

Outsourcing at Ericsson

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LM Ericsson, a leading marketer and distributor of telecommunications equipment, surprised the business world in January 2001 by announcing that it would no longer manufacture cell phones. Instead, Ericsson would outsource to Flextronics, a leading designer, manufacturer, and supplier of equipment.

While other cell phone companies (including Nokia and Motorola) had already outsourced portions of their manufacturing, Ericsson's maneuver was the most ambitious to date. "[We] will take responsibility for more than just manufacturing," said Michael Marks, Flextronics' chairman and chief executive. "We are being asked to manage [Ericsson's] operations, including new product introduction, supply-chain management and logistics."¹

Ericsson

LM Ericsson Telephone Co. was formed in 1918, and by 2001 was involved in international telecommunications, including systems and services for handling voice, data, images and text. The company was organized into three business segments: Network Operations and Service Providers, Consumer Products (including cell phones), and Enterprise Solutions.²

Ericsson produces equipment for both wireline and wireless applications. In 2000, Ericsson had a 10% market share in cell phones and sold 43.3 million cell phones worldwide. However, market share had been declining, and in 2001 was expected to fall to approximately 7%, with most of the loss going to the Finland-based industry leader, Nokia.

Unlike some of its competitors, Ericsson traditionally focused on network infrastructure devices, not consumer products. The Consumer Products division was under significant profit pressure, losing money on an operating basis (excluding restructuring charges).

In the fourth quarter of 2000, Consumer Products sales declined by 17% and losses were substantial. There was speculation as to the future of the division; specifically, whether the business would be sold or Ericsson would enter into a joint venture, with, for example, a Japanese electronics firm.

Flextronics

Flextronics International, Ltd. is a leading provider of electronics manufacturing services to original equipment manufacturers (OEMs) in the communications, networking, computer, medical and consumer markets. The company had design, engineering, and manufacturing operations in 27 countries on four continents.³

Flextronics is one of the most successful Electronic Manufacturing Services (EMS) firms – firms that make products on an OEM basis for other companies under outsourcing contracts. Other leading EMS firms include Solectron, Celestica, and Jabil Circuit. It grew very rapidly. Earnings per Share compounded at greater than 30% from 1998 to 2000, and the company employed over 70,000 people. Acquisitions played an important part in growth. Sales were derived primarily from telecom (about 30% of sales), computer (29%) and networking (24%). After Ericsson, Cisco was Flextronics' second largest customer, accounting for 10% of sales. Its relationship with Ericsson started in 1996, when it bought factories and signed an outsourcing contract.

Under the new agreement, Ericsson would account for about 20% of Flextronics' sales. Cell phones were to rise to about 20% of Flextronics' sales, up from 7% in 2000.

Mobile Handset Market

Following years of rapid growth, the mobile phone handset market was in a slowdown by 2001, reflecting three market factors: product saturation, a longer replacement cycle, and delayed introduction of products with next-generation technologies (such as 2.5 and 3G) that had been expected to drive significant future growth for the industry. With the industry maturing, price pressure was expected to intensify.

The Outsourcing Decision

Ericsson surprised some observers in late January 2001 when it announced its alliance with Flextronics. Its stock fell 13%, due in part to the market's disappointment that a more radical solution had not been selected. However, the transaction represented the largest single acquisition of an OEM supply chain in the history of the EMS – based on revenues. Prior to the Ericsson/Flextronics deal, only about 5% of global cell phone production was outsourced.

Flextronics agreed to purchase (at book value) the equipment in several of Ericsson's existing facilities and assume responsibility for production of Ericsson's handsets. 4,200 Ericsson employees were to be transferred to Flextronics and 6,800 made redundant. Flextronics intended to shift production of the more competitive items to its own facilities in China and Malaysia while putting more expensive products into the higher cost Ericsson plants. Ericsson's plants being transferred were located in Sweden, the U.K., Brazil, Malaysia, and the U.S. (Virginia). Ericsson expected that all of its production

would be shifted to Flextronics by the end of 2001. The deal was for manufacturing only; Ericsson would retain responsibility for product design, marketing, and R&D.

Ericsson expected to save SKr15 billion (about \$1.5 billion) annually beginning in 2002, while Flextronics anticipated a jump in revenues of \$2 billion per year. Analyst Keith Dunne at Robertson Stephens suggested that Flextronics might produce cell phones in China and Malaysia and make infrastructure equipment in China, Poland, Mexico and Sweden.

Ericsson management believed the agreement would allow the business to return to profitability by the end of 2001. But not everyone agreed. A Merrill Lynch analyst wrote, "We are giving no benefit of the doubt to this business due to its performance over the last three years and we expect losses to continue in 2001 and 2002. As we iterated, this is primarily due to Ericsson's ability to read the market and design savvy handsets that end users get excited about." Similarly, UBS Warburg's Jeffrey Schlesinger wrote: "We remain skeptical of the company's ability to turn the design side of the business around on a sustained basis. First, Ericsson's handset drama is as much related to an inappropriate product mix and pure product design as it is to production efficiency. Hence, lower production costs are unlikely to fully resolve Ericsson's handset woes. We continue to question the company's understanding of consumer markets, the pace of change in the mobile phone industry, and its ability to continuously design products that can drive volume with good margin."

Questions for Analysis

It's December 2000. You are to make a presentation to the Ericsson Board of Directors outlining the pros and cons of outsourcing to Flextronics and making a recommendation on whether or not to do it.

Questions to think about: (a) What are the pros and cons of outsourcing relative to keeping production in-house? (b) What are the pros and cons of outsourcing relative to exiting the business altogether? (c) Does Flextronics' role pose a long-term risk to Ericsson? (d) Although Ericsson's arrangement with Flextronics is the most ambitious to date, others in the industry are also turning to outsourcing. Why do you think they are doing so now, rather than earlier in the "life cycle" of wireless phones?

Additional Information Sources

Ericsson's web site: <http://www.ericsson.com/>

Flextronics' web site: <http://www.flextronics.com/>

Notes

Charles Miller and Kenneth Goldman prepared this case under the supervision of David Backus and Luis Cabral for the purpose of class discussion rather than to illustrate either

effective or ineffective handling of an administrative situation. © 2001 David Backus and Luis Cabral.

¹ Ojo, Bolaji, “Ericsson Transfers All Mobile Handset Production to Flextronics”,
<http://www.ebnews.com/manufacturing/news/story/OEG20010126S0010>

² Marketguide.com, <http://www.marketguide.com/mgi/busidesc.asp?nss=www&rt=busidesc&rn=30650>

³ Wrolstad, Jay, “Ericsson Abandons Cell Phone Manufacturing”,
<http://www.wirelessnewsfactor.com/perl/story/7019.html>