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Ericsson scraps hybrid outsourcing model

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Ericsson LM signed the death warrant on its hybrid outsourcing model this week with the wholesale surrender of its wireless-handset manufacturing operations to Flextronics International Ltd. The move also bolstered the notion that large OEMs are devolving into engines for brand marketing and product design as they continue to hand off production, distribution, and logistics responsibilities to EMS providers.

By contracting with Flextronics to manage full production of its mobile-phone operations, Ericsson was forced to tacitly acknowledge the failure of its in-house production system as well as its strategy of outsourcing only portions of its manufacturing operations.

“We've taken a fundamental look at how we run the consumer business and we've decided to completely outsource supply and production of mobile phones,” said Kurt Hellstrom, Ericsson's president and chief executive, in a statement.

While Ericsson insists it has no plans to exit the handset market, its decision raised questions about what functions OEMs should keep in-house and how the closer working relationship they are forging with EMS providers will affect their design, R&D, components procurement, and other supply-chain management activities.

Until Friday, Ericsson and rivals such as Nokia, Motorola, and Samsung had followed a patchwork system through which they made some of their cell phones in-house and others at EMS sites.

That strategy appears to be crumbling as the major players confront supply-chain difficulties that issues such as component shortages, pricing pressures, and stiff competition imposed on the industry in the last six months.

In the past few weeks alone, communication-equipment companies such as Motorola and Lucent Technologies have indicated they will increase the portion of their products manufactured by EMS companies in a push to lower costs and regain market share. Ericsson's strategy stands in sharp contrast with that of its rivals, which still plan to maintain some production facilities in-house.

“What's new here is the company's intention to outsource all production, which isn't something that has yet been done,” said Per Lindberg, an analyst with Dresdner Kleinwort Wasserstein, London. Lindberg said he expects Nokia and Motorola to follow Ericsson's lead and move to offset significantly lower-than-expected handset sales in 2000 and into this year.

Although the two companies did not disclose details, Flextronics may be getting up to \$10 billion in revenue from this transaction and others that it is expected to announce in coming months, according to J. Keith Dunne, an analyst at Robertson Stephens Inc., San Francisco.

Flextronics itself said during a conference call that the expected revenue from the Ericsson deal will be “substantial.” To fund the expected acquisition of about \$380 million worth of assets, Flextronics said it will sell up to 28.7 million shares. The company currently generates about 5% of its revenue from cell-phone sales, a level that is likely to go up to between 15% and 20% within the next few years.

The Ericsson transaction moves the relationship between EMS providers and their OEM partners further up the food chain. While an Ericsson spokesman said the company will not relinquish its cell-phone design activities, Flextronics indicated a deeper relationship might evolve.

“We're going to be very much integrated into how OEMs work from design to production,” said Michael Marks, Flextronics' chairman and chief executive during the conference call. “This is a natural progression of our business.”

Flextronics said it will handle Ericsson's mobile-phone production and other logistics activities globally. It will take over Ericsson facilities in Brazil, Malaysia, Sweden, the United Kingdom, and some plants in the United States. The company will “take each order, configure, fulfill, and ship to customers,” Marks said.

Other EMS companies are also likely to benefit from increased outsourcing opportunities from both the PC and wireless markets, according to analysts. EMS providers' revenue from handset production will likely rise to \$29.9 billion from \$15.5 billion in 2000, according to Bruce Spivak, an analyst at Technology Forecasters Inc., Alameda, Calif.

In large part, Ericsson and its rivals are being compelled to outsource because of troubling market conditions. The Swedish company has been losing money in its wireless-handset business for two quarters and posted a group operating loss of \$155 million in the fourth quarter. Its consumer business unit, which consists largely of the wireless-handset business, lost money again during the quarter, hastening the company's push to reduce costs at the unit.

Also, Ericsson estimates that total cell-phone unit sales this year will be between 500 million and 540 million, slightly lower than previously forecast. The company sold a total of 43.3 million units in 2000, including almost 12 million in the fourth quarter.

“The losses [in the unit] are caused by delivery failure from key suppliers and an inadequate product mix in the entry-level market,” Ericsson said in a statement. “The delivery failures have led to loss of large sales volumes and serious underutilization of production capacity, which has forced us into costly restructuring measures.”

Nokia, the No. 1 global mobile-phone manufacturer, is expected to unveil steps to deal with similar problems when it announces its results later today. Analysts said Nokia's fourth-quarter report will also confirm stiffer competition and more muted demand facing the company.

“The overriding question surrounds [Nokia's] ability to live up to its brave forecast of 30% to 35% revenue expansion in the first half, while keeping its profitability around current levels,” Dresdner's Lindberg said. Additional reporting by Bruce Gain and Claire Serant



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