Barclays Global Technology, Media and Telecommunications Conference

Company Participants

- Phil Spencer, EVP of Gaming

Other Participants

- Raimo Lenschow, MD & Analyst, Barclays Bank PLC, Research Division

Presentation

Raimo Lenschow {BIO 4664646 <GO>}

(presentation)

So that's really good. Hi. that's a really impressive intro. I don't know how to follow up on this one now.

Phil Spencer {BIO 4399320 <GO>}

I only intro with videos (inaudible).

Raimo Lenschow {BIO 4664646 <GO>}

Hi. thanks for being here, folks. I believe it's like the first time you kind of meet with investors kind of chill like that they're not going to ask all these horrible questions here on stage. So it's all good.

Phil Spencer {BIO 4399320 <GO>}

Yes. All good.

Questions And Answers

Q - Raimo Lenschow {BIO 4664646 <GO>}

Maybe start a little bit. So like give us a little bit of your background, how you've gotten to where you are today.

A - Phil Spencer {BIO 4399320 <GO>}

Sure. I started at Microsoft in 1988 as a programming intern. I now run the gaming organization, reporting to Satya Nadella, our CEO. So I'm member of the SLT, overseeing gaming across all of devices, content, all the services we build.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. Perfect. Then talk a little bit about -- if I think about Microsoft, there's kind of Azure and there's Office and Office 365. And gaming kind of -- with the Xbox, that's kind of -- it wasn't kind of at the real center and heart of Microsoft for a while. And that seems to be changing now. Talk a little bit about the evolution that you see. And what role did Satya play in this as well?

A - Phil Spencer {BIO 4399320 <GO>}

Yes. It's a good journey. I became the head of Gaming at Microsoft a couple months after Satya took over as CEO. And we started to have discussions about what gaming could mean at Microsoft. We started with defining the size of the business, where I think any kind of startup business should start. When you look at today's world, there are over 2 billion gamers on the planet. Half of the connected world plays video games. It's $150 billion a year in revenue. And both of those numbers are growing double digit. And when you look at Microsoft, gaming really fits in to our intelligent edge, intelligent cloud strategy. Almost all games that are built today rely on an intelligent cloud in some way to deliver the services to their customers across all devices. And games are probably the #1 form of entertainment on any edge device that a customer owns, whether it's a phone, whether it's a PC, obviously, whether it's a game console. So when you look at a large TAM that gaming is and a growing TAM, Microsoft, having brands and services and fans in the category. And the strategy of where the secular trends that we see in the category aligning very well with Microsoft's strategy, it made sense for us to start to invest more heavily and in a more strategic way.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Okay. And just to get us kind of all on the stage, some of them in the audience look a little bit older. Like can you talk a little bit about the evolution?

A - Phil Spencer {BIO 4399320 <GO>}

I think they look like a young vibrant crowd.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes, yes. It must be my (inaudible). Can you talk a little bit about the evolution? So like we started -- we had the consoles. We had the PC games. So how has the industry evolved over the last few years?

A - Phil Spencer {BIO 4399320 <GO>}

Yes. There's really been transformation in 3 important areas in gaming. If you think about content transformation, technology transformation and business model transformation. And they're all happening simultaneously. I think a really good example is a game -- a huge game right now called Fortnite. I imagine most people

have heard of Fortnite. Fortnite was a game that was born on the PC. Many years ago, Epic Games -- I was actually in Raleigh, North Carolina yesterday meeting with them, we had been working with them for many years. They started this game development on PC. They decided they were going to ship this game on console and PC with a cloud-connected back end. When the game came out literally a year ago and just started just taking over, they all supported the game to the phone. So what you have today is a game that natively runs on phone devices, on PC, on console. All your players play together, which requires technology to connect those players regardless of what device they come on -- they come from. The economy of the game spans all the devices. So if I get in and I buy their in-game currency on an iPhone, I'm able to consume that currency on an Xbox or on a PC. The game, much like every other form of media, natively lives in the cloud. And the on-ramp to that experience is the consumer's choice. And we see this happening more and more across many games. A game that we own is a game called Minecraft. We acquired Minecraft a few years ago, one of the biggest games on the planet as well. And we have Minecraft players across all devices and all geos. And we learn a lot from watching what players want to do.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. And now a first alert, a first investor question. Like how did the -- how is the monetization model changing for gaming? Like how do you make money with this?

A - Phil Spencer {BIO 4399320 <GO>}

Yes. The great thing about gaming today is all forms of monetization are actually growing and are very healthy. Even the traditional retail model of somebody building a game and selling that game for $60, we just had a huge launch in our industry, something called Red Dead Redemption 2 from Take-Two. And it was -- I think if I remember the stats, it's the largest entertainment launch over its weekend, doing something like $750 million in revenue in its first weekend. That is predominantly a $60 transaction. Somebody buys the game and then they play the game. And we see growing in retail. In-game monetization or free-to-play games or low-priced games that actually have an in-game economy, which is what Fortnite is, also growing tremendously. One thing we added in the last year was a gaming subscription, where I'm actually able to pay $10 a month and I get access to over 100 games. So for people who -- whether they get their music, their video, they become very accustomed to getting their media, building their library through a subscription. And we're seeing very good growth in Game Pass, our game subscription. So we see subscription growth. We see in-game monetization growth and retail continues to be a great way to sell games both digitally as well as packaged products.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. Like for us, remember like when Xbox came out like years and years ago, it was like, oh, there's Xbox and the hardware sale. And they're losing money. And that world has changed. We basically...

A - Phil Spencer {BIO 4399320 <GO>}

Yes. We had our highest revenue year last year with over $10 billion in revenue in the gaming category. We're seeing software and service grow double digits. And the business is performing very well. It is an activity that the youth on the planet love. It is what they're engaging in. The other secular trend that we see. And people have probably seen this with services like Twitch and Mixer, is not only do people play. But they actually watch other people play and it's become the socialization of gamers to watch other people play. And I get asked, hey, what is this watching video games? And I'm old enough to remember the advent of SportsCenter on ESPN, a channel where people didn't actually have live sports. It was a channel I was going to go to, to watch sports highlights. And I remember, there was some skepticism of whether a channel like that's going to work. It seems like it's worked out okay. And you see in the video game space that people watching streamers play as they talk about their experiences is growing tremendously as well. And I think there's real monetization capability there that we haven't even tapped yet.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. So $10 billion. That's 10% of Microsoft. So that's not a small number.

A - Phil Spencer {BIO 4399320 <GO>}

Yes. Amy -- Amy Hood, our CFO, she likes to tell me I've made the spreadsheet now and she says that can be a good thing. And I'm on the spreadsheet. So she's going to pay attention. But the support we've had from the company has been incredible. We've acquired and started 7 new first-party studios in the last year. We obviously don't do that without tremendous support from Satya and Amy. We understand content is a critical component of what we're going to try to go build. And the support from the company has been tremendous.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Let me kind of stop you for 1 second. Like in terms of the -- how games are played. And I think I get it. But tell me -- so like when I started in college, it was mostly PC. Then the consoles came out. Now we have mobile. How is that kind of line kind of blurring at the moment? Like is that all coming together eventually? Or like how is that going to play out...

A - Phil Spencer {BIO 4399320 <GO>}

Yes. It's a great question. The business grew up as what I would call a per-device business. I build a game for a specific device. That device has a certain gaming demographic and it was very much a per-device model. Today our whole model has shifted to per user because gamers play games on any device. If they're sitting out in the audience and somebody boring is on stage, they might be playing a game on their phone. If they're sitting in class and they've got their PC open, maybe they're playing a game on their PC. They go home. There's a big television on the wall. They want to sit down. And they want their experience to span all of those screens seamlessly. So our transition over the last few years has been very much from a per device, of I'm a PC gamer, I'm a console gamer, I'm a mobile gamer to just I'm some somebody who likes to play games across any device. The video we showed there of Project xCloud is us really looking at the body of content that we have on our

platforms today and how do we bring that content to any device that somebody is looking at. We focus first on an Android phone because there's over 1 billion Android phones on the planet and it's a place that the content that we've natively built up over the past decades on our platform hasn't been able to reach. But we look at cloud streaming as a way, over years, where we're going to be able to bring content to customers on any device that they have regardless of the local compute capability, again building the experience around the customer, giving the customer choice on where they want to play. And obviously, when you look at that, we'll have multiple business models that will work with streaming. But the connection of streaming with the subscription model makes a ton of sense. You see it in music. You see it in video. So you can look at Project xCloud and you can look at something like Game Pass. And you can see there's natural synergies between those 2 things.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. And to make that successful, like if you think about it, you have the consoles. And you're really strong there. But you have PC games and mobile. Like PC, you started with a little bit. Mobile, kind of a still -- I would think that mobile is a little bit a work in progress. Like how do you kind of play -- make sure you play or do you not need to play because it's actually -- as long as you get the experience for any device it kind of works? How do I have to think about that?

A - Phil Spencer {BIO 4399320 <GO>}

Yes, 3 or four years ago, there's a big focus on -- I'll just use mobile because it's probably the easiest example, of who are the big mobile studios out there and what are the great mobile games. And maybe there should be acquisition M&A that we do in a pure mobile category. I'll use Fortnite again, Fortnite being one of the biggest games on the planet, or even Minecraft, our own game, another huge mobile game but also huge on PC, big on console. We ship it on Nintendo. We ship it on PlayStation. It's on all the platforms. Those games, are they mobile games? Or are they PC games? Or are they console games? In the end, they're just games. And I think more and more you're going to see less content that's tailored to only one device because it subsets the market and the technology that we're building allows you to bring that content to every screen. So what you're seeing. And you also see things like free-to-play games working on console, which traditionally, console was the world of retail, mobile was the world of free to play. And you'd say PC was somewhere in the middle. Now you see business models are working across all the devices because, again, you're actually focused on the same customer who've become accustomed to that business model across all the screens.

Q - Raimo Lenschow {BIO 4664646 <GO>}

So the whole -- like our idea, if I talk to a hedge fund and they're all accepting this mobile gaming content and now you're going to buy the next big -- that actually the world has moved on in a way.

A - Phil Spencer {BIO 4399320 <GO>}

Yes. I mean, it's -- maybe just because I was in North Carolina yesterday. But you can sit there. You can look at PUBG. You can look at Fortnite. You can look at Minecraft.

You can look at these huge games. And the games do very well on mobile. They're incredibly strong on mobile. But that's not to the expense of the other devices where they do well. You look at these games that have tens of millions, if not hundreds of millions of monthly active players across all these devices. And we know because we run Xbox Live. We think about content as a critical, critical aspect. Gamers play games. The community around these games is allowing people to be connected to their players and their friends and their content across all the devices. This is why we invest in Xbox Live and Mixer, our video streaming platform. And then cloud. So we think about it as 3 Cs, content, community and cloud. Cloud is the way we can deliver community and content to a player on any device. Yes, I'd say I'd hesitate to look for a game studio that's only capable of building on one device because gamers play games on all devices. And I think you're just -- you're missing out on an opportunity if you're not thinking about games that can work everywhere players show up.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. Okay. Let's change gears a little bit. Like so I've got 3 little daughters. I'm all concerned about like what they do and how they play. Talk a little bit about the social and regulatory risk that is kind of going -- coming with the industry. Or is it there? Is it changing? Is it coming? How do you think about that?

A - Phil Spencer {BIO 4399320 <GO>}

Yes. It's one of the things that our team takes very seriously. We ask ourselves, what does it mean for Microsoft to be in this category of entertainment, what should we stand for. And I think the kind of cultural push and input that Satya has had into the company has been written about many times. And we think about Microsoft playing a role in the gaming industry as a way for us to be leaders. And I'm proud of the work that we've done around parental controls, around toxicity online, around different topics that we need to address, I'll say, as a society. But it can show up in multiple forms of entertainment. We're in the gaming space. I think about how many kids have their first computing experience grabbing mom or dad's iPhone and playing Minecraft on that device. And I think our responsibility as the shepherd of those kids coming into a new social platform, a new game-play platform, potentially seeing other players. So the parental controls work that we do is critical. I also think there's a positive -- very positive aspect to this. For example, one of the things we've done with Minecraft is we have a complete focus on Minecraft in education. And we've had over 60 million kids take coding practice in Minecraft using the educational work that we've done there because those kids -- I mean, I started in this space because I played video games as a kid. And I remember my mom telling me, these video games are going to be the end of you. And it turned out okay so far. But yes, I think a lot of kids are really -- they learn, they get interested in STEM. They get interested in technology. They get interested in how these games are built. And I think it's important that we make sure gaming is safe and inclusive for everybody. But it's also a great, great way for us to take the interest that youth have and actually show kids how games are built and the stepping stools onto many different career paths.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes. Okay, good. So as a parent, I can kind of somewhat chill.

A - Phil Spencer {BIO 4399320 <GO>}

Well I'll say it. If you have kids that play, set up a parent account on Xbox LIVE. You should do it. You should understand what your kids are playing, just like you should understand what your kids are watching on YouTube, you should understand who your kids are messaging on Facebook. It's no different than any other form of media. The parental control system we have, not to get all soap-boxy about it. But it allows you to set parental timers on when your kids can play, screen time. So you can say "Hi. when you get home from school, do your homework." The box isn't actually going to turn on. You can do that. As a parent, you can approve everybody who gets to play your kids online. So make sure you're diligent. I'm in the gaming space. So I focus on this. I think as parents, we should be. I have 2 daughters as well. And it's important that we understand in an online world who our family is interacting with. And we work more and more to give people the controls for content and community so that they can curate that experience to their desire.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Okay. Let's shift gear again. Like you started talking about content earlier and how important it is to have content. Talk a little bit about your situation in terms of like you own content but then also have the third parties that you get in here. And there was going to be a follow-up question on Fortnite. But, yes, let's start there.

A - Phil Spencer {BIO 4399320 <GO>}

Okay. Yes. When I think about who I see as our long-term competitors over the next decade in this gaming category, I think you're going to see the big tech companies that Microsoft competes with in many different areas entering. And you see it. Amazon has Amazon Game Studios, they have for a while. AWS has a very large workload in the gaming space. Google has just started working on Project Stream. And they are -- you can see the work that they're starting to do to enter this category. Tencent is a huge gaming company. So when I think about one of the -- some of the strengths that we have as Microsoft, we've been in this space for almost 2 decades now. We have long relationships with the best content creators on the planet. And their content runs on our platform today. So we did some work early on to allow older Xbox games to work on today's Xbox. And our fans loved that feature. And it made a ton of sense in terms of we sold more games, we drove more engagement on the platform. That was great. When you look at a service like Project xCloud, then you start putting the math together and say, okay, now we have thousands of pieces of content from our partners. They've already built this content and I can basically stream it to any player anywhere with any device, which opens up a huge new market for them. The third-party relationships that we've built. And not only the games that are under development today but the past 2 decades of games that they've built on our platform, we're unlocking new business opportunity for that third-party content. We know that our system really only works if third parties are monetizing well on our platform. Our first parties are important here. But the third party relationships are a critical, critical aspect. And we have strong business relationships with the EAs, Activision, Take-Two, Capcom. You can go through the whole list and we've had long, long relationships and they ship hundreds of pieces

or thousands of pieces of content on our platform. Our first-party content capability, as we're building new business models like Game Pass and adopting new services, are really the creators of the flywheel. We're going to invest ahead of the curve in the market that we see getting created. And subscription is a perfect example. There are obviously subscription models and other forms of media that you can use as an example. But investing in your own content to attract players to your subscription service and the flywheel that gets created as we see millions of people coming into the subscription and you invest to continue to get fresh new content there, is probably the most important thing in growing that service.

Q - Raimo Lenschow {BIO 4664646 <GO>}

And how do you -- so that's the -- and the Fortnite question is coming out. Like we were all sitting as a team and we were like, what does Phil think about, like why can we not do Fortnite. Like if you think about that, like on the one hand, you're benefiting from third-party content. On the other hand, it's like why can we not do that? How do you think about that kind of success of a game versus not success of the game and success of your content versus others?

A - Phil Spencer {BIO 4399320 <GO>}

Yes. I think, Fortnite having such huge success on our platform is a perfect example of a strong platform. So I would start by saying, do we have the biggest games in the world shipping on our platforms natively? Like did we have to do extra work to make that happen? And we did not. Epic, who built this game. And we all know this, there's tens of thousands of games in development as we sit here, building a strategy around us being able to pick the ones that are going to be the hits is not a strong strategy. Us being a platform that all of the creators target and ensuring that when the successes happen, they happen on our platform is a good strategy. And that's -- so the thing I love about Fortnite is that it happened on our platform. It happened on other platforms as well. But we were able to reap the benefits of Fortnite's success without us actually investing in Fortnite as a specific form of content because Fortnite, in a lot of ways, looked like other games that were on the platform. And maybe somebody out there has a crystal ball on what makes one form -- thing in entertainment successful over another, that's not our strategy. Our strategy is to have the best place for all creators to create their content and make sure they have the monetization tools to go and drive a great business for us. And we will get our fair share of that through the business relationship that we have. So I see Fortnite as a massive success for us because it happened without us actually having to go do any special work to have it happen on our platform. Then, the game monetized so well and found so many customers on our platform.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Okay. That's great. Then just as part of the monetization, let's talk a little bit about Game Pass. So that's kind of -- subscription is kind of the way forward. How do -- and I get that part. How do you differentiate that against like what a Sony does or an EA does? Like how does that all fit together?

A - Phil Spencer {BIO 4399320 <GO>}

So for us, it's all about how we reach 2 billion gamers. If you build the market around a couple hundred million people that are going to own a game console or a high-end gaming PC, then your business model diversity can actually narrow because your customers are narrow. But when you think about reaching a customer with this content, where their only compute device could be an Android phone, you think about, well, what are all the ways that, that person pays for content, if they do at all, today. So we need to make sure we're world-class at free-to-play content but we also look at subscription as a much lower-barrier way for a customer to build their library of content. So we built Game Pass and it started on console. It will come to PC and eventually it will come to every device. We use the flywheel that we have with customers on an Xbox to start the growth in Game Pass. But if somebody is sitting back and taking a longer-term view of where our business is going, you should look at that as a business model that we think scales to billions of people, not hundreds of millions of people like retail does. So for us, growing Game Pass early, we're seeing the success in Game Pass today. It has been critically important, where the content investment, first-party studio investments we're making now are all about accelerating the flywheel of customers coming in. And we're seeing that work.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Yes, yes. And (Mike) is going to kill me if I ask you that. Like. So if you think about like, in that respect, listening to you on Game Pass but also listening to you on content. So on the investor side. And I have an alert now, like this is all -- you have to buy EA because there's so much content. And that one you kind of own the industry. But it doesn't sound like that's necessary.

A - Phil Spencer {BIO 4399320 <GO>}

Yes. You've seen the studio -- well, I don't know if you've seen it. If you watched the studio acquisitions we've done, we're focused on teams. We're focused on creative teams that we think can build very interesting content to help the flywheel Game Pass grow and our platforms grow. We're probably less interested in management teams and infrastructure and things that we already have inside of our organization. And you can just look at the track record. We've added 7 studios in six months. And if you look at them, I think you'll see certain, both, valuations but, more importantly, the creative teams that we're picking up, knowing that we can then plug them into a Microsoft infrastructure, an Xbox infrastructure to help those teams succeed with more solid funding, alignment towards goals around Game Pass reaching gamers everywhere. And we don't have to pay for some of the things that some of the bigger publishers have that we probably already have under our roof. So yes, our focus hasn't been on going out and kind of adding duplicative function that we'd be paying for that I don't think we need. But more how do we find the creative independent teams out there. And I feel really good about the path that we're on right now.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Okay. Last question from me. As I think about -- you started to talk about streaming next year in the cloud. Talk a little bit of what you do there. Then also how much extra commission do you get? Because you must be driving Azure traffic like crazy. And

the Azure team must love you because there's so much that needs to be coming their way if you are successful here.

A - Phil Spencer {BIO 4399320 <GO>}

Yes. If you go and you watch that video again, one of the things to take notice of is the silicon we're using to stream these games is actually the silicon from our console. And it turns out that consoles have very compatible kind of design criteria to what a blade in a server looks like. We want a high power to energy use, low-priced, cooling is an issue, all the things that these devices care about in the home work really well on a server blade. The thing that's interesting for us as we roll forward is we're actually designing our next-gen silicon in such a way that it works great for playing games in the cloud and also works very well for machine learning and other non-entertainment workload. So as a company like Microsoft, we can dual-purpose the silicon that we're putting in. We have a consumer use for that silicon. And we'll have enterprise use for those blades as well. It's all in our space around driving down cost to serve. And your cost to serve is made up by 2 things, how much was the hardware and how much time is that hardware monetized. So we can monetize that hardware over more cycles of the day -- in the 24 hours through game streaming and other things that need CPU and GPU in the cloud. We will drive down the cost to serve in our service. So the design, as we move forward, is done hand-in-hand with the Azure silicon team. And I think that creates a real competitive advantage. And if you looked on the map of where Azure lives today on the planet, it lives really close to a lot of people who don't play our traditional games today. This is about global scale to the infrastructure that Azure has built and making sure that our silicon and the work that we're putting into those data centers is used for multiple uses inside of Microsoft.

Q - Raimo Lenschow {BIO 4664646 <GO>}

And that's more -- now this is the last question. On the personal -- but how do you solve it? When you're going to listen to this, it sounds really cool. But it's always the issue of network latency to kind of make the gaming experience a little bit cranky. How do you solve that? Are we at that point already that we can -- that we're able to solve that?

A - Phil Spencer {BIO 4399320 <GO>}

Yes. I mean we're using -- I've been on the road for 10 days now. I've been playing a ton of games on my Android phones streamed. I go to different parts of the planet. Right now our servers are in our data center in Washington as we're testing, which is still about 5 hours from our Redmond campus. The thing about Azure is the global scale of where Azure is. Scott Guthrie, Jason Zander, the team that's been building out Azure has really built a global strength in Azure in terms of where our data center and our edge nodes are. And we're putting them close to places where people will want to go play and specifically players we don't reach today. Now I love the fact that I see Azure instances on the continent of Africa. There's 1.2 billion people on the continent of Africa. And the average age is, what, about 20, 21. Now that's not a huge gaming market for us today. But if you think over the next decade, the demographic works. If you look at India and you start looking where Azure has data centers today, they have a lot of data centers in Azure, look at Southeast Asia. These are places we're going to be able to deliver content to customers that know what our brands

are. They know what this IP means but they're not able to go play those games today on the devices that they have. Putting the data center closer -- data centers closer to the players is how we work on latency, among other kind of magic software solutions that we put in place. But the global scale of Azure is a huge benefit to us in this space.

Q - Raimo Lenschow {BIO 4664646 <GO>}

Perfect. That's a perfect closing statement. I know our time is up now. But that worked really well. Phil, thank you. Thanks for being here. That was really insightful.

A - Phil Spencer {BIO 4399320 <GO>}

Thank you.