From:	Tim Stuart </O=EXCHANGELABS/OU=EXCHANGE ADMINISTRATIVE GROUP (FYDIBOHF23SPDLT)/CN=RECIPIENTS/CN=MICROSOFT.ONMICROSOFT.COM-55760-TIM STUART>
To:	Phil Spencer
Sent:	12/4/2020 6:39:25 PM
Subject:	RE: Xbox console volume

Good mail. Sounds like there is a yield discussion at SLT, but that doesn't solve all of the gap – it's more of noise in the system vs a true need to invest more earlier. I edited a few numbers in your mail below.

2nd bullet below, Amy did ask that we don't invest above the AM budget until we hit +10%, meaning we should strive to exceed plan until the +10% target then invest additional from there. It will get a little washed as we move throughout the year, but might be good to acknowledge the ask.

4th bullet – might be good to highlight that we know we will likely be behind Switch and PS5 in the holiday volume due to supply, in addition to the comp vs Xbox 360

The xcloud investment of $500M feels high. We will spend about $100M in capacity and another $100M in OPEX. You could round up and say big pieces of our content spend go there to get to something bigger like $500M, but that is a big round up.

I would not highlight a $700M gap in AM target (yet). You could lower it to something like ~$500M, but there are still big areas we an push back on to solve some of the gaps and we don't need Amy to engage here yet on target planning, especially with the Zeni ask of $300M. Two years in a row not hitting +10% AM growth could just be giving them something to hit back with when that really isn't the point of your mail.

From: Phil Spencer <philsp@microsoft.com>
Sent: Friday, December 4, 2020 10:14 AM
To: Tim Stuart <timstu@microsoft.com>
Subject: Xbox console volume

EXHIBIT
PX1145
10/11/22 CB

Give this a read. Please fix any numbers.

I know there are a lot of discussions about Xbox console supply right now and I wanted to provide my pov on how we got here, our plan forward and more of a meta-commentary on our strategy. I want to start by saying this is not an ask for P&L relief, it's not complaining about constraints, this is meant to ensure we have a shared perspective.

Some useful data points in Gaming:

- Our FY21 Gaming P&L has a $1.5B hardware subsidy with the $499 and $299 price points on our consoles, that's our largest hardware subsidy ever in the Gaming P&L.
- Our FY21 budget for AM is about $930M which does not meet the traditional 10% AM YoY growth that we'd be running Gaming under for the past 5 years. This was an agreement going into the FY and shows MS investing more than our mean in Gaming in FY21. We appreciate the investment and are on target to exceed this budget.
- Gaming will have it's largest revenue year ever in FY21 reaching $12B in revenue and Q2 FY21 will be our largest revenue quarter in Gaming's history.
- We had our largest launch day for Xbox console with Scarlett but will fall behind Xbox 360 in the quarter due to supply.
- Somewhat random anecdote but we are also selling 20x the weekly runrate of Xbox One S right now and will be sell out permanently this month leaving us with Xbox Series S and Series X as our two consoles in market. There is real console demand but we still see the global console TAM as 200M units/generation, so we do not anticipate console TAM growing.

So when the question comes up about “why don’t we have more Xbox consoles right now” there are many factors but I think we aren’t really focusing on the right issue if we are focusing on the yield miss for Scarlett or the Halo launch date miss (both are execution issues, not ducking those, they are just not the main factors in our console scarcity).

I believe we could be selling 2-3x the number of console we are going to sell this quarter if we had the inventory. And if we did that our hardware subsidy on the P&L would also grow to 2-3x the number we have now. I believe could have sold 10M console this year and more next year with supply. Sony has done 15M+/year in some years and I believe we could get close with our product lineup, price points and game lineup coming. But I also do not think this is the right thing for our long term strategy given our investment.

Gaming makes sense for MS, imo, as the focus on consumer. It’s a $200B TAM with 3B people playing and both of these numbers are growing by 10%+/year. I can see no other clear consumer category with this TAM where Microsoft has the product truth today and customer demand that we have in Gaming and where the disruption that is happening in the business plays to some of Microsoft’s long term strengths (cloud and subs).

On the capital allocation that we are making in Gaming, I believe our investments in content and xcloud are critical to realizing our potential in Gaming. Amazon Luna and Google Stadia do not have the console strength we have giving us developer engagement, gaming community and catalog of content. But they also do not have the console subsidy on their gaming P&L that we have which could be an enabler for them. And other the other side we have Sony with PS5 and a very analogous hardware subsidy. Sony’s Gaming P&L runs at lower GM and AM % margins than our Gaming business even though they have 2x the console IB.

Bringing this back to our console volume now and for the next year. We are trying to thread a needle of investing in a disruptive future which requires real capital allocation ($500M in xCloud this year, $1B in games) while also competing with Sony. Yes, TSMC/AMD yield on our 7nm die is costing us about 20% of our console volume we planned for in our launch quarter (Sony has similar yield issues). We could add 20% to our Q2FY21 console volume and we’d still feel considerable constraint.

As a team we are starting to work through our FY22 plan. Right now we have 9.6M consoles in our FY22 plan, 31M Xbox Game Pass sub ending balance and 22.5M game streaming entitlements. We will be investing in our V3 blades for xCloud and see concurrency in xCloud as android, iOS, PC and Xbox One will be streaming clients. Early numbers in our planning, we see $14.5B in revenue but we also have a $700M AM gap to our growth commitment for FY22 which we will work. We will land an FY22 plan that meets our AM commitments, this isn’t an ask for relief. One area we will likely constrain, again, is console volume. Just like we could likely sell 2-3x the consoles we are selling now with supply I think we could sell 12M+ consoles next year with supply but with considerable subsidy. The LTV for these units is positive but the FY P&L his is sizeable. I realize that what I’m typing is almost the exact definition of the innovators dilemma.

From a strategy perspective I believe in our tradeoffs for Cloud and Content in Gaming over console volume. I would obviously love to invest in all unconstrained but I completely support the tradeoffs we are making. With hardware timelines we can’t be as agile on supply when our revenue or AM targets exceed budgets as we are seeing in FY21 (even without Halo). We are making Q2 and Q3 decisions to airfreight consoles this FY which will pull some volume forward given how our P&L is tracking but this is more of a timing fix than a volume fix. We need to plan our FY22 hardware volumes now. With our strategy and opportunity console volume will still be the thing we constrain to grow our long term ambition.

So while we talk about yield as our issue with Xbox Series S|X today, there is some small truth to that but in reality if our yield was on plan right now we’d feel the same constraints and customer sentiment. We could sell more consoles this year and next year, there is demand.

I’m happy to go deeper on the P&L investments if there is a desire. I realize there are a ton of decisions on spend, C19 impact on gaming release dates, XGP content investments etc. I believe in the tradeoffs we are making for our long term goals but there are near a mid-terms consumer engagement and console unit volume tradeoffs. I just wanted to ensure we were all aligned.

Phil