

Microsoft Memo

To: Ted Hannum
Cc: Richard Fade
From: Peter Braman
Date: 4/24/91
Re: Compaq Prepaid OS/2 Problem

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Ted,

Compaq is asking for additional relief on OS/2 prepaid dollars. The issue is that there is still \$867,000 in OS/2 bad prepaids. Although we have given Compaq a DOS cap against OS/2 prepaids for the last 4 quarters, they are asking for additional relief.

Clearly the last time we negotiated the cap with Compaq that was the final time. However, Compaq did not expect or anticipate lower OS/2 sales nor did we expect a change in IBM's OS/2 pricing. Nor did Compaq expect it's new pricing policy, which will have a huge effect on margin in FY 91 Q3 and Q4.

If Compaq had met their expected forecast of 4,000 copies of OS/2 per quarter at the \$100 per copy royalty rate, the prepaids would have been used up in FY91 Q4. However, their royalty numbers have dropped from actuals of 4,737 in FY91 Q1 and 3,328 in FY91 Q2 to estimated numbers of 1,500 for FY91 Q3 and each subsequent quarter. At this run rate, at our current \$100 royalty, it will take 6 quarters to burn off the remaining UPBs. At our new \$40 royalty, at the current run rate, it will take 10 quarters to burn off the UPBs. I don't believe you will see Compaq's OS/2 royalties increasing much with a drop in their OS/2 SRP to \$150.

Their new pricing will have a significant effect on earnings and margins through the end of the calendar year. Their FY91 Q3 earnings came in at \$970 million against \$1 billion in FY91 Q2. Their net profit dropped from \$135 million to \$114 million. Earnings per share dropped from \$1.50 to \$1.26. Their forecasted Q4 margin will drop even further to about \$104 million or \$1.18 a share. Any relief on OS/2 prepaids will have a direct effect on net income and earnings per share in Q4, because the Compaq auditors have already written off these prepaids.

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Compaq has asked for \$500,000 additional relief against their DOS royalties for their Q3 payment due on April 15th. With their combined Q3 and Q4 OS/2 estimated volume of 3,000 units and the \$500,000 additional relief they have asked for, they would be left with \$67,000 in prepaids. Relief of \$500,000 would increase their net income by \$500,000 in FY91 Q4 and improve their earnings per share by one cent.

If we gave Compaq this relief, there would not be any impact on forecasted FY91 Compaq revenue. Because their DOS royalty numbers for Q3 will come in as expected and the BallPoint Promotion will have much larger effect than forecasted, the Q4 numbers will be larger than last forecasted.

I have confirmed that Compaq shipped at least 235,000 systems in Q3, which brings their DOS revenue in at \$3.9 million. The BallPoint promotion will add a total of \$2.5 million, based on Compaq taking 50,000 BallPoints thru June against my original forecast of 30,000. (This is conservative. We will invoice Compaq 30,000 units in April alone.) I expect that Compaq will take between 60,000 and 70,000 Ballpoints before the end of Q4. The result is that if we give Compaq this additional \$500,000, our revenue will still come in at \$6 million or 113% over the \$5.3 million forecast and it could be as high as \$7 million.

Current FY91 Q4 Forecast	FY91 Q4 Forecast with \$500k relief
\$5,300,000	\$6,045,000 - 50,000 BallPoints
	\$7,065,000 - 70,000 BallPoints

I feel that we should give Compaq this additional relief for the following reasons:

1. Our new OS/2 pricing will stretch out their prepaid problem for an additional 10 quarters. Compaq will continue to ask for relief. I think it is better to make a clean break now when there is a small effect on FY91 revenue. We should take the hit when we can afford it and not wait until FY92, where we need to show revenue growth.
2. Using these prepaids as an enticement for a Windows bundle, will not work. Compaq feels this is manipulative. It will create obstacles in our Windows' negotiations rather than help them. Using the prepaids against future Windows sales is the wrong answer to Compaq problems. In addition, I don't think we will have a Windows agreement until the end of this fiscal year.
3. Because of our split with IBM, I feel that it is that much more important to keep the Compaq relationship as solid as possible now. I would not want \$500,000 in prepaids to distract Compaq and Microsoft from either NT or Windows business.

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Compaq Prepaids

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