Microsoft's Multiple Challenges: Is Its Size a Benefit or Burden?

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Microsoft announces that it will spend about $2 billion to fend off rivals such as Google and thwart Sony's video game ambitions, and the company loses more than $30 billion in market capitalization in a day. Fair trade or overreaction?

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Probably a little of both, according to experts at Wharton. Microsoft certainly isn't hurting financially. The company reported net income of $2.98 billion on revenues of $10.9 billion for the quarter ending March 31. But the big question is whether that performance will be maintained over the next decade. According to Wharton finance professor Andrew Metrick, the reaction to Microsoft's increased spending plans for 2007, which were detailed in the company's fiscal third quarter earnings report April 27, may reveal concerns about what has become an increasingly competitive landscape. "Spending $2 billion doesn't lose you $30 billion in market cap," says Metrick. "Let's face it; $2 billion to Microsoft is like a pimple on an elephant. The reaction was the market inferring that the company is much more scared than investors thought it was about the future."

Indeed, Microsoft is a company in transition, and investors, customers and the entire technology industry would be wise to pay attention. At issue is whether Microsoft has grown too big to be nimble enough to compete with its long list of rivals on many fronts: Google in Internet search and advertising, Sony in video games with the launch of its Playstation 3 on November 17, Linux inside the corporation, and Apple Computer in digital media, to name just a few. Meanwhile, Microsoft's Vista operating system will miss the peak holiday season: While it will be available to volume-licensees in late 2006, other businesses as well as consumers won't see it until sometime in 2007. By extending its reach into new markets, such as mobile communications and digital entertainment, Microsoft may be stretching itself too thin without getting sufficient returns, say analysts.

Not that those concerns have stopped the Redmond, Washington-based software giant from investing heavily in new businesses, such as the money-losing Xbox game machine. For the nine months ending March 31, Microsoft home and entertainment division, which includes Xbox, had an operating loss of $848 million on revenues of $3.1 billion. Microsoft is a third place player in search behind Google and Yahoo, and its MSN unit posted a small loss in the third quarter. And Windows Live, an effort to provide some features of Microsoft's Windows platform as web-based services, is in its formative stages.

Don Huesman, senior director of information technology at Wharton, suggests that Microsoft's investments are designed to buy the company time to find a way to reinvent itself. By investing in new markets, Microsoft can "put itself into a holding pattern until it can remake the company," says Huesman. "The competition isn't just Google. Sooner or later in the future, you won't own software but have access to it [online]."

At a Silicon Valley event on May 11, Microsoft CEO Steve Ballmer acknowledged that the company's core business -- selling Windows and Office -- could change. "Software really is evolving to be software

and service as opposed to software as some kind of standalone entity," he said.

Wharton operations and information management professor Eric Clemons says Microsoft's quest for new businesses may show that the company is a good student of history. IBM, for example, stayed with big mainframe computers too long and "missed both the rise of work-group mini-computers and the shift from hardware-based profitability to software-based profitability in the PC industry," says Clemons. "Maybe that's why Microsoft keeps trying to gain control in the net, gaming and other software areas. They don't want to be a big operating system company if the market moves to something completely different."

Given that Microsoft has no intention of losing its standing as a technology titan, it has an obligation -- not to mention its $34.8 billion in cash as of March 31 -- to invest heavily in new markets, says Wharton management professor Sarah Kaplan. "If [Microsoft] wants to make a transformational change, it will need to make a transformational investment," she notes.

Creative Destruction

Transformational investments are one thing, but returns on those expenditures are another. In a May 4 research note, Sanford C. Bernstein analyst Charles DiBona questioned Microsoft's plan to invest what he estimates will become a $2.3 billion outlay. Of that sum, DiBona estimates $700 million will go toward shipping more Xbox consoles before Sony launches its new Playstation, $100 million will go to Chinese PC manufacturers to help market legitimate copies of Windows, and $1.5 billion will be spent on competing with Google on Internet advertising and web services. That last investment "is likely to persist indefinitely."

"Concern has grown that the company appears to be flailing at its opponents," writes DiBona. "Given Microsoft's recent struggles in the Internet space, many investors question the utility and wisdom of spending even more money to pursue what appears to be a losing battle. In the absence of greater insight into the spending, its necessity and its potential returns, the concern is that the spending is a waste."

Kaplan, however, argues that Microsoft should be experimenting with new markets and that even a failure isn't a waste of money. "A big company like Microsoft should be running a lot of (potentially conflicting) experiments. Only some will work out. Creativity must almost by definition involve failed experiments. That's why creative destruction is the essential dynamic of the marketplace."

DiBona's concerns, however, illustrate the hurdles Microsoft has to clear to declare a new venture a success, says Clemons. "Established companies have to think seriously about gambling to an extent that startups don't. If a couple of kids in a garage fail, they are out their time and their VC's money, while if they win, they win big time," Clemons notes. "This encourages risk-seeking behavior. If Microsoft, IBM or Apple fail, it's visible and gets press coverage that little guys don't have to worry about."

The solution: Buy breakthrough technology but don't invent it. "Big companies don't often invent break-through products like PC operating systems, or super premium ice creams or non-carbonated beverages; if they're smart and agile they buy the companies that make [them]," says Clemons.

Although Microsoft has followed Clemons' playbook and bought numerous companies to enter new

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markets -- most recently with Massive Inc., a company that provides advertising inside video games -- concerns persist that when it comes to the Internet the software giant is mired in a Vietnam-like quagmire against smaller rivals that it can't beat. Clemons says those concerns are overblown. While it's likely that Microsoft's goals to compete on multiple fronts may be based on a "domino theory" -- which says if the software giant loses in a category, then it could lose dominance on the operating system -- it's not rational as long as Microsoft software continues to run most of the computers globally.

Playing Defense

Because Windows is so dominant, all the investments made by Microsoft have to be viewed through the prism of the operating system -- and the annuity-like profit stream it provides, says Metrick. While many analysts consider Microsoft to be a hypercompetitive company that plays offense, Metrick portrays the company as a largely defensive and reactive one. In fact, Microsoft has no choice but to play defense when it comes to Windows: The software giant enjoys an operating system monopoly with profit margins that can't be replicated.

Microsoft is worth $236 billion as of May 12. If a startup becomes a company with $2 billion in annual revenue, it is considered a success. Microsoft would need more than 100 successful business launches just to keep its current market capitalization if the Windows and Office franchise were eroded. "There's nothing you can do to be offensive when you are talking about hundreds of billions of dollars," says Metrick. "All of these new ventures are small potatoes if you lose Windows and Office."

Viewed in that context, Microsoft's investments are really an attempt to look into the future to see where the threats to its earnings are. "Should Google succeed in slipping its platform between service-oriented applications and Windows, we estimate that a combination of slowing PC replacement, lost market share, pricing pressure and margin compression would eviscerate the Windows client franchise," DiBona writes.

And if that outcome were to happen, Microsoft could lose out in growth markets such as India and China, says Metrick. As a result, a $1.5 billion investment to erode Google's search dominance today is worthwhile if it keeps the Internet giant from denting Microsoft's operating system earnings in the future.

Given the long odds of a new venture becoming a Windows-like success, why would Microsoft bother with new markets? Microsoft's leaders are strategic and recognize that they have to defend the Windows business in subtle ways, says Metrick. "Microsoft isn't about innovation. It's really about competition and holding onto the desktop. If Windows goes away, I don't see how Microsoft replaces that. To maintain that market share and the Windows annuity, Microsoft has to expand into every PC device."

Viewed in that context, Clemons says, many seemingly contradictory moves by Microsoft make sense. "Ultimately moves that may appear inexplicable on the profit front -- providing free browsers and free email bundled with MSN -- are cross subsidized out of profits from Windows and are ultimately designed to allow Microsoft to charge more for the operating system," he notes.

Size: Pros and Cons

The overarching question is whether Microsoft is too big to play defense, enter new markets and thwart fast-moving companies like Google. Is it, as DiBona suggests, flailing at its competitors? Ballmer has stated that Microsoft is up for the challenge. "Nobody should get in the technology business if they're not prepared to live with, 'Oh, geez, the world is changing.' Of course, the world is changing; embrace it.

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How do we drive growth, how do we embrace the next trend, how do we be a leading-edge innovator?"

While the jury is out on Microsoft's ability to navigate change, Wharton professors indicate that size has its advantages. "Big isn't necessarily bad in the software development industry, especially when it produces strong economies of scale or significant marketplace advantages due to the ability to ensure superior interoperability or to bundle a near-monopoly, must-have primary product with what would otherwise be a competitive secondary offering," says Clemons.

And given Microsoft's profitability, it's hard to argue that size is a problem. Huesman says Microsoft's heft -- and penchant to attack new markets -- has left it with a diverse revenue stream compared to Google, which relies almost exclusively on advertising. Ultimately, diversification could be Microsoft's biggest weapon in the future as it drives profit and revenue growth in areas such as the Xbox, databases, business process software, development systems and advertising, Huesman notes, adding that "Microsoft's size, built upon diverse revenue streams, provides insurance against the vagaries of specific markets."

However, Microsoft's size can also be a handicap. Take the delay of its latest operating system, Vista, caused in part because it has to remain compatible with previous versions. Microsoft's last operating system release came in 2001 -- indicative of an approach that stands in contrast with the more incremental updates common in most software today.

And then there's "brain drain" and Microsoft's ability to develop a new generation of leaders. Huesman warns that Microsoft's size could hamper the company as it tries to attract talent. "A company Microsoft's size can't offer the freedom and equity that a smaller one like Google can. It will be very interesting to see what happens when the current management turns gray."

But don't count Microsoft out. Huesman notes that Vietnam-like war analogies to describe the challenges facing Microsoft against Google may be only partially correct. In fact, the more likely analogy for Microsoft's battle may be the Civil War, where a smaller, more nimble force in the south (like Google) took on a relatively plodding, yet wealthy force in the north (akin to Microsoft). "The south, led by the most brilliant generals of the day, dominated early on with a series of amazing successes," says Huesman. "Ultimately, however, the slower but stubborn forces in the north prevailed, due largely to their sheer size and wealth."

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