# Microsoft FY 2019 Third Quarter Earnings Conference Call

**Michael Spencer, Satya Nadella, Amy Hood**

**Wednesday, April 24, 2019**

**(Operator Direction.)**

**MICHAEL SPENCER:**

Good afternoon and thank you for joining us today. On the call with me are Satya Nadella, chief executive officer, Amy Hood, chief financial officer, Frank Brod, chief accounting officer, and Keith Dolliver, deputy general counsel.

On the Microsoft Investor Relations website, you can find our earnings press release and financial summary slide deck, which is intended to supplement our prepared remarks during today’s call and provides the reconciliation of differences between GAAP and non-GAAP financial measures.

Unless otherwise specified, we will refer to non-GAAP metrics on the call. The non-GAAP financial measures provided should not be considered as a substitute for, or superior to, the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the company’s third-quarter performance in addition to the impact that these items and events had on the financial results.

All growth comparisons we make on the call today relate to the corresponding period of last year unless otherwise noted. We will also provide growth rates in constant currency, when available, as a framework for assessing how our underlying businesses performed, excluding the effect of foreign currency rate fluctuations. Where growth rates are the same in constant currency, we will refer to the growth rate only.

We will post our prepared remarks to our website immediately following the call until the complete transcript is available. Today's call is being webcast live and recorded. If you ask a question, it will be included in our live transmission, in the transcript, and in any future use of the recording. You can replay the call and view the transcript on the Microsoft Investor Relations website.

During this call, we will be making 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 materially differ because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the risk factor section of our Form 10-K, Forms 10-Q, and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

And with that, I’ll turn the call over to Satya.

**SATYA NADELLA:**

Thank you, Mike, and thanks to everyone on the phone for joining.

It was another strong quarter with double-digit topline and bottom-line growth – the result of picking the right secular trends, accelerating innovation, and maintaining a relentless focus on our customers’ success.

Our trusted, extensible cloud platform – spanning application infrastructure, data & AI, productivity & collaboration, as well as business applications – enables every organization to create their own intelligent systems and experiences to compete and grow.

Now I’ll briefly highlight key areas of innovation and growth across our business.

Microsoft 365 empowers everyone – from the largest multinationals to small businesses; from knowledge workers to firstline workers – with an integrated, secure, compliant experience on any device. It is the ONLY comprehensive productivity, collaboration and communications solution that integrates with an organization’s business process workflows.

Microsoft Teams brings together everything a team needs – messaging, video conferencing, meetings and collaboration – into a single, integrated user experience scaffolding, eliminating the need for discreet apps that only increase an organization’s security and compliance exposure. 91 of the Fortune 100 use Teams, and more than 150 organizations have over 10,000 active users.

And we are expanding Teams to new industries like healthcare, with priority notifications for patient care and the ability to securely access patient records.

Cybersecurity is a central challenge, and Microsoft is the clear leader in cloud security with our unparalleled operational security posture, and our growing portfolio of security and compliance solutions – spanning identity, device endpoints, email, information, cloud applications as well as infrastructure.

In financial services, National Bank of Canada, BNP Paribas, and Refinitiv – a joint-venture between Thomson Reuters and Blackrock – all chose Microsoft 365 for our advanced security and compliance.

We expanded Microsoft Threat Protection to include the Mac and manage vulnerabilities in third-party applications – providing the best defense for customers’ heterogenous environments. And we introduced two, first-of-their-kind services: Azure Sentinel analyzes security signals at massive scale across an entire organization, using AI to detect, investigate and respond rapidly to threats. Microsoft Threat Experts is a new ‘cyberthreat hunting’ service that provides access to our security experts on demand.

All this innovation is driving growth: Office 365 commercial now has 180 million users. Our EMS install base reached 100 million. And the Outlook apps on iOS and Android surpassed more than 100 million users for the first time this quarter.

We expanded our Surface family of devices with the Surface Hub 2S, which brings together Teams, Windows, and our category creating Surface hardware to power teamwork for organizations like Volvo, Domino’s Pizza, Northwestern University and Nasa Jet Propulsion Labs.

Finally, Windows 10 is now active on more than 800 million devices and continues to gain traction in the enterprise as the most secure and productive operating system.

Moving to business applications.

Today, traditional systems of record and engagement are often siloed, limiting the value of an organization’s most important asset – its data. Dynamics 365 solves this challenge – connecting all their systems and creating digital feedback loops – enabling any organization to become a true, AI-first company.

The Open Data Initiative we announced last year with Adobe and SAP delivers on this promise, and is already enabling customers like Unilever to unify their business data across all their line-of-business applications to unlock new AI-driven insights.

Personalization is increasingly key to every organization’s marketing strategy – enabling them to effectively engage customers, tailor their experiences and increase return on investment. Tivoli, is one of the world’s oldest amusement parks, is using AI in Dynamics 365 to help personalize marketing campaigns and transform how their firstline workers engage with guests, reducing churn and increasing customer loyalty.

And we are not stopping there. We are leading in two emerging categories: robotic process automation and mixed reality. Our Power Platform brings together robotic process automation with self-service analytics and no code-low code app development.

Recent updates enable citizen developers to build higher-quality PowerApps faster and easier… and, along with new capabilities in Power BI empower customers like SNCF, France’s national railway, to create a more data-centric culture.

Our new HoloLens 2 is the most advanced, intelligent edge device available… and, in combination with Dynamics 365 and new Azure mixed reality services – enables organizations like PACCAR and Chevron to digitize physical spaces and interactions to empower their firstline employees with the right information at the right time, in the context of their business process work.

All this innovation is driving growth: Revenue from our Power Platform grew triple digits year-over-year, and, for the first time, more than 50 percent of our Dynamics revenue was driven by the cloud.

Moving to LinkedIn.

LinkedIn again exceeded expectations across all lines of business – driven by record levels of engagement in the feed, content shared across the platform, and messages sent this quarter.

Marketing Solutions was up 46 percent year-over-year, and customers are relying on our new Pages experience and audience targeting capabilities to connect with LinkedIn’s nearly 630 million members.

We saw record job postings again this quarter and are making it easier for job seekers to find more relevant and higher paying jobs – and get personalized salary insights.

We have the most comprehensive solution for every organization to manage and engage their most important resource – their talent. New tools in Glint empower managers to quickly analyze and action feedback to have the greatest impact on team performance. And with our combination of LinkedIn Talent Solutions, Talent Insights, LinkedIn Learning, and Glint – we are helping employers access data driven insights to attract, retain and develop the best talent in an increasingly competitive jobs marketplace.

Now let’s talk about Azure.

From the outset, we took a differentiated approach to the cloud, to meet the real-world needs of customers. Our architectural advantage is a clear reason for our success. Azure is the ONLY ‘true hybrid,’ hyperscale cloud that extends to the edge. Operational sovereignty is increasingly critical to customers, and Azure uniquely provides consistency across development environments, operating models and technology stacks – whether connected or disconnected to the public cloud.

And we’re accelerating our innovation. Azure Stack extends our hybrid differentiation, enabling customers like Airbus Defense and Space to build and run cloud applications at the edge. And now with our new Azure Stack HCI, customers can build and run virtualized applications on-premises in a consistent way.

Azure Data Box Edge is a powerful, new, AI-enabled edge appliance that sits within a customer’s environment – in their data center or on a factory floor – so they can use AI to reason over data at the edge.

More than 95 percent of the Fortune 500 run their workloads on our cloud, including TD Bank. And AT&T chose Azure to shape the future of 5G with computing on the edge.

We are building Azure as the world’s computer, with more global datacenter regions – and now two in South Africa – and more compliance certifications than any other cloud provider. And just last week we announced two new Azure government regions to meet the stringent requirements for maintaining the security and integrity of classified U.S. government workloads.

Every organization needs an IoT strategy to manage the 20 billion connected devices coming online by 2020. Our comprehensive Azure IoT platform enables customers to build, manage and secure their connected devices, and our recently announced acquisition of Express Logic furthers our goal, bringing our cloud to more than 6 billion MCU-powered endpoints.

BMW Group is partnering with us to speed the adoption of industrial IoT, both in automotive and more broadly in manufacturing, and Renault-Nissan-Mitsubishi Alliance and Volkswagen both chose Azure to fuel their new connected car experiences.

Data and analytics is the foundation for building an organization’s AI capability, and we are investing to make Azure the best cloud for data estates – from data warehousing to real-time stream analytics. Daimler chose Azure as its new platform for big data and advanced analytics, and third-party analysts affirm our price-performance lead in this fast-growing space.

And we are investing to make Azure the best place to build AI. This quarter we introduced new Azure Cognitive Services for fraud detection and image identification. Telefonica is using our Azure AI services to create new intelligent experiences for their customers around the world and transform customer engagement.

Developers will play an increasingly vital role in value creation – and we are committed to giving them the tools they need to be productive on any platform. GitHub surpassed 36 million registered users, and free private repositories expand the opportunities for all developers, with private repository creation more than doubling this quarter. The new Visual Studio 2019 optimizes developer productivity and team collaboration.

And I’m excited to share more about how we are empowering developers at our Build conference in two weeks.

Now to gaming.

We are investing in content, community and cloud to capture our massive opportunity in gaming, delivering record user engagement again this quarter.

Microsoft Game Stack brings together our tools and services to empower game developers – from independent creators to the biggest game studios – to build, operate and scale cloud-first games across mobile, PC and console. Our Xbox Live community – now 63 million strong – is key to our approach and we are enabling developers to reach these highly engaged gamers on iOS and Android for the first time.

Our fast-growing gaming subscription service, Game Pass, is expanding our reach, bolstered by our growing pipeline of first-party content. And Project xCloud, our new game streaming service, will be in public trials later this year.

In closing, I’m energized by our progress – and incredibly optimistic about our opportunity ahead.

Across all our businesses, we are delivering differentiated value for customers and creating new categories of growth that position us well for the future.

With that, now I’ll hand it over to Amy who will cover our financial results in detail and share our outlook.

And I look forward to rejoining for your questions.

**AMY HOOD:**

Thank you, Satya, and good afternoon everyone.

This quarter, revenue was $30.6 billion, up 14% and 16% in constant currency. Gross margin dollars increased 16% and 18% in constant currency. Operating income increased 25% and 27% in constant currency. And earnings per share was $1.14, increasing 20% and 22% in constant currency.

Our sales teams and partners delivered strong results across each of our segments, once again resulting in double-digit top and bottom line growth. From a geographic perspective, most markets performed in line with our expectations, however, results in Japan were much stronger than we anticipated.

In our commercial business, cloud services strength drove our annuity mix to 90%, up 1 point year over year. Commercial unearned revenue was better than expected at $25.1 billion, up 19% and 20% in constant currency. Commercial bookings growth was strong, increasing 30% and 34% in constant currency. Bookings growth was driven by healthy renewals on an expiration base that was over 20% larger than a year ago as well as an increase in the number of larger, long-term Azure contracts. As a reminder, an increased mix of these larger, long-term Azure contracts with low upfront billings will drive more volatility in our commercial bookings and unearned revenue growth.

Commercial Cloud revenue was $9.6 billion, growing 41% and 43% in constant currency, highlighted by healthy growth in the US, Western Europe, the UK, and Germany. Commercial cloud gross margin percentage increased 5 points year over year to 63% driven again by significant improvement in Azure gross margin.

Company gross margin percentage was 67%, ahead of our expectations, and up year over year primarily from an increase in margin in our More Personal Computing segment due to sales mix shift.

FX reduced revenue growth by 2 points and COGS growth by 1 point in line with expectations.

FX reduced operating expenses growth by 1 point, less than anticipated. Even with this headwind, operating expenses grew in line with expectations, increasing 9% and 10% in constant currency.

Strong revenue growth, improving gross margins, and disciplined investment in strategic and high growth areas resulted in operating margin expansion.

Now to segment results.

Revenue from Productivity and Business Processes was $10.2 billion, increasing 14% and 15% in constant currency, ahead of expectations driven by performance in Japan and LinkedIn.

Office commercial revenue grew 12% and 14% in constant currency. Office 365 commercial revenue grew 30% and 31% in constant currency driven by installed base expansion across all workloads and customer segments, as well as ARPU growth from our customers’ continued shift to our E3 and E5 offerings. Office 365 commercial seats grew 27% and benefited from the strong performance of our Microsoft 365 academic offers. Office consumer revenue grew 8% and 10% in constant currency, ahead of our expectations, with 4 points of growth from transactional sales in Japan. Office 365 consumer subscribers grew to 34.2 million.

Our Dynamics business grew 13% and 15% in constant currency, driven by Dynamics 365 revenue growth of 43% and 44% in constant currency. We saw continued progress in our Finance and Operations offering, with strong growth in customer billings and deployments.

LinkedIn revenue increased 27% and 29% in constant currency with continued strength across all businesses. LinkedIn sessions increased 24% as engagement once again reached record levels.

Segment gross margin dollars increased 15% and 17% in constant currency and gross margin percentage increased 1 point year over year as improvements in LinkedIn and Office 365 margins more than offset increased cloud mix.

Operating expenses increased 4% and 6% in constant currency driven by continued investment in LinkedIn and cloud engineering. Operating income increased 28% and 30% in constant currency.

Next, the Intelligent Cloud segment. Revenue was $9.7 billion, increasing 22% and 24% in constant currency, ahead of expectations driven by continued customer demand for our differentiated hybrid offerings. Server products and cloud services revenue increased 27% and 29% in constant currency. Azure revenue grew 73% and 75% in constant currency, driven by strong growth in our consumption-based business across all customer segments, partially offset by tempering growth in our per-user business. Our enterprise mobility installed base grew 53 percent to over 100 million seats. And our on-premises server business grew 7% and 9% in constant currency, driven by the continued strength of our hybrid solutions, premium offerings, and GitHub, as well as increased transactional demand ahead of end of support for Windows Server and SQL Server 2008.

Enterprise Services revenue increased 4% and 5% in constant currency, driven by growth in Premier Support Services.

Segment gross margin dollars increased 21% and 23% in constant currency. Gross margin percentage decreased slightly as the growing mix of Azure IaaS and PaaS revenue was partially offset by another quarter of material improvement in Azure gross margin.

Operating expenses increased 22% and 23% in constant currency, driven by continued investment in cloud and AI engineering, GitHub, and commercial sales capacity. Operating income increased 21% and 23% in constant currency.

Now to the More Personal Computing segment. Revenue was $10.7 billion, increasing 8% and 9% in constant currency as better than expected performance in Windows was partially offset by lower than expected Gaming revenue.

In Windows, the overall PC market was stronger than we anticipated driven by improved chip supply that met both unfulfilled Q2 commercial and premium consumer demand as well as better than expected Q3 commercial demand. Therefore, OEM Pro revenue grew 15% and OEM Non-Pro revenue declined 1%.

Inventory levels were within the normal range.

Windows commercial products and cloud services revenue grew 18% and 20% in constant currency, with continued double-digit billings growth and a higher mix of in-quarter recognition from multi-year agreements. Windows 10 deployments across new and existing devices remained healthy.

In Gaming, revenue grew 5% and 7% in constant currency, below expectations, driven by lower than expected monetization across third party titles and console sales. Xbox software and services revenue grew 12% and 15% in constant currency, with continued momentum in Xbox Live and Game Pass subscriber growth.

Surface revenue grew 21% and 25% in constant currency, driven by continued strength across our consumer and commercial segments, particularly in Japan.

Search revenue ex-TAC increased 12% and 14% in constant currency, primarily driven by Bing rate growth.

Segment gross margin dollars increased 13% and 15% in constant currency and gross margin percentage increased 2 points due to sales mix shift to higher margin products in Windows and Gaming.

Operating expenses increased 1% and 2% in constant currency and operating income increased 25% and 28% in constant currency.

Now back to total company results.

Capital expenditures including finance leases were down sequentially to $3.4 billion, and lower than initially planned, primarily due to normal quarterly spend variability in the timing of cloud infrastructure buildout. Cash paid for property, plant, and equipment was $2.6 billion.

Cash flow from operations increased 11% year over year driven by strong cloud billings and collections. Free cash flow was $11 billion and increased 19% year over year, reflecting the timing of lower cash payments for property, plant, and equipment.

Other income was $145 million, driven by interest income and net gains on derivatives and investments, offset partially by debt and finance lease expense.

Our effective tax rate came in lower than anticipated at 16%.

And finally, we returned $7.4 billion to shareholders through share repurchases and dividends, an increase of 17%.

Now let’s move to next quarter’s outlook.

First on FX. Assuming the current rates remain stable, we expect FX to decrease revenue growth by approximately 2 points and COGS and operating expenses growth by approximately 1 point. Within the segments, we anticipate about 2 points of negative FX impact on revenue growth in Productivity and Business Processes and Intelligent Cloud, and 1 point in More Personal Computing.

Second, we again expect customer demand and solid execution to drive continued strong performance across our commercial business in our largest quarter of the year. The expiry base will grow in Q4, but at a more moderated rate than in Q3 and we expect commercial unearned revenue to increase 36% to 37% sequentially.

Commercial cloud gross margin percentage should continue to improve year over year as material improvement in Azure gross margin will be partially offset by the continued mix of revenue towards Azure IaaS and PaaS services.

Third, capex, our full year outlook remains unchanged. Therefore, we expect a sequential dollar increase in capital expenditures in Q4 as we continue to invest to meet growing customer demand.

Now to segment guidance.

In Productivity and Business Processes, we expect revenue between $10.55 and $10.75 billion. The Office commercial revenue growth rate will be slightly down sequentially as is normal for Q4 due to the high mix of cloud billings during this quarter. As a reminder, under ASC 606, a higher mix of cloud billings is reflected in more unearned revenue and less in-period revenue recognition. Dynamics should see another quarter of double-digit revenue growth driven by Dynamics 365. LinkedIn revenue growth should be in the low 20’s against a high prior year comparable.

In Intelligent Cloud, we expect revenue between $10.85 and $11.05 billion. In Azure, we expect continued strong growth in our consumption-based business and moderating growth in our per-user business given the increasing size of the installed base. In our on-premises server business, demand for our hybrid solutions and premium offerings should remain strong, and we expect continued benefit from the upcoming end of support for Windows Server and SQL Server 2008, though as a reminder, the prior year comparable will impact the year over year growth rate.

In More Personal Computing, we expect revenue between $10.8 and $11.1 billion. In Windows, overall OEM growth rates should normalize, with revenue growth roughly in line with the PC market.

In Surface, we expect low double-digit growth, with continued momentum across our commercial and consumer segments.

In Search ex-Tac, we expect revenue growth similar to Q3.

And in Gaming, we expect revenue to decline year over year, driven by the tough comparable in Xbox software and services and the continuation of the hardware trends from Q3.

Now, back to overall company guidance.

We expect COGS of $10.65 to $10.85 billion and operating expenses of $10.7 to $10.8 billion.

Other Income and expense should be approximately $50 million as interest income is partially offset by interest and finance lease expense.

And finally, we expect our effective tax rate in Q4 to be approximately 17%, with some potential volatility given it is the final quarter of our fiscal year.

Now I’d like to provide some closing thoughts as we look forward to FY20.

Overall, we feel very good about the progress we’ve made thus far in FY19. Our decision to invest with significant ambition in high growth areas coupled with strong execution has resulted in material revenue growth at scale and a stronger position in many key markets. As FY20 approaches, we again see tremendous opportunity to drive sustained long-term growth. We will invest aggressively in strategic areas like Cloud thru AI and Github, Business Applications thru Power Platform and LinkedIn, Microsoft 365 thru Teams, Security, and Surface as well as Gaming. At the same time, we will continue to drive improvement and efficiency as our business scales. This consistent approach of investing in future growth while delivering strong operating performance will result in double digit revenue and operating income growth in FY20 with stable operating margins.

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

**MICHAEL SPENCER:** Thanks, Amy.

We'll now move over to Q&A. Operator, can you please repeat your instructions?

(Operator direction.)

**HEATHER BELLINI, Goldman Sachs:** Great, thank you so much for taking the question today. Amy, if I go back and look through your KPIs, it looks like the year-over-year growth in commercial bookings has never been this high on a constant currency basis. At least I was able to go back through fiscal '13. You mention an increase in the number of larger, long-term Azure contracts, which obviously is a driver of this. But, is there any more color you could share? Is this coming from a handful of customers?

I mean, that are just driving all of their -- like outsourcing everything to you guys and shutting down their data centers, or do you see this as kind of a broad-based trend, even in some of the industries that have been slow to move to the cloud, where this is really starting to snowball?

And then, the follow-up would be just Azure gross margins, where you guys have done a remarkable job just continuing to increase efficiency there. How much room is left to go and how do you think about the percentage of COGS in Azure that are variable versus fixed and has the ratio been changing?

**AMY HOOD:** Great, Heather. Let me try to take both of those questions.

On your commercial bookings growth question, I find it easiest to think about commercial bookings, before I answer the larger question about one time, in two ways. The first is the expiration base absolutely does matter and that's how we talked about it. And we had an actually very good quarter here in terms of renewals and what I think of as revenue recapture where we're able to grow the revenue in existing contracts. And so that absolutely contributed and has contributed over the past couple of years to what I do believe has been reasonably consistent commercial bookings strength versus the expiration base.

The second component is what I would put in the bucket of new business, whether that new business comes as what you saw this this quarter two ways. There was some on prem strength this quarter. It does show up in booking. It doesn't show up in unearned and it does show up in the P&L. We had a good quarter there. And we did have some large Azure contracts which tend to be longer dated and tend to have low billings up-front. That means it shows up in bookings and, again, not in the unearned balance in the same way.

And so you will see as we go forward, and you're already starting to see it, more volatility in this number, not just based on the way we've traditionally talked about it, which is the movement of the expiration base, but also in some of these larger, longer term commitments by what we now think of, not just as customers, but these are really now partnership relationships that we have where, to your point, we're co-collaborating to help customers be successful as they build their digital future. And so you will see a little bit of volatility in this number as those contracts and those types of contracts start to land.

On your second question of Azure GM, we have continued to see strong improvement in the core gross margin of Azure. The team has done a nice job on a number of fronts, continue to make progress on both software innovation, but also importantly hardware innovation and working with our supply chain to continue to have and see benefits on that side. It also is increasing use of premium services also contributed to Azure gross margin improvement.

So while we remain focused on efficiency and the utilization of the hardware and software, it's also important to continue to see premium up-sell, premium workload usage, so the customers are getting the most out of their deployments and usage of the Azure platform.

In general, it hasn't changed a ton in terms of that final component about fixed versus, I think, variable base. It's still been in, I think, the low 40 percent as a range for us in terms of what's depreciation versus what's more variable.

**HEATHER BELLINI:** Thank you.

**MICHAEL SPENCER:** Thanks, Heather.

We'll move to the next question now, please.

(Operator Direction.)

**KEITH WEISS, Morgan Stanley:** Excellent. Thank you, guys, and a very impressive quarter.

I'm going to take a similar question to Heather's, but I'll use you, Satya, to try to get a higher-level answer. During this quarter it just sounds to me like I've heard Amy talk more about exceeding expectations than we have in prior quarters and exceeding plan more than we have in prior quarters. This matches up from what we're hearing actually from sort of talking to customers. It almost sounds like there's an inflection point going on in the adoption of cloud and visualization efforts.

The question to you is, are you guys seeing that? Are you starting to see an inflection point in terms of these adoption trends and the investment that you guys have made behind it really starting to take hold?

And then perhaps a follow-up for Amy, so operating margins really exceeded our expectations this quarter and I think consistent with expectations. Talk a little bit about kind of what drove that and kind of why we wouldn't see as much of that on a go-forth basis in terms of operating margin expansion?

**SATYA NADELLA:** Yeah. Thanks, Keith, for the question. So, let me start.

I think overall what we are seeing is continued momentum. If you think about even our overall approach as being to have a view of an architecture that is grounded in our customers' needs. So, we always believed that in distributed computing you'd need a cloud and an edge, you need hybrid. And, guess what, today in 2019 hybrid has become much more mainstream. But we were talking about this even five years ago.

We also sort of said things that will matter in this transition to the cloud will be consistency and productivity. So, for example, whether it's developer productivity or IT productivity, it's not any one dimension. You need to bring IT and developers together to drive agility in an organization and the digital capability building. This is, again, a place where we've had all this traditional strength and that's showing up in the marketplace.

And also, if you look at our cloud stack, we have application and infrastructure, data and AI, productivity and collaboration as well as business applications. That's pretty unique again. So that's, I think what is showing up at scale as a competitive differentiation and that's what you see in our numbers. But most importantly, I think you'll see it in the customer momentum and what I believe is what is customer success. Digital technology today is not about tech companies doing innovation, it's about the rest of the world doing innovation with technology. And Microsoft is uniquely in position to enable that.

**AMY HOOD:** And on your operating margin question, Keith, there's a couple of things I would say to that. In this quarter in particular the places where we had a lot of outperformance were especially high margin areas. And I would point out three: The first is obviously the OEM and chip supply; the improvement in that in Q3 is obviously very high margin and falls to the bottom. Japan as a geography for us is a high transactional market. And so, when Japan is strong, it tends to be a very high margin landing down to the bottom line. And the other one is the on-premises server number, which is very good in terms of hybrid demand this quarter also is high margins. So when that happens, you do see, because it's a lot of, almost 100 percent in-quarter recognition, a lot of help at the operating margin line.

Now the more sustainable conversation I think we continue to have on operating margin is our ability to pick the right secular markets and the right secular trends, you see significant revenue growth. We continue to focus on improving the growth margin of each individual product area, which creates leverage over time, and finally focused investment in operating expense and that obviously creates leverage. And I think you do see that in general through the year as we continue to keep that formula.

**KEITH WEISS:** Excellent. That is super helpful. Thanks a lot, guys. It's been a great quarter again.

**MICHAEL SPENCER:** Thanks, Keith.

We'll take the next question now, please.

(Operator Direction.)

**MARK MOERDLER, Bernstein Research:** Thank you. And congratulations on the really strong quarter, everyone.

Amy, Satya, Amy, can you delve into the impact of Azure Hybrid Benefit on Azure revenue, Server and Tools, renewals. I don't think it's really well understood. Is it having impact on Azure's reported revenue growth because of the fact that some of this may appear in Server and Tools?

And, Satya, can you give us some added color on why this specific offering is resonating so well with customers, which is what we're hearing?

Thanks.

**SATYA NADELLA:** Yeah, maybe I can start on the second part, and then it leads to the first question.

I would say, Mark, the main thing that this offering enabled is the flexibility with which customers can adopt hybrid computing. And as I've always said that hybrid computing is important for workloads that are more in the characteristic of -- can be characterized as lift, shift and modernize. So, that's one motion. And then there is new world hybrid as well, which is people are building, in fact they'll do an AI training job in the cloud but want to deploy the model close to the edge. And in both of these cases Hybrid Benefits actually help with -- our business model is basically differentiated in supporting the architectural needs and the flexibility needs.

The one additional thing I'll mention, which is increasingly becoming clear to us, is operational sovereignty will become important. The world and its distributed computing needs is not going to become some homogenous set of requirements, but it's going to be very heterogeneous, very in many cases regulated. And so what we provide in terms of both the technology and the business model I think shows up with the maximum flexibility.

**AMY HOOD:** And let me talk a little bit about the question around server products and services and how to think about the hybrid use benefit. In general today, Mark, almost all of that benefit shows up in what I would say is the on-premise KPI. And so over time, though, how you should think about that, it will eventually show up in Azure consumed revenue growth. This is a benefit that's fundamentally about high-value and flexibility and meeting customers where they are so that they can make the determination of when to make that choice.

And so it tends to be why I keep focusing people back on the all-up KPI because it's the best representation of really customer commitment and usage of our architected from the beginning hybrid cloud.

But to your specific question, it shows up today in the on-prem number is where you could see most of the strength of that value and over time as it gets used and consumed, it will show up more in the Azure ACR number.

**MARK MOERDLER:** Perfect. Thank you, I appreciate it.

**MICHAEL SPENCER:** Thanks, Mark.

Operator, we'll take the next question now, please.

(Operator Direction.)

**KARL KEIRSTEAD, Deutsche Bank:** Thanks.

Amy, I would like to ask you about the big revenue beat in the Intelligent Cloud segment that drove much of the upside and in particular the server product KPI that was just addressed, up 9 percent. I'm just wondering if you could frame how material the contribution of the version 2008 upgrades were, and assuming that that lift can continue throughout calendar 2019, could it be enough to keep that on-prem KPI, as you described it, flat or even up slightly in the coming two quarters despite the tougher comps?

Thank you.

**AMY HOOD:** Thanks, Karl.

When I think about the on-prem number, I really divide it into things that have durable value and things I think of as more one-time. When I think about the durable trends that I expect to see, it's been the hybrid value prop that we really just talked about on Mark's last question, and then the premium mix. Those two we have seen and continue to see.

I do think we felt some benefit of end of support, but I would not say it was the primary benefit this quarter. The primary benefit was the two things I just talked about. End of support, obviously we've got SQL in July and then Windows in January. And so I do think we saw some impact, particularly in SQL, and I do expect we'll see some of that in Q4.

But the Q4 comparable for on-prem is very big. And so even with some of that benefit of the durable trends plus, I think, a more temporal one of end of support, I do expect to see a deceleration in that number in Q4.

**KARL KEIRSTEAD:** Got it. Thank you, Amy.

**MICHAEL SPENCER:** Thanks, Karl.

Operator, we'll take the next question, please.

(Operator Direction.)

**JENNIFER LOWE, UBS:** Great. Thank you.

I wanted to turn to the Office 365 Commercial business a bit, and that's been a consistent, very strong performer for you all and was again this quarter. But maybe just sort of two related questions there. First, if I heard you right, Satya, I think you said there's 180 million users now on Office 365 Commercial, which seems like you're hitting a lot of the customers that you thought might be there a couple of years ago. So, I was just curious to get your view on how far along you are in that adoption cycle and if there's still a lot more opportunity in terms of seat expansion in the upcoming year?

And then, related, you know, Amy, you mentioned E3 and E5 were both pretty big contributors on the ASP front in the quarter. Are we starting to see a shift in where E5 is sort of increasing in relevance and E3 is played out a bit, or is it sort of equally balanced? I'm just curious to get sort of the mix in there as well.

Thank you.

**SATYA NADELLA:** Sure. In terms of overall reach of Office 365, you know, we continue to see significant opportunity going forward on multiple dimensions. So, for example, we never participated as much in I'll call it non-developed market medium and small businesses with all of the sophisticated workloads. So, now with a SaaS approach you can reach a much broader base of business customers all over the world is one opportunity.

The second opportunity is, if you look at Teams as an example, we are now reaching a lot of first-line workers, so this is whether it's in healthcare, whether it's in manufacturing, whether it's in retail, just not knowledge workers, but where you now have messaging solutions as well as business process workloads integrated.

So, it's that combination of things where we're going from knowledge workers to first-line, and the ability to reach all sizes of businesses is what's going to continue to help us, I think, have overall seat growth or socket growth.

And then, of course, there is the other dimension, which is the levels of Office 365 all the way to E5 with significant value. And the one thing I'd mention is, having compliance, security, that spans all of these tools is also proving out to be a very big architectural advantage and a customer value proposition, because I think as customers look to use more SaaS applications, they don't want an exponential increase in their security exposure or more compliance burden. And so, therefore, Office 365's approach resonates even there.

**AMY HOOD:** And, Jen, maybe a little to your question, which is fundamentally about seat growth and RPU as the drivers of that all-up Office 365 Commercial growth number. This quarter and a little bit last, I actually think some of the RPU increase has been matched by some of the trends in seat growth. What I mean by that is, that 27 percent seat growth is starting to include some lower RPU seats that Satya just mentioned, whether that's in academic, in Edu, in frontline workers, and that's really important for us to keep having that seat growth even if it's not at the same RPU level, those are not seats that we ever could reach before at any level and that's absolutely new opportunity for us. But it does kind of mask a little some of the RPU improvement that we've seen. It's still E3 and E5. There's opportunity on both, although we are starting to see the impact of E5 in that RPU number.

**JENNIFER LOWE:** Great. Thank you.

**MICHAEL SPENCER:** Thanks, Jen.

Operator, we'll take the next question please.

(Operator Direction.)

**MARK MURPHY, J.P. Morgan:** Yes. Thank you very much.

Satya, we've seen many indications of Azure winning a greater share of enterprise workloads recently. Do you think that you have found the right formula now for Azure to win the majority of workloads in the enterprise IT world?

And then, Amy, just given the trajectory and the long-term commitments that you mentioned there, do you see a path for Azure to surpass Office 365 Commercial and thus become the largest revenue stream for Microsoft, I'll say in the next couple of few years?

**SATYA NADELLA:** Sure. I'll start, Mark.

Having grown up essentially in our infrastructure business at Microsoft, I would say that compared to even the previous era where we did well, in the client-server era, in the face of tough competition and in this era, again in the face of a different set of competitors, we are doing well. And we're doing well, much better than we did in the previous era, because we are seeing these tier one workloads, which we never saw in the past.

If you think about it, in the client-server era, we never participated in the core of the digital infrastructure of financial services or in healthcare or in retail or in manufacturing. And absolutely when we think about the digital transformational design wins, deployment, consumption, it's kind of like what we would have done with some ISVs of the past. How we worked, perhaps, with SAP in the '90s when we were coming out with SQL Server and they were coming out with R3 is what we're now doing with many, many, many businesses as they build out their digital businesses. So that's sort of perhaps characterizes for you what's new in terms of Microsoft's own growth in this space.

**AMY HOOD:** And the way that would show up, Mark, is a little bit I think where you were leading with the question you asked, which is when we think about the Microsoft Commercial Cloud at $9.6 billion and growing over 40 percent, how do you see that evolving? And really the question is, we have quite a bit of per seat or per user type businesses, but what Satya just talked about is really about the Azure concept of participating both in an expansionary total addressable market, which I think people have talked about for a long time, but what was different about what Satya just said is our ability frankly to have higher share in the next era than we had in the last era.

And so if you look about then our ability to grow and will Azure be larger over any period of time than our per seat or per user businesses, it certainly could be but I don't want that to really diminish the fact that there's a lot of room for us in our per seat businesses, particularly in business applications across LinkedIn, the Power Platform work we're doing. Satya mentioned security, identity, compliance, there is a lot of room for us to continue to add value and growth in that area as well.

**MARK MURPHY:** Thank you very much.

**MICHAEL SPENCER:** Thanks, Mark.

Operator, we'll take the next question, please.

(Operator Direction.)

**ROSS MCMILLAN, RBC Capital Markets:** Thanks so much and my congratulations as well.

We continue to see this really nice progression in the Commercial Cloud gross margin and you called out the Azure gross margin improvements. And within that there's some moving pieces. I think you got better utilization and efficiency of core Azure. You've got premium services. And then you've got this maybe counter-prevailing force of the different growth in consumption versus user base.

Two questions on this, one for Satya. On the premium services, I'm just curious as to which one or two or three are you seeing maybe breakout and become the largest or growth the fastest? Which are most meaningful at this point?

And then, second, for Amy, as we think about this trend are you convinced that we'll continue to see not just for fiscal Q4 but into fiscal '20 and beyond consistent progression and growth in the overall Commercial Cloud gross margin?

Thanks.

**SATYA NADELLA:** Sure. I mean on the first question, Ross, as far as premium services, just even on the application infrastructure side, for example, in compute there is increasing need for things like IoT services. Essentially there is a new business application like set of services that are getting developed to help people manage their complex IoT application development. IoT Central is a good example of that. When you have many, many connected devices, you need a control plane for many of those devices so that you can tame the complexity of your app deployment, security management. That's one example.

The other one is, of course, data. And, the sophistication of the data estate is growing exponentially both in terms of the needs of the databases required, the processing that is required close to data. So that's another place where something like Cosmos DB, which is very unique in its capability in the marketplace, is definitely another service that's got real traction.

Even data warehousing, the scale at which -- this is another market which we never participated in in the past, whereas now we have one of the most competitive products when it comes to benchmarking around data warehousing.

So those are all things that I would say are premium services that just talking about new applications being built on Azure, not counting all of the SaaS applications above that.

**AMY HOOD:** And to your overall Commercial Cloud gross margin question, you're right, the fundamental driver is when I look forward into next year I expect each service, just like it did this year, to really see gross margin improvement, whether that service is LinkedIn or Dynamics or Office 365, Azure per user, or Azure IaaS and PaaS. But what you'll see is a revenue mix shift, right, that will offset that to Azure IaaS and PaaS.

So what that generally will do will be a headwind to continued gross amount of the improvement even though you'll see individual improvement across all of the GM services, and you'll continue to see Azure increase as a percentage of the total revenue.

**ROSS MCMILLAN:** Super helpful, thank you.

**MICHAEL SPENCER:** Thanks, Ross.

Operator, we'll take the next question, please.

**BRAD ZELNICK, Credit Suisse:** Great. Thanks very much for taking my question and congrats on the strong outperformance.

I want to follow-up on Karl's question, but more generally on database products. With the end of support coming for SQL Server 2008 in July, Satya, can you tell us how that's sparking conversations with customers about database offerings on Azure and moving workloads to the cloud?

And, Amy, can you perhaps help us contextualize the opportunity to move traditional database workloads onto Azure and what the expansion economics look like?

**SATYA NADELLA:** Yeah, a couple of things, Brad. One is overall the need to get on the latest and greatest database technology just because of what is the increasing need for compute and data at the edge is what's driving a lot of the conversation on SQL Server. Interestingly enough, we have a lot of requirements around edge devices so that you can have databases with compute, so that you can really have what is needed at the edge. That's sort of one conversation.

The other one is, in terms of the cloud migration there is a variety of different use cases. We see people who are using SQL DB, which is essentially a PaaS service with complete compatibility of SQL Server. They want managed services around SQL Server, which we have. And so both of those are all happening in parallel.

A good example of this is, in fact, even the rewrite of -- complete revamp, I would say of Dynamics. Dynamics 365 and its architecture at least in my eyes is a thing of beauty, because it's completely been rewritten for the new database technology, whether it is on the database side or on the data warehouse side, again uses a whole bunch of micro-services and functions, so that you can do AI close to data.

That type of architectural approach is what we see is possible now for every SaaS application vendor out there, as well, because if you think about the number of business applications that were based on SQL Server, I feel that that's an architecture that can support both what they want to do on the edge, but as well as in the cloud.

**AMY HOOD:** And on the contextualizing opportunity, the reason I said it's not the primary driver is because the vast, vast majority of our server business is annuity based. And so when it's annuity based there's really no opportunity to see it as upside in Q4 from an end of support frame. For the smaller portion of our business that's still non-annuity, pure transactional it does provide, as I talked about earlier, some opportunity. But, it's not that large. The nature of the commitment our customers now is far more of the annuity type.

**BRAD ZELNICK, Credit Suisse:** Great, thank you.

**MICHAEL SPENCER:** Thanks, Brad.

Operator, we'll take our last question now, please.

(Operator direction.)

**RAIMO LENSCHOW, Barclays:** Hey, thanks for squeezing me in. Can you talk a bit on the Windows OEM side you mentioned that the chip situation is kind of easing a little bit? Are we kind of fully done there, in terms of what you see there from the Intel side and did that create some pent-up demand for the coming quarter that people are thinking about moving over to Windows 10 with the end of life coming up? Thank you.

**AMY HOOD:** Thanks, Raimo. I think we actually in Q3, as I said, met sort of the unfulfilled Q2 demand and Q3. So I don't think of it as a pent-up situation heading into Q4 and our guidance certainly does not indicate that that is what we believe will happen.

What I would say is I think we feel good about the supply in the commercial segment in the premium consumer segment, which is where the vast majority of our revenue is in OEMs. And so I think in those segments we feel fine for Q4.

**RAIMO LENSCHOW:** Perfect. I'll leave it at that. Thank you. Well done.

**MICHAEL SPENCER:** Thanks, Raimo.

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

**AMY HOOD:** Thank you.

**SATYA NADELLA:** Thank you all.

END