

Lotus Update

Key Findings and Implications

- ❑ Lotus' DOS business has been declining at a faster rate than their Win Apps business is growing, resulting in a net decline in App revenue. But, with Windows Apps sales now comprising more than 50% of all revenues, Lotus' overall revenue growth is positioned to accelerate. Lotus' DOS transition bumps are almost over and they will be less vulnerable as a result.
- ❑ Lotus' DOS Apps transition market opportunity remains very large. According to some surveys, half of the DOS market has yet to adopt a Windows spreadsheet. Lotus enjoys clear advantages of familiarity, customer access, and compatibility. The DOS 1-2-3 installed base remains as one of Lotus' strongest assets and the spreadsheet category's crown jewels - still twice the size of the Windows spreadsheet installed base.
- ❑ 1-2-3 is the linchpin to SmartSuite's success. Including all versions, the 1-2-3 product line still represents 40% of Lotus' total revenue and enjoys the strongest share position vis-à-vis Microsoft than any other Lotus App. Increasingly, Lotus is seeking to leverage 1-2-3's brand equity in building SmartSuite. Successfully attacking 1-2-3's franchise may therefore be our most successful strategy to halt SmartSuite's growth.
- ❑ Although SmartSuite's year over year revenue increase was impressive (153%), Lotus' overall sell through market share in the office/suite category stalled at 15% during the first 9 mos. of FY94 with WinOffice maintaining slightly more than 80% of the market.
- ❑ Lotus is reputedly making a big investment in a totally re-written, object-oriented version of 1-2-3, code named Walden (v 5.0) that is due in mid '95. Lotus is attempting an end run around Microsoft, seeking to deliver a leaner, faster, and more portable spreadsheet.
- ❑ Lotus has finally attained profitability on their communications business, with significant room for margin improvement in the next few years. But, they face big competitive and pricing challenges. The Notes pricing model is currently more akin to an Apps pricing model with avg. seat pricing at \$300. Many users believe that Notes will need to adopt an OS pricing model to spur volume installations. Managing this balance of maximizing near vs. long term profitability and penetration may be the most important strategic decision facing Lotus today.
- ❑ Lotus is now reaching out to smaller companies with Notes, offering a Notes starter pack and opening up broader retail distribution for this product through Ingram.
- ❑ For an undetermined reason, Lotus has been more successful than Microsoft in touting wins and getting coverage in the press. Lotus is also downright devious in its use of misleading statistics to portray a market gain or advantage.
- ❑ Lotus employs a more segmented and targeted approach to channel development. The company uses proposal-based funding to build volume with key resellers, utilizes different discounts and rebates to set street pricing and to focus resellers on specific products, and requires internal market share reporting by product category to track results.

Current Business Strategy

- ❑ Dominate the workgroup market
 - ↳ communications remains key differentiating factor near term
- ❑ Successfully transition from single category DOS leadership to WinApp leadership
 - ↳ migrate installed base of DOS 123 users
 - ↳ compete with complete Suite offering
- ❑ Reduce G&A, Development expense, improve manufacturing efficiencies

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Product Strategy

- Seek differentiation on the desktop through enhanced usability, integration, and group enabling
 - ↳ improve user interface, learning tools
 - ↳ add workgroup enabling features
 - ↳ break new ground in mobile computing
- Make Notes the computing platform and communications infrastructure within corporations
 - ↳ Windows to become the graphical C prompt (Manzi)
 - ↳ link communications and desktop Apps

Marketing Communications Strategy

- Actively link communications products with desktop Apps, position "working together"
- Broaden Notes awareness and interest to mainstream business markets
- More clearly define Notes from a tangible product point of view
- Define office/suite category as collection of best of breed Apps, use critical acclaim to support their superiority
- Insure that SmartSuite is in the "consideration set" of suite/office category through direct comparisons to MS Office
- Slow momentum of MS Office
- Leverage broad awareness for 1-2-3 to build suite credibility
- Adversarial tone may be being used to rally troops against Msft.

Channel Policies

Discounts, rebates, net discounts (excluding volume discounts)

(Direct Reseller/Distributor)	Lotus			Microsoft		
	Discount	Max. Rebate	Net Discount	Discount	Max. Rebate	Net Discount
Full packaged product						
Spreadsheets (Windows)	40%/42%	6.5%	43.9%/45.8%	43%/46%	9%/5.5%	48.1%/49%
Spreadsheets (DOS)	40%/42%	2.5%	41.5%/43.5%	n/a	n/a	n/a
Wordprocessing (Windows)	48%/50%	6.5%	51.4%/53.3%	43%/46%	9%/5.5%	48.1%/49%
Notes/systems/networking	40%/42%	6.5%	43.9%/45.8%	43%/46%	9%/5.5%	48.1%/49%
All Other (Windows)	44%/46%	6.5%	47.7%/49.5%	43%/46%	9%/5.5%	48.1%/49%
All Other (DOS)	44%/46%	2.5%	45.4%/47.4%	43%/46%	9%/5.5%	48.1%/49%
Upgrades						
All products (Windows)	20%/22%	6.5%	25.2%/27.1%	17%/20%	9%/5.5%	24.5%/24.5%
All products (DOS)	20%/22%	2.5%	22%/24%	17%/20%	9%/5.5%	24.5%/24.5%

- Although Microsoft and Lotus do employ slightly different approaches, the overall discount, rebate and net discount structures are not dramatically different.
- Lotus utilizes discounts and rebates to adjust street pricing of specific products and to focus resellers on specific products.
- Lotus appears to be using lower net discounts on spreadsheets to provide higher marketing fund allowances and to fund special channel discounts to high volume deals.
- Windows product rebates are 4 points higher than for DOS. Thus, Lotus is pushing Windows in a big way.
- Lotus requires internal market share reporting in key product categories. Reporting is required for rebate eligibility.

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Marketing fund programs

	Lotus	Microsoft
Standard MDF Accruals		
Direct Resellers	n/a	2.8% of net purchases
Disti's/franchi's	n/a	.28% of net purchases
Large Indirects	n/a	2.8% of net purchases
Supplemental /Program Funds	n/a	approx. 1-1.5% of net purchases
Proposal-based funds	approx. 7% of net purchases for key resellers	approx. 1% of net purchases
Total estimated MDF for "key resellers"	approx. 7% of net purchases	approx. 5% of net purchases

- Lotus depends more on reseller proposals than accrual to allocate market development funds.
 - ↳ segment by reseller type, don't follow one size fits all philosophy
 - heavy merchandising and advertising at superstores, MORs
 - rep incentives (spiffs, contests) at HW outbound, CARs
 - ↳ allow more flexibility at the field level to negotiate deals
 - go after desired accounts and offer big bucks up front
 - Lotus looks for ROI in awarding MDF
- Microsoft has adopted a more legally conservative approach.

Channel Structure and Strategy

- Lotus has 2 distis, 4 franchisers and 12 direct resellers.
- Lotus is pursuing a three-pronged channel strategy
 - ↳ Two-tiered channel for shrink-wrapped Apps and Mail products
 - ↳ VARs for Notes
 - ↳ Consulting for communication services and expertise
- Lotus reportedly has access to 8,000 reseller locations, including 3,600 VARs
- Lotus has moved Notes from direct-only sales to channel-only sales and is now expanding the channel beyond VAR-only to two-tiered distribution support
 - ↳ sell Notes more quickly with less expense
 - ↳ reach wider audience - smaller businesses
- Lotus has adopted the Novell channel authorization model for Notes VARs.
 - ↳ Resellers must be certified to sell Notes.
 - ↳ There are two classes of resellers: Standard and Premium.
 - ↳ Premium resellers are eligible for joint marketing.
 - ↳ Lotus will match expenditures 1:1 for approved activities.

New Product Directions**New Products in 1994**

- Approach (3.0) by June (probable launch at WinWorld)
 - ↳ hooks into Notes (F/X, forms) "PowerFields" which allow forms to interface directly with Notes via field exchange (F/X).
 - ↳ LotusBasic (object model support, visual programming tools, OLE 2.0 hooks)
 - ↳ clean up consistency problems with other Apps (icons, menu structure)
 - ↳ improved external access (DataLens drivers, ODBC drivers for Notes)
- SmartSuite (2.x , 3.0?) by June (probable launch at WinWorld)
 - ↳ with Approach 3.0
 - ↳ ".1" releases of Ami, Freelance and 123
 - ↳ incremental functionality planned in each App

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- ↳ better and more consistent integration with Notes (F/X, doc properties)
- ↳ some OLE 2.0 support (Approach + object model support within other Apps)
- ↳ new lotus App manager (MOM equivalent)
- ↳ cheap and easy intelligence stuff (autocorrect in Ami)
- ↳ some LotusBasic support across Apps
- **NotesSuite *Workgroup Edition*** by June
 - ↳ positioned as workgroup/network-based suite
 - ↳ bundled with Notes client App and workgroup templates
- **Notes 3.1 server for Netware** (now)
- **Notes 3.1 server for Win NTAS** by fall
- **ScreenCam Release 1.1** (bundled with Notes 3.1, OEM deals, some retail) by summer
- **Lotus Forms** (end of June)
 - ↳ form designer, 12 sample forms
 - ↳ LotusScript macro language
 - ↳ run time "filler" licenses for data entry
 - ↳ ODBC support, some workgroup "tracking" of forms as they move through workgroup
- **Notebook (Notes ViP)** under development. (VBA knock off due by end of year)
 - ↳ LotusScript macro language, which will be incorporated in all Apps by mid '95
 - ↳ graphical user interface builder
 - ↳ utility for building charts
 - ↳ sold in developer and runtime versions
- **cc:Mail Mobile 2.0** - just announced
 - ↳ better remote access to wired and wireless networks

New Products in 1995

- **1-2-3 r 5.0**
 - ↳ code-named Walden, due 3 to 6 mos. after Chicago
 - ↳ complete object oriented re-write of 1-2-3 available for Windows, OS/2, Mac (reportedly!), and UNIX.
 - ↳ Key features expected to include modeless InfoBoxes, customizable help, 32 bit, and LotusScript.
- **SmartSuite v 4.0**
 - ↳ this will probably be the Chicago version with full version upgrades to the big 3 component Apps.
 - ↳ in addition to the new version of 1-2-3, we should expect full version upgrades to AmiPro and Freelance
 - ↳ likely to be 32 bit implementations, and include some of the main features named above in the 1-2-3 release - namely LotusScript, InfoBoxes, and customizable help
- **Notes 4.0** in mid '95
 - ↳ better UI, more scaleable, better programming tools, 32 bit
- **cc:Mail 3.0**
 - ↳ code-name Sequoia
 - ↳ more consistency between platforms
 - ↳ support for some new environments including AIX and HP-UX. (early '95)
- **Notes Communication Server**
 - ↳ available in early '95
 - ↳ will provide a common communications architecture for cc:Mail and Notes.

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Other projects under development

- ☐ **PhoneNotes**
 - ↳ being developed by Simpact
 - ↳ allows phone keypad access to Notes server
- ☐ **VideoNotes**
 - ↳ add on to capture and embed video clips
 - ↳ some reports mention video conferencing with Notes in 2 to 5 years
- ☐ **AT&T Network Notes**
 - ↳ Notes servers supported by AT&T and accessed via phone lines
 - ↳ supposedly developing special "lite" client version for offering
 - ↳ may be getting as much as 12.5% of service revenues
 - ↳ may be seeking similar pacts with European phone companies

Lotus' Sales Performance (year to year comparison)

<i>for the quarter ending</i>	3/31/94	3/31/93	growth
Net Revenues	247	227	9%
<i>P&L in terms of % of rev's</i>			
Cost of sales	18.8%	22.2%	
Gross margin	81.2%	77.8%	
Operating expenses	68.2%	68.6%	
Other (income)/expense, net	(0.5%)	(0.0%)	
Pre-tax income	13.5%	9.2%	
Provision for income taxes	4.9%	3.8%	
Net income	8.6%	5.4%	

as seen from above, earnings improvement was a result of:
 a. revenue increase; b. cost of sales efficiencies; c. lower effective tax rate

Cost of sale efficiencies:

- Some of the factors for improvement are:
1. Scale efficiencies realized via consolidation of US operations (closure of Puerto Rico operations; centralized other US locations)
 2. Utilize excess production capacity by manufacturing for others (i.e. PowerSoft)
 3. Product shift from Lotus 123 to Notes and cc:Mail (COGS for Notes is less than 1% assuming 23 seats per server; COGS for cc:Mail is less than 5% assuming 36 seats per server).
 4. Continual improvements in material costs and production

Lower effective tax rate:

	3/31/94	3/31/93
The effective tax rates are:	36.00%	41.00%

There is no precise intelligence to date to determine rationale, however, the following are guesstimates as to reasoning behind change:

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1. Lotus has existing Net Operating Loss carryforwards (Per annual report footnotes) that it might be using in the current quarter.
2. Increased profitability has afforded Lotus the ability (i.e. more flexibility with foreign/captive sub treatment) to do better tax planning.

Revenue increase (see table below for complete breakdown):

1. Communications products are driving revenue growth, and are more profitable per seat
 - Notes revenue increased 142% YTY
 - Notes came in 43% higher than analysts estimated (+\$10m)
2. Its not clear whether growth in Notes revenues is a function of unit volume or increase in revenue per unit (i.e. agreement with IBM terminated.....agreement required lotus to provide IBM up to 25-33% royalty on each sale).
3. SmartSuite sales grew 153%, but overall App sales declined 7% due to rapid deterioration in DOS market.
4. Transition to SmartSuite sales seems to be cannibalizing growth in standalone App sales.

Lotus' Revenue by Product
Lotus Development Corp
Quarterly Sales Breakdown

Fiscal Quarter Ending	04/02/94	% total	04/03/93	% total	% change
Net Sales	\$ 247	100%	\$ 227	100%	9%
Communications	\$ 72	29%	\$ 39	17%	85%
Notes	\$ 35	14%	\$ 15	6%	142%
cc:Mail	\$ 27	11%	\$ 18	8%	52%
Consulting	\$ 9	4%	\$ 6	3%	48%
Apps	\$ 172	70%	\$ 185	82%	-7%
Windows Apps	\$ 132	54%	\$ 115	51%	15%
SmartSuite	\$ 58	24%	\$ 23	10%	153%
123	\$ 40	16%	\$ 59	26%	-32%
AmiPro	\$ 12	5%	\$ 10	5%	20%
Freelance	\$ 17	7%	\$ 22	10%	-23%
Approach	\$ 2	1%	-	-	-
Organizer	\$ 1	0%	-	-	-
Improv	\$ 1	0%	\$ 1	0%	0%
DOS Apps	\$ 40	16%	\$ 70	31%	-43%
123 2.x	\$ 27	11%	\$ 48	21%	-43%
123 3.x	\$ 13	5%	\$ 22	10%	-43%
Other (Mac/ OS2/ Unix)	\$ 3	1%	\$ 3	1%	0%

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Key points:

- * Overall results were slightly lower than Lotus was estimating
- * Revenue shortfall (from estimates) maps closely to lower than expected 123 revenues
 - 123r4 for DOS never shipped and is likely scuttled
 - 123r4 for Win got beat up pretty badly by the introduction of xl 5
- * Although the DOS decline was precipitous, it seems to be falling at a predictable rate of 40% annually
- * Breakdowns were estimated using public statements from Lotus executives and analysts

Relative Sales Performance

	Microsoft		Lotus	
	\$'s (a)	% growth (c)	\$'s (a)	% growth (c)
WinOffice(b) vs. WinSmartSuite	\$330	128%	\$58	153%
WinExcel vs. Win123 (d)	\$142	53%	\$40	-32%
WinWord vs. WinAmiPro (d)	\$86	5%	\$12	20%
WinPPT vs. WinFreelance \$13	57%		\$17	-23%

- (a) \$'s are as of 3/31/94 and are in millions
- (b) includes office pro
- (c) % growth is based on comparing the quarter ended 3/31/94 to 3/31/93
- (d) office and SmartSuite allocations are not reflected in stand alone products

Key points:

- 1) Microsoft has been more successful in managing transition to integrated Apps (e.g. sustained positive sales growth in stand alone Apps), whereas Lotus has not.
- 2) Period comparison is biased by introduction of xl 5 during qtr. and launch of word 6 in previous qtr.

WW Market Share (PC Data - sell through)

Office and Standalone App share (excluding Office)

	July -Sept. 94		Oct. - Dec. 94	
	Msft	lotus	Msft	lotus
WinOffice(b) vs. WinSmartSuite				
lic	79%	14%	81%	15%
rev	81%	13%	82%	15%
WinExcel(a) vs. Win123				
lic	30%	32%	15%	26%
rev	39%	42%	26%	40%
WinWord(a) vs. WinAmiPro				
lic	31%	9%	30%	6%
rev	34%	6%	32%	6%
WinPPT(a) vs. WinFreelance				
lic	21%	23%	15%	22%
rev	20%	20%	16%	27%

- (a) office and SmartSuite allocations are not reflected in stand alone products
- (b) includes office pro

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Standalone App share including Office

	July -Sept. 94		Oct. - Dec. 94	
	Msft	lotus	Msft	lotus
WinExcel(a) vs. Win123 lic	43%	27%	37%	22%
WinWord(a) vs. WinAmiPro lic	45%	10%	43%	8%
WinPPT(a) vs. WinFreelance lic	60%	18%	64%	17%

(a) Office and SmartSuite allocations are included in stand alone products

(b) includes office pro

note: revenue shares were not calculated with office/suite allocations as it is unlikely that a common method of allocation exists. At this time, we did not want to create a measuring device that would be inconsistent with other numbers that may be available. More work will be done in this area in the future.

Key points:

- Office maintained a greater than 80% rev and lic share for the first 9 mos. of FY94 while SmartSuite's share stalled.
- All Msft Apps were bolstered by Office's contribution, reflecting our strong relative position in the office/suite category. Excel and PowerPoint, climb to #1 positions (licenses) when including Office.
- Excel's standalone market share (license and revenue) was hit hard in Oct. - Dec. timeframe due to pending Excel 5 intro., the shift to Office as a primary purchase vehicle, and Borland's aggressive pricing activity.
- 1-2-3 has the best relative share position to Microsoft Apps with a #1 rev share of 40% in the standalone spreadsheet category.
- Borland's QPro 5 had significant market impact in the Oct. - Dec. timeframe, capturing 58% (#1) of lic share and 33% (#2) of rev share, more than doubling their previous period lic share. Borland's presence as a standalone category player hurt both Lotus and Microsoft.
- WP maintained the #1 position in the standalone WP App market and sustained this advantage with office/suite sales factored in. WP grew from about 60% of total lic and rev share to 64% on a standalone basis, and increased their lic share from 45% to 49% when office/suite sales were included. AmiPro fell from about 9% to 6% on a standalone basis (lic), and from 10% to 8% with SmartSuite included. Rev share remained a dismal 6%.

Market Momentum

- Big bet on Notes "vision" is finally paying off
 - ↳ defining a new category of workgroup, generating broad interest and awareness. positive pr
 - ↳ first to market, accelerating adoption, entrenching lead position, strong revenue gains
 - ↳ potential Trojan horse for Apps sales
 - ↳ selling "electronic keiretsu" whereby Notes installations pull other Notes installation as firms set up networks for suppliers, customers, and business partners to communicate
- Lotus is at last competitive in Windows SS market, offering a credible migration path from 123DOS
- Growth in sales of SmartSuite, improved awareness as the only "other" office/suite player. Lotus will continue to work hard to solidify this position to prevent Novell/WP from gaining toehold in category.

Strengths

- Big installed base of DOS 123 to feed from (~10mm), with improved WinApps to sell in.
- Strong brand recognition from 123's "most popular software application in the world" position
 - ↳ helping to build SmartSuite awareness quickly, and establish credibility in WinApp market

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- Market perception of workgroup superiority, first to market in "new" category, thought to have 12 -18 month lead in workgroup market position and product development cycle
- Narrower focus on fewer fronts ameliorates scale disadvantages.
- Viable alternative to over-dependency on Msft, important leverage for many ORGs
- SMORG penetration is 3 times higher than Msft's, best position in fast growing market
- Generally well-rated products across the board in Win Apps
- Best rated product in graphics, provides some leverage in shoot-outs
- Only suite with PIM (Organizer), added leverage in shoot-outs, point of difference
- Strong penetration of cc:Mail, rivals MS Mail
- Apps integration with Notes (great FUD potential, picked up on by the press)
- Aggressive, large scale marketing efforts - big budget ads, national seminar selling
- Managing growth through strategic acquisitions
- SWAT Team approach to organizational selling, makes customer feel like support will be better
- Focused, internal effort to establish common code usage
 - ↳ lower development headcount, cost
 - ↳ cleaner more usable code that can be utilized by more products
 - ↳ reduced disk space for SmartSuite, reduced COGs, easier installs

Weaknesses

- Unproved internal product development program
 - ↳ acquisition driven growth, company must now upgrade Apps to grow share
- Low market share in major categories
 - ↳ AmiPro still lagging in market share (<10%)
 - ↳ SmartSuite stalled at 15%
 - ↳ Approach not even on the map yet
- DOS business declining faster than Win App business is growing
 - ↳ net decline by 7% in applications sales over last year
 - ↳ DOS business declining 40% annually
- Still viewed by many as a one product company
- Comparatively low operating profit margins (12% compared to 35% for Novell, Msft)
- Smaller scale to support R&D, sales and marketing expense
 - ↳ higher relative costs
 - ↳ would have more difficulty in withstanding price war and therefore unlikely to start
- Playing catch-up in features, technology in Win Apps product line
 - ↳ no CML, OLE 2.0, Wizards, IntelliSense
 - ↳ less consistency in GUI and method of operation across Apps
- No Mac Apps
 - ↳ undermines cross-platform message
- No common communications architecture to unify cc:Mail and Notes yet available
- Weak infrastructure to support Notes advance
 - ↳ despite the hype, lotus does not yet have the channel structure in place to support widespread adoption and usage of Notes
- Recent re-org of field has left created ill will
 - ↳ reports of losing key Notes Acc't mgrs. and SEs, compensation is lower, lotus is trying to hire replacements

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Opportunities

- Attack Lotus' 1-2-3 franchise.** Increase efforts to switch DOS 1-2-3 users. Subsegment switcher market to identify real hot buttons for switching, and most effective/targeted means to reach them. Focus more marketing efforts on Excel to force Lotus to protect franchise and divert resources from SmartSuite.

- Make scale advantages work to our benefit.** Today, Microsoft divisions often compete with each other over resources, to the benefit of our competitors. Lotus' narrow focus on Notes and SmartSuite makes their marketing dollars go further. We need to insure that we leverage both technology and marketing scale.
- Redefine "information exchange" as the real "workgroup" category.** Thwart Notes momentum by elevating discussion to solving customer problems with solutions rather than "anti Notes" selling. Leverage marketing and product planning across divisions.
- Maintain product cycle time and technology leadership** in product development.
 - ↳ Better integrate Msft's Apps and workgroup product planning efforts to develop better workgroup enabled solutions.
 - ↳ Develop better insight into what workgroup enabled features will be added to SmartSuite. use to blunt Lotus' advance
 - ↳ Maintain lead in programmability, integration, consistency, usability
 - ↳ Gain first move position on Chicago, on-line support
- Block growth in Lotus' business partner development through SP/VAR recruitment.
- Recruit and hire Lotus SEs and marketing personnel with knowledge of Lotus' strategy
- SMORG focus
- Exploit Mac platform support advantage

Threats

- Notes adoption accelerates, creating insurmountable lead in workgroup.
- Lotus successfully links Notes and SmartSuite, creating difficult to match point of difference.
- DOS base migrates to 123 Win en masse during Chicago upgrade wave.
- Lotus steps up efforts to target SMORGs, entrenches users, maintains current advantage.
- SmartSuite attains market share parity in suite/office category.
- New versions of desktop apps eliminate our feature/technology edge.
- A total re-write of 1-2-3 produces leaner, faster and more portable code.

Next Steps - Major Area Drill Downs

- New product development
 - ↳ timing, features, platform support
 - ↳ code sharing, design process
- Competitive research review
 - ↳ consolidate all available internal research with competitive content
 - ↳ summarize major findings, implications and recommendations
- Marketing Communications review
 - ↳ Advertising/Media plan update
 - ↳ identify positioning, spending levels, audience targets, key messages
- Financial Analysis
 - ↳ create comparative financial model
 - ↳ P&L assessment, revenue breakdowns, ratio analysis, efficiency measures
- Organizational Structure
 - ↳ resource allocation, emphasis areas, communication/decision making
 - ↳ new players, resume/personality profiles
- Customer Service and Support
 - ↳ compare and contrast customer support programs and policies
- Channel Analysis and Planning
 - ↳ merchandising/promotional program audit, channel pricing, distribution analysis

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