# MSFT Earnings Conference Call

Chris Suh, Satya Nadella, Amy Hood

Thursday April 27th, 2017

**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 and corporate secretary.

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.

As a reminder, this is the first full quarter of LinkedIn results. As a result, comparisons made to prior years will be affected accordingly. During this call, Amy will discuss the financial impact of LinkedIn as she provides the overview of business results for the quarter. Our key investor metrics remain unchanged due to the LinkedIn acquisition.

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 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.

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 April 27th, 2018.

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, and thanks to everyone on the phone for joining.

Today I’ll share results for the third quarter, and discuss what’s ahead.

I’m proud of the progress this quarter.

We delivered $23.6 billion in revenue — up 7 percent in constant currency.

Across all industries, organizations are looking to digitally transform with state-of-the-art cloud services, AI and new natural user interface technology.

Increasingly, these organizations are turning to Microsoft as a partner they can trust for the innovation and their own digital capability building.

Now let’s look at the progress we made this quarter by segment, starting with Productivity and Business Processes.

We crossed a major milestone with more than 100 million monthly active users of Office 365 commercial. Office 365 commercial seats grew 35 percent year-over-year, and revenue is up 45 percent in constant currency.

Across industries, customers recognize Office 365 is the productivity platform of choice. Companies like H&R Block, Johnson & Johnson, Deutsche Bӧrse AG and Louis Vuitton Moet Hennessey all chose Office 365.

And we continue to innovate and add new value. This quarter we made Microsoft Teams broadly available to Office 365 customers in 181 markets. Our new chat-based workspace is already empowering a new way to work for more than fifty thousand customers including Accenture, J. Walter Thompson, J.B. Hunt and Expedia. Teams also creates a new platform opportunity for developers to reach 100 million Office 365 users with rich extensibility for bots, apps and services.

Additionally, we are expanding the relevance of Office 365 to new segments. Retail, hospitality and manufacturing companies have a huge need to empower their front-line employees. Our expanded offering for this segment includes Microsoft StaffHub, Teams, OneDrive, Skype for Business, and more to give these critical employees a robust collaboration toolkit to maximize their impact.

Now let me talk about the second part of our ambition in this segment – reinventing business processes.

Accelerating our growth opportunity with LinkedIn by driving value for members and customers remains our top priority. This quarter, we redesigned the LinkedIn desktop to create a more seamless, intuitive experience across devices. We continue to invest in the LinkedIn feed, bringing curated news and views to help members stay informed on what’s most important to them. Our innovation across both desktop and mobile is driving strong engagement momentum, with sessions up more than 20 percent again this quarter.

LinkedIn marked an important milestone this week, exceeding 500 million members, and our jobs platform hit record levels with more than 10 million jobs posted. The strong momentum with jobs and engagement is continuing to fuel the growth across Talent, Marketing, Sales and Learning Solutions.

We took significant steps this week to redefine social selling with deeper integration of Sales Navigator and Dynamics 365 – enabling sales professionals to dramatically increase their effectiveness by drawing on the relationships in their personal networks. Customers like Visa are choosing Dynamics 365 because of our deep integration across Office 365 and now Sales Navigator. I’m excited to put the Microsoft enterprise salesforce and partner ecosystem behind this new opportunity.

Dynamics 365 solves a critical challenge for businesses, helping them break free of monolithic, siloed suites of applications to unlock insights across organizations. You see this in our new Dynamics 365 Talent application which combines HR business processes with LinkedIn Recruiter to help companies manage the employee life cycle from recruiting to retention.

Our innovation in Dynamics is driving strong revenue growth with Dynamics 365 up 82% in constant currency this quarter.

Now, let’s talk about the progress we are making in our Intelligent Cloud segment.

Our commercial cloud annualized revenue run rate now exceeds $15.2 billion.

Customers are increasingly choosing the Microsoft Cloud. They value our differentiated approach as the most trusted, global, hyper-scale cloud with hybrid support and higher level services to help drive their digital transformation. Moreover, they appreciate the agility, operational consistency and security across the entire digital estate – spanning Enterprise Mobility, Office 365, Dynamics 365 and Azure.

Take Maersk, the largest transport and logistics firm in the world with operations in 130 countries and a fleet of over a thousand vessels. Maersk began their journey to the Microsoft Cloud with Office 365, Enterprise Mobility & Security and Windows 10. They chose Dynamics 365 for Operations to streamline container production and maintenance. Now Maersk is using Azure to digitally transform its supply chain management and global trade. The intelligent services in Azure deliver up-to-the-minute insights on carrier performance and equipment usage with real-time data visualization and advanced analytics, enabling them to trim costs and create new revenue streams. For a company that ships 17 million containers annually, the ability to react quickly can mean the difference of tens of millions of dollars to the bottom line. This is a great example of our three clouds coming together to enable deep digital transformation.

Across industries, customers are choosing Azure. UBS announced they are using Azure for risk management and GEICO chose Azure for hybrid capabilities. Publicis Groupe announced they will use Azure and Cortana Intelligence Suite to deliver AI-powered marketing solutions at scale. Flipkart, India’s leading online marketplace, chose Azure as the platform to enable their rapid growth.

We continue to rapidly innovate and add new capability to drive further customer value. Microsoft IoT Central is the first SaaS offering that provides the end-to-end solution for organizations of all sizes to manage their entire IoT ecosystem across devices, cloud, analytics, networks, and software. This week at Hannover Messe, the world’s largest industrial trade show, manufacturers showcased how they are using our solutions to transform all aspects of manufacturing, from water management to food and beverage packaging to improving safety on the factory floor.

When it comes to AI this quarter we made our cognitive services for face recognition and computer vision broadly available to enable any developer to become an AI developer.

We are excited about how Azure Stack and SQL Server are helping to define the edge computing paradigm.

Azure Stack will enable customers to extend Azure capabilities to their private datacenters in a truly consistent hybrid computing environment.

SQL Server 2017, coming this Fall, is the first database with cloud-tiering and artificial intelligence built in. It runs on Windows and Linux, supports Docker container deployment, and popular programming languages such as R & Python for machine learning and data science.

We will share more about all these advances and more at our upcoming BUILD developer conference.

Now I’ll turn to our progress in More Personal Computing.

Almost two years ago, we introduced a new approach with Windows 10, transforming the way customers experience Windows on all their devices. Now, customers are always up-to-date, running the most secure Windows ever.

This quarter the Windows business grew 5% in constant currency and we delivered the next phase of innovation with the Creators Update.

Creators Update is about inspiring the creator in us all. We create technology so that others can create their own content and technology. We want to empower people to paint in 3D or paint with numbers in Excel. We empower people to create in Word or in Minecraft. These new forms of creation and expression are shaping Windows for the next generation.

Gaming is a key scenario to expand our opportunity across the PC and console. We are building on our already strong foundation with Xbox One and our Xbox Live community, up 13 percent to 52 million active users this quarter. With Creators Update, we integrated gameplay broadcasting into Windows 10 PCs as well as Xbox One. We are off to a very strong start with both streamers and viewers. In fact, the majority of streaming in the industry today is on PC and console, and we are uniquely positioned to provide the best, most complete gaming experience from hardware to software to broadcast services. It’s early days and we are excited to pursue this new, growing opportunity.

This quarter we also revealed more about our forthcoming Project Scorpio, which will be the most powerful console ever and will enable true 4k gaming in the living room.

Our commercial customers continue to adopt Windows 10 as the secure, trusted platform of choice. Customers like the Department of Education in the UK, British Telecommunications, and the Adventist Health System, one of the largest healthcare providers in the United States, all chose Windows 10.

When I talk to business and government leaders, they value security and privacy of their data, the reliability of their systems, and choice and control over how and when they deploy. We remain committed to our core values of trust, transparency, privacy and security for every customer.

Finally, devices. This quarter our Surface results fell short of expectations impacted by end of product life cycle and increased price competition. We continue to innovate and invest in creating new computers and computing experiences. Surface Pro; Book; Hub; Studio and HoloLens are all creating new markets for the Windows ecosystem and pushing differentiation with new natural user interface capabilities – ink, vision, voice, touch and mixed reality.

In the context of Mixed Reality, we just passed the one year anniversary of Microsoft HoloLens. We now have more than 150 exclusive HoloLens apps in the Store. Moreover, many of our commercial customers are using HoloLens to drive digital transformation and seeing real impact. HoloLens based innovation was featured front and center at NRF, HIMMS and most recently this week at Hannover. Digital transformation across these industries is being shaped by new technologies from IoT to Mixed Reality to AI and the cloud.

ThyssenKrupp Elevator is using HoloLens and Azure to digitize their entire sales and order process, shortening delivery times up to 4x, and chose Dynamics 365 to enable transformation in their steel division.

Leading global medical technology company Stryker chose Office 365 to empower employees and is using HoloLens to improve operating room design for surgeons, staff and ultimately, the patients. All this creates a strong foundation for the broader opportunity ahead with digital transformation.

I’m proud of the progress this quarter and I’m enthusiastic about what’s to come. In the coming weeks, we will share more about how Microsoft is innovating uniquely to empower every customer – from students and teachers, to business professionals to developers.

Now, let me hand it over to Amy to walk through this quarter’s results in more detail and share our outlook.

I look forward to rejoining you after for questions.

**Amy Hood:** Thank you, Satya and good afternoon everyone.

Our third quarter revenue was $23.6 billion, up 6 percent and 7 percent in constant currency. Gross margin grew 7 percent and 9 percent in constant currency. Operating income grew 2 percent or 5 percent in constant currency. And earnings per share was $0.73, an increase of 16 percent and 19 percent in constant currency.

This was the first full quarter of company results with LinkedIn, which had a significant impact on revenue, gross margin and operating income. At a company level, LinkedIn contributed approximately 4 points of revenue and gross margin growth and 6 points of drag on operating income growth which includes $371 million from amortization of acquired intangibles.

From a geographic perspective, our results were mostly in line with macroeconomic trends. Our performance in Japan was better than expected, driven by increased public sector spending and improved market conditions.

Our commercial annuity mix was 88 percent, even with another quarter of higher than expected transactional revenue results. Commercial bookings increased 12 percent, or 11 percent in constant currency. Commercial unearned revenue followed historical seasonal trends, coming in at $20.4 billion, and growing 9 percent and 10 percent in constant currency. And our contracted not billed balance increased to more than $27.5 billion.

Another strong quarter of cloud services performance drove our commercial cloud revenue run rate over $15.2 billion, growing 52 percent. Our commercial cloud gross margin percentage increased to 51 percent, up 6 points from last year, with improvement across Office 365, Azure, and Dynamics 365. And gross margin dollars grew 74 percent, keeping us on pace for material gross margin percentage and dollar improvement this fiscal year. As a reminder, our commercial cloud includes Office 365, Azure, Dynamics 365 and other cloud properties, but does not include LinkedIn.

Our company gross margin was 66 percent, better than anticipated and up 1 point, as the sales mix of higher margin products and services coupled with commercial cloud margin improvement more than offset the impact of $218 million of LinkedIn amortization.

Now to FX. This quarter, the US dollar was weaker than expected. As such, we had one point less FX impact across our individual reporting segments even though overall company impact was still approximately one point as guided. FX impacted the Productivity and Business Processes and Intelligent Cloud segments by 1 point and had minimal impact in More Personal Computing.

Total operating expenses grew 12 percent, with LinkedIn contributing 13 points of growth, including $153 million of amortization of acquired intangibles expense.

Let’s move to the segment results.

Revenue from our Productivity and Business Processes segment grew 22 percent and 23 percent in constant currency to $8 billion, with LinkedIn contributing 15 points of growth.

Office Commercial revenue increased 7 percent and 8 percent in constant currency. Office 365 commercial revenue increased 45 percent driven by installed base growth across all workloads and continued ARPU expansion. Our transactional results came in higher than expected, mostly from performance in large markets like Japan and Western Europe.

Office Consumer revenue increased 15 percent and 14 percent in constant currency primarily from recurring subscription revenue as well as growth in our subscriber base.

Our Dynamics business grew 10 percent and 11 percent in constant currency with Dynamics 365 customer momentum contributing to double-digit billings growth.

LinkedIn revenue for the quarter was $975 million.

Segment gross margin dollars grew 15 percent and 17 percent in constant currency, with 11 points of contribution from LinkedIn, including $218 million of amortization of acquired intangibles. Gross margin percentage declined due to a higher mix of cloud revenue and the impact of LinkedIn related amortization. Operating expenses increased 44 percent and 45 percent in constant currency, with 43 points from LinkedIn including $153 million of amortization expense. Operating income declined 7 percent and 4 percent in constant currency, with 13 points of impact from LinkedIn.

The Intelligent Cloud segment delivered approximately $6.8 billion in revenue, growing 11 percent and 12 percent in constant currency. Server products and cloud services revenue increased 15 percent, up 16 percent in constant currency, demonstrating durable double-digit growth. Azure revenue increased 93 percent, up 94 percent in constant currency, and annuity revenue again grew double-digits. Azure Premium revenue grew triple digits for the eleventh consecutive quarter, with more than 80 percent of Azure customers using our premium services.

Our Windows Server and SQL Server transactional business continued to perform well, with better than expected results mainly from Japan and continuing post-launch demand.

As expected, Enterprise Services revenue declined 1 percent and was flat in constant currency, due to a lower volume of Windows Server 2003 custom support agreements.

Segment gross margin dollars grew 6 percent and 7 percent in constant currency, and segment gross margin percentage declined due to increasing cloud revenue mix and lower Enterprise Services margins, partially offset by material improvement in Azure margins. We grew operating expenses by 11 percent with ongoing investment in sales capacity, cloud engineering and developer engagement. Operating income was flat, and up 3 percent in constant currency.

Now to More Personal Computing. Revenue was $8.8 billion, declining 7 percent, as phone and Surface results offset healthy growth in Windows, search and gaming.

Our OEM business grew 5 percent this quarter. OEM Pro revenue grew 10 percent, materially ahead of the commercial PC market mainly due to a higher mix of premium SKUs. Additionally, the commercial PC market was slightly below our expectations, negatively impacted by channel production timing changes and upcoming Windows SKU pricing changes. Commercial end customer demand signals remain consistent and positive. OEM Non-Pro revenue declined 1 percent, ahead of the consumer PC market, with continued positive impact from the Windows premium device category. Overall, inventory levels remain in the normal range.

Windows commercial products and cloud services grew 6 percent, with healthy enterprise demand as customers continued to deploy Windows 10 for its advanced security and management capabilities.

Patent licensing declined this quarter, primarily from lower revenue per unit.

Search revenue ex-TAC grew 8 percent and 9 percent in constant currency driven by higher revenue per search and search volume.

Devices revenue declined 51 percent. We had no material Phone revenue this quarter. Our Surface business declined 26 percent, and 25 percent in constant currency as heightened price competition and product end of lifecycle dynamics resulted in lower than expected Surface Pro unit volumes.

Our gaming business grew 4 percent and 6 percent in constant currency, as Xbox Live revenue growth offset declines in hardware. Xbox Live monthly active users grew 13 percent across Xbox One, Windows 10 and mobile platforms, which contributed to software and services revenue growth of 7 percent and 8 percent in constant currency.

Segment gross margin dollars were flat, up 2 percent in constant currency. Gross margin percentage increased with a sales shift to higher margin products and services. Operating expenses declined 11 percent, and 10 percent in constant currency, from lower Phone expense and Surface launch related marketing spend in the prior year. Operating income grew 20 percent and 23 percent in constant currency.

Now back to overall company results.

We invested approximately $2.1 billion in capital expenditures, including capital leases, less than we expected, as a portion of the expense will move into Q4.

Other income and expense was $322 million, greater than originally planned, as we saw more opportunities in the equities market to realize gains during the quarter.

Our non-GAAP effective tax rate was approximately 23 percent.

We returned $4.6 billion to shareholders, continuing our balanced approach to capital allocation through share repurchase and dividends. After a period of accelerated buyback, we have resumed a buyback pace consistent with our historical trends.

Now let’s turn to the outlook.

First, FX. Given current rates, we now expect less FX headwinds in our fourth quarter. We expect about 1 point of negative impact on total revenue. Within the segments, we anticipate about 2 points of negative impact in Productivity and Business Processes and Intelligent Cloud, and 1 point in More Personal Computing.

Second, our commercial business. The fourth quarter is an important one for our commercial business, and we expect continued annuity growth and healthy renewals as customers adopt and use our growing portfolio of commercial cloud services. We expect unearned revenue between $26.8 and $27 billion, in line with historical seasonality. Additionally, we have a large expiry base in the fourth quarter and our sales execution on renewals and upsell opportunities, while contemplated in our unearned revenue guidance, should also show up in a larger contracted not billed balance and commercial bookings growth.

Third, capital expenditures. We expect capex to grow sequentially and year-over-year. Quarterly spend variability will continue and we remain on track for our full year capital expenditure year-over-year growth curve to slow.

Let’s move to the individual segments.

In Productivity and Business Processes, we expect revenue of $8.2 to $8.4 billion, driven by the ongoing annuity shift to cloud in commercial Office 365. In Office consumer, we expect growth rates to moderate from prior quarters which were impacted by prior year comparables. We expect consistent growth from Dynamics and approximately $1.05 billion of revenue from LinkedIn, adjusted for the impact of purchase accounting. Similar to Q3, we anticipate that LinkedIn, excluding amortization, will have minimal impact on segment operating income, and we continue to expect it to be minimally dilutive to non-GAAP EPS this fiscal year.

In Intelligent Cloud, we expect $7.2 to $7.4 billion in revenue. Performance trends from Q3 should continue into Q4, with annuity strength and double-digit revenue growth across our server products and cloud services. Enterprise Services should decline, with lower volumes of Windows Server 2003 custom support agreements.

In More Personal Computing, we expect revenue of $8.4 to $8.7 billion.

In our OEM business, we anticipate that revenue growth will be more aligned with the overall PC market. OEM Pro growth will continue to be driven by Windows 10 enterprise momentum and aligned to a commercial PC market that should return to typical seasonality. Our Non-Pro revenue is expected to be above the consumer PC market with continued benefit from a strong mix of premium devices.

In Search, we expect Bing’s revenue growth ex-TAC to be similar to Q3.

In Gaming, we expect to see continued healthy user engagement on our Xbox platform and we look forward to E3 in June, where we will share more on Project Scorpio and new titles for the next fiscal year.

And in Devices, we expect revenue to decline with negligible revenue from Phone. With Surface, we expect a more moderate rate of decline, given the prior year comparable and current market dynamics.

We expect COGS of $8.2 to $8.3 billion. This includes approximately $420 million of LinkedIn COGs, of which $220 million is related to amortization.

We expect operating expenses of $9.1 to $9.2 billion, with roughly $1 billion from LinkedIn, of which $150 million is related to amortization. We now expect full year operating expenses between $32.9 and $33 billion, with approximately $2.3 billion from LinkedIn. That includes about $360 million of amortization expense.

Other income and expense should be about $150 million.

And for tax, we expect the full fiscal year non-GAAP effective tax rate to be approximately 21 percent, plus or minus 1 point.

Finally, we encourage you to watch a few upcoming events – our Education event on May 2nd, our Dynamics 365 event on May 3rd, and the upcoming keynotes from BUILD to learn more about our ambitious plans leading into FY18. We will also host our Financial Analyst Briefing on May 10. The webcast will be available on our Investor Relations website.