P/2. File

"F493 Apps"

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FROM: John Jenkins
TO: Joachim Kempin

RE: Distribution of Apps through OEM's

In recent months we have seen several changes in the market with regard to applications in the OEM channel:

- Increased activity in the OEM channel by apps competition, notably Lotus and Spinnaker
- Increased interest on the part of OEM's to bundle applications with their hardware
- Increased interest on the part of OEM's to offer software on a per-copy basis.

These changes have caused OEM Management to examine our business and ask the following questions:

- Should we have a competitive response to Lotus? If so, what?
- How do we reconcile potential OEM opportunities with existing business in other channels?
- How effective are our current models? How should they change?

The purpose of this paper is to review my take on the situation, and offer some suggestions. The data and conclusions presented are the result of a synthesis of my own observations and conversations with several MS Managers and Account Managers.

EXECUTIVE SUMMARY:

How? Old version strategy

Lotus, Spinnaker, and other competitors have become much more aggressive in the OEM channel. Lotus' strategy is to be very aggressive in the OEM channel while maintaining their retail street prices, achieve high unit market share, drive MS's revenue market share downward by plugging the sockets that we are trying to create, and later convert the "plugs" into higher margin via upgrades sold at retail price levels. This is a strategy they can execute with little revenue exposure due to the relatively small contribution of new sales (less than 30%) toward Lotus' revenues.

Mass Merchant OEM Program

Substantiate

There is much greater risk that this strategy will be successful with new or unsophisticated users. There is a greater tendency for these users to stay with whatever product comes on the system, or move up within the same vendors' product line. We need to respond with an aggressive per-system program for OEM's that sell into the mass merchant and consumer channels. The program should at a minimum include the following attributes:

- Per-system applications at aggressive (sub $10) royalties if needed
- MS retains upgrade rights
- OEM includes MS reg card or gives us names
- Focused program to market other products and upgrades to the reg base
- Marketing assitance
- We should consider a mechanism to provide end-user support as well.

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Direct Mail OEM Program

Direct mail OEMs provide a largely untapped marketing channel for applications. They provide access to a well defined, well qualified base of customers. We should be stuffing products down that pipe.. the payback could be very large. Clearly if OEM can achieve higher penetration of these customers than SMSD through direct mail programs targeted at these users (not a difficult accomplishment) we will produce significantly increased revenue even at much lower pricing. We need a per-copy sales program for direct mail OEMs. The program is described in detail beginning on page 4, below is a snapshot:

- Per-copy sales
- Limited to installed base
- Sub $100 royalties for high end apps
- Large $$ min commit
- We incent the OEM to handle upgrades
- OEM provides support
- OEM must meet base level marketing requirements
- Direct sales only
- Pre-installation required
- Reg card required
- Qty limit of 100 units to any one customer
- Must agree to 30 day "out" clause

COMPETITIVE ENVIRONMENT:

?DATA

IDC estimates that 36% of all new PC's were shipped into the mass merchant channel in 1991. Microsoft and other vendors (notably Lotus and Spinnaker) have recognized the importance of introducing their products to this set of users, hoping to make them a loyal user for life. This audience is particularly appropriate for low end products since they are inexpensive and increasingly easy to use.

This interest in software bundles has by no means been limited to the low end. As more and more OEM's elect to bundle low end software, the need for differentiation drives them to higher end products such as MS-Word, Excel, and 123W. Lotus has been especially aggressive, quoting AST $45 for their "SmartSuite" (123W, Ami Pro, Freelance, CC:Mail) for a "very low" min commit with possibly docs/end user support included. Our agreement with Gateway 2000 has piqued much interest on the part of the OEMs ~~and the~~ competition. Typical OEM packages from ISV's like Lotus, Word Perfect, and Borland are in the $40 - $55 range per-copy, no min commits, support included, and no per-system requirement. In some ~~cases docs are~~ included as well.

NONE?

Lotus

(The following data are from IDC)

Since the acquisition of Alphaworks by Lotus the product has experienced a steady climb in shipment market share. With the aid of OEM agreements, increased channels of distribution and market exposure, Lotus-Works achieved a second place total shipments market position behind MS for the first three quarters of 1991. Shipment market shares increased from 7.1% in 1989, to 23.8% in 1990, to 30.5% in the first three quarters of 1991. During the same three quarter period, MS's unit share was 41.1%

While total shipments of LotusWorks have increased dramatically the revenue market share remains low reflecting the low-cost units that Lotus has shipped through the OEM channel. In 1990 LotusWorks achieved a revenue market share of 3.3%. In the first three quarters of 1991, revenue share was 6.8%. This is compared to MS's 29.1% revenue share for the same period.

According to IDC, Lotus derives over 70% of their sales from upgrades. Their strategy seems to be to be very aggressive in the OEM channel while maintaining their retail street prices, achieve high unit market share, drive MS's revenue market share downward by plugging the sockets that we are trying to create, and later convert the "plugs" into higher margin via upgrades sold at retail price levels. This is a strategy they can execute with little revenue exposure due to the relatively small contribution of new sales toward Lotus' revenues.

Lotus has also quoted aggressive pricing on the high end, as low as $45 for Smartsuite to AST (DTIV bid) and $40 per-copy (including support) to Gateway 2000 for 50K units. It appears that Lotus is picking its fights carefully ~~on the~~ high end; to date they have only signed two significant OEM 123W deals, one with Zeos and one with DEC. A third success for Lotus is Packard Bell, with 123W on a smaller subset of PB's high end systems.

Spinnaker
Spinnaker has also been very active in the OEM channel, offering royalties in the $7-12 range, support included, with no minimum commitments or per-system requirement. The most recent Spinnaker design win was Zenith, with a $9 royalty for $100K units (although there was no min commit), finished goods manuals and no uplift on translated versions. Free back-up support was provided for Zenith's support staff.

WHAT DO THE OEMS WANT?:

I believe the old "OEM" model is virtually obsolete. OEM's are no longer interested in licensing technology, building it into their proprietary products and selling the result with the end user frequently not even knowing the MS product was present. Today OEM's are looking for more than ~~just~~ "bits".

Because of the high brand recognition of MS and MS products OEM's cannot, nor do they want to, hide the underlying technology from the user. The idea that an OEM would license Excel and market it under the name "Wang Worksheet" or "Samsung Solver" is silly. A good deal of the value comes from the brand. The OEM becomes just another channel for reaching an end user and the end user expects the same level of support and service when they buy one of our products from an OEM as when they buy retail. The OEM's want four things in order of priority: Good price, differentiation, flexibility and marketing support. Support

Good pricing
OEM's feel that they deserve better than distributor pricing (i.e. better than 50% off SRP) because of their value add and the unique opportunities they offer SW suppliers, including large dollar commitments, the costs associated with building and supporting product (which are higher for them than MS due to economies of scale), access to a captive market, etc.

What it really comes down to though, is MS's pricing much higher than any of our competitors. OEM's are willing to pay more for MS, but not $230 for Excel when Lotus is offering 1-2-3W for $50, including docs and support.

Differentiation
As PC hardware has become commoditized, PC vendors are looking more and more toward software to differentiate their offering. While certainly not being limited to the low end, this is particularly true in the mass merchant/consumer channels were new and inexperienced users expect an easy to use turn-key solution. Our conversations with purchasing executives at mass merchants such as Sears, Costco, and Circuit City have confirmed that they see software bundles as being a basic requirement in this market.

Flexibility
Our existing per-system model requires a royalty accrual on every system of a particular type that the OEM produces. None of our competitors have the same requirement. Our customers find this approach too restrictive; they want the flexibility to adjust rapidly to market changes. This is especially true in the mass merchant channel, where an OEM may sell several product lines through several different chains. As an example, Packard Bell offers 4-5 lines through a host of resellers such as Costco, Sears, Circuit City, Silo, etc. They minimize channel conflict by constantly changing the mix, adding software here, tweaking hardware configurations there. They need the flexibility to turn bundles on and off as the market demands, not at pre-defined start and stop points of a contract that was negotiated six months earlier.

Marketing support
Because of the shift from the traditional OEM model to more of a reseller/branded approach, OEMs want to participate in our retail marketing programs. They don't want their end user to suffer or get anything less because they chose to buy their software from the OEM. If anything, they want the opposite.

OEM's that participate in the low end (esp. mass merchant) are asking us for support in training, promotion, collateral material, sales events, etc. I have personally received this request from Wang, Cumulus, Packard Bell, and Everex.

PROPOSAL: PER COPY SALES PROGRAM

This proposal was written to specifically address the appropriate competitive response to Lotus and others at Gateway 2000; However the recommended program and associated set of criteria was designed in order to accommodate other OEM's as well.

The Problem:
Application vendors (Lotus, Borland, Word-Perfect) have made very aggressive proposals to Gateway in order ~~to capture~~ Gateway's per-system (and per-copy) business for high-end applications. All three are in the $40 - $55 per copy range, most supply disks and docs, and all include some form of end user support.

The opportunity:
To successfully retain Gateway's per-system business
To achieve incremental revenue through per-copy sales to GW's installed base
To successfully beat Lotus at it's own game without significant cannibalization of MS's retail business
To achieve higher levels of customer satisfaction via pre-install program
To ensure on-going revenue stream by capturing follow-on upgrade business

PRICING:

Given our competitors very aggressive pricing, we feel we need to be sub $100 per copy to compete. I am proposing that we use a 2x price for per-copy (2x whatever the particular per-system price is). Pricing in this range is not unreasonable. Using Word for Windows as an example: The average selling price of the full Word package through SMSD is $177, the upgrade ASP is $95 (from the board report). According to Mike Negrin, 40% of SMSD's business comes from upgrades. A weighted average of ASP and upgrade ASP results in an effective ASP of $144. Since OEMs produce their own packaging, $20 is subtracted for COGS, and another $20 for support The result is net revenue of $104, essentially a break-even point vs. a copy sold through traditional SMSD channels.

Product	SRP	ASP	Upgrade ASP	Upgrade %	Effective ASP	COGS	Support	Gross Income
Excel	$495	$219	$106	40%	$174	$20	$20	$134
Word	$495	$177	$95	40%	$144	$20	$20	$104

There is justification for additional reduction:

- Gateway has made a huge financial commitment to applications per-system (>$10M for applications alone),
- They have direct access to a very large and well maintained user base.. we can expect to achieve much higher penetration rates than retail
- They will provide direct end-user benefit by pre-installation
- They will include an MS registration card with their product
- OEM's administrative & support costs are higher due to economies of scale

ISSUES:

Erosion of street prices

There is concern that the low royalties will result in OEM's selling MS products for significantly below existing street prices. While MS obviously cannot do anything to attempt to control street pricing, there are some steps that we can take to minimize the risk:

- Limit participation in the program. Develop a reasonably objective set of criteria for who can enter.
- Educate and remind participants on the benefits of margin and the effect of resale price on the perceived value of their solution
- Build a 30-day out clause into the agreement

Robinson-Patman

Because of the significant difference between this proposed pricing and our standard reseller discounts, there is potentially a Robinson Patman issue. I discussed this with Kevin Harrang, The general answer is that we may charge different prices based on "functional discounts", meaning the two different resellers are providing different services. Measurement here will not be precisely cost based. The area for potential problems lies with pre-installing resellers where the convergence of this program and SMSD's Pre-installing- Reseller program, at which point the two "different" resellers begin to look very similar. However, we should not have an issue here because of the following fundamental differences between an OEM and a pre-installing reseller:

- Limited market - The OEM can sell only to their installed base
- Mfg costs - The OEM must manufacture or contract for manufacture of the product, including docs
- Minimum Commitment - The OEM is making a substantially larger dollar commitment
- Support - The OEM must supply end-user support
- Risk - 30 day out-clause required

Cannibalization of retail business

Roughly one third of Gateway's systems are sold to large corporations, the remaining 2/3 go to individuals and small businesses. Our primary focus is on the latter. We will limit cannibalization of corporate business through a maximum qty limit (e.g. orders limited to max of 100 units). This will exclude large corporate purchases from the program and significantly reduce our exposure on this category of customer.

Upgrades

Recent MS thinking has been in the direction that we should take OEM's out of the upgrade business. While this may make sense in the indirects, the distinct advantage offered by direct OEMs should not be overlooked. The penetration that Dell or Gateway could achieve on an upgrade program directed to their own installed base would be significantly greater than we could achieve (unless they gave us 100% of the names, which is very unlikely). We should use the leverage that we have in working with the direct accounts aggressively... working cooperatively with the OEM to creating unique direct mail pieces for their installed base, etc. This is a marketing channel that has been <u>totally</u> ignored by MS.

Requirements of the program:

Minimum $10M annual commitment overall for MS apps
Sales and promotion is limited to the OEM's installed base of CPU customers
OEM must meet base level marketing requirements (to be defined later)
Must provide end-user support
OEM must sell direct to end users, no 2nd tier distribution allowed
Royalty deal only, no FG
OEM must pre-install
Must include MS Reg card, or report end-user names to MS
OEM cannot sell in Qty's > 100 units to any one customer
Must agree to 30 day out clause
Overall reputation... does it support the image we are attempting to convey?

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