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To: Worldwide Regional Director Meeting Attendees

From: Michael C. Appe, Jeff Sanderson

Subject: Microsoft Business Approach - *The Channel*

CC: RGM's, Mike Maples

Situation - The Channel Today

Today we continue to see rapid evolution in how software products are marketed and sold to customers. No longer is it possible for individual developers or publishers to create, market, sell and distribute software directly to customers, both end users and organizations, alone. Customers have many unique requirements for how they want to evaluate and acquire software products. It is this imperative that has brought about a broad spectrum of marketing, selling and delivery partners for software products in the marketplace.

> *Today, the primary objective in making our software products generally available through the broadest and strongest possible channels of distribution is to satisfy our customer's requirement to make it easy for them to evaluate and purchase our products in the most convenient manner possible.*

Secondarily, we use, develop and strive to enhance our position with a broad set of channel partners to help us achieve our own key objectives, which are to:

1. Increase customer satisfaction.
2. Increase our market share with each of our products.
3. Broaden our sales and marketing reach.
4. Reduce our expense of distribution and delivery.

When we judge how and where we should ultimately market, sell, and distribute our broad and diverse individual products and lines of products, we must ensure that we not only satisfy our customers needs but that we recognize and achieve the other objectives outlined above.

Broadly defined today, the "channel" encompasses any party interested in helping us achieve our objectives outlined above. To define the means by which software is ultimately marketed, sold, and delivered through the value chain to the end user today dictates the need to identify the primary segments of distribution that software is made generally available to consumers. For simplicity, I've divided the distribution channel into four primary segments:

1. <u>Original Equipment Manufacturers (OEM's)</u> - A unique segment of the software distribution channel, the OEM PC manufacturer that is capable of marketing, selling, and supplying software in a solution bundled directly with the manufacturer's own brand of PC hardware. OEM's have the unique characteristic of further marketing, selling, and supplying their solutions on through the three other segments of the distribution channel outlined below.

2. <u>Distributors (Two Tier Distribution)</u> - A segment of distribution partners who market, sell, and deliver product generally, if not always, only to other resellers never directly selling to the ultimate end user. Segments of this part of the channel can be broadly broken into the following categories:

- General Computer Hardware/Software Distributors - Examples include Ingram Micro, Merisel, Computer 2000, Tech Data.
- Franchisers/Aggregators - Examples include, Intelligent Electronics, Inacom, Microage.
- Software Only Distributors - Examples include Kenfil, Baker & Taylor Software, Software Resource.
- Specialty Distributors - Examples include NACScorp (Education only), Handleman (Mass Merchant only), GT Software (Warehouse and Department store only distributor).

3. Resellers (One Tier Distribution) - A segment of distribution partners who market, sell, and distribute generally, if not always, only to direct to end users nearly never to other resellers. Segments of this part of the channel can be broadly broken into the following sub-categories:
   - Outbound Resellers - Examples include *hardware & software outbound resellers* such as individual Computerland, Microage, Entre outlets, *software only* outbound resellers such as Corporate Software, Software Spectrum, ASAP, 800 Software.
   - Mail Order/Catalog Resellers - Examples include *general software mail order resellers* such as Micro Warehouse, PC Connection, Dustins, Tiger Software, Dell Direct and *specialty software mail order resellers* such as Programmers Connection, Programmers Shop.
   - Retail Resellers - Examples include *computer superstores* such as CompUSA, Computer City, *electronic superstores* such as Best Buy, Circuit City, Sears, *software specialists* such as Software City, Software Etc., Babbages, Egghead, Electronic Boutique, *mass merchants* such as Target, Service Merchandise, Wal-Mart, *office superstores* such as Office Depot, Office Max, Staples, *warehouse clubs* such as Price Costco, Sam's Club, *regional TV/appliance stores* such as Lechmere, American TV, Sun TV & Appliances, *electronics stores* such as Tandy Name Brand, Nobody Beats the Wiz, Willoughby's, 47th Street Photo, *military exchanges* such as Army/Air Force Exchange, Navy Resale & Services, *TV shopping* such as QVC, Home Shopping Network, *furniture/electronic stores* such as Smith's Home Furnishings.
   - Solution Providers - Examples include *system integrators* such as Anderson Consulting, EDS, *value added resellers (VAR's)* such as Valinor, Dun & Bradstreet.

1. Direct - The publisher identified as a direct selling segment of the channel itself. It includes any program or system of direct selling by the software manufacturer to the customer (end user or organization) in areas such as direct fulfillment programs, annuity programs, on-line services, etc.

Channel Segmentation, Sizes, and Growth

In an effort to simplify the view of the channel from a segmentation perspective this analysis will concentrate on the primary source for where end user customers make purchases today - namely the one tier (*reseller channel*).

1992 Estimated U.S. Market For Personal Computer Software

Reseller Channel Segment	$ Million	%		Growth Trend
Outbound Resellers	1,690	43%	•	Flat
Mail Order/Catalog Resellers	120	3%	•	Growing slowly
Retail Resellers	1,850	47%	•	Rapid growth
Solution Providers	240	7%	•	Steady growth
TOTAL	3,900	100%		

Source: Merrin Information Services, Inc.

Channel Strategies

There are three items which can be a unique competitive advantage for Microsoft. Of course, all have potential for working against us if we don't manage them effectively. The top three are:

- **Breadth of Line.** No one vendor can supply as many needs as Microsoft, nor therefore provide as much opportunity for cross-marketing and cross-selling. We must not allow our marketing dollars or in-store presence to be spread over so many categories to dilute our impact, however.

- **Size.** As the largest software vendor we have leverage, both in terms of what we ask for, as well as in terms of providing the largest absolute amounts of dollars to promotion. Often, however, the reseller looks at proportional measures (like accrual rate) rather than the absolute numbers. In this, we have the same problem as listed above: advantages of size being frittered away on many little piles of efforts.

- **Brand Microsoft.** Our advertising and position in the industry pull people into stores to look for our products. Once in-store, previously undecided customer may move to Microsoft because of our reputation. In addition to the work we do in establish and managing Microsoft's brand image outside of the channel (and the sub-brands like Home), we need to capitalize (as well as further reinforce) on that work in our in-store merchandising and the co-op advertising done by the channel.

Using these assets and tuning them to specific One concept used to simplify discussion of our reseller strategy is that our goal is capturing space, both in the absolute and incremental senses. Generally speaking, this mean focusing outbound resellers with relationship and selling programs for their organization accounts (i.e., Select) and with merchandising. In this segments, as overall, the best ideas are like Windows NT: small kernel of an idea, but infinitely scaleable:

Segment	Type of Space	MS Strategy
Distributors		Maximum breadth of distribution and effective marketing by incenting distis to move well beyond our core of Senior Partners, gaining us breadth of distribution and marketing.
Corporate Account Reseller	Mind	Make Select and MOLP easy to sell. Capitalize on its use as vehicle LAR uses to "lock in" account. Allow them to build profitable services around it (such as software asset mgmt.). Use the necessary complexity of program to take up mind.
Hardware Outbound	Disk	Provide easy preinstallation program to focus on increasing software attach rate with hardware.
Mail Order Reseller	Premium	Get premium catalog positions and MS-focused pieces. Use MS registered base names as leverage for joint activity.
Business Telemarketing	Mind	Experimental. Provide training and scripts. Can MOLP be closed on phone? Use marketing funds to run sales contests.
Software Chains	Shelf, Floor, Premium	Use display and merchandizing concepts like Home Displayer and 4-12' Store-in-Store to capture space, and retail calendar to capture endcap or other premium position for focused products.
Superstore	Shelf, Floor, Premium	Capture 24-32' Store-in-Store space; end cap for the Microsoft kiosk; retail calendar to capture endcap or other premium position for focused products.
Mass Merchant	Shelf	Demonstrate how to make $ in s/w and ensure high attach rates on new hardware. Use Home displayer and 2-4' signed shelving.
Emerging Consumer	Shelf	Test and invest. Target accounts, find right distis.

Special notes: each segment manager in the Reseller Strategy group has a more detailed strategy for his/her segment. Some of the newer items in the table above include:

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- Permanent and temporary displayer assortment. This spring we will offer a four-sided "spinner rack" (such as you might see at a book store). It will initially be stocked (and signed) with Home products, but is convertible to a brand Microsoft displayer. a growing variety of prepacks and counter displayers have been developed.

- Store-in-Store. This concept takes advantage of all three unique Microsoft strengths outlined at the top of the section. We have established a Microsoft retail "look" for developing dedicated Microsoft shelving in-store. In Superstores, this means 24-32 feet of linear space where the entire breadth of the line can be displayed (for maximum effectiveness, we want to have product also stocked in key categories like word processing as well). For smaller retail outlets, we aim for anywhere from 2-12 feet of Microsoft branded area, for either a "sub-brand" (like Home) or a feature area for what's new and/or hot from Microsoft.

- Microsoft "Product Central" kiosk. The kiosk (final name yet to be determined) is designed to take up space on an endcap, mostly likely in a superstore. It contains a multimedia PC with a CD-ROM containing info and demos on Microsoft's products. The sides are shelving for product stocking and sales. There are a myriad of other uses for the kiosk and CD-ROM (Egghead, for instance will be using the CD-ROM on the Gateway demo machine). We roll out March 1 with test sites in most retailers.

Problems and Implications

Some of the problems we face in bringing our products to market today as well as meeting our customers needs can be defined in the categories below:

- *Lack of a coherent global pricing strategy* - Examples include no rationale for how we price products, how should we sell our products through OEM vs. retail, how should we price products when we sell direct, what should the differential be in our pricing through OEM's vs. two tier vs one tier vs. direct purchasers. inconsistent pricing T's & C's for Select in different geographies, inconsistent application of rebates, inconsistent polices for earning rebates, no consistent formula for calculating licensing product prices off of FPP, no promotional pricing standards, no standards for having (or not having) SRP's, no mark-down pricing standards, etc..... The implications of this lack of a coherent global pricing strategy is frustration with our policies by global corporations and channel partners who see this lack of consistency and clear direction.
- *Missing a clear distribution strategy* - Who should we sell direct to? When and why? Who should buy through two tier distribution vs. buying direct from us? How do we take advantage of our relationship with our global distributors? Should we have direct purchasing licensing resellers (CD-ROM/ELP/pre-install)? What products should we sell only direct? What products should only be sold through resellers? What defines "OEM" business? etc.....Again, the implications of this lack of a clear articulated strategy is customer and channel confusion and frustration.
- *Weak forecasting, order processing/management and delivery systems* - Lack of clear global standards for EDI and EFT transaction standards for ordering, inventory, and sales reporting, poor collaboration between sales, marketing and manufacturing in product forecasting, lack of back-end EDI aware order processing systems. The implications of this are stock-outs, over or under inventory positions, inefficient and inaccurate order management flow, and customer and channel frustration and dissatisfaction.
- *Rigid marketing policies and slow marketing response systems* - We are slower than our competitors in reacting to the needs of our customers and channel partners, we are less flexible in our marketing programs, we lack creativity in our reaction to the emerging marketing segments of the channel,
- *Too many SKU's* - Today we have over 92.000 SKU's, whereof only 7% are available for order and only 3% are active (source: Bain/Charles Stevens)

What We Need Going Forward

To address the issues outlined above, the following recommendations for immediate action are provided:

- *Coherent Global Pricing Strategy* There is two basic element of this; the price of the product as we sell it to the channel and the terms and discounts we offer along with the product.

    1. Pricing - The US already has a determined a price gradation for most product categories, MOLP A will be 53% of full product, MVLP 49% etc. This price gradation is reflected WW as most countries more or less mechanically determine their local prices based on an uplift from the US price list. In Europe, where all products will be sold from Ireland (EOC) it has already been decided that any language version needs to be priced the same regardless of what country it is sold into. Prices are adjusted to compensate for exchange rate fluctuations. North America, Europe, Far East and ROW will be responsible for setting the uplift from US price in their respective market. An English product needs to be priced the same in any country in Europe, but could be priced lower in North America. We need to extend the price gradation matrix to include OEM licenses, electronic documentation (Ali Baba) and direct sales from MS as well as set guidelines for how to quickly react to changes in price competition.

    2. Terms and conditions - For Select we will need to move to a WW consistent discount and rebate structure no later than July 1. First step is to eliminate all rebates on Select. As today's discounts vary widely (8-25%), and even more if rebates are taken into account, we could have different countries meet half way and set the discount at 21%. Alternatively set them at 24% for July 1 and decrease a couple of percentage points every year if possible. Regardless we feel we need to grandfather existing deals, including rebates. All Select sales would be converted after July 1. through dealers direct to MS - no distributor involvement.
    For FPP, MOLP and upgrades we recommend that these are sold only to 1) distributors and direct to end users from MS (very limited and under well defined circumstances) 2) SRP is eliminated 3) Rebates get set to 4% net. with three standard goal categories a) breadth/depth b) Service/marketing c) Reporting. Meeting sales out targets are not part of these goal categories. 4) The budget for marketing funds/channel funds remain at same % but is shifted towards opportunity based spendings. For Select, it should be feasible to harmonize all geographies as of July 1. For FPP, upgrades and MOLP the US, Canada and Europe should be able to agree on consistency July 1. We should aim to get the Far East and ROW working with the standard distributor T&C's FY96.

- *Clear Distribution Strategy.* Firstly there are things we should be in agreement with and could start implement right away; leveraged playing field (no direct dealers buying from MS + consistent distributor T&C's), no volume discounts for FPP's. To go further, we need a more global strategy to help us focus on leveraging the channel and measuring the same. We need to map measurement criteria for each channel segment to each product category and each customer segment. Each channel segment needs to be separated into product support (help create awareness for product) and infrastructure investments (what we need the channel to be able to deliver in terms of logistics, ASSID etc.) Bi-yearly management reports needs to show how we stand compared to goals. This would force a WW taxonomy as well as encourage sharing of best-practices. The measurement-model should be developed by channel representatives from each continent's HQ.

- *Focus on Sales Operations.* Ensure JohnCon (or other?) group is totally focused on getting resellers onto EDI and EFT and providing accurate, timely data for MBS. Build cross-disciplinary forecast squad from the Inside Sales reseller group, product marketing, manufacturing, and reseller strategy to more effectively plan product launch (as in the good work being done on street dates) and sustaining

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forecasting.

- *Increase Marketing Fund Flexibility and Responsiveness.* We should move to a greater "opportunistic" method of funding channel's marketing activities. Today, we have senior partners and direct accrue at 2.8% (net) and end up spending another 2-2.8% on supplemental fund programs and programmatic activity (Store-in-Store). While the total % should remain, we should move more to opportunistic. We need to ensure that the reseller strategy group has experts in each segment who are as tied into revenue attainment in the segment as the field, and who provide both breadth analysis of that segment as well as depth work with key account managers. They also need to develop the key programs for that segment. The field account managers need to have a shorter chain between themselves and the funding decision-makers, and in general need to be more senior for the largest national and international reseller accounts. We need to start managing these accounts (both distis and resellers) explicitly as multinational entities.

- *SKU reduction* - this project is in progress led by Charles Stevens and his SKU Task Force.