Date: 10/11/95

To: DADMGR, RBDirect

CC: PeteH, NathanM

From: Robbie Bach

RE: Building for the Next Generation

This memo is focused on our longer-term strategy for the Desktop Applications business. The goal is to evaluate the health of our business and what steps we need to take to improve that health. Note that by nature, this takes a more "negative" outlook on where we are and where we need to go. Some of it is perhaps a bit overstated and based on anecdotes, but I believe the basic issues it raises are real and significant. I also don't think that any of it is "revolutionary" or even particularly difficult to see today. I just think it's easy to lose perspective on where we are and it's useful to take the time to look at the broader picture. The bottom line thesis I present is that the business has some significant risks; that our business model, product strategy, and sales and marketing approach are mis-aligned; and that this represents a significant threat to the company's overall health and revenue stream. Comments encouraged and welcomed.

Background

If you look at our situation today, you'd see what is an apparently healthy, strong business. Our revenue growth over the past few years has been dramatic. Our products provide a phenomenal profit margin to the bottom line, which creates an engine for growth in the rest of the company. Our market share is at an all time high and our two primary competitors are in serious business and financial trouble. We've just produced a new generation of applications and have a second version of those applications close to completion. I think we have one of the best design, development, test, etc. groups in the software industry, and their work is backed by a great marketing. In short, we have an embarrassment of riches and should congratulate ourselves on a job well done.

So What is the Problem?

However, if you step back for a moment to look at the forest, the situation is less positive. The dynamics of the marketplace are changing rapidly in ways that work against us. Much of the hardware growth is taking place in markets where our sales are traditionally weak, there are fewer switchers or pure new users to sell to, and its becoming increasingly more difficult to upgrade large percentages of our installed base. In short, it's not clear where we are going to generate growth in the business and it's worth asking whether we are heading toward the revenue flattening we have already experienced in the Mac market. On the communications side, there is a perception amongst many "influentials" that our products suffer from "feature glut" and a feeling amongst our corporate buyers that we don't really understand their business environment very well. Furthermore, given our success and apparent lack of quality competition, the press is taking a much more critical approach to our business, often going out of their way to write the negative angles on various stories.

As outlined below, I think these are just a few of the warning signs that we have some significant risks to manage over the next 1-2 years. The answers to a series of fairly basic questions illuminate the challenges we face:

Question 1: Who are our customers?
The easy answer to this question is that our customers are the end-users who use our software. And certainly, at some level that is very true. We want them to have a tremendous experience with our software, purchase again, and recommend it to others. This "IEU" oriented customer segmentation is the conventional wisdom that has driven much of our marketing and product strategy over the past five years. Even in corporate accounts, we have counted on end users to drive the move towards our products from "the bottom up" creating pressure on IS managers to provide our tools.

Certainly, this is a valid model that should continue to drive some of our development, marketing, and sales resources. However, as our penetration and share has increased, and as corporate accounts have standardized on our applications, IS managers have become much more important in the process. A rough estimate would say that 25% of our sales come from a retail environment where in the vast majority of cases we are selling to an end-user. The remaining 75% of our sales are somehow driven through organizations, with IS departments playing a key role. Even if you assume that a some percentage of these sales are influenced or controlled by end-users or department level managers, you cannot escape the fact that our primary buying audience is an IS professional managing hundreds or thousands of PCs PLUS the rest of the technology infrastructure at the company. This raises some interesting questions:

1. Are we developing the right products for this customer or are we developing products designed for end-users that have to be shoe-horned into an IS decision maker's mindset and needs? Put another way, have we committed/dedicated ourselves to be an "enterprise application vendor" and aligned our product, marketing, and sales strategy accordingly?
2. Have we spent enough time trying to understand these customers and targeting our marketing at them? Are they the #1 target audience for our marketing and sales efforts?
3. Do we send a consistent, consolidated message that spans all of Microsoft's various product groups and communicates our overall strategy for meeting IS needs?
4. Is there something we should be doing to broaden our customer base and reduce our dependency on this IS group? Are there significant pockets of end-user buyers that we have not tapped into?

Question 2: Who is the competition?
Of course, the straightforward answer to this question is PerfectOffice and SmartSuite. In some shape or form, these products or their component apps have been our competition almost since the beginning of the applications business, and they are really the only products that hit the radar screen when you consider sales situations, channel focus, market share, or any other indicator.

While I still think they are competitors to whom we must pay attention and there will be specific sales situations where we must be aggressive, I think the battle is basically over. Lotus' application business has shrunk to less than $400M per year ($118M Q1 FY95) and IBM certainly did not buy them for SmartSuite. SmartSuite's development team is in disarray, they are having a difficult time shipping products and they don't have much credibility in the market. Novell's application business has shrunk in half over the past 12 months to about $350M and their latest quarter (Q4 FY95) was only about $35M (or 13% of the total company) – this is truly stunning for a company that was bought a year ago for over $1.1 billion in stock and accounted for 28% of Novell's sales at that time (Q4 FY94). In short, while we should never completely take our eye off of these products as competitors, we should recognize that they are not the major threat to our future success.

So, if SmartSuite and PerfectOffice aren't the primary competition, who is? I think there are three sources of competitive threat:

- First and foremost, I think Office 4.x (or whatever the previous version is) is our largest competitor. Buyers, in particular those in organizations, are basically happy with our products – they are nice, solid tools that get the job done. The problem, of course, is that the bar for selling upgrades to these people is now much, much higher and we don't have a good process for making this sale beyond maintenance or our traditional packaged product business. If our products are viewed as "everyday tools", then nothing is easier or better than what seems to work just fine today. This is compounded by situations in which the upgrade requires significant transition costs based on file formats, programming language changes, etc. In some ways, its analogous to the old situation where we had to convince people it was worth the effort to switch from 123 and WordPerfect, and we had to provide appropriate tools to make that easier.
- Second, the last gasps from SmartSuite and PerfectOffice create competitors of a different nature – namely IBM and Novell – companies that desperately want to blunt our thrust into the enterprise market. One effective way to do that is to sacrifice a dying business (their applications) to either enhance their enterprise offerings through bundles/giveaways or to drive prices down thus reducing the cash flow we generate from applications to invest in BSD and other areas. IBM is the larger threat here because of their bigger, deeper pockets, but Novell has very little to lose (who would buy their apps business if they wanted to divest) and in many ways is more threatened by our BSD initiative.
- Third, shifts in technology or the fundamentals of the market could pose a threat. Historically, the thing that has knocked the leader off the top of the hill in our business has been a failure to identify and respond to basic discontinuities in the market. Examples include the standardization on DOS, the move to GUI, and the move to Suites. There are at least two technology shifts that I can see that could hurt us (I'm sure there are more). The most obvious is the move toward the Internet and a connected world. Companies like Netscape will try to change the entire dynamics of the industry creating a set of standards that are semi-independent of Windows, that drive the creation of "new" applications just for the Internet, and that make our existing technology look big, overly cumbersome, and not designed for the connected world. Another example is the whole move toward componentization where smaller companies can create specialized objects that provide the basic tools and functionality people need without the "extra baggage" that our current Office model requires. Two anecdotes in point are Stewart Alsop's articles on spreadsheets and StarOffice's components approach and his discussion of Software Publishing's ASAP presentation software. Note that my point is less that these are the likely discontinuities and more that there will be discontinuities and we need to deal with them appropriately.

So what is the bottom line on the question of competition? I think it boils down to some basic issues:

1. Are we creating products that meet the future competitive threat head-on or are they designed to win the battle that is almost over?
2. Should we lead the change to newer technologies/paradigms or should take a more incremental approach based on the existing platform we have?
3. How much unit share are we willing to sacrifice to protect the fundamentals of the business? Is it even possible to do this? How do we combat aggressive/non-economic based pricing models?
4. How do you develop, market, and sell products when you are your own primary competitor.

Question 3: What is our product strategy?
If you look at the latest DAD 3 Year Plan, it says that our mission is to "To make the most popular line of desktop productivity tools in the world". While I don't have a better formulation in mind, I think this is a pretty narrow definition of what we need to accomplish and begs the question "have we done that already"? And if you look at the actual detail of the plans, I'd argue that while the quantity of architectural change is high, the actual approach is fairly incremental. Put another

way, let's ask the question "why have our products been successful in the past". First, we have a first-class development team that has consistently produced superior products. But given all the dynamics and inertia, I don't think that is enough. When its all said and done, I think the two biggest factors in our success have involved capitalizing on market changes which the competition was slow to address. We led the move to GUI products (both Windows and Mac) and then developed both a leading word processor and spreadsheet that we've integrated and sold in Office.

The combination of these points makes me wonder if we've really pulled back from the trees and asked ourselves to articulate a broader vision of where we need to take our products. Can anyone articulate a vision for our products that engages and excites customers (either IS or end-users); that challenges them to think we can add real value to their business going forward; that motivates our own DAD employees to new heights; or that transforms the way people think about desktop applications? I've tried and I cannot do this (OK, that may say more about my marketing skills than anything else!), and with the possible exception of BillG's upcoming Comdex speech, I don't know of anyplace where we are pushing this envelope. I also think many of the "new" things we are doing (like the Internet/connectivity stuff) is reacting to the market rather than driving the market. It's great that we can respond quickly, but at some point we will miss something or get to it too late.

All of this is a very difficult when at the same time you are trying to sell products to a huge installed base that may not immediately be interested in having their world turned upside down. So here are the issues:

1. Does our product strategy really map to the customer, competitive and market changes that I've articulated above?
2. Is there a guiding vision and strategy for our development work beyond "more of what we've done for the past 10 years?" Is our "12/24" strategy designed to fight the previous war or is it designed to bring basic, fundamental innovation to the computing environment?
3. Are there completely new products that we should be working on that change the basic paradigm of desktop productivity tools, obsolete the entire category, or move us into new markets?
4. What is the next equivalent to the "move to GUI" or "move to Suites" and how are we going to drive that shift and profit from it? Perhaps its the "connected world", but are we driving that or being driven by the market?
5. How does our product strategy move the industry forward in fundamental ways without leaving our huge installed base behind?
6. Do we have sufficient focus in our development work or should we be dropping development for alternative platforms like the Mac, Mips, Alpha, etc.

Question 4: Where will we generate future growth?

For the past two or three years, we've been forecasting slower growth rates in the desktop applications business. And while our growth has slowed, each year various factors have worked in our favor to enable us to exceed even some of our optimistic assumptions. But questions 1-3 above don't paint a very favorable picture from a growth perspective. Here is the sobering view

- Much of the migration from DOS to graphical environments is over. There are still some people upgrading their hardware and potentially switching to our applications, but we have captured much of the cream of this crop.
- A big percentage of corporate accounts have made their move to suites and consolidated on one vendor. We've been fortunate to benefit from much of this migration, but while there is more

revenue to generate here, the volume is slowing.

- While our installed base has grown dramatically, upgrading this group is getting more and more difficult – both due to lack of perceived need and the fact that many of the users reside in organizations that purchase centrally.
- Our Macintosh business has reached a plateau and is in fact declining in corporate accounts. Hardware trends here are working against us as Apple's sales are moving toward the home and both their and our development efforts are leaving the large 030 and soon 040 installed bases with no easy way to upgrade/migrate. It's fair to ask if the Mac business could be a $150-200M in FY97.
- More importantly, Intel hardware growth is moving away from our traditional applications markets and into the home/consumer market where our penetration is much lower.
- The move to 32-bit applications is off to a slow start, thus limiting what we can do in the short-term to drive FY96 sales. Ultimately we will benefit here but it may be a longer, slower road than we expected.
- A variety of factors are driving revenue/unit sold down, thus slowing our growth rate independent of the unit sales trend.
- While the move to CD is positive, we've squeezed a ton of the cost of selling Office out of the system. Of course there is more we can do, but meaningful profit growth will have to come from the revenue side.

The positive way to look at this is that for a variety of reasons we've done an incredible job harvesting a huge amount of revenue driven by some significant discontinuities in the market. The challenge we face is finding the next source(s) of revenue to keep up this pace and grow the business from $3 billion to $4 billion and beyond. Here are some questions to address:

1. How do we generate growth in the corporate market when this group is the closest to saturation? Is there any way to increase penetration now that share is very high?
2. Given our current set of products, what can we do to sell them into new or expanding areas like the Sorg, Soho, or home markets? Are there changes in our products that we should undertake to make this easier?
3. Are there new products, services, add-ons, etc. that can generate meaningful revenues or increase our penetration in existing accounts?
4. Can we do a better job generating more revenue by attacking verticals, competitive pockets of strength, international markets, piracy, etc?
5. How do we leverage the huge installed base we have created to generate a regular annuity revenue stream from them?

Question 5: What is our business model?

If you think about everything that has been presented above, it ultimately comes down to a question of how you define our business model (everything from the product, to production, to selling, etc.) and how that needs to change. A modified version of the "4 P's" for DAD products would look like this:

- Product: shrink-wrapped productivity software tools
- Placement: through channels of distribution (as opposed to direct)
- People: targeted at end users
- Price: 10-20% premium with special terms for corporate, education, and switchers/upgraders

While this is certainly the model we began with, it doesn't reflect how much the market and our approach to it has changed. In most cases today the product is not shrink-wrapped (~50% of our sales are license sales of one type or another). In addition, our product mix has changed dramatically with over 80% of Word sales coming through Office rather than as standalone apps. For a meaningful percentage of these sales, we have a direct sales relationship with the customer, even if they end up buying from a channel partner. The buyers of the software are NOT end-users but are IS managers and business decision makers who may or may not be "engaged" in our products. In fact, I'd wager that the majority of people who use our products don't know that they have Office on their machine nor do they have much control over repeat purchases or upgrades. These IS managers don't often view our software as strategic or differentiated – more likely they see it as a basic commodity tool that they have to provide and support for their end-users. This makes charging a price premium increasingly difficult, especially when we often end up negotiating with purchasing managers whose primary motivation is cost driven, not value driven. All of this raises some pretty fundamental business questions:

1. How do we prevent our products from becoming commodities in the marketplace? If we cannot do that, how should our business model change?
2. How do we manage headcount, marketing expenses, etc. in a situation that could easily degrade into a downward price spiral (and rising costs of sales) over the medium to long-term?
3. How do we change our pricing, distribution, product, services, etc. to structure an annuity business around our large installed base?
4. Should we change our pricing model relative to individual apps? What role do they play in our sales and marketing mix?
5. How should we evolve our distribution system to reflect on-line selling opportunities, pressure to sell our product through OEMs, etc?

Question 6: Are we organized for success in this new environment?
We've done quite a bit of restructuring in DAD over the past 2-3 years to reflect the changes taking place in the marketplace. In particular, we've centralized marketing and created an Office Product Unit to reflect the importance of Office in our business. The company has also made some significant changes to empower the divisions to focus on their businesses and enable the field to focus on specific sets of customers. Overall, these changes have been positive and have enabled us to keep pace with the changing environment. Having said that, I think there are some significant ways in which the current organization is dysfunctional:

- Within DAD, marketing has drifted too far away from the development teams, which has hurt both groups. Some of this was an over-reaction to the creation of the product planning teams and some of it is a function of having two versions of the product under development with marketing only able to focus on the "near-term" product. To provide some scope to the problem, nobody in DAD Marketing has a crisp view of what is in Office 96 except at a very cursory level and my team does not have as much expertise even on Office 95 as I'd like.
- As a somewhat outside observer at DAD technical managers meetings, I'm pretty amazed at how much "negotiation" and "coordination" still has to go on to finalize on product specs and final code. Despite lots of progress, we still have lots of inconsistencies and my guess is that neither the Office team nor the individual apps teams enjoy the constant badgering that goes on to push the project forward. Some of this is good because it challenges people both to do the right thing for their product AND for Office and the division as a whole, but it makes doing almost all phases of our work more difficult.
- We do a poor job integrating work across product divisions, both on the marketing and development levels. For example, having Access development in a different division is one contributing factor that has made it difficult to synch that product with the rest of Office. We

burned tons of resources on issues like the OPP, beta dates, vouchers, etc. in trying to sort out how to deal with Access and Office Pro. I hear continual "issues" between the Exchange and Ren teams and I don't think we have a coordinated view on how these products integrate together for our corporate customers – from a product or licensing perspective. At last count, customers will be able to get three different mail clients from us (Win95, Exchange, and Ren) and I've heard talk of work beginning on a Schedule+ version 8 and a new Win95 client called Athena. On the marketing side, we've done almost no work to integrate with BSD to market to our joint IS target audience nor have we worked well with the Consumer Division on issues like Works vs. Office, or penetrating Sorg/Soho. Some of this is "normal tension" in the organization and there are some exceptions – we've worked well with the Win95 marketing team for example. But even assuming some of the anecdotes above are just "rumors" or gossip, overall there is lots of friction in the system.

- Finally, with the possible exception of the EUCU, we are out of synch with our counterparts in the customer units. Over the past year, we've had almost no interaction with the Enterprise Unit and our interaction with the Organizations Unit has been erratic and generally unproductive. Furthermore, we've had almost no interaction with the field sales people and our customer interaction has been largely focused on EBC type situations. To be frank, this is pretty shocking when you consider how much of our business flows through these two groups and how important that is to the company, and I think it's a situation where both the product and customer units have failed.

When I look at the organization issues I've raised above, I'm personally pretty frustrated because despite good intentions, I know we've not leveraged the organization well in DAD Marketing – and I fear the same is true to some extent in development. Some of these challenges have been around since I joined the company – and I don't see them going away very quickly. Again, what I can offer is some questions:

1. What are the relative roles of product planning and marketing and how should marketing integrate with the development teams? Is it useful to have product planning playing an intermediary role?
2. How does marketing function in a 12/24 system where resources just get stretched too thin to track both the marketing of the current version AND the development of two new versions?
3. With customers looking for us to "make it all work together" and expecting a more unified strategy and product line, how can Marketing and Development drive their own businesses and yet still integrate well (and easily) with other divisions?
4. How can product marketing support the customer units and the field without getting into situations where we are duplicating functions and pretending to be experts in other people's areas?

Are There Any Bright Spots?

With all of the doom and gloom above, its worth noting that there are significant positive areas. This is hardly an exhaustive list, but it is what comes to mind after re-reading the memo:

1. I think we have a great team – both within DAD and across the company and this is significant foundation on which to build solutions to our issues. I know this sounds like apple pie but most of our success is driven by having smart, focused people working on our business when our competitors, for a variety of reasons, have either not been smart, not been focused, or both.
2. There is tremendous leverage in our current leadership position and economies of scale. We have both market inertia and financial strength working in our favor, and unless we do something foolish, that is usually a good combination. Put another way, I don't envy Lotus, Novell, Netscape,

Apple or other challengers/underdogs. The trick for us is to turn that leadership into a dollar valued benefit.
3. We can exploit opportunities for synergy and leverage across divisions and with the research group. We've already seen several instances of that in Office 4.x and Office 95 and more will accrue in Office 96. It always astounds me how much research, thinking, development, experimentation, etc. is going on in the company and how we manage to productize a reasonable percentage of it.
4. Despite a few concerns that I've been pretty vocal about, Office 96 is going to be a great product and will give us some breathing room to work through the challenges above.
5. We are clearly ahead in terms of developing and marketing Office as a solutions platform beyond the productivity business. This is a longer sell with most accounts, but its also more strategic and is a great way for us to increase penetration and ensure longevity in the account. It also creates barriers to entry for competitors since they not only have to create the development tools and support for this, but they have to build the third party infrastructure to drive it.
6. Although it may take some time, I think we have a huge opportunity for growth outside our established markets. This will take patience and investment, but our "old" competitors have been retracting from many of these areas and its not clear their new "parents" view the apps as strategic enough to leverage their existing strengths (beyond OEM type deals) to help SmartSuite or PerfectOffice.

Fine, the World Might Be Ending, What Should We Do?

It's all well and good (and relatively easy) to paint a gloomy picture, but I want to provide some ideas for addressing the issues I've raised. If you review everything I've written above, I think it all boils down to re-evaluating our entire business strategy (across all disciplines) and developing a plan going forward that brings all elements of our business into alignment against our key objectives. I don't think this is the case today as evidenced by four key points (and some related, ancillary issues):

1. We have not made a commitment to be an Enterprise vendor, either in development or marketing, even though that is where we sell most of our product and it is our largest installed base opportunity.
2. The competitive landscape has changed – we are our own biggest competitor and need to adjust our product and marketing strategies to reflect that.
3. Our product strategy is more tuned to the "previous war" and is not aligned with our current customers' needs nor designed to drive (as opposed to chase) future discontinuities in the marketplace.
4. Growth is going to be difficult going forward and we don't have a product or business strategy in place to deal with this.

I did a short personal "brainstorm" on these issues and came up with 10 actions/ideas for us to pursue – some strategic, some tactical. I know that some of this work is already being done, there are probably other efforts that I don't know about, and I certainly won't pretend that I have the right ten. Having said that, here is my brainstormed action items to ensure a healthy future for DAD:

1. Decide definitively that we are an Enterprise vendor and need to have "Enterprise-friendly" applications – this involves understanding this target audience a lot better and designing things especially for them. Note that this doesn't mean we are only an Enterprise vendor – just that committed resources will go to this.
2. Re-think the way we deploy development resources from two teams that do 12/24 work to one of several models that could help us address the issues above. As an example (and only an example), one team could focus on specific work for corporate customers, another team could

focus on core end user tools, and perhaps Consumer could focus on Soho/Home modules to pair with core Office components.

3. Split off a small team (someone from each functional group?) to map out what our products would look like if we were starting from scratch today. This would force us to ask hard questions and make trade-offs between revolution and evolution.

4. Do the in-depth analysis on "annuity" selling both for corporations and end users and determine how our financial, development, marketing, and sales models need to change

5. Broaden our vision from offering "productivity tools" to offering a range of tools, information, services, etc. to generate on-going interest in our products. This is one component necessary to create the annuity relationship discussed above.

6. Take a small group and ask them to treat our products as a competitive app and figure out what they would have to do (product, marketing, selling, support, etc.) to get a company to switch to some new set of apps. The point here is that at the extreme, this is the decision a company makes when they upgrade from one version of our product to the next. Of course we would learn about how to address other competitors but the real issue is to make sure we understand how to get people to upgrade

7. Work with DRG to understand what we would have to change in our business to be a true development platform, in a similar way to Window (this is a DougHe idea). Ultimately, it may not be practical and might not be the right model, but it would tell us some intermediate steps we can take to accelerate the "Solutions" efforts we have underway.

8. Do a quick project at the senior manager level and ask them what they would cut in terms of resources and spending if they had to reduce their costs 20%. This would get at the question of how our division would have to change to compete in a low price, commodity world.

9. Re-focus our market research and understanding on opportunities for growth and new segments. At the extreme, we could stop all short-term focused research for a period of time and address the knowledge gap we have to fill to change our overall business approach to be successful in the future.

10. Finally, we have got to figure out how to work across divisions more efficiently. This is painful in marketing today, and I assume it is difficult in other areas as well. I don't have a specific proposal, but it needs to be in the top 10.

Development team notes: Word guys: Spell-it is very, very cool as is background auto-format. I've demoed them a lot but not written a long memo in awhile and they really made it easier. The only thing I'd like is for Spell-it to recognize possessives better – is there some option for that? PPT guys: I did the outline for this in PPT (sorry Word guys) which was great – I use your app more than any other except, unfortunately, mail. One issue: how do you (can you) do automatic numbered lists in PPT? Answer Wizard and Help were clueless – if it's not in the product, I think it would be pretty popular. XL/Access: Nothing to report on your products – although I will say that my productivity is up because of AutoCalc (I'm serious, we use this a bunch doing marketing estimates and rough cuts) and we did our marketing budget integrating an Access custom form using replication with XL Pivot Tables! Just want to make sure everyone knows that despite all our gripes, and all of the comments above, marketing is easy when we have the products you build – how was that for marketing spin?