

# Microsoft's Cultural Revolution

How the software giant is rethinking the way it does business in the world's largest market

BY SARAH SCHAFER

**M**ICROSOFT'S largest beachhead outside the United States is in the state most hostile to it: China. Since arriving in Beijing in 1992, the Gates empire has assembled a network of business operations, from research and development to sales and marketing to customer support, second only to its Redmond, Wash., hub. Bill Gates and CEO Steve Ballmer, whose minutes are managed as priceless commodities, regularly swoop into China for meetings with customers and government officials, trying to find a way to make it in the elusive China market.

A quarter century after its landmark opening to the West, the lingering absurdities of Chinese communism continue to foil the multinational dream of huge profits in the world's most populous nation. Most Western companies still lose money in China as a result of bureaucratic meddling, mistrust of foreigners, weak legal protections and other symptoms of the incomplete transition to capitalism. Even Microsoft, a famously efficient cash machine, admits it

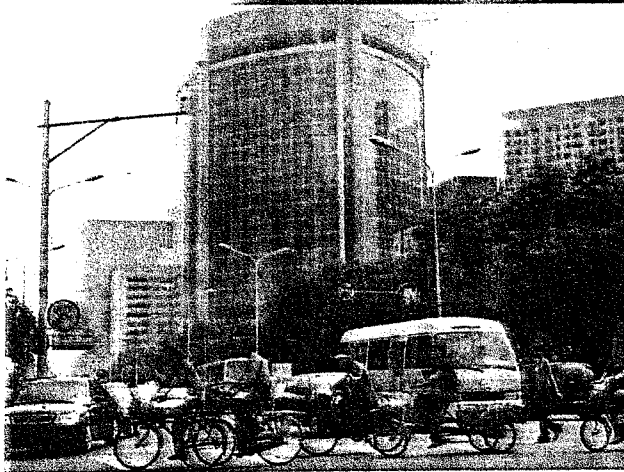
struggled mightily in China. But there are now signs of change: from cars to couriers, more American companies are starting to crack the code. Microsoft sees its future in international sales and desperately needs to make it in the mother of all markets. To a large degree, Ballmer's legacy depends on it. For now, executives say only that the software giant is not making the profit it should in China. But the outlook is improving, owing in part to a 180-degree shift in strategy. On several recent occasions, Ballmer has conceded that China is perhaps the one nation "absolutely big enough" to seriously challenge global computer standards like Windows. Between the lines, it's clear that Microsoft is no longer trying to change China; China is changing Microsoft.

For Microsoft, the problem with doing business in China comes down mainly to one thing: piracy. Touts line the street outside a new \$80 million Microsoft research center in Beijing, steering customers through alleys to run-down apartments where bootleg copies of Microsoft Office and Word are peddled for about \$1, at least \$199 less than the global retail price. Ninety percent of Microsoft products used in China are pirated, and for years the company battled back with its signature mix of bullying and intimidation. But in China the government has been sympathetic to the pirates, openly hostile to the Microsoft monopoly and officially embraced Linux, the free rival to Windows. Cheap software has been critical to China's economic boom, and Beijing saw no upside to forcing citizens with an average annual income of \$1,000 to spend much of it on Windows.

The new Microsoft China strategy attempts to create a constituency for full-price software, starting with the political and business elite. This means improving customer support for big Chinese companies, helping Beijing develop a domestic software industry trained on and tied to Microsoft products, sharing more technology than it normally would and easing up on buyers of pirated software (but not on pirates). In September Microsoft made Timothy Chen its new China CEO and the face of its softer strategy. Chen, a 10-year veteran of Motorola China, says he was drawn by a mandate from the top—Gates

and Ballmer—to revamp the Microsoft operation. "They all wanted to see an integrated China strategy, a road map," says Chen. He has dropped "the threatening-letter approach" and focused on recruiting large corporations as paying customers: "If we do that, I think then the legal users will come."

**China's government has been sympathetic to pirates and openly hostile to Microsoft**



Chen, the new CEO of Microsoft China, says that if big companies shun the bootleggers, other buyers will follow

The master plan was long overdue. In the past decade China has grown into the world's second largest market for PCs, and

potentially for Windows. Microsoft doesn't break down its China numbers, but Beijing tech analyst Huang Yong estimates that the company is in fact losing money in China on yearly revenue of \$200 million to \$300 million (out of \$35 billion worldwide).

At first, in the early '90s, Microsoft ignored bootleggers, betting that once people got hooked on its software, they would willingly pay for upgrades. But that didn't happen. Microsoft began threatening legal action against large corporations for using fakes. Most ignored the threats, in a sign of the turmoil to come. Some big Chinese companies began buying Linux-based

products as a cover and today continue to use pirated Microsoft programs. Others attack Microsoft's uniform global price, saying it's unfair to poor countries. By 2000 Beijing was championing Microsoft rivals, particularly Linux. "Because there is no competition, the price of Microsoft products is much too high," says Li Wuqiang of China's Ministry of Science and Technology. "We cannot control Microsoft, but we should have an option." Fearful of cyberspies, Beijing also preferred Linux's open-source code over the secrets of Windows, and chose Linux for many state agencies.

Microsoft at first laughed off Linux as a threat to its China market share. In 2002 Ballmer said he had seen Windows selling "in funny packages" for \$2.50 at a Beijing bookstore and cracked, "I don't mean to sound facetious, that's not where we want to be, but really, for most people in China, Linux and Windows cost the same amount of money." Lately Microsoft is taking the Linux challenge more seriously: in February it agreed to share its source code with Beijing to ease security fears.

Meanwhile the company was struggling with turnover at the top of its operation. Four China general managers have left in the past five years, not always quietly. In 1999 former general manager Juliet Wu published a best-selling memoir in which she blasted Microsoft China for ridiculously high prices and weak commitment to the China market.

Microsoft started to heed the critics, and to embrace China more fully. Recognizing that China is more likely to fight pirates if it has its own software industry, Microsoft in 2002 pledged \$750 million over three years to help train software and hardware developers, in part by providing free access to Microsoft products. The company is helping to develop computer courses at 36 universities. On a trip last year, Ballmer pledged \$10 million to wire local schools. Tang Min, president of ChinaSoft, a software developer, says that until recently Microsoft just wanted a sales agent, but is now broadly cooperating—even flying her engineers to Redmond for training.

Chen is leading the campaign to befriend top Chinese companies. He cut out layers of Microsoft bureaucracy to shorten lines of communication between Redmond and China, and set up a Microsoft User Club that provides customers instant support. His team began seeking corporate allies, becoming the first foreign member of the Chinese Software Industry Alliance, a lobbying group. Ballmer has credited his "very well-connected" China CEO with im-

Counterfeit Microsoft products on sale near the company's Beijing research center



## Microsoft Cozies Up to China

Microsoft's strategy has evolved to meet the realities of business in China. The focus now is on cooperation with the government and other firms. Some highlights along the way:

**1992** First Chinese office opens, in Beijing.

**1995** Microsoft China is founded.

**1996** Shanghai and Guangzhou branch offices open.

**1998** Technical support center opens in Shanghai. Beijing Research Center undergoes a major expansion.

**2001** Chinese PC makers persuaded to bundle Windows XP as part of a piracy-fighting strategy.

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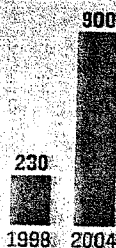
**2002** Cooperation agreement signed with government. First Chinese joint venture, Wicresoft, is launched. Censoft, the first Microsoft-backed Chinese software start-up, debuts.

**2003** Enters joint venture with state-owned CS&S. Opens Advanced Technology Center in Beijing.

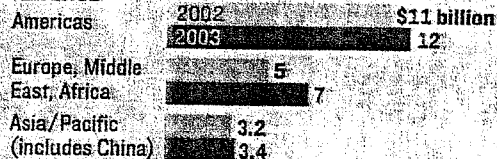


THE LEADING EDGE: Research in Beijing

**MICROSOFT EMPLOYEES IN CHINA**



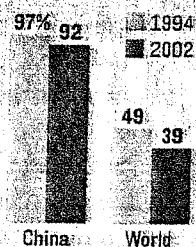
**REVENUE**



**RETAIL SOFTWARE SALES LOST TO PIRACY\*, 2002**



**PERCENTAGE OF SOFTWARE IN USE WHICH IS PIRATED\***



\*INDUSTRYWIDE FIGURES SOURCES: MICROSOFT CORP., BUSINESS SOFTWARE ALLIANCE

proving Microsoft's relations with Beijing and putting "Windows on a very good path in China." On one key issue, Microsoft refuses to budge in China: prices.

Yet even top Redmond executives are now sounding almost Confucian, certainly more patient than their norm, about profit in China. Kevin Johnson, Microsoft's group vice president of worldwide sales, cites a Chinese fable in which an old woman makes a needle from an iron rod by rolling

it back and forth on a rock, even though her neighbors tell her she is crazy. "We also recognize this is a long journey," says Johnson. He cites the cases of Taiwan and South Korea, where piracy rates fell as incomes rose and the governments began fighting pirates as their domestic software firms grew. Both countries are now profitable for Microsoft. And with \$10 billion in annual profits worldwide, Microsoft can afford to roll the iron rod in China.