

m

Microsoft M e m o

To: Mikehal, Mikemap, Joachimk, Richmac, Lewisl, Mikene, Larryed, Tomge,
Richardf, Ronh, Jeffl
From: Donnag and Johnwil--Entry Business Unit
Date: August 27, 1991
RE: ~~EBU OEM Strategy~~
CC: Susanb, Melindaf, EBUMKTG

EBU has a significant opportunity to sell to a new base of customers by bundling software with specific OEM hardware targeted at first-time and small business users. This document explains EBU's strategy for selling entry level applications through the OEM channel and rationalizes pricing strategies employed. The pricing schedule included herein will be incorporated into the OEM pricing schedule during the week of September 9. Please respond to Donnag by Wednesday, September 4, if you have any questions about this strategy.

Current Situation

The OEM channel has long been a successful market for Microsoft with systems products such as DOS and Windows. As the PC market has begun to mature, hardware manufacturers have started to aggressively sell into the growing first-time user and small business market, via the mass merchant and consumer channel with "all in one solution" PCs. Hardware manufacturers have found value in providing entry level software with their PCs; an approach IBM legitimized with their PS/1 PC¹. Works has been a primary benefactor of this emerging trend, shipping almost half a million units through the OEM channel (worldwide) during FY91, while remaining the # 1 integrated product in the retail channel.

The EBU Opportunity

EBU has an opportunity to dominate the OEM channel during FY92, with the release of the Microsoft Solution Series products. Works for Windows, Publisher and Money are ideal products for OEMs to bundle on their mass market PCs. EBU is currently courting several key OEMs in an effort to gain third party relationships and endorsements, that will be communicated during the product launch² and beyond.

OEM bundling provides Microsoft and EBU with several benefits, including:

Increased market share: Gaining 100% penetration on important OEM PCs provides an instant base of users. The more users introduced to our applications will lead to increased word of mouth exposure, and will eventually push more buyers to purchase the applications, be it at retail or bundled with PCs.

Increased revenue and profit potential: OEM bundling provides an incremental method of incurring revenue and profits. Royalty revenues, in addition to long term, cross-selling and upgrade revenues, make OEM bundles a viable and vital selling mechanism.

Solution Series Applications force OEM adoption of Windows: Several major OEMs have not yet begun to bundle Windows. Works for Windows, Money and Publisher legitimize

¹IBM's PS/1 is targeted at home and first time users, and is bundled with Microsoft Works, Prodigy, and an online computer tutorial. IBM introduced these machines during Summer 1990, and pushed them through mass merchants, such as Sears and Dayton Hudson.

²Product launch for Solution Series will take place on September 16, 1991.

X 190756
CONFIDENTIAL

8/27/91

EBU OEM Strategy

Page 1

DEPOSITION
EXHIBIT
32
10/26/01

the Windows environment for first time users, and provide a reason for OEMs to bundle Windows.

Competitive displacement: If Microsoft Works or Microsoft Works for Windows are not bundled on new user and small business PCs, it is likely that LotusWorks or Spinnaker's PFS:WindowWorks will be. Given the nature of new users, and the fact that they made the decision to buy a PC bundled with software, it is very unlikely (in the short term) that they will go to retail to purchase Microsoft Works. Thus Microsoft will have forfeited both the OEM and the retail revenue.

Bundling EBU applications with strategic hardware enables EBU to reach a vast customer base, generate substantial revenue and pre-empt competitors from displacing Microsoft applications. OEM bundles with EBU software facilitates putting "a computer on every desk and in every home, running Microsoft software."

The OEM Environment

Several factors make the OEM channel a critical vehicle for EBU to leverage NOW, at the launch of the Solution Series:

1) Bundled software is a competitive necessity: As just about every major OEM enters the first-time buyer/home office/small business market,³ all have seen the need to differentiate themselves from the tremendous competition that exists. "All in One Solution" PCs have forced OEMs to provide incremental value by bundling software. In most cases, integrated software is bundled in order to provide a base-level of software functionality.

2) Competitive Environment: Most major software companies have entered the OEM bundle marketplace, with a myriad of aggressive pricing programs. Lotus' emergence with LotusWorks⁴ and Spinnaker's introduction of PFS:WindowWorks have increased competition, while dramatically decreasing pricing levels.⁵ Lotus and Borland have also made a viable business of bundling old versions of their software software and then upgrading users to new versions.⁶ In most cases, if an OEM does not bundle Microsoft software, they will bundle someone else's.

3) Perfect Path to EBU Customer: Software bundles on hardware selling through mass merchants and targeting first-time users and small business provides an excellent opportunity for EBU products, especially PC Works and Works for Windows. These customers do not traditionally shop in Egghead or Computerland stores, and thus are not usually reached by our marketing efforts. By introducing users to Microsoft software early, we also create a strong franchise for future retail cross-sell and upgrade business.

EBU OEM Objectives

Several key objectives will drive EBU's efforts in the OEM channel.

³The final holdouts, Compaq, Apple, and AST, to name a few, have finally conceded that this channel and market represents a substantial revenue opportunity. All will have PCs bundled with software shipping this fall.

⁴Product acquired in 1991, from Alpha Software.

⁵Spinnaker provided PFS:WindowWorks to several key OEMs at \$0 royalty for 6 month periods at the introduction of the product. Lotus provided LotusWorks to Packard Bell at \$2 below "whatever Microsoft was offering." Both companies consistently provide packaged product for under \$15.

⁶Lotus was very aggressive with 1-2-3 v2.2, bundling it with many OEM systems just prior to the release of 1-2-3 v2.3. Borland has aggressively sold earlier versions of Quattro, in an attempt to get the OEM user to upgrade to new versions.

1) Drive increased penetration of EBU applications while maximizing profitability.

- OEM bundling provides excellent vehicle to reach first time user/small business customers.
- Augments retail distribution, by allowing customers alternative means of procuring software.
- Provides 100% penetration on target PCs.

2) Provide Strong Introduction message for launch of Solution Series

- Third party endorsements by credible OEMs will make EBU's message more believable.
- Facilitates product adoption via word of mouth exposure.
- Legitimizes products and marketing messages.

3) Accelerate Windows acceptance

- Solution Series applications make Windows viable for new and small business users and also create additional sockets in which to sell additional Microsoft Window applications. (either entry level or high end)

Pricing Strategy

OEM pricing must take into account competition in the marketplace and where a product is in its life cycle. EBU's OEM pricing strategy sets a price which is comparable in profitability to retail, and below which we will not sell the product. Using this as a basis, a tiered pricing model provides volume discounts and insures additional profitability. Important factors included in price determination include:

Product life cycle: The beginning and the end of a product's life cycle provide two key opportunities for EBU applications in the OEM channel. Aggressive pricing is often warranted in order to get EBU applications bundled on a large number of strategic OEM PCs, which provides leverage at product launch. Products nearing the end of their life cycle, such as PC Works, are also able to sustain high market visibility and gain incremental penetration and revenues with some well-placed OEM bundles.

Competition: Flexible pricing is often necessary with important OEM deals, especially when faced with competition. Pricing must insure profitability, but also enable EBU to compete for worthwhile bundles.

Pricing Model

OEM pricing must insure incremental revenues and profitability than is gained at retail. The EBU OEM pricing model multiplies a product's penetration rate/goal by its retail revenue and results in a "required revenue per PC" figure. Using this as a baseline, EBU is able to guarantee profitability by increasing pricing, based on various unit commitment levels. PSS costs are also factored in to cover expenses incurred for callers who call Microsoft instead of the OEM for product support.⁷ Using this penetration model, cannibalization of retail sales are factored in, and compensated for.⁸

⁷Most OEMs handle their own software support. Users who call Microsoft will be deferred to their OEM, however a subset of users make it through the system. EBU will propose a secondary pricing model during September, which will enable OEMs to pay Microsoft for supporting bundled software.

⁸Example: 100 PC (bundled with Windows) deal: With a penetration rate of 5%, it is likely that 5 copies of software will be sold per 100 PCs sold. If MS makes \$25 per copy of software, we'd realize \$125 at retail. By multiplying the \$25 revenue figure by the penetration rate of 5%, we get \$1.25. Using this figure as a baseline, if we charge a royalty of \$1.25 for 100 PCs, MS would realize \$125 in revenue.

OEM Pricing Analysis:

<i>Profitability at retail:</i>			
Product	WinWorks	Publisher	Money
SRP	\$199.00	\$199.00	\$69.95
Average Selling Price (47% off)			
Revenue	\$105.47	\$105.47	\$37.07
-Cogs	\$16.00	\$16.00	\$6.00
-Partial SMSD and Int'l retail allocations	\$21.02	\$21.02	\$7.41
Modified Operating Income:	\$68.38	\$68.38	\$23.66
Windows Penetration Rate (goal)	2.30%	1.20%	2.6%
-Penetration Breakeven price	\$1.57	\$0.82	\$0.62
PSS Costs			
-Cost per unit ⁹	\$1.00	\$1.00	\$1.00
Lowest Price/Breakeven:	\$2.57	\$1.82	\$1.62
% of SRP	1%	1%	2%

From the floor determined above, a pricing schedule has been created, which factors in elements such as competition and product life cycle. Works for Windows will be the primary application that will be bundled with OEM PCs, due to its breadth of functionality and mass customer acceptance. It will also leverage the success that has been achieved by its predecessor, PC Works. Because of PC Works success and the competitive nature of the market, Works for Windows will assume a similar price structure to that of PC Works. Both products will start with prices that equate to 10% of SRP, at the lowest commitment level, and will decrease from there, based on increased unit commitments..

Publisher and Money will be priced less aggressively, since neither are currently faced with competition. Publisher and Money royalties will start at 13% of SRP at the lowest commitment level and will decrease from there, based on higher commitment levels. OEMs will be eligible for incremental discounts, based on software pre-installation, including MS registration cards in their packaging, incremental marketing opportunities/plans and bundling multiple applications.

Works for Windows will be sold more aggressively to more OEMs, since it will provide first time computer users with the basic functionality they will require with their computer. Its existence on OEM machines should facilitate pushing OEM end-users to retail, to purchase additional EBU and Microsoft software. Publisher and Money will be sold when OEMs demand the additional differentiation, or when additional ammunition is required to get a strategic deal. Otherwise, these products will be less visible in the OEM channel, and will not get sustained focused efforts by the OEM sales force. Additional EBU products,

⁹PSS figure derived from PC Works actual cost of approximately \$3.00 to support each retail unit sold. Assumptions: 60% of OEM customers will use the product. Currently 25-50% of PC Works support issues involve installation and printer driver questions. With Windows and software pre-installed by OEMs, 1/2 the calls will be avoided. Support costs will then equate to approximately \$1.00 per OEM unit, per product.

such as Windows Productivity Pack and Windows Entertainment Pack will get similar treatment from OEM, and will follow a similar pricing strategy.¹⁰

Pricing exceptions will be made on a case by case basis, based on the state of the market, the value the OEM brings to the table, and competitive pressures. Exceptions will be made with approval from EBU product marketing and OEM management.

OEM Pricing Schedule

Units:	PCWorks	% of SRP	WinWorks	% of SRP	Publisher	% of SRP	Money	% of SRP
<25k	\$15	10%	\$20.00	10%	\$25.00	13%	\$9.00	13%
25k+	\$10	7%	\$17.00	9%	\$22.00	11%	\$8.00	11%
50k+	\$7	5%	\$15.00	8%	\$20.00	10%	\$7.00	10%
100k+	\$6	4%	\$10.00	5%	\$18.00	9%	\$6.00	9%
250k+	\$5	3%	\$8.00	4%	\$16.00	8%	\$5.00	7%
500k+	\$4	3%	\$6.00	3%	\$12.00	6%	\$4.00	6%

Cross Sell/Upgrade Potentials

The other opportunity that OEM creates is incremental retail and upgrade business.¹¹ By distributing product registration cards with all OEM bundles, Microsoft will have access to a larger set of users. Assuming that 15% of OEM users will submit registration cards, and the following set of approximated assumptions, the models below estimate that Microsoft will be able to derive \$6.26 (average of both scenarios) for every OEM unit sold and \$41.75 (average of both scenarios) for every name collected.

Example #1: OEM User who later purchases Money and Excel at retail

Units:	100,000
15% Reg rate:	15,000
Cross-sell 1 SS App	
25% buy Money	3,750
Money Rev @ \$37	\$138,750.00
Cross-sell high end app	
20% buy Excel	3,000
Excel Rev @ \$250	\$750,000.00
Incremental Rev Per OEM Unit:	\$8.89
Incremental Rev Per Registered User:	\$59.25

¹⁰See Appendix A for complete listing of EBU products and pricing schedule.

¹¹This business will be explored further and conclusions will be published during September.

Example #2: OEM user who upgrades to next version of WinWorks and purchases Money at retail.

Units:	100,000
15% Reg rate:	15,000
Upgrade to WinWorks 2	
30% upgrade rate:	4,500
Upgrade Rev @ \$50	\$225,000.00
Cross-sell 1 SS App	
25% buy Money	3,750
Money Rev @ \$37	\$138,750.00
Incremental Rev Per OEM Unit:	\$3.64
Incremental Rev Per Registered User:	\$24.25

Risks

While the OEM opportunity is substantial, there are also some risks inherent in selling EBU applications through the channel. Each can be managed, in order to reduce the downside exposure.

1) Reseller Alienation: Resellers may feel that Microsoft is reducing their revenue opportunities by bundling software with OEM PCs. This is a legitimate concern, but one that has lessened during the last 12 months, as hardware and software companies have begun to do this en masse. Resellers should be encouraged to deal with the changes that have taken place in the channel and determine methods of reaching the multitudes of new computer users. The following points should be used as supporting data.

- **Retail is EBU's #1 Priority:** EBU's #1 objective is to have the most successful software products at retail. This business is paramount, and will continue to drive our marketing programs and product development. Resellers with concerns about lost business should be reminded of the evolving state of the consumer computer market.
- **Mass Merchants are becoming common place:** The computer and software distribution channels are maturing and changing, especially for consumer-oriented titles. As mass merchants become more significant PC vendors, more users will be reached and more PCs and software will be sold.
- **Mass Merchants DEMAND PCs bundled with software:** Mass merchants generally do not have the sales and support staff to adequately merchandise and sell software. Most mass merchants prefer to sell computers with software pre-installed, as it helps to sell more computers. Mass merchants have also become very influential in demanding that certain software packages be bundled on their hardware.
- **Strategic Bundling:** It is important to note that Microsoft is bundling to new users on OEM hardware that is being targeted at this growing market. Lotus, on the other hand, is bundling most of their applications on just about any PC, going to any market that they can sell too. Software manufacturers are relying on the OEM channel to grow their business. Microsoft is doing it with a small set of products, to a market where it is required to be competitive.

Tactics

EBU will execute several tactical programs to increase the OEM business and to enable Microsoft to capture names and eventually cross sell into the OEM customer base. The following outline several programs being developed.

1) OEM "Starter Kit"

- Coupon provided for all OEM customers
- Potential "differentiating factors" for key OEMs.
- Allows for collection of names/registering of customers
- Provides mechanism to send user to retail
- Kit Contents:
 - America Online-Microsoft Small Business Center
 - Growing Your Business Booklet, via coupon fulfillment
 - Software registration cards
 - Solution Series product info
 - Incentives to drive customer to retail
 - Free checks w/ purchase of Money
 - Free clip art/page wizard w/ purchase of Publisher
 - Upgrade offers to Word, Excel, etc.

2) OEM Sales Force Resources

- OEM sales force training
- Sales Materials: Product and presentations provided to all OEM sales reps

3) Co-Promotions with key OEMs

- EBU to consider special collaboration with OEMs doing "special" marketing to EBU customers.

Summary

The marketplace is changing, and software and hardware manufacturers are beginning to take advantage of key methods of reaching the burgeoning first time user and small business markets. Microsoft has an opportunity to reach this growing market, in a way that is profitable in the short term and the long term. Microsoft Works for Windows, Publisher and Money provide compelling reasons for OEMs to bundle Windows and the applications make excellent "solutions" for first time computer users. As competition intensifies, Microsoft will be able to better compete for the business, as long as we understand the opportunity the channel provides and we put controls and processes in place to service its needs. EBU will employ marketing and pricing strategies that provide maximum profitability.

By providing hundreds of thousands of new users with powerful PCs, pre-installed software and compelling applications, Microsoft and key OEMs can reach a whole new set of users, that may eventually move up to additional Microsoft applications. The opportunity is tremendous, and Microsoft will strive to be the most successful software company in this channel, while augmenting our retail business and adding significant profitability to Microsoft's bottom line.

Appendix A

ENTRY BUSINESS UNIT OEM STATUS GRID										Revised:	8/22/91
A) CURRENT/NEW DEALS											
OEM	Product	Units	Price	Machine(s)	Start Date	Term	Deal Type	Support	Manuals		
Canon	PC Works	5,000	\$43.00	286/386	Mar-91	Mar-92	Packaged	MS	n/a		
	WinWorks	5,000	\$43.00	ix and up	Jan-91	Jan-92	Packaged	MS	n/a		
Commodore	PC Works	30,000	\$20.00	286	Oct-89	Oct-91	Royalty	MS	OEM		
Cumulus	WinWorks	60,000	\$5.00	Scars PCs	Sep-91	Sep-92	Royalty	OEM	OEM		
	WinWorks	50,000	\$10.00	ix and up	Sep-91	Sep-92	Royalty	OEM	OEM		
Compuadd	WinWorks	10,000	\$20.00	MPC	Sep-91	Mar-92	Royalty	OEM	OEM		
		—	\$20.00	MPC Upg Kit	Sep-91	Mar-92	Royalty	OEM	OEM		
IBM	PC Works	200,000	\$6.00	PS/1	Oct-90	Oct-91	Royalty	OEM	OEM		
Leading Edg	PC Works	40,000	\$10.00	286/386	Jan-91	TBD	Royalty	OEM	OEM		
Smith Coron	PC Works	30,000	\$10.00	286	Mar-91	Mar-92	Royalty	OEM	OEM		
Us Integrate	PC Works	10,000	\$20.00	286/386	Nov-90	Nov-91	Royalty	OEM	OEM		
Wang	PC Works	6,000	\$13.25	286	Apr-91	Apr-92	Royalty	OEM	OEM		
	WinWorks	4,000	\$17.25	386	Apr-91	Apr-92	Royalty	OEM	OEM		
B) DEALS PENDING											
Leading Edg	WinWorks	40,000	\$10.00	ix and up	TBD	TBD	Royalty	MS	OEM		
Packard Bell	Winworks	500,000	TBD	ix and up							
	Barney	500,000	TBD	ix and up							
	Voodoo	500,000	TBD	ix and up							
Leading Tech	PRODUCT AND PRICING IN NEGOTIATION										
Laser	PRODUCT AND PRICING IN NEGOTIATION										
Tandon	PRODUCT AND PRICING IN NEGOTIATION										
Samsung	PRODUCT AND PRICIN										
Everex	PRODUCT AND PRICING IN NEGOTIATION										
Goldstar	PRODUCT AND PRICING IN NEGOTIATION										

20 30

Units:	PC Works \$149.00	% of SRP	WinWorks \$199.00	% of SRP	Publisher \$199.00	% of SRP	Money \$69.95	% of SRP	WEP \$39.95	WPP \$59.95	LDos \$49.95
<25k	\$15.00	10%	\$20.00	10%	\$25.00	13%	\$9.00	13%	\$4.00	\$4.00	\$4.00
25k+	\$10.00	7%	\$17.00	9%	\$22.50	11%	\$8.00	11%	\$3.50	\$3.50	\$3.50
50k+	\$7.00	5%	\$15.00	8%	\$20.00	10%	\$7.00	10%	\$3.00	\$3.00	\$3.00
100k+	\$6.00	4%	\$10.00	5%	\$18.00	9%	\$6.00	9%	\$2.00	\$2.00	\$2.00
250k+	\$5.00	3%	\$8.00	4%	\$15.00	8%	\$5.00	7%	\$1.00	\$1.00	\$1.00
500k+	\$4.00	3%	\$6.00	3%	\$12.00	6%	\$4.00	6%	\$1.00	\$1.00	\$1.00

8/27/91

EBU OEM Strategy

X 190763
CONFIDENTIAL