Microsoft FY23 Third Quarter Earnings Conference Call

Brett Iversen, Satya Nadella, Amy Hood

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**BRETT IVERSEN:**

Good afternoon and thank you for joining us today. On the call with me are Satya Nadella, chairman and chief executive officer, Amy Hood, chief financial officer, Alice Jolla, 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. Additionally, new this quarter, more detailed outlook slides will be available on the Microsoft Investor Relations website when we provide outlook commentary on today’s call.

On this call we will discuss certain non-GAAP items. 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 these items and events have 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 very much, Brett.

The Microsoft Cloud delivered over $28 billion in quarterly revenue, up 22% and 25% in constant currency, demonstrating our continued leadership across the tech stack.

We continue to focus on three priorities:

First, helping customers use the breadth and depth of the Microsoft Cloud to get the most value out of their digital spend.

Second, investing to lead in the new AI wave across our solution areas, and expanding our TAM.

And, third, driving operating leverage, aligning our cost structure with our revenue growth.

Now, I’ll highlight examples of our progress, starting with infrastructure.

Azure took share, as customers continue to choose our ubiquitous computing fabric – from cloud to edge, especially as every application becomes AI-powered.

We have the most powerful AI infrastructure, and it’s being used by our partner OpenAI, as well as NVIDIA, and leading AI startups like Adept and Inflection to train large models.

Our Azure OpenAI Service brings together advanced models, including ChatGPT and GPT-4, with the enterprise capabilities of Azure.

From Coursera and Grammarly, to Mercedes-Benz and Shell, we now have more than 2,500 Azure OpenAI Service customers, up 10X quarter-over-quarter.

Just last week, Epic Systems shared that it was using Azure OpenAI Service to integrate the next generation of AI with its industry-leading EHR software.

Azure also powers OpenAI API. And we’re pleased to see brands like Shopify and Snap use the API to integrate OpenAI’s models.

More broadly, we continue to see the world’s largest enterprises migrate key workloads to our cloud.

Unilever, for example, went all-in on Azure this quarter, in one of the largest-ever cloud migrations in the consumer goods industry.

IKEA Retail, ING Bank, Rabobank, Telstra, and Wolverine Worldwide all use Azure Arc to run Azure services across on-premises, edge, and multi-cloud environments. We now have more than 15,000 Azure Arc customers, up over 150% year-over-year.

And we’re extending our infrastructure to 5G network edge with Azure for Operators.

We are the cloud of choice for telcos, and at MWC last month, AT&T, Deutsche Telekom, Singtel, and Telefonica all shared how they are using our infrastructure to modernize and monetize their networks.

Now, on to data.

Our Intelligent Data Platform brings together databases, analytics, and governance, so organizations can spend more time creating value and less time integrating their data estate.

Cosmos DB is the go-to database powering the world’s most demanding workloads at any scale.

OpenAI relies on Cosmos DB to dynamically scale their ChatGPT service – one of the fastest-growing consumer apps ever – enabling high reliability and low maintenance.

The NBA uses Cosmos DB to ingest more than 10 million data points per game, helping teams optimize their gameplay.

And, we are taking share with our analytics solutions. Companies like BP, Canadian Tire, Marks & Spencer, and T-Mobile all rely on our end-to-end analytics to improve speed-to-insight.

Now, on to developers.

From Visual Studio to GitHub, we have the most popular tools to help every developer go from idea to code and code to cloud – all while staying in their flow.

Today, 76% of the Fortune 500 use GitHub to build, ship, and maintain software.

And with GitHub Copilot, the first at-scale AI developer tool, we’re fundamentally transforming the productivity of every developer, from novices to experts.

In three months since we made Copilot for Business broadly available, over 10,000 organizations have signed up, including the likes of Coca-Cola and GM, as well as Duolingo and Mercado Libre, all of which credit Copilot with increasing the speed for their developers.

We’re also bringing next generation AI to Power Platform, so anyone can automate workflows, create apps or web pages, build virtual agents, and analyze data using only natural language.

More than 36,000 organizations have already used existing AI-powered capabilities in Power Platform.

And with our new Copilot in Power Apps, we’re extending these capabilities to end users who can interact with any app through conversation instead of clicks.

All-up, we now have nearly 33 million monthly active users of Power Platform, up nearly 50% year-over-year.

Now, on to business applications.

From customer experience and service, to finance and supply chain, we continue to take share across all categories we serve, as organizations like Asahi, C.H. Robinson, E.ON, Franklin Templeton choose our AI-powered business applications to automate, simulate, and predict every business process and function.

And we’re going further, with Dynamics 365 Copilot, which works across CRM and ERP systems to bring the next generation of AI to employees in every job function, reducing burdensome tasks like manual data entry, content generation, and notetaking.

Now, on to our industry and cross-industry solutions.

Our Cloud for Sustainability is seeing strong adoption from companies in every industry, including BBC, Nissan, and PCL, as they deliver on their respective environmental commitments.

Our Cloud for Healthcare was front and center at HIMSS last week, as we expanded our offerings for payors and added new AI-powered capabilities for providers.

We showcased the first fully AI-automated clinical documentation application, Nuance DAX Express, which will bring GPT-4 to more than 550,000 existing users of Dragon Medical.

And, at Hannover-Messe manufacturing trade show, Siemens shared how it will use a Teams app integrated with Azure OpenAI Service to optimize factory workflows.

Now, on to future of work.

Microsoft 365 Copilot combines next generation AI with business data in the Microsoft Graph and Microsoft 365 applications, removing the drudgery and unleashing the creativity of work.

Copilot works alongside users, embedded in the Microsoft 365 applications millions use every day, and it also powers Business Chat, which uses natural language to surface information and insights based on business content and context.

We’ve been encouraged by early feedback, and look forward to bringing these experiences to more users in the coming months.

Teams usage is at an all-time high and surpassed 300 million monthly active users this quarter.

And we once again took share across every category — from collaboration, to chat, to meetings, to calling — as we add value for existing customers and win new ones like ABN AMRO, Jaguar Land Rover, Mattress Firm, Unisys, and Vodafone.

We announced a new version of Teams that delivers up to two times faster performance, while using 50% less memory, so customers can collaborate more efficiently and prepare for experiences like Copilot.

Teams is also expanding our TAM. Nearly 60% of our enterprise Teams customers buy Teams Phone, Rooms, or Premium.

Teams Phone is the undisputed market leader in cloud calling, helping our customers reduce costs with a three-year ROI of over 140%.

Teams Rooms revenue more than doubled year-over-year.

And Teams Premium meets enterprise demand for AI-powered features like intelligent recaps. Now generally available, it’s one of our fastest growing Modern Work products ever, with thousands of paid customers just two months in.

With Microsoft Viva, we’ve created a completely new suite for employee experience.

Viva brings together goals, communications, learning, workplace analytics, and employee feedback. Across industries, companies like Dell, Mastercard, and SES are using Viva to help their employees thrive.

Just last week, we announced Copilot for Viva, offering leaders a new way to build high-performance teams by prioritizing both productivity and employee engagement.

And with Viva Sales, we’ve extended the platform to specific job functions, helping sellers apply large language models to their CRM and Microsoft 365 data, so they can automatically generate content, like customer mails.

All this innovation is driving growth across Microsoft 365. Ferrovial, Goldman Sachs, Novo Nordisk, and Rogers all chose E5 to empower their employees with our best-in-class productivity apps, along with advanced security, compliance, voice, and analytics.

Now, on to Windows.

While the PC market continues to face headwinds, we again saw record monthly active Windows devices, and higher usage, compared to pre-pandemic.

We are also seeing accelerated growth in Windows 11 commercial deployments. Over 90% of the Fortune 500 are currently trialing or have deployed Windows 11.

And with Windows 365 and Azure Virtual Desktop, we continue to transform how employees at companies like Mazda and Nationwide access Windows.

All-up, over one-third of our enterprise customer base has purchased cloud-delivered Windows to date. And new Windows 365 Frontline extends the power and security of Cloud PCs to shift workers for the first time.

Now, on to security.

Our comprehensive, AI-powered solutions spanning all clouds and all platforms give the agility advantage back to defenders.

Among analysts, we are the leader in more categories than any other provider, and we once again took share across all major categories we serve.

And we continue to introduce new products and functionality to further protect customers.

With Security Copilot, we’re combining large language models with a domain-specific model informed by our threat intelligence and 65 trillion daily security signals, to transform every aspect of the SOC productivity.

We also added new governance controls and policy protections to better secure identities, along with resources they access. Nearly 720,000 organizations now use Azure Active Directory, up 33% year-over-year.

And, all-up, nearly 600,000 customers now have four or more security workloads, up 35% year-over-year, underscoring our end-to-end differentiation.

EY and Qualcomm, for example, both chose our full security stack to ensure the highest levels of protection and visibility across their organizations.

Now, on to LinkedIn.

We once again saw record engagement, as more than 930 million members turn to the professional social network to connect, learn, sell, and get hired.

Member growth accelerated for the seventh consecutive quarter, as we expanded to new audiences.

We now have 100 million members in India, up 19%. And as Gen Z enters the workforce, we saw a 73% year-over-year increase in the number of student sign ups.

In this persistently tight labor market, LinkedIn Talent Solutions continues to help hirers connect to job seekers and professionals to build the skills they need to access opportunity. Our hiring business took share for the third consecutive quarter.

The excitement around AI is creating new opportunities across every function, from marketing, sales, and finance, to software development and security. LinkedIn is increasingly where people are going to learn, discuss, and uplevel their skills, with more than 100 AI courses.

And we’ve introduced new AI-powered features, including writing suggestions for member profiles and job descriptions, and collaborative articles.

Finally, LinkedIn Marketing Solutions continues to be a leader in B2B digital advertising, helping companies deliver the right message, to the right audience, on a safe, trusted platform.

More broadly, we continue to expand our opportunity in advertising.

Our exclusive partnership with Netflix brings differentiated, premium video content to our ad network.

And, our new Copilot for the web is reshaping daily search and web habits.

Two months since the launch of new Bing and Edge, we’re very encouraged by user feedback and usage patterns.

All-up, Bing has more than 100 million daily active users.

We are winning new customers on Windows and mobile. Daily installs of the Bing mobile app have grown 4X since launch.

We’re making progress in share gains. Edge took share for the eighth consecutive quarter, and Bing once again grew share in the United States.

We continue to innovate with first-of-their-kind AI-powered features, including the ability to set the tone of chat and create images from text prompts, powered by Dall-E. Over 200 million images have been created to date.

And, we see that when people use these new AI features, their engagement with Bing and Edge goes up.

As we look towards a future where chat becomes a new way for people to seek information, consumers have real choice in business model and modalities with Azure-powered chat entrypoints across Bing, Edge, Windows, and OpenAI’s ChatGPT.

We look forward to continuing this journey in what is a generational shift in the largest software category – search.

Now, on to gaming.

We are rapidly executing on our ambition to be the first choice for people to play great games whenever, however, and wherever they want.

We set third quarter records for monthly active users and monthly active devices.

Across our content & services business, we are delivering on our commitment to offer gamers more ways to experience the games they love.

Our revenue from subscriptions reached nearly $1 billion this quarter.

This quarter, we also brought PC Game Pass to 40 new countries, nearly doubling the number of markets we’re available.

Great content remains the flywheel behind our growth. We have now surpassed 500 million lifetime unique users across our first party titles.

And I’ve never been more excited about our pipeline of games, including the fourth quarter launches of Minecraft Legends and Redfall.

In closing, we are focused on continuing to raise the bar on our operational excellence and performance, as we innovate to help our customers maximize the value of their existing technology investments and thrive in the new era of AI.

In a few weeks times, we’ll hold our Build conference, and we will share how we are building the most powerful AI platform for developers. And I encourage you to tune in.

I could not be more energized about the opportunities ahead.

And with that, let me turn it over to Amy.

**AMY HOOD:** Thank you, Satya, and good afternoon everyone. Our third quarter revenue was $52.9 billion, up 7% and 10% in constant currency. Earnings per share was $2.45 and increased 10% and 14% in constant currency.

Our results exceeded expectations, driven by focused execution from our sales teams and partners. In our commercial business, revenue was up 19% in constant currency. We saw better-than-expected renewal strength, including across Microsoft 365 which also benefited Windows Commercial given the higher in-period revenue recognition. In Office 365 standalone products, we saw improvement in new business growth, while growth trends in EMS and Windows Commercial standalone products remained consistent with Q2. In Azure, customers continued to exercise some caution as optimization and new workload trends from the prior quarter continued as expected.

In our consumer business, PC demand was a bit better than we expected, particularly in the commercial segment, which benefited Windows OEM and Surface even as channel inventory levels remain elevated which negatively impacted results. Advertising spend landed in line with our expectations.

We have seen share gains in Azure, Dynamics, Teams, Security, Edge, and Bing as we continue to focus on delivering high value as well as new innovative solutions to our customers, including next generation AI capabilities.

Commercial bookings increased 11% and 12% in constant currency on a strong prior year comparable, with a declining expiry base and 3 points of unfavorable impact from the inclusion of Nuance in the prior year. The better-than-expected result was driven by strong execution across our renewal sales motions mentioned earlier.

Commercial remaining performance obligation increased 26% to $196 billion. Roughly 45% will be recognized in revenue in the next 12 months, up 18% year-over-year. The remaining portion, which will be recognized beyond the next 12 months, increased 34%. And this quarter, our annuity mix was again 96%.

FX impact on total company revenue, segment level revenue, and operating expense growth was as expected. FX decreased COGS growth by 2 points, 1 point favorable to expectations.

Microsoft Cloud revenue was $28.5 billion and grew 22% and 25% in constant currency, slightly ahead of expectations.

Microsoft Cloud gross margin percentage increased roughly 2 points year-over-year to 72%, a point ahead of expectations driven by cloud engineering efficiencies. Excluding the impact of the change in accounting estimate for useful lives, Microsoft Cloud gross margin percentage decreased slightly driven by lower Azure margin.

Company gross margin dollars increased 9% and 13% in constant currency, including 2 points due to the change in accounting estimate. Gross margin percentage increased year-over-year to 69%. Excluding the impact of the change in accounting estimate, gross margin percentage decreased slightly driven by a lower mix of OEM revenue.

Operating expense increased 7% and 9% in constant currency, about $300 million lower than expected. Operating expense growth was driven by roughly 2 points from the Nuance and Xandr acquisitions, as well as investments in cloud engineering and LinkedIn. At a total company level, headcount at the end of March was 9% higher than a year ago.

Operating income increased 10% and 15% in constant currency, including 4 points due to the change in accounting estimate. Operating margins increased roughly 1 point year-over-year to 42%. Excluding the impact of the change in accounting estimate, operating margins decreased slightly and increased slightly in constant currency.

Now to our segment results.

Revenue from Productivity and Business Processes was $17.5 billion and grew 11% and 15% in constant currency, ahead of expectations primarily driven by better-than-expected results in Office commercial.

Office commercial revenue grew 13% and 17% in constant currency. Office 365 commercial revenue increased 14% and 18% in constant currency, slightly better than expected with the strong renewal execution mentioned earlier and E5 momentum. Paid Office 365 commercial seats grew 11% year-over-year to over 382 million, with installed base expansion across all workloads and customer segments. Seat growth was again driven by our small and medium business and frontline worker offerings.

Office commercial licensing declined 1% and increased 5% in constant currency, better than expected with 11 points of benefit from transactional strength in Japan.

Office consumer revenue increased 1% and 4% in constant currency with continued momentum in Microsoft 365 subscriptions, which grew 12% to 65.4 million.

LinkedIn revenue increased 8% and 10% in constant currency, driven by growth in Talent Solutions.

Dynamics revenue grew 17% and 21% in constant currency driven by Dynamics 365, which grew 25% and 29% in constant currency with healthy growth across all workloads.

Segment gross margin dollars increased 14% and 18% in constant currency and gross margin percentage increased roughly 2 points year-over-year. Excluding the impact of the change in accounting estimate, gross margin percentage increased slightly driven by improvements in Office 365, partially offset by sales mix shift to cloud offerings. Operating expenses increased 4% and 5% in constant currency, and operating income increased 20% and 27% in constant currency, including 4 points due to the change in accounting estimate.

Next, the Intelligent Cloud segment. Revenue was $22.1 billion, increasing 16% and 19% in constant currency, slightly ahead of expectations.

Overall, server products and cloud services revenue increased 17% and 21% in constant currency. Azure and other cloud services revenue grew 27% and 31% in constant currency.

In our per-user business, the enterprise mobility and security installed base grew 15% to nearly 250 million seats.

In our on-premises server business, revenue decreased 2% and was relatively unchanged in constant currency, with continued demand for our hybrid offerings, including Windows Server and SQL Server running in multi-cloud environments, offset by transactional licensing.

Enterprise Services revenue grew 6% and 9% in constant currency, with better-than-expected performance across Enterprise Support Services and Microsoft Consulting Services.

Segment gross margin dollars increased 15% and 18% in constant currency and gross margin percentage decreased slightly. Excluding the impact of the change in accounting estimate, gross margin percentage declined roughly 3 points driven by sales mix shift to Azure and the lower Azure margin noted earlier. Operating expenses increased 19% and 20% in constant currency, including roughly 3 points of impact from the Nuance acquisition. Operating income grew 13% and 17% in constant currency, with roughly 6 points from the change in accounting estimate.

Now to More Personal Computing. Revenue was $13.3 billion, decreasing 9% and 7% in constant currency, with better-than-expected results across all businesses.

Windows OEM revenue decreased 28% year-over-year and Devices revenue decreased 30% and 26% in constant currency, both ahead of expectations. We saw better-than-expected PC demand as noted earlier, particularly in the commercial segment which has higher revenue per license, although results continue to be negatively impacted by elevated channel inventory levels.

Windows commercial products and cloud services revenue increased 14% and 18% in constant currency, significantly ahead of expectations primarily due to the strong renewal execution with higher in-period revenue recognition noted earlier.

Search and news advertising revenue ex-TAC increased 10% and 13% in constant currency, including 2 points from the Xandr acquisition. Results were driven by higher search volume with share gains again this quarter for our Edge browser globally and Bing in the U.S.

And in Gaming, revenue declined 4% and 1% in constant currency, ahead of expectations. Xbox hardware revenue declined 30% and 28% in constant currency on a high prior year comparable that benefited from increased console supply. Xbox content and services revenue increased 3% and 5% in constant currency driven by better-than-expected monetization in third-party and first-party content, and growth in Xbox Game Pass.

Segment gross margin dollars declined 9% and 5% in constant currency and gross margin percentage increased slightly year-over-year. Operating expenses declined 5% and 3% in constant currency, even with 3 points of growth from the Xandr acquisition. Operating income decreased 12% and 7% in constant currency.

Now back to total company results.

Capital expenditures including finance leases were $7.8 billion to support cloud demand. Cash paid for P, P, and E was $6.6 billion.

Cash flow from operations was $24.4 billion, down 4% year-over-year as strong cloud billings and collections as well as lower supplier payments were more than offset by a tax payment related to the R&D capitalization provision and employee payments primarily related to headcount growth and an increase in employee compensation. Free cash flow was $17.8 billion, down 11% year-over-year. Excluding the impact of this tax payment, cash flow from operations increased 1% and free cash flow declined 5%.

This quarter, other income and expense was $321 million, higher than anticipated driven by net gains on foreign currency remeasurement.

Our effective tax rate was approximately 19%.

And finally, we returned $9.7 billion to shareholders through share repurchases and dividends.

Now, moving to our Q4 outlook, which unless specifically noted otherwise, is on a US dollar basis.

My commentary, for next quarter and FY24, does not include any impact from Activision, which we continue to work towards closing in fiscal year 2023, subject to obtaining required regulatory approvals.

Now to FX. Based on current rates, we expect FX to decrease total revenue growth by approximately 2 points with no impact to COGS or operating expense growth. Within the segments, we anticipate roughly 2 points of negative FX impact on revenue growth in Productivity and Business Processes and Intelligent Cloud and roughly 1 point in More Personal Computing.

Overall, our outlook has many of the trends we saw in Q3 continue thru Q4. In our largest quarter of the year, we expect customer demand for our differentiated solutions including our AI platform and consistent execution across the Microsoft Cloud to drive another quarter of healthy revenue growth.

Last year we had our largest commercial bookings quarter ever with a material volume of large, multi-year commitments. On that comparable, we expect growth to be relatively flat. We expect consistent execution across our core annuity sales motions with strong renewals and continued commitments to our platform as we focus on meeting customers’ changing contract needs, which include shorter-term, quick time-to-value contracts in this dynamic environment. Our key focus remains on delivering customer value.

Microsoft Cloud gross margin percentage should be up roughly 2 points year-over-year driven by the accounting estimate change noted earlier. Excluding that impact, Q4 cloud gross margin percentage will be relatively flat as improvements in Office 365 will offset the lower Azure margin and the impact of scaling our AI infrastructure to meet growing demand.

We expect capital expenditures to have a material sequential increase on a dollar basis driven by investments in Azure AI infrastructure. Reminder there can be normal quarterly spend variability in the timing of our cloud infrastructure buildout.

Next to segment guidance.

In Productivity and Business Processes, we expect revenue to grow between 10 and 12% in constant currency or $17.9 to $18.2 billion US dollars.

In Office Commercial, revenue growth will again be driven by Office 365 with seat growth across customer segments and ARPU growth thru E5. We expect Office 365 revenue growth to be roughly 16% in constant currency. In our on-premises business, we expect revenue to decline in the low 30s.

In Office consumer, we expect revenue growth in the mid-single digits, driven by Microsoft 365 subscriptions.

For LinkedIn, we expect mid-single digits revenue growth driven by Talent Solutions with continued strong engagement on the platform.

And in Dynamics, we expect revenue growth in the mid to high-teens driven by continued growth in Dynamics 365.

For Intelligent Cloud we expect revenue to grow between 15% and 16% in constant currency or $23.6 to $23.9 billion US dollars.

Revenue will continue to be driven by Azure which, as a reminder, can have quarterly variability primarily from our per-user business and from in-period revenue recognition depending on the mix of contracts.

In Azure, we expect revenue growth to be 26% to 27% in constant currency, including roughly 1 point from AI services. Growth continues to be driven by our Azure consumption business and we expect the trends from Q3 to continue into Q4 as noted earlier. Our per-user business should continue to benefit from Microsoft 365 suite momentum, though we expect continued moderation in growth rates given the size of the installed base.

In our on-premises server business, we expect revenue to decline low-single digits as demand for our hybrid solutions, including Windows Server and SQL Server running in multi-cloud environments, will be more than offset by unfavorable FX impact.

And in Enterprise Services, revenue should be relatively unchanged year-over-year as growth in Enterprise Support Services will be offset by a decline in Microsoft Consulting Services.

In More Personal Computing, we expect revenue of $13.35 to $13.75 billion US dollars.

PC demand should be similar to Q3 and given channel inventory still remains elevated, our revenue will lag overall market growth as it continues to normalize. Therefore, Windows OEM and Devices revenue should both decline in the low to mid-20s.

In Windows commercial products and cloud services, revenue should decline low to mid-single digits. While we expect healthy annuity billings growth driven by continued customer demand for Microsoft 365 and our advanced security solutions, a reminder that our quarterly revenue growth can have variability primarily from in-period revenue recognition depending on the mix of contracts.

Search and news advertising ex-TAC revenue growth should be approximately 10%, roughly 5 points higher than overall Search and news advertising revenue, driven by growth in first-party revenue that’s similar to Q3.

And in Gaming, we expect revenue growth in the mid to high-single digits. We expect Xbox content and services revenue growth in the low to mid-teens driven by third-party and first-party content as well as Xbox Game Pass.

Now back to company guidance.

We expect COGS to grow between 3% and 4% in constant currency or $16.8 to $17 billion US dollars and operating expense to grow approximately 2% in constant currency or $15.1 to $15.2 billion US dollars.

Other income and expense should be roughly $300 million as interest income is expected to more than offset interest expense. As a reminder, we are required to recognize mark-to-market gains or losses on our equity portfolio, which can increase quarterly volatility.

We expect our Q4 effective tax rate to be in line with our full year rate of approximately 19%.

And finally, as a reminder for Q4 cash flow, we expect to make a $1.3 billion cash tax payment related to the R&D capitalization provision.

Now I’d like to share some closing thoughts as we look to the next fiscal year.

With our leadership position as we begin this AI era, we remain focused on strategically managing the company to deliver differentiated customer value as well as long-term financial growth and profitability.

As with any significant platform shift, it starts with innovation, and we are excited about the early feedback and demand signal for the AI capabilities we have announced to date. We will continue to invest in our cloud infrastructure, particularly AI-related spend, as we scale with the growing demand driven by customer transformation. And we expect the resulting revenue to grow over time.

As always, we remain committed to aligning costs and revenue growth to deliver disciplined profitability. Therefore, while the scaled capex investments will impact COGS growth, we expect FY24 operating expense growth to remain low.

As a team, we have continually focused on pivoting our resources aggressively to the future as we execute at a high level in the moment to deliver value to our customers. That balance has enabled the company to successfully lead across a number of platform shifts over a number of decades. Therefore, we are committed to leading the AI platform wave and making the investments to support it.

With that, let’s go to Q&A. Brett?

**BRETT IVERSEN:** 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. Joe, can you please repeat your instructions?

(Operator Direction.)

**KEITH WEISS, Morgan Stanley**: Excellent. Thank you guys for taking the question, and congratulations on really a fantastic set of results and what we all know to be a still difficult environment out there. I think it really illustrates Microsoft’s advantages, and a lot of these technology innovations that you guys have been talking about.

I wanted to ask you a question that I get probably more often than anything else, and one that I, frankly, don’t have a good answer to, and that’s around the OpenAI partnership, and particularly the accounting for that partnership. I was hoping you could give us a little bit of color about whether or not revenue is flowing from OpenAI into Microsoft on the CapEx side of the equation, whether there’s any impact, just to give us a better understanding of how the accounting around that relationship is working.

**AMY HOOD**: Thanks, Keith. In some ways, let me start by saying it’s a great partnership. We’re proud to have worked together for a number of years, leading to some of the announcements that you’ve heard us make more recently. And we’ve talked about the foundation of our partnership remains that when we both are successful, the other benefits. When we grow, it helps them, and when they grow, it helps us.

But specifically to your question on how does it show up, it’s easiest in this situation to think about them as a customer of ours, like any other customer who would use the Azure infrastructure and our Azure AI Services in service of supporting their end customers. And so, when they do that, like any other customer who has a commercial relationship with us, we recognize revenue on that behalf.

That’s probably the simplest frame, Keith, that I hope is helpful.

**KEITH WEISS:** Yeah, that’s super helpful. I appreciate that.

**BRETT IVERSEN:** Thanks, Keith. Joe, next question, please.

(Operator Direction.)

**MARK MOERDLER, Bernstein:** Congratulations on the quarter and the guidance, and thanks for taking my question. I’d like to drill into Azure, and more specifically, Azure IaaS PaaS consumption. IaaS PaaS consumption is really stepped down recently, and it’s important to understand the macro versus an optimization that will rebound, whether it’s going to rebound quickly or is there a more fundamental issue? In other words, is this simply purely macro, and everyone is stepping back a little bit, and they’re going to hit the pedal as soon as this comes back, or is there something more fundamental that is driving corporate maybe to step back and that that slowdown to sustain even when the IT spending rebound? Thank you.

**SATYA NADELLA:** Thanks for the question. Maybe I’ll make three comments. And it’s also important, I think, to distinguish between what I would say is macro or absolute performance and relative performance, because I think that’s perhaps a good way to think about how we manage our business.

First is optimizations do continue. In fact, we are focused on it. We incent our people to help our customers with optimization, because we believe, in the long run, that’s the best way to secure the loyalty and long-term contracts with customers, when they know that they can count on a cloud provider like us to help them continuously optimize their workflow. That’s sort of the fundamental benefit of public cloud, and we’re taking every opportunity to prove that out with customers in real time.

The second thing I’d say is we do have new workloads started, because if you think about it, during the pandemic, it was all about new workloads and scaling workloads. But pre-pandemic, there was a balance between optimizations and new workloads. What we’re seeing now is the new workloads start, in addition to highly intense optimization driven that we have.

The third is perhaps more of a relative statement. Because of some of the work we’ve done in AI even in the last couple of quarters, we are now seeing conversations, whether it’s coming to you in just OpenAI’s APIs, right? If you think about the consumer tech companies that are all spinning essentially Azure meters, because they have gone to OpenAI and are using their API. These are not customers of Azure at all.

Second, even Azure OpenAI API customers are all new and the workload conversations, whether it’s B2C conversations in financial services, or drug discovery on another side, these are all new workloads that we really were not in the game in the past, whereas we now are.

Those are the three comments I would make, both in terms of absolute macro, but more importantly, I think what is our relative market position and how it’s being changed.

**AMY HOOD:** That’s maybe the one thing I would add to those comments, is we’ve been through almost a year where that pivot that Satya talked about from we’re starting tons of new workloads – we’ll call that the pandemic time – to this transition post, and we’re coming to really the anniversary of that starting.

And so, to Satya’s point, we’re continuing to incent optimization, but at some point, workloads just can’t be optimized much further. And when you start to anniversary that, you do see that it gets a little bit easier in terms of the comps, year over year. And so, you even see that in a little bit of our guidance, some of that impact from a year-over-year basis.

**MARK MOERDLER:** That was incredibly helpful. I really do appreciate it. Thank you for the color, and again, congratulations on what’s happening.

**BRETT IVERSEN:** Thanks, Mark. Joe, next question, please.

(Operator Direction.)

**BRENT THILL, Jefferies:** Thanks. On Copilot monetization, can you just give us a sense of how this shows up, where we’re going to see it? And ultimately, is there a simple price lift that you think you can get through a copilot, say 10%, 20%, 30% above where you saw the regular components of the suite, or is it too hard to factor in? Thank you.

**SATYA NADELLA:** I mean, overall, we do plan to monetize a separate set of meters across all of the tech stack, whether they’re consumption meters or per-user subscriptions. The copilot that’s priced, and it is there, is GitHub Copilot. That’s a good example of incrementally how we monetize the price lists out there, and others are to be priced, because we are in preview mode. But you can expect us to do what we’ve done with GitHub Copilot pretty much across the board.

**AMY HOOD:** Yeah, Brent, the best way of thinking about this is when we believe we’re adding a lot of value, and frankly, that’s what the copilots are doing and some productivity improvement, you can expect that we will have a list price for those. And you’ll be able to look at that as we get to release. And to Satya’s point, GitHub Copilot is a great example.

**BRENT THILL:** Thanks.

**BRETT IVERSEN:** Thanks, Brent. Joe, we have the next question, please.

(Operator Direction.)

**RAIMO LENSCHOW, Barclays:** Thank you. Congrats from me as well. And just staying on the AI theme and more thinking about the gross margin impact on Azure, can you just, Satya, maybe talk a little bit about how you see the cost of compute for AI workloads versus kind of the classic workloads? And how do you think that will evolve over time? Thank you.

**SATYA NADELLA:** Yeah, a couple of things. One is clearly, the accelerated compute is what gets used to drive AI. And the thing that we are very, very focused on is to make sure that we get very efficient in the usage of those resources. If you think about sort of what a hyperscaler does is not just rack and stack sort of hardware. They use software to optimize the performance of a given workload, and in fact heterogeneous workloads on a given set of hardware.

And so, we have many knobs that will continue to drive optimization across it. And you see it even for a given generation of a large model, where we start with the cost footprint to where we end in the cost footprint, even in a period of a quarter, changes. So, you can expect us to do what we have done over the decade plus the public cloud to bring the benefits of, I would say, continuous optimization of our COGS to a diverse set of workloads.

The other thing I would mention is that there are a lot of workloads now. One of the reasons why we got together with OpenAI primarily was we came out and said this type of workload, whether it’s a training or an inference workload, is going to be much more generally relevant for us, not just in the context of AI. And so, you can see, I’ll supply in other contexts as well.

**AMY HOOD:** And Raimo, we talked a bit about this when we talked about the new Edge and the new Bing with analysts. And I think one of the important things to keep in mind, which Satya is pointing to, is that it’s not really just the cost of Azure and the ability to optimize across the Azure workloads. It’s that really, even our first-party workloads and apps that are built are built on the same platform.

And we’re able, because we are a hyperscaler and because we have a large commercial cloud first party, as well as consumer apps like Bing that are first party, we’re able to take advantage of that and GPU utilization, AI services utilization across the stack. And so, it’s not just sort of where Satya wanted to see even a broader benefit of being a hyperscaler.

**RAIMO LENSCHOW:** Thank you.

**BRETT IVERSEN:** Thanks, Raimo. Joe, next question, please.

**KEITH BACHMAN, BMO**: Good afternoon. Good evening. Thank you for taking the question. Amy, I wanted to address this to you, if I could. On your prepared remarks, you commented that you thought that operating expense growth would be lower. I was hoping to just maybe flush that out with some broader comments. Excuse me.

Could you talk about how you see any kind of directional color on how you see gross margins evolving, given mix, and particularly supporting generative AI, and/or any other comments that might help shape our thinking as we begin to look at the operating margin for the next fiscal year? Thank you.

**AMY HOOD:** Thanks, Keith. And this is probably a good opportunity to explain a bit about how I think about where we are, which is you look at all of the businesses we’re in, and we look about our competitiveness in those businesses. And this is where Satya started to comment a bit about our relative performance versus absolute. And I’ll tell you that the energy and focus we put right now is on relative performance and share gains.

Right now, we have the largest commercial cloud with increasing commitments by customers, with new workloads, new TAM opportunities that Satya’s talking about with customers. And our focus is going to be and will be on continuing to take a growing share of that, while we continue to focus on our customers’ success and getting a ton of value out of what we are selling, whether that’s the E5 product of Microsoft 365, whether that’s Windows 365 to help. Maybe it’s on compute costs and PC cost, whether it’s working across the Azure stack.

And so, with that opportunity plus in our consumer business, the largest number of active devices we’ve had in Windows that are still being used more, being able to focus on Edge share, and Bing share and gaming, bringing it to the PC as well as across to mobile, these are the opportunities that we focus on, as we think about next year.

And so, if we feel like, and I do, that we are well positioned to continue to take share in so many key places, then I say great. And we want to be able to focus on investing in AI, which I talked about. We’ll increase COGS growth, but we’re committed to making sure we have healthy profitability by keeping operating expenses low.

And so, what really this past year has been about, but really what Q3 starts to show is our willingness to pivot to the future, to make sure we can keep all those commitments that Satya listed. While I know that’s not giving specificity, it is in fact how we think about long-term success, is being well-positioned in big markets, taking share in those markets, committing to make sure we’re going to lead this wave, staying focused on gross margin improvements where we can. Some of them will come in AI over time, given our commitment to the buildout. We will charge for those AI capabilities, and then ultimately, we’ll deliver operating profit.

**SATYA NADELLA:** Yeah. I mean, just to add to it, during these periods of transition, the way I think, as shareholders, you may want to look at is what’s the opportunity set ahead when we have a differentiated play to go after that opportunity set, which we believe we have, both the opportunity set in terms of TAM is bigger, and our differentiation at the very start of a cycle, we feel we have a good lead, and we have differentiated offerings up and down the stack.

And so, therefore, that’s the sort of approach we’re going to take, which is how do we maximize the return of that starting position for you all, as shareholders, long term? That’s sort of where we look at it. And we’ll manage the P&L carefully, driving operating leverage in a disciplined way, but not being shy of investing where we need to invest, in order to grab the long-term opportunity.

And so, obviously we will see share gains first, usage first, then GM, then OPInc, right, like a classic P&L flow, but we feel good about our position.

**KEITH BACHMAN:** All right, many thanks for the answer.

**BRETT IVERSEN:** Thanks, Keith. Joe, next question, please.

**KARL KEIRSTEAD, UBS:** Thanks. We’ve had a lot of questions on AI and Azure, so maybe just to round it out, just on the Office 365 business, Amy, 16% constant currency guide for June, not really seeing much seat degradation despite obviously a tight labor market. So, it’s proven to be very resilient.

Could you just unpack the sensitivity to that headcount reduction, given that across your customer base, at least slower rate of hiring, just given that this is an enormous seat based business, it doesn’t seem to be showing up? Maybe you could just help us understand what’s driving that continued seat growth and how durable that is.

**AMY HOOD:** Yeah. Thanks, Karl. I think I would step back and say we have seen, I mean, the Office 365 suite, but broadly, the Microsoft 365 suite adds a ton of value for users. And so, if you think about the users and on the global base, we’ve been able to add users, which you continue to see, we still have in the frontline scenario and an SMB opportunity to continue to grow. And in the enterprise, where we are a basic productivity tool, the labor market is still tight in those places. And we continue to see customers committed to the value they’re getting.

And so, this is not something that I think our focus has really been on continuing to get healthy renewals, continuing to add new products and renewal where it makes sense to save customers money and increase value. And so, I think that’s the story of the resilience you’re seeing. And, of course, we did have a good E5 quarter, which you’re starting to see, and it helps on RPU.

**BRETT IVERSEN:** Thanks, Karl. Joe, next question, please.

**RISHI JALURIA, RBC:** Wonderful. Hi, Satya. Hi, Amy. Thanks so much for taking my question. Nice to see continued resilience in the business. I wanted to get back to the topic of AI, but think maybe a little bit longer term. How are you thinking about the potential for regulation around AI, some of the concerns around data, and customer privacy and governance? And what do you think you can do to maybe quell some of those fears that governments, and customers and organizations have around that? Thanks.

**SATYA NADELLA:** Yeah. Thanks, Rishi, for the question. Overall, we’ve taken the approach that we are not waiting for regulation to show up. We are taking an approach where the unintended consequences of any new technology is something that, from day one, we think about as first class, and build into our engineering process all the safeguards.

For example, in 2016 is when we put out the AI principles. We translated the AI principles into a set of internal standards that then are further translated into an implementation process, that then we hold ourselves to internal audit, essentially. That’s the framework we have.

We have a Chief AI Officer who is sort of responsible for both thinking of what the standards are, and then the people who even help us internally audit our following of the process. And so, we feel very good in terms of us being able to create trust in the systems we put out there.

And so, we will obviously engage with any regulation that comes up in any jurisdiction. But quite honestly, we think that the more there is any form of trust as a differentiated position in the AI, I think we stand to gain from that.

**RISHI JALURIA:** All right. Wonderful. Thank you so much.

**BRETT IVERSEN:** Thanks, Rishi. Joe, we have time for one last question.

**MICHAEL TURRIN, Wells Fargo:** Hey, great. Thanks. I appreciate you squeezing me in. I want to ask a question on the consolidation play that Microsoft is positioned for, given that’s something we hear clearly top of mind for IP decision makers currently. You have clear plays across security infrastructure apps in other areas. So, it would just be great to hear your view on the Microsoft consolidation playbook in the current environment, and if there are certain areas you’re particularly focused on or seeing the most traction around. Thank you.

**SATYA NADELLA:** Yeah. I mean, I’ll start, and then, Amy, you can add.

I think Amy referenced this in the context of Microsoft 365 and Office 365, but fundamentally, what we’re focused on is making sure that the customers are able to derive the value out of our offerings, whether it’s the Microsoft 365 suite value, which is significant, whether it’s E3 or E5. And we want to make sure that they’re getting deployed, they’re getting used. And that’s obviously going to lead to our share gains in many cases.

Same thing in security. That’s a place where this quarter, you saw some good results from us. And same all up and down the stack across Azure.

When you think about AI, the anatomy of an AI application is not just an AI model. In fact, ChatGPT itself is a great example. ChatGPT, for example, uses Cosmos DB as their core database. And so, therefore, we want to make sure that our services, as they are competitive, get used together, whether it’s the IaaS layer, or the PaaS layer, or the SaaS layer.

**AMY HOOD:** And maybe one thing I would add, Michael, is that I know the question is consolidation, but another aspect of that is that some of the new business process automation work that’s going to get done, whether that’s the Dynamics workloads that we’ve talked about, it also will benefit from having the AI services available in Azure, from having the core Azure capabilities, as well actually some front end stuff that people are buying in Microsoft 365 to close these loops in a new way.

And so, I think maybe it’s not the traditional definition of consolidation, but when people look and say, what vendor adds a lot of value and has the tools that we need, and in many instances already own, to be able to do this business process work, I think we have a great, great value, and frankly, probably leading tools in almost every vertical.

**MICHAEL TURRIN:** Great, thank you.

**BRETT IVERSEN:** Thanks, Michael. That wraps up the Q&A portion of today’s earnings call. Thank you for joining us today, and we look forward to speaking with all of you soon.

**AMY HOOD:** Thank you.

**SATYA NADELLA:** Thank you, all. Thanks so much.

END