



To: February 1995 Worldwide Regional Director Meeting Attendees
From: Joachim Kempin
Re: FY96 Perspective and FY95 Reflections: OEM
Date: January 31, 1995

Growth Perspectives:

After a slow start into FY95, the second quarter is turning out to exceed last years 20%+ growth rates. The PC industry is following more and more in the footsteps of the consumer electronic industry - with bigger and bigger bumps in the Christmas quarter. The rest of FY95 and FY96 will continue to see healthy growth rates of at least 15%, but expect different geographies to show significant differences.

1. USA

The Fed's credit policy will restrict growth to 12-15%. I am optimistic that late in FY96, we will see large businesses finally buy increased numbers of Pentium PCs to replace low end 486s and 386s. Consumers will continue to be the major force behind PC unit growth and Win95 will help this tremendously by conquering new groups of novices through ease of use and most attractive titles.

2. Latin America

Expect a very mixed picture based on how the latest currency crisis will get worked out. Brazil, having the most robust economy, will lead all other countries and might hit 1 million PC units in FY96. The buying will largely be fueled by LOGs and SMORGs and less by consumers, but great Spanish and Portuguese consumer titles are a long term "must have" if we ever want to attract the home buyer.

3. Europe

Europe's economies are roaring back to life led by Germany, which is starting to overcome it's unification pains. I expect Europe to show 15-20% growth in FY96 in PC units, knowing that LOGs and SMORGs have pent up demand and Eastern Europe is still very underdeveloped.

4. Far East

a) Japan

A 25% growth in FY96 PC shipments would not surprise me. The PC, with it's more attractive price point, is starting to replace some Japanese word processors and Japanese companies are finally accepting more and more PCs as office tools. The recovery of the local economy will do the rest to make my optimistic predictions come true.

b) PRC

As long as the Intellectual Property issues aren't getting resolved, we will see shifting policies in regard to taxation and imports, meaning our business will not prosper and we should not invest heavily either.

c) Korea

Will remain a local market served by local manufacturers. Growth will continue to be impressive in particular if the education market continues to grow. I expect some non-Korean manufacturers to try harder to gain share - but doubt that they will be very successful. Compared to Japan, Korean custom fees are too high to compete effectively.

5. South East Asia

Will continue to produce 20%+ growth rates, the key for us is to find a way to overcome piracy and establish a good distribution network (DSPs). This is a key investment area for OEM in FY96 in particular Indonesia and Philippines.

6. Middle East

As long as the peace process continues, we will see solid growth. The oil is still flowing and most countries (except Saudi Arabia) are still in investment mode. Most PCs are used for business. Key

for our success is to continue a sensible localization strategy and to be ready when the consumer market develops (2-3 years from now).

7. Other countries:

a.) South Africa

Expect high growth based on pent up demand.

b.) Australia

Economy and government are weak. investment climate is not very favorable. Expect 15% growth at the most.

PC-distribution channels:

Depending on how fast the local markets mature, we will see a shift in buying from large mass merchant chains instead of resellers. At the same time, local assemblers will continue to deliver 20-35% of all PCs by providing customization and better attention to local customers. Many customers are just finding out that PCs do need some backup support and these large brand name manufactures are still ill equipped to supply it, knowing that their local sales partners do not have the margin structure to do it for free. The conclusion for OEM: invest even more in selling through the local assemblers and capture more "naked systems" and fight piracy/counterfeit operations. The two channels with limited growth potentials seemed to be the captive OEMs and the direct mail order OEMs. It seems to be harder and harder for them to attract attention. The captive OEMs have a lot of small outlets which can't be as attractive as super stores and the mail order OEMs seem to have reached their limits by not being able to change buying habits faster.

Technology Advances:

While CY95 might still belong to the 486 when it comes to PC volume, CY96 will see the change to Pentiums. Intel will price Pentiums more aggressively to sustain their growth as a company and to keep the lead. All other "Pentium" clone efforts will have no significant manufacturing capacity for the next 18 months even if IBM helps out. For us this means Win96 should have some advantages when running on Pentium PCs.

Over the next 12-18 months, we can expect significant advances in integrating sound, phone and video technologies. This will lead to PCs being used as smart answering machines when idle, as well as video conferencing tools. I do not expect the conferencing solutions to be very attractive - they are either too expensive or won't have the desired sound / video synchronization as well as movie characteristics. CD-ROM drives will get to 4x quality by next Christmas as a standard and we will see the first re-writable CD-ROM drives arrive at below \$500 cost. This will be the start of more local CD piracy. The greatest challenge for us will be to support all these advances well under Win95 / 96 and think through a PC subset definition which will enable us to compete with the game machine manufactures. One of the cornerstones here is the development of better graphic sub-systems with the leading component suppliers. WS graphic capabilities are needed at PC prices to make the PC environment as attractive as possible.

From the Desktop to Server:

The PC server environment will finally be the accepted standard. All RISC architectures will be measured against it and if they can't prove that they have at least a 30% price performance advantage they will lose against the x86 platforms. With the appearance of NT and an avalanche of applications, it will be harder and harder for RISC/UNIX platforms to compete. Key for the server buyer are reliable and supported hardware, availability of development tools, and integrated applications. It takes any new platform at least 2-3 years to fulfill that need. I predict that UNIX based RISC systems will continue to be too expensive and that Novell based x86 systems will not have the development tools and applications available. Manuring NT based X86 and RISC platforms will win in both aspects over the next 18 months. Therefore, I expect more companies to enter this higher margin segment, but the barriers to entry will be high as long as the contenders (Compaq, HP, DEC) can leverage their engineering strength. Today, Intel helps companies with no engineering teams to build desktop PCs. If they start doing this for servers as well, we will see a very fast margin deterioration which means a great support infrastructure

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will determine the sales success. Expect all contenders to work this very hard and provide ease of installation as well as backup support in a way the clone manufacturers can't deliver it.

RISC vs x86

After the IBM PowerPC hardware debacle, I do not believe that IBM can pull off a PowerPC miracle during the next 18 months. Apple's continuing non cooperative behavior, a very foggy OS strategy and lackluster ISV support will make IBM's PPC strategy continue to fail through FY96. MIPS will continue to be insignificant but Alpha will increase it's presence in the server market. This is where PPC might score some points as well, long before it gets recognized on the desktop. In both cases, we are well positioned with NT and BackOffice to take significant share. In OEM, we will continue to work with solution provider OEMs who sell servers to promote NT and BackOffice solutions and direct them to work with the MS field offices primarily when it comes to local sales and cooperation. In a nutshell, no breakthrough is expected on the desktop for RISC systems. Apple will continue to shift it's user base and complement it's effort by licensing no-name companies who won't be able to compete on price, technology or distribution (most important).

AMS Reporting

While IBM will try hard and fail, not having a viable desktop operating system for PPC, we should expect a lot of hype and hope, so we in OEM will continue to preach reality.

Nevertheless, some OEMs might get tempted to jump in the water as we know from Taiwan. Some of them will start offering (at least on the server) "dual socket" machines, which would accommodate a Pentium or a PPC-CPU. This might be a good hedging tactic on the server, but on the desktop, the costs are probably prohibitive to pursue this.

Last but not least, I expect the PPC to debut in a lot of PDAs probably based on an IBM micro kernel, if they can get the size right. Unfortunately, we do not have a competitive product for these customers and I hope that our revised WinPad 96 project will enable us to defend our turf.

Windows 95/96

This is by far the key event in CY95 and beyond, no expectations needed. The successful introduction of this product requires teamwork from a lot of people on MS:

Product group	great and reliable product
ISV relationship	more ISVs to Win32 API
E/U	to create a memorable launch event and create demand
ORG	more LOGs to Win32/Win 95
OEM	make sure sufficient numbers of preinstalled systems will be sold through the OEM channel

Where are we on the OEM plan?

Marketing Development Agreement (MDA)

Understanding that the product would be late, we decided to offer approximately 70 OEMs a framework in how to support Win95 in the market place.

Main goals:

- **Build great Win95 PCs**
 - PnP Bios
 - Win95 add on cards
- **Promote the Win95 idea in public**
 - Show compliant hardware at tradeshows
 - Tell your customers you are doing the right things to make your PCs work well with Win95
 - Use our logo to label these Win95 PCs
- **Build a support infrastructure for Win95**
 - Train your support people
 - Train your sales and marketing people

Knowing that the industry has no margins of error left, we generated an incentive program whereby we would allow these OEMs to improve their Win95 pricing if they cooperate with us and put in the effort to do what was required. As of today, nearly all OEMs signed the MDA after some early resistance, and what is more important, they are working with us to generate the right hardware and public awareness.

Licensing of Win95

We will kick this off 2/15/95 and I am sure it will be scrutinized as the MDA agreement was, so here is your briefing:

The goal in licensing Win95 to OEMs is not to replace all Windows and WfW licenses with Win95 licenses as fast as possible. Based on first feedback, we expect this to be a 12-18 month process, whereby a slower adaptation through the OEM channel should create some profitable retail upgrade business. Consumer systems will be converted faster than LORG systems, reason being: LORGs want Win32 Applications more than ease of use. Knowing that this will be a time delayed adaptation in the OEM channel like Win 3.x was, we still don't want anybody to say, "Win95 adoption is slow". Our message should be, "we will convert these OEM systems as fast as possible and at the right price".

Not being too eager to license Win95 on all OEM systems, will allow us to sell it at a higher price. OEMs goal is 20-25% more \$/unit sold on average. While this is true for royalty OEMs, we will increase DSP pricing by less than 5%. This will equal the playing field a little bit. The reason for asking the higher OEM prices is easily explained:

We invested a lot of money in Win95 to help the OEMs to continue and hopefully accelerate their unit growth and we would like to see some pay back for our efforts. In case OEMs do not see value in licensing Win95, they can continue to license MS-DOS, Win 3.x and WfW 3.x. We are happy to upgrade the customers later. At the same time, as always, we won't be arrogant and will find a balance between moving a critical mass of OEM systems to Win95 and our pricing expectations. Our public statement should be, "we would like to get fair market value for this exciting piece of software." (please do not discuss numbers and goals with the press people). } mda }

OEM Coupon Program

Last but not least, we are considering to offer OEMs a coupon program for at least 3 months prior to RTM

Goals:

- Avoid system returns
- Avoid purchase delays
- Enable smooth transition for channel and OEMs

Only danger we can see is that people will accuse us of selling "vapor"ware = "paper"ware. We will work with the PR group to limit the damage. You should look at it as an insurance fee. We are aware of the possible retail upgrade impact and are working the numbers.

Windows 95 OEM product considerations:

- With Piracy and counterfeit being our biggest competitor, we will get more sophisticated in protecting our products.
- All Win95 deliverables will include a COA integrated into the cover of the manual. This is visible and will further educate the channel as well as the end-users.
- All products will include a 100-150 page manual which should cut support costs and increase satisfaction.
- On all DSP products, we will include the MS-Press support products. (Cue-cards on diskette version, — full tutorial on CD version).
- We will guard the bits on all Win95 CDs and will not let OEMs add any content without our approval. This will pay off if we want to add Apps demos or a full Ali-Baba version one day.

- End users will be asked to enter their COA number when using the system first time around. (Work is needed to address some LORG concerns). This should make COAs further popular and restrict counterfeit operations.
- We will start using registration cards as means to find out about pirating.

Key Competition

- Piracy and Counterfeits
We have made progress in '94 shutting down some counterfeit organizations and kept a lid on grey market activities. We have been experiencing more Consumer and Mice unbundling instead and are in the process of implementing serialization and COA programs for these products as well. But the fight will never be over. In order to really be in control, we all need to watch it and report any violations.
- Apple Units Sold
Apple on the other hand is the only true x86 volume competitor in the market when you look at units. At the same time, they have made a successful PowerMac intro and enjoying higher ASPs. With Win95, I expect them to lose some market share and it remains to be seen if they can survive on their own. Their licensing program is nothing else than a non-serious trial. Until they sign up a big OEM, nothing has changed.
- OS/2 Units Sold
OS/2 Warp remains a niche product. All the feedback I have from Germany says, this is an ultra hard product to sell and causes end user returns because of incompatibilities, missing drivers and missing apps, and it does not work well on 4MB. Only banks and insurance companies - long time Big Blue accounts - who have written some mission critical apps to the OS/2 API continue to demand it. The rest is curiosity.

bundle both Win 95 & OS/2?

Only two German accounts ESCOM and VOBIS have been seriously experimenting with it and I expect them to change their mind sooner than later. Win 95 will make it even harder for OS/2 to continue. If IBM can't clone the Win 32 APIs within 12 months, users will completely move away. Nevertheless we are taking IBMs marketing push seriously and are doubling our efforts to work with our customers in a very cooperative fashion.

The Win 95 Licensing Plan

MDA Accounts

We will license these agreements first for Win95 starting May/June 1995 and allow them to include a Win 95 upgrade coupon in all licensed systems for redemption in at least North America, Europe, Australia, New Zealand, South Africa and most parts of Latin America. The end user will be asked to prepay a nominal fee for COGs and fulfillment charges. We will only do this in countries where we can guarantee fulfillment. The enduser will pay no money to MS for royalties - because it was prepaid by the OEM.

The coupon distribution will be limited to 1-2 months after Microsoft release to manufacturing and the redemption will be limited to 4 months after MS-RTM. The coupon can only be redeemed by an enduser and a copy of the invoice is needed. The PC manufacturers name printed on the coupon must match the name on the invoice.

Non-MDA Accounts

We will offer them a per system and per copy coupon program like the MDA OEM's with smaller volume discounts.

Why offer it?

DSP accounts (local assemblers)

We will create a combo (MS-DOS + Win) and upgrade coupon containing box whereby the per copy royalty will be higher than the per system royalty of the other accounts. This should enable them to compete. The fulfillment rules will be changed, whereby the coupon will NOT have the OEM name included. To avoid a secondary market in these coupons the local assembler will have to pay a high royalty for these coupons.

Key OEM Partnerships

Compaq

- Win 95 marketing partner
- Expect consumer systems to be 100%. Commercial systems to follow over 12-18 months
- Completely committed to NTAS and BackOffice
- Field will get compensated and reporting will be in place

DEC

- Expect Alpha to be more NT and less UNIX centric
- Expect us to work closer on field level
- Good cooperation on Win 95
- Expect them to push X86 servers as well

AT&T GIS

- Committed to NT; great to work with

Packard Bell

- Great customer, but too secretive to really work with on field level

Gateway 2000

- Super relationship, true friend in the marketplace and it shows in their 100% MS commitment

NEC

- Great relationship in Japan, committed to MS platforms

The IBM Company

The Chinese wall which existed for some time between Personal Systems Products and the PowerPC as well as the PC company does not exist anymore. Both the groups are on a clear sell IBM software path. The ultimate goal is to dethrone MS and Intel with PPC and OS/2 top to bottom! This is not a strategy, this is carried out as a religion until something (like the P/L statements) might break. Gerstner is known for trying hard but changing when needed as well. So for the time being assume - no cooperation, except some practical things. We will work with IBM to make their PCs Win 95 compatible and save us both embarrassment. They will probably sign a Win 95 agreement, maybe even the MDA; but they will not get behind it. I expect comparable behavior as they have shown with the Intel Pentium situation if we give them any opening. At the same time the PPC Company will offer NT as just another environment and we will work with them to let it shine - not necessarily the PPC. Joint seminars, marketing etc. all this is on hold until they find out OS/2 is not going to cut it (12-18 months from now). Then we might reconcile - and therefore let's compete in front of customers but not bash each other in public. Possible risk: If they could get a hybrid CPU (PPC + x86 combined) into the market and take advantage of both worlds before the HP/Intel alliance is starting to produce results. We will stay tuned...

OEM FY96

Product plan/ Goals/ Policies

1. Win 95
Increase Win 95 penetration to achieve 90% of Win+WfW penetration at end of the FY without compromising \$\$/unit much
2. Frosting
Actively sell frosting to selected key accounts to help product group create momentum if needed
3. Mice
Continue to aggressively sell mice at 30-40% growth rates. Get a foothold into Compaq
4. Keyboards
Sell 1 million keyboards through the OEM channel focusing on medium tier and mail order accounts
5. Consumer Software Products
 - Expand distribution into DSP channel for Works and slow selling CD titles
 - Continue on a 25-30% growth path, but be more price conscious, without losing mega opportunities.
6. BSD Products
 - Move SP OEMs to be WW LARs instead of OEM licensees
 - License only high volume OEMs directly if the above can't be achieved
 - Separate client licenses will not be available through the OEM channel

Action for us?
7. DAD Products
 - Use Office 95 as an opportunity to increase \$/system sold
 - License Office + Office Pro to a few select OEMs only - if competitive pressure is high enough to lose significant share
 - Pursue single APPS opportunities for the SMORG market if local end user unit management agrees.
8. All APPS Products
Develop a model whereby the OEM/MS/Reseller can obtain more \$/system than in the traditional OEM licensing model

OEM Programs for FY 95/96

1. OEM relationship programs:
 - Design systems to help customers
 - Reorganize large account teams
 - Continue to improve DSP coverage and marketing activity by reaching out to capture the mind of the assemblers
2. Piracy/Counterfeit/Grey Market Programs
 - Tie OEM and retail approach together
 - Have a dedicated program manager to work with legal and piracy teams world wide
 - Have systems in place to easily spot violators
3. Triangle Model Program
 - Increase \$\$/unit for MS when selling APPS by bringing resellers, OEMs, and MS together in a comprehensive and attractive marketing approach