

**Microsoft Fourth Quarter 2010 Earnings Conference Call Transcript**

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**PETER KLEIN, CHIEF FINANCIAL OFFICER:**

I’m very pleased to share with all of you our strong financial results - we achieved record revenue, operating income, and earnings-per-share for both the fourth quarter and the full year.

This quarter, our strong revenue performance was both broad and deep, with every business achieving double-digit growth. Strong sales execution closed the year with fourth quarter bookings increasing 27%. For the year, both the Windows Division and Server and Tools Business achieved record revenue.

We are equally enthusiastic about the customer and product momentum we’ve achieved this year across the breadth of our portfolio.

Of course, I have to start by noting Windows 7, which has received tremendous market response. With 175 million licenses sold to date, it is the fastest selling operating system ever and now runs on over 15% of all PCs worldwide.

Capitalizing on the recovery of the server hardware market, Windows Server 2008 R2 has enjoyed strong demand and increased Windows Server market share.

With the launches of Exchange 2010 and, most recently, SharePoint 2010 and Office 2010, we delivered key innovations in our productivity portfolio.

Equally as important for our long term growth, we made significant strides in our cloud initiatives by bringing Windows Azure to market and by increasing customer traction with our commercial online services.

Throughout the year, we continued to update and enhance Bing, which has now achieved thirteen consecutive months of market share growth.

And finally, we focused on consumers with our new Xbox 360 consoles and the announcements of Kinect and Windows Phone 7, coming to market this holiday season.

Meanwhile, as a result of our ongoing commitment to managing costs, we held annual operating expenses roughly flat. Our continued revenue strength and cost discipline drove yet another consecutive quarter of margin expansion and record annual profits in the Windows Division, Server and Tools Business, and Entertainment and Devices Division, as well as the company in total.

We grew full-year operating income by almost $4 billion and generated operating cash flow of $24 billion. Of this amount, we returned about two-thirds, or almost $16 billion, to shareholders in the form of stock repurchases and dividends.

Finally, I’m particularly pleased by our growth in earnings-per-share of 50% for the fourth quarter and 30% for the full year.

So, it’s been a great fiscal year and an outstanding fourth quarter. With those remarks, I’ll now turn the call over to Bill to provide more details on the quarter.

**BILL KOEFOED, GENERAL MANAGER INVESTOR RELATIONS:**

As I review this quarter’s performance, keep in mind all growth comparisons relate to the corresponding period of last year unless I specify otherwise.

As Peter noted in his opening remarks, we finished the year with terrific financial results. Total revenue for the quarter grew 22% to over $16 billion, a record fourth quarter result. Windows, Online Services, Entertainment & Devices, Server & Tools, the Business Division… each of our operating segments grew revenue double digits this quarter, reflecting broad-based strength across all of our businesses.

Fourth quarter GAAP operating income grew 49% while EPS grew 50%. Looking at the full year and adjusting for the tech guarantees, we had four consecutive quarters of margin expansion with EPS growing faster than revenue every quarter.

Operating cash flow was up 46% to a fourth-quarter record $5.6 billion. And for the year, operating cash flow surpassed $24 billion as Peter noted, also a record.

Customer demand was strong across the breadth of the Microsoft portfolio this quarter, as we saw total bookings growth accelerate to 27%.

In the enterprise, businesses continue to invest in and commit to the Microsoft platform. Sales execution and enterprise agreement renewal rates have improved as unearned revenue at the end of the quarter was $14.8 billion, up a very healthy 21% sequentially. The contracted not billed balance ended the year over a record $15 billion.

The small and mid-market customer segment continued to experience robust growth and was up approximately 20%.

Finally, continuing a trend this year, consumer demand was fantastic with growth in Windows, Office, Search, and Xbox.

Geographically, we saw strength across all regions led by emerging markets. Growth in the US improved this quarter while demand in Europe remained healthy.

The PC market continues to thrive and we estimate the market grew between 22 and 24%, with both consumer and business growing in the same range.

From a geographic perspective, emerging markets remain a significant driver of the PC market with almost twice the growth of mature markets.

With that PC backdrop, I’ll move on to the Windows and Windows Live Division.

Windows revenue grew over a billion dollars or 32% this quarter when adjusted for the Windows tech guarantee last year.

Total OEM license growth was 26% and outpaced the PC market for the third quarter in a row. Consumer and business licenses both grew approximately 26%. The business PC refresh cycle has accelerated and we recorded the second straight quarter of double-digit business license growth.

As in past quarters, to help you bridge PC growth to OEM revenue growth, we have provided a reconciliation slide in our earnings deck.

At 31% growth, adjusted Windows OEM revenue outgrew PC shipments by 7 percentage points this quarter. The hardware segment mix was a 3 point headwind to revenue growth. As I mentioned earlier, emerging markets continue to outpace mature markets. Windows attach and inventory drove 6 percentage points of growth. We exited the quarter with normal inventory levels and continue to benefit from solid attach gains in both business and consumer. Finally, upsell and channel dynamics drove 7 percentage points of growth reflecting a higher Windows 7 offering mix.

Enterprise adoption of Windows 7 accelerated and the non-OEM portion of the Windows Division grew 36%, driven by an increase in volume licensing to businesses and retail sales of Windows 7.

Clearly the Windows franchise is thriving. Importantly, customer satisfaction for Windows 7 is incredibly high at 94% and businesses are deploying Window 7 in the enterprise.

In the browser, IE 8 is now the fastest growing and most popular web-browser in the market, with IE 9 coming soon.

Now let’s move to Server and Tools which posted 14% revenue growth in the fourth quarter and had a record year with $14.9 billion of revenue.

We estimate the underlying server hardware market grew 25 to 28%. Non-annuity revenue grew approximately 20%. Windows Server grew with the market, while SQL Server 2008 R2 and Visual Studio developer tools also contributed to the growth.

Annuity revenue, which is approximately 50% of the business, grew about 15% with improved enterprise demand.

From a product perspective, Windows Server, SQL Server, and System Center all experienced double-digit growth.

Enterprise Services, about 20% of revenue, grew 3%.

Windows Server continues to gain share as businesses replace and procure new hardware in the datacenter. We estimate Windows Server grew its market share over 1 percentage point while at the same time increasing premium mix to about 25%. Our virtualization suites almost doubled this quarter.

In addition to the share gains in the traditional server market, Microsoft is leading the way to the cloud with our Windows Azure services platform.

Just last week at the Worldwide Partner Conference, we unveiled a number of new cloud innovations and partnerships, further increasing the alignment between our on-premise Windows Server, SQL Server, and System Center products with the Azure platform.

Next I’ll move on the Online Services Division, which grew 13%. The Online advertising component of the division grew 19%, primarily driven by our search business, which again outperformed the market.

We continue to be encouraged by Bing’s ongoing share gains, due to the pace of exciting innovation and differentiation it brings to market. June marked the 13th consecutive month of share gains in the US which is now up over 4 points since launch.

Turning to the Microsoft Business Division, revenue grew 15% and Office 2010 is off to a great start.

Consumer revenue, which includes OEM and retail, grew 51% following the launch of Office 2010 heading into the back to school season.

The business portion of MBD grew 8%. Non-annuity license sales jumped 15% trending towards PC shipment growth as expected. The annuity licensing portion of the business grew 6% driven by an increase in enterprise demand.

Office and the integration with SharePoint, Office Communications Server, and Dynamics CRM has had strong demand and each of these products grew double digits this quarter. The cloud enhances these productivity scenarios, and our customers are purchasing suites of our online services at an increasing pace. 70% of our Business Productivity Online seats represent new business to Microsoft.

Let’s move on to the Entertainment & Devices Division which grew 27%.

Gaming revenue grew 30% as we sold 1.5 million consoles, a unit increase of 26%, taking share as we grew faster than the overall market. Xbox Live continues to be a tremendous asset with over 25 million members. This year marked the first time that Xbox Live Digital Marketplace revenue exceeded subscription revenue, illustrating the service’s increasing level of customer engagement and monetization.

Non-gaming revenue was up 23%, driven by growth in Windows Embedded and sales of PC accessories that generally align to PC market growth.

This quarter at E3, we unveiled Kinect, the Xbox 360 motion sensor which will enable you to play games, and control your music and movies with just your voice or the wave of your hand — no controller required. Earlier this week we announced product and pricing for the all new Kinect experience. The Kinect experience, with more than 15 games available this holiday, begins in North America on November 4.

Now let me cover the remainder of the income statement.

Foreign exchange had a 2% positive impact to revenue this quarter. We experienced a headwind from the Euro as one would expect, but this was more than offset by our hedging program and the dollar weakening in other currencies.

Cost of goods sold increased 23% to $3.2 billion, driven primarily by increased online costs, royalties, and other charges.

Operating expenses were $6.9 billion in the quarter, under our guidance range, and we were very pleased with Q4 execution and financial discipline. Headcount decreased 4% year over year.

We repurchased $3.8 billion of shares and paid $1.1 billion of dividends.

So, to wrap up, our product cycle momentum continues with the release of Office 2010 and the breadth of our portfolio which drove record results. Our cost discipline remains strong. In the cloud, we have great momentum and are seeing businesses invest in the Microsoft platform.

And with that, I’ll hand it back to Peter, who’s going to discuss our business outlook.

**PETER KLEIN, CHIEF FINANCIAL OFFICER:**

Thanks Bill. I’d like to now share our thoughts on the first quarter and total fiscal year 2011.

We are entering the year with great momentum. We are encouraged by the resurgence in business PC shipments and expect the business PC refresh cycle to continue through fiscal year 2011. The recent refresh of our enterprise products has positioned us well to meet customers’ needs as they return to investing in information technology.

Turning to our outlook by business, we expect Windows Division revenue to grow roughly in line with PC shipments for the first quarter and full year, excluding the $700 million revenue impact from the Windows 7 retail launch and $276 million from the technology guarantee revenue carried-over from fiscal year 2009.

For the Microsoft Business Division, consumer and business non-annuity revenue, approximately 40% of the total, should continue to track with their PC shipment growth rates for the first quarter and full year. Annuity revenue for the first quarter and full year should grow low to mid-single digits.

Moving to the Server & Tools Business, for the first quarter, we expect non-annuity revenue to be up mid-to-high single digits as first quarter bookings are sales-cycle driven and tend to be the softest seasonal quarter, irrespective of hardware shipments. For the full year, we expect non-annuity revenue to generally track with the hardware market. We expect annuity revenue to grow roughly high-single digits for the first quarter and full year. Enterprise services revenue should grow mid-single digits.

For the Online Services Division, our online advertising business should outperform the overall online advertising market. Regarding our search partnership with Yahoo, we are working closely with them to migrate both algorithmic and paid traffic in North America for this holiday season.

And finally, I’ll cover the Entertainment and Devices Division. Based upon the compelling wave of consumer offerings coming to market, we expect revenue will grow in the mid-teens for the first quarter and full year - following its normal seasonal skew to the first half of the year.

Moving to costs of goods sold, gross margins will be impacted by product mix, and particularly by the increase in hardware sales that will drive growth in the Entertainment and Devices Division.

We remain focused on diligently managing our cost structure and are lowering our full year operating expense guidance to between $26.9 and $27.3 billion, which includes our estimate of Yahoo search integration expenses.

We expect our effective tax rate to remain approximately 25%.

Switching to the balance sheet, we expect that the first quarter unearned revenue balance will track to normal historical patterns on a sequential basis, after adjusting for the impact of tech guarantees in the prior year.

Capital expenditures for fiscal year 2011 will be about $2.5 billion. This will be the second year in a row in which capex spending will be lower than depreciation expense.

We will continue to generate strong free cash flow and remain committed to returning capital to shareholders through dividends and stock repurchases.

So in summary, I’m very pleased by our outstanding financial results for the quarter and the full year. We have great product momentum in the market with strong business and consumer demand for our most recent wave of products. With the exciting pipeline of consumer products arriving to market this holiday season, we are well positioned to continue this momentum this coming year. On that note, I'm looking forward to seeing all of you at our financial analyst meeting next week, and I'll now return the call to Bill so that we can begin taking your questions.

**BILL KOEFOED:** Thanks, Peter. We want to get questions from as many of you as possible. So, please stick to one question and avoid long or multi-part questions. Barb, can you please go ahead and repeat your instructions.

**WALTER PRICHARD, Citi:** Hi, I was wondering if you could elucidate a little bit on the PC side your assumptions for Fiscal '11, and just talk about tablets and how you're thinking about that market. Are you talking about growing in line with traditional PCs, and what impact do you think tablets will have on the market, and what may be your share in that area, and how does that affect your growth rate?

**PETER KLEIN:** Yes, we're very excited about the market. The PC market is the PC market, excluding tablets. But, obviously, we're super-happy with both the state of the PC market and the customer traction for Windows 7. We think tablets are very interesting and remind us that there are always new scenarios and new opportunities, and we're constantly working with our partners and our OEM partners. In fact, I think one of the things that's driven the PC market and Windows growth this year has been the work we've done with our OEM partners on multiple scenarios and form factors, and price points to hit all those.

Tablets I think are interesting and great, because I think they sort of enlarge the overall opportunity. I think they're additive to the opportunity. And, again, it reminds us that there are lots of interesting new scenarios that we are continuing to work on, and so we're excited by that.

**WALTER PRITCHARD, Citi:** Great, thanks.

**PETER KLEIN:** Thanks, Walter.

**BILL KOEFOED:** Next question, Barb.

(Operator Direction.)

**ADAM HOLT, Morgan Stanley:** Great, thank you. It looks like a really good start to Office, 8 percent business growth was the highest number I think you've seen in two years. Do you think business revenue growth can get to the same levels you saw with the previous Office cycle, where it reached north of 20 percent? And why wouldn't the annuity business for Office grow faster than low-single digits in the heart of the cycle next year? Thanks.

**PETER KLEIN:** Thanks, Adam. I'm not going to give guidance, other than the driver frameworks that we gave. In terms of the annuity business, obviously, in terms of the deferred revenue, we've had the last year or year-and-a-half has been slow. And so we're kind of digging out of that hole of the recognitions that we have from the deferred revenue balance. And so, in the course of this year, we'll be building that back up.

And, as I said, we expect Q1 unearned revenue to also return to normal, historical, sequential pattern. So, we feel good about the opportunity to continue to drive bookings with Office, but in terms of the annuity revenue recognized growth, that's impacted by sort of the billings that we saw over the course of the last year. But, having said that, we're certainly very optimistic about business uptake of Office 2010.

**ADAM HOLT:** Terrific. Thank you.

**BILL KOEFOED:** Barb, can you move to the next question?

(Operator Direction.)

**HEATHER BELLINI, ISI:** Hi. Yes, good afternoon. I was wondering if you guys could talk about the decline in the consumer premium mix, and what percentage of the decline is related to emerging markets, and what are the other reasons if that doesn't explain all of it? Thanks.

**PETER KLEIN:** Thanks, Heather. All of it, it's all related to the growth in emerging markets.

**HEATHER BELLINI:** That was easy, then. Thank you.

**PETER KLEIN:** Thank you.

**BILL KOEFOED:** Barb, the next question, please.

(Operator Direction.)

**PHILIP WINSLOW, Credit Suisse:** Hi, guys. Great quarter. I just wanted to have one question back on the Windows Division. If you look at that commercial and retail license line, it still remains very strong year over year and even sequentially. Obviously, in the first part of the fiscal year that was driven by consumers upgrading to Windows 7. Just what are you seeing there?

And then, also, as we start to think about Fiscal '11, obviously that doesn't include commercial licenses, too. What would you expect for the impact of potentially enterprises upgrading to Windows 7, and sort of on top of the PC replacement cycle? Thanks.

**PETER KLEIN:** Yes, no. It's great. We're very optimistic about that opportunity. But, remember, it's a small part of the business. It's about 20 percent of the business. So, while there's great intent to deploy and we're already seeing great deployment, that is a little bit of a tailwind, but it's not by any stretch of the imagination a material mover of the business, but it is a nice additive.

**BILL KOEFOED:** Barb, next question, please.

(Operator Direction.)

**SARAH FRIAR, Goldman Sachs:** Great. Thanks for taking my question, guys. Two questions. First, on the overall environment, you sound incredibly upbeat. You've clearly had a very strong quarter. Was there any shift as you got towards the end of the quarter, because clearly other street earnings have started to note more weakness in Europe, for example, or government spending. We'd just love to get your perspective.

**PETER KLEIN:** Yes, we didn't really see any differences throughout the quarter, and we are encouraged. We had strong demand, and strong sales execution, and obviously did slightly better than we had hoped and talked about last quarter for our product set. So, we're thrilled with customers adopting our products. And there was really no difference throughout the quarter.

**SARAH FRIAR:** So, it sounds like with the product cycles, your kind of expectation is you can kick through even some slight decline on the macro side?

**PETER KLEIN:** Yes, we certainly feel really good about the tracking of our product sets, no doubt.

**SARAH FRIAR:** Great. Thanks a lot, Peter.

**BILL KOEFOED:** Barb, next question, please.

(Operator Direction.)

**BRENT THILL, UBS:** Peter, you're continuing your strong expense discipline in the quarter, and I'm just curious if you could talk about Fiscal '11, and what really changes as we go into next year to continue that discipline. You did take your expense guidance down a little relative to your past guidance, and if you could just explain what drove that?

**PETER KLEIN:** Yes. It's the same thing. This is an ongoing process, something we think about every day. And so, continually, as we go through, we're always scrubbing. We're always looking at our plans. We're always looking to make the most effective use of the money. And as we've done that, and we've made progress, then we can lower our guidance, and that's just what we did. We did better in Q4 than we expected, and we're continuing to take that into next year, and we'll just focus on it continuously.

**BILL KOEFOED:** Thanks, Brent. Operator, next question.

(Operator Direction.)

**KATHERINE EGBERT, Jefferies:** Hi. Good afternoon. Your contracted but not billed balance was up $1.5 billion this quarter. Can you tell us about that?

**PETER KLEIN:** Yes. As we said, it was a strong bookings quarter all up, if you look at the revenue, and the unearned, and the CNB. Our bookings growth was 27 percent, and so it's reflective of the sales execution and the enterprise demand for our products. And it's interesting, Bill has kind of touched on this, it was very broad-based across geographies, and across products, and across customer segments and size. So, that's what is really driving that.

**KATHERINE EGBERT:** Will that continue to increase?

**PETER KLEIN:** You know, we haven't given guidance on that. We did give expectations on the unearned, so I would take that as sort of a proxy for how things are going.

**KATHERINE EGBERT:** Okay. Thanks, Peter.

**PETER KLEIN:** Thank you.

**BILL KOEFOED:** Next question, Barb.

**KASH RANGAN, Merrill Lynch:** Hi. Thank you very much. Looking at the unearned balance for Server and Tools, and MBD, it looks like it's back up to multi-quarter highs. And, also, your unearned metric which you reported is well above what it has been, the highest it's been in eight quarters. Yet, at the same time, the guidance for the annuity growth rate, it still sounds like we're in a recession, listening to your guidance on what seems to be low to mid-single digit. Can you help us understand the disconnect here?

It seems to me that you're being a little bit conservative with your annuity guidance for what seems to be two big product lines given the improvements in bookings off balance sheet, and on balance sheet. It occurs to me that as the deferred revenues start to build up, in your words, in the normal seasonality, that you should take your guidance up in the next few quarters. So, comments or reactions, explanation would be appreciated. Thank you.

**PETER KLEIN:** Yes. What you're seeing, Kash, is the recognitions next year are a function of the deferreds that we've had. And as you mentioned, this is the first quarter where we've really bumped it up. So, the recognitions and the annuity revenue that you're seeing next year in the reported number is a function of sort of the challenges we've had on our deferred balance. And so, as we build that up over time, you'll start to see the annuity business do better. So, that's what you'll see as you get towards the latter part of next year, because this is the first quarter where we really saw that unearned balance take off.

**KASH RANGAN:** So, if the deferreds continue to build up normal seasonality, we should expect you to take your guidance up for the annuity growth rate in your two main businesses, right?

**PETER KLEIN:** You know, it's too early to tell. You should just take the guidance that we gave. It's our guidance for FY '11.

**KASH RANGAN:** Okay, great. Thanks.

**BILL KOEFOED:** Barb, next question, please.

(Operator Direction.)

**BRAD REBACK, Oppenheimer:** Hey, guys. How are you?

**PETER KLEIN:** Good.

**BRAD REBACK:** So, Peter, in the slides on 18 it talks about COGS being sort of negatively impacted next year. Based on the expectation of mid-teen growth in E&D, can you give us any sense of what the headwind is on the COGS side?

**PETER KLEIN:** Well, you know what I tried to do is give you the drivers, and I think you should go through your model, think about what assumptions you're going to make, and clearly the assumptions, the biggest one that we like to call out that we think is most material, by far, is the growth in E&D, and the headwind from the hardware sales, which is obviously a great thing for the long-term, but in the short-term will provide a headwind to COGS. And so, the reason we like to give you the drivers is to allow you the flexibility to kind of work that through your model as you come up with your product mix.

**BRAD REBACK:** I understand. Not to pick here, but you did put the mid-teen guidance out there. So, based on that, there's no way to give us any sense of what type of headwind that generates, so we're all on the same page here?

**BILL KOEFOED:** I would just say, Brad, do the math. And I think it will come out whatever your assumptions are for the driver framework.

So, let's move on to the next question.

(Operator Direction.)

**SANDEEP AGGARWAL, Caris & Company:** Thanks for taking my question. Peter, we are in the middle of an enterprise refresh, and premium mix for business edition has gone up from 28 to 29 percent, but if I look at the historical trends, during the mid of enterprise refresh, actually you have been in mid to late 30s in terms of the business premium mix. Why has it only seen 100 basis points improvement, or is there a time maybe in the next few quarters, where we can see it reaching to the historical levels?

**PETER KLEIN:** Yes. I would say, one, it is early in the refresh cycle, so we should watch it. I think that really is the answer.

**BILL KOEFOED:** Next question, please, Barb.

(Operator Direction.)

**ED MAGUIRE, CLSA:** Yes, good afternoon. Last quarter you provided some metrics around your online services subscriptions. Could you provide some at least directional indications and help us understand, as well, some of the traction around Azure and how that may be impacting some of the traditional server revenues?

**PETER KLEIN:** Yes, as we talked about on the commercial productivity online services, as Bill talked about, 70 percent of those wins have been competitive wins, which has just been really good. So, we're really accelerating the traction there. On the Azure side, it's early. We just launched that this year. The productivity online services are farther along from the customer perspective. But, we've really accelerated the developers and the users we have on the Azure platform.

It's not material to the financials now, but we're really sort of establishing a leadership position in that of users, and we've had some ‑‑ on the productivity side, we've had some great wins. We had the State of Kentucky, which was 700,000 users. So, acceleration and continued progress and leadership in that.

**BILL KOEFOED:** Next question, please, Barb.

(Operator Direction.)

**GREGG MOSKOWITZ, Cowen:** Thank you. Good afternoon, guys. Just to follow up on Office 2010. Qualitatively, Peter, how are you thinking about consumer and enterprise adoption rates in the first 12 months or so, post release, as compared with a similar period, with regard to Office 2007?

**PETER KLEIN:** Yes, you should just take the guidance that we gave you, and on the non-annuity side you should expect it to track to the PC shipments, which is a pretty strong result, especially given the mix of PCs to emerging markets where we have slightly lower attach. So, we'll ‑‑ this quarter will be a big quarter. We'll look at the back to school and see how we're doing. But, other than that we're very excited, off to a great start as you saw the 51 percent number. That is a very strong number for early on.

**BILL KOEFOED:** Barb, let's move on. Let's make this the last question.

(Operator Direction.)

**ROBERT BREZA, RBC Capital Markets:** Hi, thanks for sneaking me in. Just quickly, maybe as a follow up to Gregg's question, as you look at the PC shipments, your expectations for Q1 are helpful. As we look at the trend kind of in the second half of the year, would it be natural to assume after back to school and holiday season that we see a slight tail-off? Can you just give us kind of maybe a front-half, kind of second half thought? Thanks.

**PETER KLEIN:** You know, we're not giving color on sort of half-by-half. The one thing I would say that will continue all year is that emerging markets will continue to grow faster than developed markets and that has an impact on our business.

**ROBERT BREZA:** Great. Thank you.

**PETER KLEIN:** Thanks, Rob.

**BILL KOEFOED, GENERAL MANAGER INVESTOR RELATIONS:**

So, that will wrap up the Q&A portion of today's earnings call. We look forward to seeing many of you at the Financial Analyst Meeting next week, where we will provide more details about our long-term strategies and provide you with a hands-on opportunity to experience our technology and engage in great discussions with our management team. For those of you unable to attend in person, you will be able to follow the day from our investor relations website at Microsoft.com/msft. Please contact us if you need additional details. We hope to see you there.