Microsoft finally put an arduous executive recruitment process to rest by naming one of its current executives, Satya Nadella to the CEO post, replacing Steve Ballmer.

When Steve Ballmer announced his plans to step down in August 2013, the immediate speculation centered on whether the company would recruit from outside, or from within the company. There were clear benefits associated with either approach, as an outsider could bring fresh new ideas to the company, and would have the benefit of not carrying a lot of political and cultural baggage from having worked at Microsoft for years prior. Any outsider coming to a culturally-strong company, and one as internally focused as Microsoft, would have had to establish clear credibility with a large and influential group of technically elite employees – something that probably was a deal-breaker for some candidates.

The alternative of hiring from inside would not face any cultural challenges, but would put a new CEO in the uncomfortable role of having to make difficult decisions that positively – and negatively – affect different parts of the business. Long-standing business practices need to be questioned, re-evaluated, and in some cases changed. Would an insider be willing to take on such challenges, or could an insider even fully recognize the different areas where Microsoft's business needs to evolve and respond to industry changes?

The selection of Nadella is an acknowledgement that internal morale is one key lynchpin for future success with any initiative the company takes. Microsoft is known for powerful internal division heads and while the "One Microsoft" reorg addressed this same issue, the effectiveness of the reorganization now rests on Nadella’s shoulders who must marshal consensus, drive the vision and make the company considerably more agile.

As an insider, Satya Nadella has broad internal credibility, and already has a full understanding of Microsoft's business. The benefit of being an insider means he needs to spend little or no time learning about Microsoft's business operations. Nadella is a seasoned executive who has held multiple vice present-level roles in the Microsoft Business Division, Online Services, and most recently, in the Cloud and Enterprise group.

Gates is Back
Of particular interest is the news that Bill Gates is coming back to spend a third of his time at Microsoft. While this move may be marshalling internal alignment, it also provides Nadella a co-pilot that can help him learn the ropes as he takes on significantly more responsibilities including overseeing worldwide sales and other corporate functions. Gates remains highly respected internally, and it comes as a surprise that he returns given earlier statements.

While comparisons with Steve Jobs' famed return to run the company will likely be cited, IDC believes that this is a change of a different color. Unlike Apple then, Microsoft is a highly profitable and growing company, and Gates has remained continuously involved in steering Microsoft as the chairman of its board. Gates is stepping down from the Microsoft board most likely to create the bandwidth needed for his new role along with his significant other commitments at the Bill and Melinda Gates Foundation.
While Bill Gates is a technology visionary, we believe he needs to be utilized as a resource with a fairly narrow scope – where he can make a significant impact on a very small number of transformational innovations. As well, this needs to be Nadella’s company, with one person installed as the clear leader. Therefore we believe the long history that Nadella and Gates have as Microsoft business leaders will be an asset, where Nadella will be able to say “no” to Gates when he deems necessary.

**Challenges Abound**
While Microsoft just completed a record quarter with $24.5 billion of revenue, the bulk of the revenue growth came from Devices and Consumer Hardware (Microsoft Surface and xBox), and from continued expansion of Nadella's business, the Cloud and Enterprise Engineering group. The Cloud and Enterprise Engineering group, which is primarily made up of the former Server and Tools Business unit, has been a perennial producer, growing at upper single digits to low double digits for years. While we would expect that business to continue to be healthy for years to come, it is not where the explosive growth is or will be.

Microsoft's revised reporting segments, which were introduced at the start of the company's fiscal 2014, split out device revenue and cloud revenue into two largely independent categories. The recent 2Q FY2014 results showed strong year-over-year growth of 218% in the Devices and Consumer Hardware segment, where xBox and Microsoft Surface revenues are captured. This growth, however, came at a low profit margin. The cloud business, which is included in the Commercial Other segment, grew year over year at 28.1%. Those two businesses collectively accounted for 26.5% of Microsoft's revenue in Q2. However, in Q1, those same businesses only accounted for 16.7%. Can the company sustain that growth going forward?

Microsoft's vision and aspiration to be a full ecosystem provider remains in place and is the right one, but the company has to iterate faster to constantly adjust its vision to emerging realities and has to articulate how its various businesses contribute to this vision. IDC believes that a full ecosystem vision is essential for long-term relevance, and that if Microsoft executes well, it can still present an effective ecosystem competitor to Apple, Google and Amazon in the long-run.

The company's investments in its Windows Azure product, and in the network of global datacenters that support online products including Windows Azure, Bing, Windows Intune, Dynamics CRM, are enormous and it is questionable if the investments have begun to pay back in a meaningful way. However, the company's approach has always been a long-term strategy – and while that is the right strategy for cloud and 3rd platform solutions, investors remain highly concerned that Microsoft is lagging Amazon, Google and other large scale service providers. This is a business area where Satya Nadella has had years of hands-on experience, but he needs to clearly demonstrate that Microsoft can compete with, and beat, these other mega-providers.

There are other areas, however, where Nadella has not had first-hand experience, including with some of the application and device businesses.

Devices, in particular, remain a significant challenge for Microsoft. After damaging relationships with some of its biggest partners—the PC OEMs that helped drive the success of Windows—Microsoft's Surface products have failed to have much impact in the market. Launched at the same time as Windows 8 in late 2012, the first iterations suffered from Gen1 design issues and too-high prices.

After taking a substantial financial write down in 2013, and launching a second generation of improved but still pricey products, Microsoft finally seems to be figuring out how to market the devices. Shipment totals remain low, but it’s clear the company plans to stay the course with Surface. How the existing Surface team will be merged with the incoming Nokia hardware team remains to be seen and will likely be heavily scrutinized as a key indicator of Nadella’s ability to lead Microsoft going forward. Convincing OEM partners to continue to build Windows-based devices as the company ramps up production of its own will be a challenge, especially considering that Google’s free operating systems come with no such conflict of interest given its planned sale of Motorola Mobility to Lenovo.

Nadella will also be tasked with continuing the work to mend fences with OEMs such as HP and Dell, stung by Microsoft's Surface launch and further damaged by the public's poor reception of Windows 8 and Windows RT. Dell, among Microsoft's most stalwart supporters, was among the few OEMs willing to ship
products running the doomed Windows RT, a version of Windows designed to run on low-power ARM processors. Windows RT continues to flounder in the market—only Microsoft and Nokia continue to ship devices with the OS—and its fate is one that Nadella should address early in his term. Also, commercial buyers continue to steer clear of Windows 8, concerned that its reliance on the touch-first Modern UI will hurt worker productivity. As a result, most commercial buyers are buying PCs running Windows 7 (or are doing in-place downgrades as permitted by Microsoft's licensing of professional grade products). This isn't a tenable situation for Microsoft, and it must address the needs of commercial buyers more effectively. IDC believes that Microsoft has come to terms with most of these market realities and a future Windows update is likely to bring back additional desktop functionality to non-touch Windows users, a wise move in our estimation.

Another key issue Nadella must address is ongoing problems with its flagship suite Office. Nearly 16 months after the launch of the touch-first Windows 8 operating system, Microsoft has still not shipped a version of Office designed to run in the operating system's Modern UI. Plus, it still hasn't shipped versions of Office for Android phones and tablets, and has not shipped a version optimized for the Apple iPad.

To date, Microsoft has attempted to use Office as the carrot to drive adoptions of Windows-based tablets and phones. It's a strategy that has simultaneously failed to drive adoption of these devices and put at risk Office's dominance in the business productivity market. The company is not only leaving a great deal of money on the table, but it's also forcing tablet users to find alternatives to Office. That's not easy to do in mature markets where Office is well entrenched, but in emerging markets where Office doesn't yet hold sway, it is much easier. Eventually these alternatives—including free offerings from Google and Apple—will be good enough, and Microsoft will have lost yet another important market. The new CEO has to consider how to move more aggressively to push Office to non-Windows platforms. Microsoft must come to terms with a new multi-platform world and leverage it to its advantage.

The company has to move faster in its R&D cycle, and that is where Nadella, of all other CEO choices, is best suited. Microsoft has already shown more agility in execution with the delivery of Windows changes faster than before, but remains hobbled by the massive code-base and its accumulated complexity. Thinking outside of the box here and making big decisions on how to better integrate Open Source into the mainstream workflows inside the engineering team will be critical for improving this agility. The new CEO also has to re-invigorate the Microsoft developer ecosystem. First on the agenda is should be developing a unified smartphone and tablet platform that run the same apps. Almost as important is ensuring that desktop application developers see a viable long-term platform that receives continued investment and evolution.

Finally, one additional challenge is the company's aging licensing program. Built in a period when customers were highly integrated with Microsoft products from top to bottom, the influx of devices if all sorts including Android and iOS tablets, phablets and phones, and an increasing presence of Mac OS X on PCs in BYOD to work scenarios is changing the game. Microsoft's classic licensing program, which relies on Software Assurance subscriptions for customers to access many of the technologies required to support BYODs has failed to keep up with the changing needs of the market.

Conclusion
This move is a good choice. It is about the future of Microsoft. A future where creating next generation products and services are more important than protecting past "hits". Microsoft is fighting for relevancy in too many markets where just a few years ago it was unchallenged. Nadella needs to move quickly to develop products and services that customers crave— not have to use. This starts with product and service innovation. As with any new CEO, there will be a period of adjustment, but Nadella will need to make clear that he can bring new thinking to the table, and can drive those new ideas through the company at breakneck speed.

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