

Has Nokia Lost It?

The Finnish cellphone maker has lost market share, and its stock price has fallen. Getting growing again won't be easy.

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(FORTUNE Magazine) – IT'S JUST BEFORE 8 A.M., AND DAWN OVER HELSINKI

IS STILL hours away, but Nokia CEO Jorma Ollila is in his office waxing on about the virtues of *sisu*, a hard-to-translate Finnish word that means "guts," as well as "courage" and "perseverance." In the coming months Ollila will need all three in guiding the world's largest mobile-phone maker through what is likely to be the most difficult stretch of his 13 years as CEO. "When the Finns are under pressure, that's when the *sisu* comes out," says the 54-year-old Ollila, whose owlish features turn intense whenever the subject of Nokia's shrinking market share comes up. "The fact is, we've been targeted by umpteen challengers, and now we're a challenger again. We enjoy the challenger role. It has to do with being Finnish--being from a small country."

Between 1998 and early 2004, Nokia was to mobile phones what Cisco is to networking or Microsoft is to software: a global behemoth. It controlled well over a third of the \$100 billion phone market, with outsized profit margins to match. The phones rolled out, the profits rolled in, and everything went according to plan, not unlike life in this tidy, efficient Scandinavian country. Then the inevitable happened. Newly aggressive Asian competitors, such as Samsung, Sharp, and LG, started churning out phones with features and styles that Nokia couldn't match, and at better prices.

It didn't take long for Nokia's seemingly impregnable position to begin crumbling. The Finnish giant's market share went from roughly 38% worldwide in 2003 to 30% in the first nine months of last year, according to International Data Corp., an IT consulting firm. In Europe, where Nokia used to have a stranglehold, the deterioration was even more dramatic, with market share plunging from 51% in 2002 to 32.6% in 2004. The company was forced to warn several times that profits would disappoint Wall Street, and its stock has dropped 14% over the past 18 months. Ollila might deny it, but Nokia began to resemble Motorola, the once-mighty American cellphone maker that it dethroned in the late 1990s. Wall Street is now deeply divided about Nokia's future, and some analysts are convinced the company will share Motorola's fate as another faded tech star.

But Ollila is promising a comeback. He has shaken up the company's top management and is betting that fresh designs and surging demand for sophisticated, high-margin smart phones in the years ahead will power profits higher again. Whether he delivers will not only determine the direction of Nokia's shares but also decide whether Ollila, whose contract is up next year, can hang on as one of the tech world's most visible and enduring faces. There are a few encouraging signs. Nokia managed to regain a bit of share in the third quarter of 2004, and its stock has risen from a low of just over \$11 last summer to \$15.50 this month. On Wall Street, optimists like Sanford Bernstein's Paul Sagawa are still in the minority, but he's betting that earnings this year will be up significantly, thanks to better sales of mid- and upper-range phones.

The first clues about whether Ollila's strategy is working will come later this month, when Nokia reports last year's fourth-quarter results. More than simply looking at revenues and profits, Wall Street will be studying the numbers closely to see whether Nokia gained traction during the crucial Christmas season without having eroded its profit margins. Even if the short-term picture improves, however, Ollila faces another, even bigger challenge: getting Nokia's long-term profit growth back on track. If he can't, Nokia will join the likes of Microsoft, Cisco, and Intel as tech giants that continue to earn billions of dollars but are lackluster investments because earnings growth is limited.

ALTHOUGH NOKIA'S PROBLEMS HAVEN'T been as severe as those of other telecom players like Lucent, Nortel, or Swedish rival Ericsson--it is expected to earn \$4 billion in 2004--the company's downward slide during the past 12 months suggests that gravity has finally caught up with one of the corporate world's most highflying success stories. In the mid-1980s, when Microsoft and Intel were becoming household names and Cisco was generating buzz in Silicon Valley, Nokia was a sprawling Finnish conglomerate making toilet paper, wooden flooring, rubber boots, cable, and telecom equipment. Outside Scandinavia, few had heard of it.

Ollila joined the company in 1985 after earning a graduate degree at the London School of Economics and working for Citibank. Within a year he was Nokia's chief financial officer. By then Nokia was shifting its orientation to tech and divesting its old-economy businesses. After making his reputation by turning around Nokia's nascent mobile-phone unit in the early 1990s, Ollila became CEO in January 1992.

Quickly selling off what remained of the cable and consumer electronics businesses, Ollila focused Nokia on telecom--just in time for the communications boom of the 1990s. That wave helped Nokia become one of the best-performing stocks of the decade, rising 34,000% between 1992 and the end of 2000. Even with the bursting of the tech bubble and the setbacks in 2004, Nokia shares are up 11,000% from when Ollila took over, compared with a 300% gain for Motorola. If Nokia and Ollila got a little cocky, that's no surprise. When the telecom industry imploded, Nokia kept chugging along. In 2001 and 2002, while Lucent, Nortel, and Ericsson were losing billions, Nokia earned a combined \$5.2 billion and Ollila gained a reputation as Europe's most successful tech CEO.

That only made the collapse in market share in early 2004 all the more painful. Suddenly the coolest company in Europe went cold. Its monoblock phones lost ground to flip phones from Samsung, Sony Ericsson, and LG that also had bigger screens with jazzier color images, better cameras, and a wider range of styles. "Nokia didn't have the coolness factor," says Jack Gold, vice president of Meta Group, a Connecticut tech consulting firm. "They didn't really do flip phones; they were a little late with cameras, and they didn't push them. Coolness in the consumer space is a big deal, and they were stodgy."

Not only was Nokia losing market share, but its profit margins were also being squeezed; they shrank from 23% in 2003 to the mid-teens by the second half of 2004. If anything, says Dresdner Kleinwort Wasserstein analyst Per Lindberg, the mobile-phone industry's 20% to 25% increase in shipments last year camouflaged just how much Nokia's business had deteriorated. While Nokia continues to dominate the market for cheaper phones, Lindberg says, it is substantially weaker in the mid- to high-end segments in Asia, Europe, and North America, which is where most industry handset profits come from.

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Ollila would rather talk about the speed at which Nokia moved to fix things in the second half of 2004 than the mistakes it made in 2003 and early 2004. Asked if Nokia erred in underestimating the demand for flip phones, the normally unflappable Ollila exhales and is momentarily silent. "Yes, we were a little slow to change to new form factors," he allows. "Our timing was not right. There was a six- to nine-month period when we didn't have the midrange and clamshell phones" that consumers wanted. Anssi Vanjoki, a longtime Ollila lieutenant who heads the company's multimedia efforts, is somewhat more candid: "We read the signs in the marketplace a bit wrong." While Nokia was focused on functional advantages like phone size and ease of use, the competition was emphasizing factors such as color richness and screen size. "That's attractive at the point of sale," he says. "We missed that one."

When sales began to slide in the first quarter, Nokia did act swiftly, especially for a company with nearly \$40 billion in sales and 55,000 employees. Manufacturing was fine-tuned so that existing production lines could churn out a wider variety of phones, which helped the company ship 21 new models in the second half of 2004. "We can make phones that consumers can't recognize are from the same platform," says executive vice president Olli-Pekka Kallasvuo, who oversees the mobile-phone division. "There's more emphasis on new form factors like clamshells, swivels, slides. I'm pushing them as quickly as I can." What's more, Nokia cut prices aggressively, which depressed earnings but allowed the company to stanch the erosion in market share.

Nokia has also followed the lead of its Asian rivals and signaled a new readiness to customize phones to meet the needs of service providers. Dedicated internal teams have been set up to deal directly with Vodafone, Cingular, Orange, and other providers that have a big say in what brands consumers see when they sign up for cellular service. "We have definitely put more emphasis on our relationships with operators in the past 12 months," says Nokia president Pekka Ala-Pietila, whose rimless frames and steely gaze make him seem even more intense than Ollila. "Those teams have a shortcut to the operators, making response times faster." Outside observers say Nokia's new attitude has been noticed by the service providers. "A year ago operators were quite wary of Nokia and didn't like the fact they had so much power," says Goldman Sachs analyst Tim Boddy. "The operators have noticed Nokia's change in attitude."

All Nokia's top execs also insist they now understand that design is crucial, especially given the success of Samsung's stylish new offerings and Motorola's ultrathin V3 Razr phone. But talk to them long enough, and you begin to wonder if they don't fundamentally look at mobile phones as digital devices rather than the consumer accessory they've become for buyers like Orly BousSIDAN, a young London banker. When she finally decided to make an upgrade from her bricklike, four-year-old Nokia, BousSIDAN went for the Motorola Razr. "I am a fashion victim," she says. "It is a slim and sexy phone, and I chose it for its look, feel, and design." Vanjoki would rather rhapsodize about how Nokia's high-end phones will combine the functions of a BlackBerry, a PDA, and other mobile devices than the finer points of style. "This is not a cellphone," he says, holding up one of Nokia's latest models. "It has a cellular engine, but this is a computer. Everyone else is selling cellphones; we are selling computers."

No, says Goldman Sachs's Boddy. In a couple of years convergence might be key, but right now "the market is becoming more fragmented and driven by style and fashion tastes rather than being primarily focused on functionality." The coming months will show if Nokia has found the elusive balance between form and function. True, it has come up with stylish new models such as the Nokia 7280, which resembles an art deco lipstick case and retails for more than \$600. But Boddy worries that Nokia hasn't proved it can regain its design edge. "Their existing product range is still behind in terms of design," he says. "Investors are very much skeptical about where they are."

WHILE OLLILA WAS REVAMPING STRATEGY IN THE MOBILE-device business, which accounts for 80% of Nokia's revenue and 82% of its profit (the balance comes from selling wireless infrastructure equipment, such as base stations and switches), Nokia's management team underwent its biggest reshuffle in more than a decade. In November chief strategy officer Matti Alahuhta quit to become president of Finnish elevator manufacturer Kone. Two weeks later 21-year Nokia veteran Sari Baldauf resigned as head of the infrastructure business "in order to do something different," she says, "outside of global corporate life." At other companies departures like those would have meant heads were rolling, but Ollila insists that the moves were entirely voluntary and that Baldauf's exit was in the works well before the problems in mobile phones cropped up. "At Nokia," he says, "you don't seem to have the slamming of doors."

Indeed, most of Nokia's top brass are still longtime Ollila associates who have been with the company since the conglomerate days. Mobile-phone chief Kallasvuo, for example, has been at Nokia longer than Ollila, having started out in 1980 as a lawyer with the company. But if Ollila and his team can't get profits and revenues growing again, pressure for a wider management shakeup is likely to mount. And getting growing again won't be easy. Despite higher sales volumes, falling phone prices mean Nokia's 2004 revenues are likely to come in at \$37 billion, down more than \$1.5 billion from 2003.

For now, Ollila's job looks safe. Despite last year's reversal of fortune, he is still highly regarded by his fellow Finns, and the company's successes over the past 15 years remain a source of national pride. But Wall Street is unusually divided about the company's prospects. While earnings projections for other closely watched tech giants such as Cisco and Microsoft cluster in relatively narrow ranges, analysts are all over the map when it comes to Nokia. Earnings-per-share estimates for 2005 go from 65 cents all the way to \$1.17, and the price target for Nokia's shares ranges from \$11 to \$25. (In early January the company's American depository receipts were trading at \$15.52.)

"There is little visibility on Nokia's products right now," says Boddy, and over the next year "investors could again have a very volatile company on their hands." Nokia will continue to enjoy huge sales volumes, he says, but falling prices for low-end phones and competition at the high end will be a drag on profit growth. And in the upper end of the market, Samsung, LG, Motorola, and Sony Ericsson could continue to steal market share.

The long-term picture is just as cloudy. Ollila predicts that surging consumer demand for high-margin smart phones with easy Internet access and features like MP3 players and digital cameras will restore Nokia's profit growth. But there's no reason the same Asian competitors won't turn up the heat in this segment as well. "Handsets integrated with consumer electronics are at the heart of Asia Inc.," says Dresdner's Lindberg. "Nokia has never faced the full power of the Asian companies before. Now they are, making Nokia's future much tougher."

Lindberg's pessimism may be overdone. After all, Nokia still controls nearly a third of the global handset market, and Ollila has steered his company through crises before. Despite fierce competition, Nokia will remain a master manufacturer, producing millions of low- to medium-range phones and enough high-end ones to still earn several billion dollars a year. It has little debt and \$16 billion in cash. But it is increasingly certain that Nokia's days as a hot stock are not coming back--and that the Finnish giant will look more like Microsoft and Intel than the fast-growing tech company it was a few years ago. Ollila insists he won't let that happen. "We would not be happy to be a laggard with no momentum, even if we were earning a billion a quarter," he says. "That's not what makes us tick. That's not the Nokia way."

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