**Microsoft Earnings Conference Call**

**Satya Nadella, Amy Hood, Chris Suh**

**Thursday October 22, 2015**

**CHRIS SUH:** 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 John Seethoff, deputy general counsel.

On our website, Microsoft.com/investor, 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 provide the reconciliation of differences between GAAP and non-GAAP financial measures. Our website also includes information related to our new financial reporting segments announced in September.

This is also the first quarter that reflects the revenue recognition accounting for Windows 10. As a reminder, we report Windows revenue prior to any accounting adjustment in our More Personal Computing segment. The corresponding revenue deferral for Windows 10 sales is then reported in Corp and Other in our segment reporting. Earnings commentary today, and going forward, will focus on results prior to the net deferral impact as we believe this is the best reflection of business health.

Unless otherwise specified, we will refer to non-GAAP metrics on the call. The non-GAAP measures exclude the impact of last year’s integration and restructuring charges and the current Windows 10 net revenue deferral. 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 first-quarter performance in addition to the impact that these items and events had on the financial results. Additionally, any mention of operating expense refers to segment operating expenses as defined in the footnotes of our Form 10-Q, and includes research & development, sales & marketing, and general & administrative, but excludes the impact of last year’s integration & restructuring charges

All growth comparisons we make on the call relate to the corresponding period of last year unless otherwise noted. We 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. At the segment level, we provide constant currency growth for both revenue and gross margin. However, due to the recent change to our segment reporting groupings, we aren’t able to provide segment level constant currency operating expense growth, and consequently cannot derive constant currency segment operating income either. We do provide constant currency operating expense and operating income growth at the company-wide level.

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 until October 21st, 2016.

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, Chris. Good afternoon, everyone. I’m looking forward to today’s call. This quarter we delivered $21.7 billion in revenue and grew profit. Also, as part of our commitment to balanced capital returns we meaningfully increased our quarterly dividend and continued our stock repurchase plan. More importantly we are focused and making progress towards the goals for fiscal year 18 that we shared six months ago. Now more than 110 million active devices are running Windows 10—we’re well on our way to reaching 1 billion Windows 10 active devices. People are moving from needing, to choosing, to loving Windows. Similarly, we’re making great progress towards our goal of $20 billion in annualized commercial cloud revenue run rate, which now exceeds $8.2 billion. The results speak to our differentiated cloud strategy, expanded market opportunity, and the speed at which customers are adopting our services. As I reflect on the quarter, it’s important to note that we are investing in significant addressable markets where we also have meaningful differentiation. Today, we’ll walk through our financial results for the first quarter and discuss how we’re delivering new innovation and growing users and usage across each of our three segments.

Let’s start off with Productivity and Businesses Processes. ­Clearly, how people work has changed dramatically, but one thing remains true: everyone wants to get more out of every moment of their life. After all, time is our scarcest commodity. That’s why we set out to reinvent productivity and business processes. The recent [release of Office](https://blogs.office.com/2015/09/22/thenewoffice) is a big step forward. We designed Office 2016 and Office 365 to take the work out of working together. We want to help change the nature of work within organizations of all sizes by focusing on the mobility of the person’s experience, enabling collaboration, and building a rich service that spans all aspects of how people work today. This approach is resonating with both our consumer and commercial customers. More and more consumers are using Office across device platforms, which is driving Office 365 growth. There are now more than 18 million consumer Office 365 subscribers. We surpassed 200 million downloads of Office mobile. More than one billion to-do lists have been created so far in Wunderlist. And more than half a billion people manage their documents and photos in OneDrive. We continue to see strong adoption in the commercial space as well—from our largest customers, such as Kraft, GE and Louis Vuitton—to schools and small businesses around the globe. Of note, commercial Office 365 monthly active users grew to 60 million, with nearly 60 percent of our install base using premium workloads. And, we added 50 thousand new small business customers in each of the last 19 consecutive months. As customers move to our cloud it enables us to deliver even more value and push for new growth by entering new categories. Information protection is a great example where we’ve done this because of natural synergies with our existing services. In fact, nearly 20 million people already use our new premium information protection capabilities in Office 365. That’s a tremendous validation of how the cloud accelerates the adoption of new workloads and grows our ability to monetize new value in the $10-billion information protection market. The new organizational analytics market is another area where we see growth opportunity, so we’re investing with our acquisition of VoloMetrix—a powerful cloud-based tool for analyzing organizational productivity. The ability to visualize how people engage with others inside and outside an organization is something the cloud is uniquely suited to do. It’s exciting to be on the forefront of creating a new technology category. This illustrates how our vision for productivity goes beyond helping individuals to empowering groups of people and entire organizations to accomplish more, together. Our addressable opportunity will expand further as we launch more advanced security, voice, and analytics workloads in our new premium Office 365 SKU next quarter. Let’s talk about business processes. With Dynamics, we are making great progress in breaking down the boundaries between business processes, collaboration, and productivity to truly empower organizations. The companies I talk with every day are under pressure to grow revenue while differentiating themselves on customer experience. It’s one reason usage of CRM is growing. Dynamics CRM Online enterprise seats more than tripled year-over-year. Dynamics AX revenue also grew double digits as the operational system for agile business processes. And we have a new release for Dynamics NAV for small businesses that is tightly integrated with Azure, Office 365, and Dynamics CRM.

Moving to the Intelligent Cloud. Before I talk about the great progress we’re making with our intelligent cloud platform I want to pause and reflect on where we are as an industry. While many companies are developing commercial cloud offerings, there are really only two driving enterprise cloud platform innovation at massive scale: Amazon and Microsoft. We push each other, and we each have a unique approach. Microsoft has bet on a strategy to build a hyper-scale public cloud as well as reinvent servers as the edge of our cloud. This approach gives customers a true hybrid distributed computing platform that reflects their real-world needs. Our unique hybrid approach coupled with high-value services is clearly a structural advantage. It’s great to see our customers like Walmart, Jet.com, and Alaska Airlines seize the benefits of the cloud to transform and push for growth. Azure revenue and compute usage more than doubled year-over-year, and we’re continuing to channel our innovation into high-growth scenarios with new features and services. In the last quarter alone we made major updates spanning Azure App Services for building enterprise web and mobile apps, Azure Data Lake for near infinite data management and analysis and Advanced Threat Analytics, which helps organizations identify breaches and threats using behavioral analysis. CIOs are increasingly adopting our Azure premium services for security and manageability. Enterprise Mobility Services has more than doubled to 20,000 plus customers. Our install base has increased nearly 6 times year-over-year, making EMS the largest mobility and identity management solution in a new and growing market. Our acquisition of Adallom, an innovator in cloud security, will bring customers visibility and control over application access and company data stored across popular cloud applications, including Office 365, SalesForce, ServiceNow and many more. To be a worldwide cloud player, global scale is a must. With that in mind, we launched new datacenters in India, bringing our global total to over 20 regions—more than any other major cloud provider. We aren’t just selling into these countries, we see the cloud as an accelerator of local economies by offering tools that empower emerging businesses, transform public sector services, and create value for new local partners. Our differentiated hybrid capabilities mean customers get to choose how they adopt the cloud and distribute their workloads. This in turn is driving the growth of our server business. Premium versions of Windows Server, SQL Server, and System Center Server all grew double digits. Lastly, we reached a big milestone with SQL Server - one that has been twenty years in the making. The database software market is still one of the largest and now we are an unparalleled leader in Gartner’s Operational DBMS Magic Quadrant.  That speaks to our differentiated vision in the category and the value we deliver to customers - and we’re certainly not done innovating. This milestone with SQL juxtaposed with our rapid growth in Azure and its position in the cloud magic quadrant shows the overall strength and progress we’re making with our Intelligent Cloud Platform.

Now, let’s shift to progress in our More Personal Computing segment—specifically, how the launch of Windows 10 is sparking new growth opportunities for the entire Windows ecosystem. As a platform company, we think about bringing the needs of multiple constituencies together—developers, IT professionals and users—and we’re seeing great response from all three. There are now more than 110 million monthly active devices running Windows 10. The majority of the upgrades in the first ten weeks were naturally from consumers and are 3 times that of Windows 7 over the same time period after launch. We are also seeing a fast start to business adoption with more than 8 million business PCs now running Windows 10.  We’re adding more enterprise features, and we’re making it easier for businesses to buy and support Windows devices. Our early success in attracting developers, apps and store visits. Our Store has seen over 1.25 billion visits, and developer revenue per download has grown 4 times since the Windows 10 launch. Developers are responding to the opportunity, including Facebook, which will release Universal Apps for Facebook, Instagram, and Messenger. Windows 10 is also driving increased usage of other Microsoft services. Specifically, Bing share is up to 20.7 percent in the U.S. and advertising revenue grew 29 percent worldwide, helped by Windows 10 users asking Cortana more than one billion questions. Further, in gaming, we’ve also seen an increase in active users as we extend our gaming experiences from the console to Windows 10 PCs. Xbox Live continues to grow active usage, and every day nearly half of the Xbox One user base is engaged in the service. It will be a great holiday for all gamers. The Beta release of Minecraft for Windows 10 is off to a strong start with players having already placed over half a billion blocks. And next week we are excited to launch one of the most-anticipated new games this holiday with Halo 5: Guardians.  This new Halo includes an epic hunt for Master Chief along with ground-breaking multiplayer matches on Xbox Live.  As a result, I confidently predict that time will become much more scarce for Xbox One owners starting on Tuesday. We see all of this Windows 10 usage as an early indicator of our ability to drive growth over the life-time of a device. Two weeks ago, we took the next major step in our journey with the announcement of new Windows 10 premium devices from us and from our OEM partners. It’s an incredible line-up across a broad spectrum of categories, from the new Surface Pro 4 and Surface Book, to the new Lumia 950 and 950 XL, to the Microsoft Band 2 and HoloLens developer edition. Early reviews are generating excitement with customers, and we’re delighted that our pre-order sales are reflecting the positive sentiment in the market. We are also seeing hundreds of new device designs from our partners—the widest range ever for this holiday. It’s clear that by bringing together our applications, operating system, and hardware we will invent new personal computers and new personal computing.

Overall, I’m proud of our results this quarter and I’m optimistic about our growth prospects. We are poised to seize opportunity in the largest technology shift of our generation with the enterprise cloud. We are increasing users and engagement in services that cross over every aspect of a person’s life from Office at work to Xbox at home. While at the same time we’re positioning Windows for growth. Our transformation is well underway.

Quarter after quarter ….
We build new capability.
We enter new markets.
Scale our new businesses and new business models.
And we are being disciplined in our execution.

I’ll now hand off to Amy to talk about this quarter’s results in greater detail, and I look forward to rejoining you after that to answer questions.

**AMY HOOD:** Thank you Satya, and good afternoon everyone.

Before addressing this quarter’s results, I want to briefly comment on the reporting segment change we announced during the quarter. We believe our new segments, in combination with the supplemental metrics and the profit measure of operating income, provide transparency into our progress against our ambitions. As Chris mentioned, my commentary today on our results and outlook will reflect the new segments, and excludes the net revenue deferral impact of Windows 10.

Last quarter, we discussed the material impact that foreign exchange movement would have on our financial results through fiscal 16. In Q1, the FX impact on total revenue was 5 points with most of the impact in the Intelligent Cloud and Productivity and Business Processes segments given their high annuity mix. This was in line with the expectation we shared in July.

This quarter, revenue was $21.7 billion, down 7 percent, and 2 percent in constant currency, primarily due to the changes we’ve made in our phone business. Gross margin declined by 3 percent, but was up 3 percent in constant currency. We were thoughtful with operating expenses realizing savings but investing as well. As a result, operating income grew 1 percent or 11 percent in constant currency. Earnings per share was $0.67, growing 3 percent, and growing 15 percent in constant currency. We continued to see solid performance across most developed markets while the challenging macro conditions in Brazil, China, Japan and Russia persisted this quarter.

Commercial results are now included in each of the reporting segments. Therefore, each quarter, I will cover overall commercial results in my commentary. Our commercial business continues to be healthy, with momentum in cloud services and a higher annuity mix across all our segments. Commercial bookings were slightly better than we expected and grew 10 percent in constant currency. We executed well on expirations and commercial unearned revenue came in as expected, growing 3 percent to $21 billion, up 10 percent in constant currency. Our contracted not billed balance was more than $23.5 billion, in line with seasonality for the quarter.

As Satya remarked, our commercial cloud annualized revenue run rate surpassed $8.2 billion, growing nearly 70 percent year on year, and in line with our expectations. Consistent with the revenue pattern across our commercial business, we typically drive the largest volume of renewals and new agreements in June, and consequently see a lower sequential growth rate in Q1. Importantly, our commercial cloud gross margin percentage improved again sequentially from Q4, as we benefitted from increasing scale and efficiencies. As I will talk about shortly, our leading indicators around usage, new cloud services and customer demand remain healthy and we are clearly on track toward our $20 billion goal in FY18. Now, let’s turn to the detailed results of each segment.

Our Productivity and Business Processes segment, which is made up of commercial and consumer Office including Office 365, as well as Dynamics, delivered $6.3 billion in revenue, declining 3 percent and growing 4 percent in constant currency. In Office Commercial, revenue grew 5 percent in constant currency, and was slightly better than we expected. Increased cloud channel sales capacity, higher adoption of premium services and continued install base growth all contributed to our performance. We saw broad-based Office 365 seat growth across both large enterprise and the SMB customer base. Office consumer revenue declined 4 percent in constant currency, better than the underlying consumer PC market, and slightly better than we expected. This quarter, recurring subscription revenue more than offset the impact of customers transitioning to Office 365. Our Dynamics business grew 12 percent in constant currency, slightly better than we expected. Growth was driven primarily by Dynamics CRM Online. We continue to make progress by investing in product innovation organically as well as adding capabilities through acquisitions like FieldOne and Fantasy Sales Team. Segment gross margin declined 6 percent, but grew 1 percent in constant currency. Gross margin percentages have been impacted by the mix shift towards our rapidly growing cloud services including our consumer properties like OneDrive. As Chris mentioned, this year, we can’t provide constant currency impact at the segment level for operating expenses and therefore operating income. That said, FX in general, as at the company level, had a favorable impact on operating expenses which declined 6 percent.

The Intelligent Cloud segment, which includes our portfolio of Server products, Azure cloud services and Enterprise Services, delivered $5.9 billion in revenue, up 8 percent and 14 percent in constant currency, in line with our expectations. Our differentiated cloud platform offerings and rapid pace of innovation continue to be compelling to both new and existing customers. Segment gross margin grew 8 percent, or 15 percent in constant currency. We continue to invest in research and development resources to realize the large and growing addressable market opportunities, and are accelerating our plans to add incremental sales capacity to support growing customer demand for cloud services. Segment operating income grew 14 percent.

Now to our final segment, More Personal Computing, which includes Windows, Devices, Gaming and Search. Revenue was $9.4 billion, declining 17 percent and 13 percent in constant currency mainly due to the changes in our phone strategy. As Satya mentioned, since the launch of Windows 10 in late July, we have seen solid momentum in our ecosystem and with our customers. And importantly, we saw positive engagement and usage signals across services like search and gaming that provide post-sale monetization opportunities. Overall, our OEM business declined 6 percent this quarter outperforming the PC market and better than we had anticipated driven primarily by non-Pro OEM. As we discussed previously, this was a transition quarter as the ecosystem moves to Windows 10 and we believe overall inventory in the channel is at normal levels as we head into holiday. OEM Non-Pro revenue declined 4 percent, as we saw OEMs focused on premium devices aligned to the Windows 10 launch. This drove a richer hardware mix to market, leading to improvement in the average revenue per license. OEM Pro revenue declined 7 percent, slightly ahead of the overall commercial PC market. Windows volume licensing grew 4 percent in constant currency, with annuity growth in mid-single digits. Search revenue increased to more than $1 billion this quarter. And we passed an important milestone as our Search business reached profitability. In our Devices portfolio, revenue declined 49 percent and 45 percent in constant currency, mainly due to Phone revenue which decreased $1.5 billion. As expected, Surface revenue slowed with market anticipation of a new Surface Pro device for the holidays. Surface continues to gain ground with businesses and schools, creating opportunities for our rapidly growing partner channel including Accenture, Dell and HP. Both the number and size of deals in our commercial segment for Surface have increased double-digits year-on-year. This quarter in Gaming, revenue grew 6 percent in constant currency. We saw growth in Xbox Live transactional revenue and our first party game portfolio offset by declines in hardware revenue due to lower volumes of Xbox 360 consoles sold. Segment gross margin declined 10 percent or 4 percent in constant currency. Gross margin percentages were flat year-over-year excluding phone. Segment operating expenses declined 13 percent due primarily to lower phone expenses. As a result, segment operating income decreased 4 percent. Back to our overall company results.

As usage of our cloud services grows, we will continue to invest capital into our datacenters and servers globally. This quarter, we invested $1.5 billion to support demand-driven growth. Other income was negative $280 million, due in part to foreign currency re-measurements and interest expense. Our non-GAAP effective tax rate was 21 percent, below our guided range. This was driven by the change in geographic mix of earnings and lower non-deductible operating losses associated with Phone. This quarter, we returned $6.9 billion to shareholders, up 51 percent. This includes our recently announced 16 percent increase in the quarterly dividend to $0.36. With that overview of the quarter, let’s move to our outlook. I’ll start with some overall comments and then move to a discussion by segment.

First, on FX:

Based on current rates and the forecasted geographic mix of revenue, we expect 4 points of negative impact on total revenue in Q2. By segment, we expect a 7 point drag in Productivity and Business Processes, 6 points in Intelligent Cloud and 3 points in More Personal Computing.

In H2, we expect the impact to lessen to around 3 points in total, weighted towards our segments with the highest percentage of annuity.

Next, to our commercial business which we expect to remain healthy in Q2. Our annuity mix should trend up, with good execution on contract renewals and continued adoption of our commercial cloud services. Accordingly, we expect commercial unearned revenue to be within the range of $19.5 to $19.7 billion, benefiting from these positive trends. With the ongoing increase in cloud demand, we expect to accelerate our investment in datacenters and capital equipment for the remainder of the fiscal year, expanding geographic coverage and capacity. Now let me share some additional thoughts on each segment.

In Productivity and Business Processes, we expect revenue of $6.6 to $6.7 billion. Adjusted for 7 points of expected FX impact, the revenue growth reflects continued momentum of Office 365 and our Dynamics portfolio. And, as Satya discussed, with our new E5 SKU in Q2, we’re expanding our opportunity into security, analytics and voice.

For the Intelligent Cloud segment, we expect revenue of $6.2 to $6.3 billion, including a 6 point FX impact. Our hybrid approach continues to drive growth in our server licensing business, and robust growth in our services. Gross margin in this segment will reflect the accelerating mix of cloud services.

We expect More Personal Computing revenue to be $12 to $12.4 billion, including the 3 points of FX impact. Because of the mix of devices and software in this segment, let me provide a bit more context.

* First on Windows. Overall, in Q2, we expect our OEM business to look similar to Q1 with non-Pro outperforming the underlying PC market.
* As we move deeper through the fiscal year, the device mix should evolve as our OEM partners produce more models at a wider range of price points.
* In Search, we expect Bing’s strong trajectory to continue, remaining profitable for the remainder of the year.
* We will continue to see the impact of the phone restructuring. Revenue declines and gross margin percentages in Q2 should look similar to Q1.
* With the strong Surface holiday line-up, we expect revenue to grow in Q2. Gross margins will reflect the mix of device life cycles between Surface 3, Surface Pro 3 and a growing mix of Surface Book and Surface Pro 4.

We expect COGS to be $9.7 to $9.9 billion, with variability driven by the device sales. We expect operating expenses between $8 and $8.1 billion in Q2. For the full year, we are lowering our guidance to $31.9 to $32.1 billion.

We are and will continue to thoughtfully reinvest operating expense savings to accelerate growth in key areas, expand our addressable market and transform how we work to better deliver products and services to our customers. We expect other income and expenses to be negative $300 million in Q2, similar to Q1. This includes the net cost of hedging and interest expense, offset by dividend and interest income. We expect our Q2 and full year tax rate to be between 19 and 21 percent. Similar to Q1, this reflects the changing geographic mix of revenue as well as lower non-deductible operating losses associated with Phone.

In closing, during Q1, we exceeded our own expectations across many of our businesses and more importantly, we saw healthy indicators of future growth. Through business model transitions and strategic shifts, our solid execution paired with a focus on achieving our bold ambitions has enabled us to take share in existing areas while we enter new ones. And with that, I’ll turn it back to Chris for Q&A.

**CHRIS SUH:** Thanks, Amy.

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

(Operator direction.)

**KEITH WEISS, Morgan Stanley:** Excellent, thank you guys for taking the question and very nice quarter, indeed. I want to ask about the Azure in particular and the public cloud performance that you saw this quarter. It again seems like you're seeing an acceleration in that overall business and more broadly it seems like industry-wide, both you guys and AWS are seeing something of an inflection point going on in terms of more and more business accruing to those public cloud environments. So my question is just that, would you agree with that statement that there's an inflection going on in the business, and if so what do you think is causing that and is there a changing nature in how people are using that cloud?

And then maybe for Amy is there something we should bear in mind in terms of your traditional business, sort of the on-premise business, that maybe impacted as that inflection takes place that we should bear in mind as you go forward?

**SATYA NADELLA:** Yeah, I'll start, Keith. Thanks for the question. Overall what we are seeing is the public cloud, or cloud infrastructure makes it much more possible for businesses of all sizes and developers of all sizes to get at infrastructure with much less friction than ever before. I grew up in our server business in the past. We were definitely the ones who democratized servers by bringing servers to small businesses.

But when I think about what's happening, for example, in Office 365, where we are 50,000 small business customers who now get the most sophisticated server technology, but now as a SaaS service, that's what's really happening world over with all application categories and that's where the growth is. I don't know long-term whether there is a zero sum equation, but right now and in the intermediate timeframe we see in our case growth in both sides.

And in our case the vision also we have for distributed cloud infrastructure is just that. It is distributed. So we don't think of our server as a legacy business. I think of it as the edge of our cloud, if you look at what we are doing with SQL. We will have the ability for any customer of SQL to stretch even a single table from between their on-premise to the cloud. Those are the kinds of things that we are excited about, but we clearly are seeing very rapid growth and adoption of our Azure cloud, but in our case there are two unique aspects.

One is this true distributed hybrid and second is we don't think of Azure in isolation. We think about it in the combination of Office 365, Dynamics, EMS, because really it's one cloud infrastructure, first of all, from a capital perspective that sort of serves all of these. And there's a virtuous cycle between all of these for our customers, as well.

**AMY HOOD:** And, Keith, to your second question, the place you'll actually see it will be in the gross margin percentage. As Satya said, I do expect both to grow, both the on-premise and the cloud, but I expect the mix to increasingly shift toward the cloud, given its sort of robust growth rate, which will impact the gross margin percentage over time.

**KEITH WEISS:** Excellent, that was very helpful, thank you.

**CHRIS SUH:** Thanks, Keith.

We'll take the next question please.

(Operator direction.)

**MARK MOERDLER, Bernstein Research:** Thank you. Congratulations on the quarter, everyone. Two questions, but related, let me give you the first one. The commercial cloud annualized revenue run rate grew slightly from $8 billion to $8.2 billion or more than each of those, yet Office 365, Azure, Dynamics CRM Online; all of them seem to be growing very fast. How should we think about the difference, should we figure that the run rate reaccelerates next year, next quarter, excuse me. And then I have a follow-up.

**AMY HOOD:** The way to really think about that number, just because of some of the seasonality in our business market, is to think about the year-over-year growth rate of 70 percent. For me that is more symbolic of how you should think about the pace and that is a very fast number on an increasingly growing base.

**MARK MOERDLER:** That makes perfect sense, thank you. The second one is the cloud margins improved nicely, given the data that's in here it looks like they've all started to move up, Azure seems to move up. You said in the FAM the gross margins for '15 should be about 44 percent. How should we think about cloud gross margins for '16? I know you don't know obviously the mix of all the cloud products, but how should we think about the improvement there?

**AMY HOOD:** Thanks, Mark. Looking in the old segments, as I know you all have done, we saw year-over-year improvement in the overall Commercial Other segment that we disclosed this time, too, of about 10 points year-over-year. We saw sequential improvement from Q4 to Q1. We're still focused on continuing to have that sequential improvement, especially as some of the things Satya talked about, which is the addition of premium services, the pace of innovation especially on the premium end. And if you think about our launch of E5, which is a premium SKU in Office 365, it continues to give us the opportunity to both get more efficient in the infrastructure and to add higher margin products, especially at the SaaS end.

**SATYA NADELLA:** Yeah, just the one thing that structurally I think that we think a lot about and we're very disciplined about is our capital allows us to build all of the cloud services from Office 365, to EMS, to Dynamics, to Azure, and that diversity of workloads long-term is what lead to margin improvement and there will be changes and seasonality from quarter to quarter. But, structurally those two things, the diversity of what we're doing and how capital is utilized across all of it is, I think, a big structural differentiator for us.

**MARK MOERDLER:** Beautiful, it's great to see that improvement happening. Thank you very much.

**CHRIS SUH:** Thank you, Mark.

We'll go to the next question please.

(Operator direction.)

**PHILLIP WINSLOW, Credit Suisse:** Hi, thanks guys, congrats on a great quarter, just a question for Satya, then a follow-up to Amy.

Satya, you talked about good adoption of Office 365 on the commercial side, both in SMBs and large enterprise. I wonder if you could just sort of break that down and sort of where are you seeing the faster adoption as you start to get into the enterprises, especially that might have enterprise agreements with Microsoft, how is that sales motion going and sort of what is the pitch there?

And then to Amy, I thought this was a key point, something that we've been looking for. You noted that the subscription, the recurring business now has offset the cannibalization of the license. Is that kind of something that we should think about going forward, or was there something specific about this quarter that would push that out? Thanks.

**SATYA NADELLA:** Yeah, first as far as the Office 365 usage itself, I talked about some of the numbers of 60 million monthly active users, the fact that our seats grew 66 percent year-over-year, the small business number. I talked about the 50,000 per month additional customers that we are adding to Office 365. These are all the growth numbers and the usage growth numbers.

The mix even, that information protection, I mean that's just another very important point, which is amongst the customers who are using Office 365 already 20 million are using some of these premium services like information protection. And of course we're going to further expand that with new SKUs and new categories that are going to become part of Office 365.

So I see that stretching on both sides, which is to small business on one end and then these premium SKUs on the other end. And we see nice attach, as far as EAs to the cloud, as well. And that's definitely a big driver of our growth.

**AMY HOOD:** And so let me take the second and I'll add something to what Satya said. One of the important things that's distinct about the small business market is that there tends to not be much of a lag in terms of buying and deployment. They kind of want to be able to instantaneously use and get value very quickly and that's something we've actually seen and a real testament to our ability to add so many customers in every quarter.

And what you've seen in the consumer side, which it was an important point, you know, once we've built this install base up to 18 million users on the consumer side, that recurring rate does, in fact, offset the deferral from new. And so it is an important inflection point for us this quarter.

**PHILLIP WINSLOW:** Great, thanks guys and congrats.

**AMY HOOD:** Thanks.

**CHRIS SUH:** Thanks.

Next question please.

(Operator direction.)

**HEATHER BELLINI, Goldman Sachs:** Great, thank you. I just had two quick questions. I was wondering, Satya, if you could give us a sense for just a high level commentary about the split of IaaS versus PaaS in Azure and maybe some color on the growth you see in each of those and how you see them evolving and then the second question would be related to the launch of Windows 10. You gave the Bing example for the month of September and the solid pull forward there, or pull along there. I'm just wondering if you could share with us any other areas where you're seeing a similar kind of pull along with Windows 10 adoption. Thank you.

**SATYA NADELLA:** Sure, Heather. On the first one, on the mix between IaaS and PaaS and SaaS, the thing that we are seeing is, quite frankly, all of these are growing, but the most interesting thing for me as a pattern is growth in IaaS leads to growth in other PaaS services or SaaS services.

I mean to put it very concretely, take something like Azure Active Directory, that's probably the best manifestation of the virtuous cycle that we see in any of the cloud adoptions that we have, right. It could be someone coming from Office 365, it can be someone coming from Azure or Dynamics, EMS, all of those tenants get into Azure Active Directory, which is our largest PaaS service, because it's got even developer APIs. So that means more developers are using it, more IT professionals are using it as a control plane. So that's the network effect that we see when it comes to the PaaS services.

And then in terms of infrastructure itself, as again I said, there's people who are tiering even applications, people who build hybrid applications where the storage could be even on-premise in some cases, but the mid-tier and the web and the mobile back ends are in the cloud. We see a lot of growth there. We see a lot of growth in our data, both in terms of infrastructure, but in the new services like our Data Lake services, which are PaaS services. Hadoop is another good example. We see lots of Hadoop usage inside of IaaS, but we also see HD Insight growth.

So I would say there is a really good mix of those two and then on Windows 10 the -- I mean I'm very, very excited obviously about what's happening with Bing. I think Amy talked about we have a billion dollar quarter, with 29 percent growth and good share position growth in the United States. That's fantastic to see. But gaming is the other place where we talked about Xbox Live now that spans both console and PC. We see increased engagement, because of that. We see, in fact, increased engagement with titles like Minecraft. So we have some high hopes for what we can achieve with engagement around Xbox Live across the console plus PC.

**CHRIS SUH:** Thank you, Heather.

We'll go to the next question please, operator.

(Operator direction.)

**BRENT THILL, UBS:** Good afternoon. Satya, Michael Dell mentioned with you on stage a week ago that he's seeing from his perspective stronger Windows 10 adoption among enterprise customers faster than he had seen I the past. And I'm curious if you're starting to see a halo impact where those that are looking to move up are saying we want to go with more of the complete infrastructure set and are you seeing different sales motions those enterprise customers as those customers are coming back to you?

**SATYA NADELLA:** Thanks, Brent. I mean that is absolutely the case that is we are seeing a much faster adoption cycle, obviously starting with the consumer side, but even the 8 million business PCs that are already running Windows 10, before we have started, in fact, the push on enterprise, we expect the enterprise deployment to start in earnest the beginning of next calendar year or the second half of this fiscal year.

But, to your point, the fact that there is pull already is a very, very good indicator of, and a good sign and it's even better than what we saw with Windows 7. And so to me that's all positive news, but yet we are very, very focused on delivering I think new value to the enterprise customers, because if you look at Windows 10 we've already talked a lot about all the consumer value, but just take security itself, I think that Windows 10 represents a real breakthrough in terms of security on the end point, as well as in embedded, which we are very excited about in terms of driving the enterprise upgrade cycle.

**BRENT THILL:** Really quick just for Amy on cash flow. Is there anything that we should take into account this year versus what happened last year?

**AMY HOOD:** I don't think anything unique that I would bring up, no. Thanks, Brent.

**BRENT THILL:** Thank you.

**CHRIS SUH:** Thanks, Brent.

Operator next question please.

(Operator Direction.)

**RAIMO LENSCHOW, Barclays:** Hey, thanks for taking my question. Besides Azure in the Intelligent Cloud, you obviously have very, very good momentum on the server in the classic server and tools business. Can you talk a little bit about the volume versus price effect that you see playing out here, and how is it now and how do you expect that to play out going forward?

And one of the things on Azure was usage, and you mentioned how that kind of improved quite significantly. Satya, can you talk a little bit where you see that current usage standing and where do you think that can go? We obviously didn't get a number, just a growth rate, but where do you see usage? Because that's obviously one of the things that one of your competitors keeps talking trying to knock on you.

Thank you.

**SATYA NADELLA:** Yeah, I mean I think the usage numbers is the one that, Raimo, that we talked about, which is doubling of compute, doubling of storage. We talked about the growth in EMS, which is a higher level service. We talked about the growth in Active Directory. So we have usage growth in Azure which is very, very healthy.

**AMY HOOD:** On the server question you asked at the beginning, let me say that we did see, I think, around 9 percent constant currency growth of the core server product. And a lot of that was premium driven.

Now, I have a distinction between a price question that you sort of asked versus seeing the value of a premium SKU. And so I do think it was premium driven as opposed to sort of a price driven in particular.

**RAIMO LENSCHOW:** Perfect. That's helpful. Thank you.

**CHRIS SUH:** Thank you, Raimo.

Next question, please.

(Operator Direction.)

**KARL KEIRSTEAD, Deutsche Bank:** Thanks very much. I wouldn't mind going back to Windows 10. Three months ago on the June quarter call, the messaging was that Windows 10 would not likely lift Microsoft's performance results until the second half of Fiscal '16, yet it feels like as early as this first quarter it's creating a lift, at least to the Windows OEM business. And I just wanted to understand what's changed in the last three months such that it's having an earlier than expected positive impact on Microsoft? Thank you.

**AMY HOOD:** Thanks, Karl. Why don't I take that and then Satya can add. In particular what we saw this quarter was really as much about the mix of the devices that the OEMs are bringing to market as it was in the absolute unit distinction. And you saw that in the non-Pro revenue performance. And so for us I think really the way to think about the early signs of the impact were the strong device mix, some higher price units across a wide variety of OEMs as we build into holiday did provide some slightly better than expected results, as you noted in the non-Pro business.

But really some of the other upside that we saw in the quarter was from things that are the second sort of derivative of that, which was our search results were better than we had thought because of some of these results about where the PCs were upgraded and the pace at which they were upgraded.

And so I do think we are encouraged, as Satya said, but we're a quarter in. And I think what's exciting for us is really the opportunity we have going forward. We're excited about Q2 when the devices hit the shelves. We're excited to have so many first party devices in Q2. And then the next stage after that, which is really the enterprise deployment, which as Satya mentioned we expect in the second half of the year.

So it's early, but you're right, we did see some incremental improvement over what we expected.

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

**CHRIS SUH:** Next question, please.

(Operator Direction.)

**WALTER PRITCHARD, Citi:** Hi, thanks. Amy, I'm wondering if you could talk about on the computing side, the personal computing side, you talked about this quarter seeing growth ahead of the PC market. You alluded to a diversity of devices coming in the second half. How do you think about that variable in the model, say, beyond this sort of launch period where you have a little bit of a differing mix going on in devices, and you get to more of a steady state out in kind of years two and three of the Windows 10 launch, do you think you can grow ahead of the PC market or do you think -- I know for the last few years you've grown below the PC market. I'm just wondering how we should think about that.

**AMY HOOD:** Thanks, Walter. Let me talk a little bit about what I said in my outlook. This quarter, as I just talked about, the non-Pro outperformance versus the market was really due to a higher revenue per license. I expect that actually to continue in Q2. I expect our overall Pro business to remain in line with business PCs. Once we work through sort of the end of XP bump that really should be in line.

And as we talked about, as we move though the year, I do expect things to more normalize overall in terms of our P&L comparisons. But I do think that's probably the best way to think about the curve over the course of the year.

**WALTER PRITCHARD:** And then on the commercial licensing part, specifically within productivity I know you sort of had an old breakout and a new breakout where we don't see commercial licensing necessarily within Productivity, but would you expect that piece, the commercial licensing within productivity given the transition going on to be stable or would that decline as you see the transition over to the cloud in productivity specifically?

**AMY HOOD:** Let me try and if I miss the question or misunderstood it you can help me again. I think you're asking about our core sort of Office Commercial business, the product side versus the service side.

**WALTER PRITCHARD:** Correct.

**AMY HOOD:** And really -- okay, good. The trend we saw there, we're 5 percent up in a constant currency basis. That was sort of 70 percent cloud minus 8 percent on prem. That's a trend that's not new for us. We've thought about making this transition as quickly as possible, but what we're seeing, what you heard us talk about, was a transition to sort of increasing premium mix, selling more workloads, doing all that while we're growing the install base.

So if you think back to how we've talked about the long-term, the lifetime value equation, it's those components that I really think about proving out over time, and we had lots of encouraging signs about that. New users, Satya referenced on the small business and midmarket side. Premium mix we talked about how many premium services we're now selling. And then in terms of renewals, you know, they're quite good, which we talked about. And so I think all of those, when you talk about should we expect sort of the traditional business to be in decline, I don't think that's new.

I think what's important is our ability to switch it to the services and add more over time that I really focus on.

**WALTER PRITCHARD:** Okay. Thank you.

**CHRIS SUH:** Great. We'll move to the next question, please.

(Operator Direction.)

**MARK MURPHY, J.P. Morgan:** Yes, thank you very much. Amy, I see the commercial bookings numbers in the KPI sheet. But I do not see the total bookings numbers. I'm wondering if you could just comment on that so that we can try to maintain a consistent analysis there if it's relevant?

And also, Satya, now that SQL Server has taken over this number one position in the Gartner quadrant for the database market, could you help us understand how the roadmap evolves from here, as we did notice Amazon made its debut also in the leaders quadrant, and I think we're trying to understand how the movement to cloud platforms like Azure could further alter the database landscape and how you could capitalize on that?

**AMY HOOD:** You go first.

**SATYA NADELLA:** I'll go first. I think the data architecture that underlies what's happening in the enterprise underneath the applications is going through a dramatic change. That said the relational database itself remains still a very strong component, but not the only component anymore, both on premise and off premise. And what we want to make sure as a company is to cover all of that landscape with a very rich data platform.

So if you look at what we're doing, the length and breadth of our ambition, as well as our delivery today, everything from what SQL itself is doing, we have now all in-memory workloads for OLTP, BI, data warehousing built in. We have the ability to now tier even the database with the cloud. This is all the things that are coming in SQL 2016, and we're excited about that.

When it comes to the cloud itself, we have a PaaS service for SQL which is very unique in terms of SQL Azure. We have now the DataLake service for basic petabytes, exabyte scale data management. We have higher level data services like Azure ML, which is about advanced analytics, a category we didn't even participate in the past. So we've entered that category. Revolution R fits into that. So we have a very rich story. And this is not even talking about some of the other end user BI capabilities like Power BI.

So I think we have a very rich vision and execution on what is an expanding data platform opportunity, and it's nice to see us innovate on the new services while we also in what is still the big market, which the relational database market, claim a leadership position.

**AMY HOOD:** And, Mark, on the total bookings number, the reason we moved to commercial bookings is it's a far more comparable number to look at period to period. Total bookings, because the volatility, frankly, in consumer businesses in times like the holiday period, it can make it far more volatile than usually what many of you have been asking for, which is sort of the continuity and health of the overall commercial business.

If you want to get to total bookings, you just add back in all the consumer revenue is technically how you would do it. But I do think the more helpful KPI for us in terms of bookings is the commercial ones.

**CHRIS SUH:** Great. Thanks, Mark.

Operator, we'll have time for one final question, please.

(Operator Direction.)

**ROSS MCMILLAN, RBC Capital Markets:** Thanks so much for squeezing me in, and congrats on the quarter.

Amy, I just had a couple. The first one, just your comment that the consumer Office business you're seeing basically the subscription revenue now being larger than the offset, if you will, on the license side. Where do we stand with regard to that on the commercial side of the Office transition?

**AMY HOOD:** The way to think about that is how I look at -- well, the way I would generally say it is, you look at each of the KPIs we give, so the Office commercial business grew 5 percent, it was negative 8. There's some transition earning back off the balance sheet, the total cloud is 70. When we start to get to this point, and the percentage we already have in the cloud, it is really an offset. And that's probably frankly been true a little bit longer than we talked about, technically, in terms of what goes off and what comes on, given we've now got, as Satya said, 60 million users, and more than that in terms of seats sold.

Now that can technically, Ross, be interesting in certain quarters of the year where we have very heavy expirations. And so it just depends year-over-year, that's why the commercial is slightly harder to do it on, because there's some volatility in the ins and outs based on seasonality.

**ROSS MCMILLAN:** Just if I think about the incremental subscription revenues from the commercial side versus the license declines, it sounds like this year, this fiscal year, we're making that pivot like we have made on the consumer side. Would that be a fair statement?

**AMY HOOD:** It gets complicated. I want to make this simple, and unfortunately it's just slightly complicated because so much of our install base was already on an annuity contract, it makes this transition mathematically hard.

I think what you're asking is specifically for our transactional component, when the old transactional component has gone. But it's a very hard -- but that's a component of the number, not the total. So it's why it's technically difficult to answer the question you're specifically asking, Ross.

But the way I would think about it is, we are moving such a substantive piece of our EA business and with our annuity mix all up in commercial up to 86 percent, we're feeling very good about our ability to transition people add LTD and grow the business overall at a very high level.

**CHRIS SUH:** Thank you, Ross.

**ROSS MCMILLAN:** Thank you very much.

**CHRIS SUH:** So that wraps up the Q&A portion of today's earnings call. We look forward to seeing many of you in the coming months at various investor conferences. For those unable to attend in person, these events will be webcast and you can follow our comments at Microsoft.com/investor. Please contact us if you need any additional details and thank you for joining today.

**AMY HOOD:** Thanks, everyone.

**SATYA NADELLA:** Thank you, everyone.

END