

Agenda

- Current license agreements
- Windows Desktop Family License Agreement
- Competitive position
- Financial analysis
- PC Company projected operating system shipments
- Negotiation status
- Counter proposal
- Action plan

Current Microsoft Contracts Significant Terms

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- Windows 3.11, WFW, & NT 3.51 for Intel-based systems
 - Windows 3.11 \$9 royalty thru 9/97 - best terms in industry
 - Windows for Workgroups \$12.50 royalty thru 9/97 - best terms in industry
 - NT 3.51 Workstation \$195 royalty thru 9/97, no volume commitment
 - NT Server \$456 royalty thru 9/97, no volume commitment
 - Reseller right to install (IAA)

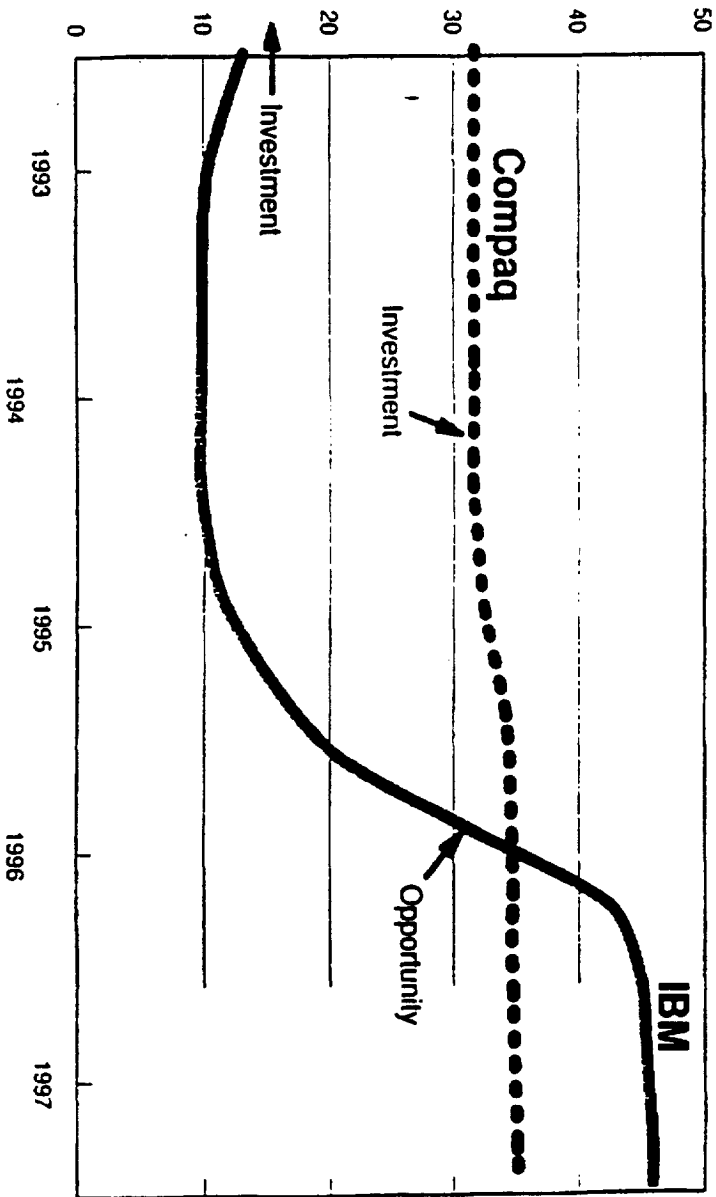
■ MS DOS

- \$2 royalty for Enhanced Tools
- IBM ships limited quantities for special bids
- PC DOS - \$8 royalty to PSP

■ Windows 95

- Market Development Agreement (MDA) gives royalty discounts
- \$46.60 royalty thru 9/96 (incl. \$14.50 MDA reduction)
- Unlimited liability for third party installation (affects EIAA)
- Patent immunity granted to MS and its customers
- Must ship documentation (\$1)

Microsoft Royalty vs. Investment



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Chart - 3

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Cooperative Development Opportunities

- Enhance Windows 95 as corporate client
 - Tivoli and NetView full client support
 - Object Database Client (ODBC) support for DB/2 and CICS
 - Nashville support for Notes data (including Active-X)
 - Nashville support for SmartSuite objects
- Enhance NT as corporate client
 - Eagle integration with NT
 - Internet server
 - Nashville support for Notes data (including Active-X)
 - Nashville support for SmartSuite objects
 - NT scalability for enterprise servers
 - NT clustering on enterprise servers (SP2)
- Product coupling
 - Ultimate Gamer
 - Personal Workstation
 - Support for corporate Mobile NT use
- Piracy prevention
 - Hardware protection for Windows installation

Windows Desktop Family License Agreement - Overview

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- Combines existing agreements into one Family Agreement
 - Windows 95 terms used as a base
 - MS-DOS, Win 3.11, Win 95, Win NT Workstation
 - Raises royalties on MS DOS, Win 3.11 and Win 95
 - Combines volumes of all products to reduce royalties significantly on a higher cost product, Win NT Workstation
 - Excludes Win NT Server and PowerPC (for Intel systems only)

Windows Desktop Family License Agreement Discussions to Date

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- Win 3.11, W/1W, WinNT 3.51 license expires 9/97
 - IBM: "let the marketplace dictate products' extinction and 'grandfather' existing terms except royalties"
- Win95 license expires 9/96
 - This includes expiration of the current \$14.50 MDA
 - If IBM does not sign Family, no further MDA effective 10/1/96
- New Win9x MDA applies only to the Desktop Family Agreement
 - Current assessment is that IBM will qualify for \$15 of the total \$20
- WinNT 4.0 GA targeted for 8/96, requires Family License Agreement
- MS wants IBM to sign by 6/1/96, in exchange for NT 4.0 upgrade
 - Upgrade program undefined for IBM, despite many requests to MS
 - Dell announced upgrade program
 - Compaq verbally offering upgrade to customers
- Royalties (English, Per System Only, \$14.50 MDA) as follows:

	Current Agreement	Windows Family
MS DOS	\$2.00	\$18.50
Win 3.11	\$9.00	\$29.00
Win 95	\$46.60	\$47.50
Win NT	\$195.00	\$112.50

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CHART # 6

Windows Desktop Family Agreement Microsoft's Initial Position & Proposal

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- Microsoft position 5/1/96
 - Transition Win 3.11 & NT 3.51 terms on 1/1/97
 - Reseller installation (EIAA) agreed to in principle
 - MS stands firm on royalty amounts
 - In general agreement with other operational issues

- Microsoft reviewed IBM issues with Joachim Kempin
Results: Microsoft Proposal to Santelli 5/10/96
 - Microsoft now wants to waive \$5M credit offer to IBM, in exchange:
 - Microsoft will approve EIAA
 - Microsoft will reduce Win 3.11 royalty from \$62 to \$55 (with PC DOS)
 - Microsoft will grandfather current Win 3.11 & NT 3.51 T&C's thru 9/97
 - IBM must sign Windows Desktop Family Agr. by 6/1/96 under these terms

- IBM analysis of proposal
 - EIAA already agreed to
 - Windows 3.11 royalty reduction of no value (see financial analysis)
 - Grandfathering of T&C's until 9/97 (exclusive of royalties)

Consultant Studies

■ Workgroup Strategic Services

- Frequently quoted industry figure
- Close Microsoft & OEM contacts
- Long term IBM consultant on Microsoft issues
- Stated Compaq 10-14% < IBM
- Reviewed/confirmed our estimates as to base price & royalty reductions

■ Dr. Kenn Walters, 20 year veteran of BIS

- Detailed study - interviewed OEM contacts
- Estimated base & MDA reductions
- Confirmed Microsoft policies & amounts
- Within 5% of WGSS figures
- Confirmed C&L belief that base prices varies due to soft \$

■ Coopers & Lybrand

- Consumer-only study of bundling
- Windows 95 figure incidental
- Taken from Taipei OEM interview pre-Windows 95 GA
- No other methodology used
- Believes base highly variable despite Justice Dept., due to:
 - Total Microsoft billing (Gateway largest)
 - Long-term relationship with OEM
 - Other soft \$ marketing activities

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Windows Desktop Family MDA Discounting

- All OEMs receive MDA discounts for similar activities
 - Maximum MDA discount cap of 35% from unreduced base
- Compaq receives est. \$8-10 reduction from \$62 base for Frontline partnership and Plug-n-Play joint development
- H-P receives est. \$4-6 reduction from \$62 base for joint development and enterprise solutions development
- DEC receives est. \$2-4 reduction from \$65 base for enterprise-scale solutions
- IBM receives no reductions from \$62 base, due to lack of strong relationship, competing products and no joint dev.

■ Estimated net pricing by Top tier OEM

	Compaq	H-P	DEC	IBM
Base price (incl. vol. adj.)	\$62	\$62	\$65	\$62
Joint partnering Reductions	\$8-10	\$4-6	\$2-4	\$0
Est. MDA Discounts	\$17	\$17	\$15	\$15
Est. Net Win95 Price	\$35-37	\$39-41	\$46-48	\$47
Est. WinNT Price *	\$83-85	\$94-96	\$101-103	\$112

* Based on all source information - competitive prices may be higher

Sources: WGSS, C&L, K&B Walters Reports

1995 Windows 95 MDA Cost Comparison

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MDA MILESTONE ACTIVITIES

	REDUCTION	IBM	COMPETITION
1. Desktop Compliance w/ HDG	\$3.00	\$3.00	\$3.00
2. Mobile Compliance w/HDG	-----	\$2.00	-----
3. All PNP Cards in Systems	\$2.00	-----	\$2.00
4. Win 95 Base Marketing Program	\$2.00	\$2.00	\$2.00
5. Trade Show Demonstrations	\$3.00	-----	\$3.00
6. Win 95 on 50% Systems win 60 days	\$.50	\$.50	\$.50
7. Win 95 Logo on Carton	\$.50	-----	\$.50
8. Win 95 Logo in Advertisements	\$2.00	-----	\$2.00
9. Participate in Win 95 Launch	\$1.00	\$1.00	\$1.00
10. Win 95 as only OS in advertisement	\$1.00	-----	\$1.00
11. T3 Class / Train Support HC	\$1.00	\$1.00	\$1.00
12. Train Sales Force (Fighter Pilots)	\$1.00	\$1.00	\$1.00
13. Win 95 Present at Customer Event	\$1.00	-----	\$1.00
14. Convert / Publicize Customer to Win 95	\$1.00	-----	\$1.00
15. Customize Applets / Help for Win 95	\$1.00	\$1.00	\$1.00
16. Create / Announce Win 95 Spl. Center	-----	\$2.00	-----
17. Company Specific Opportunities	\$2.00	-----	\$2.00

MDA Reductions \$25.00 \$14.50 \$25.00

- Frontline Partnership ----- \$4.00
- Joint Dev. Reduction (Plug N Play) ----- \$4.00

Total \$14.50 \$93.00

1996 Windows Family MDA Cost Comparison

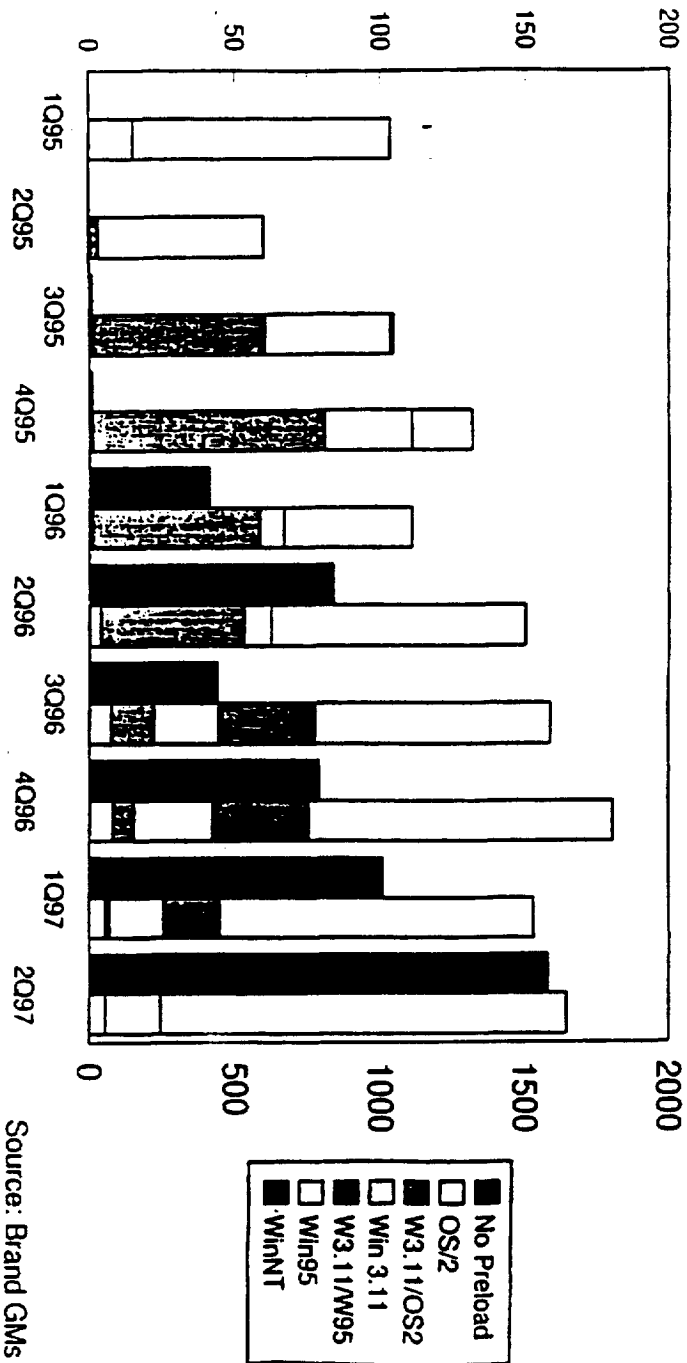
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MDA MILESTONE ACTIVITIES	REDUCTION	IBM	COMPETITION
1. All systems compliance w/ HDG by 8/1/96	\$2.00	\$2.00	\$2.00
2. APM or UniModem or Audio after 8/1/96	\$2.00	\$2.00	\$2.00
3. Preload OPK w/in 60 days	\$2.00	-----	-----
Preload localized versions of OPK w/in 60 days	\$1.00	-----	-----
4. Attend WinHEC / OPK Training	\$1.00	\$1.00	\$1.00
5. UI compliance w/ OPK w/in 90 days	\$1.00	\$1.00	\$1.00
6. All cards PNP compatible by 7/1/96	\$2.00	-----	\$2.00
7. MS URLs and Logo on IBM Web by 7/1/96	\$3.00	\$3.00	\$3.00
8. 40 MCPs by 8/1/96: Attend NT T3 & Ed Plan by 7/1	\$1.00	\$1.00	\$1.00
9. Win 9x Logo in Advertisements	\$1.00	\$1.00	\$1.00
Win 9x Logo on system chassis	\$1.00	\$1.00	\$1.00
10. MS GP Logo in advertisement / coll / promo by 7/1	\$3.00	\$3.00	\$3.00
All Advertised systems ship with OS by 7/1			
All Systems to target countries with OS by 7/1			
10% Exception for RTC			
BSA URL on IBM Web Page by 7/1			

MDA Reductions	\$20.00	\$15.00	\$17.00
■ Frontline Partnership	-----	-----	\$4.00
■ Joint Dev. Reduction (Plug N Play)	-----	-----	\$4.00
Total	\$15.00	\$15.00	\$25.00

PC Company OS Volumes by Quarter

- Win95 included on 75% of systems (5.2 million)
- Win 3.11 volumes declining, IBM projections higher than industry
- IBM Win NT WS projections significantly below industry expectations



Source: Brand GMS

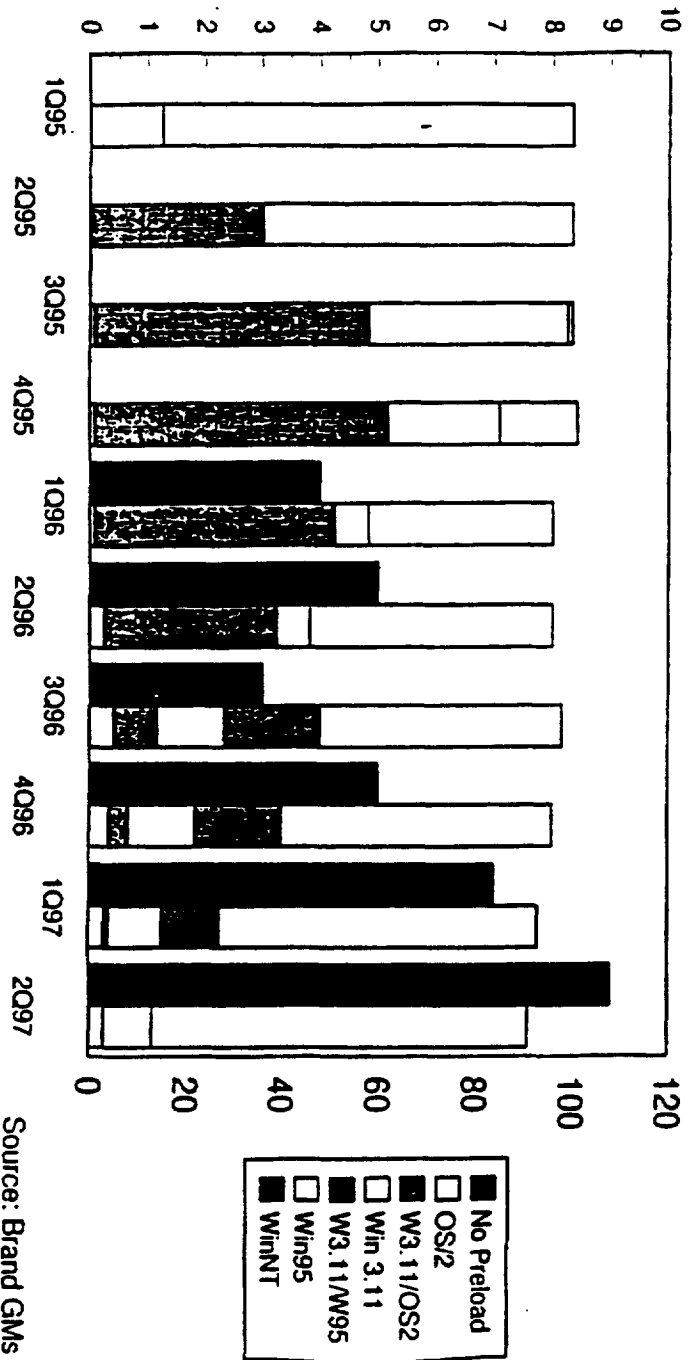
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PC Company OS Percentages by Quarter

- Win95 included on 75% of systems (5.2 million)
- Win 3.11 volumes declining, IBM projections higher than industry
- IBM Win NT WS projections significantly below industry expectations



Source: Brand GMS

Windows Family License Agreement Financial Analysis Summary

- Royalty History/Projections
 - 1995 Royalties to MS = \$60.8M
 - 1996 Royalty Projections to MS = \$250M (Obsolescence of Win 3.11by Win95)
- Financial analysis covered 3 cases - June '96-July '97
 - 1. Current royalty terms with MDA expiring 9/96
 - 2. Proposed Family Agreement
 - 3. Proposed Family Agreement and individual license without volume aggregation for Win 3.11

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Windows Family License Agreement Financial Analysis Summary

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■ Case analysis:

	Case 1	Case 2	Case 3
Royalty to MS	\$370.2	\$416.3	\$402.3
Less MDA	(16.6)	(94.9)	(94.9)
Net Royalty to MS	353.6	321.4	307.4
Delta to Case 1		(32.3)	(46.3)

■ Delta to Case 1 by quarter:

	Case 2	Case 3
3Q96	\$12.4	\$7.7
4Q96	(9.2)	(13.6)
1Q97	(14.8)	(17.4)
2Q97	(20.6)	(23.0)
Total	(\$32.3)	(\$46.3)

Financial Analysis -- Royalty Assumptions

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Time Period: July 1996 - June 1997

Case 1 - Current royalty terms

	Royalty	Exp. Date
Windows 95 #	\$ 61.10	9/30/97
Windows 95	\$ 62.00	10/96-6/97
PC DOS (\$8)/Win3.11(\$9)	\$ 17.00	9/30/97
WinNT 3.51 (preloaded) #	\$190.00	9/30/97

MDA: \$14.50 7/1/96 - 9/30/96 \$0 10/1/96 - 6/30/97

Case 2 - Proposed royalty terms (Family Agreement)

	Royalty	Exp. Date
Windows 95 #	\$ 61.10	7/96 - 9/96
Windows 95 #	\$ 62.00	10/96-6/97
MS DOS/Enh Tools/Win 3.11 #	\$ 55.00	
WinNT 3.51 #	\$127.00	

MDA: \$14.50 7/1/96 - 9/30/96 \$15.00 (est) 10/1/96 - 6/30/97

Case 3 - Proposed royalty terms (Fam. Agr. with Individual License for Win 3.11)

	Royalty	Exp. Date
Windows 95 #	\$ 61.10	7/96 - 9/96
Windows 95 #	\$ 62.00	10/96-6/97
PC DOS (\$8)/Win 3.11 #	\$ 51.50	
WinNT 3.51 #	\$127.00	

MDA: \$14.50 7/1/96 - 9/30/96 \$15.00 (est) 10/1/96 - 6/30/97

MDA applies

* All royalty amounts above represent English Per System copies

Financial Analysis -- Case Summary

■ All figures in \$US

	Case 1	Case 2	Case 3
Royalty to Microsoft	\$370.2	\$416.3	\$402.3
Less MDA	(16.6)	(94.9)	(94.9)
Net Royalty to Microsoft	\$353.6	\$321.4	\$307.4
Delta to Case 1		(\$32.3)	(\$46.3)
Consumer	\$118.4	\$96.1	\$96.1
Mobile	70.4	59.5	58.4
CDT	164.9	165.8	152.9
Net Royalty to MS	\$353.6	\$321.4	\$307.4

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Chart 17

IBM Leverage and Liabilities

- **IBM Leverage points**
 - Microsoft's desire to remove \$5M credit offer from their books
 - Windows 3.11 T&Cs & royalties
 - Worldwide volume shipments
 - RISC & Intel potential aggregation
 - Large Accounts (relationships and know-how)
 - Investment in Power (although volumes low)
- **IBM liabilities**
 - IBM competes with Microsoft:
 - OS/2 & PC DOS vs. Windows & MS DOS
 - SmartSuite vs. MS Office
 - Notes vs. Exchange
 - Eagle vs. BackOffice
 - IBM policy decisions prevent Frontline Partnership
- **Motivators to sign Family Agreement**
 - Windows 95 license agreement expires 9/96
 - MDA expires 9/96
 - No license for Win NT 4.0
 - MS will become unresponsive if 6/1 contract date not met

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Microsoft Proposal

- Microsoft Proposal to IBM 5/10/96:
 - Microsoft now wants to waive \$5M credit offer to IBM, in exchange:
 - ▶ Microsoft to approve EIAA
 - ▶ Microsoft to reduce Win 3.11 royalty from \$62 to \$55 (with PC DOS)
 - ▶ Microsoft to grandfather current Win 3.11 & NT 3.51 T&C's thru 9/97
 - ▶ IBM must sign Windows Desktop Family Agr. by 6/1/96

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PC Co Counter Proposal

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Recommend Royalties to change as follows:

	Current Agr.	Win. Family	Counter to Family	Best Comp. Price
MS DOS	\$2.00	\$18.50	N/A	\$5.00
Win 3.11 *	\$9.00	\$29.00	\$25.00	\$25.00
Win 95 *	\$46.60	\$47.00	\$40.00	\$35.00
Win NT*	\$195.00	\$112.00	\$80.00	\$80.00

* includes \$15 MDA royalty reduction

- Windows 95 - rationale for lower royalty

- ▶ Windows 95 volumes 5x those of Windows 3.11
- ▶ Will accept Windows 3.11 \$20 increase for Windows 95 \$4 decrease
- ▶ Settlement agreement waiver of \$5M
- ▶ Will accept loss of \$5M for Windows 95 \$1 decrease
- ▶ **New Windows 95 target of \$42**

- NT Royalty - rationale for lower royalty

- ▶ Must reflect IBM investments in Windows NT:
 - Power development \$40M
 - Middleware development \$37M
 - Education \$2M
- ▶ **\$32 royalty reduction (\$4M) to cover \$60M investment**

PC Company Response to Microsoft Proposal

Lead with Discussion:

- Royalties are too high
- Within 90 days of signing:
 - Launch marketing campaign describing IBM as a worldwide MS Solution Provider, Authorized Support Center, Authorized Technical Educ. Center
 - Launch co-operative development and marketing on 3 major fronts

■ Microsoft Proposal:

- Forego \$5M credit in Settlement Agreement
- Approve EIAA
- Grandfather current Win 3.11 & NT 3.51 T&C's through 9/97
- Reduce Win 3.11 royalty from \$62 to \$55 (with PC DOS)
- Must sign Family Agreement by 6/1/96

■ IBM Response:

- May waive \$5M in exchange for lower royalties
- Need EIAA (previously agreed to)
- To both parties' benefit to grandfather terms
- \$43.50 Win 3.11 royalty without volume aggregation better
- 6/1/96 not possible without Microsoft's position in a **red-lined draft**
 - Need response to issues from 4/30 mtg
- Sign ASAP, effective on 10/1/96
- Family Agreement must include Power

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**If Counter Proposal not Accepted As Is,
IBM's Prioritized Negotiable Items**

- **Move Windows 3.11 to monthly reporting effective 3/97**
 - Currently paying quarterly net 60 days; move to monthly net 30 days
- **Relinquish Windows 3.11 source code rights for support**
- **Limit quantity of products used for internal use and demos**
 - Current agreement: 10,000 internal use, unlimited demos
 - Propose to limit royalty free rights to PS Group only
- **Relinquish reseller installation under Windows 3.11 agr.**
 - Move to accept proposed EIAA amendment with limited liability
- **Agreed to separate contract for Power**
- **Transition terms in current Win 3.11 and Win NT 3.51 agreement to Family Agreement on 6/97 vs. 9/97**
 - Will require significant negotiation to allow for transition
- **Agree to higher Win NT royalty for lower Win 95 royalty**

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Action Plan

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- Santelli and Martson call to Kempin
 - Wednesday 5/22/96
 - Present high-level IBM counter proposal
 - Request meeting with Jeff Raikes, Steve Ballmer and Sam Palmisano to discuss joint sales and marketing opportunities
- Moffat contact MS Finance re: audits and royalties
 - Avoid audit during negotiations (45 day notice required)
- Team to incorporate executive input into negotiation strategy
- Team to work with Microsoft after red-lined draft received
- Norris to staff 3 additional people in Project Office to execute:
 - Microsoft Solution Provider
 - Authorized Support Center
 - Authorized Technical Education Center
 - Development projects

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