
STATE OF THE COMPANY ISSUE

mgmt memo

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MEETING FOCUSES ON CRITICAL ISSUES AND CHALLENGES FOR DIGITAL

At the June 1 State of the Company Meeting, approximately 375 senior managers were challenged to help improve Digital's competitive position. The messages were consistent. We must more closely identify with our customers' needs, dramatically increase our productivity, understand our contribution to the bottom line and do a better job of allocating internal resources. Ken Olsen defined Digital as a product company, challenged engineers to design products on a more timely basis, and challenged all management to work toward winning solutions in our highly competitive environment. He urged management to focus more on the accomplishment of quality work than on the bureaucracy, which sometimes slows down creativity and productivity. Ken closed the day with a presentation about the company's low-end strategy.

A synopsis of the presentations made by Ken and most of the morning speakers follows:

KEN OLSEN: KNOWING THE COMPETITION AND OUR STRENGTHS WILL HELP US WIN

When we were small, and when we were fighting against all those who were established and bigger, we had one goal in mind - to show them we were best. And everybody had the same goal, and it was easy. It was fun, we owned the territory, we knew it was ours. But we generated too much pride, self-confidence, red tape, organization, just because of our great victories for so long.

We've gone through a number of years where things have been just too easy for us. Now, we have to change the way we're doing things in order to first of all, survive, and then show the competition how. We want the best all

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"MGMT MEMO" is written by Corporate Employee Communication for the Office of the President. It is written for Digital's managers and supervisors to help them understand and communicate business information to their employees. Editorial Contact: Richard Seltzer, CF02-3/K23.

For Internal Communication Only

KEN OLSEN....
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the way; the best equipment, the best people, the best manufacturing, and the best marketing.

Now I've announced at this meeting the last several years a number of changes that you've seen come to pass and we've had some great success in just aiming in these directions. We set about to get rid of the red tape in much of our selling operation. In Europe, Digital is a different place with tremendous improvement and efficiency. We have set out to equal or get ahead of IBM in disk technology. In some ways we think we're ahead, in other ways we're with them. A major accomplishment. We have gotten now to the position in our semiconductor technology that we rate with the best. When it comes to laying out complex computers, we know how to do it.

When we aim our guns at something, we're good. When we generate red tape, we're extra good at that. The problem is that red tape people don't have dreams. The red tape in itself is the goal. We have to turn that around. We have to have dreams for products, dreams for the customers and dreams for marketing those products, and then budget for them. Now budgets and controls are important. In all areas, we have to have our dreams, know exactly what they are, and know exactly where we aim the guns. The red tape, the budget, the controls, and the data are only there to help.

When we moved a group to Colorado Springs, away from the Mill, great things came out of it. I was out there just a few months ago. It's a beautiful feeling; just being free of stifling management and overhead. We had a couple of other groups recently which said they had to get as far away from Maynard as possible in order to carry out their plans. We set one up in Seattle and one outside of San Francisco. They had dreams. We gave them the money and the freedom. And it looks good.

Now there are some factors involved in that. You've got to have a competent leader-manager-dreamer to pull off a move like that. Very few people can go to Seattle and open up a shop and accomplish great things. But we've got to find those people and give them the freedom to do it.

If we're going to survive, we have to measure Engineering by quality and by the speed of getting products out. We have to measure the organization by how many people are generating products and how many just guard them, watch them, budget them, schedule them, and say no to new ideas.

When we had simple-minded, old-fashioned management, you laid out a plan. It was your plan and when it was accepted, it was yours and you ran with it. You made it work. If it didn't go right at first, you corrected it and made it work. Now, all too often people just collect all the data and bring it to top management and say 'Here's the data. You make the decisions.'

We've got to change our rules. We have too many of them. We've got to sell.

It's fun to have a goal. If you're a good tennis player, it's fun to play with a good tennis player. (So, I've been told...I don't play tennis). Now that we have obvious competitors, we can do so much to solve the things that are frustrating us. I want to win, and we'll have fun doing it. We'll get products. We'll learn to sell. We'll use red tape, budgeting, and data collecting to help us rather than hinder us. And the competition better watch out because we're experienced, we're the experts and we intend to win.

JACK SMITH: WINNING WITH INTEGRITY

There have been many times in Digital's history when we needed to change. We've made those changes no matter how difficult. We've succeeded.

The truth is we still have some problems. We've had some disappointing booking quarters, but the trend seems to have changed. We now have good, competitive products but they have to be marketed and sold. We've been late to market with many major new products. It's obvious from our profit situation that our costs have out-raced our ability to generate revenue.

We are at war. Being at war, we have to identify our enemies. Once we understand our enemies, we must understand our battle plan, our future and how we will win. The competition isn't coming. It's here and it's been here for quite awhile. So we're going forward as a team and we're going to win with integrity.

Basically, we have two enemies. The first enemy is on the outside. It's obvious that IBM is going to be into all our markets, and there are other, smaller companies nibbling at our markets.

A recent issue of Business Week magazine had 30 ads for products competing with ours. The message in all of those ads was very similar: "Our products can solve your problems." We have to keep in mind that our customers think of themselves as individuals. But, in reality, 90 percent of them use the same CPU, peripherals, and software packages; basically the same technology to solve their problems. They don't understand this; they don't want to understand it, and they don't need to understand it. They just want to be treated as individuals. We have to put all our resources into making our customers feel that they are what counts to us. We have to be smarter than the competition.

Our second enemy is internal: our "business as usual" practices. The bureaucracy, the inaction, the inward focus -- these are the things we have to change. These are the internal enemies.

A couple of years ago we had a manufacturing plant managers' meeting. We said we have to get 20 to 25 percent better. When you added up the inflationary costs of material, the inflationary costs of labor, the inflationary costs of overhead, and considered pricing and the relationship of cost to price, the message was simple. We had to double output without adding any more people. That's not "business as usual."

In the past, growth was the most significant change that we had to deal with. But, volume alone won't solve our problems anymore. During previous recessions, we had a profit plan backed up by hiring. When we stopped hiring, the relationship of our cost to revenue would come back in line. But now with Manufacturing already trying to double its output without adding people, a "no-hire" strategy cannot solve our problem. This isn't true just of Manufacturing. Everyone has the same problem. No matter what you do, you're going to have to double your output with the same number or fewer people.

We have changed the way we're going about doing our business. Most recently we changed the committee structure. I think this is going to prove to be

one of our most significant changes because more senior people will now be involved in the direction of the company. We're also getting the tactical aspects of our field operations closer to the customer.

In Manufacturing, we've changed the way we look at backlog and inventory. In the past we thought more was better. But, we've discovered that weeks of backlog and inventory really don't give customers more service. The way you give better service to your customers is to understand them, be close to them and react to their needs as quickly as possible.

Another significant change is the elimination of Final Assembly and Test (FA&T). We're at the point now where about 35 percent of our shipments that hit the customer's dock are dock-merged. Also, in engineering, we're now operating in many new small exciting places such as Taiwan; Seattle, Washington; Reading, England; Mountain View, California and there will be more.

You don't get productivity from having everybody run in nine different directions at the same time. You don't get productivity by having everyone internally compete with each other. You don't get productivity by having different goal sets. You get productivity by making clear what you want, making sure that people who have to carry out plans understand their individual tasks, and everybody pulls in the same direction. Productivity means everyone working toward the common goal set, understanding their jobs, and being measured in those jobs.

We must work smarter, not harder. In the past, we really haven't been particularly successful in those areas where we've applied massive resources. Rather we've made dramatic strides in the areas where we took a hard look at what we were doing and then did it differently with small groups.

The greatest productivity suggestion I've ever heard is "don't do it all". The second greatest is "do it right the first time". That approach will eliminate 35 to 40% of your cost. Just think about the mechanisms that click into place when we don't come out with a new product on time. You have to order more of the old product, slow down the material on the new product, change the message to the customer, pull back the order, get the new order, move in the order -- chaos. Instead of correcting what we didn't do right the first time, all of this energy should be directed towards the customer.

There are a couple of messages I want to stress. First, to win in an increasingly competitive marketplace, we have to change. Secondly, all of us have to become closer to our customers. We have to put the spotlight back on our customers. In addition, all of us have to start pulling together--understanding what the customer needs and heading in the direction of what the customer wants. When we do that, we're helping our account managers, our sales force and getting closer to the customer.

So what's our future? How are we going to win?

We have the ability to win, but its going to take hard work. The true strength of Digital in the past and the true strength of Digital in the future is our ability to change. It's up to us to understand the need for change. We have the best people. We have the will to win. And, we will win.

WIN HINDLE: TARGETING THE CUSTOMER

Our financial results in FY83 are less than they were in FY82. This has been brought about by the recession and the fact that we haven't been as quick as we should have been to predict some of the changes in our competitive environment.

Competition from both large companies, such as IBM, and smaller start-up companies has been an important factor. It has caused us to change our pricing so that we have less spread between our costs and our operating profit. And because we have less profit, we have less money to spend.

In FY84, our spending for people and programs has to be less than it was in FY83 except in those areas where we are directly creating revenue. We probably have about the right number of people as we go into FY84, but unfortunately that population is not in the right places. We need more people in direct contact with customers, selling and servicing the product. We need fewer people in staff roles. So the challenge in FY84 is to put the population in the right places.

We want to keep all of the good people at Digital. But, we need to work toward leaner staffs, which means cutting down on staff work. While we work to reallocate our human resources, we want to remember that good staff people can be turned into excellent line people.

There has been significant progress in simplifying our organization. I am very optimistic about the opportunities we have.

We have a number of new and exciting marketing thrusts. We have a two-pronged thrust into business applications for small and large companies, and a strong thrust into office applications. We also have the re-seller group which has been known as the personal computer group. They are responsible for selling our products through re-sellers to end-users, and for base product marketing in the terminals and personal computer area. In the Manufacturing-Engineering market, we've combined the MDC and the ESG groups to coordinate our marketing thrust into the manufacturing and engineering automation area. The Large Computer Group will work to bring DECsystem 10 and 20 customers into an integrated Digital architecture so that they can continue to use all of the capabilities of the DECsystem 10 and 20 software, while benefiting from our developments in networks, clusters, personal computers and communications.

OEMs are another major marketing focus. We want OEMs in the future who will go after different markets than we target directly. Those OEM customers that we've supported for many years, and which are in competing markets, will continue to be supported effectively. Our major thrust in future OEM markets will be toward those which cover the markets where we're not able to go directly.

Finally, we have the Technical Group, which along with OEMs, is one of our oldest and most respected markets. We have a high market share in universities and laboratories. We intend to keep that high market share. Our strategy is to make sure that the leading researchers and educators around the world continue to use our equipment.

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Ed Kramer, as vice president of Corporate Marketing, is responsible for making sure these marketing thrusts are coordinated. The next step in our marketing development is to create engineering-marketing teams which work together, providing plans for the company that can be executed once they are approved. We want teams to come forward and tell us their plans, their dreams, and their ambitions. We want these teams to work in a coordinated fashion.

The field has been placing operational responsibility closer to the customer by emphasizing account management. In addition, we are putting administrative functions in field centers. We already have the top service organizations in the industry - field service, software service, education service. There's nobody in the industry that has equivalent strength in these service capabilities.

There are several simple messages that I want to stress. They involve serving customer needs in our individual jobs, increasing revenues, building quality products, and supporting groups that are dependent on us for their success in meeting their plans.

Something in what everyone of us does has to support the customer base. If you trade positions with a customer in your mind, are you doing the things which the customer would want most? You've got to put yourself in the customer's position to see whether what we're doing serves the needs of the customer.

Each of you has to understand how your job helps increase revenues because that's how you measure your productivity. The more quality products we build and the more aggressive and clever our marketing, the greater our revenues will be. There are many ways to increase revenue, but every job has got to have that element in it. And I'd like you and the people who work for you to think about it that way.

The third thing I'd like you to think about is how cooperatively you work with other groups. There is no group in the company that exists in a vacuum. Your plans effect other people's plans. Are you being sensitive to working with other groups in a supportive fashion?

We're in a challenging time. But, we have a new marketing approach, strong products, and great strength in our field organization. We will succeed in proportion to the dedication each one of us gives to supporting the customer and one another.

BILL THOMPSON: MAKING OUR BUSINESS MODEL WORK

My objective is to take a look at the business model of Digital to help you understand where we have been, where we are and where we are going. I hope this will help you better understand some of the changes that have already taken place and those that must take place.

In FY82, we missed our NOR budget. This began to put pressure on our operating margin, and we began to take steps in terms of hiring delays, frugality and discretionary spending. We tried to modify the situation. We were able to maintain our profitability because we delayed hiring plans. It became clear as we went into FY83 that we were not going to reach our projected volume. As a result, operating profit dropped dramatically despite the actions we had taken.

Now if we begin to dissect our business model, there are some bright spots and some challenges before us. One of the bright spots is our service business. There has been a strong, solid steady growth of all the service businesses. They have all done an excellent job, even during the recession, in delivering steady, predictable growth at an excellent profit for the corporation.

You see an historical steady growth and profitability in our hardware business, which is our bread and butter. But in FY83, serious price competition has caused a deterioration in the profit of our hardware business. In FY82 and FY83, we have roughly the same net operating revenue, but profit decreased because, in absolute dollars, the hardware business is delivering less now than it did in FY82. This profit trend obviously cannot continue. Plans call for aggressive growth in the order rates into FY84 despite the continued price competition.

Another way to look at the business model is to look at the hardware gross margin of the corporation. Despite improved productivity, despite all the things that we did and the challenges that we set for ourselves and met, the outside world intruded with its pricing structure and caused the gross margin to go down.

In our efforts to reduce expenses, we were careful to continue investing in critical areas--for example, Office Automation and Small Systems. Engineering was the most significant place we put money. The investment between FY82 and FY83 represents roughly an increase of \$110 million. This is money the company invested in our future, in new products, new technologies, and new opportunities. In other words, in the face of less dollars available, we put over \$100 million in additional spending in Engineering. To continue that level of investment, we must have more volume and some of those Engineering investments have to come to fruition as timely, competitive products.

Two other areas where we invested funds, in a modest way, were sales and advertising. This amounted to about \$25 million each.

BILL THOMPSON....
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Looking to the future, I have great hopes for the new organization. It is leaner, meaner, and better focused. I believe the economy will support a return to growth and that our engineering investments will result in more leadership products. But we are in a different competitive arena, and I am afraid we will still have lower gross margins. So, to retain the business model, we're going to have to work on the expense/profit side of the picture and the asset side. We have to get better in inventory and receivables and asset utilization.

All of the company's costs, except for investments in Engineering, have to be absolutely flat in dollar growth in order for us to achieve a healthy profit picture. This is the productivity challenge which management must meet. We have to do 70 percent more because that same pressure will continue with no more dollars to do the job.

We've got a job to do. We've got to do it professionally. But we've got to get that job done without redundancy. The low-end of our product offering is building. We don't know the specific trajectory, but the orders are coming. Manufacturing is rolling and we have quality products. Our service businesses are our constant strength. The order rate has improved consistently. We have productivity increases. Although it has not been easy, we have managed expenses.

What must we do? Whatever we can do to focus on volume will help us. We have to be more productive. We have to look at why are we doing some things. We must re-allocate resources to attack the most critical problems. We need a lot of management effort to figure out how we do that effectively. Clearly our human assets are one of the keys to our success.

Timeliness is important! A new product brought out on time provides a far higher margin than a product that is late. So one of the things that all of us can do is to make sure that we bring products to market on time. With that we will get the higher margins which will relieve some of the business model pressure.

I believe the people in this room have the ability to meet the financial goals of our corporation and all the other goals of excellence that we have. To do so, we must be willing to do these three things: manage, which means making the tough decisions and the tough choices and making sure that things happen; motivate, which means stimulate people to understand the changes, to accept the changes and to see and share the new vision; and communicate, which in our company is very, very critical. I believe that if the challenge is clearly communicated to people, they will rise to it. We have the talent and the products to succeed providing we can focus our resources at a clear goal.

KEN OLSEN: WINNING AT THE LOW END

We weren't sure which approach was going to be the winner in personal computers. So we tried three: the Professional to take advantage of the PDP-11, to use proprietary software and to make the best quality machine we could think of; the Rainbow to use industry-standard CP/M software; and the DECmate to exploit the 20 years of experience and magnificent software that we have on it. In addition, we also developed a low-end multi-user PDP-11 minicomputer. That strategy was smart. Things didn't work out precisely the way we thought, regarding which machine would do better in the marketplace, but the overall result was just as planned: we have the products that people want.

We have a tradition of doing a good job of supplying many markets with many products. However, over the last year, this has resulted in turmoil over our low-end strategy. These conflicts over prices and budgets have helped us sort through the differences between the OEM business and the end-user business, and between personal computers and minicomputers.

A minicomputer, as we defined it for the last 25 years, is a machine that will do anything for anybody, grow to any size and connect into anything. Usually, it will take any number of users, limited only by the computation capability of the machine.

Sometimes you see a little minicomputer all by itself. But it is not unusual to see a whole wall of equipment with one little Digital minicomputer running the entire system. We accomplished this tremendous freedom by using a bus structure so users can add components as their needs grow. We also have standards in our software so all the pieces work together and the computer feels the same to the user as systems are expanded.

From one point of view, we arrived at the personal computer by cutting down a minicomputer. By definition, it's a one user machine, limited in potential growth, in power and in capability. The result is a machine that is delightful, exciting, even thrilling for many applications. But we must remember that it's smaller because it is limited. It uses the same computer chip, the same technology as our minicomputers. It's filled with cleverness, but it's a limited minicomputer.

When you want a limited machine for personal computer-type applications, our personal computers win hands down. When, however, you want your computer to grow beyond a certain limit, the minicomputer wins hands down. That's the way we designed it. When you want to do real computing, minicomputers win.

Personal computers are so easy to use that, at first, they seem like the answer to all of life's problems. It seems like we should make them bigger and bigger, and put them together in clusters, and everything will be great. But the world doesn't work that way.

If a computer is designed to grow, designed to be a real computer, it isn't going to be a personal computer on a desk. When it comes to a contest in size and capability, the minicomputer wins.

Our strategy has to sort out minicomputers -- growable computers -- from personal computers. Over the last few months, that distinction has been getting much sharper.

We also have to take advantage of the bus structure way of designing; so we design a component once and use it in many different systems. We're experts in the bus way of doing things, but we have to start applying that in our personal computers.

Our discussions about the low end have led us to realize that there are three separate low-end market areas: OEM, end-user and re-seller. The OEM is a traditional Digital business. End-user groups sell to customers directly with our sales people, through our own stores, and through independent retailers and dealers.

Re-sellers represent another large market that can be separated from our other efforts. There are about 10,000 micro-dealers -- small companies that are experts in business. They aren't just retailers who sell computers like lawnmowers. They are people who solve problems for customers. They would like to carry our equipment. But these re-sellers are in direct competition with our end-user sales efforts and often feel in competition with some of our OEMs.

Our OEMs add to our product, or make our product part of theirs. They cover many of the applications that we can't do ourselves. Re-sellers sell our products in close contact with the customer.

We've done well in parts of all these markets. We're developing a strategy that separates them so we can focus attention on the needs of each.

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This concludes the State of the Company
Meeting portion of "MGMT MEMO." Please
be sure to share this information
with your employees.

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CHANGES IN HIGH-END STRATEGY

Digital has decided to forego development of a new 36-bit high-end processor, known internally as "Jupiter." According to Win Hindle, vice president, Corporate Operations, "Recent Computer Interconnect and Ethernet local area network product announcements have led us to the conclusion that the future needs of our DECsystem-10/20 customers will be better served by providing them with the ability to integrate their systems into Digital's Distributed Computing Architecture. Rose Ann Giordano and her group are responsible for carrying that strategy forward and making sure that we have a high-end marketing strategy that encompasses both our 10/20 and our large VAXs."

Development on existing DECsystem-10/20 products will continue, including extensive communications capabilities, associated hardware and software support for the TOPS-20 and TOPS-10 operating systems, and a set of mass storage products.

At the State of the Company Meeting, President Ken Olsen explained, "The 10/20 was designed in the early 1960s. It's a tremendous success story. It's probably the longest running machine of significance in history. But with the new technologies, with personal computers and what we do to tie computers together with networks and clustering, and developments underway for the VAX, it's time that we simplified our high-end strategy. After almost twenty years, we cannot simply keep doing things the old way."

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BEN FORDHAM TO HEAD ORGANIZATION CONSULTING TEAM

To support line managers responsible for implementing various changes initiated by the new corporate Committees, an Organization Consulting Team is being established, with Ben Fordham as manager. Ben, who has been with Digital since 1977, most recently worked with the team guiding the movement of Marketing Operations to the Field Organization. In his new position, he reports to Win Hindle and John Sims.

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DIGITAL IN THE PRESS....

In The Fifth Generation: Artificial Intelligence and Japan's Computer Challenge to the World by Edward A. Feigenbaum and Pamela McCorduck, Engineering Vice President Gordon Bell is cited for his concern about the Japanese threat to the survival of the American computer industry. The chapter titled, "Are there any more American Heroes," describes Gordon's efforts in establishing the Microelectronics and Computer Technology Corporation (MCC), for long-range technical advances. Published by Addison-Wellesley, 1983, the book sells for \$15.55.

DIGITAL SUPPORTS MIT IN MAJOR EXPERIMENTAL PROGRAM IN COMPUTER EDUCATION

Digital has agreed to collaborate with Massachusetts Institute of Technology (MIT) on a five-year project to integrate the next generation of computers and interactive graphics into undergraduate engineering education. IBM is also working with MIT independently to introduce computers into the non-engineering departments.

Digital's contribution, the largest in corporate history, totals over \$30 million in equipment, software, service, maintenance, support, research grants and on-campus personnel over the five-year period. In addition, MIT has begun a campaign to raise \$20 million in grants to provide funds to sustain the project.

The program, called Project Athena, is based on the premise that computers with advanced computational and graphic capabilities represent a revolutionary new learning medium.

Senior engineer Ed Balkovich will represent Digital at MIT as associate director of Project Athena. Four other Digital engineers will be on the MIT campus to develop and evaluate the system.

Sam Fuller, manager, Corporate Research and Architecture, believes Athena will effect the long-term direction of computing. "This is the most ambitious research project Digital has ever undertaken," he said. "We believe it will provide us with insight into how the engineer of the future will work. It's a breeding ground for new engineering opportunities which can be tested in a research environment."

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