From: Orlando Ayala
Sent: Wednesday, February 12, 1997 11:38 AM
To: Joachim Kempin; Jeff Raikes; Michel Lacombe; Charles Stevens
Cc: Steve Ballmer
Subject: RE: OEM/DSP update and Mouce pricing action item

in general i agree with this proposal... some few comments

On the NT front the only reservation I have is the fact that medium size and small integrators and ISV's and in general SP's see the sale of NT (the product) as an integral part to open the door for their services business. If we decide to go all the way with DSP's this is something that we need to understand how to deal with as many of these "value added" channel partners will see that as a problem unless we find smart ways to provide them with leads in accounts being penetrated by DSP machines.

In the pricing formula the rebate component is very small as at least in ICON we moved very aggressively the rebate $$$ to the "value added resellers/SP's" and in many cases disties now receive not more than 2%.. I think pricing formula for DSP's should reflect the fact that later we may need to invest some money in the reseller channel (lead management,etc) to ensure they take those bundled NT and turn them into real installations. So I am not sure we should discount from Dist: pricing teh rebate piece at least for NT.

An initiative to clearly understand channel synergies (overlap) between DSP's and OCU is a must. I can not agree more there is a ton of money to be made if we can aggressively close the cycle from DSP sale to full impact and leverage of that in OCU customer segments

I think the SBE strategy is a great thing.. let's do it all the way as i am convinced unless we capture those bits at the time we sell the OS.. they will be lost for ever to piracy. We should develop metrics for teh OCU/OEM guys in terms of SBE penetration on WIN95 licenses.

Don't have major comments in mice.. I think what is proposed is right.

One tactical comment about revenue recognition.... we will need to think on how this will impact our tracking of revsum numbers as all these move of revenues from one bucket to another screw-up things and specially sell out #'s when we try to tie reseller sales .. as i understand it our current system do not allow for a simple and smart way to reflect OEM revenue being credited also to the FG channel .. past mid year review was a good indiaction of this when major OEM bundles in the FG side basically made some numbers very hard to reconcile all teh way to sell out.

-----Original Message-----
From: Joachim Kempin
Sent: Friday, February 07, 1997 11:48 AM
To: Jeff Raikes; Michel Lacombe; Orlando Ayala; Charles Stevens
Cc: Steve Ballmer
Subject: OEM/DSP update and Mouce pricing action item

Pls. read and comment and avoid forwarding it broadly until we agree.

The following will discuss some pricing and revenue recognition issues we are trying to resolve between our OEM and FG business.

1. **DSP pricing and revenue recognition of Server (NTS) and DAD products.**

   <u>Packaging, Support and Pricing</u>

   Packaging: OEM DSP product packaging is differentiated from the retail product.

   OEM DSP products are generally packaged in 5-pack form vs. the retail 3-pack form and individual packaging of DSP products is a very bare bones style vs. that of the retail package.

   Support: OEM DSP NTS and DAD products will be marked clearly as being supported by the System Builder to avoid end user confusion and calls.

   Pricing: The strategy of OEM DSP pricing for the products in question will be to establish a net neutral revenue position to that of the retail product. The OEM DSP *channel* has the following costs that the retail *channel* does not experience:

   • The OEM provides end user support
   • The OEM pays for COGS separate from the royalty paid to MS
   • The OEM receives no rebates from MS
   • The OEM covers the cost of all returns

   Therefore in order to balance these two channels, the additional costs incurred by the OEMs as well as the lack of rebates given must be taken into account in the original price. Therefore, we will match the lead country pricing and use the following formula to establish the DSP price.

   OEM DSP PRICE =

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DISTI price
- rebates
- cost of returns
- cost of support
- COGS

In the case of NTS we will begin with the country FPP price in our formula. The *only* OEM DSP NTS SKU sold, will include 5 CALs. We expect to add Small Business NTS (SAM) during the year using the same logic. We will not sell any upgrades to this channel but are considering adding a CAL only SKU to our offering (5 CALs/SKU, 3 SKUs in a package) if there is enough demand. (We are testing this today in NA).

In the case of DAD products, specifically Office97, SBE will be the only DAD product offered through the OEM DSP channel. For the OEM DSP pricing, we will begin with either FPP or CUP pricing depending on local decision. I hope we can make at least regional decisions to avoid a lengthy sub-by-sub approach. I understand that some subs are thinking about adding local content to the standard SBE content. We will not sell such versions through DSPs -- our SKU will be built out of standard MS components only. No Office97 products will be offered through the OEM DSP channel in Japan.

Revenue recognition
For the DSP products mentioned above, we will recognize the revenue in a new channel called ROEM. The revenue will start showing up in Q3FY'97 in both the OEM and the FG channel. The idea is to make this a transparent business for both divisions and provide a means to calculate marketing money for the subs at budget time while acknowledging that they are creating the demand for these products, but leave the sales planning and execution in OEM. I firmly believe this will bring the OCU and OEM people closer together to explore increased joint opportunities to optimize our $/PC in this overlapping customer segment. The trials we have done in Europe suggest that this could be a successful strategy.

Revenue from royalty OEMs
The revenue will continue to stay in the OEM channel and is primarily done with direct OEMs for Office97 SBE. Additionally, we will license Works and Word97, BUT no Office97 Standard or Office97 Pro deals in this segment at aggressive per unit pricing. In the case of DELL you will see them selling Office as a *WW LAR* on their commercial "Optiplex" PCs and bundle Office SBE on their entire consumer "Dimension" line through an OEM license starting in April of 97.

Why we are doing this and future directions

Over time you will see us getting smarter with the royalty OEMs as well. In the case of NTS, we still have some direct licenses - some of which will migrate into LAR business. As of today, we have done this with Compaq and the only other large direct licensee today is DELL. We are asking for a commitment from an OEM in order to have a royalty license with MS that involves pre-installation and per system agreements. This has reduced the number of licensees already. At the same time, we expect additional OEMs to come along over the year to explore the SB segment with preinstalled solutions. For the right price we will do a limited numbers of these deals. As of now, Wolfpack will be an OEM product only and we will pursue limited deals here until version 2.0 next CY.

In a nutshell, we expect to gain more market share with the measures we are taking, work more cooperatively on a local level and hopefully stop competing on price internally.

2. **Windows Desktop Family products (NTW,WIN 95)**

Most of the units in this category are sold or will be sold through the OEM channel. Therefore, we have decided that OEM is the lead within the country for both products. The subs will therefore establish their pricing for upgrade and FPP to the OEM DSP prices. I recommend to use the following formula:

FG Upgrade price =
OEM DSP price
+ rebates
+ cost of returns
+ cost of support
+ COGS

> From there, any adder would be at local discretion. Additionally, pricing for FPP would also be at local discretion as long as it's not priced below the price established from the formula above.

> Revenue recognition for these products licensed through the OEM channel will remain in OEM.

3. **Mice**

Our main competitor here is Logitech and for years it has been our goal to increase our market share. This has lead to selling mice to large OEMs in bulk to bundle with their systems. This has improved our position in the market place, but at the same time we have not made as many inroads in the FG business. Three years ago we started selling mice through DSPs and during FY'98 we should reach a volume of 4.5-M units WW. The key differences between the different channels are pricing and less expensive packaging in the OEM channel. The pricing differential between OEM and retail has enticed some Named accounts in the past to create a secondary market by improperly selling the mice without a system. After we introduced tracing mechanisms we have shut all of these violators down. Recently we have seen counterfeit mice coming in from PRC, which as of today, we haven't been able to shut it down at its source. In addition, we have done a retail deal with a subsidiary of SNI that has pumped another 800k mice into Europe that cannot be traced effectively. So in a nutshell, we need to clean up the mess.

Action item
Steve and I believe effective Q3FY'97 we should agree on a better pricing model for mice and do the following:

Continue to sell Mice to large OEMs as we do today and continue to strictly police.
Have one price for standard Mice and a higher price for IntelliMouse, based on a simple formula:

FPP Disti price =
   OEM DSP price
    + rebates
    + cost of returns
    + cost of support
    + the difference in COGS *(packaging)*

This means we would have to effectively lower our retail prices substantially. Today, the DSP mouse is priced at $20/unit and gets delivered in 10 packs. We are proposing to price the IntelliMouse at $30/unit for a 10 pack through the DSP channel; meaning new FG Mouse pricing to Distis would be approximately $25 and $35 respectively. We are convinced that the Mouse is a global product with low local value add; therefore a global pricing model makes sense, in particular when we want to gain market share against Logitech. Steve and I would like some feedback on this proposal by next week.

The only other HW product sold through DSPs is the keyboard. I believe we should follow a comparable model until we have a new lower priced and OEM specific keyboard by 1HFY98.