GO>}

Absolutely. Particularly as we work with customers to help them take advantage of the cloud, security is a huge issue that we want to make sure we address.

And one of the things we are very focused on is to essentially drive security as an intrinsic part of the workloads we deliver. So not thinking of security as kind of a bonus [ph] product to the side. But security as infused into the additional capabilities for Office 365, security infused as an intrinsic value proposition of Windows, security as infusing to the part of how you manage mobile devices through EMS.

And so, we are seeing tremendous amount of success across our product portfolio whenever we infuse a security value proposition into the workloads that we go to market with, whether it's Office 365, whether it's MS, or Windows with mass [ph] threat protection.

Then, we are essentially also making it easier for customers to sort of secure their employee base across the board with this offering called secure productive enterprise. So then we make it super easy for customers to have one transaction to cover all their employees with, whether it's the security technologies in Windows, security technologies baked into Office 365, or across devices with EMS, enterprise mobility suite, which grew 85% (technical difficulty) tremendous amount of success.

So that's kind of how we are approaching it in terms of infusing security deeply into the workloads that we deliver and essentially making sure that they work seamlessly across.

A - Ross MacMillan {BIO 1994797 <GO>}

Is it monetized or is it just you are, as you said, infusing that into the product portfolio and so it becomes part of what you offer?

A - Takeshi Numoto {BIO 21693553 <GO>}

Basically, it's -- a lot of times it's part of the higher editions of the offer. The security is always one of the things where we want to make sure even our baseline products is secure. But you want to be able to layer on additional value propositions from that perspective.

And so, Office 365 E5 is one let way of layering on strategic value proposition on top of the base Office 365 workload. And we have Windows enterprise that essentially also delivers additional enterprise treatment (technical difficulty) additional security capabilities on top of what you would get on your Windows subscription, as well as EMS essentially that lets you deliver mobile device management and mobile application management across devices to be able to deliver security capabilities there. So you can think of it as essentially value propositions that we are both infusing into the product. But also layering on top of those workflows.

A - Ross MacMillan {BIO 1994797 <GO>}

Great. Just the last thing I wanted to touch on, because this was an announcement just earlier this year, was on the Dynamics 365 business. Maybe at a high level you can just talk to us about what that is, what's different about Dynamics 365 versus Dynamics. And what is it from a customer standpoint that they would look at that and say this is new, this is something that we didn't get from Microsoft before?

A - Takeshi Numoto {BIO 21693553 <GO>}

We are taking a different approach with Dynamics 365 from the traditional way that bizapp, I think, vendors have gone to market, which is sort of the segregation of different functionality and business processing to pieces. So there was sort of a notion of a CRM versus an ERP that was separate.

But that separation is largely sort of a vendoring use notion in the sense of from a customer standpoint, they want to be able to have a solution that goes from leads all the way to cash and order fulfillment. So basically with Dynamics 365, we've essentially unified our traditional what used to be a CRM and ERP offering into one cloud service that goes across the entire business office from leads to order fulfillment all the way down.

And at the same time as unifying it, we've also made it very modular and purpose built so that you don't have to buy this monolithic mixing [ph] end to end. But can start with any one of the business processes you want address. So if you want to start with just customer service, you can do that. If you want to just use us for field service or process service automation or our customer sales automation, you can just get going, knowing fully well that it's essentially future proof for future expansion to address more applications and business processes as you move forward. So that's kind of a very different approach than we are thinking from the marketplace.

And we are also building it on top of all the goodness of Azure and all the capabilities, higher-level services, that it can take advantage of. So it's infused with what we would think of as intelligence capabilities, whether it be things like essentially building a model for each of the customers that use the product to do things like an inventory stockout alert, or being able to do your relationship helping your customers' sales automation so that depending -- regardless of what the human judgment is on the ability to close this deal, we can actually say, hey, this deal really is going to close based on that relationship help that we observed in the customer engagement through our system.

So you can think of it as infusing business -- connecting all the business processes across different areas. And then essentially letting customers start wherever they want, knowing fully well that it's future proof for expansion.

A - Ross MacMillan {BIO 1994797 <GO>}

Great. I'm conscious of time; we are coming up against the end of our slot. We could probably go on for another half an hour, easily. But there is a breakout; it is across the way. So Takeshi, thank you so much for coming today. Appreciate it.