Microsoft, Manufacturing Partners Become 'Frenemies'

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LOS ANGELES (AP) — With the launch of its Surface tablet computer, Microsoft is becoming a genuine "frenemy" — part friend, part enemy — to its longtime manufacturing partners.

Since its founding 37 years ago, the Redmond, Washington state, company has had a mutual understanding with makers of computer hardware: Microsoft creates software.

Companies such as Dell, HP, Acer and Lenovo pay Microsoft a licensing fee to place the Windows operating system on the desktop PCs, notebooks and other gadgets they market to consumers.

Now, Microsoft is complicating the cozy relationship by making and marketing its own tablet computer. The company announced Tuesday that the Surface will start at $499 when it goes on sale Oct. 26. The new tablet is set to invigorate an already hotly contested market for touch-screen computers. But for the first time, Microsoft will be in head-to-head competition with partners that help generate sales for its $14 billion-a-year Windows software business.

Microsoft is no stranger to manufacturing hardware, but it usually does so in businesses that are sideshows to its mainstay computer software. It has made the Xbox game console since 2001, for instance. It also made the Zune music player and Kin line of phones, although both were short-lived.

CEO Steve Ballmer insists Microsoft Corp. must move into manufacturing to bring consumers "delightful, seamless experiences" that they can enjoy "right out of the box," according to a letter he wrote to shareholders recently.

Of course, it's not just for the sake of consumers. The strategy of making both gadgets and software could pay off for Microsoft, too.

The company is coming out with a new version of Windows next week, one that is optimized for touch-screen devices and will run on tablets and PCs. Every time it sells a Surface, analysts say, Microsoft will record some revenue for the Windows 8 operating system. Manufacturers that build competing Windows 8 tablets will pay Microsoft a fee, estimated between $30 and $80 per device.

That's a big expense, especially considering that manufacturers are allowed to use Google Inc.'s Android operating system for tablets and smartphones for free. The extra cost of making Windows 8 tablets could put Microsoft's partners at a disadvantage in a cut-throat tablet market.

"It's always tough when you're competing with your partners," says Shaw Wu, an analyst with Sterne Agee. "That's what Microsoft has decided to do."

The expense also comes at a time when tablet prices are dropping.

In the past few months, Google Inc. and Amazon.com Inc. have undermined tablet leader Apple Inc. with 7-inch (17.8-centimeter)-screen tablets using Android. The cheapest goes for $159, which barely covers manufacturing costs.

Apple, too, is expected to downsize its iPads with a mini version that might also give consumers a less expensive tablet option ahead of the holidays.

Having a product that is priced well above these smaller offerings will give Microsoft's partners a better chance to make a profit. The downside? Windows tablets may be too expensive to become a popular stocking stuffer this Christmas.

Microsoft's Surface has a 10.6-inch (26.9-centimeter) screen, slightly bigger than the iPad's 9.7 inches (24.6 centimeters). Unlike the iPad, Surface also has the ability to run Office and other Windows applications. That, plus its optional touch keyboard cover for $100 more, may enable the devices to cross the productivity gap between tablets and PCs.

Several of Microsoft partners are trying — at least publicly — to remain upbeat about their coming competition with the Surface. At a recent event showcasing Windows 8 tablets in San Francisco, a Lenovo executive said Surface highlights the advantages of Windows 8 and encourages the development of more applications for the system.

"Surface is about Microsoft standing up and saying, 'We want to make sure the market understands the importance of Windows 8,'" said Tom Butler, director of ThinkPad marketing for Lenovo. "All the Microsoft Surface announcement does is help validate the ecosystem that we all want to see develop around the new interface."

Dell Inc., the second largest PC maker in the U.S., also believes Surface will spur more interest in Windows 8, says Bill Gordon, the company's executive director for end user computing.

"We think Microsoft is trying to build the market, so we think it's great," Gordon says. "They are just trying to generate more excitement. Google did its own devices for Android, so I think it's kind of the same thing."

To warrant prices on par with the latest iPad, which also starts at $499, Microsoft needs to prove that the Surface is a more powerful tool. Early demonstrations suggest that Surface and other Windows tablets could be of interest to large corporations, many of which have created internal software that operates on the Windows platform, says Rhoda Alexander, an analyst with market research company IHS iSuppli.

"They're looking for a secure tablet solution that will support legacy operations," she says.

IHS sees worldwide tablet sales exploding in the next few years from 19.9 million units sold in 2010 to 386 million in 2016.

This year, Apple's iPad is the dominant player, with 62 percent of the market, compared with 34 percent for tablets using Android and 3 percent for tablets that run on an older Windows operating system.

But Windows' share is expected to blossom. According to IHS, by 2016, its tablets will have nearly caught Android, with a 24 percent share compared with Android's 29 percent. It predicts Apple will still command nearly half, or 47 percent, of the tablet market.

Whatever the potential downsides to Microsoft, its entry into tablets is seen as crucial because the PC market is expected to decline this year for the first time since 2001.

"The worst thing that can happen is stagnation in the market," Nomura analyst Rick Sherlund says. "At least (Microsoft is) getting in the game now."

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