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Microsoft Memo

To: Billig, Russw, Stevob, Jeremybu
From: Joachim Kempin *Joachim*
Date: August 15, 1989
Subject: OEMs and Windows 3.0
Cc: Richardf, Rorh, Bobo

This is a response to Bill's challenging May 18, 1989 memo, where he discusses our OS strategy. One of the key statements made was: "Per system money from the OEM channel is the only way to make a lot of money."

In our history we have only sold one product in this fashion: MS-DOS. It has indeed made us a lot of money and will continue to do so. Can we repeat this with a similar success with the appearance of WIN 3.0?

Let me first examine the differences between MS-DOS and MS-WIN sales and distribution:

A) MS-DOS got helped by early design wins to all manufacturers. In particular IBM. This goes back to the early 1980's. Most of these early design wins were done on a low flat fee basis and later on painfully converted to royalty agreements. This was possible because of the ISV and IBM momentum behind the DOS platform and its corporate acceptance of being the dominant PC OS standard. Even competitors like DRI could not reverse that and most of their damage has been done in keeping price pressure up with "no name" OEMs. But all OEMs selling PCs today have experienced the demand for MS-DOS as a standard deliverable. For the non-per system OEMs we therefore developed in 1986 an alternative solution of buying per copy FG-DOS from us. This is sold only to HW manufacturers or their distributors. Even if a grey market exists at least legitimate copies are being distributed—and at the same time we continue to reinforce our distribution policy. Allowing Phoenix to be an alternative source for this product has more than doubled our penetration in the U.S. with comparable profit margins. International is still on the 1986 sole source distribution plan—time to reconsider?

The ultimate goal of OEM Sales is to convert all per copy FG-DOS customers into per system licenses and increase our share of system SW by adding WIN, OS/2, LAN MAN, etc. to an initial DOS license. This has worked well in the U.S. and in International over the years. Key issues:

1. Constant price erosion of HW systems, resulting in demand for lower DOS royalties as % of COGS. As described in Bill's memo—we will have to deal with it case by case until we can develop a workable formula. % of COGS could be a workable one and could be better than E/U price. The creation of 8086 DOS, maybe a low end 286 DOS and ROM-DOS could be other tactics. But all of these different products will take away from the one-standard strength of MS-DOS. Markiche and myself figured out that by end of next year we could have as many as 7-12 DOS versions in the market. Could this create openings for competitors? It sure won't make it easier for customers! Somebody in Systems Marketing needs to take a hard look at this.

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Next you will find how much the prices "have deteriorated" in the U.S. between FY87 and FY90 (Do not have precise shipment info for International)

	Q3 + Q4	all	all
	<u>FY87</u>	<u>FY88</u>	<u>FY89</u>
DOS REVENUES (MS)	14.0	43.6	54.2
SYSTEMS SHIPPED (k units)	937	2808	3274
AVERAGE PRICE (\$)	14.9	15.5	16.6

Please note that the data tracks only true MS-DOS royalties, no funny combinations (therefore lower units tracked). The surprise is that there is no deterioration so far. Adding the shell \$ will allow us to look even better. A calculation which I did shows that the planned DOS royalties will go up 40 cents per system because of the shell. Nevertheless the threat remains to be serious.

2. Availability of Compaq, IBM and FG-DOS as separately sold products in the channel do confuse OEMs and customers and have given us some grief: "Why do I have to bundle?" So far we have been able to hold the line. And suggestions like: not including GW-Basic manuals, preloading DOS on HD have done two things: kept the COGS down and in generating a bootable system—making it easy for users. We will have to go beyond this in allowing OEM customers to copy and update within their corporations as IBM allows it today. As long as all PCs are sold on a per system DOS basis this will be no issue. With the current flow of boards from FE to locations all over the world, we will need to again address the issue of licensing to board manufacturers at the country of origin. ROM-DOS could be a tool to do this—but I expect that localization issues might prevent us from achieving a high penetration. If I see it correctly this could be the situation in FY90, when it comes to the flow of goods—PCs:

FY 90 PCS IN M Units

	Manufactured	Distributed	Consumed	IBM
USA/Canada	3.3	4.9	4.6	1.2
FE/Icon	6.7	4.2	2.3	.5
Europe	1.5	2.4	4.6	1.2
TOTAL	11.5	11.5	11.5	2.9 = 14.4 (TOTAL)

The flood of board from Asia is our number one enemy in achieving more than 85% penetration. Presence in Taiwan should enable us to get more control over this—over time.

In summary, despite some danger signs, our per system DOS distribution strategy is still working well despite DRI's constant threat, HW-OS price pressures and certain distribution conflicts. We will continue to stay well alert as part of our successful implementation of our binary standard strategy.

- B) The windows situation presents itself very different. Windows is a 1984 brainchild—not to see the market before 86 and clearly being a "dog" until release 2.X arrived more 286 and 386 PCs got more popular and made available in quantities. Only during the last 12 months a huge ISV momentum can be noticed. IBM never made it part of their standard OS offering—despite the fact that they bought several hundred thousand copies WW for promo purposes. Unfortunately

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this is not as widely known as I would like. Our distribution strategy has been to sell WIN retail as well as through OEMs. The core number of OEMs who licensed WIN per system early on has not changed significantly over the years. New OEMs licensed were mainly on a per copy basis and/or as packaged goods agreements. But this is not the only way we "sell" Windows. Being an afterthought to DOS and opening the door to the world of standard graphic OS—competing with the MAC—we license a runtime system to ISVs for free with the hope and understanding that users will go out and buy the full WIN environment after they get used to its "runtime ease of use." Both the availability of runtime versions of Windows and the MS shelf product are a hindrance in convincing more OEMs to take on the product on a per system basis. This goes hand in hand with their desire to cut COGS. WIN royalties, its two different versions and its high manufacturing costs make it increasingly hard to find new per system OEMs. IBM and Compaq not carrying it is another motive for saying "no." In order to generate more OEM revenue-per system deals, I recommend we discuss the following ideas:

As I understand the release of WIN 3.0, available at the end of CY 89, will be a superior product and create exciting APPS-ISV momentum. This core product will be merged with DOS 4X and made the standard OS/1 (?) IBM is going to offer—say in Q3 of FY90. This product will be a product sold for 286 and 386 PCs as one SKU which will contain a "WIN disabling technique" for 8086/88 PCs. At the same time an improved DOS 4.x shell will be part of the product—to facilitate the low end users.

Will this strategy make us more money—not taking IBM or OS/2 into account? While it removes the endorsement doubt and creates a new binary standard for graphical DOS APPS, it will add royalties and manufacturing COGS to OEM systems. OEMs will ask: Can this new OS/1 move more boxes, e.g. gain market share versus MAC—or will they grind their teeth and say: "Because of IBM, we will have to offer it." With the exception of some very few true believers (people who believe this will be the cause for more PCs on every desk!) the latter will be true. Because of Compaq's leadership position, we will have to gain their support to be successful and I am convinced the market will follow a bit slowly because of the costs. Puette (HP) just told me that if IBM does it he would follow! Opposite to MS-DOS' original licensing tactics—we plan to license at high royalty rates and not at low flat fee rates. Charging approximately \$250 RRP for the combined retail package are to be expected at least. I believe this will create an opening for competitors on the low end systems for FG-DOS as well as for royalty sales:

There are still a lot of non-GUI believers out there (thanks to LOTUS and MIS people attitudes) and there are a lot of very cost sensitive smaller OEMs and/or low margins OEMs out there. I strongly believe that we will need a 4.x based 8086 DOS offering (the new shell is most welcome) for royalty and FG-DOS Sales. If we go straight to OS/1 for 286, 386SX, 386 and 486 systems we might in addition experience a lot of resistance from low end 286 and 386SX manufacturers to license the full blown OS/1 and bundle it with these machines. OEMs will not make a positive decision based on religion but on user demand. If the low end 286 and 386SX user buys mainly cheap (?) nongraphical APPS they will not burden their systems with GUI-WIN costs. Even good salesmanship and high UPBs might not successfully influence this. I expect 3M units of 8086 and probably 3M units of low end 286 as well as 3-5M units of 386SX sold in '91. This is dangerous. The way out could be to pick a selected number of OEMs out of the first 20 shippers in the world and offer them a marketing proposal whereby these WIN royalty increase with their growth rate. I could see two working models:

- 1 Low royalties, say \$2/per system any 1% of growth adding \$.50. Meaning a company growing at 20% pays \$12 system. To sell this we might work this in reverse, \$20 per system and 40 cents off for every 1% of growth.
- 2 A 500k flat fee for the first year and regular royalties thereafter with an option to gain growth points.

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Both models could be used to lure in new OEMs and to make them feel we care about their success and their COGS.

During the transition time from DOS and separate WIN 3.0 to OS/1 we will have to cease retail distribution of stand alone WIN 3.0 completely. I recommend to work towards a RUP product to upgrade DOS customers to OS/1 (valid DOS necessary) as well as to upgrade current WIN/DOS users. But we will not sell pure OS/1 into the retail channel. This will get OEMs thinking towards offering OS/1 per system—another reason why I like a first year flat fee solution for the WIN component. The faster we can convert them, the more money we will make in the long run.

Another remaining issue we need to understand is how to defocus from DOS only licensing. Most OEMs have 2-3 year contracts, are we going to tell them they can't extend them and have to license OS/1—no more DOS 4.X licenses available? (Exception on the low end!) This might get us into a situation like we have today. Our feedback indicates that a lot of larger corporations are resisting the move to DOS 4.X and demand DOS 3.X. If this happens, we will get into deep trouble with licensing OS/1 only. Cost sensitive customers will only use the DOS position of the product and will give OEMs a hard time regarding the higher prices for a not fully used product. In allowing large corporations to copy OS/1 if the OEM has a per system license could confuse the issue to our benefit—reducing OEM COGS and securing full royalties for us.

To summarize:

- Get Compaq to license OS/1, and WIN 3.0 early, without pushing too hard or giving it away..
- Study if different WIN 3.0 pricing can add new licensees.
- Offer a 8086 version of DOS when OS/1 comes along.
- Study the possibility of offering low end 286 and 386 OS/1 pricing.
- Revisit OEM/LA way of physically distributing MS-System SW products.

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