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Microsoft's "Can't Lose" Mobile Strategy

Microsoft has been trying to recapture momentum in mobile after ceding the early market leadership it had 5-6 years ago due to its lack of adequate investment and resultant inability to stay competitive. And its renewed focus and execution over the past 1-2 years is indeed enabling it to make progress. But behind the scenes Microsoft has a strategy to become a driving force in the market and will likely produce more profits than many of the handset manufactures. And this is regardless of whether Windows Phone is successful.

Microsoft makes no mobile hardware, and licenses its OS software to several handset manufacturers (e.g., HTC, HP, Samsung). Its latest version of Windows Phone 7 (Mango) is refreshingly competitive and shows a lot of promise. And its distribution partnership with Nokia could propel it into a leadership position (although we remain skeptical that it will happen as quickly as some predict). Many observers focus on Microsoft's attempt to gain ground on the competition by increasing its anemic smartphone OS market share. But the number of smartphones now being sold with windows mobile or the newer Windows Phone 7 is pretty small (various estimates are less than 5% of the market). Even at an estimated \$10-\$15 license fee per phone, the stakes are pretty small for a company the size of Microsoft.

But licensing the OS should actually be Microsoft's back-up position. Frankly, there is far more money to be made other places. First, Microsoft is now putting a squeeze on all of the Android handset makers by enforcing its patent portfolio and claiming all such manufactures must license Microsoft IP to prevent infringement. And the handset makers are coming on board. Deals have been struck with HTC to start, and negotiations continue with others (e.g., Samsung). It is quite likely that Microsoft will be able to extract licensing fees (eventually) from all the manufacturers. And at \$5 per handset produced, that is a staggering sum.

Adding to this revenue stream is yet another lucrative deal for Microsoft. Virtually every smartphone made (including Apple and Google Android, but with the exception of BlackBerry) licenses ActiveSync as the way to both connect to email (via Exchange) and to control the device (e.g., kill, provision). Microsoft controls 80%-85% of the enterprise email market. Without ActiveSync capability, the devices are unable to work in the business world, and what high end smartphone maker wants to be excluded from the corporate world? So licensing fees of \$3-\$5 per smartphone device for ActiveSync licenses has huge potential.

So what does this mean for Microsoft's revenue streams? Currently, all versions of Microsoft powered phones sell about 12M units per year (based on smartphone sales of approximately 400M worldwide estimated in 2011*, and 3% market share for Microsoft). That amounts to \$180M best case (at \$15 per device). There will be an estimated 140M Android phones (based on 35% market share) and 80M iPhones (based on 20% market share) sold this year worldwide. That amounts to \$660M - \$1.1B for ActiveSync licensing. And it's likely that Microsoft will get many (if not all) of the Android vendors to pay royalties, so that's another potential \$700M (at \$5 per device). This is not guaranteed, given it has not yet signed licenses with many of the vendors and some vendors in emerging markets may not care if they are infringing. But even if Microsoft only generates half of this amount, it's a substantial sum. The OS revenues look paltry by comparison to potential IP revenues. And IP doesn't require the substantial investment in updates and improvements that the OS does, making it even more lucrative.

Further, the smartphone market is likely to at least double over the next 3 years when we expect Microsoft to capture 15% of the smartphone market (primarily with Nokia). So 15% of an 800M device smartphone market = 120M devices and at \$15 per device for licensing the OS = \$1.8B in revenue. But the number of devices to be sold on Android = 45% of the total or 360M and on Apple = 15% or 120M. And at \$8-\$10 license fee per Android device and \$3-\$5 per Apple device, that's \$3.2B - \$4.2B in revenue.

And moreover, even though Bing is currently way behind Google search in market share, it is now the favored platform for phone manufacturers distancing themselves from Google's dominance. We expect Bing to capture 25% of mobile search in 3 years. This represents a huge revenue opportunity for Microsoft, although it's hard to quantify at this point.

Bottom Line: Microsoft can generate a lot of revenue from its deal with Nokia. But even if it doesn't, the number of licensees of its IP will guarantee Microsoft a sizeable chunk of the mobile revenue stream. And that doesn't even include the potential for revenues generated by cloud-based and Bing centered services. So Microsoft stands to gain handsomely from mobile, whether it succeeds with its own OS or not. It really can't lose.

**Market Statistics and Projections (compiled and adapted from various estimates):*

- *Current Smartphones shipped worldwide 1Q 11 = 100M units. Estimated 400M total units in 2011.
Approx Shares: Android = 35%, Apple = 20%, RIM = 15%, Symbian (Primarily Nokia) = 25%, Windows Mobile = 3%, Other = 2%*
- *Future Smartphone estimates for 2014 = 800M units
Shares: Android = 45%, Apple = 15%, RIM = 15%, Windows Phone (Primarily Nokia) = 15%, Other = 10%*

For more in-depth comments or analysis on this or other subjects, feel free to contact us.