# Microsoft FY 2019 Second Quarter Earnings Conference Call

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

**Wednesday, January 30, 2019**

**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 Carolyn Frantz, 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.

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 second-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 for joining on the phone.

We delivered $32.5 billion in revenue this quarter with double digit topline and bottom line growth, driven by strength across all our commercial clouds.

Our commercial cloud revenue grew 48%, anchored by Azure revenue growth of 76%.

These results speak to us picking the right secular trends in large and growing markets – many of which are still in their infancy – as well as focused innovation and execution.

Leading companies in every industry are partnering with us to build their own digital capability to compete and grow.

This is creating a broad opportunity for everyone, including our ecosystem. As one example, the co-sell program we introduced 18 months ago has already generated $8 billion in contracted partner revenue.

Now I’ll briefly highlight our momentum and innovation across our businesses.

Microsoft 365 empowers everyone – enterprises, small businesses, and the more than 2 billion firstline workers – with an integrated, secure experience that transcends any one device. We are helping every business build out their system of communication and collaboration to drive their productivity as well as their business transformation.

Microsoft Teams is the hub for teamwork and a powerful on-ramp for Microsoft 365, and we are seeing increased usage of OneDrive, SharePoint, Yammer and the entire Office suite of applications. Teams is the only enterprise-grade solution that brings together messaging, meetings, video conferencing, as well as document collaboration…and as of this quarter, enhanced voice capabilities like group call forwarding, delegation and location-based routing – are all being brought into Teams.

We are seeing rapid adoption of Teams with more than 420,000 organizations of all sizes and 89 of the Fortune 100 using Teams – including customers like Pfizer which chose Teams as the collaboration platform for their 115,000 employees. And we are expanding into new and underpenetrated markets.

This quarter we introduced new capabilities to empower firstline workers in the service and task-oriented roles to communicate and collaborate more effectively on-the-go, with mobile schedule management, location sharing, as well as the ability to easily record and share secure audio messages.

We are expanding our opportunity in Education with Microsoft 365, innovating in hardware and software to improve learning outcomes…from more collaborative classrooms with Teams, to personalized learning tools in OneNote, to social learning with Flipgrid, to affordable, easy-to-manage, Windows 10 devices.

Cybersecurity is a central challenge and Microsoft is leading the way, helping all organizations operate in what is known in the industry as a “zero trust” environment. It all starts with Azure AD and the deep work we are doing with Microsoft Threat Protection to provide an integrated solution for our customers that extends across identities, device endpoints, email, information, cloud applications and infrastructure. And, this quarter we introduced new advanced capabilities for identity and threat protection, and for information protection and compliance. Our comprehensive approach to security and compliance is another reason why customers are adopting Microsoft 365.

Customers from Neiman Marcus, to Brooks Running, to global biopharmaceutical leader Sanofi all chose our solutions.

Surface had its biggest quarter ever this holiday – delivering strong double digit growth in both consumer and commercial. We continue to innovate and expand our family of devices, setting the bar for the industry with the newest Surface Pro, Surface Laptop and Surface Go.

More broadly, Windows 10 continues to gain traction in the enterprise as the most secure and productive operating system. And at CES, our OEM partners showcased always-connected Windows 10 PCs that deliver breakthrough levels of performance to enable powerful new scenarios, like immersive gaming.

Moving to business applications and LinkedIn…

Dynamics 365 grew 51% this quarter as we win customers with our differentiated approach to systems of record and systems of engagement by making them more modular, extensible and AI-driven.

Increasingly, business process automation includes digitizing physical spaces, activities and interactions. Dynamics 365, along with advances in Azure IoT, AI and Mixed Reality, are leading the way for organizations to create these new Systems of Observation & Systems of Intelligence that drive end-to-end business processes, and bridge the online and offline worlds. For example, we now have the capability for customers to manage inventory in real time from the shelf, to the warehouse, to the farm. But we’re not stopping there.

Our Power Platform – spanning Power BI, PowerApps and Flow – enables anyone in an organization to start building an intelligent app or workflow where none exists. It is the only solution of its kind in the industry – bringing together no-code/low code app development, robotic process automation, and self-service analytics into a single, comprehensive platform. And it enables extensibility across Microsoft 365 and Dynamics 365 as well as the leading third-party SaaS business applications.

With Power Platform, Microsoft is fundamentally democratizing business processes – empowering everyone to make smarter, faster decisions. I’m energized about the tremendous opportunity in this space.

Already, Centrica is relying on Power BI, Power Apps, and Flow, along with Dynamics 365, to transform scheduling and dispatch for its firstline workforce in the United Kingdom.

Virgin Group is using Power Apps and Dynamics 365 to generate a single view of its passengers, surfacing insights to improve customer service and increase operational efficiency.

And, in Italy, the postal service is using Dynamics 365 to jump-start the digital transformation of thousands of post offices across the country.

Moving to LinkedIn

We continue to generate strong revenue growth across all businesses, with sessions growth of 30% year-over-year, fueled by record levels of engagement in the feed and content shared across the platform. We also saw record job postings again this quarter.

We introduced new brand and community-building tools for Marketers with LinkedIn Pages, making it easier for organizations of all sizes to foster stronger connections with LinkedIn’s 610 million members.

Finally, Glint broadens our market opportunity with its industry-leading employee engagement platform. At a time when competing for talent and skills development is a priority for every leader, the combination of LinkedIn Talent Solutions, Talent Insights, LinkedIn Learning, and now Glint helps every business attract, retain and develop the best talent in an increasingly competitive jobs marketplace.

Now turning to Azure.

Azure is the only hyperscale cloud with a consistent computing stack that extends from the datacenter to the edge – and customers across every industry recognize this architectural advantage.

In retail, Azure was front and center at NRF.

Kroger is partnering with us to redefine customer experience in stores and provide employees with AI-driven insights, while The Gap chose our cloud to accelerate its digital transformation. And, just last week, Albertsons chose Azure as its preferred cloud.

In financial services, Mastercard is partnering with us on a new, more secure way to verify digital identities. BlackRock is applying the power of the Microsoft cloud to reimagine retirement planning. And UBS is using Azure to increase agility across the organization while meeting the highest bar of compliance and security.

In healthcare, Walgreens Boots Alliance chose Azure to put people at the center of their health and wellness, with digital solutions to improve healthcare outcomes and lower costs. In addition, they will roll out Microsoft 365 to more than 380,000 employees and stores globally.

We are accelerating our innovation in emerging workloads like IoT and Edge AI. At CES, our partners showcased how Azure IoT and Azure AI are enabling them to build new connected devices and experiences that span the cloud and edge – from connected homes to cars to smart cities. Just this month, Starbucks chose Azure Sphere to secure its business-critical edge devices in stores.

Developers will increasingly drive and influence business processes and functions across every organization – and we are committed to giving developers the tools they need to be productive on any platform.

More than 12 million developers around the world use Visual Studio to build applications, and new features enable them to collaborate in real-time and spend more time driving innovation.

We closed our acquisition of GitHub this quarter, enabling us to bring our tools and services to new audiences while enabling GitHub to grow and retain its developer-first ethos.

GitHub has more than 31 million developer accounts and recently surpassed 100 million code repositories – a major milestone. Development teams at more than half of the Fortune 50 do their work in GitHub Enterprise. This month, we announced significant updates to make GitHub accessible to even more developers, introducing unlimited private repoes, as well as a new, simpler, unified enterprise offering, already available through our Microsoft global salesforce. And we’re not stopping there.

Just last week, we announced our acquisition of Citus Data – the leading provider of Postgres SQL – enhancing our overall data platform differentiation and building on our investment on Azure, making it the most comprehensive cloud for open source and proprietary data workloads at any scale.

Now I’ll turn to gaming.

We continue to pursue our expansive opportunity to transform how games are distributed, played and viewed. Our investments in content, community and cloud services across every endpoint drove both record user engagement and record average revenue per user, and contributed to our largest gaming revenue quarter ever, driven by software and services.

We acquired two new studios this quarter, bringing the total to 13, and more than doubling our first-party content capacity in the past six months.

Xbox Live monthly active users reached a record 64 million, with the highest number of mobile and PC users to-date. Xbox Game Pass subscribers and Mixer engagement also hit new all-time highs. And Minecraft, which continues to be one of the most popular and durable gaming franchises in the industry, delivered record revenue as we expanded into new platforms, geographies and segments like Education.

PlayFab surpassed one billion player accounts this quarter, and xCloud will be in public trials later this year as we make progress on our ambition to build a world-class gaming platform spanning mobile, PC and console.

In closing, our accelerating customer momentum is driven by our deep and growing partnerships with leading companies, and differentiated innovation across our portfolio.

Every company is becoming a digital company and they are looking for a trusted partner to help them build tech intensity. Microsoft is that partner.

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

I look forward to rejoining you after for questions.

**AMY HOOD:**

Thank you, Satya, and good afternoon everyone.

First, as a reminder, my comments across our results and outlook include the impact from GitHub, inclusive of purchase accounting, integration, and transaction related expenses.

This quarter, revenue was $32.5 billion, up 12% and 13% in constant currency. Gross margin dollars increased 12%. Operating income increased 18%. And earnings per share was $1.10, increasing 15% and 14% in constant currency, when adjusting for the net charges related to TCJA.

Strong execution and continued customer demand for our hybrid cloud offerings drove another quarter of double-digit top and bottom line growth. We continued to benefit from favorable secular trends and IT spending conditions. From a geographic perspective, our performance was in line with macroeconomic trends, with strength across the US, Western Europe and the UK, partially offset by weaker performance in Central and Eastern Europe and the Middle East and Africa.

In our commercial business, annuity mix grew 3 points year over year to 89%. Commercial unearned revenue was $25.3 billion, growing 20%, slightly above expectations. And commercial bookings were strong, growing 18% and 22% in constant currency, driven by solid renewal execution and an increase in the number of larger, longer-term Azure contracts. As a reminder, strong performance in larger, long-term Azure contracts, Azure consumption overages, and pay as you go contracts will drive bookings growth and in-period revenue but will have a limited impact on unearned revenue.

Commercial cloud revenue was $9.0 billion, growing 48% and 47% in constant currency. Commercial cloud gross margin percentage increased 5 points year over year to 62%, driven by significant improvement in Azure gross margin.

Our company gross margin percentage was 62%, flat year over year, as improving cloud margins were offset by sales mix shift to Commercial Cloud and Surface hardware.

The US dollar was a bit stronger than anticipated, which resulted in a slightly greater impact to our results. FX reduced revenue, COGS, and operating expense growth by less than a point.

Operating expenses grew 7%, slightly lower than expectations as some marketing spend shifted to Q3.

We again expanded operating margins as a result of focused investments, solid execution, and improving gross margins in key product areas.

Now to segment results.

Revenue from Productivity and Business Processes was $10.1 billion, increasing 13%, driven by Office 365 commercial, LinkedIn, and Dynamics 365.

Office commercial revenue grew 11%. Office 365 commercial revenue increased 34% and 33% in constant currency, driven by seat growth of 27% and ARPU expansion from continued customer migration to higher value E3 and E5 offerings. We saw installed base growth across all workloads and customer segments.

Office consumer revenue grew 1% and 2% in constant currency, below our expectation. As discussed on our last earnings call, Q2 revenue growth was impacted by channel inventories normalizing after the pre-launch builds in Q1, but was further negatively impacted by a smaller than expected consumer PC market and execution challenges during the quarter. Office 365 consumer subscribers grew to 33.3 million, a sequential slowdown primarily due to changes made in how Office 365 is sold in Japan.

Our Dynamics business grew 17%, driven by Dynamics 365 revenue growth of 51% and 50% in constant currency. This quarter, more than 9 out of every 10 new Dynamics CRM customers chose our cloud offering.

LinkedIn revenue increased 29% and 30% in constant currency, with continued strong execution across all businesses. LinkedIn sessions grew 30% as engagement once again reached record levels.

Segment gross margin dollars increased 11% and gross margin percentage declined slightly year over year as increased cloud mix offset the benefit from improvements in LinkedIn and Office 365 margins.

Operating expenses increased 3% and 4% in constant currency as we continued to invest in LinkedIn and cloud engineering. Operating income increased 20% and 19% in constant currency.

Next, the Intelligent Cloud segment, which now includes GitHub. Revenue was $9.4 billion, increasing 20% and 21% in constant currency, ahead of expectations, driven by continued strength in our hybrid solutions. Server products and cloud services revenue increased 24%. Azure revenue increased 76%, with strong growth from both the consumption and per-user based businesses. In our on-premises server business, continued customer demand for flexible hybrid solutions and our premium offerings drove growth of 3% and 4% in constant currency.

Enterprise Services revenue increased 6% and 7% in constant currency, driven by growth in Premier Support Services and Microsoft Consulting Services.

Segment gross margin dollars increased 20%. Gross margin percentage was relatively unchanged as revenue mix to Azure IaaS and PaaS was offset by material improvement in the Azure gross margin percentage.

Operating expenses increased 26% with continued investment in cloud and AI engineering and as well as commercial sales capacity, and the addition of GitHub. Operating income grew 16% and 15% in constant currency.

Now to the results from the More Personal Computing segment. Revenue was $13.0 billion, increasing 7%. Results in our Windows OEM business were lower than expected, partially offset by strong Surface results.

In Windows, the overall PC market was smaller than we expected primarily due to the timing of chip supply to our OEM partners which constrained an otherwise healthy PC ecosystem and negatively impacted both OEM Pro and Non-Pro revenue growth. Windows OEM Pro revenue declined 2%, roughly in-line with the commercial PC market. OEM non-Pro revenue declined 11%, below the market with continued pressure in the entry level category.

Inventory levels ended the quarter below the normal range.

Windows commercial products and cloud services grew 13% and 14% in constant currency, with continued customer adoption of our premium offerings. Windows 10 deployments across new and existing devices remained strong.

Gaming revenue grew 8% and 9% in constant currency. Xbox software and services revenue increased 31% and 32% in constant currency, primarily driven by continued strength from a third-party title. Additionally, strong subscriber growth across Xbox Live and Game Pass helped to offset lower than expected performance from other third-party titles on the platform. Xbox hardware performed better than expected, but declined year over year given the holiday launch of the Xbox One X a year ago.

In Surface, revenue increased 39% and 41% in constant currency, to nearly $1.9 billion, ahead of our expectations, driven by strong growth across both our consumer and commercial segments.

Search revenue ex-TAC increased 14% driven by Bing rate growth and increased volume in US and international markets.

Segment gross margin dollars increased 6% and 7% in constant currency and gross margin percentage decreased due to sales mix to our lower margin Surface and Gaming businesses.

Operating expenses declined 4%. As a result, operating income increased 18% and 19% in constant currency.

Now back to total company results.

Capital expenditures including finance leases were down sequentially to $3.9 billion, lower than originally planned, mainly due to quarter to quarter variability in the timing of cloud infrastructure buildout. Cash paid for property, plant, and equipment was $3.7 billion.

Cash flow from operations increased 13% year over year driven by strong cloud billings and collections. Free cash flow was $5.2 billion and decreased 2% year over year, reflecting the timing of higher cash payments for property, plant, and equipment.

Other income was $127 million, higher than anticipated, driven by interest income and investment gains, partially offset by interest expense and net losses on foreign currency remeasurement.

Our non-GAAP effective tax rate was slightly above 17%, in line with expectations.

And finally, we returned $9.6 billion to shareholders through share repurchases and dividends, an increase of 91%. Our Q2 share repurchase was $6.1 billion, higher than our normal quarterly pace, and aligned to our commitment of incremental buyback to fully offset stock consideration issued in the GitHub transaction by the end of the fiscal year.

Now let’s move to our outlook.

For Q3, first FX. With the stronger US dollar, and assuming the current rates remain stable, we now expect FX to decrease revenue and operating expenses growth by approximately 2 points and decrease COGS growth by approximately 1 point. With 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, continued strong customer demand, healthy bookings growth, and increasing revenue annuity mix should drive another solid quarter in our commercial business. Commercial unearned revenue is expected to decline approximately 2% to 3%, in line sequentially with historic trends.

We expect commercial cloud gross margin percentage to continue to improve year over year as material improvement in Azure gross margin will again be partially offset by the mix of revenue towards Azure consumption-based services.

Third, capex. We expect a sequential dollar increase in capital expenditures as we continue to invest to support increasing demand.

Now to segment guidance.

In Productivity and Business Processes, we expect revenue between $9.9 and $10.1 billion driven by double digit growth in Office commercial and Dynamics as well as healthy LinkedIn growth on a strong prior year comparable. We expect Office consumer revenue growth to continue to be in the low single digits as growth in Office 365 will be partially offset by the continuation of the consumer PC market headwinds.

For Intelligent Cloud, we expect revenue between $9.15 and $9.35 billion, with our hybrid demand continuing to drive strong growth in server products and cloud services. Azure growth will continue to reflect the balance between strong growth in our consumption-based business and moderating growth in our per-user business.

In More Personal Computing, we expect revenue between $10.35 and $10.65 billion with a shift in revenue mix to our Surface and Gaming businesses.

In Windows, overall OEM revenue growth should be in the low single digits as we anticipate continued market impact from constrained chip supply in Q3.

In Surface, continued momentum from Surface Pro 6, Surface Laptop 2, and Surface Go will drive another strong quarter of over 20% growth for Surface.

In Search ex-TAC, we expect revenue growth similar to Q2.

In Gaming, we expect revenue growth to be slightly higher than last quarter. Sales mix will shift to software and services, where we expect healthy growth.

Now, back to overall company guidance.

We expect COGS of $10.35 to $10.55 billion and operating expenses of $10.1 to $10.2 billion, inclusive of marketing spend that moved from Q2 to Q3.

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

And finally, we expect our Q3 effective tax rate to be in line with the full year rate of 17%.

Now a few comments on our outlook for Q4 and the full fiscal year, which are unchanged from October.

First on FX. In Q4, assuming rates remain stable, we expect FX to decrease revenue growth by approximately 2 points and COGS and operating expenses growth by approximately 1 point.

Second, in Q4, we expect continued strong performance in our commercial cloud business, but as a reminder, we also have several challenging comparisons from the prior year, specifically in on-premises server, LinkedIn, Windows OEM, and the strength of a third-party title in Gaming.

In terms of operating expenses, we continue to expect full year growth of roughly 8%. We will continue to invest in strategic growth areas like Azure, AI, GitHub, Dynamics Power Platform, LinkedIn, Teams, and gaming content given our significant growth opportunities, competitive advantage, and growing momentum.

We still expect full year operating margin to be up slightly year over year, inclusive of the full GAAP impact of GitHub.

For capex, we continue to expect the growth rate for the year to moderate even as we meet the high demand for our cloud services.

We remain committed to an incremental share buyback, beyond the normal quarterly pace, that will fully offset stock consideration issued in the GitHub transaction by the end of this fiscal year.

And finally, we still expect the full year effective tax rate to be roughly 17% with quarterly variability.