Agenda

- Current license agreements
- Windows Desktop Family License Agreement
- Competitive position
- Financial analysis
- PC Company projected operating system shipments
- Negotiation status
- Counter proposal
- Action plan

GOVERNMENT EXHIBIT 2194
PENGAD-Bayonne, N.J.

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Current Microsoft Contracts Significant Terms

- Windows 3.11, WfW, & NT 3.51 for Intel-based systems
  - Windows 3.11 $9 royalty thru 9/97 - best terms in industry
  - Windows for Workgroups $12.50 royalty thru 9/97 - best terms in industry
  - NT 3.51 Workstation $195 royalty thru 9/97, no volume commitment
  - NT Server $456 royalty thru 9/97, no volume commitment
  - Reseller right to install (IAA)
- MS DOS
  - $2 royalty for Enhanced Tools
  - IBM ships limited quantities for special bids
  - PC DOS - $8 royalty to PSP
- Windows 95
  - Market Development Agreement (MDA) gives royalty discounts
  - $46.60 royalty thru 9/96 (incl. $14.50 MDA reduction)
  - Unlimited liability for third party installation (affects EIAA)
  - Patent immunity granted to MS and its customers
  - Must ship documentation ($1)

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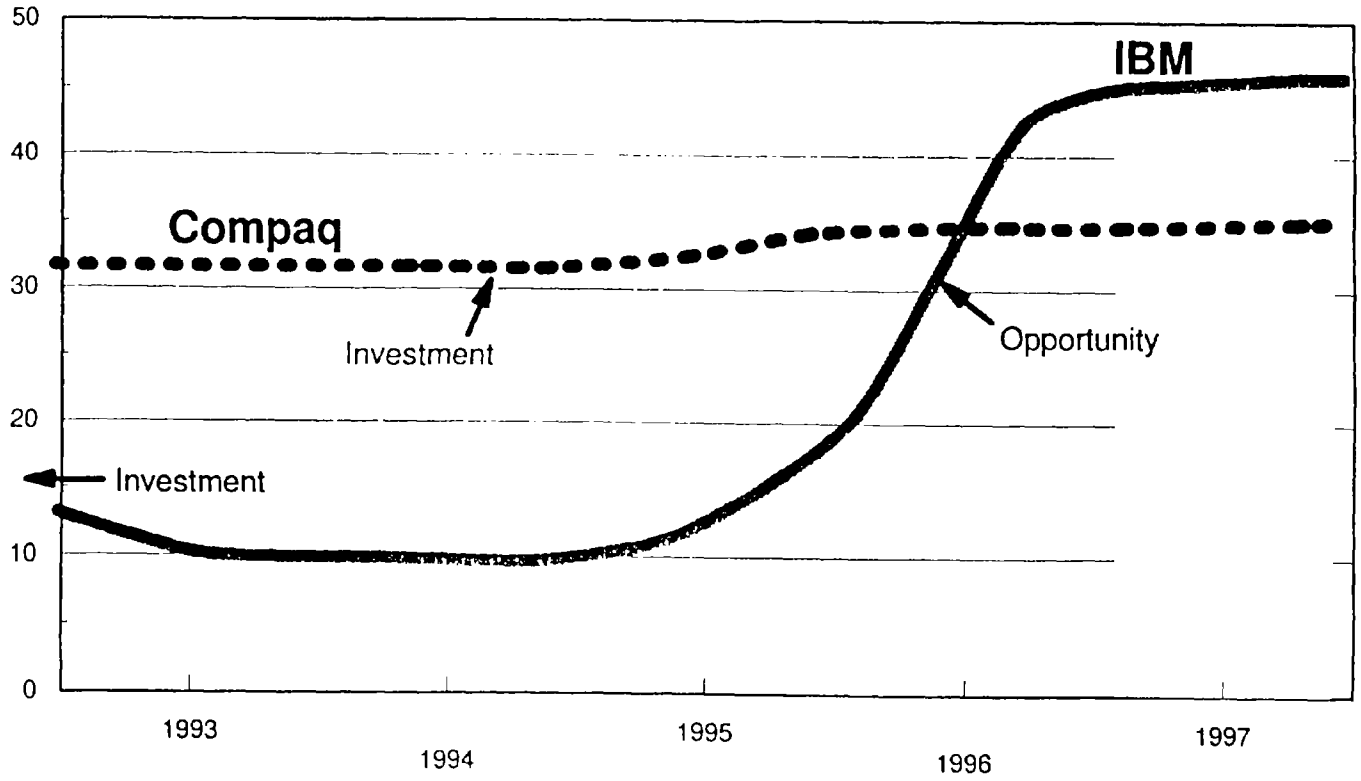
Microsoft Royalty vs. Investment



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Cooperative Development Opportunities

- Enhance Windows 95 as corporate client
  - Tivoli and NetView full client support
  - Object Database Client (ODBC) support for DB/2 and CICS
  - Nashville support for Notes data (including Active-X)
  - Nashville support for SmartSuite objects
- Enhance NT as corporate client
  - Eagle integration with NT
  - Internet server
  - Nashville support for Notes data (including Active-X)
  - Nashville support for SmartSuite objects
  - NT scalability for enterprise servers
  - NT clustering on enterprise servers (SP2)
- Product coupling
  - Ultimate Gamer
  - Personal Workstation
  - Support for corporate Mobile NT use
- Piracy prevention
  - Hardware protection for Windows installation

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Windows Desktop Family License Agreement - Overview

- Combines existing agreements into one Family Agreement
  - Windows 95 terms used as a base
  - MS-DOS, Win 3.11, WfW, Win 95, Win NT Workstation
  - Raises royalties on MS DOS, Win 3.11 and WfW
  - Combines volumes of all products to reduce royalties significantly on a higher cost product, Win NT Workstation
  - Excludes Win NT Server and PowerPC (for Intel systems only)

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Windows Desktop Family License Agreement Discussions to Date

- Win 3.11, WfW, WinNT 3.51 license expires 9/97
  - IBM: "let the marketplace dictate products' extinction and 'grandfather' existing terms except royalties"
- Win95 license expires 9/96
  - This includes expiration of the current $14.50 MDA
  - If IBM does not sign Family, **no further MDA effective 10/1/96**
- New Win9x MDA applies **only** to the Desktop Family Agreement
  - Current assessment is that IBM will qualify for $15 of the total $20
- WinNT 4.0 GA targeted for 8/96, requires Family License Agreement
- MS wants IBM to sign by 6/1/96, in exchange for NT 4.0 upgrade
  - Upgrade program undefined for IBM, despite many requests to MS
    - Dell announced upgrade program
    - Compaq verbally offering upgrade to customers
- Royalties (English, Per System Only, $14.50 MDA) as follows:

	Current Agreement	Windows Family
MS DOS	$2.00	$18.50
Win 3.11	$9.00	$29.00
Win 95	$46.60	$47.50
Win NT	$195.00	$112.50

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Windows Desktop Family Agreement
Microsoft's Initial Position & Proposal

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- Microsoft position 5/1/96
  - Transition Win 3.11 & NT 3.51 terms on 1/1/97
  - Reseller installation (EIAA) agreed to in principle
  - MS stands firm on royalty amounts
  - In general agreement with other operational issues

- Microsoft reviewed IBM issues with Joachim Kempin
  Results: Microsoft Proposal to Santelli 5/10/96
  - Microsoft now wants to waive $5M credit offer to IBM, in exchange:
    - Microsoft will approve EIAA
    - Microsoft will reduce Win 3.11 royalty from $62 to $55 (with PC DOS)
    - Microsoft will grandfather current Win 3.11 & NT 3.51 T&C's thru 9/97
    - IBM must sign Windows Desktop Family Agr. by 6/1/96 under these terms

- IBM analysis of proposal
  - EIAA already agreed to
  - Windows 3.11 royalty reduction of no value (see financial analysis)
  - **Grandfathering of T&C's until 9/97 (exclusive of royalties)**

Consultant Studies

- Workgroup Strategic Services
  - Frequently quoted industry figure
  - Close Microsoft & OEM contacts
  - Long term IBM consultant on Microsoft issues
  - Stated Compaq 10-14% < IBM
  - Reviewed/confirmed our estimates as to base price & royalty reductions
- Dr. Kenn Walters, 20 year veteran of BIS
  - Detailed study - interviewed OEM contacts
  - Estimated base & MDA reductions
  - Confirmed Microsoft policies & amounts
  - Within 5% of WGSS figures
  - Confirmed C&L belief that base prices varies due to soft $
- Coopers & Lybrand
  - Consumer-only study of bundling
  - Windows 95 figure incidental
  - Taken from Taipei OEM interview pre-Windows 95 GA
  - No other methodology used
  - Believes base highly variable despite Justice Dept., due to:
    - Total Microsoft billing (Gateway largest)
    - Long-term relationship with OEM
    - Other soft $ marketing activities

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Windows Desktop Family MDA Discounting

- All OEMs receive MDA discounts for similar activities
  - Maximum MDA discount cap of 35% from unreduced base
- Compaq receives est. $8-10 reduction from $62 base for Frontline partnership and Plug-n-Play joint development
- H-P receives est. $4-6 reduction from $62 base for joint development and enterprise solutions development
- DEC receives est. $2-4 reduction from $65 base for enterprise-scale solutions
- IBM receives no reductions from $62 base, due to lack of strong relationship, competing products and no joint dev.

- **Estimated net pricing by Top tier OEM**

	Compaq	H-P	DEC	IBM
Base price (incl. vol. adj.)	$62	$62	$65	$62
Joint partnering Reductions	$8-10	$4-6	$2-4	$0
Est. MDA Discounts	$17	$17	$15	$15
Est. Net Win95 Price	$35-37	$39-41	$46-48	$47
Est. WinNT Price *	$83-85	$94-96	$101-103	$112

*** Based on all source information - competitive prices may be higher**
Sources: WGSS, C&L, K&B Walters Reports

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1995 Windows 95 MDA Cost Comparison

▪ MDA MILESTONE ACTIVITIES	REDUCTION	IBM	COMPETITION
1. Desktop Compliance w/ HDG	$3.00	$3.00	$3.00
2. Mobile Compliance w/HDG	-----	$2.00	-----
3. All PNP Cards in Systems	$2.00	-----	$2.00
4. Win 95 Base Marketing Program	$2.00	-----	$2.00
5. Trade Show Demonstrations	$2.00	$2.00	$2.00
6. Win 95 on 50% Systems w/in 60 days	$3.00	-----	$3.00
7. Win 95 Logo on Carton	$ .50	$ .50	$ .50
Win 95 Logo on Chassis	$ .50	-----	$ .50
8. Win 95 Logo in Advertisements	$2.00	-----	$2.00
9. Participate in Win 95 Launch	$1.00	$1.00	$1.00
10. Win 95 as only OS in advertisement	$1.00	-----	$1.00
Win 95 one of several OS in advertisement	$1.00	$1.00	$1.00
11. T3 Class / Train Support HC	$1.00	$1.00	$1.00
12. Train Sales Force (Fighter Pilots)	$1.00	$1.00	$1.00
13. Win 95 Present at Customer Event	$1.00	-----	$1.00
14. Convert / Publicize Customer to Win 95	$1.00	-----	$1.00
15. Customize Applets / Help for Win 95	$1.00	$1.00	$1.00
16. Create / Announce Win 95 Spt. Center	-----	$2.00	-----
17. Company Specific Opportunities	$2.00	-----	$2.00
MDA Reductions	$25.00	$14.50	$25.00
▪ Frontline Partnership		-----	$4.00
▪ Joint Dev. Reduction (Plug N Play)		-----	$4.00
Total		$14.50	$33.00

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1996 Windows Family MDA Cost Comparison

▪ MDA MILESTONE ACTIVITIES	REDUCTION	IBM	COMPETITION
1. All systems compliance w/ HDG by 8/1/96	$2.00	$2.00	$2.00
2. APM or UniModem or Audio after 8/1/96	$2.00	$2.00	$2.00
3. Preload OPK w/in 60 days	$2.00	-----	-----
Preload localized versions of OPK w/in 60 days	$1.00	-----	-----
4. Attend WinHEC / OPK Training	$1.00	$1.00	$1.00
5. UI compliance w/ OPK w/in 90 days	$1.00	$1.00	$1.00
6. All cards PNP compatible by 7/1/96	$2.00	-----	$2.00
7. MS URLs and Logo on IBM Web by 7/1/96	$3.00	$3.00	$3.00
8. 40 MCPs by 8/1/96; Attend NT T3 & Ed Plan by 7/1	$1.00	$1.00	$1.00
9. Win 9x Logo in Advertisements	$1.00	$1.00	$1.00
Win 9x Logo on system chassis	$1.00	$1.00	$1.00
10. MS GP Logo in advertisement / coll / promo by 7/1	$3.00	$3.00	$3.00
All Advertised systems ship with OS by 7/1			
All Systems to target countries with OS by 7/1			
10% Exception for RTC			
BSA URL on IBM Web Page by 7/1			
MDA Reductions	$20.00	$15.00	$17.00
▪ Frontline Partnership		-----	$4.00
▪ Joint Dev. Reduction (Plug N Play)		-----	$4.00
Total		$15.00	$25.00

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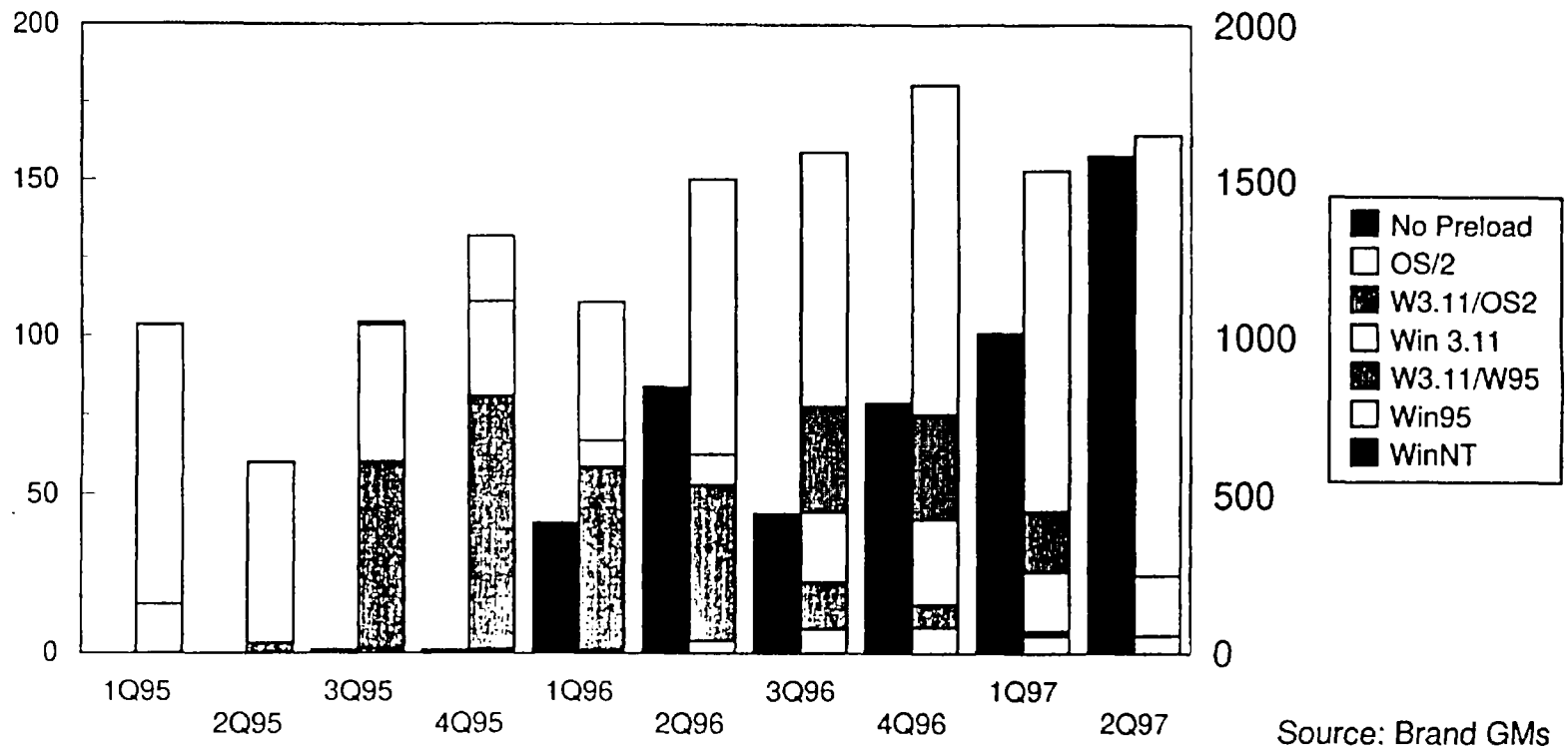
PC Company OS Volumes by Quarter

- Win95 included on 75% of systems (5.2 million)
- Win 3.11 volumes declining, IBM projections higher than industry
- IBM Win NT WS projections significantly below industry expectations



Source: Brand GMs

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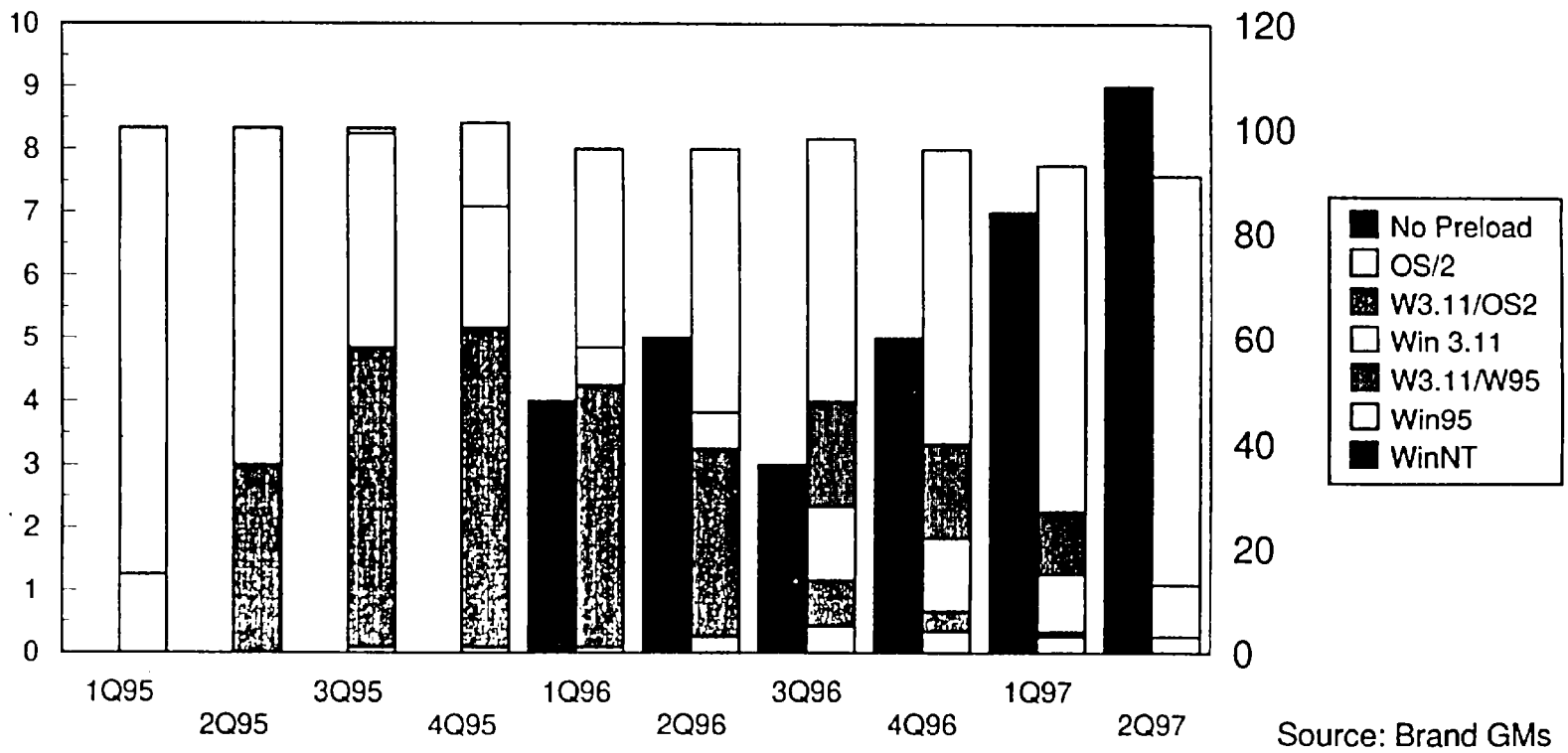
PC Company OS Percentages by Quarter

- Win95 included on 75% of systems (5.2 million)
- Win 3.11 volumes declining, IBM projections higher than industry
- IBM Win NT WS projections significantly below industry expectations



Source: Brand GMs

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Windows Family License Agreement
Financial Analysis Summary

- Royalty History/Projections
  - 1995 Royalties to MS = $60.8M
  - 1996 Royalty Projections to MS = $250M (Obsolescence of Win 3.11by Win95)

- Financial analysis covered 3 cases - June '96-July '97
  - 1. Current royalty terms with MDA expiring 9/96
  - 2. Proposed Family Agreement
  - 3. Proposed Family Agreement and individual license without volume aggregation for Win 3.11

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Windows Family License Agreement
Financial Analysis Summary

- Case analysis:

	Case 1	Case 2	Case 3
Royalty to MS	$370.2	$416.3	$402.3
Less MDA	(16.6)	(94.9)	(94.9)
Net Royalty to MS	353.6	321.4	307.4
Delta to Case 1		(32.3)	(46.3)

- Delta to Case 1 by quarter:

	Case 2	Case 3
3Q96	$12.4	$7.7
4Q96	(9.2)	(13.6)
1Q97	(14.8)	(17.4)
2Q97	(20.6)	(23.0)
Total	($32.3)	($46.3)

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Financial Analysis -- Royalty Assumptions

- Time Period: July 1996 - June 1997
- Case 1 - Current royalty terms

	Royalty	Exp. Date
Windows 95 #	$ 61.10	9/30/97
Windows 95	$ 62.00	10/96-6/97
PC DOS ($8)/Win3.11($9)	$ 17.00	9/30/97
WinNT 3.51 (preloaded) #	$190.00	9/30/97

MDA: $14.50 7/1/96 - 9/30/96 $0 10/1/96 - 6/30/97

- Case 2 - Proposed royalty terms (Family Agreement)

	Royalty	Exp. Date
Windows 95 #	$ 61.10	7/96 - 9/96
Windows 95 #	$ 62.00	10/96-6/97
MS DOS/Enh Tools/Win 3.11 #	$ 55.00	
WinNT 3.51 #	$127.00	

MDA: $14.50 7/1/96 - 9/30/96 $15.00 (est) 10/1/96 - 6/30/97

- Case 3 - Proposed royalty terms (Fam. Agr. with Individual License for Win 3.11)

	Royalty	Exp. Date
Windows 95 #	$ 61.10	7/96 - 9/96
Windows 95 #	$ 62.00	10/96-6/97
PC DOS ($8)/Win 3.11 #	$ 51.50	
WinNT 3.51 #	$127.00	

MDA: $14.50 7/1/96 - 9/30/96 $15.00 (est) 10/1/96 - 6/30/97

MDA applies

* All royalty amounts above represent English Per System copies

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Financial Analysis -- Case Summary

- All figures in $US

	Case 1	Case 2	Case 3
Royalty to Microsoft	$370.2	$416.3	$402.3
Less MDA	(16.6)	(94.9)	(94..9)
Net Royalty to Microsoft	$353.6	$321.4	$307.4
Delta to Case 1		($32.3)	($46.3)
Consumer	$118.4	$96.1	$96.1
Mobile	70.4	59.5	58.4
CDT	164.9	165.8	152.9
Net Royalty to MS	$353.6	$321.4	$307.4

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IBM Leverage and Liabilities

- IBM leverage points
  - Microsoft's desire to remove $5M credit offer from their books
  - Windows 3.11 T&C's & royalties
  - Worldwide volume shipments
  - RISC & Intel potential aggregation
  - Large Accounts (relationships and know-how)
  - Investment in Power (although volumes low)
- IBM liabilities
  - IBM competes with Microsoft:
    - OS/2 & PC DOS vs. Windows & MS DOS
    - SmartSuite vs. MS Office
    - Notes vs. Exchange
    - Eagle vs. BackOffice
  - IBM policy decisions prevent Frontline Partnership
- Motivators to sign Family Agreement
  - Windows 95 license agreement expires 9/96
  - MDA expires 9/96
  - No license for Win NT 4.0
  - MS will become unresponsive if 6/1 contract date not met

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Microsoft Proposal

- Microsoft Proposal to IBM 5/10/96:
  - Microsoft now wants to waive $5M credit offer to IBM, in exchange:
    - Microsoft to approve EIAA
    - Microsoft to reduce Win 3.11 royalty from $62 to $55 (with PC DOS)
    - Microsoft to grandfather current Win 3.11 & NT 3.51 T&C's thru 9/97
    - IBM must sign Windows Desktop Family Agr. by 6/1/96

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PC Co Counter Proposal

- Recommend Royalties to change as follows:

	Current Agr.	Win. Family	**Counter to Family**	Best Comp. Price
MS DOS	$2.00	$18.50	**N/A**	$5.00
Win 3.11 *	$9.00	$29.00	**$25.00**	$25.00
Win 95 *	$46.60	$47.00	**$40.00**	$35.00
Win NT*	$195.00	$112.00	**$80.00**	$80.00

* includes $15 MDA royalty reduction

- Windows 95 - rationale for lower royalty
  - Windows 95 volumes 5x those of Windows 3.11
  - Will accept Windows 3.11 $20 increase for Windows 95 $4 decrease
  - Settlement agreement waiver of $5M
    Will accept loss of $5M for Windows 95 $1 decrease
  - **New Windows 95 target of $42**
- NT Royalty - rationale for lower royalty
  - Must reflect IBM investments in Windows NT:
    Power development $40M
    Middleware development $37M
    Education $2M
  - **$32 royalty reduction ($4M) to cover $60M investment**

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PC Company Response to Microsoft Proposal

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Lead with Discussion:

- Royalties are too high
- Within 90 days of signing:
  - Launch marketing campaign describing IBM as a worldwide MS Solution Provider, Authorized Support Center, Authorized Technical Educ. Center
  - Launch co-operative development and marketing on 3 major fronts

- Microsoft Proposal:
  - Forego $5M credit in Settlement Agreement
  - Approve EIAA
  - Grandfather current Win 3.11 & NT 3.51T&C's through 9/97
  - Reduce Win 3.11 royalty from $62 to $55 (with PC DOS)
  - Must sign Family Agreement by 6/1/96

- IBM Response:
  - May waive $5M in exchange for lower royalties
  - Need EIAA (previously agreed to)
  - To both parties' benefit to grandfather terms
  - $43.50 Win 3.11 royalty without volume aggregation better
  - 6/1/96 not possible without Microsoft's position in a **red-lined draft**
    - Need response to issues from 4/30 mtg
  - Sign ASAP, effective on 10/1/96
  - Family Agreement must include Power

If Counter Proposal not Accepted As Is, IBM's Prioritized Negotiable Items

- Move Windows 3.11 to monthly reporting effective 3/97
  - Currently paying quarterly net 60 days; move to monthly net 30 days
- Relinquish Windows 3.11 source code rights for support
- Limit quantity of products used for internal use and demos
  - Current agreement: 10,000 internal use, unlimited demos
  - Propose to limit royalty free rights to PS Group only
- Relinquish reseller installation under Windows 3.11 agr.
  - Move to accept proposed EIAA amendment with limited liability
- Agree to separate contract for Power
- **Transition terms in current Win 3.11 and Win NT 3.51 agreement to Family Agreement on 6/97 vs. 9/97**
  - **Will require significant negotiation to allow for transition**
- **Agree to higher Win NT royalty for lower Win 95 royalty**

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Action Plan

- Santelli and Martson call to Kempin
  - Wednesday 5/22/96
  - Present high-level IBM counter proposal
  - Request meeting with Jeff Raikes, Steve Ballmer and Sam Palmisano to discuss joint sales and marketing opportunities
- Moffat contact MS Finance re: audits and royalties
  - Avoid audit during negotiations (45 day notice required)
- Team to incorporate executive input into negotiation strategy
- Team to work with Microsoft after red-lined draft received
- Norris to staff 3 additional people in Project Office to execute:
  - Microsoft Solution Provider
  - Authorized Support Center
  - Authorized Technical Education Center
  - Development projects

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