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Microsoft Memo

To	:	Bill Gates Jon Shirley Rich MacIntosh Mike Maples	David Vaskevitch Pete Higgins Phil Welt
Cc:	:	Jeremy Butler	Frank Gaudette
From	:	Scott Oki	
Date	:	December 1, 1988	
Subject	:	Kill Lotus Strategy	

- most upgrades ~~[illegible]~~ will occur in 2nd half of '89, so upgrade plan should be offset
- influence customers; which ones?
-

The purpose of this memo is to revisit the rationale for my proposal of super aggressive pricing action as an *integral* part of the "Kill Lotus Plan" (more reasonably known as "Let's Get 30% Share for PC Excel").

<u>The hypothesis:</u>

Extracted from Billg's memo dated November 7th, are the following highlights:

> "Between now and the shipment of V3, Lotus is very vulnerable".
>
> "Excel is not viewed as a mainstream product".
>
> "We have not cut his (Manzi's) sales or gotten him to be more aggressive on price".
>
> "The effect of cutting Lotus' profit in half would be significant".
>
> "...we are open to creative ideas that can really make a difference even if they cost money".
>
> "I am very keen on doing something...between now and the time V3 ships".

Pursuant to Billg's memo, a small task force met and came up with a proposal. The operative goal was to spend between $10 and $20 million to gain 30% share of the spreadsheet market over an 18 month time frame.

The market environment:

Before commenting on anything, I'd like to reinforce the relative position that Lotus enjoys in the spreadsheet market. There is no other product (or company for that matter) that has so dominated a particular application product market segment than Lotus 1-2-3[1]. To say that they have an entrenched position is understatement. They have an enormous installed base. Their monthly run rate of 1-2-3 unit shipments[2] hasn't decreased even in the face of competitive product salvos from Borland and Microsoft. Their users may be a bit disgruntled with the delays associated with V3; but, there is little to indicate total dissatisfaction or a move to jump ship. There aren't many refugees seeking shelter in Redmond or Scotts Valley.

Lotus for all intents and purposes is a one product company. This is both good and bad. The bad part is that they have enormous resources to throw at defending their position. Their sales force outnumbers Microsofts by a factor of three...and our field resources (approximately 100 full time) certainly aren't dedicated solely to PC Excel. The same holds true for all other areas. In short, Lotus has more guns and butter in the spreadsheet war.

The good part, and one that was commented on by Billg, is that even a small erosion in their financial picture will tend to accelerate their negative spiral. There are certain things that Lotus cannot respond to in defending their position because of their overriding reliance on 1-2-3. Herein lies the opportunity.

The proposal:

The proposal that was presented by Pete Higgins on November 18th was a comprehensive list of actions that we could take in order to effect a shift in market share for PC Excel to 30% from its current 10% in an eighteen month period. The most controversial part of the proposal was the aggresive pricing action. Before analysing the risks and opportunities that a deep promotional price cut represent, we should understand the true potential cost and affordability of the cut.

Basic Affordability of a Price Cut:

It only makes sense to look at the cost of the price cut on USSMD's overall profitability[3]. Without a doubt, if we look at the Excel business alone, and burden it with some reasonable fraction of our sales and marketing fixed costs, it becomes virtually impossible to make up the lost profitability and net contribution through sufficiently increased Excel sales volume. However, one of Microsoft's major advantages, particularly versus Lotus, is that we can choose to view Excel as a strategic product, cut its price, and have profitability from other products subsidize this campaign. The key is to still have sufficient profitability for USSMD as a whole to continue both selling those other products, and building longer term programs that pick up after the price cut has done its work.

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1 Only Microsoft with MSDOS in the systems category is more dominant.

2 Estimated at 100,000 units per month.

3 All numbers presented here are tentative...but close; final models will be available at the meeting on Tuesday, 12/06/88.

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If we cut the dealer cost of Excel to $135[4] and only sell exactly the volume in the FY89 USSMD forecast for January through June, then USSMD net pre-tax profitability drops by 3.9%. Of course, this is an unrealistically extreme case: we cut prices in half, and run rates rise only very nominally (nominally, because the budgetted run rate is slightly ahead of actuals). On the other hand if we assume that we are able to sell exactly double the forecasted volume in the same six months, then profitability only drops by .2% - easily and obviously affordable.

Affordability of a Price Cut *And* Everything Else:

Doing just the price cut, aggressive as it is, is not enough. It will only work if we implement other programs, including:

- Demo Disk program - including aggressive advertising, direct mail, and inclusion in every Windows 286 and 386 box;
- Adding six people to Excel Product Marketing;
- Adding five SE's;
- Increases in Excel Advertising and P/R;
- Two seminar teams, and funding for seminars;
- 45 additional field people; and,
- dropping the dealer cost for Excel from January 1 to June 30 to $135.

Can we afford all of this and a price cut too? The USSMD financial model shows that if we implement all of the above mentioned programs, and assuming we do manage to double forecasted volume in this period, then profitability for the second half of the year drops to 9.5% of net revenues from a budgeted 13.8%. The drop in absolute profit dollars is $5.8 million.

The reason the results do not look worse is that these programs phase in very neatly. The price cut can be implemented immediately and has an immediate effect on costs, revenues and volumes. The increases in headcount take longer to implement; therefore, their real effect on profitability is not felt until FY90 (when the price cut is over). Their real effect on volume and revenue also will not be felt until FY90, when we will need them to pick up where the price cut left off.

The price cut with all of the other programs is affordable...*if* Microsoft is willing to tolerate lower profitability for USSMD during the crucial period of time during which we must win the spreadsheet and windows battles. When considering this price cut, we are also suggesting that USSMD profitability be allowed to trend down to a 5%-8% range for the next 36 to 42 months and that the ramp up to 20% be made smooth from then on. It will take this long to really win the spreadsheet and windows apps battles.

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4 Costs including rebates is likely to be more like $150 - $155.

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It is my contention that in order to effect a 30% share of the spreadsheet market, we have to:

- be willing to spend (invest) a significant amount over a long period of time;
- attack Lotus on multiple fronts;
- focus our attack in areas where Lotus are severely limited in their ability to respond; and,
- use the element of surprise in taking advantage of short term windows of opportunity.

The need for aggressive pricing action:

> "...Lotus is really handing this one to us and we haven't been creative enough or aggressive enough".
>
> Billg memo 11/7/88

There are precious few opportunities that companies have to *dramatically* shift market share. A movement from 10% share to 30% share is no small shift in relative share. It is a huge shift that happens infrequently. What we are trying to do in the US market is to go from a sell-through rate of 6,000 units per month to 24,000 units per month over an 18 month period. And this assumes the spreadsheet market is stagnant. If the spreadsheet market grows nominally at 15% per year, we are looking to increase sell through to something more like 30,000 units per month...a 500% increase!

The likelihood of effecting this magnitude of shift in share typically does not come from a strategy of underspending your competition. And yet, this is what we are proposing to do: hire a few more SE's, hire a few hq based sales support people, fix deficiencies in the product, do more seminars, hire a dozen telemarketing people, send out a demo disk. This just isn't going to cut it! Even after doing this, Lotus will still have more guns and butter. Furthermore, these programs will take time to implement. And it is time that we are fighting against. The less immediate the impact, the more Lotus benefits, since the shipment of V3 and /G, not to mention Notes, LEAF, /M, et al, will cause a dissipation of any product differentiation benefits Microsoft may have held.

To be perfectly clear, I'm not saying *don't* do these things. However, I am saying that there is little chance that we would achieve the stated goal of 30% share.

Sforzando attack:

The pricing action I am advocating might best be illustrated using a musical term: sforzando. This results in attacking a note more loudly and with more force initially, and is typically followed by a crescendo. Similarly, we must launch a highly visible, targeted attack against Lotus in the short term in a way that leaves Lotus unable to answer. This must then be followed by a broad based attack aimed at preserving short term gains and the further increase in share, albeit at a probable slowed pace.

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The pricing proposal I am advocating can be bifurcated into a general consumer price reduction and a promotion targeted at the Fortune 1000. The consumer price reduction centers around an immediate price reduction in the street price of PC Excel to $159. This could be complemented by a PC Excel and old Mouse bundle priced at $199 when the new Mouse ships (April)[5] .

The Fortune 1000 component is to offer limited site licensing on a promotional basis for PC Excel. This program will be announced at the same time as the price cut, but will start on February 1 so that we have time to determine how to properly involve dealers. The basic idea is to provide corporations with an opportunity to buy manufacturing rights for Excel at $100/unit, on condition that they make an upfront commitment for 100 units. This would mean an initial payment of $10,000 - an amount which any MIS director should be able to find easily - in return for the permanent right to produce copies of Excel internally for $100 apiece. Dealers would receive $10-$25 of the $100, netting us $75-$90 on a sale with no CoGS and no distribution costs. Further, it might be beneficial to insist that the minimum commitment units be distributed within the first 90 days. This satisfies the objective of getting copies into the hands of users quickly.

V3 +90 days?

Both of these pricing components would be positioned as **limited time promotions**. They would expire on the date that V3 ships, or alternatively would terminate on a specified date (June 30, 1989). Since it is a limited time promotion, there would be a sense of urgency associated with it. Also, Microsoft's on-going exposure would be limited since prices could return to pre-promotion levels. Customers would not expect a permanent price decrease since it is a limited time offer.

The beauty in the beast:

The beauty of this pricing action is it is relatively easy to implement, the impact is immediate, and there is little that Lotus can do to respond.

> **Easy to implement:** We take advantage of the window of opportunity. In fact, I believe that pricing action is one of the only ways we can immediately impact Lotus and the opportunity they have handed to us until V3 ships.
>
> **Immediate impact:** I would expect monthly sell through to increase. One can argue price elasticity. However, my opinion is we can immediately double sell through. We immediately get more copies of PC Excel into the hands of users. If there is a belief that by getting more users to fall in love with the product that they will also recommend PC Excel to others, the sooner we get more copies into the market, the better off we are.
>
> **Limited Lotus response:** There is little that Lotus can do to respond to aggressive price action. If Manzi were to match our price, Lotus' profitability would quite literally be flushed down the toilet. As has been noted previously, Lotus' profit is already being impacted by their decisions to offer a free upgrade to V3 as well as the bundling of Allways. Any downward movement of price would further erode their profitability.

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[5] This is a great way to salvage inventories of the old Mouse.

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Risks:

There are certainly risks associated with a price cut. Let me respond to concerns that have been expressed verbally by various people and in memo form by Jons.

Price war: I don't think we would start an industry price war. The fact that we would position any reduction in the street price of Excel as a limited time offer promotion, should attenuate wide industry action leading to a scorched earth. There are many examples of companies who have done exactly what I am proposing to do. Borland typically introduces new products like Quattro with a limited time offer at a very attractive price. After the promotional period, Borland raises the street price by raising the srp.

Even when Borland introduced a permanent pricing strategy of selling language compilers at an srp of $99, this did not spawn an industry wide price war. It did force Microsoft to respond. If we could actually get Lotus to respond in a similar fashion, we will have permanently altered the business model for Lotus and we would hoist incredible short term problems onto their shoulders.

Lowered profit: I do agree with Jon that *should* an industry wide spread, the profitability of our entire industry would be lowered. However, while Microsoft may not be structured for a lower profit business, I'll contend that no one else is either. In fact, we are better positioned to withstand and respond to a wholesale reduction in price and profit than anyone.

Would massive changes to our structure be necessary? Probably yes. Naturally, should a major change in the structure of our industry ensue, we should be ready to respond. If dBase IV has an srp of $295, then USSMD would certainly recommend an srp for Omega that is comparable. Would our international subsidiaries be affected? Probably yes, if in fact the price war could not be confined to the boundaries of the US. But again, Microsoft would not be uniquely affected. Everyone would be forced into restructuring their business (sometimes not a bad thing to happen).

Cut price and make it up in volume: I think we are all aware of the pitfalls and hopefully aren't deluding ourselves with visions of absolutely no risk associated with a risky proposition.

Can a Price Cut be temporary?: There is no question that we can lower dealer cost and then raise it. We have introduced new versions of products, like Mac Word and PC Project, with much higher prices than the preceding versions and have seen associated volume increases. On the other hand, when we lowered the dealer cost of PC Word we chose to keep it at the lower point - precisely because WordPerfect had a lower dealer cost to begin with.

What can happen in the Excel case? The worst case is that when we raise the price, volumes will drop substantially. Undoubtedly, shipments will drop because dealers will stock up like crazy to have inventories of lower priced product. Therefore sell-through should stay high for some time after the price rises because dealers will continue to sell at the old cost as they run through inventory. Eventually, though, the street price will go up and there will be a slow period as purchasers get used to the fact that prices are really higher.

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There should be several mitigating circumstances. Street price will have risen gradually, not all at once, as dealers sell through old inventory. Our increased market share should have lead to increased acceptance and standardization. Other windows products will be reinforcing the GUI and Windows Is Mainstream message. The other programs, like demo disk and seminars, coupled with the newly larger salesforce should just be truly kicking in.

So, while sell through may drop somewhat, the effect should be limited, and we should definitely have reached a new plateau - which is the whole point of the program. With luck we will have permanently damaged Lotus in the process.

Manzi's response: If Jim were to cut the price of V2.01 to $200 and have a zero profit quarter, Lotus' stock will take a sharp downturn. Jim has much more to lose than Microsoft in reducing the price of 1-2-3 and Excel. However, let's assume Manzi reduces the srp of V2.01 after V3 ships. If Microsoft waits to respond, we lose. The market would view any price decrease by Microsoft as a move to position PC Excel against V2.01 and not V3. Therefore, we would not likely respond to a price cut on V2.01 with a price cut on PC Excel 2.1[6]. If on the other hand, Microsoft implemented aggressive pricing action before V3 ships and then went back to normal pricing, the market would view this as being consistent with positioning PC Excel against V3.

A Santa Claus scenario:

Let's dream for a moment. Assume that our pricing action (which we would make sure was highly visible in the press) had the effect of depressing Lotus' stock price to $12 from its current $17. Further assume we purchase 4.9% of the outstanding shares of Lotus at $12. This would entail an investment of $26.76 million (2.23 million shares @ $12). Assume we would be willing to launch a hostile takeover of Lotus. At a per share price of $25 to a buy-out of Lotus, we would need access to approximately $1.2 billion in financing (debt or equity). Assuming Manzi wants to keep his job, we could probably negotiate a "green mail" price of say $30 per share. That would leave us with capital gains of $40 million and leaves Lotus $40 million poorer. This also provides us with $40 million (or some part thereof) to *further* attack Lotus by investing in more R&D people or to spend more heavily in marketing.

This is a win win scenario: We win if Lotus agrees to be "green mailed"; and, we win if our hostile takeover is successful. If the latter happens, we would command 90% of the spreadsheet market (which would throw off a significant amount of cash); obtain key in-roads to the Office Automation product that IBM is working on with Lotus; obtain significant R&D resources; obtain rights to interesting (and not so interesting) technology: NOTES, AGENDA, LEAF, etc.; obtain access to a huge installed base of 1-2-3 users; obtain significant sales resources that can be leveraged across the Microsoft family of products.

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6 An interesting question surfaces: What would we do?!

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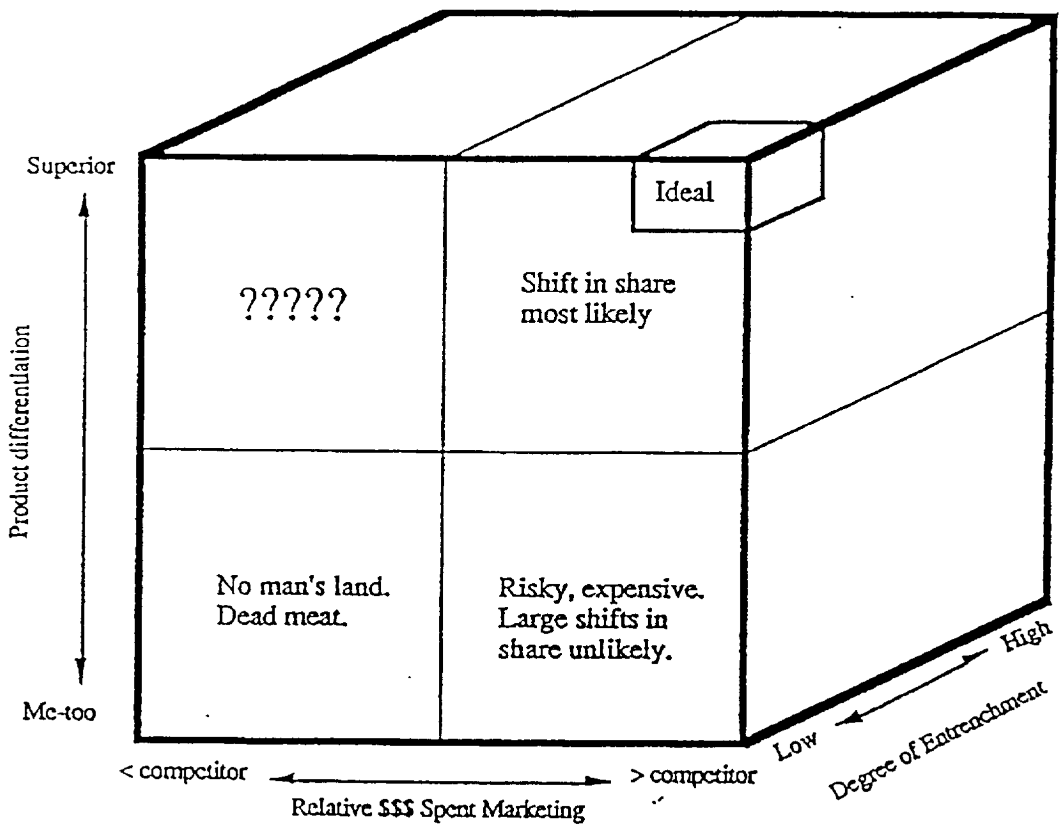
Is there hope?:

The recommendation to take pricing action should not lead one to the conclusion that USSMD is accepting defeat in all of our productivity platforms without deep price cutting. The proposal is specific to the opportunity we have with PC Excel against Lotus 1-2-3. Deep price cutting probably would not be recommended in the case of Opus against WordPerfect 5.0, nor would it be recommended for PowerPoint. The product market segments have to be evaluated independently. Unilateral action for one product market segment does not mean automatic implementation in others.

When attacking a heavily entrenched competitor like Lotus 1-2-3, the two by two matrix below illustrates some probable outcomes.



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> "Great marketing and a bad product never make it".
>
> Jons memo 11/21/88

Having a me-too product only leads to very risky and very expensive strategies to dramatically shift market share. If one has a me-too product and heavily outspends an entrenched competitor in marketing, it is unlikely that share will change. Only a completely incompetent competitor would sit still and allow share to slip away by being outspent from a smaller competitor. This would be analogous to Coke allowing Dr. Pepper to take away share by spending more heavily in advertising!

Having superior product never hurts. In fact, it is perhaps the only way to really shift share quickly and inexpensively. Advantaging oneself of technical discontinuities is wholeheartedly recommended. And, depending on the magnitude of the discontinuity, one may be able to spend relatively little to obtain major shifts in share. More typical however, is the situation where even with superior product, one has to spend considerably more than the competitor to effect dramatic changes in relative share.

Jon's challenge:

> "...tell me how to get to 30% by 1990 without cutting price--even if you still spend as much money".
>
> Jons memo 11/21/88

I am at a loss on this one. My brain cannot uncover a strategy that leads to significant shift in share by underspending competition. Independent of Lotus' superior people resources (quantity, not quality), they will still spend more than $30 million on marketing over the next 18 months. They will likely spend an enormous amount at time of V3 ship and yet again when G ships. This will only hurt us since they will attack us where we currently have the advantage...superior product. Accelerated hiring is endorsed. One way to quickly ramp up is to buy a company. However we decide to obtain the people resources, their impact would not be immediate.

Conclusion:

Getting to 30% share of the spreadsheet market by June of 1990 is an admirable goal. It is not only an admirable goal, it is also an extremely aggressive goal. If we hope to achieve this, Microsoft will have to shed its conservative chrysalis and adopt a strategy that is equally as aggressive as its goal. To do anything less, we risk passing up a once in a lifetime opportunity to permanently alter the landscape of the pc applications market.

Let's approve the proposal in its entirety. Even by investing $20 million over an 18 month period, we are still underspending Lotus! In my opinion, we stand a much better chance of reaching 30% share by doing it all in a well orchestrated manner versus a piece meal strategy that will likely lead to disappointing results.

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The best thing about this pricing action is that it is part of a longer term program. Building the salesforce, continuing to run ever better trimester programs, shipping hundreds of thousands of demo disks, increasing P/R focus, sending seminars to cities all over the country - all these things are the seeds of continuing depth and maturity in our sales and marketing efforts. The problem is that they take time and the effects will all be very gradual. Considered alone, the price cut might be viewed as too ephemeral. Viewed in the overall context, it is a very leveraged way to: jump to a new plateau while Lotus is weakest; gain widespread attention from users, corporations and resellers; have a negative effect on Lotus while it's most possible; and, have that new plateau of at least 30% marketshare for the longer term programs to tap into.

Upgrade

least risky
does the least
- dealer inertia
- inability to communicate
- won't stop 123 upgrade

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