

Microsoft Strategy

Compaq Computer Corporation
February 26, 1997

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Objectives:

- Review Action Item Decisions from last CST discussion
- "Rules of the Road" Update
- Decide on Team Structure, Work Plan and Process for developing the plan to create a "soft landing" in April '98

Decisions:

- Action item implementation
- GEO model proposal
- FLP funding:
 - 1H 97 2H97-1Q98
 - \$150K \$3.3m
- Compaq-Microsoft 2000+ Team Formation
- Strawman approach to "soft landing"
- Engage in Compaq-Microsoft 2000+ "Framework" development

Agenda

- Brief Review and Action Item Update
- "Rules of the Road"
- Field Engagement Model and FLP Funds Issues
- New License Agreement - Partnership
- Summary/Discussion

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CST 12/3/96 Action Items

Who

Status

Results

1. Establish team to work with Microsoft on Active Desktop business model	Heil, Losert, Flannigan	Done	Kurt Losert leading effort; Kempin here 3/26 with proposal
3. Decide who has responsibility for planning FLP "soft-landing" and follow-up program	Heil, Winkler, Rose, Lutz, Snyder	Done	John Rose is the Senior Executive Microsoft "sponsor" for the corporation
2. Determine process for interaction between Business team and Procurement and what Business team can and can't do	Flannigan, Goldberg, Decker	Done	Email sent out mid-December regarding "Rules of the Road"
9. Determine transition plan to Procurement model	Flannigan, Goldberg, Decker	Done	Plan in place; reqs approved to staff Decker's group
8. Communicate to Microsoft the Procurement centralization decision of Executive Staff/CST	Flannigan, Goldberg	Done	Very pleased with both John's role and Decker's team

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CST 12/3/96 Action Items

Who Status Results


7. Flannigan to work with Snyder to find how to best leverage successful EMEA model across other GEOs	Flannigan, Snyder	In progress	Decision item today
4. Determine where management of the FLP funds belong	Flannigan, Snyder	In progress	Snyder will handle when he has team in place; Decision on JK Fund replacement issue today
6. Each Group to develop process to rationalize internally MS interaction and create a focal point to facilitate intra-company communications	Each Group General Manager	In progress	Heil - L. Frick Winkler - J. Gerber Rose - R. Ward Lutz - (E. Olkkola)
5. Rationalize appropriate execution match-ups	Flannigan, CST	In progress	Continuing effort in restructuring the MS business structure within Compaq world-wide

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Microsoft Interactions Can Be Grouped Into Four Main Categories

Product Group or Geography

- Group or Geography-wide where the nature of the business relationship is mainly within a Group or Geography set of businesses.

Front Line Partnership Joint Marketing and Selling

- Small fund to stimulate field engagement
- Decision today

Financial/licensing based transactions

- Transactional in nature; signature authority for license negotiation, LOI's, MOU's, royalty tracking, reporting and payment; contract generation and compliance, etc.
- "Rules of the Road"

Company-wide, strategic in nature

- Company-wide and strategic in nature, where the impact of the interaction sets the direction and pace of our business

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WW PROCUREMENT

New Rules Of The Road

- In December '96, a communication was sent to CST members for distribution to their respective staff members announcing the new rules.
- These include:
 - All Microsoft License Agreements, LOI's, MOU's and Purchase Agreements may be executed by Corporate Materials/Operations only
- Sign off process being established with checks and balances
 - Approvals needed by Finance, Legal, and Product Group or GEO executive before sign off
- Software Procurement will be the central administration of Microsoft Agreements, as well the support for all negotiations with Microsoft.

Current Status

- Software Procurement has 7 open req's in Q1'97 to support the MS initiative.
 - Actively recruiting; expect to fill two or three by end of Q1.
 - These represent six software Commodity/Contracts Managers and one administrator, all of whom will be dedicated to Product Divisions/GEOs
- A core team has been established to develop the appropriate Software Royalty Reporting System and group to handle this function.
 - Team leader is Dave Bennett from Corporate Materials Finance
 - Goal is to have in place by Q3/Q4
- A sub-team has been established to develop and implement a part numbering method to tie software IP to Bills of Materials for tracking and reporting purposes.
 - Team leader is Ken Kelly from Corporate Materials Finance
 - Goal is to have in place by end of Q2

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- “Rules of the Road”
- Field Engagement Model and FLP Funds Issues
 - EMEA model - can we replicate this model in other Geos?
 - FLP Funding model and loss of “JK Fund”
- New License Agreement - Partnership



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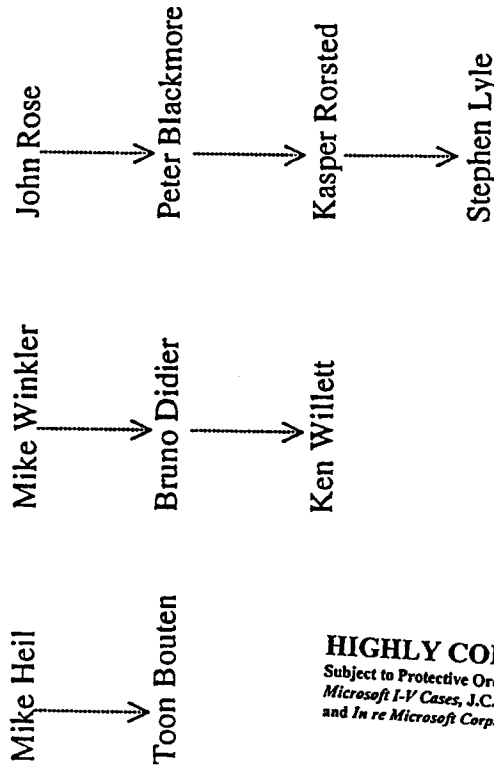
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Winning Compaq/EMEA Model



- Peter Blackmore is Executive sponsor of Microsoft in EMEA for Compaq.
- Peter focuses on Rolf Skoglund. Bruno Didier and Toon Bouten focus more on the OEM side of Microsoft.
- Peter and Kasper drive quarterly business meetings, one of which is an annual review and planning session that develops a set of objectives for the year.
- Kasper and Stephen drive this set of objectives through their counterparts in the countries; Skoglund drives same set at MS Europe.
- Manage relationship on a business basis
 - Measurable business focus activity
 - Agreement on both sides to not let corporate issues impact business in Europe
- Built on trust plus sound business
 - Exchange market data
 - Clear escalation process focused on Peter and Kasper

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GEO Partner Model

EMEA Model

Partnership Organizational Structure

- Sr. VPs give keynotes at each other's key yearly events
- Quarterly meetings result in written measurable objectives and commitments to plans (Blackmore & Skoglund)
- Alliance Manager team (Kasper/Stephen) coordinates all:
 - Marketing/Sales
 - Business Development
 - Events/Activities
- CPQ manager teams meet regularly to communicate all partner activities
- Bi-monthly Compaq/Microsoft alliance manager meetings drive partner commitments (EMEA, OCU/ECU)
- Designated partner manager per country focused on alliance objectives and sales.
- Countries handle joint programs and relationships locally with Microsoft's OCU/ECU contacts.
- Alliance planning maintains single point of contact.

EMEA & APD

Benefits of EMEA Model

- Centralization of engagements with Microsoft builds experience, trust through repeated interactions and clear measurable business accountability.
- Constant sharing and communication at multiple levels between companies shows commitment and keeps the relationship focused and strong; it also counters emotional flare-ups.
- Enable allocation of resources in an efficient manner, with dedicated resources to projects that require partnership management support.
- Success breeds imitation: APD is implementing similar partner organization.

APD Developing Model

- Recently moved ownership of relationship to sub-regions and countries.
 - Designated partner managers in each of the 4 sub-regions of APD. (HK, Korea - done)
- Partnership focused on marketing and sales : infrastructure, channels and events.
- Cooperative setting of joint priorities and goals being established on a regular basis.
- Executive management meetings by country in the planning process.

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Proposed N.A. Model

- Key missing component in N.A. is the equivalent function of what Peter Blackmore and Randy Tan fulfill in their respective Geos
- N.A. has the additional problem of being co-located with both Corporate and Product Groups
- Proposed Model
 - The logical counterpart to Peter Blackmore and Randy Tan is Bob Fernandez
 - Think of N.A. regions as countries when comparing models
 - Adjust for unique N.A. issues at both Compaq and Microsoft
 - Remain focused on measurable business objectives that drive sales and revenue
- *Decision: Move forward to the next planning phase and delegate decision to execute to Schraith*

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Bob Jackson created the concept of the Front Line Partnership to create a very high bar for other OEMs to reach. A part of that partnership creates a fund of \$.50 for every royalty-bearing unit shipped. Funds are part of Kempin's budget and are jointly managed by Compaq and Microsoft. The fund was designed to *stimulate* field engagement at the lowest level. The process drives joint planning meetings in every country. The fund only pays for a portion; Microsoft and Compaq locally have to contribute money.

Front Line Partnership Funds

- Highly leveraged program that has brought very good results
 - Increased 1000% joint activities worldwide from 4/93-present
 - Driven World-Wide Proactive Sales Force Engagement
 - From 1993 to present 1,175+ joint marketing events at a cost of \$13M (very high leverage)
- Summary 1996 Engagements
 - >\$1B Generated sales spanning 100+ major accounts
 - >6 Joint Enterprise customer briefings WW reaching >50 accounts
 - 12+ Joint Reseller strategy briefings WW
 - 35+ Joint Enterprise Sales efforts in progress
 - Over 100 joint marketing events worldwide
- 1997 Focus for Fund Allocation (Key Messages)
 - Internet/Intranet - TCO
 - Win32 Desktop and Server
 - Customer-focused Field Engagements
 - SMB

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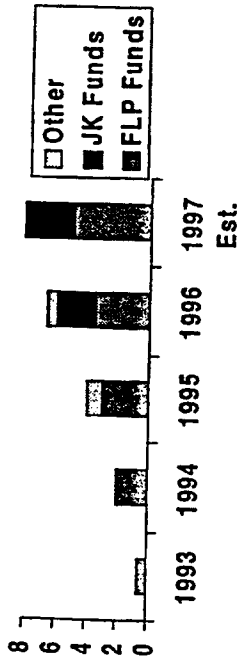
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We need to restructure the FLP Funds. Create an interim transition process that eliminates consumer burden of the "Companion CD", supplement lost funding directly, enhance APD funding level and finally create a new process for '98 and beyond.

Front Line Partnership Funds

Organization and Working Together



JK Fund Issue

- Consumer never benefited
- Microsoft sees the "Companion CD" as old and difficult to support
- Both want this restructured
- Loss of \$2,719,600 in 1997 and 1Q98 to WW GEO funded activities

Proposal

- Restructure "Companion CD" and it's associated costs
- Compaq supplements lost funds until the end of the agreement; negotiate with Kempin a 50/50 split of these supplemental funds. Also increase the APD funding level.
- Break this concept from the license agreement negotiation
- Create a new funding structure for field engagements going forward, which would be independent of License Agreement, managed from Snyder's group

• **Decision: Approve the proposal and the funding level**

- Other - fund used for specific initiatives; one time shots only
- JK funds - results from 1995 agreement to offset cost of Consumer's shipment of "Companion CD" (\$.50 per Win95 pre-installed)
- FLP Funds - base agreement fund; \$.50 for every royalty-bearing unit

<u>1H97</u>		<u>2H97-1Q98</u>	
JK	\$0		\$2,719,600
APD	\$150,000		\$ 600,000
Total	\$150,000		\$3,319,600

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- Brief Review and Action Item Update
- Field Engagement Model and FLP Funds Issues
- “Rules of the Road”
-  New License Agreement - Partnership
 - Microsoft's current OEM License structure
 - Proposed approach and team structure

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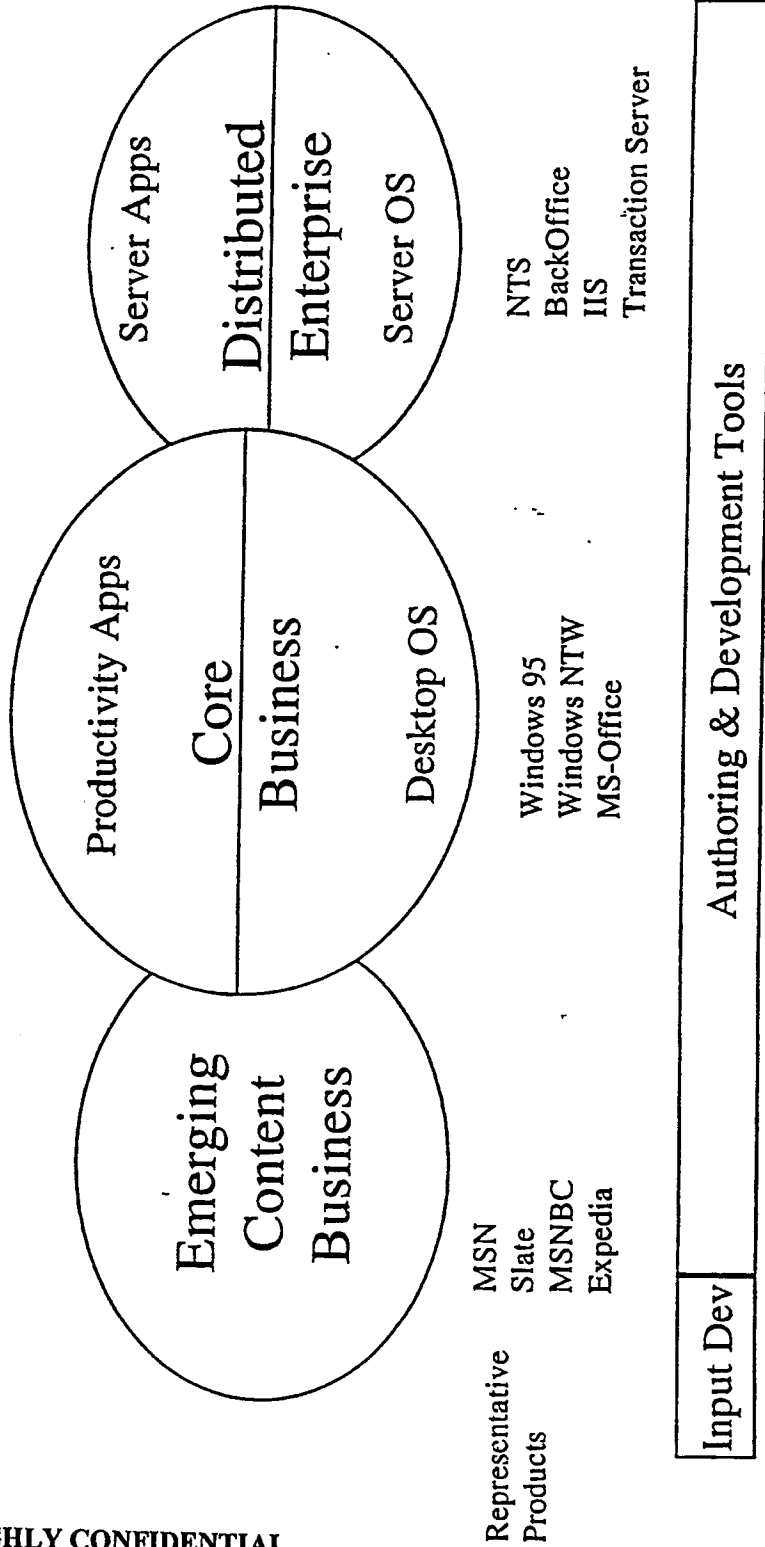
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Microsoft is managing their core business of desktop operating systems and productivity applications for profits and is aggressively investing to form two new businesses around Distributed Enterprise and Content. A robust tools effort supports all three.

Strategic Business Overview

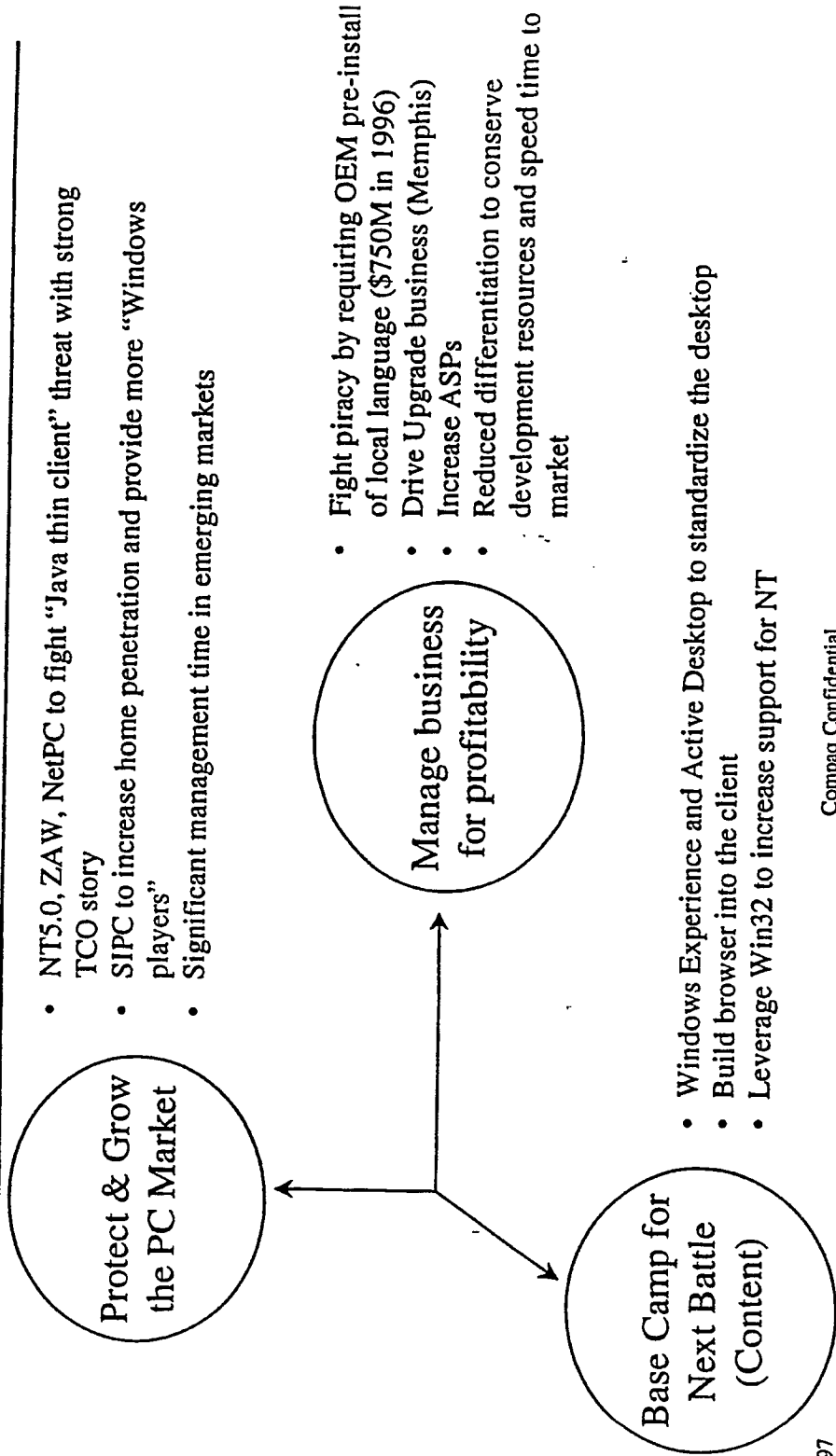


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MS will manage the desktop OS business as a maturing business. We believe Microsoft's objective is to throw off cash to fund the money-losing Content business and continue to grow the profitable Distributed Enterprise initiative.

Client Operating System Strategies



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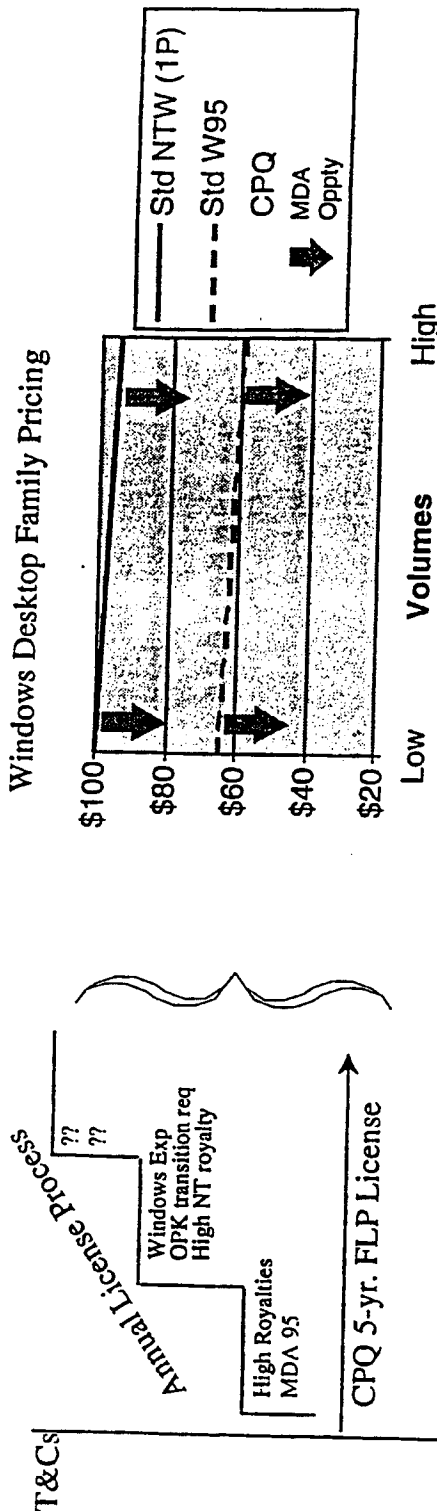
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MS has used the annual licensing process and Market Development agreements (MDA - a variant of Appendix P that defined our FLP years ago) to impose higher royalties and stiff T&Cs on the OEM community.

MS OS Licensing Model



OEM License Terms

- Windows Experience
- Per system only
- Pre-installation
- OS transition within 90 days
- Monthly reporting
- Localization Uplifts (15%)
- Pay for Performance MDA lowers next year's royalty
- NTW = 2 x W95 for one socket
- 2PNTW (1 processor & 1 socket) = 1.4 X IPNTW, etc..

1996 MDA Highlights

- PC95 Requirements (WHQL-certified)
- PC95 Recommendation
- Pre-install within 60 days
- Localized software for emerging markets
- Active participation with MS
- MS Support initiatives
- MS Logo usage

1997 MDA Highlights

- PC97 Required
- Designed for MS Windows Logo
- Transition to new O/S in 60 days
- Localized OS in each industry
- Ship media and recovery CD
- MS support initiatives (employ MS certified professionals)
- Support anti-piracy efforts
- Add-in cards Plug and Play compliant

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Recent Data on Compaq From Latest BOP

- OEM Ranking on total OEM revenue:
 - #1 IBM
 - #2 Dell
 - #3 Gateway
 - #4 Compaq

- Compaq's WW share measured in royalty reported units is 11.3% (4Q96 estimated)

- OEM revenue per machine:

<ul style="list-style-type: none"> • IBM \$55-\$60/unit • Industry average \$50/unit • Dell } ↑ • Gateway } ↑ • Compaq \$33/unit 	<ul style="list-style-type: none"> • Office Bundle Impact \$120/unit • \$-76/unit (OEM Office 95) • \$44/unit
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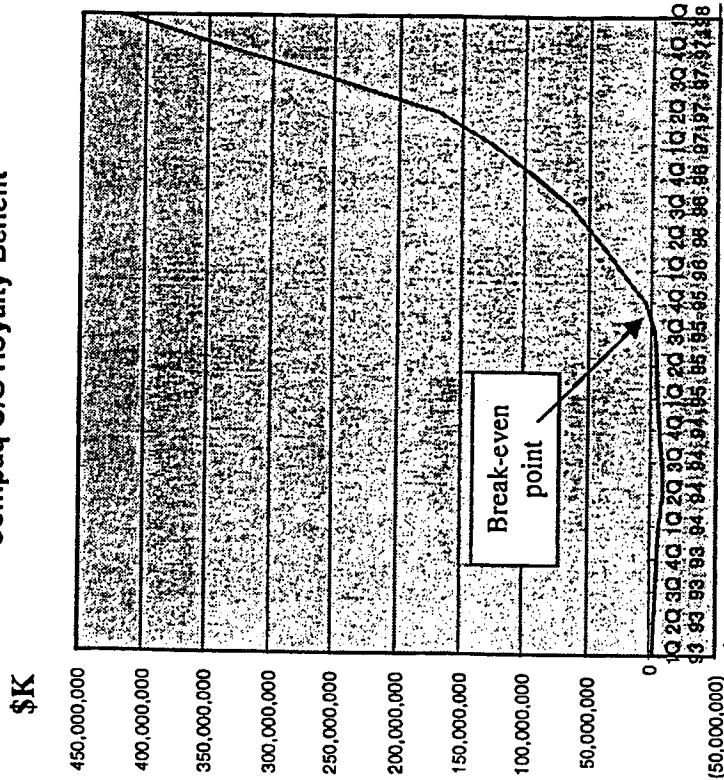
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The five year Client OS License Agreement is giving Compaq favorable royalties compared to other large OEM's on Windows 95 and Windows NTW. The P&L impact from 1Q98 to 2Q98 must be managed to a "soft landing".

The Value of the Microsoft Partnership

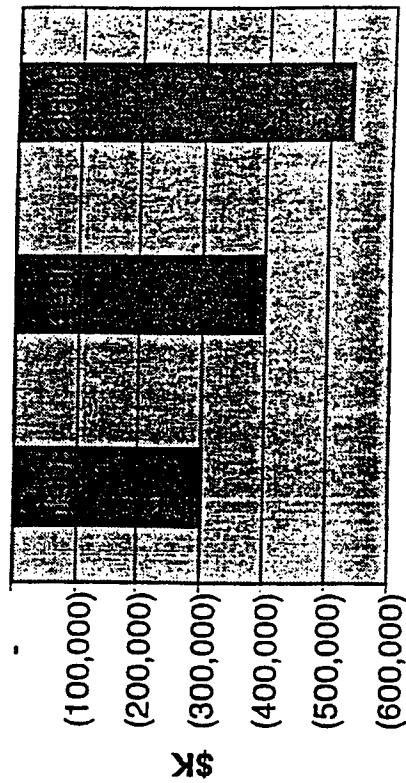
Compaq O/S Royalty Benefit



Simple Example:

Mix Assumption 30%	Impact on 10m units in '98
1. Win 9X: \$31-\$46 >\$15	\$105
2. NTW (1P): \$31 - \$86 >\$55	\$165
3. European uplift 15%	\$20
	\$290 = \$1 per share

PBI Impact of FLP Expiration (Royalty Only)



Source: Corporate Finance; Team Analysis

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Source: Compaq Team Analysis

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Compaq-Microsoft 2000+

The Strawman Structure Of The Deal

- Divide the structure of the "deal" into three levels, developed in three phases, with quarterly objectives, milestones, signposts and course corrections.
 - Level 1:
 - The "Framework" which sets out the nature of the relationship/partnership of the two companies, on a global scale, spanning the full range of market segments we currently cover and plan to cover in the future

Level 2:

- Driving from the "Framework", the "Partnership" (similar to Appendix P of the current agreement), a subset of which would include the current Microsoft OEM group's Market Development Agreement, describes the nature of the partnership, responsibilities and commitments for each partner, and the benefits (including \$\$) derived by each partner

Level 3:

- The License Agreements needed to fulfill the "Framework" and "Partnership"

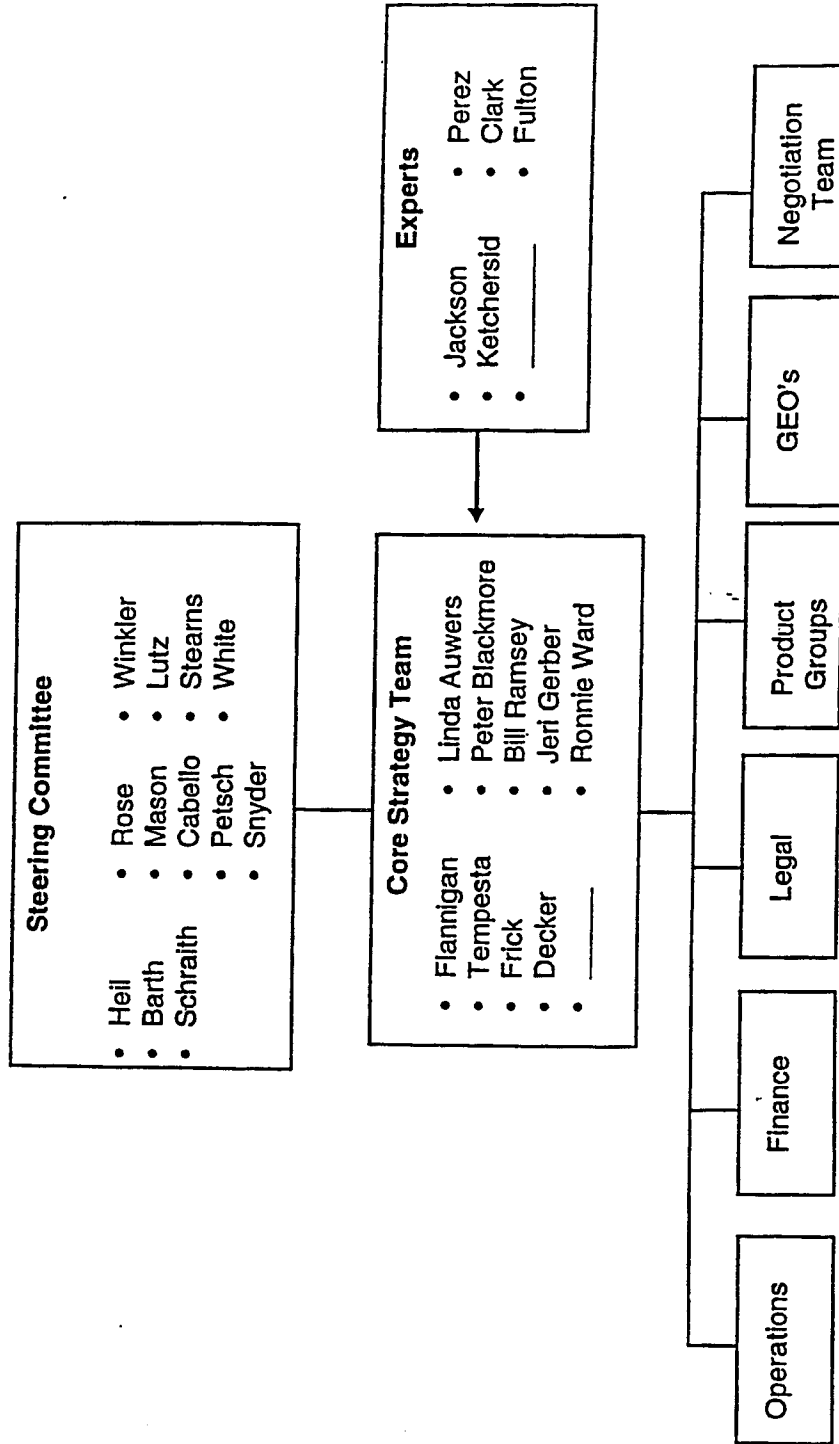
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Decision Summary

- Continued support of the decisions made in the 12/3 CST
- Action item implementation
- Start next phase of NA model and delegate execution decision to Schraith
- FLP alternate funding approval:

<u>1H 97</u>	<u>2H97-1Q98</u>
\$150K	\$3.3m

- Strawman plan and approach
- Form core team and sub-teams when needed
- Engage in "Framework" development

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Additional Slides
on
MS Strategy

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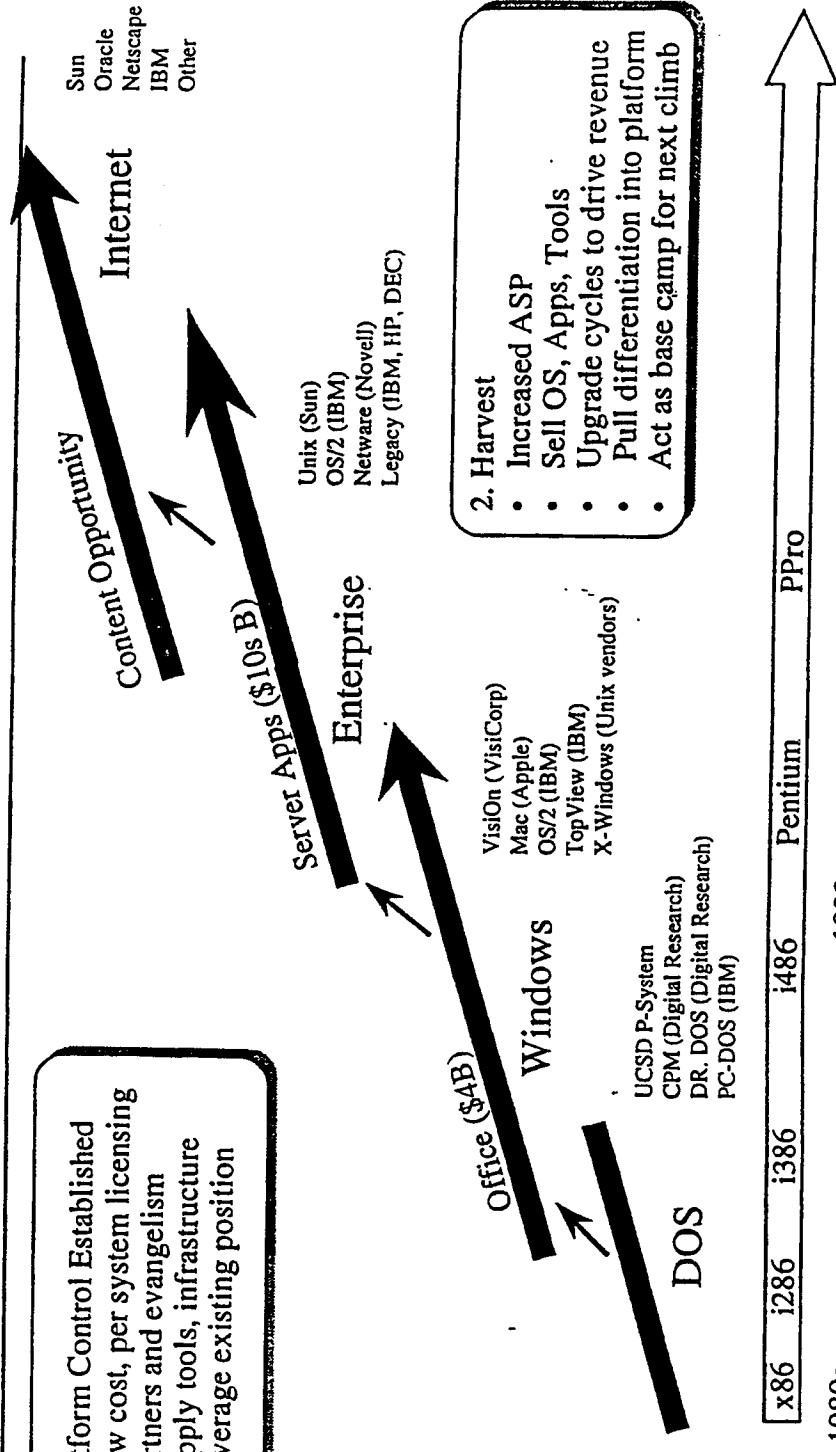
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Microsoft's Four Great Platforms

1. Platform Control Established
- Low cost, per system licensing
 - Partners and evangelism
 - Supply tools, infrastructure
 - Leverage existing position



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Hallmarks of Microsoft's Business Approach

- Design high value, low cost, high volume products for mass markets (vs. custom, proprietary solutions)
- Rely on highly leveraged operations model...Dependent on ISV, IHV, solution partners, channels to deliver full product to customer
- Historically, not "first" or "best" but now investing for/acquiring technology leadership (MS Research, Talisman, etc.)
- Learn, particularly from others' mistakes; iterate to identify correct business model; seize critical control points; profit later
- License model
- Expense everything
- Hire best talent; compensate with low base plus significant stock options at all levels

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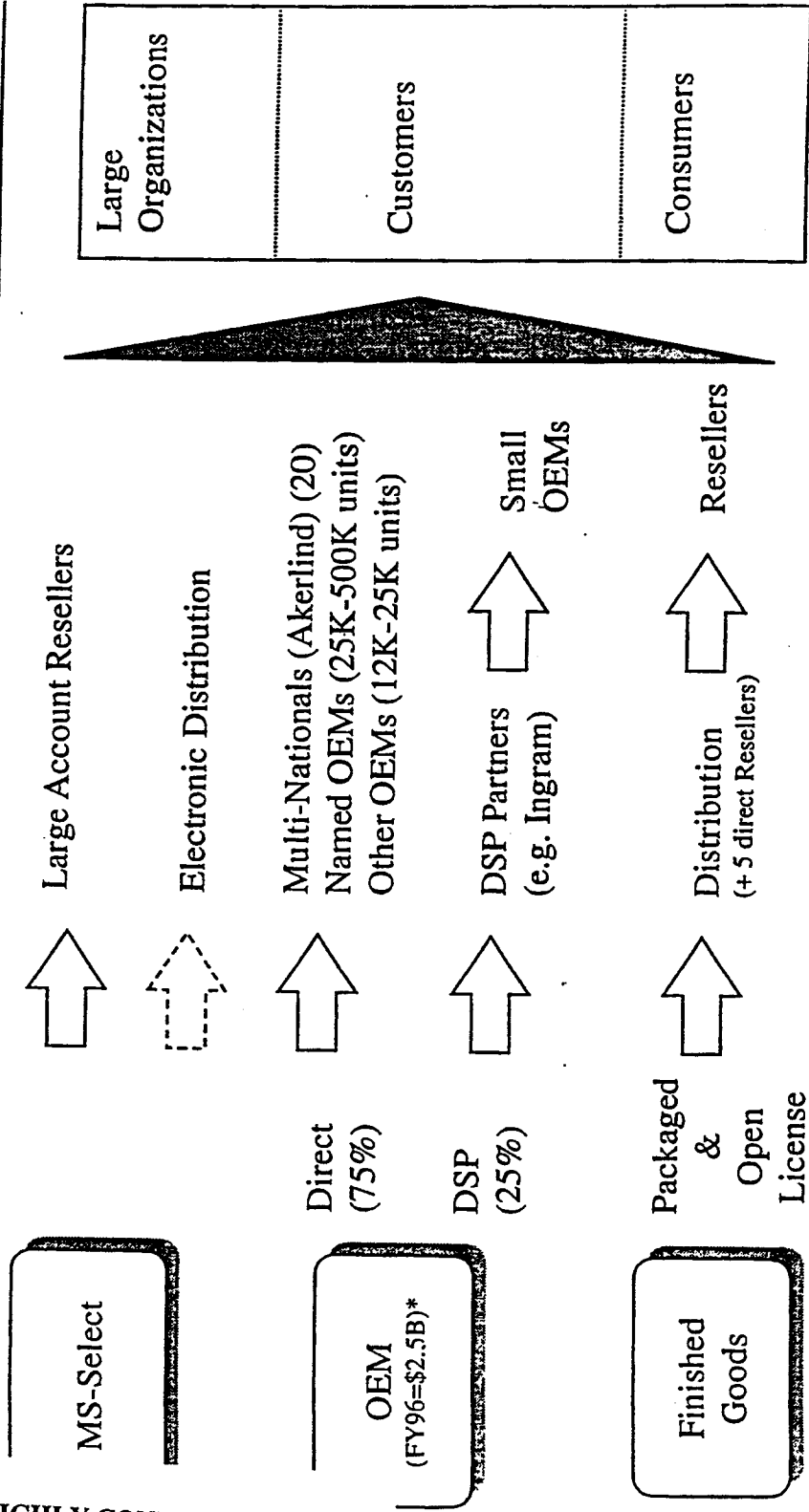
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Microsoft's business has shifted away from finished goods to license products (Select). OEM represents about 25% of MS revenues. The Delivery Services Partner (DSP) program is an OEM initiative to sell to the smallest OEMs. MS is also piloting electronic distribution through the channel.

Microsoft's Channel Structure

* Royalties from Compaq totaled \$200M



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While Compaq does not have an MDA agreement, many of Microsoft's actions can be understood by monitoring their involvement with other OEMs. This tool has been very successful for Microsoft in controlling the actions of its OEMs.

Example of Pay for Performance MDA using Compaq Volumes

MDA 96 Opportunity = 7 Million Units X \$20 = \$140 M per year

- Cost to not ship localized software pre-installed: \$7 M
- Cost to not use "Design For Windows Logo": \$28M
- Cost to not pre-install within 60 days of new release: \$16.5M
- Cost to not ship PC9x-compliant systems: \$7M
- Cost to not ship PC9x-recommended systems: \$7M

MDA 97 Will Be Different!

OEM engages in MDA Initiatives this year

to earn Royalty Discounts next year

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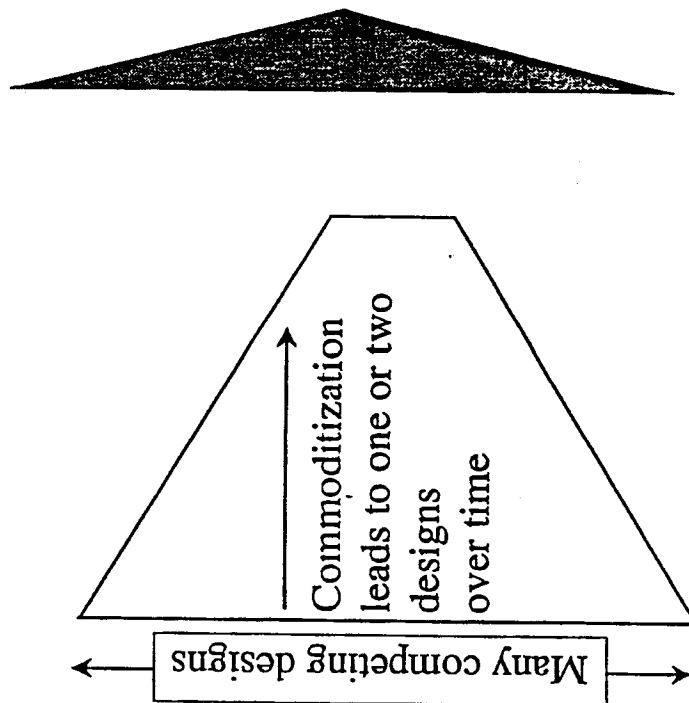
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While MS historically has supported broad OEM differentiation, it increasingly is using its clout to set standards (often with Intel) and dictate designs to drive higher PC sales and lower MS development/test costs. OEMs who work closely with MS may achieve better supported implementations earlier than the rest of the industry.

Microsoft Setting Standards

Compaq (& others) innovating/setting standards with MS support



MS + Intel + Large OEM Set Standards

- MS "chooses" preferred solution, driving as standard via PC9x & MDA
- PC9x ensures early standard setting & commoditization, leading to faster market growth
- MS develops reference implementation with most qualified OEM (e.g. ACPI, DeviceBay, NetPC)
- OEMs have limited ability to roll their own (Windows Experience)
- CPQ has opportunity to occupy OEM "spot"

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MS is depending on Office 97 for a huge profitable upgrade cycle. To attack the SMB market while cordoning off the lucrative corporate market, MS has created a special SMB package and altered its licensing strategies. MS faces a challenge by upstart Corel.

Business Model changes with Office 97

• Office97 Standard	Excel, Word, PowerPoint, Outlook
• Office97 Professional	Standard+ Access
• Office97 Small Business	Excel, Word, Publisher, Outlook, Automap, Small Business Finance Manager

OEM Deals

- MS focus is on Office SBE for Direct OEMs and Word bundle for channel-based companies.
- OEM negotiations still underway. Gateway will bundle Office SBE with a "completer" kit to Pro. Combined pricing will not be competitive with Select.
- Office Pro and Std will not be OEM'd
- MS claims that Office 95 deals will be terminated.

Select 4.0

- OEM sales no longer count towards Select commitments
- Enterprise Licensing discontinued
- New Volume Licensing "D" level for 12,500-25,000 seats
- Customers can opt to extend Select 3.0 terms for two years

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Conclusions

- MS licensing actions should largely eliminate the corporate bid problem caused by preferential pricing for Dell, Gateway, etc.
- Without a Office deal, Compaq will remain vulnerable with accounts with fewer than 5,000 productivity desktops that qualify only at MVP Level A or B or Open Licensing
- Dell may still be in a position, short term, to be important. An OEM/LAR still has flexibility.

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In the consumer space, enhancing Windows to have more appliance like functionality is a significant opportunity to increase PC sales by moving the PC from the home office into the living room. MS will use PC9x as a mechanism to drive its vision into the market.

Simply Interactive PC- Increasing PC shipments

Initiative	Benefits
• On Now / ACPI	Appliance-like operation
• Low Power Usage
• Sealed Case PC	...
• Device Bay	...
• Easy, External interface and expansion (USB, 1394)	• PC97 sets hardware specification
• Advanced multimedia	• MDA drives OEM support
• Removal of legacy support (DOS boot)	• Memphis enables

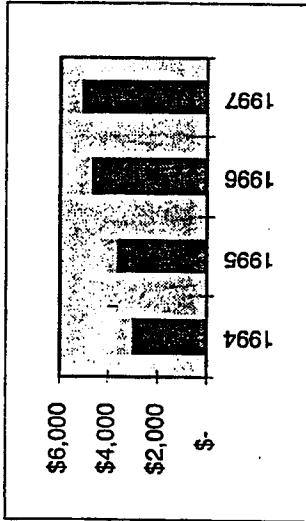
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Microsoft's application business, dominated by Office, is a mature \$4 Billion business. MS has a dominant, lucrative position in the large account but has had less success in SMB. The primary goal is to manage for profitability and provide funds to invest in other businesses.

Microsoft's Desktop Productivity Application Business

Financial Performance



Strengths

Dominant Share in many segments

- Strong brand preference

Weaknesses/ threats

- SMB/home penetration remains weak
- Strong tie to "fat client" model
- Approaching saturation
- Corel challenges limits pricing ability
- Piracy

Key Products

- MS Office (Word, Excel, Powerpoint, Access, Outlook, Schedule+)
- MS FrontPage
- Team Manager
- MS Publisher

Recent Business drivers

- Good Office 95 upgrade cycle
- Competitive upgrade business (but diminishing opportunity)
- Huge focus on Internet-enable Office 97

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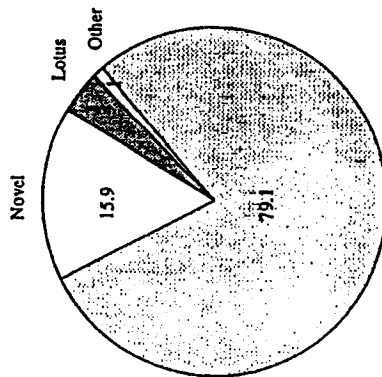
MS is market-growth bound as a result of their nearly total market share in every desktop productivity category in which they compete.



Desktop Apps

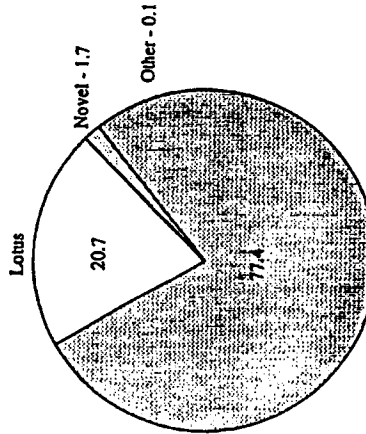
Desktop Application Share

Word Processing
1995: 100% = 1,776m



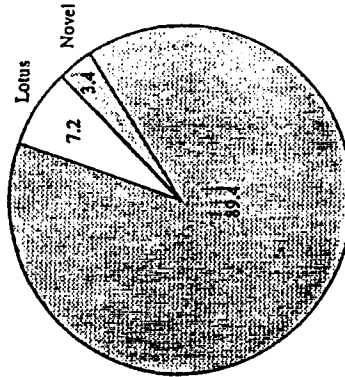
Microsoft

Spreadsheet
1995: 100% = 1,720m



Microsoft

Office Suites
1995: 100% = 3,114m



Microsoft

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	1998	1999	2000
Units			
Consumer			
Win95	3,211,289	3,853,547	4,624,257
NT	-	-	-
Tot	3,211,289	3,853,547	4,624,257
Comm-DT			
Win95	4,296,699	4,296,699	4,124,831
NT	2,864,466	4,296,699	6,187,246
Tot	7,161,165	8,593,398	10,312,077
Portables			
Win95	1,402,943	1,443,027	1,443,027
NT	601,261	962,018	1,443,027
Tot	2,004,204	2,405,045	2,886,054
W/S			
Win95	-	-	-
NT	205,360	410,720	821,440
Tot	205,360	410,720	821,440
Totals			
Win95	8,910,931	9,593,273	10,192,115
NT	3,671,087	5,669,437	8,451,713
Tot	12,582,018	15,262,710	18,643,828
\$K			
Consumer			
Win95	(48,169)	(57,803)	(69,364)
NT	-	-	-
Tot	(48,169)	(57,803)	(69,364)
Comm-DT			
Win95	(64,450)	(64,450)	(61,872)
NT	(128,901)	(193,351)	(278,426)
Tot	(193,351)	(257,802)	(340,299)
Portables			
Win95	(21,044)	(21,645)	(21,645)
NT	(27,057)	(43,291)	(64,936)
Tot	(48,101)	(64,936)	(86,582)
W/S			
Win95	-	-	-
NT	(9,241)	(18,482)	(36,965)
Tot	(9,241)	(18,482)	(36,965)
Total			
Win95	(133,664)	(143,899)	(152,882)
NT	(165,199)	(255,125)	(380,327)
Annual	(298,863)	(399,024)	(533,209)
Cumulative	(298,863)	(697,887)	(1,231,095)

Win95	31	46	-15
WinNT	31	76	-45

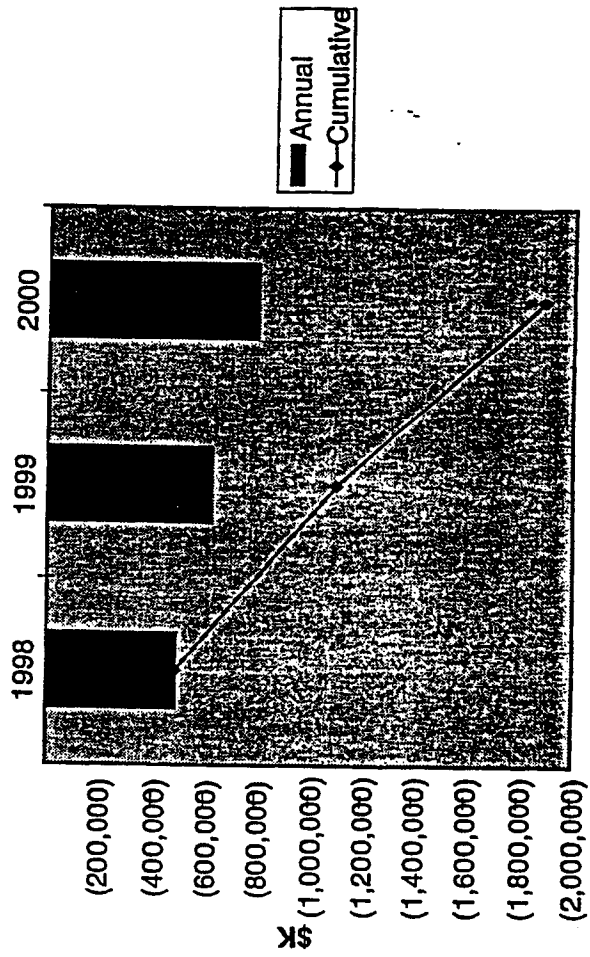
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PBT Impact of FLP Expiration (Royalty Only)



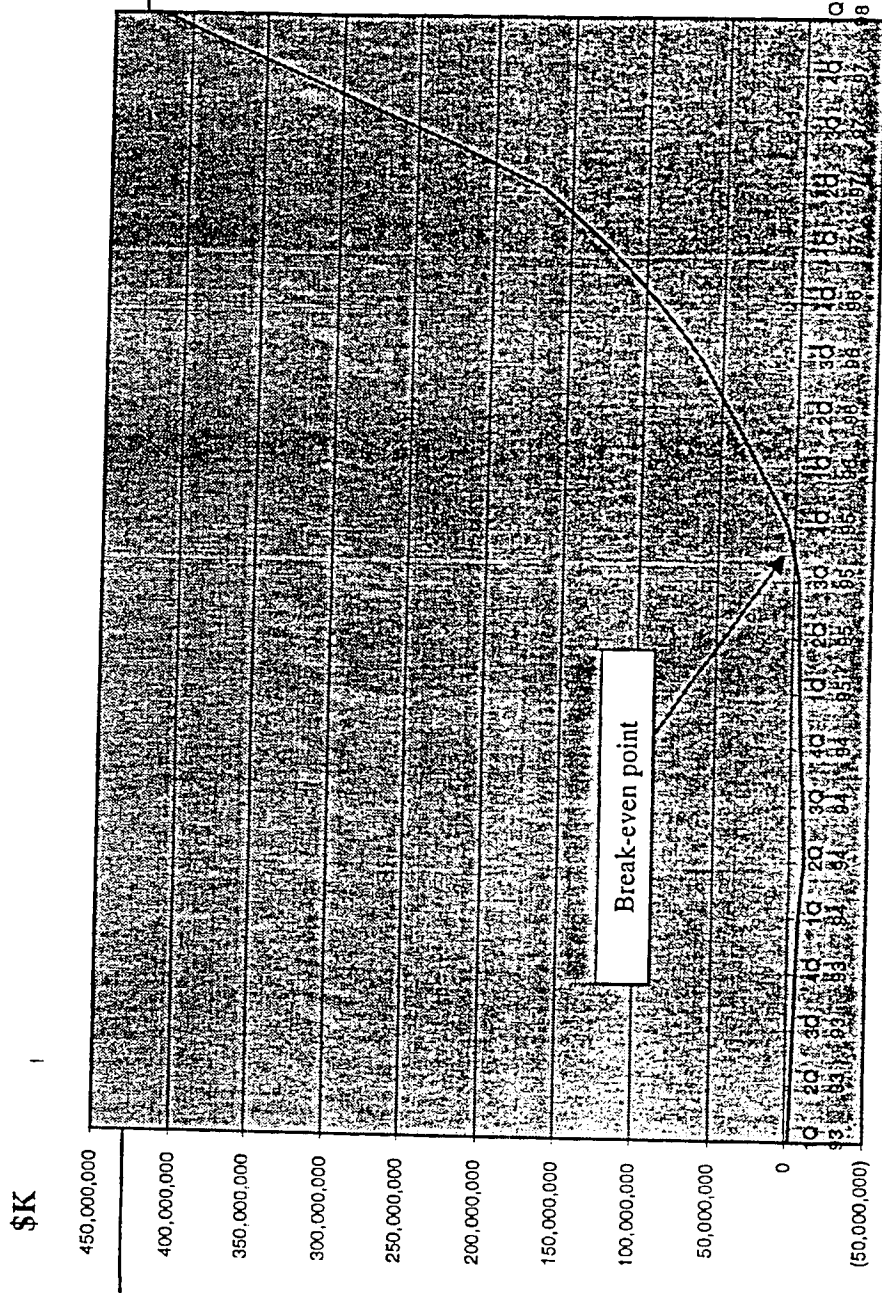
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Cumulative Microsoft Royalty Advantage



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