One Microsoft Way
Redmond, WA 98052-6399

Telex 160520
Fax 206 883 8101

cc· MaryEu
Win

Microsoft Memo

To: Mike Hallman, Scott Oki, Mike Maples, Rich Macintosh, Gary Gigot,
Jeff Raikes, Pete Higgins, Bob Gaskins, Lewis Levin

From: Bill Gates

Date: February 19, 1991

cc: Frank Gaudette, Jeremy Butler, Steve Ballmer, Paul Allen, Dave Marquardt,
Jon Shirley

Subject: Market Share of Applications in the United States

I am seriously disappointed that our applications are not gaining more share in the United States. We may never have as great a category specific product advantage as we have today and yet by the time Lotus recovers with a fine line of word processing, mail (ccmail's client is better than the product we will ship this summer and has a higher market share), group productivity (Notes is alone in its field and we won't have an answer for two years), graphics (Freelance for OS/2 is very nice product and Freelance has a lot more share than we do), spreadsheet and perhaps even a database for Windows we will have less than half of their spreadsheet share. By the time WordPerfect has very nice word processing and office software for Windows we will have less than a third of their share. These high shares translate into very high sales and profits. Estimating the market size for these categories as about $720M in the US and using a rule of thumb that after tax percent profitability in the long run will be (market share/3) generates the following:

Market share	Sales	Profits
20%	$144M	$9.6M
40%	$288M	$38.4M
60%	$432M	$86.4M
80%	$576M	$153.6M
100%	$720M	$240M

This means that every share point around 40% is worth about $2M of after tax profitability per year and every share point around 60% is worth about $3M. The "asset" value of this earning stream is worth 12x its annual rate if it lasts. A company that stays ahead in technology can expect its market share to last. This model is crude but it does show the kind of funding Lotus will have for its other businesses once it gets to technical parity in the spreadsheet business. Using only the US market understates the value of market share because more other markets in the world follow the US lead because of momentum factors like add-ons and "herd affect" (wanting to work with the leader) - this could double these numbers.

Microsoft Confidential

X 587871
CONFIDENTIAL

Microsoft°

One could argue that the proposals I present will just lead to continual price wars in the software business significantly devaluing the "reward" for being aggressive. Although this is possible I propose when there is no broad awareness of a "generation transition" taking place that price is not a good tool for gaining share and that during these rare moments the underdog (Microsoft) can use price effectively to gain attention and trial and share. When we last lowered the price of Excel the only people who paid attention were those interested in Windows - a small group already disposed to use our product.

Another important question is what portion of our application sales over time will be a set of applications versus a single product. The marginal cost to us of users using a higher number of applications is zero and if we can make it easy enough to use applications casually so that it is a benefit to have multiple applications then users will pay for this privilege and the industry as a whole will benefit. It appears that only Microsoft and Lotus will have complete quality families of applications and we are somewhat ahead. Please assume that we stay ahead in integrating our family together in evaluating our future strategies - the product teams WILL deliver on this. Our understanding of system software and our early investment in integration and having all of our applications development on one site with a uniform culture including more focus on technology will allow us to lead. We will be open with what we are doing but our skills will distinguish us.

I believe that we should position the "OFFICE" as our most important application. The simplicity a company can get by having all of these applications available to all of its users is very high - an employee can use another person's machine, you can enclose files in mail knowing people will be able to not only look at them but also edit them, there is no requisition overhead in trying to figure out what people should get, there is one vendor to ask for integration from or reasonable licensing policies.

I propose the following steps:

1. Reduce the price of OFFICE to $750. Offer the channel an extra 4% of OFFICE revenue to use to market this product (qualifying expenditures would include seminars, focused advertising, mailing, etc). The extra marketing money would make our priorities clear and get the message out. This would make the cost of owning three applications equivalent to the price of 1.5 - the penetration rate of presentation packages is low enough that it's really more like 2.2 for the price of 1.5. The MLP would be priced accordingly at $600. Street prices would be as low as $450 for the packaged product and $360 for the MLP. We would also negotiate special deals in cases where corporations commit to have 100% of the new 386 or better machines for specific locations licensed for Office - if this commitment is in the hundreds we would go down to $306 - if this commitment is in the thousands we would go down to $254. We could handle this by having a many-unit SKU like WordPerfect used too but that doesn't capture the penetration goal - penetration may be hard to set up both because of complexity and legal constraints. We would have the channel participate in this by having list prices 10/6 times higher than this and letting them discount the way they normally do. In the rare case we have to do the negotiation would have a percentage payment back to the reseller. We would make more aggressive provisions for existing machines running

other high end applications (swap up to Office). People who criticize our lack of concurrent use would see that we are very reasonable on pricing.

There are some deals that have been done at higher prices that we would have to lower, however, I think this new pricing would actually make us money even in the short term. There was some interesting data from a recent survey of OFFICE purchasers where they indicated price was a key reason for going with us and 37% did not already have any Microsoft applications! I got the data from Mike Maples so if people are interested they should get the full explanation from him. It's not a declaration of a price war since Lotus already offers Ami and 1-2-3 for $595 list and their special networking discounts and their unbelievable allowance for concurrent usage. The extra 4% would go away at some point and if necessary we could raise the price back up, however I doubt we will do that.

I get excited thinking about a user who signs up for multiple Microsoft applications - our future integration plans will keep that user loyal to us for all time. If people only buy one application, a high percentage of things I am working on aren't valuable and that is the buying pattern we want to change.

I know this overlaps our plan to have new machines bundled with applications at the retail level but that is fine with me -- we need to attack this problem a lot of ways. I am sorry we delayed the rollout of the program - I think it is strange to say our field is tied up on the $129 deal when we aren't really promoting that full bore.

2. Advertise our $129 program and encourage retailers to put it out on the shelf. I think it is strange to have this swap being presented to corporate buyers but not to the buying public at large. Our whole strategy is to get individuals in corporations of all sizes to love Excel and Word. These power users walk into Egghead to see what is new and our offer isn't there. Of course this is a limited time offer so we should extend it another 60 days and get it advertised and out on the shelves as soon as possible. This also means allowing the marketing funds from this product to be used for more than just mailing.

3. Lower the price of Excel to $333 for six months. This will get the street price of aggressive sellers down to $199. For the person trying to decide to move up to Excel price is an issue. I believe we are just short of creating a broad awareness that people should move to Excel and I think this would make a difference. There is the question of whether to use street price or SRP to accomplish this - I favor street price since we could announce it but I am open minded. This will cost us a lot of money in the short term and will force similar reductions outside the United States. It will preempt the pricing of the Borland Windows spreadsheet - I am worried that as word of his offering becomes widespread people will wait expecting that he will offer them a very good deal and our absolute price will make the buyer want

to wait. This proposal is certainly a lot more conservative than the one that said everyone who owns Windows should be able to get Excel for $129 – a 75% price cut instead of the 33% proposed here.

4. Come up with a real trial scheme. This is the wildest idea here and would be hard to implement. The idea is to let someone walk in and pick up Excel simply by filling out a card and signing it. It's like signing up for a book club - in three months you can send it back to us and you never get billed or the retailer bills you for the agreed price. This program would make it very easy to try out our product - the real thing. This would show a lot of trust in the user. It could be done on a trial basis with some retailers where we send them the stock for free. When the users reject the box could come back to us or the retailer. It's probably best if this whole thing is handled by the retailer and our involvement is limited to our payment terms and allowing the reject boxes to be like returns. If the user does not reject then the retailer gets to bill him for the "agreed" price at the time of delivery. We get paid for everything but the rejects but we work it out so that the retailer isn't stuck because the payable to us has a different average time outstanding than the "receivable" from the user. This would mean allowing Egghead (say) to pay us 90 days later for the net Excel sales. The reject packages might be reusable or not. Since our goal is to get people to see our great technology this approach benefits us far more than our competitors.

It's unlikely we will decide to all of these things but they do not conflict in any way.

	Target	Channel	Cost	Length	Rank 1-10
Office	all	Standard	None?	Forever	10
$129^	installed	Mix	Some?	June	7
$333XL	all	Standard	1/3XL$	October	6
Freetrial	enduser	Standard	Some	Trial	4

("Rank" is my confidence this is a smart idea that could be executed effectively)

I am very interested to get your thoughts on these ideas. If we are going to do any of this, the sooner the better.

WHG/jg