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To: Joachim Kempin's Direct Reports Only (Xenix DL)
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OEM Sales 96.doc

OEM Sales 96/97 Outlook
Joachim Kempin

Growth prospects of the industry

After going world wide through some 15-25% annual market expansions for the last 3-4 years we seem to be entering a less then 15% WW growth rate for the next 12-18 months. Caution should be taken when forecasting higher than 10% growth in Europe, except Eastern Europe, and North America. While development countries in general will continue to have much higher growth potential, they will nevertheless be vulnerable to local economy issues and as a total not pick up enough slack to keep the rest of the world unit growth above 15%.

Reasons for this change:

1. The talk about cheap and easy to use Internet appliances "replacing" complicated and expensive PCs are at least delaying home purchases until the frustration becomes obvious.
2. Corporations are getting the same message and evaluating if such limited access and function devices would not do for some of their workers or even 80% of them as some customer has expressed to us.
3. The Win95, NT 4.0 confusion is not making it easy for corporations to decide what to do next and is delaying some buying. The same is true for Intel's unclear Pentium or Pentium Pro message.
4. Existing technology hype, outside the Internet, is not on the horizon today. PC-TV, conferencing technology, 3D graphic acceleration and exciting new Apps are scarce or expensive. The market is maturing and a lot of business in industrialized countries is replacement business which is easier to delay the new purchases.
5. The industry and the society are its own enemies when it comes to growth:
    Inexpensive PCs below the $1000 barrier would be the greatest response and threat to the Internet appliances, but in industrialized countries, nobody wants to buy 486 based PCs anymore. Its just not socially acceptable and who needs to have 1 GB of local storage. But, try to buy a 250 MB hard drive at reasonable cost, or find a cheap 486 chip set. They have disappeared because of manufactures greed and ignorance.

The result is a temporary slow down of the industry until the fog clears. Our support for new technology is forth coming an will eventually increase demand. In the meantime, we will see significant shifts in market share and further consolidation in the industry. Healthy OEMs are OEMs with a certain market niche advantage and some other business to subsidize their home PC engagement. Today the server business is highly profitable followed by commercial desktop and a barely breaking even HOME segment. Home PCs are seen as volume generators to increase buying power for an OEM and if any profit is obtained it will come from bounties and the profit sharing methods with third party vendors which we do not support. I predict that the server business will remain profitable until software and hardware components are true network-PnP. At that point in time a lot of the support infrastructure will become obsolete and less of a decision factor in what server to buy. This commodization might not happen before the year 2000 but when it happens, we will see servers being more and more a commodity and a part of homes then today, thus expanding its market demand beyond belief but at much lower margins.
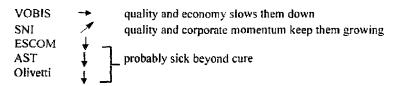
Key OEMs:

1. **Compaq**, the leading PC manufacturer. Next 12-18 months will be super tough for them heaving no other business to fall back upon. We are committed to work very closely with them, even if difficult from time to time, to move the industry forward on all fronts.
2. **HP**, potentially the number 2 manufacturer within 2 years. HP is financially super strong and has other businesses to fall back on. We differ with them in their belief of the UNIX environment and are on the way to form a closer alliance with them. They are a key force to reckon with and need our attention.

3. **PB**, the leading home PC supplier. You should assume that NEC basically owns them and as such they will probably not go under. They present a unique opportunity for us to explore certain channels of distribution and it remains to be seen if they can use their ZDS purchase to expand into the corporate market.

4. **NEC**, the leading PC manufacturer in Japan with worldwide ambitions. Their recent successful entry in the US will probably be tried in Europe next. NEC is diversified and strong to weather a storm and we will continue our great working relationship to expand beyond the traditional PC markets.

5. **Toshiba**, the leading notebook manufacturer. The opening of their Kirkland technology center is just another sign of how well we work with each other. They have great technology, solid finances and great attitudes towards us. We will help them to prosper.

6. **Acer**, the leading brand in third world countries. Smart management expanded early enough and has a solid foundation in a very diversified business. Even if local ACER subsidiaries do not always look like great MS friends, the Taiwan connection is stronger than ever. But being prudent business people, they once in a while put price over relationship and therefore it is important to pay attention to them on a subsidiary level.

7/8. **Gateway and Dell**, the two leading direct-mail order companies. While different in their market approach, they have a lot of things in common. They are marketing machines and closer in being a distributor rather than a PC manufacturer. Their model is lean, highly effective and most efficient. They presents a great balance to all the other companies and we will continue to work closely with them to take advantage of their high visibility and fast response to customer needs.

9. **IBM**, a stagnant and currently the #2 PC manufacturer with deep pockets and no sympathy for Microsoft. The only reason they work with us is to sell their hardware and at the same time be able to compete with us for their own PC software. They are our number one competitor and our goal should be no public embarrassment, but at the same time, no field engagement to avoid public endorsement of their platforms and opening of doors for their software offerings. You will see a lot of persistence on their side for the next couple of years to somehow get endorsed by us, but caution will remain to be the right response.

10. **DEC**, one of our key enterprise partners, will continue to have a hard time to find its way back to old glory. We are firmly behind supporting their Alpha technology and are looking at them as a reliable partner to help us conquer Enterprises.

11. **Fujitsu/ICL**, willing to take on larger rivals to gain share at all cost. Expect them to repeat their successful thrust in Japan in Europe and in the USA without any guarantee for success. But, they will ensure in both areas that prices will be most attractive and annoy some of the other contenders. At the same time, neither their current brand name recognition as a PC manufacturer nor their marketing approach will be as good in Japan. It will be important to resist their threat of bundling Office like Applications. With no market recognition, we shall not disturb our business model.

Miscellaneous manufacturer snapshot:

VOBIS	→	quality and economy slows them down
SNI	↗	quality and corporate momentum keep them growing
ESCOM	↓	
AST	↓	probably sick beyond cure
Olivetti	↓	

3/25/96 OEM Sales 96/97

We reorganized OEM into three major business areas 9 months ago:
*   Multi-National accounts (21 accounts)
*   Named Accounts
*   Small system builders (fulfilled through DSP channel)

While we manage the Multi-National group centrally, while we continue to manage Named Accounts and Small System Builders(SSBs) within the Microsoft regional/subsidiary framework. This segmentation allows us to work globally with Multi-Nationals, while engaging local accounts as needed to improve the business climate for MS and increase our penetration in the naked system market penetration.

I expect our business to grow to $2.5B this FY and I hope we can get close to $3.5B next FY even in a slow growing market. The group remains small with 250 people yielding approximately $10M/head. I do not foresee large manpower growth next year except in the SSB segment outside North America to help us to reduce naked system sales further. The OEM Sales focus will remain in the DT-OS area and we will start to actively license NTWS to OEMs. This will need careful budgeting to avoid double accounting. Ideally, these OEM units will come pre-installed on PCs the same way as Win95.

While we will continue to sell mice and keyboards, I expect it's growth to slow until we can get more design wins with more Multi-National accounts. Consumer software sales is continuing to grow but we will see more price erosion and the number of bundled titles being cut back by PC manufacturers as long as this segment remains to be under extreme margin pressure.

In the high end applications and the NTS business will continue to take a "defend market share" position. In the case of NTS, we are planning to discontinue all per copy sales and focus only on pre-installed per system sales, without pursuing these opportunities aggressively. In the Office 97 time frame, we want to switch Office 97 licensing through the OEM channel to be on a co-branded/co-labeled bases only. Ensuring that we do not just license Office 97 stand alone but getting a lot of visibility from OEMs and ensure their investment in quality and support. At the same time, we will be more liberal with single applications and Office 95 if we have to respond to competition. As usual, this will not be completely free of controversy and will continue to be decided with both market share and profit in mind.

To facilitate new thinking, we will reorganize OEM marketing and assign program managers for certain segments in which we want to work with OEMs, Multi-Nationals mostly.

Segments:
- Education (US only)
- HOME/SOHO (Internet)
- Small business (Internet)
- Corporate servers for the Intranet

The goal for these program managers will be to design well thought out marketing programs with key OEMs in these segments in order to help us both gain more market share and link the OEMs into ongoing field activities in these areas. The key for us will be to select the right (serious when it comes to investments) OEMs for these efforts and to engage them with us always with an Internet/Intranet component to increase barriers for other companies operating in the same field.

Contact policy

All key communication to OEM personnel will take place via the Microsoft Intranet in '97. This will improve field knowledge and field education levels. We will further explore to do the same with our customers. There are 180-200K Small system builders around the world who want to hear from Microsoft and I see the Internet as the #1 opportunity to connect with them . Combined with the right product offerings and local marketing activities I expect this to help us double our business in this segment in FY97.

Role of the DSP Channel

I expect to finish the year with $350M in that segment compared to less than $50M 2 years ago. The goal will be $1B in FY98. The importance of this channel cannot be overstated. On one side, the participating 180-200K Small business companies are the biggest pirates today, cheating us out of $500-1000M in revenue. On the other side, they are the premier system provider to the Small business segment. 80-85% of all their business is focused in that area. Their buying behavior is simply defined as "at best costs". And this means they very often do not buy from traditional sources like our distributors. They get their

goods from alternative sources. The overlap with our current distribution systems is 15-25% at the most and their buying ingenuity is truly mind-blowing. In order to develop this channel, we will have to expand our product offerings to products which are sold to small businesses, like high end apps as well as NTS, even if this conflicts a little bit with our traditional distribution channels. The difference will be in how we package/bundle our offerings and how the enduser gets supported. We will work closely with the product groups to minimize this potential conflict but we need to truly look at this as one of the few fantastic growth opportunities for the next years which will warrant some risk.

Small business segment

Today this is firm in the hands of the SSBs. 65-80% of all systems sold come from them and not from top brand name OEMs. Naturally, OEMs have started to understand that and they're making plans to attack this segment. Not understanding it's dynamics to well, the first thing we hear is to bundle software with a PC "has" to make you successful. Office being the magic bullet and not real creativity will create the following effect. It will destroy our Office business model without giving the OEMs any guarantee to succeed in this segment.

The Small business segment is very complicated and governed by consultants, VARs and Solution Providers who buy their PCs highly customized mostly from local SSBs and SW from local ISVs. The reason is simply put: Fast local response, reliable components and less post sales hassle. With this in mind, most of the Multi-National OEMs who want to participate/play in this segment are highly challenged and have to completely rethink the way they need to do business. And even if they change and come up with some creative ideas, the Small business segment, with it's low overhead, will remain super competitive and might prevail. In addition, these OEMs have to learn how to nurture the small business community after they own one of their systems. The Internet would be a great vehicle to do this but it will take significant investments to be successful and a continuous effort, which a lot of Multi-Nationals are not very patient at doing today.

In summary this will be a most interesting market to watch and our role will be to educate and work with the OEM and the MS field organization to find the best model to enhance our position in this segment.

Anti-Piracy efforts

Piracy remains our number one competitor in OEM and as a company. Education and legal actions have increased in '96 and have shown some impressive results by increasing awareness and seeing some large settlements. Counterfeiting and hard disk loading are being well attacked. "Good neighbor" software is still rampant. We will continue to protect our OEM products through a variety of means and the new COA introduced this summer will be one of the cornerstones. But, the key for us will remain the development of the SSB channel. If they believe that software can make them money, we will see less piracy. Expect better software protection to show up in FY97 and support the Multi-Nationals in development countries with the understanding that they do bundle software on most of their machines and therefore help us to win the holy war against piracy.

Summary

I expect OEM to show healthy growth despite a slowing down market and I expect us to work closer together with other parts of MS to address in particular the Small business and the corporate Intranet market segments. We need to ensure that our anti-piracy actions remain linked. We need to further ensure to take a less short term views of the business when reducing local prices unexpectedly knowing that PC manufacturers have long term contracts with us and actions like this will cause friction with them and reduce their willingness to cooperate. OEMs need to be seen by every GM as a strategic Microsoft asset and not as an internal competitor to the retail business. I know that most of us are taking such a long term view and I hope we can one day all share in this belief.