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John Gapper: Microsoft must roll with punches

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In *King of the World*, David Remnick's biography of Muhammad Ali, there is a memorable description of the 1964 world title contest in Miami between Ali (then Cassius Clay) and Sonny Liston. Ali started the fight by dancing around the ring, "moving in and out . . . easy and fluid". Liston aimed a clumsy jab at him and missed by two feet.

Microsoft, the heavyweight of the software industry, is having a similar experience with Google. A traditional, slow-moving slugger has taken on a company that plays fast and loose. It is proving not only painful but also extremely irritating. No wonder the insouciant Eric Schmidt, Google's chief executive, makes Steve Ballmer of Microsoft so angry.

Google is an odd sort of competitor to Microsoft. It has no equivalent to Microsoft's dominant franchises: its Windows operating system and Office applications suite. Yet it circles Microsoft, delivering jabs: Gmail, its e-mail service, threatens Microsoft's Hotmail and it offers free desktop search that is better than the version embedded in Windows.

Meanwhile, Microsoft grinds on with Vista, its long-delayed successor to Windows XP, which is now due to be launched next year. It had to update its Internet Explorer browser to match Firefox, its open source rival. Internal morale has slipped: some employees have left and others complain of stifling bureaucracy.

When a company's woes appear on the covers of two magazines at once – in this case Forbes and Business Week – something is probably about to go right.

New products – the Xbox 360 games console, an update of Office and Vista – will soon start to emerge and Microsoft may counter-punch by getting Time Warner's AOL to use its search engine instead of Google's.

This does not obviate the trend embodied by Google: the rise of lightweight software and services. Microsoft has always been good at focusing on the latest competitive threat and first matching and then overcoming it. But, in Google, it confronts not merely a company with an enviable product but a different way of doing, and selling, things.

Google services are simply put up on its website for anybody who wishes to try them out. A software application, such as desktop search, is made available for downloading over the internet without charge. Google is happy to distribute its products free to consumers because its revenues come from search-based advertising, not sales of software.

Nor does Google make much effort to integrate all of its products into a single, coherent whole. It launches services such as Google Maps or Orkut, its social network, when they are devised by its engineers. It is happy to have a collection of products being tested and developed – some are kept in "beta" for months – without strong links to each other.

Google is not the only one using the internet to distribute lightweight software and services. Skype, the internet company being bought by eBay, attracted more than 50m users by allowing its voice software to be downloaded free. Similarly, Firefox is offered under open source licence to anybody who wants an alternative browser to Internet Explorer.

All this is alien to Microsoft's approach to business. It makes its money by selling software: MSN, which competes directly with Google, produced only 3 per cent of its operating profits this year. It also relies on a costly distribution network: Windows and Office software is pre-installed by manufacturers on most personal computers.

Above all, Microsoft integrates its software so that Windows users are drawn to using Office applications, Internet Explorer or MSN search. The efforts of Bill Gates, its chairman, to plumb together everything from server operating systems to desktop software and browsers has provoked investigations by regulators, but he sticks with it obdurately.

Now lightweights such as Google are denying it the time and freedom of manoeuvre it enjoyed in the past. If it produces an operating system or an application with a weakness, a rival will offer a fix or an alternative free to consumers without them having to wait for Microsoft's update.

Even more ominously for Microsoft, software is no longer the product *per se* for these new competitors: it is simply a way to establish a link with users and offer a service, from e-mail to telephony. Microsoft gives away some software – notably Internet Explorer – but only to preserve the profitability of Windows.

All of this puts its heavyweight style under strain. The Vista delay, partly caused by an over-ambitious effort to integrate a complex new program with existing software, has shaken and demoralised the company. Mr Ballmer responded this week by reorganising it into three divisions to “achieve greater agility”.

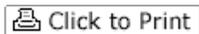
Mr Ballmer recognises the threat. The question is how much of the company’s approach to business and software he is willing to sacrifice to address it. So far, there is no obvious revolution: he intends to reform its development methods to avoid a repetition of the Vista fiasco but there is little sign of it abandoning the integration of software.

This means Microsoft will remain a heavyweight. In many ways it has no choice: that approach is integral to the divisions that produce the bulk of its profits. Mr Ballmer is betting that Microsoft can become like Ali – a heavyweight who fights like a lightweight. But Alis do not come along very often.

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