



MICROSOFT

AFTER GATES

THE CHALLENGE ISN'T REPLACING BILL. THAT'S ALREADY HAPPENED.
BALLMER'S BIG ISSUES NOW: GROWTH, GOOGLE, AND THOSE PESKY APPLE ADS.

<BY DAVID KIRKPATRICK> *Photograph by Robert Maxwell*



RS

TEVE BALLMER WAS SOBBING. He repeatedly tried to speak and couldn't get the words out. Minutes passed as he tried to regain his composure. But the audience of 130 of Microsoft's senior leaders waited patiently, many of them crying too. They knew that the CEO was choked up because this executive retreat, held in late March at a resort north of Seattle, was the last ever for company co-founder Bill Gates, as well as for Jeff Raikes, one of the company's longest-tenured executives. "I've spent more time with these two human beings than with anyone else in my life," Ballmer finally said. "Bill and Jeff have been my North Star and kept me going. Now I'm going to count on all of you to be there for me."

What the executives were witnessing was the end of an era. On July 1, Gates officially retires from daily duties at the software giant. He's leaving in order to begin a second life as a full-time philanthropist and to explore his dizzying range of intellectual interests (see "Gates

After Microsoft"). But his departure raises some obvious and very large questions about the future of Microsoft: Can the now \$60 billion behemoth keep finding new ways to grow? Will Ballmer and his lieutenants be able to successfully adapt their products to an increasingly web-driven world? In short, does the company have what it takes to thrive without its iconic founder at the helm?

There are plenty of reasons this may seem like an inauspicious time for Gates, 52, to be leaving his life's work behind. This spring Microsoft, led by Ballmer, failed to consummate a big deal with Yahoo, which it now seems to have pushed into the arms of archrival Google. Last year's rollout of the latest version of Windows, called Vista, was a public relations and consumer marketing disaster. The rest of the software industry, meanwhile, is either supporting its products with advertising, like Google, or starting to rent them as online services. Microsoft has yet to gain traction in either business. And then there's Apple. From the iPod to the iMac to the iPhone, its products have cornered the market on cool. Apple's small share of the PC market in the U.S. is growing fast—it was 7.4% in the first quarter of 2008, up from 5.1% a year earlier, according to International Data Corp. (IDC). Perhaps even more alarming, its ubiquitous "Get a Mac" TV ads have painted the personal computer loaded with Windows software—the central achievement of Gates' 33 years at Microsoft—as a loser. To a lot of consumers out there, Microsoft really does seem like that bumbling nebbish played by Daily Show contributor John Hodgman.

But despite setbacks, despite image problems, and despite Google, Microsoft is in many ways stronger than it has ever been. Just look at the numbers. Revenues grew 18% in the just-ending June 2008 fiscal year. And net profit is up even more, rising 27% to a stunning \$18 billion, according to the consensus of Wall Street analysts who follow the company.

From this position of financial strength, the software giant is going on the offensive. In interviews with Microsoft's leadership, it is clear that those pesky Mac ads have managed to shake some complacency out of the company. Sometime later this year, Microsoft will launch a rebranding campaign for Windows, its core product. It's Ballmer's answer to "Get a Mac." And while Yahoo

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may have turned down Ballmer's \$47.5 billion acquisition bid, the CEO says he'll spend as much as it takes to build a business that challenges Google on the web. The famously competitive Gates may be leaving, but Ballmer insists Microsoft will be no less aggressive without him.

THE POST-GATES ERA has actually begun already, for all practical purposes. And that is much to the relief of Gates himself. The Microsoft co-founder spent a full decade executing a painstaking succession plan. Mostly he did it by progressively passing business leadership of Microsoft to his college pal Ballmer, 52, who became president in 1998 and CEO in 2000. Four years ago Gates told Ballmer privately he wanted to leave, and then two years ago announced

publicly he would do it this July. "I've been No. 2," Gates says of his role in recent years. "I haven't been the decision-maker on anything."

Of course, he also had to find a replacement for himself as product master planner and technology strategist. He and Ballmer decided to split those jobs up. After Gates arranged to purchase technology soulmate Ray Ozzie's faltering startup Groove Networks in 2005, he quickly set about grooming 52-year-old Ozzie, best known as the father of Lotus Notes, to succeed him as Microsoft's chief software architect. The other half of his technical responsibilities went to longtime colleague Craig Mundie, 59, who oversees Microsoft's \$8 billion in annual R&D and spearheads long-term technical strategy.

But one thing is clear: There wouldn't be any post-Gates Microsoft, at least not anytime soon, were it not for Ballmer's willingness to stay around and mind the store. "Every conversation Bill has had with me about being able to transition from Microsoft is always in the vein of he couldn't be transitioning if Steve wasn't there," says Melinda Gates, Bill's wife. "You don't walk away from your life's work if it's not going well. He just could never do that."

MY, HOW YOU'VE GROWN, MR. SOFTEE!

The business that Gates is leaving behind is way bigger and much more diversified than it was a decade ago.

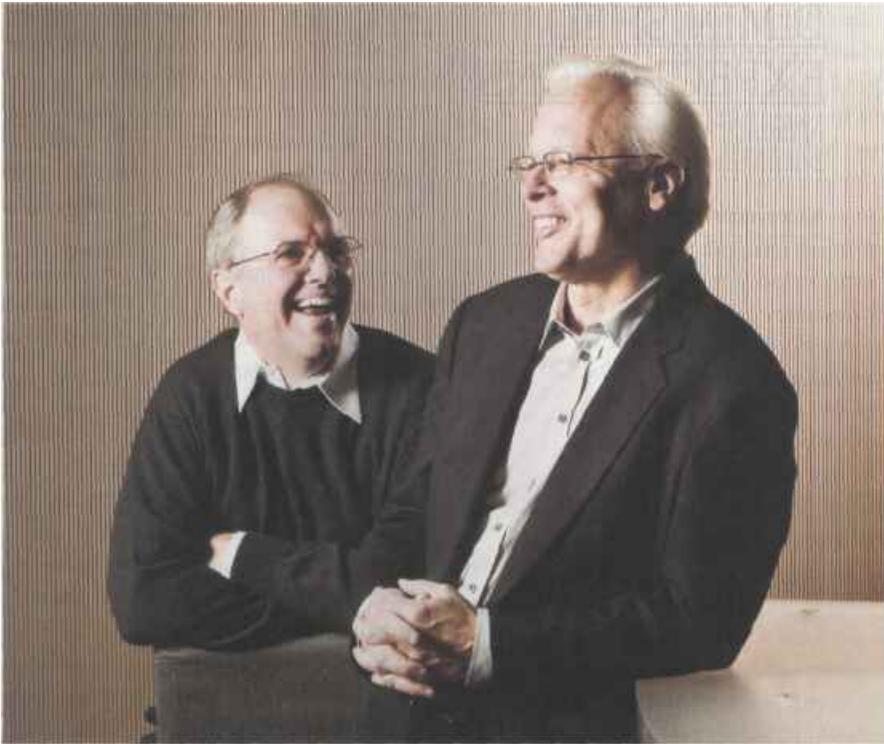
1997 Revenue \$11.4 billion

52.6%	47.5%
Platform \$5,970 mil.	Applications and Content \$5,390 mil.

2007 Revenue \$51.1 billion*

32.0%	29.0%	21.9%	12.0%	4.8%
Business (Microsoft Office, etc.) \$16,381 mil.	Client (Windows, etc.) \$14,812 mil.	Server and Tools \$11,182 mil.	Entertainment and Devices \$6,132 mil.	Online Services \$2,474 mil.

*Most recent complete fiscal year



<It takes two> Gates' role as Microsoft's technology leader is now split between a pair of executives. Company veteran Craig Mundie (left) oversees R&D, while Lotus Notes creator Ray Ozzie is the chief software architect.

Ballmer's management style has matured in the eight years he's been CEO. "He used to be in everyone's shorts, in every detail," says marketing boss Mich Mathews. "But he has changed profoundly. He is a general manager now." Ballmer made a conscious decision to step back from day-to-day management and take a larger view as he realized that his partner Gates was no longer going to be there to strategize alongside him.

Even though he never was a serious computer programmer, by all accounts Ballmer is just as good at math as Gates is. He lives and breathes data. "Steve has a computer in his head," says Bob Muglia, a 20-year company man who heads the Server and Tools division. Ballmer expects his subordinates to be adept in math as well. He distributes 11-by-17 sheets filled with numbers detailing the progress of various operations. The numerals are so small that executives use transparent magnifier rulers to see them. But there are never any columns showing percentage changes. Ballmer believes people ought to do that in their heads. It saves space on the paper for more numbers.

Ballmer has spent the past few years surrounding himself with a seasoned group of lieutenants. Kevin Johnson, 47, a 16-year company veteran who previously ran worldwide sales, now oversees both Windows and online services. To replace Raikes, who is about to become CEO of the Gates Foundation, Ballmer recently hired Stephen Elop, 44, to run the \$19 billion Business division, which centers on Microsoft Office. Elop was CEO of software

maker Macromedia until he sold it to Adobe, and more recently No. 2 at Juniper Networks. Bob Muglia, 48, the Server division chief, oversees development of the complex software employed inside business infrastructures. And Robbie Bach, 46, another 20-year veteran, runs Entertainment and Devices, which includes the Xbox game system and software for mobile phones.

The CEO hasn't been afraid to look outside the tech world for leaders or ideas. Two years ago Ballmer lured away International Paper CFO Chris Liddell, 50, for the same job at Microsoft. And around the same time, he persuaded Kevin Turner to leave his job as Wal-Mart's CIO to join Microsoft in a newly created chief operating officer role. Turner, 43, is a stickler for accountability and measurement. At Microsoft, he's developed a 30-metric "scorecard" with concrete annual goals—in everything from customer satisfaction to growing Windows market

share—for every manager in 65 countries where the company sells its products. Each month Turner gets a report on what he calls ROB, the rhythm of the business. It's the list of 30 metrics, each with a color next to it—red, yellow, or green. You don't want to be a manager with more than one red.

THE CHALLENGES that Microsoft faces are—literally—enormous. At its scale, growing means confronting the law of large numbers.

Ballmer notes with exasperation that to increase earnings by 15% for 2009, the company will have to create \$4 billion in new pretax operating income. At that size, can Microsoft still possibly be a growth company?

Wall Street is not hopeful about the prospects. According to Reuters, the consensus of analysts is that earnings growth will slow in each of the next two years, to 13% in fiscal 2009 and 10% in 2010. Microsoft's stock price has been more or less flat—in the mid-to-high 20s—for about six years. (Late last year it got up into the mid-30s, but its bid for Yahoo caused it to plummet back to the 20s, where it remains.) Right now Microsoft trades for just 16 times its trailing 12 months' earnings, below the S&P 500'S

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trailing P/E of 22. Yet analysts agree that Microsoft will report earnings-per-share growth of 31% for fiscal 2008. By contrast, Standard & Poor's estimates that the S&P 500's earnings per share will grow just 8.3% this year.

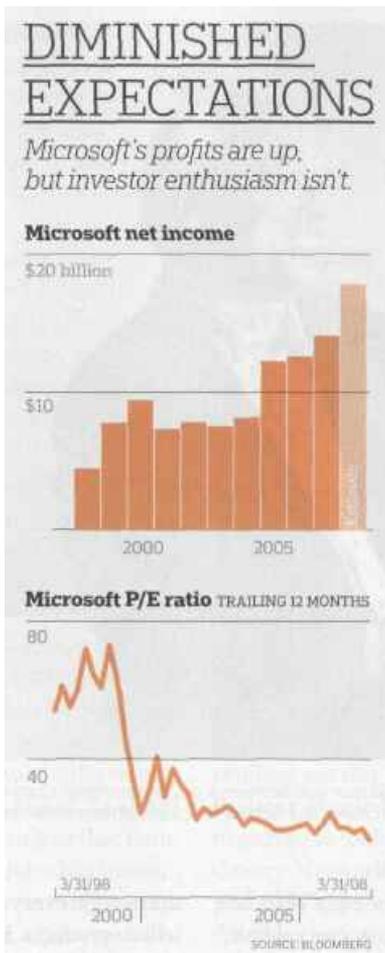
The biggest reason Microsoft can pull off that kind of performance is that its venerable Windows operating system monopoly remains wildly profitable. Despite the problems with Vista, Windows sales grew 11.3% in the 2008 fiscal year, to \$16.7 billion, according to Goldman Sachs. About 75% of that is operating profit.

One key to Microsoft's growth plan is for the company to stay resolutely global. Two-thirds of revenues already come from outside the U.S., and Ballmer and his team expect that percentage to increase significantly. There is an enormous appetite around the world for the software Microsoft produces. IDC figures show that Microsoft's fastest-growing markets are Central and Eastern Europe and Latin America, as well as countries like Vietnam. In Russia, now the company's fifth-largest market, business grew 100% this year, according to CFO Liddell. He says that in conversations with Wall Street, "most discussion is driven around what's happening in the U.S. economy in the next quarter. And—well, I try not to be facetious, but it matters less and less as time goes by." According to Microsoft, there are now more people using Windows in the world than there are English speakers.

When Liddell talks to investors, he often gets the sense that they don't appreciate the breadth of Microsoft's business. As evidence, he estimates that about half the questions he's asked on conference calls concern the money-losing \$3.3 billion Online division—or Windows Live Services, which includes Microsoft's search product and Hotmail—even though it represents only about 6% of company revenues. Of course, that's the division that competes with Google.

INVESTORS AREN'T the only ones obsessed with Google. The one concrete commitment Gates has made to Ballmer, other than continuing to chair board meetings, is that he will keep working with the search and advertising team. He's promised he'll spend two and a half hours on it each week. Why did Gates decide to focus on this particular problem? Google's overwhelming dominance of online advertising continues to thwart Microsoft's ability to grow its online consumer business. Inside the company, the subject inspires almost daily handwringing sessions.

While Gates talks casually about the likelihood of a "share breakthrough in the search market that's still very much in front



of us," at the moment Microsoft is almost hopelessly behind in both market share and mind share when it comes to searching on the Internet. Concedes Gates: "Today you'd definitely say about consumer search and advertising, Couldn't we have gotten in sooner and understood those things?"

There is more involved here than just simple Google envy. Ballmer et al. believe that online advertising is the business where its greatest potential revenue and profit growth lie. So far only about \$40 billion of the world's \$500 billion in ad spending has moved online. But Ballmer expects the Internet portion to be \$80 billion in just two years. While total worldwide spending on business technology is much bigger, around \$1.6 trillion, it isn't growing nearly so fast.

So Microsoft is making unprecedented investments in infrastructure. "You have to throw so much in the pot just to play," says Ballmer. This year Microsoft will put about \$1.7 billion into data centers and servers for its online business. In addition, the company has been pouring resources into the basic technology of search for almost five years. And it has caught up with its rival by at least one fundamental measure—the relevance of

results at Live.com, its search home page. Independent experts now rate Microsoft roughly on a par with Google.

The problem is attracting search traffic in the first place—and right now Microsoft is going in the wrong direction. Its market share of U.S. searches has steadily declined this year, from 9.8% in January to 8.5% in May, according to Comscore. Google, meanwhile, scored 62% of searches in May, and 21% were on Yahoo. Taking a page from the U.S. auto industry, Microsoft recently announced a "cash back" program, in which certain retailers will give a consumers a discount if they buy products they found using Live Search. In addition, the company is focusing heavily on unique features for searching maps, video, and images. The chances of getting a typical information seeker to shift from Google to Live.com are small. But if you really can search video, for example, in a different way, perhaps Microsoft's brand cachet could grow. Another more blatant and costly play for search converts is Microsoft's recent deal with Hewlett-Packard to make Live Search the default for browsers on that company's U.S. PCs. Google has a similar deal with Dell. One way or another, says Ballmer, "we've got to get scale."

That's why he sought Yahoo. The more searches Microsoft gets in its inventory, the more money advertisers are willing to bid to buy ads. If Yahoo's new deal to subcontract with Google and combine



some of their searches is sealed, it will be awful news for Microsoft, because Google will be able to charge even more to advertisers on every search.

The failure of the Yahoo deal raises questions about Ballmer's judgment and decisiveness. Buying Yahoo would have enabled Microsoft to triple the size of its search business; Yahoo also has a far better brand appeal for online consumers. But though Ballmer initially made a very aggressive offer—62% higher than the price at which Yahoo stock was then trading—he failed to seal the deal. After months of wrangling, he upped his offer slightly to about \$47.5 billion. When Yahoo CEO Jerry Yang reportedly wanted a couple of dollars more per share (some \$5.7 billion), Ballmer said his calculations showed it wasn't worth that much. He walked away and said the negotiations were finished. But they weren't. He and Kevin Johnson soon reconsidered, and on May 18, Microsoft instead proposed a deal to purchase Yahoo's search business for \$1 billion and make an \$8 billion investment in the company, which Yahoo also rejected. (Yang's unwillingness to deal with Microsoft has earned the wrath of shareholders, most notably activist hedge fund manager Carl Icahn.)

Ballmer claims the deal's failure means only that more money and time will have to be invested internally and on other, smaller, acquisitions. But many observers in the tech world are wondering why he wasn't willing to follow through and pay up. "He's shown almost no aptitude for organically growing a business that can compete with Google," says George Colony, the CEO of Forrester Research. "So he had to acquire something. Yahoo was obviously the best candidate. But he failed in that too." Unless Microsoft comes back with yet another offer—always a possibility—it is likely to remain way behind Google for the foreseeable future.

WHILE THE GOOGLE BATTLE is about growth, the feud with Apple is mostly about honor. It pains Ballmer and

his troops viscerally when they watch those Apple ads—and when they see how much they've harmed Microsoft's reputation. The consulting firm CoreBrand calculates Microsoft has declined from nth among global brands in 2004 to 59th today, and reports that the two-year-old "Get a Mac" campaign has almost certainly played a role.

The ads hurt even more because they strike a nerve. On the whole, Vista has been a business success. After all, about 140 million PCs have shipped worldwide thus far with this latest version of Windows built in. But even at Microsoft, where acknowledging mistakes is rare, people concede that Vista had flaws, at least at first, and that its launch was embarrassing. Microsoft execs have high hopes for the next version, Windows 7, which they say will emerge in 2009. It is designed to make the operating system on your PC only a piece of a larger Windows experience that will include your cellphone and the web. In the meantime, Ballmer does not intend to keep tolerating Apple's insults.

The new marketing campaign, which is supposed to run for three years beginning later this year, is an urgent attempt at triage for both Windows and the larger Microsoft brand. The expensive, aggressive, long-overdue rejoinder to Apple will be unprecedented at the company in its scope. A year ago Ballmer okayed the effort, led by Bill Veghte, who is responsible for both Windows and search. He partnered with marketing boss Mich Mathews, then the two recruited an all-star team from across the company—the best experts at branding, packaging, online advertising, and other specialties. Two days a week this group drove to a special skunkworks away from the Microsoft campus in Redmond to work quietly on the project, code-named FTP168 (the "FTP" is said to stand for "free the people"). Ballmer approved an additional \$200 million for Windows advertising this year, even though in nonlaunch years there is typically no budget increase at all. The aim of the campaign will be to talk about things you can do with your PC that you could never do before.

Even more important, Windows itself is being reconceived. In the next 18 months Microsoft will launch three separate "Windows" products, more or less in tandem. Aside from the flagship Windows 7, which will succeed Vista for PCs, the company will launch a new version of Windows Mobile as well as a new version of the services known as Windows Live. For the first time, they're going to be promoted as aspects of the same thing. "We're making a huge bet that a closer relationship between the PC, the phone, and the web is what the consumer wants," says Veghte. Windows Mobile is itself a fast-growing success story after many years of investment. The software currently operates on about 120 million cellphones worldwide, and the company will sell 30 million copies this year.

Microsoft people talk a lot about "soft-

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THE GATES WAY: FOUR TRAITS MICROSOFT TOOK FROM BILL

Bill Gates maybe walking out the door on July 1, but he'll leave a lasting impression. Here are some guidelines he imprinted on Microsoft that are likely, to last

<Think of software as a Utopian tool> "Thirty-three years ago the company was founded on the proposition that software would be important," says Gates. "Looking at the next decade, the value that will be created by software and popular software platforms will be greater than ever." Gates takes what colleagues call a Utopian view of software. He believes it can do anything. That means the revolution is just beginning. Says longtime Microsoft executive Craig Mundie: "Today Microsoft actually thinks about itself as just a software company—not a specific type of software company, not a PC software company, not a word-processor software company. And that has been many years in coming."

<Let the engineers rule> Microsoft employs about 30,000 programmers among its 90,000 people. In operating groups engineers are involved in every major decision. Not only that, engineers typically get paid more than businesspeople. The geeks also get lots of toys: Microsoft's \$8 billion computer science R&D lab is the world's largest. At a recent executive retreat, Gates said he thought every great businessperson at Microsoft should cultivate at least five close relationships with engineers.

institutionalize paranoia> "It's very Microsoft to prepare for the worst," says Gates. His heirs agree, and they want to keep it that way. The collective worry a few years ago was that Linux and open-source software could wipe out Microsoft. Today there are products across the company that take for granted that customers will use open-source products alongside Microsoft's own. Meanwhile, Windows Server is finally gaining market share against Linux. Fear is what enabled the company to make that necessary transition. "Bill and Steve created what I guess I'd characterize as a culture of crisis," says chief software architect Ray Ozzie. "There's always someone who's going to take the company down. It's mythical, but at any given point in time there might be two or three big competitive things that the company is juggling. It's something people here are used to, and it's accretive in terms of making things more resilient overtime."

<Invest for the long term> One of Microsoft's most successful products at the moment is SharePoint, a set of tools to enable companies to build both internal and external websites—everything from collaboration and blogs to a flagship dot-com. This year it will generate about \$1 billion in revenue. But that product has been evolving for a decade. "Whatever the cycle is, we will keep investing through the cycle," says Entertainment division president Robbie Bach, "because we know on the other side of whatever cycle happens, there is opportunity. That's just the way the company thinks about itself."

ware plus services," but this new Windows wave, combining software on the PC, the phone, and the web, will finally put the slogan to the test. It may not be dominant in search or e-mail, but Microsoft does have a large web population that is getting steadily bigger. Johnson says there are 430 million users of Windows Live Services each year, a figure growing 20% annually. Those services include Hotmail and Live Search, as well as instant messaging and blogging products and things like the clip art function in Office Online. At the moment 80 million people each month use that service alone.

Microsoft is also selling web services to business. Any company that wants to purchase 5,000 seats or more for a Microsoft Exchange e-mail system can use something called Exchange Online, completely hosted by Microsoft on servers it dedicates to that company. Coca-Cola Enterprises has 70,000 employees using such a system. Microsoft is also now beta-testing a do-it-yourself version of Exchange Online, in which companies as small as five people will be able to create a corporate e-mail system just by going to a website and submitting a credit card number. Microsoft will host and maintain the service.

Some critics assert that the entire "software plus services" mantra is only a way to maintain Microsoft's historical grip on its customers. Says Marc Benioff, CEO of Salesforce.com, the poster boy of the latest era in enterprise software: "The very term is evidence that Microsoft does not get it. They want software plus services because the software is their monopoly. They might as well rewrite it as 'monopoly plus services.'" It will be interesting to watch how much flak Microsoft gets for trying to use its Windows PC monopoly to draw people into its ad-supported online services.

BILL GATES CAN NEVER BE REPLACED. That's what Ballmer started telling his leadership team a couple of years ago. Instead, said Ballmer, he needed to be replaced by processes to duplicate elements of what he brought to the company. That is partly the genesis of the power-sharing arrangement between Ray Ozzie and Craig Mundie. And Ozzie's staff now manages what Microsoft calls its "quests." These are 70-odd efforts to create entirely new ways of using software in various parts of Microsoft's business—just the kinds of visionary efforts that might have been led by Gates back in the day. But he could never have spearheaded 70 of them. Today there are quests on things like computer vision and speech, on ways to write software using one-tenth as much code, and on how to create a "dynamic datacenter" with computers that know what software is running on them.

How long can a Gates-less Microsoft retain the driving, visionary ambition with which he imbued the company? (See sidebar.) Colleagues say Ballmer is even more competitive than the company co-founder, which is probably a big reason why Gates wanted his Harvard dormmate to join Microsoft way back in 1980. The fact is that the heart and soul of Microsoft has never remotely resembled John Hodgman's nebbishy helplessness. Microsoft is likely to remain, to use a phrase Gates particularly loves, hard-core, like the man who made it what it is.