

Last chance for gear-makers to grow

As technology demand sinks further, the big telecom equipment makers should learn from a proven downturn winner

BY MICHAEL GARSTKA

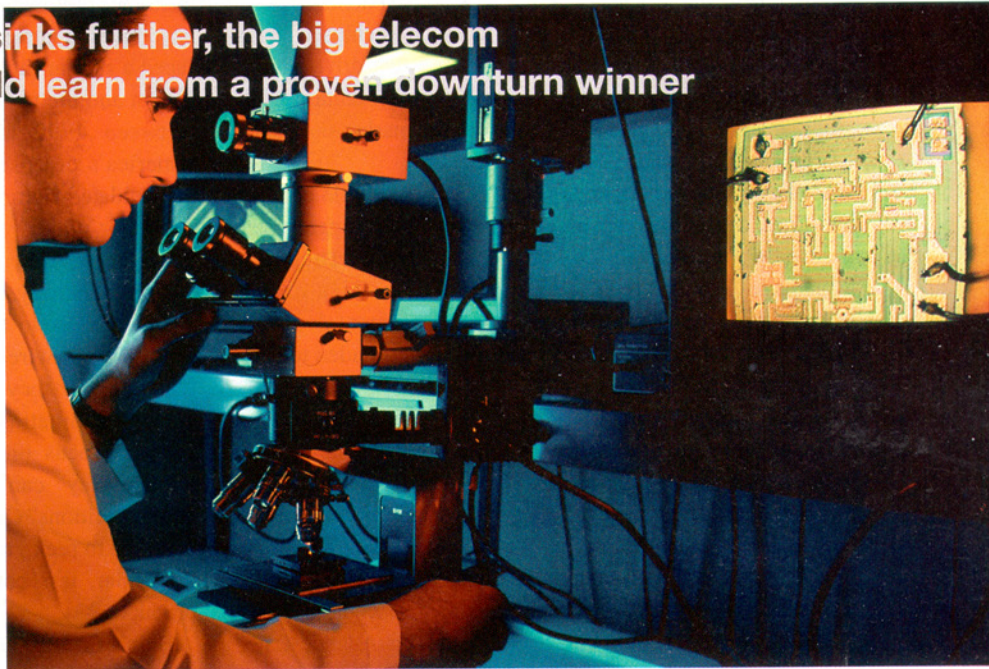
The seven leading telecom equipment makers have lost a combined \$1 trillion in shareholder value since their highs in the first quarter of 2000 — almost equal to the gross domestic product of China. Halfway through 2001 alone, they'd announced more than 80,000 job cuts.

But Alcatel, Siemens, Nortel Networks and other big telecom equipment makers face a problem beyond surviving the current technology downturn: They have limited chances to grow. To better both their odds of surviving and thriving, they need the kinds of solutions put into play a decade ago by defense-industry giants such as General Dynamics.

Consider the defense contractor's actions as glasnost changed its industry. During the Cold War, General Dynamics had grown into a defense conglomerate. But after assessing fundamental changes in its industry — a rapid decline in demand in the early 1990s alongside a shift from cost-plus contracts to cost-competitive ones where specialized scale mattered — General Dynamics gutted its portfolio to focus on products where it could become the market leader. Concentrating on armored vehicles and submarines, it jettisoned many other operations: fighter aircraft, space launch vehicles and guided missile businesses. Since then, General Dynamics' share price has risen more than eight times, outperforming all of the defense majors, the S&P 500, and even the NASDAQ. Its revenues are above its Cold War highs, despite a much narrower product set. And its margins are among the best in the business.

The defense contractor's performance supports the thrust of a decade-long study by Bain & Company. The key finding is that highly focused companies — those with a small number of strongly positioned businesses — did much better than diversified companies over the last decade. In fact, nearly 80% of the profitable, growing companies in our study held a clear leadership position in one core business. Many narrowed their focus to fuel growth, even in lackluster sectors.

But why should the Big Seven telecom gear makers change course so dramatically? The answer lies in an examination of three unrelenting external forces.



Economic structures are shifting fast

The world is changing. The World Trade Organization is opening previously restricted markets. Country-specific standards are converging. Will those factors raise the alarm for equipment vendors? Can they change as fast as is necessary from being all things to their national telecom operators to being the best thing in a few areas to operators around the world?

Consider the equipment makers' roots: Traditionally, they have operated as national champions dominating their home markets. For example, Paris-based Alcatel sold almost exclusively to France Telecom; Munich-based Siemens to Deutsche Telekom. As suppliers of choice to national customers, equipment vendors enjoyed reliable margins and developed broad product lines. Leveraging protected account relationships, they expanded their product portfolios well beyond their traditional central office switch base into fiber optics, wireless infrastructure, mobile handsets and data products.

And country-specific equipment standards reinforced vendors' grip on their account relationships. For example, the Japan-specific second-generation mobile PDC standard helped keep Finland's Nokia, the global leader in handsets, out of the Japanese market, allowing Matsushita and Mitsubishi to dominate there. In that environment, the Japanese manufacturers are earning price premiums of 50% above the prices of Nokia's GSM handsets.

But the adoption of the W-CDMA global standard for third-generation (3G) wireless will eliminate the traditional barriers to market entry in Japan and Korea. As a result, the ultimate driver of

winning strategies will shift to economics and away from traditional local customer relationships. The dominant economic factor is that 70% or more of the cost structure of a telecom equipment maker is typically scalable globally, providing lower average unit costs for the market leader. Increasingly, high-cost new product development is fixed. Manufacturing conversion costs are also heavily fixed. Market leaders can use their global purchasing scale to drive down the unit costs of materials such as chipsets, transceivers and antennas. It is those economics that drive Nokia's superior margins in its handset business, where it dominates the global market with more than two times the market share of its nearest rival, Motorola.

However, few vendors other than Nokia in mobile handsets and Cisco Systems in IP routers and switches are aggressively focused on becoming global leaders in a product segment. Most have expanded their product portfolios, seeking strength in breadth rather than in focused product segment depth and market leadership. The result is a series of debt-laden telecom equipment conglomerates.

Lucent Technologies comes to mind. The company took on high debt to finance acquisitions to add new product lines. In a bid to boost its market share in wireless products, Lucent further leveraged its balance sheet by extending vendor financing to new operators including Winstar in the U.S. and One.Tel, both of which ran into serious trouble. A potential merger between Alcatel and Lucent fell through. Had it succeeded, it would have furthered the conglomeration trend — only on a trans-Atlantic scale.

Customers are specializing — and demanding more

2 Concurrently, big shifts in service providers' strategies will drive more forceful restructuring of their equipment makers.

Customers are becoming larger, more focused, and more sophisticated.

Vodafone now has operations spanning the globe; it purchases infrastructure and handsets for more than 95 million subscribers, spending almost \$7.5 billion this year, excluding 3G licenses. And the telco marketplace is becoming more segmented. Vodafone is a mobile pure play. BT and AT&T are spinning off their wireless businesses.

Those focused companies do not need the vendors' full product portfolios. Moreover, the telcos have ratcheted up their purchasing procedures. Rather than each tapping a single vendor for each line of key equipment, they look for the best-in-class vendors. And they are insisting on open standards instead of traditional proprietary systems. Those trends dilute the strategic rationale of the equipment-conglomerate approach.

Demand recovery is a long way off

3 But the strongest factor of all is demand shock. In the last half-decade, telcos' spending on networks skyrocketed, stimulated by deregulation and the profusion of new market entrants. Between 1996 and 2000, global service providers' capital outlays grew by 26%, far outstripping their underlying cash-flow growth of 8% to 12%. That unprecedented network build-out was readily funded by the capital markets — to the tune of half

a trillion dollars during the period, almost half of it in high-yield debt. In recent quarters, as new operators filed daily for Chapter 11 and big telcos' interest payments piled higher, capital spending has been slashed. We won't see last year's spending levels again for a long time.

None of that triple-whammy of shifts in economic structure, customer preferences and demand sounds strange to longtime executives at General Dynamics. The U.S. aerospace industry faced a similar inflection point with the collapse of the Soviet Union and the resulting deep cuts in U.S. defense spending. Between 1990 and 1997, America's defense industry consolidated from more than 15 major players to a mere handful.

Coincidentally, there are currently close to 15 companies building wireless infrastructure. Will they "shrink to grow," eliminating product lines to focus on those in which they can develop strong positions? Or will they continue to seek growth with a broader, less competitive product set?

Bain's findings show they really don't have a choice. Polling nearly 2,000 companies across many industries over the last decade, Bain learned that even in good times, only one in 10 companies sustained profitable growth. And only 16% outscored the seemingly modest benchmark of 5.5% annual inflation-adjusted growth in revenues and earnings. The consistent growth leaders exhibit three clear characteristics:

- They reduce rather than extend the scope of their businesses.
- They find profitable opportunities within the boundaries of their current operations.
- They search ceaselessly for ways to improve the performance of the core business.

Like General Dynamics, Nokia has shrunk to grow from a refocused and stronger core. Others are choosing to spotlight a key product line and merge it with a former competitor's line. There may be a glimpse of things to come in the Sony-Ericsson venture for producing mobile handsets.

Businesses that fail to hit hoped-for growth in coming years may blame economic slowdown, but our research suggests they'd do better to face up to fundamental flaws in their strategies. The choices are not easy in the best of times. While the economic drivers may be irresistible, the actual unwinding of a meticulously built conglomerate is clearly painful on both organizational and personal levels. Yet the most successful leaders accept the pain, encourage their teams to do likewise, and then develop clear-headed plans to transform their companies. **AN**

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