The First Time is Free:

Microsoft's Peculiar Profit Obsession, .NET, and What It All Really Means

By Robert X. Cringely

I have written a few Microsoft conspiracy theory columns in my day, but a great one came in this week from reader Andy Hopper who seems to think that Microsoft is lately trying to emulate Apple Computer and might actually build its own PCs. I hardly think so, but Andy gives us something to chew on, and the ideas that spill from what Andy *isn't* saying tell us a lot about where Microsoft is really heading.

Andy writes:

> Microsoft has already created an instruction set (Intermediate Language, also known as IL). It's used for a stack-based virtual machine that the .NET Framework runs upon, and the code written to run in that environment is called 'managed code.' .NET's been in use in production environments for a little over a year, and from what I can see in the explosion of managed APIs for Longhorn, Microsoft is planning on migrating everything but the OS kernel to it. In other news this week, Microsoft and IBM announced that Microsoft will be creating a new processor for its next XBox. IBM has noted that Microsoft wants to be very hands-on in the processor design.

> Hmm. Perhaps as far as specifying the instruction set it uses? Just how hard would it be to implement an IBM-designed RISC processor that inter-preted a Microsoft-designed instruction set like, say, IL? 'But wait!' you say. 'What about all of the existing software that won't be compatible with the new hardware?' Well, Microsoft just recently purchased Connectix, which writes PC emulator software. Now that they have that resource at hand, they can develop an x86 emulator for a .NET platform. Microsoft can just take a page from Apple's book and provide a fallback mechanism for customers who want to run legacy software.

> Microsoft already wants to design a new PC architecture—the Palladium ini-tiative (now called Next-Generation Secure Computing Base) basically will require it. This will require millions of current computer users to upgrade just so they can lose their fair-use rights (and) take advantage of the wonder-ful new DRM features. Sure, there's been plenty of noise from Intel about how they want to support that, but I'm starting to wonder if Microsoft is ready to cut Intel out of the picture and take all of the money for itself by building Microsoft-brand processors. Who knows? Maybe they even want to do an end-run around Dell and produce their own box? Don't think that they couldn't do it. The XBox may have just been a trial run.

Does this guy sound like me or what?

Andy has interesting ideas, but I believe they aren't placed in the correct context, which is to think of Microsoft's state of mind. Everything Microsoft does—*everything* Microsoft does—has to do with profitability and market share, but in this case market share is, in the mind of Bill Gates, a proxy for survival. Microsoft can't survive, Bill thinks, if it isn't supremely profitable and if it doesn't dominate its markets. So Microsoft has to be always clawing away at its current competitors, and at new competitors it finds as it enters different markets to both make more money and preserve its power just in case we all stop buying PCs. This is the essence of the company's paranoia, where competitors and even partners see it as a bully while Microsoft always sees itself as a potential victim. The key word here is "potential."

Now this argument that Microsoft is obsessed with profitability may sound odd when you realize that nearly all Microsoft profits come from two product areas—the Windows operating systems and the Microsoft Office application suites. Just about everything else Microsoft sells at a loss. I'm sure there are exceptions to this statement (and I know you'll point them out to me like Flight Simulator and consulting) but in broad terms, it is true. And if it is true, why does Microsoft keep around all those losers if their real goal is profits?

There are two reasons. First, Microsoft has to enter new markets to be established there in case old markets go away. And just about any company entering a new market is bound to lose money at first. But Microsoft loses money on these things for years and years. Look at Microsoft Research, which hasn't, to my knowledge, come up with anything truly useful so far. MSN and MSNBC have contributed nothing but red ink to the company and have since they were started. A decade of red ink in the case of MSN is hardly investing in a new product. But it does play a role in Microsoft's real profit goal, which is profit management.

Until the last two to three years, Microsoft was able to keep its stock price continually climbing and stock splits coming by steadily increasing earnings per share. Every quarter Microsoft beat analyst profit expectations and the stock went up and up and up as a result. Lately that hasn't been the case, not because profits haven't been good but because of Microsoft's legal problems. In the long run, though, things might return to what Microsoft used to consider "normal," so Ballmer and others continue to manage for steadily increasing earnings. Now most companies increase earnings by pushing sales, sometimes at the expense of the following quarter and Microsoft may do some of that from time to time. But the other way they manage earnings is through their simple ability to stop wasting money. Rather than boosting earnings, Microsoft manages expenses. As part of this technique, they've even been accused of accounting irregularities that pushed earnings *down*, not boosted them, like just about every other company with accounting problems.

Here's how earnings management works. When Bob Scranton and I took a bowling class a million years ago at the College of Wooster, there were two girls in the class who didn't bowl nearly as well as we did, but they got a better grade at the end of the term. They did this by deliberately doing poorly at first, then got slowly better through the term, while Bob and I just stupidly bowled our hearts out right from the start. Our scores were always better, but their scores dramatically improved and ours didn't. The teacher (imagine a bowling teacher—now there's a concept) graded on improvement. And so, historically, does Wall Street.

Microsoft is so incredibly profitable that it can carry all those losing businesses along quite deliberately, knowing that at any time they can be shut down or trimmed back and the money that might have been spent converted instantly and precisely into profit. If Microsoft simply shut down all its money losers, sales would shrink by about 20 percent, but profits would double. And Wall Street would love it. But then what do you do next year? That's why Microsoft does business this way. It's better to grow earnings by 15 to 25 percent per year for several years than to show all the growth at once. And absent the accounting gimmicks, since dealt with by a consent decree and a few changes in the way Microsoft accounts for this and that, all this is perfectly legal. There is nothing wrong with overspending.

So Microsoft is a profit machine, pumping more than $1 billion per month into the corporate treasury, where it mainly sits waiting for the sun to explode or some other calamity that will stop us from buying or upgrading our PCs. And that's the very reason why Microsoft won't emulate Apple and make both the PC and the software: Apple's profit margins are simply too low. Going into the PC business would only hurt Microsoft on almost every level, so they just won't do it. And why should they? They've pretty much accomplished their goal of taking all the profit from every PC sale. If you buy an

HP computer Microsoft makes a heck of a lot more money on the total deal than does HP. For years, they did the same for every Macintosh, where they didn't even make the OS.

Then what *is* Microsoft up to, if it isn't emulating Apple?

The only way that Microsoft can keep earnings growing for the next decade or more is by entering new markets. But right now, it is hard to find any new markets profitable enough to be worth entering. The business sector is not growing. Manufacturing is not growing. Banks are consolidating. Telcos are stuck in their own mismanagement. There are no up and coming business ideas except for video games, wireless and broadband entertainment, and Microsoft is already making huge investments there. The IT world's growth is dependent on business investment, but no one is investing—we're downsizing and outsourcing instead. This didn't bother Microsoft for a few years because they were moving into the home PC market then. But now that market, too, is becoming saturated. What is a poor Microsoft to do?

The PC business is stagnant, Microsoft already commands the lion's share of profits, so if they are going to make more money, it will have to come from somewhere else. Microsoft has targeted Digital Rights Management as a key part of its new product offerings pretty much as described above by Andy. This serves at least a couple important purposes. Mainly—and this is a part most analysts and pundits ignore because they are too tightly focused on the computer business—Microsoft wants to get into the *transaction* business. Initially, this may mean media delivery and digital rights management, but the ultimate goal is to use the same technology to handle almost any transfer of money or credit anywhere. There is no better business than the money business, itself, and Microsoft is determined to be a big part of that.

But DRM also gives Microsoft added power in the computer and electronics industries, especially with the code portability Andy mentioned. Remember, IL ultimately makes .NET and Windows hardware independent, decreasing Microsoft's dependence on Intel and increasing its power over Intel—the power to give and to take away. There are instances where Microsoft might want to move away from Intel. Redmond has not done a very good job of putting its software on large-scale servers, for example, largely because its hardware partner doesn't scale well. We're seeing Intel-based servers now with up to eight CPUs, but that's about it: Above eight the increased overhead means it isn't worthwhile, so we do clustering, instead. But now Microsoft is flirting with IBM precisely because IBM's Power architecture scales beautifully. If Microsoft wants to grab one of the last pools of profit it doesn't currently own—high end corporate computing—putting .NET on IBM's Power and PowerPC are a key.

It works at the bottom of the market, too, where IL's portability means Microsoft can drop old platforms and move to new ones primarily on the basis of compliant partner behavior. Imagine a game machine or a set-top box that didn't embrace Microsoft's DRM scheme. Well, it would be perfectly in keeping with Microsoft behavior to just drop those hardware platforms in favor of others that were more cooperative. Either buy Redmond's DRM technology (ultimately giving Microsoft the transaction business, remember) or Microsoft might ignore your platform into oblivion.

So this new-found mobility is for Microsoft a new and powerful weapon to be used against friends and enemies alike.

It's particularly grim for the techiest among us because Longhorn—Microsoft's next version of Windows—is pretty dedicated to keeping us from doing anything non-boring with our PCs. You can run apps or you can run apps. This really ought to work in favor of Linux and other less-restrictive operating systems, at least among developers.

Will Microsoft have a general purpose consumer device—yes, they really have no choice, and Xbox is definitely the vehicle.

Will they make an end run around Intel and Dell? I don't think so. The PC business is a commodity. There is no real money to be made in it. And if they did Intel and Dell

can start to promote linux.

But what happens when Microsoft has all the computers, all the video games, all the set-top boxes, all the PDAs, all the mobile phones, when it has conquered the transaction business and holds all the money? That leaves only one more industry I can think of for Microsoft to enter that is profitable enough—pharmaceuticals.

Would you buy drugs from Bill Gates?