Microsoft: The Beast Is Back

That cat-that-ate-the-canary smile is no fake. As the threat of a breakup fades, a newly creative Microsoft is ready to roar. *by Brent Schlender*

You can tell things have changed at Microsoft just by paying a visit to Bill Gates. Middle age has set in—his face has lines; his hair, unkempt as ever, now shows a little bit of gray; you can see by the way he tilts his head that he's acclimating to his first pair of bifocals. But the real surprise is what's missing. Gone is the hollow look of perpetual weariness that comes with being the father of young children, the target of an historic antitrust case, and the world's best-known CEO. Instead Bill is all smiles and—dare we say—almost bubbly as he paces his blandly furnished office and describes how Microsoft's developers are creating cutting-edge technology as never before.

What's apparent is that work, for Gates, is fun again. Far from disengaging from Microsoft since his decision early last year to cede the CEO-ship to old buddy Steve Ballmer and appoint himself chief software architect, Gates has never been more absorbed. He now spends most of his time reveling in the details of Microsoft's product and technology strategies. The change seems to be paying off, and not merely for Bill's state of mind: A new cohesion of purpose and sense of inventiveness pervade the company.

This surge of vitality—which will become obvious this year as Microsoft rolls out an unprecedented wave of products and services—is sure to confound a lot of people. Just a year ago it was easy to imagine Microsoft as over the hill. It had lost its epic antitrust battle against the Department of Justice, a humiliating defeat that culminated in a court order, now under appeal, that the company be split in two. Microsoft baiting was in vogue—cartoonist Garry Trudeau even exposed a fictional employee as Satan in a series of *Doonesbury* strips. Customers, long resigned to Microsoft's practice of constantly upgrading its software and charging them over and over for the same program, grew cynical and rebellious, trading tips on

PHOTOGRAPHS BY FERGUS GREER

how to save money by skipping generations of Microsoft products.

Worse, for all of Microsoft's stupefying success in spearheading the PC revolution, the Internet seemed to be eluding its grasp. Cisco, EMC, Oracle, and Sun—the so-called four horsemen of the Internet—displaced it as Wall Street's high-tech darlings. Microsoft's financial results were never bad, but revenue growth slowed enough that as the Nasdaq soared in late 1999 and early 2000, Microsoft's stock stayed relatively flat. And as dot-coms boomed, Microsoft suffered its first-ever brain drain: Gates and his lieutenants watched in dismay as scores of talented employees cashed in their options and went to work for hot startups. No wonder that last year, when Gates changed jobs, some questioned if it wasn't just a face-saving way to step back from the business to devote himself to philanthropy or just go play.

Wrong. Not only is Gates fully engaged, but the clouds over Microsoft have begun to dissipate as well. So far this year, the stock is up 62% (the four horsemen, by contrast, have seen theirs sink an average of 34%). Profits are pouring in so fast that Microsoft's legendary cash hoard, already $30 billion, is growing by $1 billion a month (see box). Even more important, the court of appeals, whose Microsoft ruling is due shortly, will almost surely reject the breakup of the company ordered by trial judge Thomas Penfield Jackson, and throw the case back to the district court. Impact on Microsoft: lots more legal fees, but not much else.

Back before the trial, Gates' company was so feared and disdained in Silicon Valley that internal documents from Netscape referred to it as the "Beast from Redmond." Well, the beast is back. And for rivals who hoped that the rise of the Internet—even more than the antitrust case—had begun to blunt its claws, we have more bad news. Before, Microsoft used its PC operating system monopoly to crush rivals and capture markets. Now it has learned something critics said it never could: to be creative. That, more than anything, is what will let Microsoft thrive—and maybe rule—in the Internet jungle.

To appreciate the change, you have to understand that Microsoft has long been dissed by the digerati as a big fat copycat. Its coders didn't even write the original software responsible for its meteoric rise—Gates purchased what became MS/DOS from a rival Seattle programmer in 1981 for $50,000. Microsoft has more than once found itself defending its methods of software development in court: In the 1990s, Apple Computer unsuccessfully sued, claiming that Windows violated patents that defined the famously friendly Macintosh graphical "look and feel." And the federal antitrust complaint hinged in part on Microsoft's copying Netscape's Internet browser.

In each contest, Microsoft staunchly defended itself by citing its fundamental right to "innovate." Yet its modus operandi has most often been to replicate and try to improve upon others' successful software ideas, and then absorb them into its products. That's pretty much how it overthrew Lotus and WordPerfect with its Office productivity suite in the early 1990s, how it is attacking Oracle and IBM with its SQL database software today, how it hopes to displace Sun's Unix-based enterprise and Web server products with Windows 2000, and outdo Yahoo and AOL with its oft-reconfigured MSN online services. All these lucrative digital franchises were pioneered by others and grew so fast that Microsoft's hyper-competitive brain trust found it impossible to just sit by and watch.

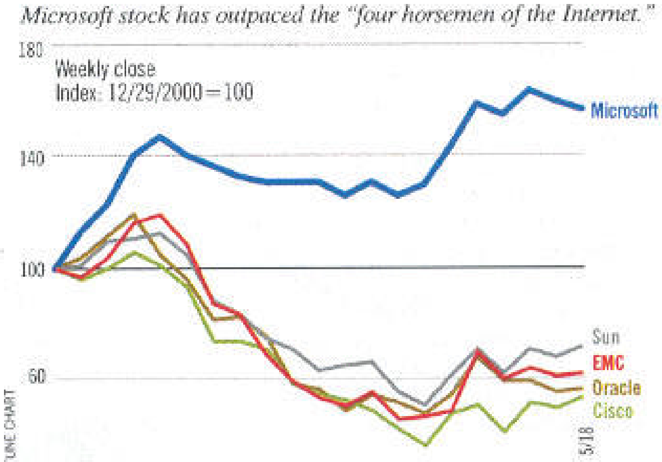
Not all the initiatives will work, of course—at least not right away. Wags joke that no Microsoft product is much good until version 3.0, pointing to Windows as the prime example: The company sold ugly-duckling versions for years before triumphing in 1990 with Windows 3.0. Still, with its try-try-again determination, Microsoft has become an immensely profitable $25-billion-a-year colossus, arguably the most successful tech company ever. In 25 years, it has never had a bad quarter, and a single share of Microsoft stock purchased for $28 on the day of its IPO in 1986 would now be a 144-share holding worth more than $10,000.

All that said, even the cleverest copycatting won't make those shares redouble again. For sustained fast growth, Microsoft will have to pioneer new markets, as well as compete and win in sectors where its desktop dominance does not guarantee a free ride: in videogame consoles, with its multibillion-dollar Xbox machine bet; in PDAs, with its PocketPC architecture; and in cell phones and Internet appliances. But here's a note to investors: If you had the opportunity, as FORTUNE recently did, to walk the halls of Microsoft's development groups, you might well come back with your checkbook poised.

The inventiveness blossoming on the company's rambling, coniferous campus in Redmond, Wash., is truly something new. "We're doing some of our best work ever," declares Gates. "In the last couple of years, a lot of our work hasn't been that visible. The lawsuit dominated the news. Then there was the whole thing about dot-com companies knowing it all. Not that we planned it this way, but there's actually a wave of products coming that will show we are at the beginning of a new era distinct from the Internet era." Or as Microsoft strategist David Vaskevitch puts it, "We are about to hit the golden age of software. The company is reinventing itself—let's call it Microsoft 3.0—so we'll be ready."

Who's Sorry Now?

Microsoft stock has outpaced the "four horsemen of the Internet."



Invent We Must

What to make of all this? Microsoft is getting more creative in large part because it has to. For one thing, it has nearly exhausted the inventory of clonable ideas that are big enough to generate material growth. Revenues in the fiscal year ended last June grew 16%, down from a whopping 36% a year earlier. Also, Microsoft has come to accept that in one crucial market—high-dollar enterprise software applications—competitors like SAP, PeopleSoft, and Siebel Systems are so firmly entrenched that it can't attack them head on. It thinks it can profit by creating new kinds of cal mannerisms to his trademark adolescent slang. (The beatnik-era "cool" was an all-purpose favorite adjective of Gates and his minions decades ago, long before its usage became cool again in popular culture in the late 1990s.) But over the years, as Microsoft grew into a 40,000-person behemoth, and as Gates, by virtue of his extreme wealth and outspoken nature, became a leading figure on the world stage, he lost touch somewhat with the inner workings of the company. "We got into a phase where I wasn't able to integrate products and strategy," he explains. "We were growing so much.... But we weren't quite as optimal in some technical areas as might have been great. Why are we not stronger in management software that lets you tell what is working in a business and what is not? If we had had great strategy coordination like I'm trying to do now, we might have that technology today."

Gates decided that Microsoft's stable of mostly homegrown managers was ready for more responsibility. His No. 2, Ballmer, had worked over two decades all around the company, leading software development groups, dealing with key partners like IBM and Intel, calling the shots in marketing, and building a massive worldwide sales organization. Ballmer, in turn, had hired or nurtured top-notch managers who were itching for bigger challenges. It seemed time to rethink how the company was run. The solution Gates hit on came in two stages. First, in early 2000, he made Ballmer CEO. Then last fall, he and Ballmer agreed that if two heads were better than one at the top of the company, how about adding a third?

They had the perfect choice in Richard Belluzzo, a seasoned executive who had run Silicon Graphics and also had been on the short list to head the legendary Silicon Valley powerhouse Hewlett-Packard. As president, Belluzzo would manage sales, customer support, finance, and other operations—making Microsoft's trains run on time—while Ballmer would focus on strategy, marketing, and being the company's public face. That would free Bill for software architecting. Suddenly Microsoft had three world-class CEOs, each concentrating on the disciplines he was best suited for.

"We hadn't thought that we could have our cake and eat it too, and, well, now that we are in that configuration, we say to ourselves, 'Gee, this is great,'" Gates chortles. "Maybe we should have done it sooner." He admits, though, that adjusting to the new roles took him and Ballmer months. "There was definitely some groping about to figure out who is supposed to be the good guy, who is supposed to be the bad guy when dealing with this or that group that is not doing an ideal job, but we love them anyway." (Can you imagine Gates as Mr. Good Guy? After our interview, he headed off to smooth the feathers of a product manager whose project had been reassigned to a different group.) For his part, Ballmer seems to thrive on being Mr. Outside. Sounding entirely CEO-like, he explains why the dot-com collapse plays to Microsoft's strengths: "We don't have all of the commotion and instability caused by random venture capital outfits soliciting our people for jobs that sound like get-rich-quick schemes. That, and having the stock market settle down, is good from our perspective, because it reminds everybody this is a long-term game. It's about having vision, being patient, executing, all that good stuff."

Managers up and down the ranks, especially in the product development groups, say they're glad to have Gates paying more at-

Bent on rewiring business: Doug Burgum of Great Plains, strategist Vaskevitch, Office boss Steven Sinofsky, and bCentral's Hebert

ALYSON ALIANO

tention, and in some cases acting as referee. Says group vice president Jim Allchin: "There are always conflicts among development groups, and two years ago Bill used to let us just fight it out. Now he spends time looking for technical synergies and driving us to achieve them." Bob Muglia, group vice president for personal services, agrees: "Not only is there less duplication, we're taking a longer-term view. Bill helps us think more broadly, rather than obsessing on our little piece of things."

"Creative" at Microsoft is not the same as "laid back." Gates is no less demanding as chief architect than he was as CEO, and his technical planning sessions are intense. The product development groups shower him with meticulously researched "opportunity maps" showing the competitive landscape for a certain software market; with detailed "scenarios" demonstrating how new software might be used in the real world; and with Microsoft's equivalent of management-consulting reports, which identify universal "schemas"—business processes within and between companies that are ripe for sophisticated automation. In short, Microsoft has become wonkier than ever, just like the boss.

The Ultimate Office

The best place to observe Microsoft's creativity in action is inside its rapidly evolving Productivity and Business Services group, one of the three major chunks of the company. While much of the innovation at the other groups would make sense only to nerds, nearly all of us can relate to the word processing, presentation graphics, and number crunching performed by Microsoft Office, the group's primary product. Jeff Raikes, a 20-year veteran who on the side co-owns the Seattle Mariners, is charged with expanding the Office market, as well as with Microsoft's campaign to wire small businesses and the effort to create software that can tap into SAP and other corporate applications.

Microsoft's Mattress Fund

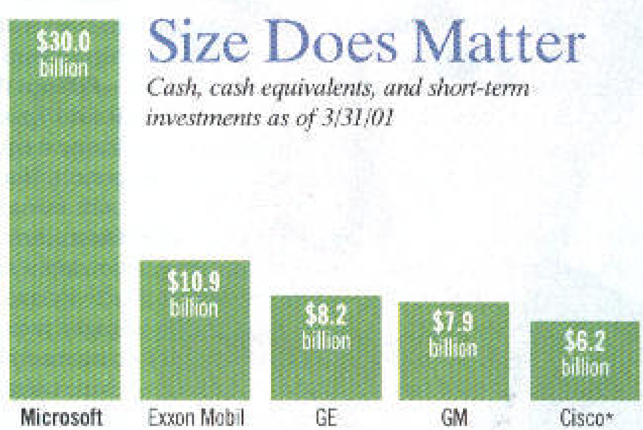
Steve Ballmer has a $30 billion stake to bet with. He'll probably let it ride.

As corporate headaches go, this is the one to have: What to do with $30 billion in cash? Even though Microsoft is no longer a stock-market meteor, profits continue to pour in, giving the company a hoard that dwarfs the holdings of many other big-name corporations (see chart). Indeed, business is so good, says analyst Mike Stanek of Lehman Brothers, that the money is piling up at the rate of roughly $1 billion a month, which will give Microsoft about $40 billion in cash and short-term investments by the end of 2001.

Historically, companies have tried to return excess capital to shareholders through dividends or buybacks. For now, though, Microsoft execs seem content to stuff the cash in the financial equivalent of a mattress, investing it in ultra-safe securities like U.S. government notes, muni bonds, and short-term corporate debt. Dividends are a rarity in the growth-oriented tech industry, and according to Stanek, Gates has dismissed the idea of a stock buyback, preferring to increase earnings per share through internal growth. (Microsoft does buy back stock to fund its employee-option program, and to avoid diluting existing shares it would have to spend $12.9 billion if all options exercisable today were redeemed.)

Size Does Matter

Cash, cash equivalents, and short-term investments as of 3/31/01



*As of 4/28/01.

FORTUNE CHART

A big cash acquisition doesn't seem to be in the cards, either. Microsoft doesn't want to stir up antitrust sentiment. And given the dubious acquisitions often made by companies with cash to burn—Quaker Oats' buyout of Snapple, Ford's of Jaguar—Gates & Co. may be smart just to let the cash pile up. Besides, as analysts point out, the cash serves as a nice cushion for the stock in a down market.

Microsoft argues that its stash is nothing new anyway. CFO John Connors says the company has always kept a lot of cash to fund R&D and strategic acquisitions. "We've looked at the idea of issuing a dividend from time to time," he adds, "but have no current plans to pay a dividend on common shares."

Still, $30 billion could go a long way. The stock has stagnated over the past two years; a one-time $6 dividend on each of the company's 5.4 billion shares would brighten the day for investors. (It would also put $4.4 billion into the pocket of the largest shareholder, Bill Gates). And though fiduciary responsibility would forbid such largesse, Microsoft has enough cash to give $100 to every man, woman, and child in the U.S. and still have $1.5 billion left over. That's a handout that would make Washington tax cutters proud.

— Nelson D. Schwartz