**Microsoft opens the gates: Patent, Piracy and political challenges in china.**

In the mind of 1980s Microsoft made its first foray into the greater china region, a region consisting of Hong Kong, the people’s republic of china, and Taiwan. It was not until 1992; however that Microsoft entered the mainland by opening a sales office in Beijing. Lured by China’s phenomenal economic growth and Chinese engineering talent, Microsoft has progressively deepened its involvement in china. By 2007 it had a global support center in Shanghai, a mayor research lab in Beijing, and employed more than 2,000 individuals throughout the country. Along the way, Microsoft has faced significant challenges, such as the widespread piracy of its products. Chinese government pressures to transfer its technology, host government promotion of competitor’s products, discriminatory procurement practices by sub national authorities in China, and strong encouragement to enter into joint ventures (JVs) with local films. To manage these challenges, Microsoft’s top executives have built relationships with top Chinese leaders and the film has invested heavily in china and built alliances with a number of Chinese technology companies. From time to time, Microsoft has lobbied the US government to pressure China to enhance its protection of the intellectual property rights (IPR) of foreign companies.

The operating environment in china has been, at times, quite trying for Microsoft. Indeed, Microsoft senior counsel Fred Tipson said in November 2006. “We have to decide if the persecuting of bloggers reaches a point that it’s unacceptable to do business there.” Even so, Microsoft is likely to plow ahead in its quest to profit from china. China’s double-digit GDP growth rates and status as the world’s second-largest PC market, and Microsoft’s expectations that software sales will surge by 20 percent in 2007 suggest any other course of action is highly unlikely. Over the longer term, Microsoft ability to tap China’s riches will depend upon factors such as the country’s continued economic growth, the development of country’s indigenous technology sector, and the extend to which for eign governments exert pressure on China.

**Risks Facing Software Firms operating in China**

 In 2001 China the world Trade Organization (WTO). Pursuant to its WTO agreements, China Committed itself to honor the IPR ---e.g. patents, copyrights, and trademarks -----of foreign companies, including software firms. China quickly moved to make the requisite legal changes, but software piracy rates still ran an astounding 92percent in 2004. The next year they fell to 86 percent, dropping to an improved but still troubling level of 82 percent by 2006. Aside from piracy, software enterprises generally face great risks in defending the IPR in China. Specific challenges include an unclear specification of IPR enforcement responsibilities among government agencies, weak criminal sanctions, corruptions localism, and poor education about the requirements of IPR.

 Beyond China’s weak protection of IPR, foreign software firms operating in China must deal with a government deeply concerned about the development of China’s technology sector. In February 2006 for example, China’s state council (Cabinet) identified software as one of eleven sectors for prioritization. Nine months later, nine Chinese ministries, including the ministry of commerce, issued a document designed to boost China’s software exports to $10 billion by 2010. Given this, it is not surprising that the government has moved to build up china’s software sector. Its initiatives include subsidies, the provision of training, support for alternatives such as open source application software, efforts to create Chinese software standards, and preferential government procurement policies.

 Foreign software firms also must contend with a strong undercurrent of Chinese nationalism. This nationalism can make government units, firms, and individuals reluctant to buy foreign products or do business with foreign firms. Even if it does not have this effect, nationalism can lead to extreme sensitivity about the behaviors of foreign business. At the extreme, it can even engender worries about the impact of foreign software firms on national security and national independence.

**Exploring Microsoft**

Founded in 1975, Microsoft is the world’s largest standalone software maker. Microsoft operating systems, such as Vista and XP, run on 90 percent of all PCs worldwide. Aside from operating system software for PC’s, Microsoft offers systems software for servers and devices like personal digital assistants (PDAs) and mobile phones. Microsoft also develops security and collaboration software for the business market, diverse application software, including the Microsoft Office productivity suite, computer games and operates Web sites such as MSN.com. While Microsoft is primarily a software company, it derives significant revenues from hardware items such as Xbox gaming system and computer peripherals such as keyboards.

 Although no longer the high growth-stock it once was, Microsoft registered very healthy results in 2006. Its revenues were $44.28 billion, almost $4.5 billion more than the previous year. Furthermore, the software giant’s net income ran an impressive $12.59 billion. These results gave the company a return on equity of 28.5 percent, far than many of its peers. While the financial picture has remained bright, Microsoft has long recognized the need to develop new sources of growth in order to deal with the maturation of the American market, regulatory challenges like the EU’s antitrust action against Microsoft, and the rise of new competitors such as Google.

 Microsoft took its first steps overseas in 1978 by establishing a sales office in Japan. Within 12 months Microsoft moved into Europe by signing a sales arrangement with Belgian firm Vector International. In 1982 Microsoft established subsidiary in England, following the next year with the opening of subsidiaries in France and Germany and the purchase of a distributor in Australia. Two years later, Microsoft initiated its first production facility outside the United States in Dublin, Ireland. In 1986 the firm turned its attention to Latin America by establishing a subsidiary in Mexico. Three years later, Microsoft opened in European headquarters in France. In 1990 the firm deepened its involvement in the Asia Pacific by striking distribution arrangements in Indonesia, Malaysia, and Singapore and by opening a research and development center in Japan. In 1997 Microsoft opted to set up a research laboratory in England. One year later, Microsoft opened a development center in India, its largest outside the United States. Expanding in presence in India, Microsoft opened a support center in Bangalore in 2003. Thereafter, Microsoft worked to build up its presence in China and other areas.

**Table 1** **Microsoft Timeline**

1975: Microsoft is founded.

1981: MS-DOS debuts on IBM’s first PC.

1983: Microsoft introduces MS Word, MS Windows, and the Microsoft mouse.

1985: Microsoft sells the first retail version of Windows; Revenues reach almost $140 million.

1986: Microsoft holds its IPO.

1989: Microsoft launches Microsoft Office, a suite of business software including excel.

1990: Microsoft becomes the first software company to exceed $1 billion in revenues. U.S. Federal Trade Commission begins investigation into possible anticompetitive sales practices by Microsoft.

1993: Microsoft launches Windows NT, a platform for network servers.

1995: Microsoft introduces its Windows 95 operating system and its online MSN service. Revenues reach almost $6 billion.

1997: U.S. Justice Department sues Microsoft for violating a 1994 consent decree relating to the licensing of Windows. A U.S. district court orders Microsoft to unbundle Windows 95 from its internet browser.

2000: Judge Thomas Jackson rules Microsoft a monopoly and orders breakup of the company and changes in its sales practices.

2001: Microsoft launches Windows XP and the Xbox gaming system. U.S. Appeals Court overturns Jackson’s breakup ruling.

2004: European Union (EU) determines Microsoft is guilty of anticompetitive practices, fines it $613 million, orders it to share code, end certain practices, fines it $613 million, orders it to share code, end certain practice, and untie certain music players from Windows.

2005: Microsoft hits nearly $40 billion in revenues.

2006: EU fines Microsoft $358 million for noncompliance with its 2004 ruling.

2007: Microsoft releases Vista, its largest operating system and makes its largest ever acquisition, a 6$6 billion purchase of online marketing firm aQuantive.

**Microsoft’s Quest to Excel in China**

Microsoft did not station its first employee in China until around 1991. A U.S. china accord in

1992 on IPR spurred Microsoft to intensify its pursuit of opportunities in China. Subsequently,

Microsoft opened a representative office and signed an agreement with various Chinese PC

producers to preload its software on their computers. In 1994, then Microsoft Chairman and

CEO, Bill Gates, visited China to launch Chinese Windows. Following a frosty reception by

Chinese elites who felt Microsoft was not giving China due deference, Gates did an about face

and pursued a more cooperative relationship with Beijing. Still, Microsoft did not shy away from

aggressive measures to defend its interests. For example, it cheered efforts by the Office of the

U.S. Trade Representative to obtain new IPR enforcement commitments from the Chinese

government.

 In November 1998, Microsoft and China opened Microsoft Research China, the company’s

second international research lab and first research facility in Asia. Around the same time,

Microsoft established a major support center in Shanghai. Michael Rawding, Microsoft’s Greater

China regional director gushed, “China is the most populous country in the world, and its beco-

ming an ever more important location for information technology….It’s very important for

Microsoft to understand and really be in the forefront of what’s happening there”. The next year,

though Microsoft returned to a more confrontational path when it sued a Chinese company, Yadu

Science and Technology, for piracy. The episode became a debacle for Microsoft, which not

only lost the case but also suffered a public relations defeat.

 While pressing for more progress on software piracy, Microsoft embraced a policy of cooper-

ation. In this vein, it lobbied vigorously in 2000 for China’s WTO accession and, in the same

year, launched a simplified character version of Windows 2000. Relations with China were still

antagonistic, though, because the Chinese government actively began to champion Linux (an

open source operating system software) as an alternative Microsoft’s products. Chen Chong, a

deputy minister in the Ministry of Information Industries., stated that China’s support for Linux

would “break the monopoly of the Windows operating system in the Chinese market”.

 There was reluctance, too, at the municipal level to embrace Microsoft. For example, in

December 2001, the Beijing Municipal government shunned Microsoft by awarding operating

system software contracts for 2,000 PCs to Red Flag Linux, a local Linux developer. On the

bright side, Microsoft signed agreements with four leading Chinese computer makers-Legend,

TCL, Tsinghua,Tongfang, and Great wall- to preinstall Windows XP on their machines. As well,

it signed an accord with the Shanghai regional support center into a global support center, and

train thousands of software architects. Furthermore, it became the first foreign firm to become a

member of the Chinese Software Industry Association.

 In 2002 Microsoft entered into its first Chinese JV, Zhongguancun Software, with two

Chinese firms-Centergate and Stone group. The deal was small but represented a change for

Microsoft, which typically shunned such ventures. The same year, Microsoft signed a three year,

$750 million deal with China’s State Development & Planning Commission, which committed

Microsoft to invest in education and training, academic and research cooperation, and local

software companies. Over the next two years, Microsoft agreed to let the Chinese government

see the source code for the Windows operating system and all office 2003 products (lest there be

hidden security holes), signed a large investment and cooperation deal with the Beijing Commi-

ssion on Science and Technology, and struck strategic partnership deals with various Chinese

firms such as Petro China. Despite Microsoft’s efforts, the Chinese government continued to

discriminate against the company by requiring all ministries to purchase Linux-based software.

 In 2005 Microsoft MSN announced a partnership with Shanghai Alliance Investment Ltd.

(SAIL) to launch the MSN China online portal for delivering MSN products and services to cus-

tomer’s in China. Concurrently, Microsoft developed a partnership with a Chinese mobile soft-

ware and services firm (TSSX) to enable the delivery of MSN mobile products and services.

According to Tim Chen, CEO of Microsoft China, “creating a joint venture for MSN China and

SAIL and our transaction with TSSX signifies the importance Microsoft attaches to the China

market”. Eager to tap new sources of growth outside the maturing U.S. market, Microsoft

worked in 2005 and into 2006 to conclude new agreements with Chinese PC manufacturers,

develop new partnerships, and better its relations with the Chinese government.

 As for commercial contracts, Microsoft signed deals with almost $2 billion with Chinese PC

makers Founder Technology Group, Lenovo, Tsinghua Tongfang, and TCL Group to preinstall

Windows. With respect to partnerships, Microsoft began to license technology to Chinese firm.

As a sign of bettering relations, Microsoft signed a five-year multibillion dollar agreement in

April 2006 to outsource hardware production to Chinese firms as well as invest in others. Along

similar lines, Microsoft signed a training, technology provision, and local investment agreement

with the Guangzhou government in July. Microsoft’s chief technology officer, Craig Mundie,

noted that Microsoft was willing to continue to invest in China “even though the climate for our

business has been suboptimal”. Because China was a priority for the firm both as a market and as

a source of technology.

 Analysts partly attributed these favorable deals with Chinese PC firms and the Chinese

governments 2006 decision to require all PC manufacturers to have legitimate operating systems

to Microsoft’s concerted overtures towards China. Tellingly, during his April 2006 visit to the

United States, Chinese President Hu Jintao opted to meet with Bill Gates before meeting with

President George Bush Jr. Moreover, during his tour of Microsoft’s headquarters in Redmond,

Washington, Hu complimented Gates as a friend of China.

 At the beginning of 2007, Microsoft announced that it would set up an R&D facility in

Shanghai to bolster its MSN offerings in China. Microsoft’s relatively small $20 million invest-

ment was symbolically important, given that it was the company’s first overseas MSN R&D

venture. In April 2007, Bill Gates announced that Microsoft planned to double its R&D staffing

in Beijing and Shanghai. Microsoft China CEO Chen told the *China Daily*, “our core strategy is

to implement a unified strategy, get rooted in China and grow with the local economy”. In May,

it was reported that Lenovo had inked a new $1.3 billion software deal with Microsoft, following

its $1 billion-plus deal in 2006.

**The Vista for Microsoft in China**

Going forward, China represents an immediately attractive market for Microsoft, a critical battle-

ground, and a source of rich talent. China’s 110 million Internet users, 350 million mobile phone

subscribers, and 20 million PC sales in 2006 underscore its attractiveness as a software market.

Bill Gates has repeatedly commented on China’s immense scientific talent, most recently when

receiving an honorary degree from Qinghua University in April 2007. There is little chance that

the company will leave China despite Microsoft CFO John Connor’s 2004 comment that “we can

still be successful without large scale China growth”.

 Over the longer term, analysts expect that Beijing’s 2006 decision to require Chinese PC

manufacturer’s to preinstall legal operating systems on all new PCs as well as various govern-

ment agencies decisions to require the purchase of only PCs preloaded with software will aide

Microsoft’s prospects. Also in Microsoft’s favor are rising incomes that enable consumers to pay

more, the improving legal environment for IPR, and the rise of indigenous Chinese high tech

sector which can profit from IPR. Finally, Microsoft’s extensive efforts to nurture partnerships,

deepen its relations with China, and build a Microsoft oriented software sector in China through

training, certification, and the like should bolster the company’s prospects.

 Microsoft has come a long way since 1998 when Bill Gates reportedly said “although about

three million computers get sold every year in China, people don’t pay for the software….Some-

day they will…as long as they’re going to steal it, we want them to steal ours. They’ll get sort of

addicted, and then we’ll somehow figure out how to collect”. As one article put it, “Microsoft’s

investment [in China] can be best described with an old Chinese proverb ‘give in order to take’.

By doing so, Microsoft finally sees the twilight of making profit in China”.

Table 2 **China’s closed gates**

$295 Price for basic, legal copy of Microsoft Vista in China

$1.30 to $4.00 Price of a pirated copy of Microsoft Vista on the street in china

86% Percentage of software on Chinese computers that is pirated

70% Percentage of software on Chinese government computers that is pirated

$3.8 billion Estimated software losses to piracy in China in 2005

**Questions for *Review***

1. What are the risks that Microsoft has faced in operating in China and dealing with the Chinese government? Do you see these risks as increasing, diminishing, or changing in the future? Are these risks unique to China or present in other developing countries?
2. What approaches did Microsoft take to manage its political risks in China? Why might it have favored some of these techniques versus others? Which do you feel worked best? What should Microsoft do going forward?
3. In its dealings with China, Microsoft frequently had to deal with lower levels of government. What special types of challenges and opportunities did this present?
4. Do other firms have the same risk management options as Microsoft? If so, why? If not, why not?
5. Is Microsoft creating serious risks by supporting, financing, and transferring technology to local Chinese software firms? How might Microsoft manage these risks?