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- Bank Rates
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- California | Local
 - National
 - World
 - Entertainment News
 - Business
 - Sports
 - Politics
 - Opinion
 - Columnists
 - Print Edition
 - What is RSS?

- Calendarlive
- Travel
- West Magazine
- House & Home
- Health
- Food
- Car Culture
- Obituaries
- Crossword, Sudoku
- All Sections
- Corrections

- BUY, SELL & MORE
- Jobs
 - Cars
 - Real Estate
 - Apartments
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Microsoft Puts Profit on the Line With Web-Based Focus

The firm wants to steer away from prepackaged software and toward online offerings.

By Charles Pillar, Times Staff Writer
March 13, 2006

As the Internet transforms the way people use computers, Microsoft Corp. co-founder Bill Gates has a message for the world's biggest software maker: Adapt or die.

"We must act quickly and decisively," Gates wrote in an Oct. 30 memo to Microsoft executives. "The next sea change is upon us."

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In the four months since Gates put his company on notice, the maker of the Windows operating system and Office suite has embarked on a restructuring no less significant than its adoption of the graphical, mouse-based user interface 20 years ago or its embrace of the Internet a decade later.

This time, Microsoft wants to diversify away from prepackaged software and toward Web-based services that provide steadier, faster-growing income streams. In this vision, users would lease access to online software or use services for free in exchange for putting up with on-screen ads.

Gates warned his lieutenants that every part of the company would have to embrace the new market realities: "This coming 'services wave' will be very disruptive."

The pressure is on. Microsoft's sales grew 8% last year, a precipitous slide from the 49% annual growth rates of a decade ago. Wall Street has greeted its vast profit — \$3.65 billion last quarter alone — with a yawn. The company's stock has stagnated for three years.

By contrast, rivals such as Google Inc. pull in billions of dollars for ads on free Web-search pages. Salesforce.com Inc.'s leased sales-and-marketing software brought it revenue and profit growth above 65% last quarter. Apple Computer Inc. recently announced it had sold the billionth download for the iPod, which has become the company's biggest revenue source.

"Microsoft hates the services business," said Jeffrey Tarter, executive director of the Assn. of Support Professionals. "If they can't solve the services problem they'll gradually begin to see themselves drifting into a backwater."

But to embrace the next big thing, Microsoft risks further slowing the most prolific cash machine in software history and forcing product managers to take huge risks that could alienate customers.

Analysts compare the transformation to a war — it would require mobilizing everyone in the company and persuading them to give up their private interests.

Not even Gates knows whether his firm — with 60,000 employees in more than 100 countries and \$40 billion in annual revenue — is still nimble and aggressive enough to reinvent itself again.

A generation of investors has gotten rich betting that Microsoft would steamroll competitors despite frequently playing catch-up on key technologies. The company that touches nearly everyone on the planet who uses a computer knows how to move trends

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in its favor.

In the late 1980s, the old command-line interface on which Microsoft built its initial fortune was waning. Windows was regarded as a clunky joke compared with the graphical interface pioneered by Apple's Macintosh computer. Gates marshaled his forces. Microsoft now powers more than 90% of the world's computers; Apple, less than 3%.

In 1995, Microsoft was again caught off guard when Netscape Communications' Navigator browser became the instant leader on the nascent Web. Gates and company countered with Internet Explorer. A few years and antitrust trials later, Explorer was the overwhelming leader and Netscape was barely hanging on to a tiny following.

Gates has now set his sights on Web services. Again, he warned that failure could gradually turn Microsoft into an also-ran. A shift today might prove vastly harder, given the company's size. Since 1995, its payroll has tripled and revenue has risen nearly sevenfold.

Microsoft declined to disclose how much of that has come from services. Analysts said it was a minuscule fraction because the company handed off most such work to consultants and resellers of its products. Meanwhile, large competitors, such as IBM Corp. and Oracle Corp., earn vast profits from maintenance and consulting, a backbone of the Web-services concept.

Since Gates' missive, the company has been rolling out Windows Live and Office Live, which include free and fee-based website hosting, customer-management support for small and medium-size businesses, personalized home pages and revamped mapping that includes satellite imagery, e-mail, address books and messaging.

The company is adding Windows Live OneCare, a combination security and PC tune-up service, and plans to offer an EBay-like marketplace. It is gradually introducing adCenter, meant to compete with Google by giving advertisers precise targeting of Web viewers.

Gary Flake, a Microsoft executive involved with the efforts, said adCenter and related tools would offer any business data-mining previously available only to giant companies.

He predicted that the protracted, multiyear process for creating new versions of Microsoft applications would gradually be replaced with nearly instantaneous improvements of Web-based services sparked by customer feedback.

Products can be revised "on a minute-by-minute basis, like the evolution of innovation itself," Flake said.

Microsoft will look to profit from the myriad ways the Web spawns communities — such as chat rooms on in-progress sports events and online role-playing in artificial worlds. Individuals' preferences would be reflected in targeted ads.

Google and Yahoo, among others, offer or are developing similar features. But Flake, who was recently hired from Yahoo, argues that because Microsoft is not dependent on advertising, as are those rivals, it will experiment more boldly.

"We not only have the necessity," he said, "but the freedom to do entirely new things."

Flake said Microsoft had a radical goal: to erase nearly all distinctions between the Internet and computing.

"No one today thinks about how power gets through the lines to your home," he said. "But today we are very aware of the boundaries between our desktop computer and the Internet. We will see that boundary become invisible."

Microsoft faces a big problem with that vision. It could cannibalize its businesses that earn billions in profit in favor of unproven ideas. That risk has some analysts wondering how serious Gates is about making Web services the company's next epochal shift, especially considering how little is new in Microsoft's offerings.

Many of the business-support features of Office Live were tried in a Web portal called bCentral launched with little success in 1999. Portions of Windows Live were introduced in 2000 with what Microsoft called its .Net initiative and on the MSN website.

"The name Office Live has created the perception among some people that Microsoft is offering the core Office products — for example, Word and Excel," the popular word-processing and spreadsheet products, Brendan Barnacle, an analyst at Pacific Crest Securities, wrote in a recent research report. "Microsoft will likely never offer a fully [Web-] hosted version of Windows or Office."

Such key omissions reflect the company's understandable reluctance to risk its cash cows.



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It's also a sign of Microsoft's tin ear for consumer marketing, a big problem for a services company, Tarter said. He cited the current ad campaign that depicts office workers who don't use Microsoft's latest products as dinosaurs.

"What's the message there?" he said. "That we sell to people who have pea brains?"

Gates' choice to oversee the move to push the whole company toward Web services — Chief Technical Officer Ray Ozzie — also has some Microsoft watchers scratching their heads. He's considered a visionary but is an outsider who signed on less than a year ago and lacks authority over the company's sprawling divisions.

Ozzie declined interview requests, but in a company memo he noted that "complexity kills. It sucks the life out of [software] developers, it makes products difficult to plan, build and test, it introduces security challenges, and it causes end-user and administrator frustration."

His work is complicated by a company culture devoted to big, complex products.

Mark Lucovsky had been a top Windows engineer for 16 years when he defected to Google a little more than a year ago.

On his blog, he said Microsoft's endless product-upgrade cycles and bureaucratic responses to problems made it ill-suited to a fast-paced services model. Amazon.com Inc. takes the opposite approach, Lucovsky wrote, reporting that a friend at Amazon found and fixed a defect that helped millions of users in a single day without any of them noticing the change.

"Not a single customer had to download a bag of bits, answer any silly questions, prove that they are not software thieves, reboot their computers," Lucovsky wrote. The companies to watch, he added, "have embraced the network, deeply understand the concept of 'software as a service,' and know how to deliver incredible value to their customers efficiently and quickly."

Unlike earlier challenges that genuinely threatened Microsoft's survival, Web services are treated like one more number to cover on the roulette table, said David Yoffie, a business professor at Harvard University. It's a reason to doubt the company's seriousness about transforming itself, he said.

"Microsoft has moved from a highly focused firm to a software conglomerate," Yoffie said. "They are betting on basically everything that has potential to be large and important on the software side of computing, communications and entertainment."

If so, the services push may be Gates using his famously effective paranoia to keep the company hungry, and partly a ploy to keep competitors off balance.

"Microsoft is going to remain a software company for as long as they possibly can," said Matt Rosoff, an analyst at Directions on Microsoft. "There's a bit of misdirection going on here."

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