

01072010 Financial Analyst Briefing Bach Mount

**Who:** Robbie Bach, President, Entertainment and Devices Division; Mindy Mount, Chief Financial Officer, Entertainment and Devices Division

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**ZON ELLIS:** Hello, everybody. We're going to begin now. First of all, I want to thank everyone that made it here. And I want to give a special welcome out to the people that are joining us via the Webcast. A little introduction, I'm Zon Ellis. I'm with Microsoft Investor Relations. You probably met my colleague Emily Zander out in front. And, of course, you're here to listen to these two guests. We have Mindy Mount, who is the Chief Financial Officer of the Entertainment and Devices Division; and, of course, Robbie Bach, President of the Entertainment and Devices Division.

The format is going to be similar to what we've used before where we'll give you a little bit of a summary of the highlights from the keynote, talk about some momentum points, and we'll do the vast majority of this as Q&A. Just a reminder that if you do ask questions, you'll be captured by the Webcast. We'll want to capture it with the microphone, so I'll walk around and try to get you to talk into it, and we'll consider this implicit consent to be recorded for all posterity.

And while we're making legal disclaimers, I should add that we may make some forward-looking statements. This is of course subject to various risks that are disclosed in our most recent 10Q and 10K filing. Finally, just a reminder to folks that we're three weeks in front of earnings release, so we will not be taking specific questions on the December quarter performance, but strategy is fair game.

So, without further ado, and with all our disclaimers out of the way, I'll turn it over to Mindy.

**MINDY MOUNT:** Yes. Terrific. So what I thought I would do is just talk to a few of the momentum points. We've just come out of our second quarter. As you know, big, big quarter for Microsoft. I mean, starting off with Windows 7, two months into the launch. Steve talked about it last night, I think Robbie will give a little bit more detail, but it's just gone tremendously, as many of you know. Right now, with Windows 7 out in the marketplace, there's more choice than ever before in hardware, and different types of devices around the world. There's over 1,400 logoed Windows 7 PCs available to consumers today.

In terms of the holiday, very strong holiday. Sales of PCs were up 50 percent year on year. Granted, last year was probably a little light because of the economy, but nevertheless, strong, strong performance. The fastest selling OS that we've ever had with 94 percent customer satisfaction. So it's great. I don't know if any of you guys have started using it yet, but it really is a joy to use.

On the Xbox front, Xbox continues to go strong. Last night we said we've now sold-in almost 39 million units worldwide of Xbox 360. Xbox Live is continuing its very, very strong momentum. The transaction volume in Xbox Live has been tremendous. I mean, they were throwing out a few tidbits last night. For example, since we've introduced avatar clothing, we've sold 200 million items of apparel for your avatar. I have to admit, I'm probably not

keeping up with my level of shopping on that one, but I've probably got an underdressed avatar.

More than 100 million songs have been sold when you look at things like what we've been doing with Rock Band, and Guitar Hero. And through the holiday period, we were adding one member a second to Live. So in terms of just the momentum during the holiday period, it's very, very, very strong.

We now actually have the Zune Marketplace where you can stream high def 1080p movies. We have it live here in the U.S. and in 17 other markets -- 18 markets around the world -- and here in the U.S. we have 25,000 movies available for folks to download. So there's just tremendous momentum on that front.

Media Center is another business that is moving along quite well. Right now we have deals with more than 20 operators around the world. Last night, Steve said that we are in more than four million households delivering IP TV services around the world. Bing has also had a tremendous last six months since its launch earlier in the year. There is tremendous brand recognition and you can see our market share has been picking up. We're now over 10 percent in the U.S. I think folks are feeling great about that one. And Zune Social now has more than -- I think the last number was four million active members -- using the Zune Social.

So, all around, I think we're feeling very good about our business, as we've just had a good quarter, and I think, as Robbie will talk about, we have a lot of exciting things coming up in the next year. So, I think it's all looking pretty good for E&D.

**ROBBIE BACH:** Thanks, Mindy.

Why don't I talk just briefly about the keynote last night. Some of you I'm sure were there. Some of you probably weren't able to make it. Some of you got lost in the darkness as you were walking through the Hilton.

It was actually a very good event for us. Steve started off by talking and showing the diversity of PCs and ecosystems. If you haven't had a chance, walk through our booth, and just look at what's coming in the PC marketplace. And it's not just numbers of machines per se, although 1,400 is an impressive number, it's different styles, different models, different capabilities, everything from very high end -- leave aside enterprise and server machines, those are also there as well -- but let's just talk about high end desktop machines for gaming all the way down to some new tablet PCs that Steve showed last night, with great range, great innovation, and very cool designs. We think that market, as Mindy said, is very, very vibrant.

Steve also spent a fair amount of time talking about television and video delivery. We're at CES, that's pretty much a TV show, and so we wanted to show off all the different ways in which TV and video is delivered to and through Microsoft technologies. And that includes, obviously, Media Center, it includes Zune, it includes the work we do even just on the browser with services like Hulu, and we showed all that last night. We also announced, as Mindy alluded to, Media Room 2.0. With Media Room 1.0, we are in over four million households. However, Media Room 2.0 now takes you beyond just delivering video to a TV, and enables you to deliver and enables AT&T, Deutsche Telekom and others, to deliver video services to the PC as well as to mobile phones. It also creates a more open environment for developers to create custom applications. And the idea that video is going

to involve custom application development and custom editions to content is very real, and expanding quite quickly.

So that was the major news in Steve's thing. One other thing I should point out, Mindy mentioned Bing. The deal with HP Worldwide to have Bing and MSN be the default on their PCs is actually quite important to us, and important for that business as it continues to ramp up.

I then came on stage and talked pretty much exclusively about Xbox. There are really three things to highlight. I think the coming year for Xbox is going to be a phenomenal year. I said last night, and I'll say again today, I think it's going to be our biggest year ever. I've said that before, and been right before. I think I'm going to be right again, and it's going to be bigger than it's been in the past.

Three big reasons, a great game lineup, and we only talked about some of the games last night, but we went through five or six major franchises that are going to be exclusive to the platform. A couple of them from Microsoft; Alan Wake is one I would highlight from Microsoft. Obviously Halo: Reach, which is the next generation of the Halo franchise, a big title coming in the holiday of 2010. And then several from third party publishers as well -- Electronic Arts, UbiSoft, Activision, and a few others. So we are very positive about the portfolio of what you would call traditional Xbox games. I'll come back to that in a moment.

The second big reason is that Xbox Live continues to rock. Mindy went through some of the momentum numbers. You are going to see us over the course of 2010, continue to expand not just in the gaming space, but also in the social entertainment space on Xbox Live. The work we've done with Facebook, Twitter, Last.fm, and Zune video are pretty phenomenal, with 10 million people signing into those services since they were launched in November. We feel that's very positive momentum. Mindy talked about the crazy transaction volume. We just see a lot of engagement from people on the service, Netflix, BSkyB, Canal+, et cetera.

We also showed Game Room last night, which is sort of retro for some of you. But if you ever remember seeing or playing Centipede, or Asteroid, or games like that, those are all coming to Xbox Live. Now, for consoles, that's not actually new. People have been doing retro views of old arcade games for a while. The big thing that's different here is it's on Xbox Live, which means you can meet your friends and you can play against your friends. You get access to leaderboards, you get access to all the things that you get on Xbox, and you still get to play those old, fun games. In addition, it's not just on Xbox on the console, it's also on our Live game site for Windows as well. So you can play those games on a PC. Again, same access to all those things you like on your Xbox Live service.

The theme I've been talking to you about for several years now of three screens with a cloud service, you really are starting to see this. Zune moving to multiple devices. Gaming moving to multiple devices. You're going to start to see the world in which the services, the things people are counting on, and the screens there are going to be the more convenient things. You know, when I'm in a certain place, I want a certain screen. And I just want access to my content.

The third reason this is going to be a big year for Xbox we've talked about a little bit before. Project Natal is very much real. We're making a lot of progress on the development front. We've got over 70 percent of the publishers are already working on game titles and all the big companies you'd think about are doing game titles for Project Natal, obviously including Microsoft. We announced last night that we confirmed a fall 2010 delivery for the product.

We're very excited about Holiday 2010 and what we think that could bring. We have not, and did not, and won't today talk about pricing configurations, any of those kinds of things, or specific game titles. But, suffice it to say that there's a lot of game work going on, but we feel like it's on track. We're confident enough to talk about an availability date at CES. So, we feel really good about what that's doing.

We showed a video that shows you how the technology is created. The thing I'd highlight from that video and the reason we showed it is this is not something that's going to be easy for somebody else to follow with. This is deep technology and it's actually quite complicated. It's not just chipsets, it's not just hardware, it's not just a camera. It's got a lot of software involved and we're pretty excited about what we think it means for the future growth of Xbox.

So, that's a summary of the keynote, with Mindy talking about momentum. I'm going to pull a chair over to the center, Mindy can pull hers over to the center. We're going to open it up. We can take questions on E&D. We can certainly take questions on Microsoft. Some of which Mindy and I are qualified to answer, and if we're not we'll tell you so.

**ADAM HOLT, Morgan Stanley:** Hi, it's Adam Holt from Morgan Stanley. Maybe I'll just ask a first question about Natal, which you just referenced. How do you think Natal will impact the late cycle dynamics around the box? What could it potentially do to the lifecycle, and without getting into too much detail on pricing or any of that which you said you're not going to touch on. Would you walk us through maybe some of the potential new business models around areas like social networking?

**ROBBIE BACH:** Why don't I take the first half and then maybe Mindy can talk a little bit about social networking. We think that for a variety of reasons, one of which is Natal, this generation of consoles is going to have a slightly longer lifecycle than the consoles we've had in the past. I'll go through a couple of the reasons, including Natal.

First, and perhaps most importantly, historically five-year lifecycles have been driven by graphics power, and a cycle on chipsets of driving new graphics power. Well, once you get up to 1080p performance, the increment you get from improved graphics has to be quite dramatic for a consumer to actually experience it. So, for Sony and Microsoft at least, there isn't going to be the driving need to up our graphics capability as quickly as perhaps there might have been in the past. Nintendo has a slightly different situation, because they're not at high definition yet. And that may lead to some slightly different dynamics for them. But, certainly for us, graphics isn't driving us to do a lot of new things. That's one thing.

The second thing is consoles have changed. It no longer requires hardware to upgrade and enhance the system. So, if you look at what we did this year with Xbox Live. You look at what we're doing with Project Natal, it's a very different console than when we launched it in 2005. In fact, it's nothing like what we launched in 2005. And we think there's enough headroom for that to continue.

It doesn't mean there won't be future consoles. I think there will be future consoles. That's not my point. My point is, the shape of that curve is going to be a little different. The last point I'll make on this, look at price points. The volume of units sold at price points that are actually above historical standards is quite large. We're 39 million and growing. Nintendo has got a good unit. Sony has got maybe not quite as good units, but still big numbers. You add that all up, the industry is well over 100 million already and price points aren't down to where the bulk of consoles sold last time, which was \$199; the average price point

is still above \$199. So, I think for all those reasons the lifecycle is going to be a little longer.

Mindy, maybe you want to talk about the business model for social networking.

**MINDY MOUNT:** So, first when we talk about business models and Xbox, and most of you are pretty familiar with the business, but one of the beauties of the Xbox and Xbox Live business is the diversity of business model that we have within it. In fact, when we look across E&D it's one of the things that distinguishes the Xbox business, because we've got hardware both in terms of the console, as well as accessories. We've gotten a subscription that we have with Xbox Live. We have advertising revenue. We have the third party licensing revenue. We have the product content and now with things like the Avatar Marketplace, we're selling virtual goods. So, the beauty of that business is the diversity of the business models that we have. Xbox Live is effectively a social networking platform. I mean, that is the beauty of it. And so when we -- the way that we think about social networking, and the way that we're leveraging it into the Xbox Live ecosystem is just that way, and trying to think about the diversity of transactions that you can do. Now, with this Joyride game we've just released, we have premium type games, virtual goods, a lot of the kinds of transactions and the kinds of business models that you're seeing out in the general gaming community today.

**ROBBIE BACH:** Yes, just to expand on that, even in the gaming space beyond social networking. Alan Wake talked about it last night and I think it sort of got lost in the speech a little bit, not Alan Wake, but the point I was trying to make. That's going to be an episodic game. It's a story that will evolve over time. And that creates yet another sort of business model as part of what we're doing.

**MINDY MOUNT:** Exactly, so instead of us selling \$60 for a game, we might sell multiple episodes of however many dollars and at the end of the day, you'd have the opportunity to monetize it that much more by providing a lot more great content for that.

**QUESTION:** So, I apologize a little up front, because clearly there's a lot of great things going on and we saw that last night. But, I want to talk about Windows Mobile, since it falls under your remit, too, and I know you have Barcelona coming up next month, yada, yada, yada. But, the question is --

**ROBBIE BACH:** You already stole my answer.

**QUESTION:** I'm not taking that as an excuse. So, on Windows Mobile, clearly it seems like that is the area that is lagging most right now, in terms of what's happening with the operating system, market share and so on. So, what do you think strategically are the key levers for you to turn that momentum around and can you give us any kind of sense of timing around Windows Mobile 7? Could that be more like a Windows 7 event for you, et cetera.

**ROBBIE BACH:** So, I think the number one thing that we have to do on Windows Mobile going forward is about the experience people had with the phone itself. I don't think we have a business model problem, per se. I don't think we have some specific challenge outside of the fact that our experience is very skewed towards business users, and it's not as modern as it needs to be. And I'll just be as straightforward as that.

So, the challenge for us as we come into 2010 and we are going to have some new things that will talk about at Mobile World Congress, as we come into that, the first bar people

should look at is to say, wow, are they doing a great job with the product. And when you look at the product, I'm sort of like, I have the luxury of having seen it, to be able to look at it and played with it a little bit, but I'm certainly confident people are going to see it as something that's differentiated and something that really does move the bar forward, not in an evolutionary way from where we are today, but it's something that feels, looks, acts and performs completely different.

So, that's the first going I think we have to do. The second thing I'd highlight is our go to market approach has been -- we haven't been as engaged in the go to markets as we need to be going forward, let me just say it that way. Certainly our operator partners will take the majority of the go to market work when they bring a phone to market. OEMs participate in that, as well.

We have not played as big a role in that in the past. And what we're seeing happen, particularly with smart phones, is that whether you're an Apple, or you're actually producing the hardware, or whether you're a Google where you're sometimes sort of producing the hardware, and sometimes not. They're participating more heavily in the go to market that's driving consumer demand. And what that means is more volume for the products that are getting the marketing spent. It's not a crazy idea.

So, that's an additional muscle we have to build. That's why we launched the Windows Phone brand. We've actually had good success without spending a ton of money. Raising awareness on Windows Phones in the U.S., and a couple of European markets where we've actually spent against it. Our goal is to enhance that and pick up that momentum.

So, those would be the two big things. Once you get past those things, then you get the opportunity to do a lot of other things. I think there are services opportunities, I think there are search opportunities. I think there are other opportunities we can build on top of that. But, those are sort of the ante to be a serious competitor and somebody who people can look at and say, wow, I think these guys are going to build a big business here and it may take them a little bit of time, but these guys are serious.

**QUESTION:** So, I won't quote what I think FAM indicated your R&D spend was on Windows Mobile. But when Apple spends \$1.3 billion on all their product line, how does that make you feel about sort of R&D efficiency, and maybe the need to try to find smaller, more efficient teams, that maybe even spending less might drive better product development?

**ROBBIE BACH:** Well, let me talk about the concept, and then Mindy can talk about what we've done in the last 12 months. It's important to look at both of those things. Certainly at a conceptual level, we are very focused on making sure we're effective and efficient in what we do in development. And whether you're talking about Windows Mobile, whether you're talking about Xbox, whether you talk about our mice and keyboard business, or Zune, or whatever, I think we do a very good job at keeping the teams small and bringing things to market quickly and effectively.

Having said that, you know, in the last 12 months you've certainly seen our P&L improvement. Some of that has come from being smarter about things in marketing and other parts of the organization. But certainly some of it comes from development.

Mindy, do you want to comment a little bit about what we've done in this segment?

**MINDY MOUNT:** Well, in the last year, it's been much of the same messaging you've heard from across Microsoft. I think we, as a company, have been taking a much harder

look at what we're spending on operating expenses, and in E&D, we're also continuing the strong work that we have been doing on COGS.

Last year, from a COGS perspective, what was a problem in the world actually created tremendous opportunity for us, in particular in some markets like memory, and things like that, we were able to take advantage of some of the disruptions in the marketplace. And we're very aggressive in doing that. And also helping, to the extent people wanted to lock in volumes, it actually provided tremendous opportunities for us.

We also did a lot of work. Within E&D, we spent a lot of time last year really trying to look through a couple things: one is prioritizing very rigidly, and making sure that we had a clear priority, and that we actually pulled resources from the bottom of the pile, and reallocated. So to the extent, for example, Xbox needed more folks to help with Natal, or driving some of the additional things around Live, we literally took our prioritization stack, pulling out of the bottom of the stack, and reprioritizing to the higher businesses.

We've also spent a lot more time trying to make sure that we are avoiding duplication across not only E&D but also across Microsoft, trying to make sure that we're getting the most efficiency and effectiveness across the company. One of the issues when you have a company as large as Microsoft, you have multiple people doing similar things, and trying to kind of drive that one down. And the net effect of that is when you saw from our operating income perspective is that we had a lot of improvement over the year. In Q1 we were flat with revenue, yet our operating income was up. Part of that is COGS, but a bit part of it is improvement in operating expenses. And that's a discipline that we want to kind of continue through this year.

**ROBBIE BACH:** Yes, and I would tell you, I think that discipline isn't something you turn the switch on overnight. It's something that you take time to go through the entire organization and drive it. We're absolutely in that process.

Mindy and I were laughing coming over here. We're standing in the back talking, and she was saying, you know, the supply chain guys are staying in a different hotel, and their rooms are \$100 cheaper. I wonder how that happened.

**MINDY MOUNT:** And they got free workout facilities.

**ROBBIE BACH:** And they got free workout facilities.

**MINDY MOUNT:** Why are we having our procurement guys get our hotel rooms?

**ROBBIE BACH:** There really is, certainly on the COGS side, I think we are getting to be world class at driving supply chain, procurement, and those types of things. And from an operating perspective, we're probably not 100 percent of the way there, but we've made a lot of progress.

**QUESTION:** A few questions on Xbox, one on Natal. Could you talk a bit about what the demographic target is, and how do you overcome some of the limitations that the Wii had in terms of the the ratio, and the types of games that were applicable to the system?

The second question on episodic content, it's an interesting idea, but arguably Grand Theft Auto, which is one of the biggest franchises out there, had a great product, highly rated, promoted well, it just didn't work, or it didn't work as well as Take Two has said that they

would have liked it to work. So what happened there, and what will overcome that in the future?

And then, finally, any thoughts on how tablet computing will impact the gaming business?

**ROBBIE BACH:** Okay. You'll have to help me keep honest.

**MINDY MOUNT:** Keep track, yes.

**ROBBIE BACH:** The first question was on Project Natal, and was about --

**MINDY MOUNT:** Tie ratios.

**ROBBIE BACH:** Demographics and tie ratios, thank you. Demographics on Natal, you might look and say, oh, gosh, this is something that's designed just for casual gamers. And it certainly is designed for people who might ordinarily not think of themselves as gamers. But I will tell you that I think it's going to be the product that appeals to consumers.

Now, where we have certain demographics, we've pushed a little harder with certain games, of course. The marketing has to be very targeted. But on a product concept level, take your hardest core gamer, they're going to love Natal. Now, they'll play a different style of game on that when they're doing it. When they play Halo: Reach, they might be back with their controller doing some very targeted things. But the style of game they will play will be different. But they will absolutely love Natal.

And then I think there are people who traditionally don't think of themselves as gamers. I might look at my counterpart here, Mindy, who will say, gosh, now I can do things and have fun with things that are completely different. So, I think it does expand the pie, not shift the pie for us. And I think that's a very important concept.

Your question about tie ratios. Nintendo's issues with tie ratios don't have anything to do with their controller. It doesn't have anything to do with the fact that they are a more casual gaming company. The tie ratio challenge there is that Nintendo has a different business model than Sony and Microsoft do. Their business model is about first party success. It's about Nintendo IP being successful on Nintendo hardware. And it's a good model. There's nothing wrong with the model. It's just different. And so they have lower tie ratios, because they're driving content mostly themselves. They're not trying to drive broad third party content. They get some of it, but they're not really trying to drive it. And so their first party titles do very, very well. That's a highly profitable business.

And you don't need big tie ratios if you get successful full party IP at the level that they have. And this is not a new phenomenon. Game Cube was the same way, and consoles before that were exactly the same way. So, I think people try to ascribe it somehow to what they've done with the controller, or the approach they've taken, but to us that part has not surprised us one bit. It's the genetics of the way the company works, it's the way the business model operates, et cetera. And I think it's just natural. So we don't see that as being a big issue.

Remember also that Natal works on every 360 that's been sold. So tie ratio is an interesting question. How do you think about tie ratio? Some of those consoles already have tie ratios of 7, 8, 9, 10, and they're going to add a Natal title to that, and then there will be some new consoles that will start from zero and build up. So, I think you won't ever

hear us quote a tie ratio from Natal because it builds into and on top of the entire install base.

And then your third question, quickly, was?

**QUESTION:** (Off mike.)

**ROBBIE BACH:** Okay. Mindy, why don't you talk about episodic, or do you want me to talk about it?

**MINDY MOUNT:** Yes. Why don't you talk about it?

**ROBBIE BACH:** So episodic to me, look, our belief is that episodic has been very successful for us. When we look at add-on packs, which is the simplest, most basic form of episodic, it has been very successful for us, and it's been successful for our third party publishers.

So does that mean 100 percent of the add-on packs are 100 percent the same success? The answer is no. I didn't track, frankly, the add-on pack for Grand Theft Auto and how successful it was, and how that tie ratio compared to other people's add-on tie ratio. But, overall, when we look at the business, that's been a good business for us. It's been a very good business for our publishers, because it doesn't require the release of a whole new set of technology and a whole new product.

Now Alan Wake takes us one step further and says, no, the product is going to be designed for continuous episodic work. And the secret to that success is, the core story has to be good, and people have to like the core story. You're totally right that if people don't like the core story, the idea that you're going to sell it episodically, that's just not going to work.

Final point on tablets. For us, part of what we were trying to show last night, as I said earlier, was breadth of the PC ecosystem. Tablets are just expanding that PC ecosystem. All three of those tablets you saw last night are running Windows 7, and running it very successfully. They're going to be great products. We started with desktops and laptops, but we added notebooks, then we added netbooks, now we're adding tablets at the high end you add All-in-Ones, then you add game machines. That market continues to expand because there's more innovation, more choice, more utilization of the PC in different environments. I think the tablet phenomenon is an opportunity. We'll see. There haven't been very many of these new devices sold, so you don't really know, but certainly the promise from a browsing, from a reading, from a media engagement perspective, and watching movies, and things like that, seems like a good concept, and seems like the PC will be very value-added.

**QUESTION:** Thank you very much. Going back to Windows Mobile for a moment, in comparing actually the Xbox world to the smart phone world, right now there are three major platforms out there. You're one of them, and at various times in the past there have been four, generally not many more than that, but somewhere between three and five. As you look at the smart phone world, clearly iPhone seems to be well established. Android appears to be establishing itself right now. And then you have Blackberries is sort of there. We're not quite sure where they stand. Windows Mobile is vying to get in there. How many platforms do you think the smart phone world, after the whole shake out happens in a year or two years, how many can adequately be supported, and do you see similarities between those two worlds, maybe you can port it back and forth. And how can you ensure that you'd be one of the final survivors in it?

**ROBBIE BACH:** Well, it's not -- the analogy is not quite right, because the way the business model works in the two cases is actually very fundamentally different. By definition, most consoles tend to be a managed environment where you have a much more vertical structure in the ecosystem. Microsoft, Sony, and Nintendo all have their own first party publishing capabilities. We've introduced hardware and software service. So, it's much more closer actually to Apple, if you want to think about it that way.

In general, in the mobile space, you have operators and OEMs who have a big say and impact in what goes on in the marketplace. But, I think it is a little bit different. With that said, I think everybody would say, there are too many operating systems in the mobile world today. I'm not talking about the smart phone world necessarily, but if you just look across the million, two million, or billion, two billion, feature phones sold today, I don't think there's an operator in the world that wouldn't tell you that it's a pain to support all the different operating systems they have, in particular the 17 versions of Linux they have on feature phones, all of which are a little quirky and a little different, require separate network certifications, network product support, and the like that goes along with that.

So, I think there will be inevitably some trimming of that tree. I think that's certainly true. In the smart phone case, I think you're going to see two types of things developed. One, I think you'll see some people put Apple in this category who will say, hey, I'm going to do operating system, phone, et cetera, all myself. So you can decide to categorize that by OS, you can also categorize that by hardware and be the same categorization.

There will be other people like us, perhaps Android. They can be some place in-between right now who will say. No, actually, we're working with a lot of different hardware manufacturers. So, there will be a hardware market share number that will be a blend of different operating systems for each hardware vendor. And then there will be an operating system share.

You know, overall, you look at markets like this, we think over the next three to five years it's going to be 400 or 500 million smart phones sold a year. I think there's a lot of room. It's going to quality in term and not capacity. I think some of the current systems will fall away. I don't think that will be because there's not room for another operating system. I think it's because their quality bar won't stack up. And they won't get the scale that they need. And our job is to make sure we get that scale. So, I won't speculate on the number of operating systems you can see. I certainly think in the feature phone space you'll see some pruning of the Linux tree, and I don't think that's really sustainable.

I think you'll see some guys who are doing end-to-end things, who obviously control their own destiny and will either be successful or not. And then you'll see some folks like us who are supporting multiple hardware manufacturers. I certainly think we're going to be in that list of companies that are successful and then maybe there will be a few others.

**QUESTION:** (Off mike.)

**ROBBIE BACH:** That is -- that's beyond a forward-looking statement, don't you think, Zon?

**ZON ELLIS:** A little bit.

**ROBBIE BACH:** We're very focused and confident in the work we're doing right now and while I don't think, if you looked across the past two years and what we've brought to

market, we've executed as well as we would like. I think the market data would bear that out. I'm quite optimistic with the new team we have. I'm quite optimistic with the new work we're doing, and I'll gladly drive for that two-year period and meet you on the other side and feel comfortable we're going to be in the right place.

**JOHN DIFUCCI:** Hi, Robbie. John DiFucci from JP Morgan. I'm sorry to keep going back to mobile and that scenario that you've struggled with, but everything else seems to be going so well.

**ROBBIE BACH:** I've been waiting for you guys who want to talk about the good stuff for five years.

**JOHN DIFUCCI:** I have a question on mobile. Last night Steve used the term PC pretty loosely, more loosely than I've heard him use it before in describing a lot of different devices, at least maybe I wasn't listening before, but it seemed to me anyway, he used it pretty loosely. When I look at your vision of three screens and a cloud, that one screen seems to be the most dynamic when you think about cell phones, PDAs, Blackberries, iPhones, people are talking about tablet. Is that coming down from PC or coming up from there. When I look at all that and I think about your struggles in mobile, and I sort of wonder how is all that driving your strategy in mobile and how does Zune play into all this, because you've gotten a lot of critical acclaim with Zune, but your adoption probably has been somewhat disappointing. I know that's a broad question, but if you can address that?

**ROBBIE BACH:** It's actually two questions in one, so let me separate out the questions. Certainly, in terms of the way we think about the segmentation in that marketplace, I think of devices that you put in your pocket and talk on, and I think of devices that you might carry with you as a different class of devices.

I think of devices that you're going to want to do, where the user experience has enough real estate, where you can have a rich experience with what I'll call a Windows 7 class UI as one type of device. The smaller devices can have a great UI and be very interactive. But, it's going to be a different form factor and a different UI.

So, broadly, when we say three screens, we're saying small portable screen, that mid-sized screen, and then there's the big TV screen. Now, the truth is, those are all going to blend at some level and, in fact, when I say three screens and a cloud I could just as easily be saying many screens and a cloud, because you have more than one PC screen in your household. You have more than one TV screen in your household. And actually in our household we have five mobile phones. So, it's actually a many-screen strategy.

Over time the distinction between the screens from the user's perspective, when am I on my phone versus when am I on my PC, that's going to blur a little bit. The service delivery is going to be critical, that's why our cloud applets are so important. That's why I keep talking about cloud delivery, what we're doing with Windows Live, what we're doing with Xbox Live, why Azure is so important to us, because it really will enable us to reach all of those different screens.

Now, your other question was about -- I'm getting old. Zune, so Zune has been critically successful. And the way Zune is going to be successful for us in the future is you should think of that as our media service across multiple screens. We'll continue to have the Zune device screen. But, we now have Zune on Xbox. We have Zune on the PC. There are other places where Zune logically could go that we don't get to talk about yet. And I think lots of different screens with that capability can go.

So, the reason I'm excited about the critical success. Do I wish we were selling a few more Zunes? Of course, we always like to sell more. The product is doing fine. But, the reason I love the critical success is because we have a great design. We have a great concept. Now, I've got to help build the brand. I've got to move it to get more leverage out on the screen, and as we do that I think we can really take that to a higher level.

The last thing I'll say about Zune, you have to decide how you think about Zune. Is Zune a business of a capability? In large part, Zune is about delivering video and music. Video and music has business aspects for us, but the process of being a music distributor is not a fabulous P&L business. The P&L business is based on selling more phones and more Xboxes, and more PCs, and all those kinds of things.

So, that's kind of the way, to give you sort of a general way of thinking about Zune and where we're going. That was sort of a general answer to kind of a general question, but hopefully it gives you a little bit of the direction.

**QUESTION:** (Off mike.)

**ROBBIE BACH:** That will fall into the category of things that Zon will get very upset at me at. So, I won't speculate on that. We need to move over to the other side of the room at some point.

**QUESTION:** Thank you. A little bit about the publishing and software market. It clearly has not been a healthy cycle for you third party partners, if you look at their stock prices, maybe talk about the challenges last year, and that that can turn this year. And then piracy seems to be a bigger issue, certainly on a PC, but we're also getting some Xbox numbers, what you're doing to fight that, and then maybe if you could talk about what you're doing to get third party support, and what the business model might be like for you and for them on that.

**ROBBIE BACH:** So, on how many on the prior year, I would say this. I think it's a tale of a little bit of two cities. I think there is a city of people who had big franchises who actually did pretty well. But the problem you have in a down economy was people bought fewer games, and they focused on the key franchises. And so the breadth of the portfolio didn't actually come into play. So now, for people like Activision and EA, they have enough core franchises, enough big core franchises that while maybe they didn't have 100 percent of the success they would have liked, they're still able to carry their business. And Call of Duty: Modern Warfare makes up for a lot of shortcomings in other places as an example.

If you're a midsize publisher, it's a little tougher because you may not have as many of those big franchises, and so the last year made that market it a little bit more difficult. For us, going forward, this is a place where we think Natal can act as sort of a mid-life kicker for everybody. It's an opportunity for people to get engaged on something that's exiting, something that's bringing consumers back into stores, something where they can create something differentiated. For those who maybe didn't get into the 360 cycle as fast as they should have, it's an opportunity to get in on the ground floor, and the guys who have gotten in on the ground floor have generally done better. So, in a way, it creates a new opportunity to do what you said.

Piracy, our answer is simply the following: Obviously we don't like it. We spend a lot of energy and time on it. It is a technical game within the game, because it's basically a continuous effort on our part, continue to make it difficult to pirate games on our platform,

and to continue, on the part of the pirate, to figure out ways to do that. And we make regular changes in our products, both hardware and software, to manage that issue, and keep it as controlled as we possibly can. I actually think this generation, I would have given us not a great grade in the first generation of Xbox because our hardware was so off the shelf that it was difficult for us to be heavily protected there. Because we have custom hardware on 360, we've done a much, much better job this generation. And overall I would give us a pretty good grade on that front. There are still places where there are challenges, I'm aware, but I think we continue to make progress, and we've got some of our best technical people actually having to work on that issue, because it's actually quite a hard -- it is a technical problem. There's a bunch of legal issues, and enforcement things you can go through, too, and we do that. But the core, and best defense is to stay ahead of people with better technology, and that's what we're trying to do.

**QUESTION:** (Off mike.)

**ROBBIE BACH:** Well, exclusives, you saw the results last night. I talked about some big exclusives from Electronic Arts, from Activision, from UbiSoft, three of our largest partners, and there will be some others. How do exclusives work? Well, exclusives work because they see a big opportunity on a platform, they've got big volume on our platform. They see us joining with them in marketing to help market and bring their products to market. They see an opportunity on Xbox Live for differentiation and being able to get some additional revenue streams, whether that's advertising or downloads, or whatever it is. That's the business model. And I think we'll continue to see them.

Do I think that's going to be -- well, and then you go to Natal. Anything anybody does for Natal is, by definition, an exclusive. That to me is a pretty exciting concept.

**QUESTION:** (Off mike.)

**ROBBIE BACH:** The question is about how Natal is going to be delivered, and I'll just cover that very quickly, because there's only so much I can talk about. First of all, it will work on every Xbox 360. This will be something that will be easy connect. We aren't talking about -- obviously it will be some hardware, there's a camera associated with it, so there's something you have to buy and take home. We aren't talking about how you buy it. We aren't talking about how it's configured, or how it's priced yet. But that gives you some idea of the basics.

So, in fact, there's certainly an install base opportunity with the product. And I think perhaps obvious, but when you're thinking about it from a business model perspective, there's certainly an install base opportunity almost 39 million Xboxes sold in. We hope some percentage of those will be excited about Natal and want to buy it.

**ZON ELLIS:** We have time for about probably two more questions. I'm afraid we're not going to be able to get to everybody here. Who wants to be one of those two?

**QUESTION:** I've got a three-part question on the Media Room product. (Laughter.)

**ROBBIE BACH:** Come on, Zon, you knew that was going to happen.

**QUESTION:** So, first, can you walk us through what the current business model is, and then also looking into opportunities for that business model to evolve over time, and then finally just sort of what you see coming down the pike that might sort of trigger sort of great adoption levels for that type of product?

**ROBBIE BACH:** Why don't I take the second part? Mindy, maybe you want to talk about business models.

**MINDY MOUNT:** Right. So the current model that we have is a very traditional client-server model that we sell them, we sell the servers. It uses our Microsoft server products. And the client it goes in, and they pay --

**ROBBIE BACH:** For just the dollar amounts, but it's a client-server.

**MINDY MOUNT:** Exactly, it's a basic client-server business.

**ROBBIE BACH:** And there are services associated with it.

**MINDY MOUNT:** And some services, yes, on a maintenance basis.

**ROBBIE BACH:** If you're trying to model it, you think of it from a Microsoft business model perspective, it's closer to SQL Server. Think about how our server products get licensed, that's the basic concept. In terms of where it's going, I think there are a couple of things that are happening. First of all, this is a market that I think we were there early, we're clearly the leader. The market is advancing and developing in a good way, which we're excited about. When you think about what's going to spur it forward, certainly the continued expansion of high-speed broadband networks is going to help a lot, and that is continuing to grow. That's been a little bit of a governor on growth historically, but that's going to change. And so we're optimistic about that.

The second thing is, Media Room 2.0 actually enables us to deliver video services over more traditional DSL lines beyond enhanced pipes that some of the operators have put in. So that creates another business opportunity for us that is slightly less constrained by bandwidth than the existing business. So, I think those two things are going to drive things.

And then the third thing, I hate to come back to this, but it's just real, while we think of music and video and gaming as three screens and a cloud businesses, Media Room is just a three screen and a cloud business. It just happens in this case we're providing the cloud to the operator, and they're running the cloud. In the case of Xbox Live, we run the cloud. In both cases, Media Room 2.0, we announced it last night, mobile phones, PCs, TVs. That should be a theme. So it's just a different business model, a different go to market model, but the basic concepts of what we're trying to deliver to the consumer is exactly the same.

Zon, do we have time for one more question?

**ZON ELLIS:** We do. And if it's fast, we might have time for two.

**ROBBIE BACH:** Okay.

**QUESTION:** Just a question on how you're thinking about these casual games that are showing up on the iPod Touch, and showing up on Facebook, and how you're going to participate in that, and what kind of a threat or opportunity that is?

**ROBBIE BACH:** We think that there are in the gaming and social entertainment space a lot of growing opportunities. Let me just say that. I think there are opportunities for us, for publishers, for new companies. I think that's a market that is still in some degree still in its

infancy. On the other hand, there are a lot of people farming on Facebook. And we look at that and see that as another form of entertainment. You can think of all the things that we provide, and think how that logically could fit in, and we'll see where that takes us.

**ZON ELLIS:** Okay, we do have time for one question or so. We started with Adam, we'll end with Adam.

**ADAM HOLT:** I have some questions about Xbox Live, but I'll condense them into two questions, I guess. It looks like you're at about 25 percent penetration of your total box base with paid Xbox Live usage. Where do you think that can go over time? The first question.

And then, secondly, if I remember correctly, you said you have a billion dollar stream of revenue for Xbox Live, half of which is transactional. What are some of the metrics around individual sort of same story stales on transactional revenue, and where do you think that can go over time?

**ROBBIE BACH:** So, I will decline to go through some of the specifics, just because I don't -- I'm certainly not on record on some of the specifics, maybe somebody else can put a number, but it's not me.

**MINDY MOUNT:** I don't think we are.

**ROBBIE BACH:** It's not me. So, I'll stay away from that.

The one thing I will say about Xbox Live, while certainly subscription is an important part of the business model, we don't think about it as just a subscription business. This will be hard for you to model. Mindy's team gets the challenge of modeling this for us, and it's not trivial. But because advertising continues to grow in that space, because transaction volumes, whether it's music, video, clothing, add-on game sales continues to grow. Live itself has its own rich business model that you have to kind of dissect. And so talking about specifics, and talking through the subscription thing wouldn't tell you anywhere close to the whole picture. And as hard as it is, particularly because we don't break things down very far, really trying to understand that Live part of what we're doing I think is an important thing for you to think about, because it's complicated, but it's very diversified, which is exciting for us.

I want to thank you guys for finding the Galileo Room, that was not easy. I appreciate your attention to the time. I guess the next time we see you is Financial Analyst Meeting, maybe.

**MINDY MOUNT:** Yes, exactly. We'll have some Analyst Blog days I think we've got on in March.

**ROBBIE BACH:** Anyway, thank you for coming.

END