To: PaulMa, BradSi, JimAll, RobG, SteveSh, JonL
Fr: TonyA
Re: Financial Presentation Follow Up
Da: 8/10/92

Attached are a copy of the slides presented last Friday at the staff meeting. I've also included an explanation of the Systems gross profit margin (GPM) for FY92 and a list of opportunities/risks which were highlighted by the slides.

Explanation of Systems GPM for FY92

During the presentation, some questions were raised about the lower than expected gross profit margin (GPM) for Systems overall, and particularly the MS-DOS&Windows group for FY92. The numbers as presented are correct.

Systems overall GPM for FY92 was 78%. Systems was broken down into 5 subgroups: MS-DOS&Windows (84.8%), SPAG (51.6%), Networks (83.6%), UNIX (81.3%) and MMS (96.9%). But Systems overall GPM is obviously weighted heavily by MS-DOS&Windows (79%) and SPAG (13%). So as we thought in the meeting the real issue lies with the explanation behind the MS-DOS&Windows GPM.

The chart below identifies the major revenue components of the MS-DOS&Windows group. Since royalties only account for 36% of the total revenues, the overall GPM for the group is heavily skewed by package product and upgrades. With the growth of Windows units in the OEM channel for FY93, I would expect the GPM for the MS-DOS&Windows group to increase this year.

Product	Revs (in $M)	% of Total	Approx GPM%	Wgt GPM%
Royalties	328	36%	100%	36%
Full pkg	359	39%	85%	33%
Win Upg	91	10%	71%	7%
DOS Upg	143	16%	83%	13%
Total	921	100%		89%
Less:Non-prod COGS				4%
Net GPM%				85%

Opportunities/Risks

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- **MS-DOS**
  - Naked systems represent approximately 3 million units annually. OEM is attempting to capture these units with Packaged MS-DOS and EZ MS-DOS as well as

increasing our piracy efforts. OEM will also attempt to control production of MS-DOS with the OEMs buying the package from us. This would allow for serialization of packages in the channel and ultimately more controls to help prevent piracy. Its expected this will take a few years to be widely implemented. We will track progress of these measures.

- The MS-DOS 5 upgrade has only a 4.3% penetration of the MS-DOS installed base (excluding MS-DOS 5.0). We estimate there are more than 80 million PCs with a down level version of DOS. We need to find additional ways of getting customers to upgrade and of capturing customer names for our reg base. Bradc and I will work closely with OEM and Channel Marketing to develop some programs for the MS-DOS 6 rollout.

- Two uncertainties will have an impact on the DOS market in FY93 - Novell's bundling of DR-DOS with NW Lite (promo pricing at $79/client; reg SRP $129) and IBM's bundling of OS/2 on PS/2s. Also IBM may come out with their own version of PC-DOS 6.0 with the Workplace Shell. May want to resurrect Blue Moon plan (MS-DOS 6 for PS/2s) if we haven't been successful in getting IBM to launch a single version of DOS 6. We need to make sure we are taking the proper steps to aggressively address these issues.

- **Windows**
  - Dramatic shift in sales of units from retail channels to OEM occuring in FY93 (FY92 - 47% to FY93 - 59% forecast). Overall FY93 Windows penetration forecast to be 60% of Windows capable systems. This shift will likely become even more skewed to OEM in the Chicago timeframe. The OEMs will see this as an opportunity to get a discount on their MS-DOS/Windows royalty. Our ability to grow the operating systems business at the rates we are accustomed to will be dependent on our delivery and marketing of high end, high quality products on schedule (WFW, Win NT and Cairo) and better penetration of the installed base with our low end products.

  - Win 3.1 upgrade penetration of Win 3.0 installed base has only hit 17% thru FY92. International is particularly low with 7%. Need new programs to improve this and more mindshare from domestic and international sales force. We should set a goal of X% penetration on upgrades for each new version and then manage to this goal. Currently there is incredible hype at announcement and then marketing and unit sales ramp down rapidly after the initial month.

  - Shift to OEM will make it imperative that we either charge OEMs for support or do a better job of ensuring OEMs provide good support for their customers. The extent to which OEM customers use MS support isn't clear today. I will work with PSS to get a better handle on this problem.

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- Need to better understand RTR program and the impact it has on lowering support costs. I will work with OEM and PSS on this.

- **Hardware**
  - During FY92 International OEM units lagged Domestic OEM units by a factor of 2.7 (434k vs 1,179k). This is primarily attributable to 3 factors - (i) transfer price too high preventing the subs from making adequate margin on OEM mice sales; (ii) stocking of insufficient inventories in Ireland to meet OEM orders on short notice; and (iii) booking Intl OEM revs in the Intl Retail channel which prevents appropriate sales incentives for OEM reps in the subs. We have already solved the first 2 issues before the beginning of FY93. The third issue is currently being addressed with Finance.