Investor Call: AI-powered Microsoft Bing and Edge

Company Participants

- Amy Hood, EVP & CFO
- Brett Iversen, General Manager of IR
- Philippe Ockenden, CVP Finance

Other Participants

- Brad Zelnick, Head of Software Equity Research and Senior US Software Research Analyst, Deutsche Bank AG
- Brent Thill, Equity Analyst, Jefferies LLC
- Kasthuri Rangan, Analyst, Goldman Sachs Group, Inc.
- Keith Weiss, Equity Analyst, Morgan Stanley
- Mark Murphy, MD, JPMorgan Chase & Co

Presentation

Operator

Greetings, Welcome to the Microsoft Conference Call. (Operator Instructions)

As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Brett Iversen, Vice President of Investor Relations.

Brett Iversen {BIO 22252603 <GO>}

Good afternoon. Thank you for joining us as we share more about our advertising business, the opportunity in front of us, and the announcement today regarding Microsoft's new Bing and new Edge, your AI-powered copilot for the web.

On the call with us today are Amy Hood, Chief Financial Officer of Microsoft; and Philippe Ockenden, Chief Financial Officer of the Windows, Devices and Search businesses.

On our investor relation's website is a slide deck which is intended to follow today's presentation.

Following the call you can also replay this webcast and view the transcript.

During this call we will make forward-looking statements which are predictions, projections or 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 today's webcast and in the risk factors section of our Form 10-K, Form 10-Q and other reports and filings with the Securities and Exchange Commission.

We do not undertake any duty to update any forward-looking statements.

With that, I'll turn the call over to Amy.

Amy Hood {BIO 18040963 <GO>}

Thank you, Brett, and good afternoon, everyone.

As you heard in our earnings commentary two weeks ago, and as you saw from Satya and Yusuf in the presentation earlier today, Microsoft is at the forefront of the AI platform shift.

We have built the world's most powerful AI supercomputing infrastructure in the cloud, having invested for years for this wave. We've already released products like GitHub Copilot, putting that investment and its benefits in the hands of our customers.

Going forward, as customers select their cloud providers and invest in new workloads, we are well positioned as an AI leader and as the world's largest commercial cloud provider.

Today we introduced our new AI-powered copilot for the web on Bing and Edge. We are reimagining the search and browser experience with AI. As Satya mentioned, during today's announcement, we're going to have fun innovating at a fast pace in search. And of course, I'm even more excited for people to get started using it.

Sam discussed it earlier today, but our partnership with OpenAI began when we made our initial investment in 2019. Just a few weeks ago, we announced our latest investment and our expanded partnership that includes joint research and development, as well as commercial agreements across the company.

As an example, through our joint R&D, we are combining a new next generation OpenAI model that is more powerful than ChatGPT with Bing's real-time information to create a proprietary collection of capabilities that will power the new Bing and the new Edge. Through our new commercial agreement, we will benefit from each other's successes.

Before I move on to the business opportunity, I want to address our ongoing commitment to responsible AI. In addition to our comments this morning during the webcast last week, Brad Smith published a blog on responsible AI that I urge each of you to read. We are committed to the advancement of AI driven by ethical principles that put people first.

With that, let's turn to why we're investing in a new AI-powered search and browser experience.

At Microsoft, we position ourselves in markets with large and growing total addressable markets where we can profitably take share with high-value differentiated experiences, and digital advertising is one of those markets.

As people continue to spend more time online, advertising dollars follow. The overall digital advertising market, which includes spend from search, social, display and video, was over $0.5 trillion in 2022, growing in the high teens and highly profitable. Approximately 40% of that market was in search advertising, and we expect this opportunity to continue to grow.

I'm going to turn it over to Phil to talk a bit more about our advertising business.

Philippe Ockenden

Thanks, Amy.

At Microsoft, our 2 largest digital advertising businesses are search and news advertising and LinkedIn Marketing Solutions. Over the last 12 months, our total advertising revenue was nearly $18 billion, and the businesses continue to be profitable.

Today, I'm going to share an update on our search business, the growth we've seen to date and how we expect the new AI-powered search and browser experience will expand growth opportunities going forward.

For a long time, we've invested in our search and news businesses, organically improving quality, creating the new Edge browser and increasing the pace of releases, adding user value in places like shopping and weather.

And more recently, we have completed acquisitions such as PromoteIQ and Xandr to ensure we could better meet the needs of advertisers. Those investments mean we have a breadth of advertising solutions across our first and third-party portfolios, and we have a world-class browser with Edge, which is taking share for 7 consecutive quarters.

Our search and news advertising revenue ex-TAC has grown double digits over the past 8 quarters faster than the market, and we have done that profitably and with growing margins. With that strong foundation, we are well positioned to transform

the search and browser experience with AI technology, and Windows is the best place to use it.

We have more than 1.4 billion monthly active Windows devices and are seeing increased engagement that is up 10% versus pre-pandemic. We innovate the users in the activities they do the most, which includes working in the Microsoft 365 productivity suite, communicating and collaborating in Teams and gaming in the Xbox ecosystem.

Most of the time spent on the PC, however, is browsing, searching, shopping and consuming the news. The new Bing and the new Edge will help customers do this better and more efficiently in 4 ways.

First, better search. Users will get a better search experience, including improved ranking and more relevant results.

Second, complete answers instead of just a list of relevant links, Bing reviews results from across the web to find and summarize the answer you're actually looking for. For example, you can ask for a comparison of top-rated car seats or what to use as a substitute for eggs in any recipe.

Next, chat. The integrated chat experience lets you naturally interact and refine complicated research queries to better tailor your answers for areas like travel, planning and shopping. For example, it would not only give you links for how to plan a trip, but rather plan one for you. Instead of giving you results for hotels in Paris, it will recommend the best hotels fitted for your preferences.

And finally, spark creativity. You are no longer limited by searching for what already exists. Bing will help you create new content with just a description such as writing a poem, drafting in e-mail or translating either of those into a different language.

These new AI-powered search capabilities will also be in the sidebar within Edge, creating a better browsing experience.

Simply put, the new Bing and the new Edge will drive revenue growth through increased volume and increased rates. Because our search and browser will deliver a better customer experience, will increase our volumes by attracting new users and driving higher engagement across our existing user base. A higher volume of users will attract more advertisers to our platforms.

Additionally, the new Bing will have the context into what the user is trying to accomplish. Ads will become more personalized, and while the user may see fewer ads, they will be of higher value to advertisers.

While this new experience will be delivered at a higher cost-to-serve, gross margin dollars will grow as usage grows. Importantly, we'll bring more experiences to more

entry points over time, including mobile, where getting an answer is more helpful and efficient, given the smaller screen. Therefore, the volume and rate growth opportunities will materialize gradually as the full experiences, rollout and advertisers see the benefits of this innovation.

New users, higher engagement and increased advertising rates will fuel revenue growth. As Amy mentioned earlier, the digital advertising TAM is over $0.5 trillion. And within that, approximately 40% is in search advertising. For every 1 point of share gain in the search advertising market, it's a $2 billion revenue opportunity for our advertising business.

Today, our share of the search advertising market is mostly on Windows PCs, which is where we expect to see the initial benefits from the volume and rate growth. We particularly have an opportunity to grow in international markets, given the large language models enable better transformation and a better understanding of local market content.

And now, I'll hand it back to Amy for some closing thoughts.

Amy Hood {BIO 18040963 <GO>}

Thanks, Phil.

I'm excited for the position we are in after years of investment into the AI platform. We've been delivering AI innovations through our OpenAI partnership to customers since 2021, and the pace of releases is clearly accelerating with Teams Premium, Viva Sales and your copilot for the web on Bing and Edge in the last 7 days. And we are pleased to be OpenAI's exclusive cloud provider.

As a company, we will continue to invest in additional capacity to support the near-term and long-term demand we see for all AI workloads.

And as we said at earnings, AI is the next big platform shift. For us, this will impact every part of our tech stack, creating new solutions and new opportunities. We believe value is created when companies lead and platform shifts, and we're going to lead in this AI era.

With that, let's go to Q&A, Brett.

Brett Iversen {BIO 22252603 <GO>}

Thanks, Amy.

We'll now move over to Q&A. Out of respect for others on the call, we request the participants please only ask one question.

Joe [ph], can you please repeat your instructions?

Questions And Answers

Operator

(Operator Instructions) Our first question comes from the line of Keith Weiss with Morgan Stanley.

Q - Keith Weiss {BIO 6993337 <GO>}

Excellent. Thank you guys for hosting the conference call and really fascinating announcements and great demos. I was just watching the video.

I think what a lot of investors are wondering about right now from you, Amy, is the cost side of the equation. We've seen OpenAI and Sam Altman talked about a couple of cents per query, and you guys are talking about there's 10 billion queries done every day. And that could add up pretty quickly.

How should we think about the underlying expense that that Microsoft is going to be taking on? Does this materially change gross profit forecast in the near term, or CapEx forecast in the near term? Or is this already incorporated into what you guys were thinking about for the year?

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Keith. And that's a great question because I think there's lot of a nuance to it, and it gives me a time to talk about first a couple of things.

While we'll focus on the cost side in the second, it always starts with the size of the opportunity. This is probably, and I think Satya said it today in the intro comments on the webcast. This is the largest software category that exists. And it's incredibly profitable, incredibly large and still growing. And we're a very small share player today. Even though we gained share over the past 7 quarters, grown in excess of the market for 2 years, there is a lot of upside in this category for us.

And so what's important is that the platform, which we are using to deliver the AI is the same platform that we're using, whether it's the Azure APIs that are being utilized across first party and third party, whether it's some of the new experiences you've seen us launch in the applications that will be Viva Sales or Teams Premium. This is -- the scale for us will be applied at every layer of the stack.

And so when you think about to the search experience specifically, you heard us say the first and most important thing is we're going to see usage growth. We're going to continue to roll this out. We said to millions over the coming weeks. As we see usage grow, you'll see revenue growth. And for each of those new users or increased usage that's incremental gross margin dollars for us even at the cost-to-serve that we're discussing.

And so I tend to put this in the category of its net new and net new profitably at both the GM line and the operating income line, which is encouraging. And it's a leverage platform that starts at the supercomputer layer, which means we can use the utilization and the cost that will, by the way, continue to come down over time. We've seen platform shifts before. And so, cost per tends to come down with scale, of course. And I think we're starting with a pretty robust platform to be able to do that.

A - Brett Iversen {BIO 22252603 <GO>}

Thanks, Keith.

Joe [ph], next question, please.

Operator

The next question comes from the line of Brent Thill with Jefferies.

Q - Brent Thill {BIO 1556691 <GO>}

Amy, can you talk about the ramp time of how quick you can influence advertisers to come on? What does this duration look like to bring them into the fold?

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Brent. What's great about this is we already have a substantial advertising business. I've talked about it's an $18 billion business that's been growing in excessive market rates for quite a while. And because of that, we've made investments over the past 2 years to really build a robust advertising platform. And it's why I still happen to mention the acquisitions we've done, PromoteIQ and Xandr.

This has really been a vision that we've invested in. As we've seen the AI platform shift coming for a number of years, we've strengthened the platform that we have for advertisers to be able to take advantage of it. And we've seen wins from third parties, some of which are big names that you're all familiar of, who've chosen our advertising platform to fuel their growth, too. So we're actually relatively mature in that process.

So what we're looking for really here is to make sure advertisers can see with this new experience, the higher quality of the ads and the rates that they'll be able to see. This is actually good for customers in terms of the experience you're getting to use and you saw on the webcast, but also good for advertisers. But I don't think it requires ramp time for our advertisers. It's more about rolling it out to users and seeing them get engaged.

A - Brett Iversen {BIO 22252603 <GO>}

Thanks, Brent. Joe [ph], next question, please.

Operator

The next question comes from the line of Mark Murphy with JPMorgan.

Q - Mark Murphy {BIO 1542399 <GO>}

So Phil, the experience of using ChatGPT is truly remarkable. And now we're seeing how you're bringing that power to Bing and Edge products.

If you think forward and we're preparing to see some of the competitive responses to ChatGPT in the coming days and weeks, could you speak to the competitive differentiation that you're going to have? In other words, is OpenAI's underlying model more powerful? And just how do you think about sustaining the competitive differentiation in this area as you collaborate with OpenAI, but also leverage that infrastructure that you've been building for several years?

A - Philippe Ockenden

Yes. Amy talked about earlier how we're taking the new Edge models from OpenAI, we're combining it with the real-time information from Bing. And we think that's going to create a product that's really special. It's going to be running on our AI infrastructure. So we've built across all of our products, and we think that gives us a lot of leverage as well.

A - Amy Hood {BIO 18040963 <GO>}

And maybe one perspective I would add, Mark, is that when you're a newer, a smaller share player in a category, it does allow us to continue to innovate at a great pace, continuing to experiment, learn with our users, innovate with the model, learn with OpenAI and continue to ship new features.

And I think the pace you've seen from us in the past few weeks in terms of announcements at every layer of the tech stack, this has been work, we've been obviously at for quite a long time. But what I think you're going to see going forward is innovation that comes quickly. And I think that's always a good position to be in.

A - Brett Iversen {BIO 22252603 <GO>}

Thanks, Mark.

Joe [ph], next question please.

Operator

The next question comes from the line of Kash Rangan with Goldman Sachs.

Q - Kasthuri Rangan {BIO 22095432 <GO>}

Very much impressed with all the sudden burst of innovation that's coming out of Microsoft in this arena for a long time. So really happy to see that.

Amy and team, curious, as you look at generative AI, I think there are at least half a dozen projects that are really, really well funded. And sooner or later, some of the big tech companies are going to have their own semi-proprietary frameworks that we'll be able to use natural language search capabilities to generate the kind of interesting content that ChatGPT has been able to generate.

Do you see this as a platform shift? Or is it a thing that is available equally to anybody that can use these frameworks and so it's not really -- it's going to spur more innovation, but nobody really incrementally benefits? If that's wrong, why should Microsoft disproportionately benefit from this initiative in a way that others cannot benefit?

A - Amy Hood {BIO 18040963 <GO>}

Thanks, Kash. That's a great question. I'll start,. Phil, you should add anything.

One of the most important things -- and I think Kash, you've seen this a bit. This starts -- and I think even Sam mentioned it today on the call -- they're doing a lot of innovation work. But there's also a lot of proprietary work that's been done here.

To build the platform, we referenced it as the AI supercomputer. But that work has taken years and has taken a lot of investment to build the type of scale, the type of speed, the type of cost that we can bring at every layer of the stack. I think that actually is quite differentiated at the scale at which we operate.

We're the largest commercial cloud. We'll bring it in our application layers. We'll bring it, as we talked about, I think Satya mentioned, whether that's Microsoft 365, whether it's our Office features, whether it's information inside the firewall, information that sits in the index plus the OpenAI technology. I think there is, in fact, a differentiation. We built a business that's about participation at every layer of the deck so that customers, developers, end users can experience it at each of those interactions.

And so, while there are lots of models being built and there will be lots of competition in the space, there aren't that many people who've invested at the scale we have and at every layer. And I look forward to being able to continue to show that innovation at all layers of the stack. And I do think users will see a difference.

A - Brett Iversen {BIO 22252603 <GO>}

Thanks, Kash.

Joe [ph], we have time for one last question.

Operator

The next question will come from the line of Brad Zelnick with Deutsche Bank.

Q - Brad Zelnick {BIO 16211883 <GO>}

Congratulations on all the innovation and success. Clearly Microsoft has several significant advantages in these large and profitable markets we're talking about today. But when we look back Amy, in 5 or 10 years, how much of your AI capabilities will be monetized in different applications like search, which is clearly itself a huge opportunity versus horizontally through the Azure platform? And how are you thinking about allocating capital against opportunities, both platforms and applications?

A - Amy Hood {BIO 18040963 <GO>}

That's a great question, Brad.

Many of you have, I think, been covering the stock long enough and the company long enough to remember when we've gone through some of these transitions before, particularly from server to cloud. And when we made that transition at first, we had lots of different infrastructure sitting under a lot of our large-scale products. And really, the leverage we found, the gross margin improvement, the operating profit improvement, the cash flow improvement came as we brought those vacuums together to build one set of infrastructure.

The AI platform is different, and very different from the transition that we saw and went through, gosh, over a decade ago. We're starting from a common infrastructure. And so in many ways, I think right now, we're focused on where we can add high-value usage. It's about product making and product design.

Satya mentioned it a bit in passing, I thought today in the intro to the session. It's about the value of making the experience work and making AI light up in ways that users see greater productivity improvement from, see better answers from in the search or Bing experiences and the browser experience.

And so, I'm less focused at this point and where particularly business model, why the growth is going to come from because I'm actually quite confident it's going to come from an ad model. It's going to come in subscriptions. It's going to come in the consumption businesses, just looking across our stack.

But it's the fact that we don't really have to plan for precisely where it has to come from on the demand side because from a capital perspective, we're investing in a common platform. So predicting that model and monetization isn't nearly as important as frankly, it was a decade ago and we didn't have a common backend.

And so, it's a great question, and I think this is one where we'll continue to talk about new releases. We'll talk about adoption, which is the most important thing, particularly here. And we'll continue to talk about where we're innovating to make sure we can have high utilization of the infrastructure we're putting in place. And I think this is something we've been at a while now and certainly over the past few years, making investments into this platform.

So thank you, and thanks to everybody for joining us today.

A - Brett Iversen {BIO 22252603 <GO>}

Thanks, Brad. That wraps up the Q&A portion of today's call. Thank you for joining us today, and we look forward to speaking with all of you soon.

A - Amy Hood {BIO 18040963 <GO>}

Thank you all.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.

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