Transforming Lotus' Desktop Business

The following summarizes the opportunity and risk for the Lotus Desktop business pursuit of an OEM strategy. In addition, the industry is enetering a new evolutionary phase, the transition to components.

Lotus Desktop Business Overview

Lotus' Desktop business is in a difficult position. With 9% market share in the Suite category, a decline in revenues from a peak of $715 million in 1993 to $450 million in 1995, and a vicious take-no-prisoner competitor. There are two options for changing the rules of competition: the transition to the components business, which will occur over the next 3 years, and the immediate pursuit of an OEM strategy.

The Components Business

Components are an emerging market opportunity and technology transition to develop and market a new class of applications centered around simple, modular elements and environments like Lotus Notes. Lotus began a Components initiative early in 1995 and we expect to ship our first product offering in January of 1996. The Components Business has the potential for Lotus to take a leadership position and change the competitive landscape in desktop applications, and to further cement Lotus Notes as the standard for network applications.

For much of the 10 or so years in the application software industry, customers have communicated a consistent set of needs to which few vendors have responded. The consistent themes center on reducing the cost of end-user training and support, and in providing SmartSuite-like functionality in a different form which developers can easily transform into custom business applications. Users are frustrated and intimidated by the complexity of current desktop applications and are eager to find tools which will help them solve their business problems quickly and efficiently.

Components represent an additional opportunity to leverage Notes for a wider class of applications and make it the preeminent network operating system. In simpler words, to permit users to "live in Notes." By extending Notes to be a container for software components, that can easily be placed in a document or an application, we can extend the usefulness of Notes and encourage users to do all their work in Notes. Notes, follwed by Components, gives Lotus/IBM the opportunity to win back Microsoft Office accounts.

The OEM Strategy

In this context, we are presented with three options for the current business: modest growth v. exiting the business v. changing the rules of competition. The following summarizes the OEM strategy as a means to change the rules of competition.

Plaintiff's Exhibit
8818
Comes V. Microsoft

DEFENDANT'S EXHIBIT

OEM is the best choice for an immediate change in the desktop business. Given the realistic alternatives available to Lotus/IBM and the move towards components across the industry, all other options for the existing Suite business appear non-strategic. Lotus/IBM should view the desktop business as a strategic weapon against Microsoft, as opposed to a $450 million business capable of modest growth, eventually generating 15-20% operating profit on 15% share. Our objectives are to create significant option value for components and/or Notes growth by adding 25 million new SmartSuite seats and to reduce Microsoft operating margins dramatically.

We have developed a tiered pricing model, starting at $20 per unit for 10,000 units, $10 at 100,000 units, and $5 at 2 million units, which we have proposed to several OEMs. We have found initial resistance to the concept, due to concerns about the perceived value of the offering, and the reaction of Microsoft, and believe that we have a 67% probability of achieving the target of 10 million units per year. We believe that the Lotus/IBM can address these concerns with an aggressive launch of the PC Co. bundle, specific examples of the PC Co. winning business as a result of the bundle, a clear statement of support of the strategy by senior management, and a continued investment in marketing.

The financial impact of this strategy is manageable for Lotus/IBM and potentially devastating to Microsoft. We project that the impact of the OEM strategy on the Lotus/IBM business would be to shrink revenues from $450 million to $300 million in the first year. Spending could be managed to breakeven. The 10 million units should reduce Microsoft gross margin by approximately $300 million per year. Should they respond to the strategy and the industry be transformed to this model, the margin impact to Microsoft would be $1 billion per year.

Lotus/IBM could supplement this strategy with synergistic, anticipatory marketing tactics. Our components business model projects a price of $99 for the Components Suite, and the OEM prices proposed are appropriate for $99 end-user products. Lotus/IBM could reduce the retail price of SmartSuite to $99, and create a trade-up offering for existing Lotus/IBM customers of $49. Should the price of the Notes client be greatly reduced, transforming the strategy from SmartSuite to NotesSuite would increase its value and create a significant increase in Notes penetration.

The risks in this strategy are significant. As mentioned above, we must maintain and increase the customer's perception of value. In addition to PC Co. share gains and a consistent communication about our strategy and the transition to components, we must be clear about how we will manage the customer's journey to components, and we must invest in marketing the strategy. The marketing program spending for the desktop business is approximately $120 million per year, our awareness levels are low, and our Share of Voice is approximately 10%. Awareness is low; we must invest in increasing it, and in cooperative marketing with the OEM partners. Lotus Desktop should leverage IBM and Notes awareness programs, which would enable us to concentrate Lotus' marketing spend on cooperative marketing and trial programs.

Securing a critical mass of OEM units is a risk. There are several factors adding to the risk, including the amount of disk space they must allocate, the absence of complementary offerings such as multimedia and games that are currently included in the Microsoft offering and are attractive to the consumer/home segment, and that large businesses and enterprises in the US require delivery of PCs with no bundled software.

Microsoft's counterattack could include an increase in operating system prices, over time, to recapture lost margin, and additional price and give-away initiatives to destroy the Notes business.

This strategy will require transformation of our software channel relationships.

Below is Lotus' projection of unit sales, in thousands, that can be achieved in 1996.

Vendor	No Am	Europe	Japan	Latam	Not alloc	Total
Compaq	208	138	38	101	143	627
IBM	1,148	1,168	304	340	547	3,506
AST	39	29			54	122
HP	49	49		56	84	239
Acer	90	23		169	240	521
NEC	23		567		122	712
Toshiba	28	13	131		9	182
Dell	49	20			30	99
DEC	28	20			90	138
All Other	65	85		35	393	577
Total	1,726	1,545	1,040	701	1,711	6,723

Below is a summary P&L based upon 10 million units, in millions.

Desktop OEM P&L for 1996	$000K	Comments
Revenue	294	
Cost of Goods	48	
Gross Margin	246	
Expenses:		
Marketing	120	variable
Sales	25	allocation
Support	21	
Development	78	
F&O	13	allocation
Corporate adjustments	-11	
Total Opex	246	
Operating Profit	zero	