# Microsoft FY 2019 Fourth Quarter Earnings Conference Call

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

**Thursday, July 18, 2019**

**(Operator Direction.)**

**MICHAEL SPENCER:**

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

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

Unless otherwise specified, we will refer to non-GAAP metrics on the call. The non-GAAP financial measures provided should not be considered as a substitute for, or superior to, the measures of financial performance prepared in accordance with GAAP. They are included as additional clarifying items to aid investors in further understanding the company’s fourth-quarter performance in addition to the impact 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, and other statements about future events. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's earnings press release, in the comments made during this conference call, and in the risk factor section of our Form 10-K, Forms 10-Q, and other reports and filings with the Securities and Exchange Commission. We do not undertake any duty to update any forward-looking statement.

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

**SATYA NADELLA:**

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

It was a strong finish to a record fiscal year. We delivered more than $125 billion in revenue for the full year with double-digit topline and bottom-line growth.

Our commercial cloud business is the largest in the world, surpassing $38 billion in revenue for the year, with gross margin expanding to 63%.

I’m proud of what we have accomplished over the last 12 months, and I’m energized by the tremendous opportunity ahead.

Every day we work alongside our customers to help them build their own digital capability — creating new businesses with them, innovating with them, and earning their trust.

This commitment to our customers’ success is resulting in deeper partnerships, larger, multi-year cloud agreements and growing momentum across every layer of our differentiated technology stack… from application infrastructure, to data & AI, to business process, to productivity and collaboration.

Now, I’ll briefly highlight our innovation and momentum.

In a world where every company is a software company, developers will play an increasingly vital role in value creation across every organization. And GitHub is their home. GitHub is used by more than 36 million developers as well as the largest enterprises, including the majority of the Fortune 50.

And we are investing to build the complete toolchain for developers – independent of language, framework and cloud. Visual Studio and Visual Studio Code are the most popular code editing tools in the world. With Azure DevOps you can build, test and deploy code to any platform. And with Azure PlayFab, we have LiveOps, a complete backend platform to optimize engagement and interaction in real-time.

We are building Azure as the world’s computer, addressing customers’ real-world operational sovereignty and regulatory needs. We have 54 data center regions, more than any other cloud provider, and we were the first in the Middle East and in Africa.

Azure is the only cloud that extends to the edge – spanning identity, management, security and infrastructure. This year, we introduced new cloud-to-edge services and devices – from Azure Data Box Edge, to Azure Stack HCI, to Azure Kinect – bringing the full power of Azure to where data is generated. Azure Sphere is a first-of-a-kind edge solution to secure the more than nine billion MCU-powered endpoints coming online each year. And now IoT Plug and Play seamlessly connects IoT devices to the cloud without having to write a single line of embedded code.

Azure is the most open cloud, and this quarter we expanded our partnerships with Oracle, Red Hat and VMware to make the technologies and tools customers already have first-class on Azure.

Azure is the only cloud with limitless data and analytics capabilities across the customers’ entire data estate. The variety, velocity and volume of data is increasing, and we are bringing hyper-scale capabilities to relational database services with Azure SQL Database. New analytics support in Cosmos DB enables customers to build and manage analytics workloads that run real-time over globally distributed data. And we offer the most comprehensive cloud analytics – from Azure Data Factory to Azure SQL Data Warehouse to Power BI.

The quintessential characteristic for any application being built in 2019 and beyond will be AI. We are democratizing AI infrastructure, tools and services with Azure Cognitive Services – the most comprehensive portfolio of AI tools – so developers can embed the ability to see, hear, respond, translate, reason and more into their applications. And this quarter we introduced new speech-to-text, search, vision and decision capabilities. New updates to Azure ML streamline the building, training and deployment of machine learning models – bringing a no-code approach to machine learning.

Our differentiated approach – from developer tools and infrastructure to data and analytics to AI – is driving growth. The world’s leading companies trust Azure for their mission-critical workloads, including more than 95% of the Fortune 500. And just yesterday, AT&T chose our cloud in one of our largest cloud commitments to-date.

Now let’s move up the stack to business process.

We are redefining business processes with Dynamics 365 and Power Platform – with modern, modular, extensible and AI-driven applications. Dynamics 365 uniquely enables any organization to create digital feedback loops that take data from one system and use it to optimize the outcomes of another, enabling any business to become an AI-first business.

Our Open Data Initiative with SAP and Adobe builds on this promise, giving customers like Coke, HP, Unilever and Walmart a single 360 view of their customers built on one data model and one data lake, eliminating data silos driving real-time insights at scale.

This year, we introduced Dynamics 365 AI, a new class of AI applications built for an era where systems of record are converted into systems of engagement and intelligence.

The citizen developer movement is here, and we are empowering it. 500 million new apps will get created in the next five years – more than the total created in the last 40. Businesses will need to empower domain experts with tools to create applications, as well as robotic process automation to streamline and customize workflows like service monitoring and time & expense tracking.

Our Power Platform – spanning Power BI, Power Apps and Flow – is the only solution of its kind in the industry. It brings together low-code, no-code app development, robotic process automation, and self-service analytics into a single, comprehensive platform. Chevron has gone from 80 users of Power Apps to 5,500 in a year and now has 200 apps in production. This quarter we introduced AI Builder, adding AI capabilities like object recognition to any Power App. And with Power BI, we are the leader in business intelligence in the cloud, with more than 25 million models hosted on the service and 12 million queries processed each hour.

We are enabling our customers to digitize not only their business processes but to bridge the physical and digital worlds with our investments in mixed reality cloud – spanning HoloLens 2, Azure Spatial Anchors and Dynamics 365 applications. We are seeing traction in every field – from manufacturing to retail to gaming. Airbus alone is pursuing more than 300 use cases – from training to design to remote assistance.

All this innovation is fueling rapid growth, with more than 91% of the Fortune 500 using Dynamics 365 or Power Platform.

Now to LinkedIn.

People are an organization’s most valuable asset. Our strong Talent portfolio – from Talent Solutions and Talent Insights, to employee engagement with Glint, to LinkedIn Learning – enables every organization to attract, retain and develop the best talent in an increasingly competitive jobs market. New capabilities help job seekers find and land more relevant and higher paying jobs through alerts, deeper insights and a new suite of interview prep tools, contributing to another quarter of record job postings.

Marketing Solutions is now our fastest growing business, with new brand and community building tools that make it easier for marketers to connect with LinkedIn’s 645 million members.

And we are enabling every business to drive a culture of relationship selling and take full advantage of their social networks, with the combination of Dynamics 365 and LinkedIn Sales Navigator. All this innovation contributed to another record year for LinkedIn, driven by all-time high engagement across the platform.

Now, turning to Microsoft 365.

Microsoft 365 is the world's productivity cloud. It empowers everyone – including 2 billion firstline workers around the world – with an integrated, secure, AI-infused experience on any device. It is the ONLY comprehensive productivity, and collaboration and communications solution that integrates with an organization’s critical business process workflows.

Multinationals – from L’Oréal and Walgreens Boots Alliance, to the largest chemical producer in the world, BASF – all chose Microsoft 365 this year. And over the last two quarters our premium offerings gained momentum, with S&P Global, CenturyLink and KPMG all selecting Microsoft 365 E5.

Microsoft Teams has had a breakout year. Teams now has more than 13 million daily active users and 19 million weekly active users. It brings together everything a team needs – chat, voice, meetings, collaboration with the power of Office apps, and business process workflows – into a single, integrated user experience scaffolding, eliminating the need for discreet apps that only increase an organization’s security and compliance exposure. And we are broadening our opportunity, bringing Teams to new and underpenetrated markets including healthcare, hospitality and retail, as well as firstline workers. We are empowering them with mobile tools in Teams, like shift scheduling and priority notifications.

We are infusing AI across Microsoft 365 to enable new automation, prediction, translation and insights capabilities. Meetings are more inclusive in Teams, presentations are more accessible in PowerPoint, videos more searchable in Stream and emails more relevant in Outlook. And with Workplace Analytics and Microsoft Search, we take your relationships, schedules and activities and distill insights and knowledge – to help people work smarter, not longer.

We are investing in cybersecurity to protect customers in today’s “zero trust” environment. Microsoft is the only company that offers end-to-end security – spanning identity, device endpoints, information, cloud applications as well as infrastructure. It starts with Azure Active Directory and builds with three new services we introduced this year: Microsoft Threat Protection, Azure Sentinel, and Azure Confidential Computing.

We expanded our family of category creating Surface devices this year – including the new Surface Go and Surface Hub 2S. And Windows 10 is active on more than 800 million devices, with accelerating adoption in the enterprise as the most secure and productive operating system.

Finally, gaming.

We are investing to empower the world’s two billion gamers to play the games they want, with anyone, anywhere on any device with our new game streaming service, Project xCloud, which will enter public trials this Fall. Xbox Live Monthly Active Users increased to a record 65 million, with the highest number of mobile and PC users-to-date. We are bringing one of the world’s most popular video games to a new generation of mobile gamers with Minecraft Earth and mixed reality. And we nearly doubled our first party game studios this year to deliver differentiated content for our fast-growing subscription services like Xbox Game Pass, now available on both console and PC.

In closing, I’m optimistic about what’s ahead.

We are accelerating our innovation to deliver differentiated value to customers across the cloud and the edge – from GitHub to Azure to Dynamics 365 to Microsoft 365.

We are investing in the right secular trends to expand our opportunity.

And we are working to earn our customers’ trust every day.

With that, 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.

Our fourth quarter revenue was $33.7 billion, up 12% and 14% in constant currency. Gross margin dollars increased 15% and 17% in constant currency. Operating income increased 20% and 24% in constant currency.

This quarter we transferred intangible properties from our foreign subsidiaries to the United States and Ireland, which resulted in a net tax benefit of $2.6 billion. When adjusting for this and the net benefit related to the Tax Cuts and Jobs Act from the fourth quarter of FY18, earnings per share was $1.37, increasing 21% and 24% in constant currency.

In our largest quarter of the year, our sales teams and partners delivered exceptional commercial results, which drove another quarter of double-digit top and bottom line growth. From a geographic perspective, we saw broad-based strength across markets of all sizes.

Customer commitment to our cloud platform continues to grow. In FY19, we closed a record number of multi-million dollar commercial cloud agreements, with material growth in the number of $10 million plus Azure agreements. Commercial bookings growth was significantly ahead of expectations, increasing 22% and 25% in constant currency, driven by strong renewal execution and an increase in the number of larger, long-term Azure contracts. As a result, our contracted not recognized revenue was $91 billion, up 25% year over year, reflecting our continued momentum and growing long term customer commitment. We expect to recognize approximately 50% of this revenue in the next 12 months. Even with the higher mix of larger, long-term Azure contracts with low upfront billings, commercial unearned revenue was in line with expectations at $34.1 billion, up 13% and 16% in constant currency. And this quarter, our annuity mix was again 90%.

Commercial Cloud revenue was $11 billion, growing 39% and 42% in constant currency. Commercial cloud gross margin percentage increased 6 points year over year to 65%, driven again by significant improvement in Azure gross margin.

Company gross margin percentage was 69%, up 2 points year-over-year and ahead of our expectations, driven by sales mix shift to commercial licensing and OEM.

In line with expectations, foreign exchange reduced revenue growth by 2 points and COGS and operating expenses growth by 1 point.

Operating expenses grew slightly ahead of expectations, increasing 9% and 10% in constant currency driven by continued investment in cloud and AI engineering, LinkedIn, and GitHub.

Operating margins again expanded this quarter, as a result of strong revenue growth, improving gross margins, and disciplined decisions we’ve made over the past 5 years to invest in strategic and high growth areas.

Now to our segment results.

Revenue from Productivity and Business Processes was $11 billion, increasing 14% and 17% in constant currency, ahead of expectations driven by both our cloud and on-premises businesses.

Office commercial revenue grew 14% and 16% in constant currency, including roughly 4 points from a greater mix of contracts with higher in-period recognition that benefited both our cloud and on-premises businesses. Office 365 commercial revenue grew 31% and 34% in constant currency, driven by installed base expansion across all workloads and customer segments, as well as ARPU growth from our customers’ continued shift to our E3 and E5 offerings. Office 365 commercial seats grew 23% on a prior year comparable that included the strong performance of our Microsoft 365 academic offers. Office Consumer revenue grew 6% and 8% in constant currency, with 4 points of growth from transactional sales in Japan. Office 365 consumer subscribers grew to 34.8 million.

Our Dynamics business grew 12% and 15% in constant currency, driven by Dynamics 365 growth of 45% and 48% in constant currency.

LinkedIn revenue increased 25% and 28% in constant currency with continued strength across all businesses, highlighted by marketing solutions growth of 42%. LinkedIn sessions grew 22%, with record levels of engagement and job postings again this quarter.

Segment gross margin dollars increased 16% and 20% in constant currency and gross margin percentage increased 1 point year over year as improvements in LinkedIn and Office 365 margins more than offset increased cloud mix.

Operating expenses increased 8% and 9% in constant currency driven by continued investment in LinkedIn and cloud engineering. Operating income increased 25% and 31% in constant currency.

Next, the Intelligent Cloud segment. Revenue was $11.4 billion, increasing 19% and 21% in constant currency. Our on-premises server business drove our better than expected performance. Continued customer demand for our differentiated hybrid solutions drove strong server products and cloud services revenue growth, increasing 22% and 24% in constant currency on a significant revenue base. Azure revenue increased 64% and 68% in constant currency with another quarter of strong growth in our consumption-based business and continued moderation in our per-user business. And our on-premises server business grew 5% and 7% in constant currency, with roughly 4 points from stronger than expected demand ahead of end of support for SQL and Windows server 2008, as well as continued strength across our hybrid offerings, premium versions, and GitHub.

Enterprise Services revenue increased 4% and 6% in constant currency, driven by growth in Premier Support Services.

Segment gross margin dollars increased 19% and 21% in constant currency. Gross margin percentage was flat year over year as another quarter of material improvement in Azure gross margin offset the growing mix of Azure IaaS and PaaS revenue.

Operating expenses increased 23% and 24% in constant currency, driven by on-going investments in Cloud and AI engineering and GitHub, as well as revenue driven expenses given the strength of the quarter. Operating income increased 15% and 19% in constant currency.

Now to the More Personal Computing segment. Revenue was $11.3 billion, increasing 4% and 6% in constant currency, ahead of expectations as better than expected performance in Windows more than offset lower than expected Gaming and Search revenue.

In Windows, OEM non-Pro revenue declined 8%, below the consumer PC market with continued pressure in the entry level category. OEM Pro revenue grew 18%, ahead of the commercial PC market, driven by healthy Windows 10 demand, strong momentum in advance of Windows 7 end of support, and roughly 4 points of benefit from increased inventory levels due to uncertainty around tariffs. Therefore, inventory levels ended the quarter above the normal range.

Windows commercial products and cloud services revenue grew 13% and 16% in constant currency, with strong double-digit billings growth and a higher mix of in-quarter recognition from multi-year agreements.

In Surface, revenue grew 14% and 17% in constant currency driven by strength in our commercial segment, particularly in the US, Japan, and Canada.

Search revenue ex TAC increased 9% and 10% in constant currency, below expectations driven by lower than expected volume.

In Gaming, revenue declined 10% and 8% in constant currency, below expectations driven by lower console sales and monetization across third party titles. Xbox software and services revenue declined 3% and 1% in constant currency with the tough comparable from a third party title in the prior year offsetting continued momentum in Xbox Live and Game Pass subscriber growth.

Segment gross margin dollars increased 8% and 10% in constant currency and gross margin percentage increased 2 points due to sales mix shift to our higher margin Windows businesses.

Operating expenses declined 2% and 1% in constant currency. As a result, operating income grew 18% and 22% in constant currency.

Now back to total company results.

As expected, capital expenditures including finance leases were up sequentially to $5.3 billion driven by ongoing investment to meet demand for our cloud services. Cash paid for P,P, and E was $4.1 billion.

Cash flow from operations increased 41% year over year driven by strong cloud billings and collections and roughly 8 points of benefit from tax payments made in the prior year. Free cash flow was $12 billion and increased 62% year over year, reflecting strong operating cash flows and the timing of cash payments for P, P, and E.

For the fiscal year, we generated over $52 billion in operating cash flow and $38 billion in free cash flow, driven by improving margins and operating leverage across our businesses, as well as operating improvements to better optimize cash flow.

Other income was $191 million, higher than anticipated due to the recording of mark-to-market gains. As a reminder, under the recently adopted accounting standards for financial investments, we are required to recognize unrealized gains or losses on our equity portfolio. As a result, we expect increased quarterly volatility in other income and expense.

Our non-GAAP effective tax rate came in slightly lower than anticipated at 16%.

And finally, this quarter, we returned $7.7 billion to shareholders through share repurchases and dividends, an increase of 45%, bringing our total cash returned to shareholders to over $30 billion for the full fiscal year.

Now let’s move to our outlook, starting with Q1, where we expect another strong commercial quarter.

Assuming current rates remain stable, we expect FX to decrease total company, Productivity and Business Processes, and Intelligent Cloud revenue growth by approximately 2 points and More Personal Computing revenue and total company COGS and operating expenses growth by approximately 1 point.

In our commercial business, we expect continued customer demand to drive commercial unearned revenue up 11% to 12% year over year with volatility based on contract type. Commercial cloud gross margin percentage will be up slightly on a sequential basis. And we expect capital expenditures to be roughly in line with Q4 as we continue to invest to meet growing demand for our cloud services.

Now to segment guidance.

In Productivity and Business Processes, we expect revenue between $10.7 and $10.9 billion driven by double digit growth in Office commercial, Dynamics, and LinkedIn.

In Intelligent Cloud, we expect revenue between $10.3 and $10.5 billion. In Azure, revenue growth will continue to reflect a balance of strong growth in our consumption-based business and moderating growth in our per-user business. Our on-premises server business will be driven by demand for our hybrid solutions and premium offerings, as well as the continued benefit from the end of support for SQL Server and Windows Server 2008.

In More Personal Computing, we expect revenue between $10.7 and $11 billion. In Windows, overall OEM revenue growth should be slightly ahead of the PC market driven by healthy commercial demand.

 Surface revenue will decline slightly year over year driven by product lifecycle transitions.

Search ex TAC revenue growth should be roughly in line with Q4.

And in Gaming, we expect revenue to decline year over year at a similar rate to Q4 as we move thru the end of this console generation and a challenging Xbox software and services comparable from a third party title in the prior year.

Now back to overall company guidance.

We expect COGS of $10.55 to $10.75 billion and operating expenses of $10.1 to $10.2 billion.

In other income and expense, interest income and expenses should offset each other.

Next, we expect our Q1 effective tax rate to be slightly lower than our full year expected rate of 17% due to the volume of equity vests that take place during our first quarter.

And finally, as a reminder on Q1 cash flow, we will be making a $4.7 billion tax payment related to the TCJA transition tax and the Q4 transfer of intangible property.

Now I would like to share some comments on FY20.

First, FX. Assuming that current rates remain stable, we expect FX to reduce full year revenue and COGS growth by 1 point. FX should have no impact on operating expense growth.

Next, revenue. At the company level, we continue to expect double digit revenue growth with another year of strong performance and continued momentum in our commercial business. As a reminder, our commercial licensing and OEM Pro businesses in the second half of the year will be impacted by a comparable that benefitted from the end of support of SQL server 2008, Windows server 2008, and Windows 7, as well as transactional strength in Japan.

We expect revenue in our gaming business to be down slightly year over year as double digit growth in Xbox Software and Services will be offset by declining console sales. We do expect a stronger H2 than H1 in Gaming as we work thru a third party title comparison.

And as a reminder, an increasing number of large, long term Azure contracts will drive more quarterly volatility in our commercial bookings and unearned revenue growth.

Next, commercial cloud gross margin. Revenue mix will continue to shift to our Azure consumption-based services. Even with this headwind, we expect commercial cloud gross margin percentage to be up slightly as we again drive meaningful improvement in Azure gross margin. Capital expenditures will increase to meet the growing demand for our cloud services.

Finally, on operating expenses, we will continue to invest given our strong execution, growing competitive position, and our significant ambition in high growth areas. Investment in areas like Cloud thru AI and GitHub, Business Applications thru Dynamics, Power Platform, and LinkedIn, Microsoft 365 thru Teams, Security, and Surface as well as Gaming should result in operating expense growth of 11% to 12%.

Even with these strategic investments, the continued shift to our cloud business, and our very strong finish to FY19, we expect double digit operating income growth as well as stable operating margins.

We are looking forward to FY20.

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

**MICHAEL SPENCER:** Thanks, Amy. We'll now move over to Q&A. Out of respect for others on the call, we request that participants please only ask one question. Operator, can you please repeat your instructions?

(Break for direction.)

**OPERATOR:** Our first question comes from the line of Keith Weiss with Morgan Stanley. You may proceed.

**KEITH WEISS, Morgan Stanley:** Excellent. Thank you, guys, for taking the question and a very nice end to a really strong FY19. I wanted to focus on the Office 365. If I'm looking at this right, I think you guys saw an acceleration in the Office 365 Commercial business. And in the kind of recipe to get in there, seemed to have changed a little bit of that as more sort of positive pricing versus just the seat growth. Is there a changing dynamic in kind of what's pushing growth there? We had seen the F1 SKU in the frontline workers bringing down the price point a little bit. It looks like the pricing actually improved this quarter. How should we think about sort of the dynamics of what's going to be driving growth for Office 365 into FY20 and beyond?

**AMY HOOD:** Thanks, Keith. Let me walk through a little bit of this because there are some new behaviors that I think are important this quarter. But the fundamentals that you talked about are relatively unchanged. We continue to see and saw again install base growth across all of our customer segments from the enterprise to small business. That's happening not just because of frontline workers, but also continued expansion and continued movement in every segment where we see the opportunity to increase the install base.

We did see RPU growth this quarter. It wasn't as much different from past quarters. We continue to see improvement from E3 and E5 transition. Saw both again, and I think we were quite encouraged by E5 performance, particularly in Q4 as we ended the quarter, which was great to see.

What you saw a little bit, and I referred to it, was some more in-quarter recognition, but let me talk about why that's happening, because it's got two important and positive trends that underly it.

The first thing is we're seeing longer commitments. When you see longer commitments, under 606, you often have more recognition up front. And so we saw longer commitments and we got a little bit more recognition in the quarter and so you saw then revenue grow a little faster.

The other thing that we saw is increasing focus as we were having more conversations across organizations around Azure and rethinking their digital transformation plans with us. It opens up a very large conversation around the value Microsoft 365 can bring as people go through and think about those transitions.

And so the fact that we then were also seeing extensions take place of prior commitments in Office 365 to again be longer and include the Azure contract, when that happens, it's almost like you're adding new product and new value, and a lot of that gets recognized faster in quarter when you see that happen.

And so when you have a dynamic where you're seeing longer contracts, plus you're able to sell more in new things in I think different conversations around Microsoft 365, it was a good execution by the team, and I think a recognition of the value that we continue to put into that -- what we believe is our hero experience.

**KEITH WEISS:** Excellent, sounds great.

**MICHAEL SPENCER:** Thanks, Keith. Operator, we'll move to the next question, please.

**OPERATOR:** Thank you. Our next question comes from the line of Mark Moerdler with Bernstein Research. Please proceed.

**MARK MOERDLER, Bernstein Research:** Thank you very much. And congratulations not only on the great end to the year, but the confidence into next quarter and next year in terms of growth, investment, et cetera.

We met recently at E3 with your gaming team and heard a lot about the steps that were being taken. Satya, can you give us more color, explanation on how you see the gaming business fitting into the overall company's direction over the next few years? Specifically, how does gaming change? How does the synergy between gaming and the rest of the business change? How should we think about that overall mix that is going to occur. Thanks.

**SATYA NADELLA:** Sure. First, I'll say we are in gaming because of what we believe are going to be the secular changes in the gaming addressable market for us. We've always had a gaming position with console as well as the PC, but going forward, we think that any endpoint can, in fact, be a great endpoint for high-end games, which is where our structural position is.

And we now have a business model with Game Pass as well as all the supporting mechanisms for Game Pass like game streaming. We have a social network in Xbox Live that is the best in the business. So, I feel that we are well positioned to what is going to be a much larger market than what was traditionally gaming, in spite of all the success we've had over the years in gaming.

Now, the second point is that it builds on the rest of the cloud investment. So, if you think about what we are doing with X Cloud, it's a hero workload on top of Azure. So, when we think about capital allocation, what's happening in the cloud, what's happening in the edge, how with build the network to optimize for streaming. The same infrastructure, for example, is what Sony has decided to use as well and be on Azure as well as use our AI capabilities.

So, you'll see significant synergies in terms of the architecture or platform underneath gaming, Microsoft 365, Dynamics 365, LinkedIn, all being the same.

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

**MICHAEL SPENCER:** Thanks, Mark. Operator, we'll take the next question, please.

**OPERATOR:** Thank you. Our next question comes from the line of Heather Bellini with Goldman Sachs, please proceed.

**HEATHER BELLINI, Goldman Sachs:** Great, thank you so much. I had a couple questions for Amy. Just thinking through with the Azure mix becoming an ever-bigger portion of IC revenue, and when you factor in continued gross margin expansion that you continue to show in Azure, how should we think about the gross margin potential of IC overall?

And I guess I also wanted to ask about the buildout of data centers related to the cloud buildout. How do we think about your points of presence today from a coverage perspective, if you will, versus the revenue pockets that you're targeting over the next few years? Thanks.

**AMY HOOD:** Great, Heather. On gross margin, over any long-term period in Intelligent Cloud, given the expansive TAM and the growth opportunity we see, it will create gross margin pressure over the long term.

Now, over the next period, especially in H1, we continue to see -- expect to see very good hybrid performance and execution, which helps to offset some of that. So even as we continue to see Azure gross margin improvement at the IaaS and PaaS layer, just given the TAM and our opportunity, it will create long-term pressure on that gross margin number, but a lot of opportunity in terms of gross margin dollar growth, and of course operating margin dollar growth as we move forward.

When it comes to our buildout, Heather, I tend to think it's two components. The majority of our capital expenditures is actually in server equipment, it's in capacity, it's not necessarily in the overall geo-footprint buildout. We'll, of course, continue to do that where it makes sense and where opportunity presents itself. We do a very good job in terms of supply chain and being able to get those up and running quite quickly. But the majority of the investment today is to build capacity inside existing, incredibly large data centers.

**HEATHER BELLINI:** Great, thank you very much, Amy.

**MICHAEL SPENCER:** Thanks, Heather. Operator, next question, please.

**OPERATOR:** Thank you. Our next question comes from the line of Jennifer Lowe with UBS. Please proceed.

**JENNIFER LOWE, UBS:** Great. Satya, you mentioned the AT&T deal that was announced I think earlier this week. IBM also had an announcement with AT&T, Oracle's been a long-time partner with AT&T in the cloud as well. I don't want to dwell on AT&T in particular, but I think it's interesting that a few different large-scale cloud players are around the table there.

So, as you see more of these very large deals out there, and Amy mentioned the increase in $10-million deals, how often are those multi-cloud deals and companies taking that sort of approach versus ones that are committing to Microsoft? And how do you navigate that landscape?

**SATYA NADELLA:** Yeah, I mean I think overall, you all I think do a good job of tracking what is the public cloud competition, and that's the competition we pay the most attention to.

And I this context, I think we see a mix. There are a few of us who are at scale in public cloud who are very competitive, and anybody who decides to be multi-cloud, public cloud, those are the winners.

When someone thinks of only using one cloud, we're definitely one of the names. And in the case of AT&T, we were the only public cloud in there, and so that's why they highlighted us and we highlighted that in our quarterly announcement.

**AMY HOOD:** I would say in general what we see, especially as contracts get larger, the opportunity under tier-1 workloads for us, to really see TAM growth, it's just expansive. And so, Jennifer, I kind of think about this as we have an incredibly strong footprint inside existing enterprises today. That footprint, and you can see it in our results, customers are relying on us for not only that footprint, but as they continue to expand, to sit under the tier-1 opportunity we haven't seen before.

And so we, of course, see multi-cloud in a lot of our larger accounts, but this type of significant commitment is an opportunity I think you'll continue to see us execute well on.

**JENNIFER LOWE:** Great, thank you.

**MICHAEL SPENCER:** Thanks, Jenn. Operator, we'll take the next question, please.

**OPERATOR:** Thank you. The next question comes from the line of Karl Kierstead with Deutsche Bank. Please proceed.

**KARL KIERSTEAD, Deutsche Bank:** Thank you. Amy, I've got a question about the Windows business. A couple of the metrics, 18 percent Windows OEM Pro and 16 percent on the volume licensing side were extraordinary.

I know you called out a couple of, call it one-time issues around inventory levels and uptick in in-quarter revs, but I wanted to ask you two questions: How much of a tail do you think we have left on the Win7/Win10 migration? Is it too cautious to say that there's really just two quarters of that tailwind left?

And second, on the volume licensing or commercial and cloud services segment, do you think that can, in Fiscal '20, contribute to your overall double-digit growth? Thanks a lot.

**AMY HOOD:** Thanks, Karl. And I'll actually combine these because, really, there's a fundamental driver that sits underneath this and then we can get to the specifics of end of support.

There is I think a recognized momentum of Windows 10, its deploy inside of enterprises for its security and management value prop

We've worked hard, and I think Satya mentioned some of the new features as we continue to invest in security for all of our products. One of the places I think it often resonates the most is with Windows 10 and inside that value.

The OEM Pro number, as I talked about, was impacted by a number of factors, but what we've seen is over the past three or four quarters, pretty consistent sort of high-single-digit performance once you take out various impacts from chip supply and inventory levels on the tariffs.

That performance certainly has some end-of-support impact to it, as we've talked about before. I think in general, what we've seen in prior releases is it does extend a bit past the deadline, especially in our small and midsize business customers. And it's really important for us to continue to work hard to have the small and medium businesses find a path forward to make sure they can experience the most secure computing environment we have.

And so we'll see some extension past the line, we've certainly seen three or four quarters of that, and we certainly expect H1 to remain strong.

The more important part around the security and management value prop, I'm going to pivot back again a little bit because it's the same thing we saw in Office. The Microsoft 365 value prop to customers, especially in the second half of the year, and particularly in Q4, has three components: It has Office 365, it has EMS, and it has the Windows 10 Commercial component.

The Windows 10 Commercial component will look far more like our success and our motion in overall being able to sell the Microsoft 365 value prop. It was a good quarter for that. We've seen consistent double-digit billings in this segment, and it speaks to that. I expect that to continue, although you'll have volatility because what's interesting about that metric is it has a little bit more 606 impact when we sell it as an on-prem product. So, there will be volatility in this number, but the consistent theme of seeing double-digit billings that really match our strength in Office 365 I do expect to continue.

**KARL KIERSTEAD:** Terrific. Thanks, Amy.

**MICHAEL SPENCER:** Thanks, Karl. Operator, we'll take the next question, please.

**OPERATOR:** Thank you. Our next question comes from the line of Phil Winslow with Wells Fargo, please proceed.

**PHIL WINSLOW, Wells Fargo:** Thanks, guys, for taking my question and congrats on a great close on a great year. I just wanted to focus in on M365. Particularly, Satya, your comments on Microsoft Teams. Really, kind of two components to this question. How do you think about why customers are adopting Teams, especially the larger ones that you highlighted at the Ignite conference? Is it the fact that it's a single app with those combined features you talked about, or is it the broader, call it "Office experience"?

And then I guess a question for Amy, then, off that: When you think about the relevance of Teams on a going-forward basis to keep the migration up, E1, E3, E5, and then plus those add-ons that are associated with Teams like calling, et cetera, how critical is Teams to the long-term price migration here at Office and M365?

**SATYA NADELLA:** Yeah. So, overall, I think there's no question this last fiscal year has been an absolute breakout year for Teams in terms of both the product innovation and, most importantly, at-scale deployment and usage that we are seeing.

And I think, in fact, unlike any other time other than Windows, we've not had this kind of platform effect. Office has, obviously, had very, very successful individual products that have been deployed broadly, but each of them was a singular tool. Perhaps SharePoint was the last time we had a platform effect of this kind.

But Teams transcends all that. It's the communications tool, it's the collaboration tool, it's the line-of-business tool for meetings, as well as business process. And so the amount of value creation for the customer by deployment is something that we, ourselves, are sort of really learning a lot each deployment. You know, whether it's on the first line.

The other point about Teams is just not limited to knowledge workers, which has been really the only place traditionally we've played. Even our licenses to the non-knowledge workers were just mostly licenses of the tools we built for knowledge workers. Whereas now, we actually have specific value, which is in fact very valuable to those first-line workers. And the thing that we've realized is that businesses are, in fact, looking to spend more for those first-line worker productivity.

So, we're in the very early innings of it, but we're pretty excited. The one other benefit it sort of tees off of some of the comments that Amy was making is that security, compliance, and governance is a huge issue for enterprise customers and commercial customers at scale. And Teams, in some sense, helps them a lot because it builds on all the rest of the investment they made already in Office 365. And so we see the benefit even on that front.

**AMY HOOD:** And I think it's an important component of our M365 value, but it's really not outsized. I mean, we have all these components of value. That's really the secret of what customers look and see. They see Teams that can not only change what Satya talked about, but also is about culture change in terms of employees being able to be involved and collaborate regardless of org chart. And that is what you're going to see.

When you have 500 million new applications built in the next five years, you're going to see, and I believe Teams to be one of the major interfaces through which that experience and business process reinvention will happen.

Teams really spans multiple categories. So, I wouldn't think of it just as productivity or even just as collab or meetings, but as an interface as you see business process reinvention occur. I do think of this as the surface through which many people will experience it. And so I would ask you to expand your thinking on this one. It's not just Office or needed to be in Office, it's really about having employees fundamentally experience Microsoft in a different way, day to day.

**SATYA NADELLA:** Yeah, and I would point to the conference we just finished and some of the demos, and I think the customer demos in particular, I would say, that would sort of probably give you the best feel for how people look at this in terms of the deployment characteristics.

**PHIL WINSLOW:** Great, thanks, guys.

**MICHAEL SPENCER:** Thanks, Phil. Operator, we'll move to the next question, please.

**OPERATOR:** Thank you. Our next question comes from the line of Mark Murphy with JPMorgan, please proceed.

**MARK MURPHY, JPMorgan**: Thank you very much. Amy, you are mentioning large and long-term Azure contracts. I'm wondering, as we consider this robust 25-percent growth in your commercial bookings this quarter, roughly how many points are coming from that -- from any tailwind of the longer duration types of contracts?

And then, Satya, I wanted to ask you regarding the recent partnership with AT&T, some media reports said it was worth over $2 billion. Wondering if there is some hyperbole there in the media, or is this an example of how Microsoft can play in every line of a company's op-ex budget today?

**SATYA NADELLA:** I'll just take the second one. I mean, I think it is a very significant deal. I'm not going to comment on any specific dollar terms. It is the largest commercial deal that we've signed of this size. And we see -- we have line of sight to many more such deals.

**AMY HOOD:** And when you think about bookings growth, I'm not sure for me, break it down to two pieces, which is I think about bookings, which were very good this quarter. Has two fundamental motions: There's the motion around renewals, and there's the motion around new. Both were very good this quarter. And it wasn't -- while, certainly, long-term Azure contracts add a meaningful component of the new, they weren't alone in being the only component of the new.

And renewals, as I mentioned earlier, we saw very good execution, not just on renewals in quarter, but really healthy behavior in terms of maybe expirations that we had seen happen earlier in the year getting renewed because of the new value prop and the commitment of the sales team to make sure that we landed a really thoughtful, high customer value transaction.

So, while these long-term, large contracts will add volatility to that number, if you look at our CNR balance of $91 billion and see that that also grew 25 percent year over year, you'll get a sense that it certainly wasn't alone in its impact for the year.

**MARK MURPHY:** Thank you.

**MICHAEL SPENCER:** Thanks, Mark. Operator, we'll move to the next question, please.

**OPERATOR:** Thank you. Our next question comes from the line of Raimo Lenschow with Barclays. Please proceed.

**RAIMO LENSCHOW, Barclays:** Hey, thanks, and congrats from me as well. I wanted to zone in on Dynamics. There, you obviously, you're playing in applications and we've seen other vendors do SaaS applications, if you look at Dynamics Online, you now, on my math, kind of at $2 billion, still growing at a clip that organically not many others have achieved. It's now bigger than your on-premises business. Can you talk a little bit about the drivers there? How did you achieve that goal with this scale and what are the drivers going forward? Thank you.

**SATYA NADELLA:** Yeah. We're very, very excited about the progress in the last fiscal year around Microsoft 365, both the traditional business process applications themselves have become much more modular and much more modern, and we have a very disruptive business model as well that goes with it. And so, therefore, we're becoming much more competitive with these large customers deploying whether it's sales or operations.

The other exciting thing is we have this entire new class of applications. And I talked about this even in this week's conference, which is these AI-first modules, whether it's for sales, for marketing, for customer service, or customer 360. And these are modules that there isn't an install base anywhere, no competition even exists. So, in other words, we can, in fact, have these modules get deployed in commercial customers even on top of existing business applications.

And so we feel that we have plenty of opportunity ahead. Again, this is a place where we're a very low-share player, and so the fact that we've become a very competitive supplier of this technology at a time where the world needs more business process automation, we feel good about the opportunity ahead.

**RAIMO LENSCHOW:** All right, thank you.

**MICHAEL SPENCER:** Thanks. Operator, we'll take our last question, please.

**OPERATOR:** Thank you. Our final question comes from the line of Brent Bracelin with KeyBanc. Please proceed.

**BRENT BRACELIN, KeyBanc:** Thank you. I wanted to drill down into the commercial cloud gross margins. They're up 200 basis points sequentially, 600 basis points year over year to 65 percent. I guess my question here is: How sustainable are the cloud gross margins now that you're at this $40-billion-plus scale? Or were there some kind of one-time benefits that we should think about in the quarter that helped you there? Thanks.

**AMY HOOD:** There were not any one-time benefits in this quarter that helped us. This is really about seeing improvement in some of our largest services and continuing to see improvement year over year in the largest services. What we said for FY20 and particularly in Q1 is we expect to be up sequentially in Q1 and we'll continue to get some headwinds because of the strong Azure IaaS and PaaS growth we expect through the year. But we certainly think that Azure fundamental gross margin improvement will help offset that next year.

**BRENT BRACELIN:** Great. Thank you.

**MICHAEL SPENCER:** That wraps up the Q&A portion of today's earnings call. We appreciate you joining us and look forward to speaking with all of you soon. Thanks.

**AMY HOOD:** Thanks, everyone.

**SATYA NADELLA:** Thank you very much.

**OPERATOR:** Thank you. This concludes today's teleconference. You may disconnect your lines at this time, thank you for your participation.

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