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TO: Joachim Kempin
FROM: Jeff Lum/Debbie Flynn
RE: Winning the applications business at CompUSA
DATE: February 27, 1992
CC: Peter Braman, Dale Christiansen

The purpose of this memo is to bring you up to date on the negotiations with Compudyne for our applications business. As you now we are in a tough competitive battle with Lotus whereby they are willing to "give away" the business from our perspective. In addition, you know that we have had a difficult time making any progress internally on developing a competitive strategy against Lotus's aggressive proposal. It appeared earlier this week that we were going to have to walk from any kind of deal with Compudyne since the applications marketing group did not want to match Lotus's offer, which is what Compudyne said we would have to do to get the business.

Steve Dukker, President of Compudyne, agreed to let us have a few more days (until 3/2) to come up with a competitive proposal. We accomplished this by offering to license him downlevel versions of Excel (3.0) and Word (1.10) with the opportunity to make additional profits on the upgrade business to Excel 4.0 and Winword 2.0. The ability to make additional margin on the upgrade business has sparked his interest. This memo provides some background to what our competition is offering, why it makes sense to go after this business aggressively, and a proposal that allows us to be competitive with the Lotus offering.

We believe we have come up with a creative solution that provides for a competitive solution without compromising the value of our software by combining an aggressive royalty for down level products (Excel 3.0 and WinWord 1.10a) and an aggressive upgrade program for preinstalled versions of the down level software only. If you believe this is a good proposal, we need you to meet with Mikemap this weekend during your retreat, and come to an agreement that we can pursue this business. We meet with Steve Dukker, President of CompUSA, on Monday in San Francisco. We need to have a proposal in hand that we can run with or he will sign with Lotus next week (probably right after our meeting).

<u>Background:</u>

Compudyne has the ability to be the next Dell or Gateway by the sheer volume they will move the direct mail, club, and owned stores channels. With the opening of 20 new stores in the next fiscal year, their mail order business, and their plans to expand into the non-traditional computer channel, they believe that they will be shipping 30,000 units a month by December. That's a lot of machines that could be running Lotus (or Microsoft) software.

LOTUS has offered CompUSA the following deal:

- \$70 royalty for <u>both</u> Ami Pro and Lotus 123W (latest versions)
- includes documentation and support
- 20,000 unit commitment
- April 1.1992-December 31, 1992
- no min commits, pay each time documentation is ordered, if they don't hit 20K commitment, they pay the difference
- no media, software will be pre-installed.

Compudyne wants to add value by packaging software with hardware, e.g. have the customer think they get **$1000 worth of free software.** Compudyne doesn't necessarily price their bundles according to the software cost, so every dollar that doesn't go to the vendor is a margin dollar to the bottom line. Compudyne wants the MS features, but Lotus's name is enough of a draw to make this bundle move.

High end applications are becoming even more attractive because 1) it is another level of differentiation and 2) Lotus is making it attractive. At first glance, this deal may not seem to make sense because the pricing is so low, **however, once Lotus gets their products pre-installed on the machine, it is very unlikely that the user will upgrade to our product (at least in the short term).** We lose the original socket and the potential for future upgrade business. Every Lotus sale on a machine means that customer doesn't purchase a MS product at point of sale. We lose the retail customer who would have purchased an MS app if the "free" software hadn't been on the machine. There is a severe opportunity cost (both short and long term) to allowing Lotus applications on these machines.

Another issue is Lotus momentum at the OEM level. Lotus is making very aggressive deals. They have already signed with Zeos and Packard Bell. MS has a nice market share position today with our Windows applications, and we have been competitive in most situations. However, in recent months we have lost some significant business in the same channel that Compudyne is in to OEMs like Philips, Packard Bell, and Zenith. Because of Lotus's momentum and corresponding price erosion, it could conceivably cost us more in 6 months to buy this business than it does today. Why not lock them into our camp today? This is very in line with the systems business model. Our pricing model does not address the competitive issues that we are facing today. We need a competitive strategy in these situations.

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<u>Proposal:</u>

In order to "match" Lotus's $70 all-inclusive (support and documentation) royalty to Compudyne - without documentation and support from MS - we believe we need to do the following:

Offer an $85 royalty for the Compudyne version of Excel 3.0 and Word 1.10a. In addition, we need to offer an aggressive discount on the retail upgrade products that Compudyne can sell onto *preinstalled Compudyne machines*. The chart below illustrates that by offering an $85 royalty, and a $125 royalty for the upgrade. The net cost to Compudyne is $53.50 per preinstalled machine. When you factor in documentation and support on top of this, we are competitive compared to Lotus's offer of $70. However, because of the upgrade business, our net royalty rises to $123 for Excel and Word for each machine that Excel 3.0 and Winword 1.10 is preinstalled onto.

Time is of the essence in this proposal. We explored using the retail upgrade product and offering an aggressive program through SMSD, but they are not willing to talk to us about doing this. Thus, our only course of action is to go with a total royalty deal.

Assumptions:		
Potential machines - 1 yr	150,000	
Win capable machines (100%)	150,000	
Windows machines (75%)	112,500	
Bundled machines (50% of Windows machines)	56,250	
Upgrade potential (30% of Bundled machines)	16,875	
Royalty and profit analysis for CompUSA		
Microsoft Royalty for Compudyne preinstalled product	**$85.00**	Excel 3.0 and WinWord 1.10a
Upgrade revenue per Excel & Word bundle	$250.00	Excel 4.0 and WinWord 2.0 upgrade
Royalty to MS for upgrade (preinstalled units only)	$125.00	
Compudyne cost for COGS for above (approx)	$20.00	
Upgrade gross profit for CompUSA per Exc & Word bundle	**$105.00**	
Total upgrade gross profit for CompUSA	1,771,875	Upgrade potential x Upgrade gross profit per Excel/Word upgrade bundle
Number of Bundled machines	56,250	
Profit per Bundled machine	$31.50	(Upgrade gross profit / # of bundled machines)
Net royalties to MS per Bundled machine	$53.50	(Does not include support or documentation) Versus $70 for Lotus 1-2-3W and AmiPro (incl doc and support)
Microsoft revenue analysis		
Royalty for downlevel versions	$85	Excel 3.0 and WinWord 1.10a
Royalty for upgrade versions	$125	Excel 4.0 and WinWord 2.0
Total royalties	4,781,250	(Bundled machines x $85)
Total royalties for upgrades	2,109,375	(Upgrade potential x $125)
Total revenue	6,890,625	
Net Dollars/Bundled machine	$123	Total revenue / # of bundled machines

We believe this offer will be attractive to Compudyne. As you can see we are able to charge even more than Lotus for royalties on our down level products by leveraging the upgrade margin potential. In addition, these are upgrades and customers that we are not likely to get if Lotus is on their machine.

We will also ask for:

1) A Microsoft registration card in each application box including upgrades (the upgrade box will be a Compudyne colored and labled box that clearly indicates it can only be used to upgrade preinstalled Compudyne machines. We can make them include just the install diskettes in the system box so that the upgrades that sit on the shelf are useless without the install disks shipped with the system.

2) That he commits to shippng at least one MS application on every Windows machine. We propose using the following price structure for the low end bundle:

Works for Windows	$10
Entertainment Pack	$3
Money	$5

These low end products will help him round out Compudyne's product offering where they are not able to bundle high end applications. More importantly, this will kick Lotus out completely from Compudyne machines, and allow them to make an all-Microsoft solution throughout the entire product line.

We look forward to hearing from you by Sunday, March 1 about this proposal.

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