Lotus Development Corporation

1998 Fall Plan Whitepaper

Comments in This ink are from Eileen Rudden -- not received until 10/11/97

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FINAL
The Actual Submission

Executive Summary

Lotus strategies for 1998 are designed to continue our leadership of the messaging and groupware markets, build new growth businesses based on thin suites for network computers and traditional desktop platforms, accelerate our penetration of the small and medium business (SMB) market, and speed the transition to a sustainable financial model.

In the messaging and groupware markets, competitive dynamics continue to center on tradeoffs between standards and functionality. Major new releases of Domino and Notes will both shore-up the major holes in our implementation of Internet standards and reach new levels of functionality for end-users and application developers. We are also strengthening our position by delivering new clients and servers that will enable us to compete in high growth low-end segments including mass market Internet mail. Each low-end seat is a potential upgrade to our integrated client, and helps prevent our position at the high-end of the market from being hollowed out from below.

In the desktop market, we will create new, high growth businesses around Java-based network-centric applications that will run on NCs and PCs, and be used by Web developers as building blocks in interactive applications. At the same time, we have major challenges in curtailing the rate of decline in our traditional desktop business as the new market builds. Major new product introductions include Kona WorkPlace (NC and PC versions), Kona DevPack developer tools, and SmartSuite 98.

Our go to market strategy is predicated on leverage -- harnessing the broader reach and capabilities of motivated partners with focused channels for reaching customers in the enterprise and SMB market segments. In the enterprise market, the cornerstone of our strategy is to accelerate the shift of large account relationship management and vision creation to IBM's client teams. Lotus will be dependent on the Software Account Managers (SAMs) to build a pipeline for Lotus software and work with Lotus sales reps to turn that pipeline into forecasted revenue. While not without risk, an effective transition will improve both our coverage and effectiveness with large accounts, and permit the shift of some Lotus account management resources to focus on the SMB segment. Strategic alliances with the major technology consulting firms and systems integrators are also essential.

In the SMB segment, the cornerstone of our strategy for the Notes/Domino business is to focus more resources on partners with business solutions, specifically independent software vendors (ISVs), and the channels to deliver them to customers, including Internet Service Providers (ISPs), the telephone companies, and regional systems integrators. In the desktop market, strong OEM channels are essential to achieve our market share objectives. In particular, it is vital that IBM lead the NC OEM channel for our new network-centric applications.

Our consulting business will support our positioning and value proposition in the enterprise segment, and will be focused on two areas: messaging infrastructure and high value business solutions, both of which are key to driving client volumes. In the solutions space, we will aggressively pursue extended enterprise and virtual community applications, where our customers become our best sales people by deploying solutions across their value chain partners, and the emerging area of knowledge management, which has strategic appeal for senior business executives.

Customer Support will also begin to become a positive differentiator. Our goal is to position Lotus as the only vendor in our markets that customers can rely on to provide support for mission critical business applications and infrastructure. Efforts to correct the deficiencies in our support capability are making good progress, bringing our capabilities more in line with IBM's reputation. Microsoft has a weakness in this area that we will exploit through process improvements and the reflected credibility of IBM.

The core of our financial strategy is aggressive portfolio management -- funding growth in strategic segments by optimizing margin from maturing segments. We are executing this strategy to move Lotus towards a sustainable financial model that compares more favorably with other leading software companies. In 1998 we will increase revenues 20%, while reducing SG&A expenses as a percentage of revenue from 59% to 53%, and development expenses from 21% to 18%. Gross margins improve to 70%. Driving a $250 million increase in the aggregate top line growth, given the complexity of the revenue composition, with 20% less marketing program dollars and essentially flat sales headcount will expose 1998's share objectives to moderate risk.

This strategy document is composed of six sections. The first three sections focus on our core revenue producing businesses, including Communications, Desktop and Internet Applications, and Services. Section Four summarizes our go to market strategy in the enterprise and SMB segments, Section Five presents a financial summary, and Section Six includes detailed financial exhibits.

1.0 Communications Business

The major revenue components of our communications business are Notes, Domino, and cc:Mail, which together account for 94% of our 1997 comms revenue. Historically this business has been divided into messaging and groupware segments. cc:Mail and Notes hold the leading share of the electronic mail market, and Notes dominates the groupware client market with more than 50% market share. The line between messaging and groupware continues to blur, however, as other vendors are moving rapidly to deliver an integrated collaborative environment (ICE), copying the model that we have pioneered. Our challenge in 1998 is to secure a strong position in each segment of the ~~client~~ market, while continuing to drive Domino, with its unified functionality and Internet standards-compliance, as the open server of choice for all clients, including browsers.

1.1 Competition

Worldwide Microsoft continues to enhance its position as a viable enterprise infrastructure supplier. Netscape has made some gains in this area, but is still not viewed as the equal of either Lotus or Microsoft. Outside North America, Netscape has limited presence, and has in fact been suffering setbacks in support and hiring,

1.1.1 Microsoft

Microsoft continues to be our most formidable competitor, effectively leveraging its control of the PC desktop and operating system infrastructure to compete with a value proposition based on claims of better integration and lower cost of ownership. Despite market awareness of their product shortcomings (the main one being scalability), the perception that they are an "irresistible force" in the Internet/NOS areas has created a market perception of Microsoft as a "safe play" in messaging and web applications.

Microsoft is executing a market share strategy to capture the browser and Web server markets, and represents a great threat given their ability to connect the browser systemically to the operating system at the desktop and upsell. It will almost certainly guarantee its leadership of the web server market by including IIS in every NT server license, and then using this base to establish its Active Server Pages and COM+ technologies as the standards for web development. Active Platform is intended to capture the hearts and minds of VB and Windows developers, as part of their strategy to keep Java at bay.

Lotus has competed successfully by embracing our customers' investments in Microsoft technology and providing better integration, faster time to solutions, and superior scalability and flexibility. Nevertheless, we are strategically challenged by Microsoft's ability to leverage the combination of Windows, Office, and Back Office, and by their market momentum.

1.1.2 Netscape

Netscape has "graduated" from second tier status, at least in terms of perception. It has effectively neutralized all other "pure Internet standard" competitors and commonly makes the short list with Lotus and Microsoft. While Netscape continues to face major challenges in augmenting openness with functionality, they are striving to build momentum by leveraging the early adopters of their messaging and collaborative products. Given their browser share, Netscape has a potentially threatening "bottoms-up" potential.

Netscape is implementing a strategy of aggressively adding functionality to their browser to create a natural upgrade path for their installed base into the integrated client space. Their value proposition is based on simplicity, low cost, and rapid time to market -- "what we've got satisfies your needs today, and by the time you need more, we'll have it ready for you." We expect them to build momentum in the integrated collaboration market, through their SuiteSpot server bundle and integrated Communicator client.

The challenge to Lotus is clear. We must continue to add native open protocol compliance to our products, and at the same time make major functional improvements to both our client and server. Domino 4.6 supports IMAP4, LDAP, NNTP, and X.509; Domino 5.0 will offer need native SMTP and S/MIME, as well as LDAP V3 capabilities. The Notes 5.0 client will add these protocols, plus the "where you live" metaphor, which was introduced in competitor products in 1997 and will be more fully realized in 1998.

1.2 Messaging

As observed in last year's Fall Plan, the messaging market is moving rapidly to standards based systems. While Lotus products remain strong technical competitors and enjoy a commanding lead in installed base, continued leadership requires that we capture the new generation of Internet mail, just as we captured the file share generation (with cc:Mail) and the client-server generation (with Lotus Notes). Our position in small and medium business needs to be enhanced in order to achieve this goal.

1.2.1 Messaging Market Size / Share Position

The messaging market in 1998 will generate approximately $900M in revenue, and is growing at 15% per year. The e-mail market is fragmented; we hold about a 25% share position as the leading supplier with Notes and cc:Mail. In 1998 we are targeting increases in client unit share of 6% in the enterprise segment (moving from 40% to 46%), and 4%+ in the SMB segment (moving from 14% to greater than 18%). In addition, we will launch a new initiative to penetrate the "mail only" end user market, targeting 1M seats by year end, delivered via ISPs and service providers.

By 2000, essentially all messaging product revenue will derive from Domino and Notes. The 1997 cc:Mail revenue stream (which was nearly $100M in 1995) will have been absorbed into

Notes, and revenues from other products (Organizer and Soft-Switch) will no longer be significant.

1.2.2 Messaging Strategy

We will continue to promote messaging as "infrastructure," highlighting reliability, performance, compatibility, openness, and lower cost of ownership (ease of installation and administration), among other things, while stressing the evolution of messaging into groupware -- both themes significantly advantaging Domino and Notes relative to Exchange.

Our client strategy, including messaging, focuses on the delivery of a lightweight, standards-based version of the Notes client in 1998. Lotus Mail will be downplayed and repositioned only as an upgrade path from cc:Mail to Notes. We need to be religious about the client brand consistency of Notes and nothing but Notes. Alternative access to mail will be provided via web browsers against Domino servers, such that users can read/write mail without *any* e-mail client code on their desktop. We expect this approach to continue to grow in popularity as its cost-of-ownership qualities become recognized and as Java-based implementations increase performance and functionality. We will deliver a Java-based mail-only client as part of the Kona family in late 1997. This will be the mail client for embedded applications, such as the bundling arrangement that we are pursuing with AOL.

In 1998 we will begin to make serious progress on migrating cc:Mail, Office Vision, and competitive mail seats to Notes and Domino by offering better migration tools, migration support, and positioning SoftSwitch as part of our host migration offerings. Early in the year we will announce that cc:Mail is going into maintenance mode, and redirect our efforts to maximize revenue from the installed base rather than attracting new customers.

1.3 The Internet/Web Applications Market

The Web Apps and Groupware market includes companies of all sizes, driven by a need to enable groups of users to work together by sharing information and processes through a variety of applications, such as e-mail, group calendaring/scheduling, information sharing, and workflow management. The market consists of clients, servers, application solutions and tools. Our focus is on integrated clients, Intranet (collaboration) servers, the applications built on these servers, and the tools used to build these applications, including connecting them to the backend enterprise servers. Our offerings are an integral part of IBM's Network Computing Framework (NCF).

1.3.1 Web Applications Market Size / Share Position

This market continues to grow rapidly. IDC projects that the total messaging and collaboration software market will grow approximately 15% in 1998, resulting in more than 50M new client seats. The server market for all web servers is growing at 25%, but the market for paid intranet servers (increasingly collaboration and backend integration focused) is expected to grow 14%. In 1997 we project Lotus' share of the market for paid servers to be 25%.

On the client side, Notes competes in the integrated collaborative environment segment, against offerings such as Microsoft Outlook, Novell Groupwise and Netscape ~~Collabra~~ Communicator. This market is expected to grow from 15.6M users to 21.6M users, or 38% year over year. The popularity of browsers and browser extensions such as Outlook Express is placing downward price pressure on the client business, especially in North America, and again represents one of our greatest threats given the operating system leverage and monopoly product cartel of IE, Windows, and Outlook Express. Thus we expect our client revenue growth to slow from 31% to 18% in 1998. However, we still expect to ship 11.1M Notes clients in 1998, up 34% over 1997.

On the server side, we plan to ship 150,000 non-OEM servers, which represents a 25% increase from 1997. As a result, we expect a modest improvement to 27% share of the non-OEM paid server market, and to generate $188M in total Domino revenue worldwide. In the HTTP server market (primarily web publishing), we intend to capture upgrading web developers with Lotus Domino Go and Lotus Domino Go WebServer Pro, achieving a 24% share of the HTTP server market in 1998.

1.3.2 Web Applications Strategy

Our overriding objective in 1998 is to become recognized as one of the top two global suppliers of software, tools, and services for Intranet (collaborative) applications. To achieve this goal, we will capitalize Lotus' unique strengths based on a unified platform for web services, web application development, client/server messaging, mobility and enterprise application integration. This has been, and must continue to be, our major differentiator. We will extend this positioning by clearly linking our offerings into IBM's Network Computing Framework (NCF).

Recognizing that browsers are now often considered a viable client experience, we will also support browsers as a critical component of our client strategy. We ~~will extend~~ have already extended to the browser user the ability to read documents stored in a Domino database, participate in a Domino application, and read their mail through a Domino application. We will vastly improve our ability to derive revenue from browsers via client access licenses to our Domino server.

Our application development environment will begin to merge with standard web tools in the Domino 5.0 time frame, while maintaining a competitive advantage based on exposing the core workflow and security strengths of the Domino server. This will be a tricky transition to negotiate, as we add Java and Javascript and de-emphasize LotuScript, our brand of Visual Basic. We will also be the only major vendor supporting both DCOM and CORBA. By mid 1998, our lowest common denominator application development target will be a browser, either stand-alone or embedded in the Notes client. In 1998, we expect to deliver the JavaBeans application development framework for the NCF.

The Go WebServer and BeanMachine products from IBM have helped earn Lotus acceptance in the "pure" web community, but we have had difficulty linking Domino Go WebServer to the rest of our line. Although Go is embedded in Domino, we still have a difficult upgrade path, and different security and search models. Resolving these issues is a development priority for 1998.

We will also continue to enhance our integration with other enterprise systems, positioning Domino as a server in the three tier architecture linking a web browser (tier 1) to a web application server (tier 2) to a backend system (tier 3). We plan to ship our connectors as Java Beans in 1998. We will also continue to build scalability and performance into our backend connections via the Domino.Connect family. These connectors are a competitive differentiator that will enable us to sell more servers and clients.

1.4 Go To Market Considerations

During 1998 we will focus the majority of our marketing programs and our direct sales efforts (supported by business partners) on winning and satisfying enterprise customers. We will continue to enable the ISUs for enterprise selling of our portfolio. We will broaden Domino's appeal in the market by targeting small and mid-sized companies with Domino Intranet Starter Pack via the VAR business partner channel and Domino Mail via the Integrators channel.

We will undertake significantly more aggressive marketing of the Notes client value proposition, in order to build broader end user support. This is needed for "bottoms up" support of our client both in smaller and larger businesses. In a departure from our traditional client strategy, with the Maui release slated for the second half of 1998, we plan to appeal to this influential end user market with a Notes client that works with any vendor's server and is targeted as a stand-alone product.

We will continue to build the Lotus, Domino and Notes brands with the support of IBM and large scale advertising: in print, on the web and on TV. We must continue to rely heavily on IBM's marketing program support, given our own reduced resources in this area. We need to stimulate trial more aggressively and will step-up OEM sales to support this goal. Our plan is to extend beyond IBM to partner with additional OEM vendors, and open new opportunities with Maui OEM bundles.

An essential element of our strategy is to develop the market in new areas by delivering carefully selected, broadly appealing "infrastructure" applications that will drive demand for our clients and servers and generate substantial additional revenue. These applications are created by our Emerging Products Group, a development "skunkworks" that has entered the markets for document management (*Domino.Doc*), rentable applications (*Domino.SPA*), Internet commerce (*Domino.Merchant*), and distance learning (*LearningSpace*). While each of these market segments are attractive in their own right, they also showcase important Notes/Domino capabilities that can expand our core market dramatically. A key initiative in 1998 is to develop these businesses aggressively.

2.0 Desktop and Internet Applications Business

We are continuing our efforts to develop a new market for Java-based, network-centric business applications, where we believe we have a technological lead in a market that Microsoft is reluctant to exploit. At the same time, our traditional desktop business is being managed to maximize margin and protect our installed base. We are continuing scaled-back SmartSuite development to protect our existing revenue stream until the emerging market takes flight.

2.1 Market / Competitive Environment

Business applications is a $5 billion software category, with annual revenue growth of 20% according to IDC estimates. Microsoft is totally dominant, with a 60% unit share and a commanding 91% of revenues, capturing virtually all of the category growth and likely improving its position in 1997. Lotus is the number two player, followed closely by Corel (Kanata, Ontario), which markets WordPerfect Office. We feel there is a high probability that Corel will fail entirely and not be a significant factor in the business applications market in 1998. (Corel currently has less than 30 days working capital).

The market appears ripe to divide into two components: traditional Windows integrated suites, and Java-based applets and tools. Market research reveals that corporate users are dissatisfied with the cost and complexity of the current Wintel desktop computing model. The total cost of maintaining a current generation PC ranges from $8,000 to $12,000 annually, based on various research studies. An important component of the cost is in end-user support of today's integrated desktop applications. There is a real need for easier to use applications as we deliver computing to a much wider class of users, extending beyond today's power users.

IBM, Oracle and Sun are responding to the market's desire for economy and simplicity by leading the development of network computers (NCs) that are less expensive to acquire and maintain, and which will run nimble, Java-based applets downloaded from a powerful server. While market size forecasts vary, the opportunity is significant. IDC forecasts NC clients to grow from estimated 1997 worldwide shipments of 565,000 units to 6.8M units by 2001. Gartner Group estimates that 70% of NCs deployed through 1999 will replace dumb terminals, replace older PCs primarily performing terminal emulation, and provide computing capability to users who have had no device on their desk. The installed base of dumb terminals worldwide totaled approximately 24M at YE96, with slightly more than one-third of these being 3270 and 5250 terminals; an additional 15M PCs are currently functioning primarily as mainframe terminal emulators.

Lotus will capitalize on these trends by leading in the development of productivity software for these new platforms. Of course, Microsoft is the likely major competitor in this business, too, and we believe that they are building applets similar to ours. However, because Microsoft derives the majority of its total gross margin from its Office business, we believe that they will be reluctant to lead a change from the existing model. Instead, we expect them to compete by leading improvements *in the existing model.* Indeed, Microsoft's focus for Office 99 and NT 5 0 is squarely on improvements in total cost of ownership (TCO), and they are proactively attempting to set standards for a range of devices from PCs to NetPCs to Windows Terminals. Microsoft will attempt to subvert attempts at making TCO cause for a "state change" by extending Windows' reach to these new devices.

We also expect "new" competitors to converge on this business opportunity. Vendors such as Oracle, Netscape, Sun, and Apple may very well bring competing applications to market to support NCs, and there is activity from smaller players such as Corel, StarDivision, and Applix. Our competitive advantage against these entrants hinges on time-to-market and our extensive experience in desktop productivity in enterprise accounts.

2.2 Strategy

To capitalize on these trends, our strategy is to be the first to market with products that will lead the state change from traditional integrated suites to Java-based applets, while continuing SmartSuite enhancements to defend our existing revenue stream and avoid the perception that we are abandoning our installed base. Our success depends on the market's acceptance of NCs as a superior platform for significant numbers of end-users. The key is for IBM, Sun and Oracle to ignite the NC market, exerting their considerable market influence to drive NCs into suitable applications quickly.

We will lead this change in the market with two new products: Kona WorkPlace, which is an end-user collection of integrated components, and Kona DevPack, which is a collection of tools for developers of interactive web applications. We will also break from the traditional upgrade model (delivering separately priced static levels of code with optional maintenance), to implement a new annual subscription model, in which we deliver more frequent enhancements to our customers on a renewable basis. This business model is designed to aggressively capture market share and set the stage for annuity revenue growth derived from ongoing product enhancements, service and support.

Step one in our strategy is to leverage OEM relationships with as many NC vendors as possible to establish an entry level "base version" of Kona WorkPlace as the standard desktop of choice. To avoid NC market fragmentation, which would favor any Microsoft entry, we must gain exclusive distribution rights on IBM's NC platforms and quickly use this beachhead to drive agreements with other NC suppliers.

Step two in our strategy is to drive acceptance of our Kona DevPack programmable building blocks among application developers as the number one choice for creating interactive web applications, starting with our business partners. ISVs and corporate developers are increasingly interested in using pre-built Java components to speed the delivery of mission critical applications to diverse clients.

Step three is to translate success in steps one and two to "pull" Kona Workplace onto PCs for applications where cross-platform consistency is important. We believe this "backdoor" approach to PCs is likely to be more effective than competing head to head with Microsoft Office. The goal of our two-tiered strategy of Kona-based applications and ad hoc applets is to surround Office from all sides -- the NC, web-based solutions, and pockets of PC use, thereby building momentum for new applications and even broader use.

Our Kona strategy reinforces our server-side Domino strategy, as business partner solutions incorporating our Java-applets create demand for Domino servers and other back-end services from Lotus and IBM. Additionally, the Java component model on PCs or NetPCs accentuates mobility as one of Notes'/Domino's major strategic advantages, allowing the user to work with his/her desktop and applets while disconnected from any network.

In the traditional desktop suite segment of the market, we must succeed in two key areas. First, we must maintain a solid desktop revenue stream, while we continue to reduce investment in R&D, development, and marketing. Accompanying further reductions in expenditures, we project revenues declining from an estimated $244M in 1997 to $197M in 1998 (excluding Kona).

In the first half of 1998 Lotus will ship the last major feature release of SmartSuite with a native Windows UI, at which point the product will enter "maintenance mode" with a small team of developers assigned to fixing bugs and conducting certification testing for new Microsoft operating systems. Active maintenance will continue for approximately 24 months. We will also stop the production of all stand-alone applications except Lotus 1-2-3.

Second, we must articulate and effectively execute a well-defined plan for migrating our active SmartSuite customers to our component applications. Lotus plans to be very "up front" and direct with both our customers and the analyst community about this transition plan. In fact, we have architected the next version of SmartSuite to work well with our components. In 1998 Lotus will not only be able to articulate a transition plan, but also be able to demonstrate how it will work with real production software. We will focus on migrating customers quickly and smoothly to validate our strategy and serve as references.

Our most critical success factors in 1998 are: (1) timely launch of our Kona family,(2) establishing OEM arrangements with the leading NC vendors,(3) creating an effective channel for reaching web application developers with DevPack, and (4) preparing for the migration of our SmartSuite installed base to Java-applets.

2.3 Go To Market Considerations

The enterprise market segment is the primary target for both our new network-centric applications and our traditional desktop. Large customers have the most to gain from Kona's TCO value proposition, and they account for the bulk of our desktop revenue.

The primary channels for Kona will be our sales force and OEM relationships. ISV's, such as Oracle and PeopleSoft, will be the focus for our DevPack developer tools. Kona's secondary target is the SMB segment, where we will partner with ISPs and Telcos to extend our reach down-market from our traditional channels. Electronic Software Distributors (ESD) and Lotus Direct, our direct marketing operation, will be developed as alternatives to the traditional retail channel, and no physical "shrink-wrap" offerings are planned. While ESDs have not developed as a viable channel for traditional software, they could emerge as a major channel for network-centric applications.

For our desktop products, while the enterprise segment is our largest source of revenue, it is also our fastest declining segment, due to the overwhelming momentum of Microsoft Office. We will continue to leverage our traditional channels, including our sales force, corporate resellers, and direct marketers. In the SMB segment, we will emphasize the retail channel and OEM programs, which also have important spill-over benefits for enterprise customers who want to be reassured by seeing the brand in retail stores, catalogs and OEM programs. We are also pursuing more cost effective channels, such as electronic distribution and various "soft" OEM opportunities such as bundling with electronic banking software. We are challenged to grow share in this segment given continued shrinkage in our development and marketing investment.

3.0 Services Business

Our fast growing services business has three components: Customer Support, Education, and Consulting. In 1997 we expect these businesses to contribute 24% of our total revenue, growing to 26% in 1998. In addition to their revenue and margin contribution, each of these businesses makes a crucial contribution to the achievement of our market share goals.

3.1 Lotus Consulting

Lotus Consulting has the mission of accelerating the rate at which our customers achieve lasting business value from their investments in Lotus technology, while meeting specific P&L targets. The group provides value to our customers by designing and implementing global Notes/Domino infrastructures and mission-critical business solutions. In 1998 we project revenue growth of 30% to $181M, and a seven point increase in operating margins to 18%.

Our consulting resources are applied to drive Lotus' success in key markets, industries, and accounts. Our strategy is to focus on developing relationships with selected clients that are leaders in their industry and that have the capacity to commit to multi-year, multi-million dollar engagements in prominent application areas such as value-chain integration, knowledge management, and enterprise messaging. The goal is to reproduce market successes such as Procter & Gamble, in which diligence in high-level relationship building and vision creation helped secure 80,000 Notes seats in addition to substantial consulting revenues.

Key initiatives during the year will include a marketing campaign to position our consulting capabilities as more Internet-centric, helping us to compete more consistently and effectively for building corporate intranets and web-enabled business solutions. To support our work in this area, we will introduce an internal set of work practices and tools, called the "I-Net Framework" (templates, engines, implementation procedures, etc.).

Other important initiatives include (1) a greater emphasis on demand generation, including the delivery of high-level executive events that support the Lotus brand, (2) continuing the incorporation of business partners into engagements as subcontractors, (3) leveraging the virtual Notes practice with IBM IGS, (4) upgrading our Accelerated Value Method methodology to incorporate architected solutions (complex, integrated solutions), I-Net infrastructure planning and deployment, and project management, and (5) implementing a program for routine customer satisfaction measurement.

3.2 Customer Support

Customer Support will contribute 23% of our services revenue in 1998, with revenues increasing 39% to $83.7M from $60.2M. Gross margin improves to break-even, from a loss of $10M in 1997.

Our goals are to (1) reposition Customer Support to become one of the company's key differentiators leading to customer satisfaction and loyalty, and (2) significantly increase customer participation in our support programs to grow revenues and profit.

To accomplish these goals, we are implementing a number of measures to make step-function improvements in the "time to resolution" of customer problems. For example, we have implemented a "Customer First" program to improve our basic operating practices, and strengthened essential cross-organizational processes, particularly linking Support with Development. We are making better use of our global Support resources and skills through the implementation of a "virtual worldwide support center," which focuses on solving problems wherever they exist and helps ensure high quality levels as we absorb new people. We have also opened a Center of Competency for advanced skills development and the recreation of customer problems in a lab environment.

While we lead with a direct support model in the enterprise market segment, we will bolster our support capacity by employing a Business Partner led model in the SMB segment. We will also significantly enhance our support synergy with IBM, and extend our multi vendor/cross platform support capabilities through arrangements with Alliance Partners.

Key initiatives during the year will include (1) the relentless execution of our "Customer First" program, (2) the continuation of aggressive skills development and enrichment, (3) the overhaul of our support offerings, pricing, and go-to-market model, and (4) the creation of web-based self-help tools for all constituencies.

3.3 Lotus Education

The mission of our Education business unit is to (1) continue to expand the pool of certified technical resources that our customers need to successfully implement business critical solutions based on Lotus technology and tools, and (2) drive increased services revenue. In 1998 we project revenue growth of 38% to $75.6M.

To accomplish these goals, our primary strategy is to continue to strengthen the Lotus Authorized Education Center (LAEC) brand, extending it into the SMB segment as well as new and emerging regions. We will also drive more aggressively into the direct delivery of custom training in major regions, particularly North America and EMEA.

Key initiatives to support these strategies include (1) reducing curricula time to market, (2) implementing programs and tools, such as web accessed materials, seminars, and tutorials, that will accelerate the acceptance of new products, (3) broadening distribution through alternate delivery models and partnerships, to make Lotus the end-user curriculum brand in a number of formats and tools, (4) expanding channel competencies to better support Lotus and IBM requirements, and (5) expanding the Education product set, including assessment tests, testing tools, and tools for our internal use in custom engagements,. Constantly adding value and creating new business opportunities for our LAEC's is essential to retain their mindshare and help them resist Microsoft's overtures.

The following section shifts our focus from product segments to sales strategy.

4.0 Go To Market Strategy

To achieve our market share objectives, Lotus must be excellent at developing partnerships with organizations that can extend our reach and effectiveness with distinct market segments. To improve our capabilities, Lotus and IBM have formed a "virtual channel company" that maximizes the efficient allocation of our mutual resources and coordinates the way in which we engage our joint customers. This initiative enables us both to cover more accounts and deploy resources for technical enablement and new channel development.

4.1 The Enterprise Segment

The enterprise market segment is Lotus' primary target and revenue driver. We estimate that this segment accounts for 75% of our total revenue and comprises 25% of our existing customers.

In our messaging and groupware businesses, our primary strategy is to accelerate the shift of responsibility for account relationship management and vision creation to IBM client teams, thereby increasing both the extent and effectiveness of our coverage, due to IBM's greater numbers and often higher level executive relationships. The number one critical success factor is that IBM sales teams and technical resources are fully incented and trained to convincingly represent Lotus products to their accounts. We are working with IBM to step-up our enablement activities.

Lotus sales teams are opportunity focused, and bring to bear the product skills needed to close the business that is identified. Wherever practical, we organize our sales teams around industries, and our sales model stresses infrastructure and solutions. In re-engineering customer visions, we stress the convergence of messaging and application infrastructure in order to elevate the discussion to enterprise integration and collaborative work, where we have a distinct advantage. We focus on solutions in order to create the combination of business value and user support that is needed to offset Microsoft's control of the operating system and desktop infrastructures.

Our channels strategy emphasizes strategic alliances with partners who have influential positions with large accounts, such as the Big Five accounting firms, national systems integrators, and major computer vendors. OEM relationships are again key to drive trial and achieve our market share goals. ISVs, including the major ERP vendors, are essential to support our emphasis on solutions. Our traditional corporate reseller channel is also important. Our marketing messages stress business solutions instead of technology, along with the dependability, scalability and manageability required for mission critical applications.

In 1998 we will develop a new communications channel to reach internal software developers, in order to promote our integrated development environment and tools, such as BeanMachine and

Kona DevPack. Our Business Partner community, especially the custom solution developers, will be key in reaching this audience. Partner efforts will be augmented by direct marketing and education programs, such as Lotusphere and the Domino Web Developers Conference.

Other important initiatives in the enterprise segment include (1) stepping-up our enablement activities for IBM sales and technical resources, particularly the SAMs and ISU solution development resources, (2) strengthening relationships with other strategic partners, such as the Big Five accounting firms and global systems integrators, (3) deploying mail migration specialists to convert cc:Mail and PROFS accounts to Domino, where they can be protected from competitive displacement, (4) continuing our branding efforts for broad awareness, (5) intensifying our focus on industry solutions, coupled with a campaign to help our partners market their solutions more effectively, and (6) establishing our leadership in the emerging areas of knowledge management and distance learning.

The enterprise is also the primary target for our Internet and desktop applications. For our Internet applications, critical success factors are the Kona launch and our OEM recruitment activities. Our primary strategy is to use OEM agreements to carry Kona NC WorkPlace into corporations, and then leverage this beachhead to draw in Kona PC WorkPlace, too. We'll support this strategy with a campaign to convince web developers to incorporate our Java components in their interactive applications. For our desktop applications, OEM agreements and corporate resellers will be used to take SmartSuite 98 to market and drive unit volumes to achieve our share goals.

4.2 The Small and Medium Business (SMB) Segment

The SMB segment is a high priority target for Lotus, both to fuel future growth and to protect our share at the high-end of the market. We estimate that this segment accounts for 25% of our total revenue and comprises 75% of our existing customers.

In our messaging and groupware businesses, the sales model is partner led and solution oriented. Our primary strategy is to use business partner solutions to pull our clients and servers into accounts, and our marketing messages support this by emphasizing Domino-based industry solutions and the value being achieved by the industry leaders who are using them. We will continue aggressive recruitment of partners with "packaged" solutions, and help our partners bring their solutions to market on a broader scale. We are expanding support for our partners in the marketplace by redeploying some of our current enterprise resources. These resources will focus on field based marketing for demand generation, Inside Sales, and direct customer contact to close the largest opportunities.

Our channels strategy emphasizes Internet Service Providers (ISPs) and telephone companies as the vehicles for bringing partner solutions to the broadest possible audience. These new partners will provide a dependable, on-demand infrastructure to host customer solutions, as well as rentable applications, and are essential to help overcome the infrastructure and support constraints that may exist for many SMB customers. We are also recruiting regional systems integrators who provide services to middle market firms that may not be comfortable installing and configuring complex products on their own. Skilled integration partners are essential to address the impression that our offerings are complex and difficult to install and manage.

Key initiatives in this segment include (1) the expansion of our Inside Sales capabilities, (2) the recruitment of ISPs and telcos, and with Lotus' support, the broad based demonstration of the economic viability of the outsourced infrastructure and rentable solutions models, (3) the enablement of IBM's SMB resources, with an emphasis on much closer cooperation in the field and at headquarters, and (4) an aggressive program to generate demand through field-based marketing programs, connected to an effective lead tracking mechanism for our partners.

For our desktop products, our go to market strategy is a highly leveraged sales model utilizing OEM relationships and business partners. Smaller firms may find the simplicity and life-cycle economics of NCs appealing, and they may not yet have selected a standard desktop, giving us an opportunity to leverage a unique position on NCs to win the desktop. While we do not expect the traditional retail channel to be appropriate, we will test the suitability of the electronic software distributor channel as an alternative. In this segment, our marketing messages will emphasize ease of use and hence lower support costs, as well as thorough integration with the Internet, and the comfort of dealing with IBM, "just like the big players."

Key initiatives include OEM sales and efforts to promote web solutions that incorporate our Kona applets.

5.0 Financial Strategy and Outlook

Our business goals for 1998 are:

- to grow our revenue faster than the industry in strategic product segments where we hold a leadership position, and to fund this growth through managing remaining product segments to optimize margin; and

- to achieve step-function improvement towards competitive financial returns in all key financial metrics.

The first of these goals represents a continuation of the "portfolio management" approach to extending market leadership adopted in our 1997 Plan. The latter recognizes the need to begin to capitalize on our past investments in development and sales/marketing to achieve competitive financial returns.

At the end of this document are four exhibits which present the details of our 1998 financial plan. It should be noted that the 1997 numbers shown in these exhibits represent our current outlook for the year, while the accompanying compulsory charts contain our official August forecast for 1997.

5.1 Financial Strategy

5.1.1 High Growth Segments

Our 1998 financial plan reflects continued strong revenue growth in our strategic core-- Notes/ Domino and consulting/education. 1998 revenues in these segments grow 42%, following 68% growth in 1996 and 54% growth in 1997. Notes Seats (Notes Clients + Domino Servers) will grow 35% to 11.8 million in total. This follows seat growth of 52% in 1996 and 85% in 1997. It should be noted that these growth rates are off of a base which has grown geometrically over the past few years, and therefore reductions in percentage growth rates are to be expected. In 1998 we will begin to add revenues from our Kona (Java) products, which we expect to grow rapidly in 1999 and 2000.

5.1.2 Declining Segments

1998 will represent the fourth consecutive year of double-digit revenue declines in our traditional desktop suites/applications business. Revenue from this segment will fall below $200M in 1998, from a level of $244M in 1997. In addition, revenues from our cc:Mail product will decline 27% to $53.2M, and SoftSwitch revenues will decline 11% to $32.6M. Development and Marketing spending on SoftSwitch and cc:Mail will decline 66% to $7.1M in 1998. We will continue, as in 1997, to reduce our investment in development and marketing spending for suites, and reallocate a portion of these resources to Notes/Domino/Internet offerings and to Java components development and marketing. However, given the relatively small traditional desktop revenue base at this point, and the need to continue aggressive Java development, albeit with very little revenue expected in 1998, the development E/R for the Internet Applications Division will improve only modestly in 1998, from 34% to 33%.

5.2 Financial Outlook

5.2.1 Communications Business

Total revenues from our Communications Business Segment (including the Emerging Products Group) will grow 34% to $854M in 1998. Software revenue from sales of Notes/Domino will grow 46% to $773M, while revenues from other Communications products fall 26% to $81M.

Development expenses in the Communications/EPG segment will grow 14% to $138M, as we shift resources to this segment from declining business segments such as traditional desktop suites/applications. Software development E/R will improve 3 points to 17%, a level which meets the competitive model objective. (This measure of E/R uses only software revenue in the denominator.)

Marketing expenses for the Communications group will increase 24% to $255M, while the marketing E/R improves 2 points to 30%. Much of this increase is "sourced" from reductions in Suite/cc:Mail/Organizer, and redirected to Notes/Domino marketing.

Overall, the Communications/EPG Business Segment will generate a contribution margin of $541M in 1998, up 44% over 1997.

5.2.2 Desktop and Internet Applications Business

Revenues from our Desktop and Internet Applications segment will decline 14% to $211M in 1998. As mentioned above, this decline is attributable to our traditional suite/applications business, where unit volumes are expected to increase only 9% in 1998 after growing 30% in 1997. In 1998, we will begin generating the first significant revenues from our emerging Java components business (Kona). This product segment has high potential, but also high uncertainty in terms of the rate and pace of market penetration. We have structured what we believe to be a conservative 1998 revenue plan-- at $14M for revenue from Kona products.

Development expenses for the Internet Applications segment will decline another 20% to $55M in 1998 after declining 8% in 1997. Within this total, we are funding a significant buildup in resources devoted to Java components development. The development E/R for this segment (Suite and Kona) will remain at a fairly high 33% level, as we reach a base maintenance level necessary to support our existing suite/applications clients and continue to build our Java components development capacity.

Marketing expenditures in this segment will also continue to decline, falling 29% to $59M. Marketing expenditures for SmartSuite will be reduced by more than half in order to fund new programs for Kona. The overall marketing E/R improves a healthy 6 points to 28% in 1998.

The contribution margin from this segment improves slightly in 1998, from $74M to $84M.

5.2.3 Services Business

Our Services business (including Support) will generate revenues of $364M in 1998, an increase of $88M or 32%.

Margins in the Services Segment continue to improve, despite the significant investment we are making in the Customer Support segment to deal with customer satisfaction challenges. Gross

Profit Margin improves from 17% to 23%, and PTI margin improves from (1)% in 1997 to 8% in 1998.

5.2.4 Operating Expenses

Total Development expenses grow 3% in 1998, following 2% growth in 1997. Within this total of $241M, we will continue to grow our investments in Notes/Domino and fund that growth from reductions in mature segments (e.g. Suites, cc:Mail).

Worldwide SG&A expenses will increase 8% in 1998 to $727M, after a 1997 increase of 9%. Sales expenses grow 10%, reflecting investments in SMB and channels, as well as high growth markets like Asia and Latin America. Marketing expenses grow 9% to $314M in total. We continue to invest in Operations/Administration support in our growth markets and Services Business Segment. Overall, our SG&A E/R improves 6 points to 53% in 1998.

5.2.5 Headcount

Controlling headcount growth has become an increasing focus during our planning efforts for 1998. Total headcount will grow by just over 500 (6%) in 1998, after growth of 15% in 1997. Over 80% of this growth is in our rapidly growing Services segment and in our worldwide sales force. Headcount throughout the balance of the company will grow by less than 100 (2%).

Our 1998 financial plan includes one-time restructuring charges of $17.5M in our EMEA region and $7.5M in North America to bring headcount in selected functions to targeted levels more rapidly than normal attrition will accommodate.

5.3 Growth Opportunities -- Not Yet Funded

We are still working to close on the funding for two important growth opportunities that are high on our list of priorities: the markets of China and Malaysia, and the emerging areas of knowledge management and learning and adaptation systems. We will continue to work the internal issues, and as we do so, to explore synergies with the plans of the IBM Software Group, Corporate Marketing, Education and Training, IGS, and other areas.

5.4 Risk Summary

The achievement of our plan depends on the realization of important economic, market and execution conditions, as identified in the following table:

Category	*Risk*
Economic	• Strong economic conditions in the United States continue, and the economy of Japan recovers
Market	• There is strong and rapid market acceptance of the value of NCs and network-centric Java applets • Customers continue to recognize the value of integrated clients over the increasingly competitive browser and mail offerings of competitors • Java becomes a unified standard • Microsoft's position in the consumer and home markets doesn't become any more influential on business decisions
Execution	• IBM Client Teams and Software Account Managers are fully enabled for enterprise coverage -- starting January 1, 1998

We will be challenged to achieve our goals if these conditions do not materialize. While the economic risk is beyond our control, we can exert varying degrees of influence over the market and execution risks. We will do this as the year progresses, and make whatever midcourse corrections are necessary.

6.0 Financial Exhibits

6.1 Profit & Loss Statement

($000)

	1996	1997	1998	97/96	98/97
Product Revenue	829	870	1,011	5%	16%
Services Revenue	189	276	364	46%	32%
	1,018	1,146	1,375	13%	20%
Product Cost	127	122	138	(4%)	13%
Services Cost	149	230	279	54%	22%
	276	351	417	27%	19%
Gross Margin	742	795	959	7%	21%
	73%	69%	70%		
SG&A	619	675	727	9%	8%
Development	231	236	241	2%	3%
OI/OC	(25)	(11)	(10)	(57%)	(7%
	825	899	959	9%	7%
PTI before Restructuring	(83)	(105)	(0)		
Restructuring Charges	0	0	25		
PTI after Restructuring	(83)	(105)	(25)		
	-8%	-9%	-2%		
E:R Ratios				B/(W)	B/(W)
Product Cost	15%	14%	14%	1 pt	0 pt
Services Cost	79%	83%	77%	(4) pts	6 pts
SG&A	61%	59%	53%	2 pts	6 pts
Development	28%	27%	24%	1 pt	3 pts

6.2 Revenue and Volumes

Revenue **($000)**	1996	1997	1998	97/96	98/97
Notes/Domino	352	529	773	50%	46%
Consulting/Education	119	195	257	64%	32%
KONA	0	1	14		900%
Subtotal	471	725	1,044	54%	44%
Desktop Apps/Suites	350	244	197	(30%)	(19%
All Other	197	177	164	(10%)	(7%
Subtotal	547	421	361	(23%)	(14%
Contingency			(30)		
Total Revenue	1,018	1,146	1,375	13%	20%

Key Product Volumes **(K Units)**	1996	1997	1998	97/96	98/97
Notes Clients	4,534	8,317	11,122	83%	34%
Domino Servers	183	401	645	119%	61%
Notes "Seats"	4,717	8,718	11,767	85%	35%
cc:Mail Seats	2,869	3,005	1,977	5%	(34%
Smartsuite Units	7,238	9,416	10,282	30%	9%

6.3 Expenses

($000)

	1996	1997	1998	97/96	98/97
Development					
Communications/EPG	115	121	138	5%	14%
Internet Applications Division	75	69	55	(8%)	(20%
Localization	41	46	48	12%	4%
	231	235	241	2%	3%
Sales	204	233	256	14%	10%
Marketing					
Communications/EPG	171	206	255	20%	24%
Internet Applications Division	111	83	59	(25%)	(29%
	282	289	314	3%	9%
Operations & Administration	122	138	155	13%	12%
Corp Adjustments/Other Charges	11	14	2	27%	(84%
Total SG&A	619	674	727	9%	8%
Total Operating Expenses	850	909	968	7%	6%

6.4 Headcount

	1996	1997	1998	97/96	98/97
Development	1,796	1,839	1,834	43	(5
Sales	1,246	1,346	1,368	100	22
Services & Support	1,705	2,273	2,668	568	395
Marketing	571	684	718	113	34
Operations/Administration	917	1,100	1,160	183	60
Manufacturing	479	479	486	0	7
Total Lotus	6,714	7,721	8,234	1,007	513

6.3 Expenses

($000)	1996	1997	1998	97/96	98/97
Development					
Communications/EPG	115	121	138	5%	14%
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