

From: Orlando Ayala
Sent: Sunday, May 02, 1999 12:20 PM
To: Robert (Robbie) Bach
Subject: FW: Home and Retail Division WWSMM Memo

Follow Up Flag: Follow up
Flag Status: Flagged

here is some feed-back (in the memo).. good work!

—Original Message—

From: Robert (Robbie) Bach
Sent: Friday, April 30, 1999 12:12 AM
To: Orlando Ayala; Michel Lacombe; Pieter Knook; Richard Fade
Cc: Jeff Raikes; Joachim Kempin; Home and Retail Div. Staff; Home & Retail Div. Subsidiary Managers; Craig Fiebig (Exchange); Steven Sinofsky; Rich Tong (Exchange); David Cole; Nick MacPhee; John Leftwich; Sandy Duncan
Subject: Home and Retail Division WWSMM Memo

I suspect you will get this as part of your "memo packet" for WWSMM, but I thought I would send you a copy of the HRD WWSMM memo directly. The memo lays out our basic strategy, focus areas, metrics, etc.

Let me know if you have questions or thoughts.

Thanks

Robbie



Home and Retail
WWSMM Memo Fin...

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Microsoft MEMORANDUM

To: WWSMM Attendees
From: Robbie Bach
Date: April 26, 1999
cc: OrlandoA, Michell, PieterK, JeffR, JoachimK, HERDMGMT, HRDSUBMG
Subject: FY00 Home and Retail Division WWSMM Memo

I. EXECUTIVE SUMMARY

Given that the Home and Retail Division (HRD) was just formed, I thought I'd use this memo to articulate our mission, goals, and key focus areas both for FY00 and over the longer-term. In the process, I will outline how HRD integrates into the Initiative Process and what roles we will play in the various aspects of the FY00 Initiatives. At the highest level, our mission is to make Microsoft the #1 supplier of software and hardware to home PC users. Put another way, we are charged (along with CCG and Consumer Windows also defining how to win with OFFICE big time in the home as they relate to Muglias org?) with making Microsoft the leader in the consumer space by building the next profitable, multi-billion dollar business for Microsoft. If you look back historically, our record in this area is mixed. We've had some great successes with things like the Windows 95/Office 95 launch, Encarta, Flight Simulator, Mouse, and gaming devices (among others). That said, we've not yet lived up to the vision that BillG set out for the company when he launched our focus on the Consumer business 5 or 6 years ago. It is our job as an integrated HRD team to develop the strategies and capabilities needed to deliver on that vision over the next few years.

Looking more specifically at FY00, there are a number of trends worth highlighting that should influence our plans:

- *Continued PC Growth, Accelerating at the Low End:* Home PC sales continue to grow nicely, in particular at the low end. In the US the majority of machines on a unit basis sell for less than \$1,000 and almost 20% of the market sells for less than \$600.
- *Increasing Price Pressure:* Most markets in the world are facing various forms of retail and OEM price compression with strong unit growth at the low end of the consumer software and hardware market.
- *Piracy:* Counterfeit product continues to be a large drain on our revenue opportunities, in particular with the introduction of CD-R devices. During this past holiday, these devices were amongst the best selling consumer devices in many countries.
- *Industry Consolidation:* In the consumer space, The Learning Company (TLC), Electronic Arts (EA), Hasbro, and Havas Interactive have all been very aggressive on the acquisitions and strategic partnering fronts. With the pending purchase of TLC by Mattel we see the beginnings of a smaller set of large consumer companies that will be able to influence the market much more effectively than in the past. In the US, we have seen somewhat of a similar trend with our major retailers.
- *Competitive Activities:* The competitive landscape continues to evolve with new competitors in the form of Linux (Red Hat, SeSe and Caldera) and BeOS, and some competitors who are getting even more "aggressive" (Corel) due to declining financial circumstances. Local market competitors (Star Office in Germany and Justsystems in Japan) also continue to be a threat at retail. We're also seeing new forms of competition in the OEM space with ISV selling consortiums (Media Farm, Point Group). In the Hardware space, Logitech has followed us into the Keyboard market and the Gaming Force Feedback market in the past year. They have also entered the video camera market via their acquisition of Connectix.
- *Changing PC Purchase Patterns:* As the PC market matures and prices come down, it is becoming more of a replacement and "2nd PC" market. In US households, almost 30% of all new PCs are second or third machines. In addition, more of these purchases are happening online – for PCs as well as for software and peripherals. Next to books and music, software is the largest and most popular category of products to purchase on the web. In the US in CY98, 14% of all software sales were via the Internet, and this is expected to grow to 30% or more in the next 12-24 months.
- *Changing PC Usage Habits:* Consumers' use of the PC is also changing as a result of the Internet. Email, chat, community, and e-commerce are large growth areas with users in the US now spending roughly 60% of their PC time online. While that number is lower in other territories, it is only a matter of time before this trend spreads.

- *Importance of Super Users:* Households of these engaged, influential users account for the largest chunk of consumer revenue per household (roughly \$400/year in US). They drive opinion and referral, and we've learned that focusing marketing resources on this group is cost efficient and effectively produces a high return.
- *Another trend is networking at home..* recent announcements like the one we did with 3COM sound like another opportunity to go after that home wallet. Would new houses will come with networking as a feature?... should they also come with all the productivity software needed to run that smart house?

The environment outlined above certainly presents some difficult challenges for us. Nevertheless, growing revenue in the home is our clear goal. While the strategies pursued to achieve that will vary some by territory, there are some common threads that I will identify here and discuss in more detail later:

- Improve Retail Execution
- Fight Piracy
- Build OEM and other PC Attach Programs
- Leverage Office 2000, Windows 2000, and Windows 98 2nd Edition Launches
- Invest in Direct/Online Marketing and Selling
- Expand Product Line and Build Franchises
- How about licensing? How much innovation should occur here for the home?.. are we satisfied with our current ways to do... the whole South African experiment should not ne consider as part of this concept?

We need a clear set of metrics to measure the success of these and other strategies specific to a territory. In FY00, we will focus more heavily (and more consistently) on sell-through as a key measure of success. We still need a sell-in forecast for a variety of operational reasons, but our primary task is to get product sold through to consumers. In addition, we'll focus much more on growth over the previous year (and compared to the market) than on performance against budget. Certainly budgets will be important to build our resource plans, but in the end, increasing \$/PC requires strong growth. The next section will lay out these and a few other metrics in more detail. Stating that the goal is really 30% or more as the breakthrough will not be bad. Nothing like having that number burned in the team's mind.

II. SCORECARD

At the highest level, our goal is to build a set of programs that help us increase the dollars we generate from home and retail relative to the PC opportunity. Conceptually, growing \$/PC is the right way to think about expanding our business and will help us as we establish new programs. But as a practical metric, \$/PC has some significant limitations in the home space so it's important for us to have some additional goals and metrics to measure our success. While these will vary a bit by subsidiary, these are the metrics we should highlight: our current symterns (MS sales, etc) are appropriate for you to go after these metrics?.. this is a bit of the discussion we had the other day about the customer segment map of the MYR template, You need to design it really in line with what you think will be meaningful

- *Grow Sell-through:* Generating growth across all businesses and territories is a major goal. I define this as growing faster than our previous year, faster than the market, and faster than PC growth.
- *Increase Profit:* Increasing our profitability, both in absolute dollars and margin terms is important. Our goal is to have both the Hardware business and the Consumer Software business improve their profitability over last year and meet or exceed our competitor's profit margins.
- *Office Momentum:* With Office 2000, we have a huge opportunity to bump our sell-through rate to the next level and compete even more effectively with Corel. It's also critical that our retail launch help build a "buzz" around the products that drive sales in other (more business oriented) channels. Since Corel is also launching a new version, success will not be easy. We'll strive to grow our Office retail business by 35% vs. FY99, while increasing the \$/License through specific up-sell strategies and tactics with the Pro and Premium SKUs.
- *You should ask Schiro to update you of the discussion we had as a group (Fiebig and others). About the need to be more creative on the launch. I gave several ideas that will be good you also look at. Craig is supposed to be on the case and get us a proposal during the next 10 days on how to really get something really exciting. The way plans are today I see them as very lame considering the importance of this release.*
- *Windows Success:* Our challenges are two-fold: first, we must sustain Windows 98 momentum by leveraging the introduction of 2nd Edition to sell 2M units at retail worldwide. Second, we need to execute a flawless launch and ensure we are appropriately positioning Windows 2000 to the small business market via the retail

channel. Let's get early on the planning of great consumer ideas.. we should get out of the mood of getting that done just few weeks before we are going to the street.

- *Market Share:* For some categories of products, we do have market share goals. In particular for Encarta (65% revenue share), Office (90+% retail revenue share), Mouse (45% share), and Gaming Devices (60% share).
- *Thought Leadership:* Since market circumstances vary quite a bit by country, our objective is to have each territory drive a new/specific "best practice" program targeted at increasing \$/PC in that territory. As examples, the Home PC Purchase program in Sweden or Retail Direct in the US would meet this goal. There could be great space for "gold digging" working on some few things with CCG.. every location should be looking at that . and then we see what good practices will help us extend to other parts

III. RELEVANCE OF HRD TO WORLDWIDE STRATEGIC INITIATIVES

Overall, HRD is primarily focused on the \$/PC initiative and owns the home user segment of that initiative. That said, there are ways in which we support some of the other initiatives:

1. *Win and Secure the KM/Collaboration Platform:* While this is clearly a corporate focused initiative, we can help at retail by building "buzz" for Office 2000 and generating end-user momentum for the product. Many of these collaboration situations are generated at the Division or Group level within a company and involve "highly engaged" users building their own basic systems. We need to help get these types of people educated about Office's new capabilities and excited about trying/buying it. Remember that the retailers have also outbound sales forces.. we need to ensure your sales guys are leveraging that sales force to support this objective.
2. *Drive Windows 2000 Professional Desktop Penetration:* This is the retail portion of a broader effort to build the Win 2000 platform. Windows 2000 Professional will clearly be positioned as the best OS for all businesses and HRD can support the initiative by generating excitement and momentum at retail for the product. Windows NTW has already begun to penetrate the LORG market, the next big growth area for Windows 2000 adoption is in the small and medium organizations. Since many small businesses shop at retail, the success of Windows 2000 depends on how well we message and penetrate this market segment. Same comments as above.. let's be sure that companies like COMP-USA are goaling their outbounds around these initiatives
3. *Build the Online Business:* Many of the partners with whom we work in retail and in OEM are very interested in the online space. They are all trying to identify ways in which they can share in the online annuity streams, sell their products online, or use "online excitement" in the marketplace to drive in-store traffic for products they sell. As an example, Dixon's in the UK is now the largest (or one of the largest) ISPs in the country based on programs they ran to integrate an ISP offering into their regular retail business. In the US, we have at least one retailer who wants to offer discount or free PCs and make money (through revenue sharing) off of the revenue the buyer generates when he or she goes online. In any of these cases, we need to support CCG's efforts to win in the online arena by building these types of activities into our work with retailers. I would pick a couple of things to do in the US and start with that. This is an area that Best Buy is ready to do but we need to narrow the focus on what we thing could be early wins .. that could for sure enhance mind-share tgo benefit the mainstream retail business.
4. *Grow Customer and Partner Satisfaction:* From an end-user perspective, HRD has an opportunity to drive consumer satisfaction since users interact with our products and support services in a very direct way. We need to continue improving our "out of the box" experience for users and work with the Consumer Windows team to make it easier to install and use our products. We also need to market the new "Personal" PSS offerings where they are offered. HRD also manages our relationships with retailers around the world, and we need to make sure those relationships remain healthy or strengthen over time. Certainly there is an aspect of "negotiation" that goes on with these partners which can and will create tensions in relations at various times. But overall, working closely with them is fundamental to our success and is a major reason why we are moving to a direct sales model with our major retailers in the US. Only by working in partnership with them, can we identify new opportunities, respond more quickly to the market, and capture share relative to our competition. While the first corporate survey of customer satisfaction did not include these groups, we are going to do some survey work on our own to measure current satisfaction and hope to get incorporated into the next round of satisfaction survey work that is being done worldwide.

Have you talked with Jean-PC ?. we should formally include this time around. I think we should

5. *Increase \$/PC:* This is clearly the initiative that is most relevant to HRD, and I'll discuss in greater length below how we will address the consumer segment. It's worth pointing out that HRD can help raise \$/PC in

some other customer segments, in particular in small businesses. Depending on the country, some meaningful percentage of these companies actually buy hardware and software through retailers. In the US, someone like CompUSA does a good business with this audience. So while this is not an explicit focus for HRD, there will be opportunities for us to support the Small Business effort.

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Page 4

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IV. STRATEGIC INITIATIVE MAP

Initiative	Support
Win and Secure the KM/Collaboration Platform	
• Engage Customers on our Vision and Products	Support
Drive Win2K Desktop Penetration	
• Deepen Penetration on Win 2K Machines	Support
Build the Online Business	
• Grow the Access Business	Support
Grow Customer and Partner Satisfaction	
• Create a Customer Centered Culture	Support
Increase \$/PC	
• Drive \$/PC in Small Business	Support
• One Best Practice for Consumer	Owner

V. HRD CORE STRATEGIES

Given the diversity in our markets and the various stages of development within the Home segment, prescribing specific actions that every territory should use is not an easy task. Nevertheless, I want to discuss some strategies that I think apply in most markets and should guide our tactical activities over the next 12 to 18 months. I'm hopeful that each territory can use these and other strategies to meet the "Thought Leadership" objective defined above.

Strategy #1: Improve Retail Execution

In many ways, the home and retail space is all about great execution. More so than most of Microsoft's businesses, our success is directly related to how well we execute from the time the product is RTM'd, through shipment/stocking/promotion, all the way to managing life cycle sales after a product has peaked in the market. While I think we have improved over the years in a variety of execution areas, we are not a leader in this respect and many of our competitors (certainly EA, TLC, Havas Interactive, Intuit, and perhaps Corel) are more effective at it than we are. There are a variety of issues that have hampered our performance, but the bottom line is that Development, Operations, Marketing, and Sales must work better together in an integrated way to improve our performance and make us "world class" in this area. Here is a brief description of the key areas where we need to drive for excellence and some examples of problems we need to address:

- **Product Delivery:** The product teams must deliver a full portfolio of quality products. Beyond this somewhat obvious statement, one key metric for the product teams is timely delivery. Using FY99 as an example, we had several products that slipped quite a bit (Office 2K, Age 2, Tax, Streets and Trips) and this created real planning and revenue challenges for the group. And even for products that ship "on-time", the specific timing is critical around key selling periods like Holiday or the Japanese bonus seasons. This year while Works and our key Games shipped as scheduled, their planned RTM dates were too late in the holiday season for some International markets to maximize their revenues. Shipping software is not a science, but we need to keep focusing on delivering great software at the right time on a worldwide basis.
- **Manufacturing/Operations:** Given the quantities we sell and the logistics involved, efficient/effective manufacturing and operations is very important. We made many improvements this year including shorter delivery times and some great work to produce unexpectedly high quantities of product in the US. That said, we also had quite a few problems in this area. In the US, we had faulty CDs produced for Combat Flight Sim and had large logistics problems in our Indianapolis shipping center that delayed hardware products and products for Latin America. In Europe we had a variety of problems associated with the new turn-key

operations that delayed products getting to shelf in a timely way. We need this process to run super smoothly and reduce lead-times even further if we want to be successful long-term.

- *This is an area in which you really must define very tight goals for the OPS people. We need to have certainty that what we have in this front can really support your R&D and sales efforts. There has to be 3 or 4 things that must be formalized as goals for Nick's team in H&R. We have to get super crisp here.*
- *Product Marketing Support:* First and foremost, product marketing needs to produce great consumer positioning/messaging. As an example, we are still working on this for Office 2000 and the Office team and the former CCU teams have struggled a bit to coordinate this work. Additionally, Product Marketing needs to develop clear messaging around Windows 2000 to eliminate any confusion. There will be many consumers who will assume Windows 2000 is the next version of Windows 98 – we need to make sure they understand the target is the business user. Product marketing also needs to produce great packaging in a timely way. This is an area where we had serious breakdowns this year: some groups didn't solicit feedback early enough from the subsidiaries resulting in lots of late changes and lower satisfaction in the territories. In other instances, packaging became critical path to shipping a product – and that is inexcusable. Finally, we need great demand generation work from marketing – and where possible we want that to integrate well with the channel marketing and sales activities we have planned.
- *Retailer Relationships:* Having great relationships with our reseller accounts is one of the reasons we are moving to sell direct to our largest resellers in the US. Through these relationships, we get competitive information, feedback on our products and marketing strategies, opportunities for special promotions, and real creativity in building account plans. Success at retail also depends on our figuring out the right set of T's and C's that motivate our accounts most effectively – and we can only do this well when we work closely with them. Today, we don't get enough leverage from our full product line, and at least in many markets, we don't have a strong enough relationship with retailers to get the "special opportunities" that can drive incremental sales.
- *Pricing:* Getting our pricing "right" is arguably the most important marketing mix decision we make for products at retail, and today we only do a mediocre job at this. First, we need to be more flexible about price points by considering competitive activity and local market conditions better. By the time you factor in currency fluctuations and market differences, we can't just take a US price and translate that into a price point in each country. Second, we need to get the pricing right the first time around. Missing a price point out of the gate (particularly if we are too high) really stalls momentum and is difficult to change (almost impossible in some countries). In some of these categories, initial momentum is what drives reseller interest and once a product gets stalled it is tough to get it going again. Finally, we need to have offerings at more price points. With the emergence of value lines and the strength of the mass merchant and club channel segments, we need our product offerings to cover a wider range of price points. Differentiation of Office/Windows pricing vs. rest of the biz is critical. on the non OFC/WIN products is all about being super flexible and smart but aggressive with pricing. For the other two it is critical we achieve great coordination with the rest of the business and ensure we don't do in an isolated way. Communication in that front will be key to win in all fronts and not just one
- *Channel and Account Planning:* This is the nerve center for retail execution and doing it well requires the product, channel marketing and sales account groups to work as an integrated team. One of the real challenges here is managing the broad line of products we have and establishing priorities – something we don't do well yet. Today, in most markets we decide which few products should get focus and spend accordingly. This means that many products basically get little/no attention and their ultimate performance reflects that. Instead, I think we should do a much more detailed plan that establishes priorities that change by product, by promotional offer, by account type, by time of year, etc. From this, we build an overall plan that enables us to combine the right product with the right promotional offer at the right time of year with the right channel partner. As an example, in the US we don't do as well in the Club Stores as we should because we haven't really figured out this integrated offer process well for that class of trade. Now that you own this little "1B+" company you are set to go and do whatever it takes to win with the Clubs
- *In-store Execution:* The in-store environment has a big influence on what people end up buying, so it's very important that we are great at getting stocked "in category" at a minimum. Beyond that, we need to ensure that appropriate products get premium display and advertising and that the set of products being promoted varies by account and time of year, as appropriate. Replenishment is also a key aspect of this, in particular around peak selling seasons like holiday. Accounts don't necessarily do a great job on their own of replenishment so we have to provide guidance and incentives. As an example, we've had trouble in the US getting replenished in December – so this year we planned some extra promotional activity in January so accounts knew they needed enough inventory to carry them all the way through that timeframe.

- *Inventory Management and Returns:* Most of our competitors are more sophisticated at working with their accounts to manage inventory. While EA doesn't actually manage vendor inventory, accounts rely on them heavily for advice on order quantities, return rates, etc. We do some of this today but don't have the track record to get accounts to fully buy into our advice. On the returns front, we need to do a better job understanding the trade-offs between being in-stock and having high returns. Overall, we manage too aggressively to minimize returns and that means we get under-stocked and miss sales. In my view, if we get less than 10% returns, inventory is definitely too tight, and I'd be happy with returns as high as 20% assuming our sell-through was strong in an absolute sense. This is less true for Office and Windows which are generally more stable businesses so we should be able to keep returns relatively low. Just build into the plan what it takes to win... not to say we should do it in a way that you don't meet your goals of increased profitability
- *Life-cycle Management:* Our competitors are much more sophisticated about managing the pricing and promotion of their products to maximize revenue over the life of the product. In general, someone like EA gets at least 2 years of revenue generation from a good title compared to 6-18 months for Microsoft. Our competitors do a better job setting initial prices and managing those prices down as appropriate to squeeze out more sales. They also have a process to take front-line titles and profitably sell them as "value-line" products later in their life-cycle. While we've made some strides in this area over the past 12 months, we have a long way to go. This year we will have life-cycle plans built-in to our marketing plans, and we are looking at ways to implement a value line strategy.
- *When do you think you establish a discipline for this?*

Certainly, the US program to go direct to key retailers is an important part of addressing some of these issues. But we should be clear that it is not a "silver bullet" that magically fixes all of our problems. In fact it is just an enabler that makes it easier to achieve some of our retail execution objectives. And in markets outside the US, we still need to address the challenges presented above even if we are working through distributors.

Strategy #2: Leverage Office 2000, Windows 2000 and Windows 98 Second Edition Launches

During FY00 our greatest revenue opportunities will be in leveraging the launch of Office 2000 and Windows 98 Second Edition at retail. Our goal for the Office 2000 launch is more than just generating a three-month launch spike at retail. Instead we will be continually focusing on the Office line with promotions, retailer class of trade initiatives, and consistent advertising through our partners to drive our steady-state run rate to a new level. Here are some of the approaches to achieving this:

- Maximize the up-sell opportunity to the Office 2000 Professional & Premium SKUs.
- Promote Office with regular campaigns: Back-to-School/Back-to-Work promotion focusing on the Office line; holiday Office promotional efforts; and a Spring FY00 campaign focusing on the Office 2000 line and in conjunction with the Windows 2000 launch.
- Design PC attach initiatives to increase Office 2000 sales at time of new/replacement PC purchases.
- Partner with retailers to start selling (and sell "better") Open Licensing and 'Retail Open'.
- Focus on retail class-of-trade to increase Office presence in segments like Clubs and developmental accounts.
- Continue investment in anti-theft devices to keep high price Microsoft software on the shelves.

In order to increase Microsoft revenues during the Office launch, we will incorporate other products like MapPoint, Bookshelf, Natural Keyboard Elite, Wheel Mouse, Intellimouse, and Intellimouse Pro into our plans. These SKUs will have incremental retailer displays, ads, and consumer offers of up to \$30 off each. Finally, to combat Corel when they are launching their newest version (Corel WordPerfect Office 2000) next month, we have implemented an extensive "coming soon" program for Microsoft Office 2000 with various retail promotions and will focus on selling Open License of Office 2000 at retail (month of May). I assume you are already working on quarterly marketing \$\$\$\$ expenditures lined up with this?

Beyond Office, Windows 98 Second Edition will represent 75-80% of HRD's total Consumer Windows revenue in FY00. Our success with Win98 SE will be based on providing clear reasons why Win95 users need to upgrade and on positioning Win98 as the technological leader in the consumer OS market. Additionally, success here depends on excellent execution of programs during Fall/holiday and again during the spring campaigns. For Windows 2000, we must correctly position this product to our small business customers and increase penetration in the small business market. We will continue positioning Windows 98 Second Edition for the home consumer and Windows NTW/2000 for the business user.

We have also seen a tremendous increase in competitive activity in the OS space with the rise in popularity and noise surrounding Linux. This is especially evident on the retail shelf where there are multiple Linux vendors with multiple SKUs. Despite our greater sales volume, our Windows products often end up with less "presence" on shelf than this Linux collection. Due to our higher price and higher shrinkage/theft, some resellers pull Windows from the shelf to reduce their loss exposure. Because of the increased retail presence in relation to sales (total Windows still outsells Linux), flawless retail execution for Windows programs is even more critical for our ongoing success. BeOS is another Windows competitor that is continuing to develop considerable amount of coverage in the press. They will release a new version sometime in June 1999 that will have improved USB support, which directly competes with our Windows 98 Second Edition positioning.

Strategy #3: Fight Piracy

Fighting piracy may be our number one revenue opportunity. Piracy has many forms, but I divide it broadly into "institutional/professional piracy" and "good neighbor piracy". The former involves people building a business out of pirating our software and selling it in quantity to retailers or end users. This form of piracy is more difficult for us to attack at a technical level, since the pirates are usually technically savvy and can find ways to break protection schemes relatively quickly. Our best weapons against this form of piracy are legal enforcement and education with retailers and end users.

By contrast, good neighbor piracy involves individuals making a small number of copies of software to share with friends. The proliferation of CD-R devices has made this a key issue for us to address in FY00. In Europe, several retailers have told us that they will "order less" for any products that do not have some method to prevent illegal copying. We also believe that products without protection sold less than they should have relative to others that did have protection this past holiday.

Limiting good neighbor piracy requires some form of technical fix, along with appropriate education programs. For most of our consumer products (especially Games and the Encarta line), we will be utilizing a protection scheme licensed from Macrovision that basically prevents the software from working if it does not detect an original CD is in the drive. To date, this only works for products that require a CD - we are trying some solutions for products like Works that install to the hard drive but that is still under examination. We have run one limited test of this technology in France with Close Combat III and will be using it broadly for the first time this May with Midtown Madness. It's important to note that this does require a longer release process to verify disks and will require some investment in manufacturing. But given the opportunity, we are fully committed to making this happen. Hope this makes the light in fy00.. agree it can be a great buster of sales

With the release of Office 2000, we are also expanding our Office anti-piracy pilot program to Australia, Brazil, and New Zealand. In these markets, the Office Registration Wizard technology allows users to launch Office 2000 applications 50 times before registration is required. Upon the 51st use, users will need to register in order to continue using Office 2000 applications and will choose between five different methods for registering: Internet, e-mail, postal mail, fax or phone. The Office 2000 Registration Wizard will be implemented as part of a pilot program and will not appear in all copies of Office 2000. we have to make a formal assessment of results pf this pilot so we decide to move really aggressively with it.

It's important that we come up with a good PR plan as we launch these "anti-theft" initiatives. "Copy protection" has a very negative heritage so we need to manage that issue carefully. Overall though, I think most people will understand the legitimate need to introduce these types of technologies. Certainly the fact that our competitors are doing similar things will help us. Leverage the work done with Samir Bodas for the US. This year we can count as much as 170M incremental. Not a single major incident of bad press and that is because of the work done on creating a PR umbrella around economic benefit. Please see the program I approved few weeks ago for TV. It is around 1M incremental. This is to mirror the campaign made by the Germans but the one done here in the US is targeted to parents and their kids.. so as far as I am concerned that is really money being spent in your customer segment. Look at it I think it is strong and if it works then we will do more in 00

Strategy #4: Build OEM and Other PC Attach Programs

From our Windows home PC tracking study, we know that almost 75% of software purchases happen in the first six months following a PC purchase. Therefore, it's critical that we identify opportunities to attach to PC sales or generate trial and subsequent purchases around the PC purchase process. Clearly, OEM programs are one way we achieve this successfully today and there are some areas where we could expand in this regard. But our OEM business is being challenged aggressively by a variety of forces. First, falling PC prices has left OEMs with fewer and fewer dollars to spend on software. Even when we retain the socket, we are getting fewer dollars for the same (or more) software. Second, there is increasing competitive pressure from folks like Corel and Logitech who offer very aggressive pricing. In the Corel case, we are seeing WordPerfect Office Suite pricing at or below the levels we charge for Works Standard. Third, ISV selling consortiums like Media Farm and the Point Group are acting as intermediaries between OEMs and our competitors and offering built-in up-sell programs that generate revenue for the OEM. Unlike most of our offerings, these programs generally come with super low COGs and require no OEM support. Fourth, the market's focus on the internet has motivated OEMs to think about how they can add more value in that area and perhaps generate new revenue streams there. As a result, they are a little less interested in regular CD software bundles and less willing to pay the prices we charge today. The final challenge we face in OEM is an internal one. Because of the way we report/credit OEM revenue, there is a steady tension between the HRD retail teams and the OEM teams. This makes it difficult for us to make the right trade-offs between pursuing full-price retail sales and engaging in lower price but higher margin OEM sales. So how do we fix? I fixed the one on the rest of FG channel by making JK agree we will make it part of the revenue stream of the district .. atr least for the next year. So at this point they will receive credit for all sales of office and win that we sell in the systems builder channel

At a broader level, our real problem in OEM is that we don't have a well-communicated strategy for how we want to pursue this business. Aside from the requirement that we "don't lose a socket" we don't have a systematic way for thinking about our OEM sales. We need a strategy that outlines how Works, Office, Encarta, MSN, and our other offerings work together to maximize our \$/PC sold. This strategy needs to outline what we need on the product side (new features, new bundles, etc), how we make trade-offs amongst the products, and what we can do to motivate all the Microsoft people involved in the consumer space to "do the right thing" to maximize our \$/PC. We are committed to develop and communicate such a strategy before the end of FY99. Looking forward to be part of this discussion. I agree there should be plenty of space to increase \$\$\$/pc this way.g

Beyond OEM, there are a number of other programs we need to evaluate to increase "attach". Here are some examples of things we should be looking at:

- *Retail OEM:* this takes many forms but the basic point is that we must do a great job working with resellers to convince them to attach sales of our software to a machine sale. Our goal here is to have channel partners bundle or up-sell Office SBE, Works Suite or Encarta Reference Suite (or a similar product depending on the market) on every machine that does not already have one of our OEM bundles.
- *Trial/sampling Programs:* Another idea is to include demos or limited time/limited functionality versions of a broad range of our products on new PCs. These demos/trial versions would have functionality built in where the user could contact us to pay a full price or a subscription to "un-lock" the full version of the software. DAD did some experimental work 3 years ago called Ali Baba that was along these lines and the Office team has run a subscription test in South Africa that looks promising.
- *Special Purpose Bundles:* These are really special deals that enable users to get software at the time of a special PC purchase. The Swedish Home PC Purchase plan is the most "famous" of these programs today. Another example would be a program the US is evaluating to enable employees to purchase Office at favorable prices as part of corporate license deals. We've also talked about creating academic SKUs that families with K-12 children could buy for use in the home.
- *Membership Programs:* We've run a series of tests over the past 18 months in the US focused on selling "annuity products" to consumers. We've tested numerous different offers, at different price points, with different payment terms. The bottom line is that none of the basic annuity models have thus far generated a high enough response rate to justify expansion. That said, we are continuing to explore an option to "join a club" that provides information and special offers to members with no up-front payments involved. Our hope is that we can build a membership program that generates meaningful revenue from this.
- *OEM Integration with Shop.com:* We are working on a test with 3 OEMS in which the OEM will ship machines into households with a Shop.com icon on the desktop and start menu. When the user boots the new machine, they get a multi-media product presentation with an offer from MS. They then link out to the shop.com/OEM co-branded secure page to buy the products/offers. For an OEM to play, they have to agree to OEM our core

HRD products (Money/Works/Encarta). The benefit to MS is increased reach into new PC buying households, name capture, incremental s/w sale attached to new PC/increased \$ per PC, and reduced cannibalization.

The bottom line on all of these activities is that we have to think about maximizing the dollars we generate from users over the life cycle of their use of a machine. We need to sell to them at each of the key "touch points" in this life cycle: with the OEM when they build the machine, with the retailer when they sell the machine, with the end user when they buy the machine, with the end user when they come back into the store for additional items, and with the end user as part of a systematic customer communications strategy.

Strategy #5: Invest in Direct/Online Marketing and Selling

In many ways, this strategy is a direct follow-on to the "attach" strategy just discussed. The basic premise is that we need to do a better job tracking our customers, marketing to them more directly, and engaging them in a direct sales process, when appropriate. Arguably Microsoft "touches" more end users than any other software or hardware company through our existing product line, through Microsoft.com, through seminars/user groups, etc. We need to become world-class at forming a relationship with these users, profiling them, and determining how to provide them with better products and more opportunities to buy our products.

Shop.com (a.k.a. Nitro) is a great example of this process. Today, Microsoft.com generates a huge amount of traffic with people looking for information on our products and services. But until recently, we made no systematic effort to sell them our products – or put more accurately, if they wanted to buy something, we did very little to make that instantly easy. Now that we have Shop.com, it's possible to change that so that someone browsing through information on Office or Encarta will see a "Buy Now" button and have the opportunity for instant gratification. As a slightly more complex example, we see roughly 200K unique users on Zone.com each day who are playing games – yet there is no connection today to Shop.com for them to buy new games easily. We need to change this. We have to set a broader vision for SHOP.COM. We need a great thinker in your group to spec the new wave. We need to establish some level of timeline for International to use this. I know they are not happy with the fact that so far this is just a US effort. This is one we need to figure out in terms of direction during the next few months, including some of the points we discussed in our last 1:1.. bring back development to your tent and ensure the whole thing ties back to the mainstreams you do in channels for H&R

I'm still early in the process of understanding our programs to market directly to end users but here are a few early ideas on how we should attack this area:

- We need to get much more sophisticated about how we think about "registration" – in fact we shouldn't think about it as registration at all. Instead we should think about it as "membership" and we should encourage users to join our "club" so that they can get regular information and special offers. This needs to begin with the product development teams where we've not done a good job making it easy for people to "join the club" electronically.
- We need to get to a more unified mechanism for tracking users based on the Passport technology that MSN is developing. Today there are too many databases with pieces of a customer's information and very few customers where we have a "full picture". This makes membership marketing very difficult and inefficient. Furthermore, from the customer perspective, they don't have a membership number or some other way to identify their interaction with Microsoft. Each time they register a product they basically start from scratch, and when it comes to our service offerings they end up with multiple user names and passwords. Consequently, they don't have any consistent interaction with Microsoft and don't feel like they've fully joined our club.
- Huge issue and challenging one. It is key. Glad to see you see as part of your plate
- Our strategy for pursuing this area needs to be more "global" in scope. As an example, for a variety of reasons, we don't have a finalized worldwide Shop.com strategy which is unacceptable going forward. And while the specific programs we use to market to these users will need to be local in nature, there is a lot of leverage to be gained by sharing infrastructure and best practices.
- While we absolutely need to work well with our retail partners, we need to be more open to the concept of selling direct to end-users. I'm committed to helping retailers adapt to the new world (and new opportunities) opened by the Internet, and many people will want to continue buying in a more traditional store setting. That said, the reality of the Internet is that we can communicate and interact with our customers in a very direct way and we shouldn't limit our activities to "marketing" – if we can make a sale, we should do it. Almost all of our competitors sell direct to end-users in one form or another today and someone like TLC generates a meaningful portion of their business this way. We need to be more aggressive in this area. We have had a single channel

summit in the past. Being retailers your main audience.. I believe moving forward you need at least one session a year at very high level just with retailers to really bring them to the level of focus I know you want

- Finally, whatever we do in this area, we need to respect our customer's desires relative to privacy. Some customers won't want to receive anything from us, and we need to understand and honor that request. Others will want to join the club but only want information. And hopefully, the largest group will be open to getting both information and special offers. In any case, we need to understand our customer's privacy desires and deliver on that.

Strategy #6: Expand Product Line and Build Franchises

From a product perspective, there are many individual or category specific strategies designed to produce better products overall. This memo is not the right place to cover all of those strategies. That said, I do want to discuss two related strategies that cut across the products produced in HRD. First, to be successful, we need to continue expanding our portfolio of consumer products. Hit titles/products are certainly important, but once you've invested in building an efficient "channel pipe" to sell products, much of the incremental revenue and profit gets generated by "non-hit" titles. While the industry leaders all have core titles that drive revenue/profits, they rely on their excellence in retail execution to drive incremental revenue (at low additional cost) from their entire portfolio of products. Today, EA drives 44% of their US games revenue from products that are ranked #100-1,000 on the market. For Havas, the equivalent numbers is 38%. This is in stark contrast to Microsoft where we generate only 22% of our revenue from products ranked #100-1,000. Some of this is due to execution issues but much of it also relates to the small size of our overall portfolio. So we will continue to expand our portfolio of products, particularly in Games and to some degree in Learning and in Hardware. Sometimes we get feedback that we should do fewer products since we just don't have the capability to sell more. But it's our view that cutting back on our portfolio would just place a "cap" on our ability to grow – and what we really need to do is improve our execution skills so that we can handle more products (a la our competition). Looking forward to see the pmas proposed for the next 24 months... again this will be big learning for me.

The second half of this product strategy discussion concerns the adage that this is a "Hits" driven business. Over the past two years I've come to believe that this is only partially true. Certainly, finding hits (cost effectively) is a key driver of success. But an even more important activity is taking a hit product and successfully building a brand/franchise around it that you can leverage, sell, and extend for many years to come. Flight Simulator, PrintShop, Carmen Sandiego, Reader Rabbit, JumpStart, EASports (Madden, NBA Live, etc.), Adi, and Links LS are all examples of hits that have turned into hugely profitable brands with long lives. And this doesn't include brands that come from other media like Barbie, Star Wars/Trek, Britannica, etc. So as we steadily expand our portfolio, we need to do this in a way that builds a core set of franchises that we can count on year in and year out. And we need to design our sales and marketing strategies to take advantage of these brands. Today, Office, Windows, Works, Encarta, Flight Sim, Mouse, SideWinder, and a few others would fit this brand/line/franchise mold. Others like Money, Age of Empires, Mech Warrior, Madness Racing, Home Publishing, Autoroute, etc. are in the process of becoming stable brands. Hopefully, each year we can add a product or line to this list.

What is the vision for our online gaming site... where are we taking it.. is this something we want to keep investing on? (obvious answer is yes).. what is the vision and how it ties to \$\$\$/PC and future profitability including building communities that can buy from us with a lifetime approach?

Internal Partnerships

In addition to executing on these core strategies, there are a number of internal groups with which we need to work effectively for the company to be successful in the consumer space. Here is a quick summary:

- **Operations:** As mentioned above, operations is a key part of our end-to-end process for delivering product to the market. No amount of great product development or sales/marketing work will make us successful if we don't work in an integrated, team-oriented way with Operations in the US, Ireland, and Singapore. In the past, communications have not flowed smoothly and there has been a bit of a "throw it over the wall" approach to how we work with the Ops team. Ideally, in FY00 we could make this process work more efficiently and feel more like we are on the same team. PIN THEM DOWN!!!!.. PIN THEM DOWN!!!.. Let's be super crisp on our expectation here and let make them live by that law!!!
- **Office:** HRD owns the channel marketing and retail sales efforts for Office so this is obviously a key partnership. Given its importance to the company and the size of this business at retail, we must make sure we

win with Office. In the past, our retail relationships with the Office team have not been very "smooth" – this is something we must fix. In HRD, we must drive Office channel plans effectively – from the Office team we need great consumer positioning, pricing, and feedback on the channel plan. On the development side, we will continue to share technology with the Office team, including using Word in Works Suite, developing small business reference tools for Office SBE, developing dictionary technology for Office, supplying MapPoint technology to the Excel team, etc. Ok I commented about this before.. good to see this is a key partnership we have to be very aware of.

- *Consumer Commerce Group:* Since our users overlap to a large degree, it's important for us to be in sync with this team. On the marketing front, we need to partner on messaging, audience research, PR programs, etc. Retailers are very interested in this space, so our sales team needs to help the CCG team work with our retail accounts effectively. On the product side, we are already part of the MSN Network with the Gaming Zone and Encarta On-line. There are also several opportunities for us to integrate in the productivity area (calendar, email, etc.) and in the networking area in Hardware.
- *Consumer Windows:* As with Office, HRD owns the channel marketing and retail sales efforts for this group and they are an important part of channel mind share and our revenue mix. At the end of FY98 and in early FY99, we completed a very well executed Win98 launch, and we need to continue this kind of work going forward. On the product side, we are partnering with this team to ensure that Windows 98 continues to be the preferred consumer operating system used in homes and schools and Windows NTW/2000 Professional to be the preferred business operating system used in business of all sizes. Our teams need to provide feature and technical input to the Windows team as well as understand how to take maximum advantage of the platform that they provide us. Finally, there is some code work we can share in areas where Windows needs to ship some base services (like basic image editing), and we develop higher end tools that are related (i.e. Picture It).
- *Consumer Devices:* While WinCe now resides in a couple of different groups, I wanted to call-out consumer devices as an area we need to support well. As the market broadens, these "PC related" devices are going to be a bigger percentage of the opportunity. In CCG, we need to understand what support the WebTV team needs as their partners sell WebTV boxes into our channel. Likewise, in the Business Productivity Group, we need to support Microsoft's Palm PC partners as they compete with 3Com. SSchiro owns developing a plan for how we support these products given that we don't actually have any revenue responsibility for them.
- *Developer Tools:* We own channel marketing and retail sales for this group. While their business is not as big as Office or Windows, it's strategically important for the company to be successful selling our tools products. To be successful given the resources that we have, we need to excel at segmenting the key channels and selling opportunities for Tools and ensuring we are well marketed there.
- *Product Support:* This is an aspect of our offering that gets under-marketed today and should be more integrated into our plans. Until we can make Windows and our other products easier to use (especially during the "out of box" process), we need PSS to provide top-quality product support so that customers have a good experience. Given the investment we make in free PSS, we need to do more to make this a strategic/competitive advantage for us.

Additional Success Factors

Beyond our typical set of performance measures, there are several keys to success worth highlighting:

- *Worldwide Approach:* In the past, our base tactics were focused on US plans that sometimes got localized/customized to local markets. In many situations, subsidiaries basically had to develop their own plans from scratch. While some of this will continue because our markets are different in some respects, we must do a much better job of thinking like a worldwide company. Those who work in the US subsidiary must think more about "how can we help with a worldwide approach to this" – and those in the other subsidiaries must think more about "how can we leverage the work from another subsidiary (US or any other). As an example, for the first time that I can remember, we have two products that are designed solely for non-US subsidiaries (EIEL and International Football) – these are examples of the product groups taking a worldwide approach. I hope to see more of this from all HRD teams in the future.
- *Quality Internal Communications:* Part of the reason we are not as "responsive to the market" as our competitors is that we aren't good at communicating internally. In particular, when information and decisions have to cross group boundaries, we get bogged down in long email exchanges that are not very productive. We can improve in this area by agreeing to clear goals/expectations on various projects up-front, by communicating in a direct/honest manner, by deciding early on who owns a decision and escalating points of disagreement to that person quickly, and by basing our comments and feedback on facts and data rather than intuition and

anecdotes. Teamwork is fundamental to the way I want HRD to work – I expect to see more of this in the way we communicate with each other.

- *Skills Readiness:* Much of what we need to do to be successful represents a change in our approach to the retail space. Succeeding in this area overall requires that we do more than sell Windows and Office at retail (although we certainly must do that effectively). It means we have to compete head-to-head with companies whose only business is home and retail sales. In general, these companies have more experience in the retail arena and they have people who were hired specifically to win at retail. Our own team has tremendous talent and was hired to contribute to Microsoft's overall success. But not everyone was hired to "win at retail", and we don't all have the skills we need to compete successfully with the EAs and TLCs of the world. I would include myself amongst the group that is not fully prepared for the task at hand. So I'm asking all managers to evaluate their training/skill set needs and develop specific plans to train and grow their teams. 12-18 months from now, I want to look across the organization and say more than "we have a great group of people" (which is true today). I want to be able to say "we have the best home and retail team in the industry."
- *Smaller Subsidiaries:* Because our portfolio continues to expand, the HRD business is very difficult to manage in smaller subsidiaries. There always seems to be more demand for time and money than we have resources to allocate. That said, the fact that Microsoft has so many established subsidiaries is a key asset relative to our competition which can't afford to put the infrastructure in place in as many territories. It's critical, then, that we leverage this asset effectively – and the best way to do that is to focus these teams on building "the channel pipe". This means spending our people and marketing dollars to make sure that we build strong channel relationships so that we can efficiently market and sell our products. Basically, we want to build a systematic way to work with our accounts so that we can push more and more products into the "channel pipe" without having to make very many investments that are specific to any one product.
- *Retail Mentality:* Because we are part of Microsoft, it's easy to treat this as a "typical Microsoft business". The problem, of course, is that the home and retail market is NOT a typical Microsoft market. Tighter margins are a fact of life at retail, effective logistics are essential, product features generally matter less than in other MS businesses, and the influence of "consumer trends" is much stronger. As a specific example, HRD is one of the few groups at Microsoft that can't be managed effectively just by looking at revenue. Because margins are so tight, we have to manage the full P&L and will be evaluated in a very explicit way on our bottom line results. In some Microsoft businesses, you can slip a ship date, miss a promotional opportunity, etc. and still "take a long-term view" of our investment. In HRD, we have to resource the business conservatively because if we "make a mistake" our margin for error is very small.

VI. NON-INITIATIVE PRIORITIES AND PLANS

Organization Principles

Since the Home and Retail Division is new, it's appropriate to share a few thoughts on why the new organization is important to our success. In general, the new structure will help because it places all of the key functions into one team so we can make roles and responsibilities more clear, become more efficient, communicate better, and hopefully make quicker and better decisions. In fact, we are now the most "integrated" of the new Microsoft businesses and this is critical in the retail space where execution is so important. With all of this integration comes increased responsibility and accountability. In the past, it was difficult to nail down why we were successful or unsuccessful because it wasn't easy to determine who owned our success. Now that is totally clear: HRD in Redmond and in the subsidiaries clearly owns this business. With that in mind, here are a couple of things to think about relative to the organization: This is a key principle.. as I repeat over and over again.. "the guy that develops the product also sell it".. if we don't win this time around it will not be because lack of empowerment or an integrated structure. As we agreed.. let's ensure we don't live with some shit we don't have to live with.. and if we have to take shit some time let's be sure we don't live with it for too long... (that includes everything.. other groups.. people that is just not up to the task, higher management interfering when they should not, etc, etc, etc)

- *Teamwork:* For HRD to succeed, we must all work well together toward our common goal of building a large, profitable business that develops, markets and sells great products around the world. And we must partner with teams in other groups like Office and CCG to provide great products and services to our customers. Teamwork doesn't mean that everything is a consensus decision – but it does mean that everyone gives their input when appropriate and supports other people and groups as they make the decisions that they own.

- *Resource Deployment:* Now that we own this business, we need to be smarter about how we deploy our resources. Some managers in the subsidiaries have commented that it's difficult to take ownership if you don't control the amount of resources you have to apply to the challenge. This is a fair concern that we need to address. So we are evaluating how our resources are currently deployed in the US and the major EMEA subsidiaries relative to today's and future revenue opportunities. Once we've completed this evaluation we will look at other regions as well and develop some proposals for how we should approve and deploy resources so that ownership includes owning both the costs and the revenues.
- *All Products:* Our Division is unique in that we have a sales force as well as product development resources, and our sales force sells both the products we develop in HRD as well as any other Microsoft products that sell at retail. I want to reinforce that we need to be successful in the market place with ALL of these products. Certainly, we should sell our Games, Learning, Home Productivity, and Hardware products effectively, But I want to be clear that since Windows, Office, and Tools account for roughly 70% of Microsoft's retail sales today, it is absolutely critical that we sell these products aggressively even though they are developed in other groups. As an example, ensuring that Office 2000 (and related products) have a great launch at retail is a key near-term objective.

Finally, I want to highlight that BillG and SteveB are very committed to driving success in this area. They've shown a tremendous amount of confidence by creating HRD as a "company within a company" – something unique at Microsoft. They've also agreed to change our approach to retail distribution in the US which is something that wasn't possible in the past. We all need to respond to this trust and investment by creating excellence in everything we do – and ultimately building another great business for Microsoft.

VII. HOME AND RETAIL DIVISION DELIVERABLES

- *US HRD Consumer Software & Hardware Marketing plan:* Owner = JohnOr. Plan complete by June 15, 1999.
- *US Channel plan:* Plans complete by end of FY99.
- *HRD Division PR plan:* Owner = StacyEl. Plan complete by June 1, 1999.
- *HRD Resourcing model:* Owner = RobbieB. Plan complete by June 1, 1999.
- *Anti-piracy PR plan:* Owner = StacyEl. Plan complete by May 31, 1999.
- *OEM Strategy:* Owner = StevenRo. Plans complete by May 31, 1999.
- *COGs review:* Owner = MikeNe. First milestone completed by end of FY99.
- *Win CE Devices and MSN channel plans:* Owner = SSchiro. Plans complete by end of FY99.

VIII. CONCLUSION

FY00 is a critical year for HRD. We have major releases of flagship products (Office 2K and Windows 2K) that we must successfully drive to ensure growth for this year and the future. Our consumer software and hardware line-up is more complete than ever before, and this is an important opportunity to prove the profit and growth potential for these businesses. In addition, we are making a major change in our business model in the US by going direct to our top resellers, and we expect this to drive incremental business. Finally, with our new organizational focus we are being given the responsibility and capabilities to drive Microsoft's business in the home and at retail. As a group, we must rise to the challenge and build a great business for the company.

Good memo... you did a tough job here.. Only one final things.. there is a lot of deliverables here.. would be worth while to make an inventory of these deliverables and ensure you create a good framework for execution out of that memo so your people know your expectations of timing. Some of them will ned to happen in 30, 90, 60.. some others will be more of a 12 month goals and there could be others that may be in 1n 18 months window. People get excited about vision and clear expectations for execution so I believe such an effort will pay off