

## Citi Global Technology Conference

### Company Participants

- Yusuf Mehdi, CVP, IEB Marketing & Strategy

### Other Participants

- Unidentified Participant, Analyst, Unknown
- Walter Pritchard, Analyst, Citigroup

### Presentation

#### Walter Pritchard {BIO 4672133 <GO>}

(technical difficulty) with Microsoft. I'm Walter Pritchard, the software analyst here at Citi. I have Yusuf Mehdi, he is a Corporate Vice President of the Interactive Entertainment Business, which is -- I think it was Xbox and specifically run marketing and strategy. We're probably not going to discuss much the Nokia transaction. I know that's hot on everybody's mind and obviously it was announced this morning, kind of we had this whole line-up here pre-arranged before that. So I don't want to disappoint anybody. But I want to make sure we have that expectation.

Before we get going, I was just going to read a Safe-Harbor statement. Microsoft would like to remind you that this presentation contains forward-looking statements, which are any projections, predictions and other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in this presentation -- in the risk factor section of Microsoft's Form 10-K and 10-Q and other reports and filings with the Securities and Exchange Commission. Microsoft does not undertake any duty to update any forward-looking statement.

#### Yusuf Mehdi {BIO 1823106 <GO>}

Well said.

#### Walter Pritchard {BIO 4672133 <GO>}

I practice. Okay. Go ahead and have a seat. So again, thanks (for) coming out. I guess it's been a pretty busy couple of months for you in the Xbox world. We love to just get an update on where we are the console's November (18th) or November --?

#### Yusuf Mehdi {BIO 1823106 <GO>}

We're going to announce it soon.

**Walter Pritchard** {BIO 4672133 <GO>}

Okay, sorry. I wasn't trying to squeeze out of you. But I know that's sort of the rumor, I guess. Can you just give us an update on where things are and what we should look at, specifically as investors, as we get in that console launch cycle and beyond?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Sure. Yes. There's a lot to talk about. I can do a quick summary and then (get to the next) question. In terms of just how the Xbox One is going, we're on track for a launch in November. We'll announce the launch date shortly. We recently just went into full production. So we're now producing en masse the Xbox One consoles. We've got real good progress on the system. In fact, we just updated the CPU performance to 1.75 gigahertz, on top of the graphic performance improvement. So the system is really going to shine. The games on that system look pretty incredible. We've had a bunch of trade shows where people have come and seen them and we've had the best line-up of any console or games. On the game side value prop feeling very good. From a market demand perspective, we've been sold out on pre-orders of Xbox One for several weeks now. We've built more than we've ever built for an Xbox launch. We are on track to have the biggest launch ever done by a wide margin for consoles.

**Walter Pritchard** {BIO 4672133 <GO>}

(multiple speakers) most units shipped.

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. At launch. And I expect there will be multiple millions of people enjoying Xbox through the holidays, as we get to the holidays. So feeling very good about progress, still a lot of work to do. (inaudible) feel pretty good about it.

**Walter Pritchard** {BIO 4672133 <GO>}

Okay. Great. And maybe you could just step back and talk about this broader -- there's a lot of debate -- now we don't need to engage in -- some of this debate around does Microsoft need to be in the consumer business and yada, yada. But there is -- I think there is a lot of debate around the living room and how important is the living room -- which devices are converging in the living room. Could you talk about what Microsoft is looking to accomplish in the living room with Xbox One?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Sure. Yes, I mean a couple of things. The vision for Microsoft is a family of devices and services that target high-value customer needs for consumers. And we talk about -- there's all sorts of gaming. We talk about Serious Fun. So if you talk about

my teenage boy, Serious Fun is if he can finish Assassin's Creed and that's a serious thing. And for other people that's enjoying the movie that they want to watch on the night that it's opening up. What we're trying to do with Xbox One is we're trying to provide a central device in a living room that can for the first time unify all forms of entertainment in one simple-to-use effort. Today, you've got channel and game consoles, you've got streamers that can stream movies on demand. I mean you've got things that (inaudible) all together and there's live TV. And the vision of Xbox One is to not just unify it. But then allow, literally with your voice, to control your television. So you can basically say, change to ESPN, it's not my fantasy team next for the game and that's what you will be able to do with Xbox One. If you think about before there were smartphones there were regular phones, then a smartphone come out, you said, wow, it is a mobile computing device. We think that TVs are going to truly become smart TVs, where you can browse, you can do Skype communications, you can do interactive television, Xbox One is key to opening up an entire world of next-generation entertainment.

**Walter Pritchard** {BIO 4672133 <GO>}

Got it. I want to return and talk a bit about that -- those scenarios in a minute. Just next one to talk a bit about -- I love to just (quote) my model and you can fill in the unit numbers and I know you won't do that. So I guess, would just like to talk a bit about sort of how we should be thinking about -- it's been, what, eight years, seven years since there's been a console. So a lot in the world has changed since then. Obviously the world is -- there are more people, there are more TVs, there are more big TVs. So that in a sense should help the cycle?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes.

**Walter Pritchard** {BIO 4672133 <GO>}

On the other hand I think there is -- to be honest, we haven't pulled up a game console on our house in a couple of years. Everybody's got different tablets and they are using those to game on. And so, is the console market bigger than it was seven or eight years ago at launch, is it smaller than it was seven or eight years ago, how should we just -- at a high level, we think about that?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. We've got some interesting data. You can now even go and see them, we've mapped it on our site. But there is basically one account for all five generations of consoles. Every generation of consoles has been bigger than the last. So if you look at the last three, you were 100 million units, 200 million, this generation is 300 million units. We think the next generation will be bigger than that. We see it in all the research we do, we see it in -- we do see it in all the talk about the industry. The world for gaming is growing, it's the fastest growing segment of all of entertainment in terms of hours used, as well as dollars spent. And we think that that is going to continue grow in this generation, if you look at it just as a standalone game console.

Xbox One is pretty unique relative to the rest of our competition, because it's a game console and it's an all-in-one entertainment service. So we think that potentially broadens the market even beyond what you might expect for this next generation.

**Walter Pritchard** {BIO 4672133 <GO>}

Right.

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes.

**Walter Pritchard** {BIO 4672133 <GO>}

Do you think console game is actually bigger. I guess, I'd agree that gaming for sure is bigger. But console gaming --?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Console gaming, for sure, has been bigger every successive generation and we see it in all of the customer research we do. We talk to thousands of customers, do (contrary) analysis to see who wants to buy. And we see a bigger growth in this market, which is (200 million) to date for this generation.

**Walter Pritchard** {BIO 4672133 <GO>}

Got it. And did you research -- I guess, we're trying to get a sense of, with all of these different functionalities converging on the Xbox One, mainly this sort of TV viewing experience, the media consumer experience with the gaming experience, did your research suggest that people will buy this product for the features other than gaming or is it 90%, 95% of people will buy it as a gaming console?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Clearly, in the beginning it is primarily a gaming console and that's going to be the primary buyer. In all the research we've seen, there will be tens of millions of buyers in the first year and in the research we do, over 90% of them own an existing console. So I think there is going to be supply constraints in the beginning. And I think all those purchasers are going to be gamers. And I think the value prop for gaming is incredibly clear. I think the entertainment value prop, we have some nice signature things like the NFL unique on Box, interactive NFL, the ability to do some other kind of interactive television shows we're working on. But predominately it is primarily focused on being an incredible gaming device in the first version.

**Walter Pritchard** {BIO 4672133 <GO>}

Got it. And you alluded to content with NFL. In terms of just various other ecosystem players in this world, you have the cable companies. I think at this point the TV is somewhat of a commodity, it doesn't matter what TV you have. But the cable company, being the main sort of player here, there's been lots in the press about a lot of other tech companies trying to come to market with a box that fits under the TV and not being able to figure out how to deal with the content problem with cable. How does Xbox One deal with that and is the position of that player in the ecosystem change at all with this new generation of boxes?

**Yusuf Mehdi** {BIO 1823106 <GO>}

It will change some. Now, historically, we've had phenomenal relationships with the cable and the (TV) providers. They provide their apps on our platform. So you can get on-demand movies and in some cases get live TV. For example, we just announced last week The Time Warner Cable is bringing their live television channel to the Xbox. So now you can buy an Xbox and get a lot of television channels through Time Warner Cable.

**Walter Pritchard** {BIO 4672133 <GO>}

So sort of skip the cable box, is really what -- ?

**Yusuf Mehdi** {BIO 1823106 <GO>}

The way that we think about it is we want to work within the ecosystem. So we are -- we're not taking a position on cable box or not. Xbox One will work great with your set-top box. You literally can just have one HDMI cable plug in and now have live TV. So our model is to be partner friendly and to work with the operators and to add value on top and that's what we're trying -- and the value on top that we add is interactivity, voice control, new generation of content, gestures with the connect, that's the big part of our differentiation.

**Walter Pritchard** {BIO 4672133 <GO>}

Is there any business model difference there? I mean, I'm assuming I'm still going to pay Comcast way too much for a subscription that then I can plug into my Xbox and then I could just interface with it in new ways. Is that -- are there any economics in terms of your relationships with them that maybe different than what we've been used to in the past?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Nothing has significantly changed. We don't comment a lot on the relations we have with the cable companies. We have got mutually sort of beneficial relationships with everyone. But Xbox One, we're not changing that dynamic a lot. We're going to continue to work to be great distributors of their content. We're also, as I said, going to make it easy to get their content, their live TV now on Xbox One. And over time, we think we can create new opportunities through the interactivity. But that's probably further down the road.

**Walter Pritchard** {BIO 4672133 <GO>}

Okay. Then sort of a similar question. And not to go too far up on this tangent. But you did mention the NFL.

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes.

**Walter Pritchard** {BIO 4672133 <GO>}

And I think you could probably become almost a content aggregator yourself and sign deals with the NFL and other sort of very sought after sort of portions of the content streamed to the point that somebody sort of looks at that boxes as providing them a cable service. What's the thinking there from a strategic perspective about how much of a content aggregation role the company will play, versus bringing something like NFL that's just kind of a nice headline that grabs some attention?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. So the way we think about it is, I think, two-fold. So the first is that I would say today we are a great content distributor for our partners, NFL, MVPD, other content companies that do things like HBO GO. We are a fantastic service for those people who want to distribute and aiming for sort of the game providers to sell games and don't want to sell -- FIFA wants to sell Ultimate Team add-ons. We're a great provider for that capability. But in addition, our focus is to kind of go beyond, to do some differentiated things with interactive. And so what we do with NFL, that deal is primarily about two things. One is about game to an interactive version of the NFL and that's what we work together to try and get, for example, your fantasy team live while you're watching the television and be able to see that stats, scores, live update and then to make that much different on the TV, whereas before you've to go to a separate device. Then to work with them on the field using our Surface technology to help better map the play that are going on. Today, the NFL uses paper to see replays, we're going to work with them on tablets. So that you can see some replays live on video. And so it's about the technical differentiation, not just distribution of content.

**Walter Pritchard** {BIO 4672133 <GO>}

So that is similar to what you've done with cable companies, although something like NFL will be done in a much more granular level, something like Time Warner Cable might be an interactive cable guy, something like that this would be, literally, at the field level with plays and with things like that. Yes, okay. On the pricing on Xbox One, I think, there was -- and still sort of in our minds in just in Citi research, \$500 is kind of sticker shock. That seems like a lot of money, especially, it doesn't seem like consumer spending has ever returned to where it was in '08 and '09. How did you think about that pricing and it's \$100, I think, more than the previous intro price on the last generation. And what are the chances you price the product too high?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. So the way we think about it, we've always thought that price -- the product is super competitive in terms of being close to breakeven or low margin that we can get as broad distribution as possible. In this version, we made a couple of big bets. We said that there are a lot of low-end sort of simple casual game boxes, we wanted to have something that really differentiates and lets you play games and lets you play movies. We wanted to bring that -- we wanted to break the barrier, being able to voice control your television. And so to do that we added a lot of capability. And so we feel is that for four \$499, our price point, we think the value that we provide for that is a very good deal. Obviously, different people will kind of make their choices. But we feel that we've done the right balance. And if you look at either the pre-orders that we've been sold out for weeks for the largest we ever built, or you do price-adjusted inflation on say the 360, you look at the price point, it's actually pretty comparable.

**Walter Pritchard** {BIO 4672133 <GO>}

And so, I guess, I may be just burned by some of the Surface pricing that ended up too high and came down. And I understand there were some potential (structural) issues in that market about OEMs were price-tiered, you couldn't undercut the OEMs.

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes.

**Walter Pritchard** {BIO 4672133 <GO>}

Is this is a similar model to the past where you're sort of making minimal money on the hardware upfront and hope to cost reduce in the future and bring the price down? I'm not asking you, I guess, to comment on the profit and pricing, just trying to understand if the strategy is the same as it's been in the past?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. So the strategy will continue, which is that we -- as I said, we're looking to be breakeven or low margin that works on the hardware. Then we make money selling additional games, the Xbox LIVE service and other capabilities on top. And as we can cost reduce our box as we've done with 360, we'll do that to continue to price reduce and get even more competitive with our offering.

**Walter Pritchard** {BIO 4672133 <GO>}

Got it. Then as we look at -- you mentioned at launch and I think it makes sense that the hardcore gamers, I mean, some of them will pay \$1,000 for a console, it doesn't matter. When you get further into the cycle, it does feel like, well, something like Apple TV hasn't shipped enormous volume. It does seem like there is quite a bit

utility in something that's small, cheap and gives me 60% of or 50% of or 40% of what I get with an Xbox One. What is the thinking around -- and it also expands your footprint, for sure, into a down market.

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes.

**Walter Pritchard** {BIO 4672133 <GO>}

What are the thoughts about that segment of the market and the potential entry into that market in the future?

**Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. Well I think -- I mean, we'll always look at the markets and we'll look at the customer feedback to see what we can and should be doing. I think as with 360, we'd continue to price reduce, we're down to \$199 now on that console, which does much, much more than what you would do, for example, with an Apple TV. With our SmartGlass technology, where you have to pay extra, you can use any device that you own of any manufacturer to do any interactive things and control the television. So we feel like we are trying to target that market and we'll keep looking to see if we should need to go further down. But for now we see a lot of demand at the market where people really want the very best of game experience.

**Walter Pritchard** {BIO 4672133 <GO>}

Got it. So I have a ton of questions still, there's a ton of people in the room here as well. So I wanted to just pause for a second, if there's any questions we can go ahead and bring a microphone around, I think. There we go, two over here.

## Questions And Answers

### Q - Unidentified Participant

Okay. So you've talked about the thought process in terms of the economics going forward, kind of the Razer and Razer Blade model. This was talked about previously as well. The revenues, at least in the division have continued to increase, yet the profitability has been volatile, it has not shown the same pattern that you would expect from a Razer and Razer Blade model. So would love to know why it happened as it did and why should it be any different in the future. That's an oasis that keeps on being a mirage.

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. So I think -- without giving all the details, I think you've seen us over the years. I think constantly we're focused on profitability and improving sort of year-over-year. It's hard to break apart and I won't go into all of the details. But there are different points in the cycle of when you invest in new hardware. For example, with Xbox One,



their development cost in desktops. If you look at 360, that platform lasted, as you said, for seven to eight years and it's going to go for another three years. It's incredibly profitable now in the tail. So some of these things take some time in the launch year in which you invest and then they play out a bit over time. So without getting into all of that detail, our focus is very much on profitability. We've seen our Xbox LIVE subscription service continue to grow, we're up to 48 million members now on that platform, which should be more games than we've ever done before. Those are things I look to, to say, hey, we can grow, not just topline revenue but also profitability.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

There is a question right there behind him.

**Q - Unidentified Participant**

Thanks for the presentation. It seems like Microsoft has clearly put a lot of thought and effort into designing the next Xbox One. But as you said, most of the buyers in the first year or so will be hardcore gamers of some kind and while there is fan voice on both sides of the (inaudible) Microsoft and Sony, it seems like the specs, purely from a gaming perspective for this current generation seems very similar and I just wonder if that convergence, if you will, towards a sort of AMD-based gaming platform that's sort of like a PC, really means that people will just be choosing one, instead of having -- in the past people buying perhaps both, especially since they came out in separate years the (last time), I'm wondering if you could just comment on that.

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Sure. Well I think -- and a couple of comments on that. First is I do think it's an incredible time for gamers. So one of the things that's never happened that we go head to head with a competitor on the console launch. I mean that's going to bring a lot of energy to the overall gaming market and a lot of focus and attention. And I think that's going to further grow the market. So I think, in general, it's a good time to be a gamer. We feel good about our business within that. Competitively speaking, I feel -- so far, I feel like we have a much better, more complete value prop. We do things that aren't found in other platforms. With the connect, huge piece of differentiation. As I said before, the fact that we do entertainment and gaming. Then even if you just think gamers, hardcore gamers, people buy -- gamers buy for the games, they don't buy it for stats on the spec sheet. And if you look at the games we have, according to most industry experts now a better line-up of games. Our awards that we won at the E3 games show are bigger than both of our competitors combined, with over 111 awards won. We have some very unique titles, which for those usual gamers, (even now) for those of you who won't, you should try it this holiday. But in addition, things like Halo, Titanfall, which is the most regarded title of the time of our -- of this E3. But also a bunch of other game titles. So I think competitively speaking, we're feeling very optimistic about how we'll compete. But even so it'll be a great market in general.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Okay. Question in the back.

**Q - Unidentified Participant**

From an industry perspective, is there a technology hurdle that we need to overcome to -- for IPTV to find a home for dynamic ad personalization?

**A - Yusuf Mehdi {BIO 1823106 <GO>}**

Is there a hurdle to find? You know, ironically a lot of the hurdles -- I spent a lot of time with our ad center, ad platforms about five year ago and the hurdles actually don't end up being technological. The hurdles are -- actually end up being more business and cost of doing business. So what happens a lot with advertisers. And I saw this having spent a lot of time with Bing and Adware, until you can make it so simple to buy and take your existing effort and do it at volume, even if they are pieces of advertisements that they can deliver better returns, advertisers don't find it to work that extra effort to go do that work. They'd rather just apply more volume and optimize what they do know today.

So I think we'll at some point get there and I think part of what we have to do is really make it simple to have the reporting, to have the ability to create and populate that through a number of systems. And that each platform that has enough scale to make that worth the time and investment, that's really what I personally believe is the hold back to getting the breakthrough on interactive advertising.

**Q - Walter Pritchard {BIO 4672133 <GO>}**

Did you have a question down here?

**Q - Unidentified Participant**

This may be premature, maybe you mentioned this before I came in the room. But can you talk a little bit about the mobile device space and how that relates to Xbox in terms of the longer-term strategy, maybe that's coming out at your Analyst Day, I don't know?

**Q - Walter Pritchard {BIO 4672133 <GO>}**

I think that one is fair game. We (weren't) going to address the Nokia, the whole -- that purchase. So I think that's fair game.

**A - Yusuf Mehdi {BIO 1823106 <GO>}**

(If you're) in the back, the question was can you address the -- how the mobile device plays with Xbox?

So I think a couple of things. Number one, we are absolutely living in a multi-device world. In the research we see -- you pick any demographic, pick 18 to 34, 80% of the people are on a device while they are watching television, a phone or a tablet. And you guys probably all -- you guys more than anybody probably experience the same thing, because you are always checking. We're all (ADD) in terms of our content

information. And what's happening a lot of times, is we've studied that people are actually searching for information on the show, they are looking for additional details, when there is a break they want to go get some other information, whether you are a sports junkie and you are looking for stats. We've seen that and our approach to that is a couple fold. One is unlike others who say, hey, we are going to build a dedicated companion device, a newest device, that's another couple hundred dollars to buy a hardware device for gaming accessories, we've built a software approach that's called extra SmartGlass that lets you take any device you own, whether it's from Microsoft in a Windows phone which we'd prefer, or an iPhone or an Android phone. And you can download SmartGlass and use that device to now control your television, to be able to view interactive content. If you are watching a movie, we can stream content to that device. And so we want to really get after and tackle -- we see consumers today which is a disjoint entertainment experience in a living room.

Now clearly with Windows phone we plan to build a best experience of past. And I think we'll differentiate on that because we care a lot about it, because the Windows operating system will run on your phone and on your television and you can do things like snap, you can do things like the movie video experiences more seamlessly integrated. And so we are going to build some great scenarios and we do think it's a critical control. Because sometimes it is nice to control your TV with your voice and sometimes the kid's are sleeping, you don't want to be yelling at the TV. So it would be nice if you don't have to hunt for the remote, you can just pull out your phone and just with your thumb control the TV. So we'll do those tons of scenarios.

**Q - Unidentified Participant**

So will we be seeing advertising to that effect sometime in the next few months?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

When you say advertising what do you mean?

**Q - Unidentified Participant**

I mean integrating the functionality of a Windows-based phone or tablet with your Xbox with a TV?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Yes, I think we do some of that today with Xbox 360 already. And there I think are multiple different scenarios of how advertising works. A couple of examples we have talked about in the past with 360 have been where you are watching -- let's say you're watching a football game, an ad comes up for Domino's and you say I am hungry. One of the things you could do is, the simplest thing is just send the URL of that ad to your tablet and you could just pre-populate an order right there.

So there are different scenarios of how you could integrate things where they don't interact with the television or they make it more in handsets that are being done today. And I think you'll see more of that over time.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Any questions out there? Right over here.

**Q - Unidentified Participant**

Hello. So thank you. What's been in the works for -- your Xbox One has been in the works for quite a while. But we had this major reorg at Microsoft. And has anything changed in what you are doing or your focus with this with the larger changes at Microsoft?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

It's sort of -- I think the answer is sort of little bit of yes and no. No in the sense that we are kind of in the Fourth Quarter of shipping Xbox One out the door. We had to meet with Steve Ballmer about three, four weeks ago. And he said, hey, you're full steam ahead, if there are any issues with the reorg that you think will hamper it let me know right now, because there is no excuses for you guys doing your job and doing it well. So in classic form. And so we said, okay, let's go through what we need to make sure that we deliver. And so we are full steam ahead. So in that respect myself, the rest of leadership team on Xbox and the development teams are completely focused on that. And so we are full steam ahead and feel good about that.

Longer term, of course, we are thinking about, hey, how do we start to get more synergy between all our efforts. And so the question on the phone is just one of many, for example, about how are we thinking about how these two products come together, how does the operating system get more main streamed. So some of that we are having the natural conversations, which I think are fantastic because that's allowing us to re-pivot and really think about a broader family of devices versus each individual device.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Can you talk about the role of first party content is -- I mean you now have the -- obviously when the Xbox originally came out, Halo was sort of the reason to buy it. And now you have library games, lots of third-party games, lot of other reasons to buy it. The investment that Microsoft is putting in first party content actually doesn't seem like it's pulled back and it's actually doing a Halo TV show. What is now the role of first party content? Is this an area that the company is potentially sort of over-investing and it doesn't need to spend as much as it is?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Well I think for us the role of first party content is kind of multiple fold. One is absolutely to be a profit driver. So Halo, for example, is a great profitable enterprise for us. But it's also to help showcase the platforms. And so one of the things that we can do with our first party is we can ask them and say, hey, we would like you to really showcase Connect. We would like you to showcase how the future of interactive TV might look. And so let's build some shows, let's build some entertainment, some games that differentiate that.

And so our first party studio has a tough job, because they are trying to both do something that you might not do when you are trying to just maximize for profits. And at the same time they are pioneering for the greater good, because they only can fall through the rest of our platforms, our Xbox LIVE service.

So we can here want a great studio and our expanded studios for games. And recently started an entertainment studio down in California and they are the team that's doing the NFL work. They are also -- as we announced, they're going to do a movie with Halo. And so, those are two of the projects and we will hear more about the projects we'll do as we go forward.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Another question here.

**Q - Unidentified Participant**

Just keep on going. I am curious a little bit about the decision whether to build, to outsource and just a little bit of your thoughts around the development of the hardware.

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. In terms of whether we would build or outsource the hardware?

**Q - Unidentified Participant**

Right. It's a little bit around the decision and then would that change over time, just how you look at that?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Sure. One of the things I think that we have seen over time, we've embraced, it's in the Shareholder Letter and the news of today should make it clear as day. We are very convicted on being a company that excellent in devices and consumer services. And one of the things that we've learned really well at Xbox now going back for number of years is that you can really build some breakthrough products when you can bring the software and the silicon design and the hardware design together. And we've seen it a lot, because there are tradeoffs that you make in terms of say the software that taxes the power supply or the heat factor in how you design a box and being able to have that together, you get efficiencies and you're able to build some breakthrough experiences. And so, I think we're full steam ahead. If anything, we have some of the best hardware designers and pioneers in Xbox now and at Microsoft.

I've seen some of the work that we're doing we haven't talked about yet, it's really starting to pay off for us now to really have that software, hardware coming together. I see us only continue to invest in that regard.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

A question over here.

**Q - Unidentified Participant**

What role do you think gaming as a service will play going forward?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Yes. So gaming, I think gaming will do a couple of things as a service. I think, first of all, games are as I said; it's actually one of the fastest growing sources of entertainment content in the world. So if you look at movies, television, music, gaming is growing faster than any of those in the entertainment space in terms of revenue and usage perspective. Second of all, the gaming market today depends on how you connect the \$11 billion to \$12 billion of profit, about \$4 billion to \$5 billion is console gaming, you've got a couple of billion in casual gaming and then you've got a couple companies in Korea, in Japan, in China that are their own unique things. But when you look at those, it's a pretty big and growing profitable business.

We're going to continue to invest in gaming to grow it, because we think it's such a great business that consumers want more and more of and we think it can drive a profitable business for Microsoft. We also think it's a thing that will differentiate our hardware. And not just Xbox. But over time phones and tablets. We think that we can bring unique games and unique experiences that will differentiate our hardware as a result.

**Q - Unidentified Participant**

(inaudible; microphone inaccessible).

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Okay. So for people there, the question is on cloud gaming. We definitely are a believer in digital and digital games and some of the excitement from the summer, post Q3 well people had a lot of questions about our vision for digital. I think we're a pioneer in thinking about digital. There are a lot of benefits for the digital system. Let me talk about that before I hit the cloud.

So some of the questions for example that came up is why digital games, why not disk spacing. Our view is that what happened to movies and music and it's happening to casual games on phones and tablets is going to happen to full games, which is that five years ago you drive down to Blockbuster, burn a DVD, drive home, stick it in and watch the movie. And now you just turn your TV on, check the digital library and streamed the movie and maybe you already subscribed to it, you need not have to pay for it. That's the benefit of digital. You can roam through a device and you can still have the content.

That's the vision we have for Xbox One for full games. And we are delivering a big chunk of that on day one. Specifically you can now buy any of the game that we ship day in digitally through the store, you can go your friend's house, login with your ID and have him connect with your entire games library.

So our digital vision has never changed, never wavered from what we announced at E3. What we did do is we added back some capabilities, which is the ability to do disk spacing. So if you still want to have the disk spacing, which as I can just loan it to my friend and he can use it, you can do that too.

Cloud gaming is another kind of implementation on top of that digital platform. We think cloud gaming is something that's very exciting, very compelling. But it still feels like it has ways to go technically before we're -- challenges there are latency in particular and then some of the bandwidth. So you can do game trials and game demos. But to do full games where you're not at disadvantage to your friend who's playing locally. And that's a big barrier if you're a gamer. That is still going to take a bit of time technically. So I'd say I'm long term bullish. But short term, I think it needs more work.

### **Q - Unidentified Participant**

Yusuf, for the first time you don't have backward compatibility of games, you have to buy a brand new game for Xbox One. So maybe you can help us understand what is the reason for that?

### **A - Yusuf Mehdi {BIO 1823106 <GO>}**

Sure. I think the biggest challenge of backward compatibility was primarily the fact that on the game itself that just the architecture of the Xbox One is so different. And so, it really was impossible to make a simple way to have all those games work in a backward compatible way. I think you've seen the same thing from other players as well in the industry. That's the thing we wrestled with. We do care a lot about the investments that consumers have made in their Xbox. Some things we're going to carry forward to the Xbox LIVE service carries over to Xbox One. So one service works across both devices, you don't have to buy a new one. And obviously as you start to get the games that are digital, both will work across devices. But there is just a challenge with getting the backward compatibility on that.

One of things we are going to do try and help ameliorate some of the challenges is we are going to continue to invest in Xbox 360 and the two devices can work in concert. So it isn't like the day we ship Xbox One your 360 won't work, we will continue to support it. In fact, we are going to ship over 100 new games on Xbox 360. So you will be able to still play your games, just not on the same exact box.

### **Q - Walter Pritchard {BIO 4672133 <GO>}**

Yusuf, getting back to the first party discussion. And you know I think we were a bit surprised at the Surface launch Surface RT and then Surface -- I guess less relevant for Pro. There wasn't a -- given the assets on the studio side, there wasn't a Halo surface to make up an amp. Can you talk about sort of how that worked and how that may work going forward and are there incentives to -- I guess was there a mandate and are there incentives to substantially use -- to help the first party content on these devices, because clearly the Microsoft Office experience on Surface to the extent that they did sell I think that was one reason why they did sell?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Yes correct. No we absolutely don't want to do that. Now I think that's part of the vision going forward, it's to see more of our entertainment assets show up on the Surface and games and entertainment and differentiate the devices in some compelling ways. I think for the original launch it's just an issue of timing, the timing didn't line up. But our strategy going forward is to build more and you saw some of the things we did with Windows phone, when we did a recent promotion of Halo-Spartan Assault that we brought that game to phone and tablet in partnership with Verizon to differentiate a little bit at launch. You saw a little bit of a teaser that earlier in the summer and you're going to see a lot more of that as we go forward.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Okay. Then on Xbox LIVE, should we think about the attach rate of the paid live subscriptions increasing? They increased from original Xbox to Xbox 360, the increase to the life time of the console as you added more value. I mean is it something as we look forward in our modeling that we should expect this continued increase in attach rate around Xbox Live Gold, are we at some sort of point where there should be a theoretical maximum here that we can't go above it?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

It's hard to say. I mean from our perspective we are going to -- we are really focused on doing an amazing job with Xbox Live Gold. It's been a huge success and really -- it was really sought after. We are putting more and more value into it. One of the things we announced early this summer is a program called Games and Goals where we give away three games. In fact, (inaudible) we are doing two a month. And these are big games, including the Assassin's Creed and an earlier version of Halo.

So we are going to continue to invest in that. We've seen a lot of demand. Our Live usage now is up to -- the average Xbox LIVE user in the U.S. -- Xbox Live Gold user in the U.S. averages 87 hours a month. So we are talking three hours a day of usage. And people are really into that and that's for gaming and then for streaming of movies. As we bring on live TV and we add additional capabilities, you never have to be away from it. We think that the hours in usage can drive up and I think that value prop is going to appeal to a broader audience.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Then around -- still, I guess, related to Xbox Live. We saw in the last quarter CapEx really for the overall Company really spiked up. And I know there is a variety of services being built out across the Company from when the services supporting Windows all the way down to Xbox Live. Can you talk about the capital intensiveness of the new Xbox One on the service side versus what you've seen in the past with the 360? Our understanding is with Windows (inaudible), the search volumes that have been driven by that platform versus Window 8 is a huge upset. Is there anything like that in the new Xbox?

**A - Yusuf Mehdi** {BIO 1823106 <GO>}



Yes. There is. And that's one of the great things about the opportunity about now -- just with this recent re-organization we are able to kind of more unify our efforts. One of the things we are doing with Xbox One is we are really tapping into the Azure cloud service we've got. And we have about 300,000 servers now that are available for game developers to create their games. So that we can do a lot of cloud compute for the gaming. And the benefit of that is in the past and with other systems what the people do is they do kind of client side hosted boxes. People can hack those and then cheat to win in gaming. With these servers, now if you are a game developer, you don't know how to -- you can't afford to build out all these servers if you don't know if people are going to use this service. And if it explodes you can't go do them. Now we are allowing people to actually tap the cloud to go and use our services.

So that's 300,000 servers and we talked about Call of Duty now, taking advantage of a Titanfall, another big game, we'll take advantage of it. just to be a little differentiator for us and it's going to be valuable thing for the Company as we leverage all of those servers and the Azure cloud to power our productivity and entertainment services.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

You don't actually monetize it directly, you monetize it through better games (multiple speakers).

**A - Yusuf Mehdi** {BIO 1823106 <GO>}

Correct.

**Q - Walter Pritchard** {BIO 4672133 <GO>}

Okay. All right I think we are getting the yellow light here. So we will wrap up. Yusuf thanks a lot for coming and thanks everybody for your attendance.

*This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2024, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.*