To Our Shareholders

This is my first report to you since Interleaf became a public corporation, and I want to welcome you as Interleaf shareholders. By way of introduction we enclose our Prospectus which not only tells who we are but demonstrates in the most graphic way possible what we do— provide systems and software for electronic publishing. The entire Prospectus was created and edited on an Interleaf system in our Cambridge office. Because our first stockholders' meeting as a public company comes so soon after completion of our initial public offering, the Prospectus also doubles as our 1986 Annual Report to Stockholders.

Comments on Financial Statements

Interleaf had sales of $18.6 million in fiscal 1986, which ended March 31, up from $8.3 million in the previous year. Our net loss was $2.4 million, as compared with $1.6 million for 1985. Net loss per share was $.29.

Fiscal 1986 was a year of growth for the Company— growth in revenues, customer base and number of employees. It was also a year of investment in product development, OEM relationships, and in our own direct sales force. We believe that these investments are helping to position Interleaf as the electronic publishing market leader.

Our distribution strategy focuses both on our direct sales force and on our OEM distribution network. Our domestic direct sales force is well established, and accounted for three-quarters of our revenues in fiscal 1986. To truly become an industry standard, however, Interleaf needs the distribution channels our OEMs can provide. Most of our OEMs are only now beginning to deliver our products, and so the Company has yet to realize substantial revenue from them.

Product Development

In January, 1986, Interleaf released version 2.5 of its TPS® software— a significant advance in product functionality. Release 2.5 included such important new features as multiple-column text editing, automatic hyphenation and justification of text, an "electronic clip art" library of frequently used graphics, and an interface that allows users to incorporate technical drawings done on computer-aided design (CAD) systems into their Interleaf documents.

"Electronic publishing" can mean anything from using a computer to create a two-page newsletter to writing, editing and revising a 500-page manual, complete with illustrations. This latter application is where most of our current customers fit in, and much of the new functionality of Release 3.0, which is scheduled for delivery this fall, addresses the needs of long-document assembly and management.

With Release 3.0 users can, for example, let the software keep track of how section heads, paragraphs and illustrations are numbered and cross-referenced. If an item is

cut or moved, it is automatically re-numbered and references to it are updated. Indexes can also be created automatically—and fast. An index for a 500-page manual can be created in less than a minute. Tables of contents are generated just as quickly.
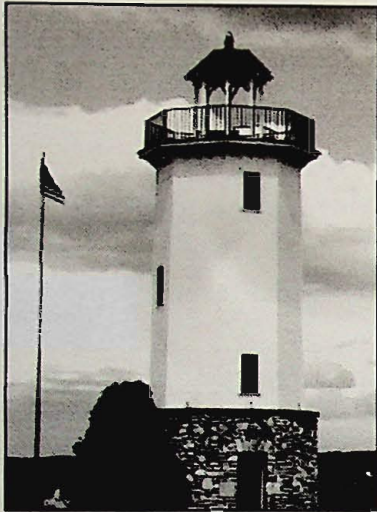
Original Photo

Electronically airbrushed photo with "cloned" flags

We've added exciting new functionality to our image editing software. For example, you can now "paint" on scanned photographs with 256 levels of gray, and perform "blend" and "fade" functions that simulate airbrushing. You can also "clone" an area of the photograph to create effects such as the ones shown here.

Sales and Marketing

Interleaf has recently opened sales offices in New Jersey, San Diego, Detroit, and Chicago, bringing our total to 20. We are also adding new sales personnel in existing offices to help meet the increasing demand for Interleaf products.

In the past several months, this demand has been brought about at least in part by the lower prices announced in March for entry-level Interleaf systems based on the Sun Microsystems Sun-3/50 SunStation and Apollo Computer DOMAIN Series DN3000 personal workstation. Both systems come bundled with Interleaf Technical Publishing Software and an Interleaf LPR-308 laser printer. A similar announcement for the Digital Equipment Corp. VAXstation II was made in May.

These reductions were made possible by price cuts by our hardware suppliers, enabling us to lower prices without adverse im-

pact on our gross margins. We expect to continue to be able to benefit from these hardware price reductions, and to expand the market as a result.

The Company demonstrated a commitment to the establishment of Interleaf software as a publishing standard in universities with the announcement of the formation of a University Software Sales Program in February. Participating universities may purchase Interleaf University Publishing Software (UPS™), which is a special version of TPS, and laser printers at substantially reduced prices. Among the universities already in the program are Brown, Harvard Business School, the Air Force Institute, Syracuse, and the University of Missouri.

Several third-party sales agreements were announced during fiscal 1986: IBM, Digital Equipment Corp., Auto-trol, and Tektronix. All of these companies have agreed to act as third-party vendors for Interleaf's Workstation Publishing Software (WPS™), a desktop publishing tool for users of engineering workstations. We expect to make other significant third-party announcements in the current fiscal year.

An important step towards addressing international markets was taken in November, 1986, with the formation of Interleaf Canada, a joint venture between the Company and the Nexa Corporation, an Ottawa-based venture management firm. Interleaf Canada now has sales offices in Ottawa, Toronto, Montreal and Calgary.

Interleaf also announced distributors for WPS software in Scandinavia, France and Belgium. Nokia, the largest publicly traded industrial company in Finland, is selling Interleaf products in all the Scandinavian countries. Representing the Company in France is Institut de Genie Logiciel (IGL), the leading French developer and marketer of advanced engineering software tools. The Belgian Institute of Management (BIM), which is selling Interleaf products in Belgium and Luxemburg, specializes in office and telecommunications systems.

600-S

In January, 1986, Electronic Data Systems (EDS) with Interleaf as subcontractor, was awarded a contract to automate the U.S. Army's technical publishing operations, the "600-S" Printing Services Contract. On June 20, the Company learned that the Government Printing Office (GPO) had canceled the 600-S contract. The GPO has since announced that negotiations will be reopened with the four vendors who submitted best and final offers for the original contract, but gave no indication of when this would take place.

Governor Dedicates New Corporate Headquarters

In January, 1986, we were honored to have Michael Dukakis, Governor of the Commonwealth of Massachusetts, dedicate our new corporate headquarters in Cambridge. The Commonwealth of Massachusetts was an early investor in Interleaf through the

Massachusetts Technology Development Corporation, a state agency.

Management Changes

Interleaf recognized two individuals who have made substantial contributions to the Company with the promotions of Stephen Pelletier to Vice President, Product Development and Frederick Egan to Vice President, Third Party Operations. Steve joined Interleaf as Senior Engineer in 1983 after holding senior science and engineering posts at NBI and Kurzweil Computer Products. He now manages the development of new technology for our core product line. Fred, previously Director of Third Party Sales, joined Interleaf in 1983 from Wang, where he had been District Sales Manager for Northern New England. He is responsible for the marketing, support and management of Interleaf's third party distribution channels.

In an effort to streamline manufacturing and customer service, a new Operations division was created in May, headed by Edmund W. "Bill" Grossman, Vice President of Operations. Bill came to Interleaf from Encore Computer Corp., where he was Vice President of Customer Service. He has also served as Vice President – Field Engineering Division and Corporate Quality Assurance at Compugraphic Corp. Bill is responsible for Field Service, Customer Support, Technical Support, Production, Materials/Inventory Control, Documentation, Quality Assurance, Design (fonts) and Product Management. Larry Bohn, previously Manager of Technical Publications for Apollo

Computer, joined the Company as Director of Product Management and Planning.

Customer Productivity Gains

Fiscal 1986 was the year that electronic publishing gained visibility as a major market. *Electronic Mail and Microsystems* said it this way: "Desktop Publishing is HOT: It is right on an intercept path that will change the concept of word processing in a way not seen since letter-quality typewriters altered handwriting forever. It is that fundamental a change that will one day rank with major events in the printing industry, coming just below the printing press, the typewriter and copiers in terms of its impact on producing the written word."

Driving the advance of electronic publishing are the benefits to the customer. Chronicled below are typical Interleaf customer experiences:

Rockwell International, Downers Grove, IL
Shortly after the installation of Rockwell's Interleaf system, Technical Publications Supervisor Mike Eleder did a study which found the following: With Interleaf there was a 50% increase in the number of pages per day they produced. The turnaround time went from 20 to 13 weeks, a reduction of about one-third. Most significantly, using the traditional process, nine documents were produced in six months, whereas with Interleaf 11 documents were produced in 2 months. That is a fourfold increase in overall productivity.

Swanson Analysis Systems, Houston, PA
Seminar Coordinators Charmaine Grunick and Leanne Paul have found that Interleaf's

on-line graphics capability has led to heightened productivity. Whereas a 250–300 page manual used to take three people three months to do, with the Interleaf system it takes two of them six weeks, including the time necessary for departmental reviews and revisions. Their productivity increased threefold.
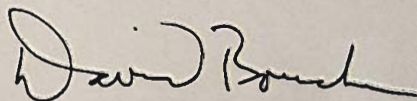
GenRad, Concord, MA

GenRad's Interleaf system replaced a traditional cut-and-paste operation involving daisywheel-produced text, hand-drawn graphics, and legends set on a phototypesetter that were manually stripped in. In addition to moving up to typeset-quality output, GenRad's Interleaf system has simplified the process and sped it up. Bill Collins, Manager of Technical Publications, estimates the entire production cycle of typeset documents has been cut in half, and the quality of the documents has been enhanced.

Electronic publishing is perhaps the most horizontal application yet developed for the computer. Fiscal 1986 was the year in which the industry came of age; during fiscal 1987 we believe we will see it expand even further.

David A. Boucher
President
September 4, 1986

This letter was composed on an Interleaf system.