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# Microsoft Acquires Nokia: Implications for the Two Companies and Finland

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## Lead-In

*Microsoft*'s acquisition of *Nokia*'s phone business has considerable implications for *Nokia* and potentially for Finland as a country, but little immediate effects on *Microsoft* and related industries. One might ask, couldn't there have been better remedies for the challenges both *Microsoft* and *Nokia* were facing?

One has to further ask, why *Nokia's* board suddenly abandoned the strategy it has endorsed for almost three years, especially when there finally were signs that the plan might actually come to fruition. *Nokia's* chairman of the board, Mr. *Siilasmaa*, defended the company's decision stating that *Nokia* didn't have the resources to successfully promote its smartphone business. He further explained that the two companies failed to find another strategy that would have been victorious for both sides.

One could also wonder whether the acquisition improves *Microsoft*'s position in any material way, particularly in the consumers' eyes. In a press conference in Espoo (Finland) today, CEOs *Ballmer* and *Elop* assured their optimism for the new *Windows Phone* software and hardware entity. At the same time, however, information provided today suggests that *Nokia* can re-enter the phone business any day, albeit with certain limitations.

Finally, what comes to possible effects on employment, the Finnish labor market has absorbed the previous batches of *ex-Nokia* employees quite well. Short-term difficulties aside, we remain optimistic regarding the broader ICT sector in Finland – the surge in demand for, and application of, software and IT services across all sectors may well continue.

These are the burning hot questions of today. In this brief, we first take a step back and look at the big picture before addressing them in detail.

## How the Mighty Fall

Up until the launch of *Apple's iPhone* in 2007, and *Google's Android* in 2009, *Nokia* and *Microsoft* were indisputable leaders of their own respective industries. Since then they were both caught by the rapid convergence of digital communications, information systems, consumer electronics, as well as software and digital content of various sorts. This convergence broke the previously prevailing sectoral silos and replaced them with a rapidly evolving *Internet of everything* world. Both companies found themselves facing new and unknown competition, and were forced to design new strategies fit for a new market regime.

The titans have clashed over the dominance of this this huge and yet-to-be conquered domain.

So far Goliaths, such as *Nokia* and *Microsoft*, have been unable to capitalize on their old competitive advantages. More agile Davids, such as *Amazon*, *Apple*, *Facebook*, and *Google* (with its arms-length allies such as *Samsung*), have done better in establishing lucrative early positions.

But so far we have only seen the first battles in a lengthy war. How does *Microsoft*'s acquisition of the *Nokia Devices & Solutions* unit in September 3rd, 2013, change the respective positions of the two companies? And what does it imply for Finland as a country? We address these questions in this Brief.

## Industry Developments Prior to the Acquisition

Figure 1 illustrates how rapidly *Nokia's Symbian* operating system (OS) for mobile phones lost its global market share in smartphones and how *Microsoft's Windows Phone* OS failed to gain ground. One should note, however, that Figure 1 underestimates *Nokia*'s overall role, as *Nokia* fared better in feature phones. On a similar note, the decline of *Symbian's* market share after 2011 was part of *Nokia's* strategy to switch to *Microsoft's* operating system.

As illustrated, the *iPhone* started a new era of smartphones, but the death knell for the early leaders was the rise and subsequent dominance of *Google's Android* OS.

One of the consequences of the digital convergence has been that our digital lives have become less tied to a particular screen. Thus, it makes sense to consider the market shares of OSs across the three main terminals for digital creation and consumption, *i.e.*, PCs, smartphones, and tablets. As Figure 2 shows, *Microsoft* still dominated this space quite recently. By the end of 2012, however, *Android* had become the biggest OS in terms of this metric.

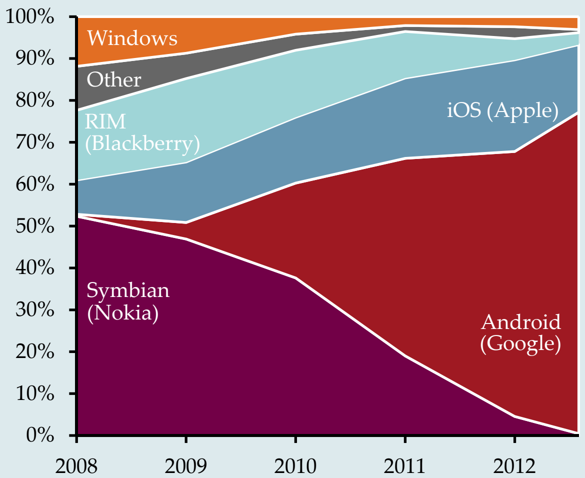
These developments have had significant consequences on companies' financial performances and valuations, as Figures 3 and 4 show. *Nokia* in particular has found itself between a rock and a hard place. Upon becoming *Nokia's* CEO in September 21, 2010, Mr *Elop's* internal slogan forebodingly proclaimed: "*Fix the phone business or get out of business*". While it is too early for the final verdict, he may have done both.

## Nokia's Ill-Advised Marriage with Microsoft Windows OS

With the benefit of hindsight, it is clear that *Nokia* rode its *Symbian* OS far too long. Slow progress in developing its *Linux*-based earlier *Maemo* OS, later *MeeGo* OS to replace *Symbian* added to the insult. *Nokia* was left with a set of undesirable choices.

Looking back, it seems clear that either sticking with *MeeGo* or hopping on the *Android* bandwagon would have been better choices for *Nokia* as a company. It is nevertheless true that, at the time, *Microsoft* seemed like the most logical choice. Once the mistake was done, both jumping ship and having a dual OS strategy were

1 Market Shares of Mobile Smartphone Operating Systems




Source: Gartner.

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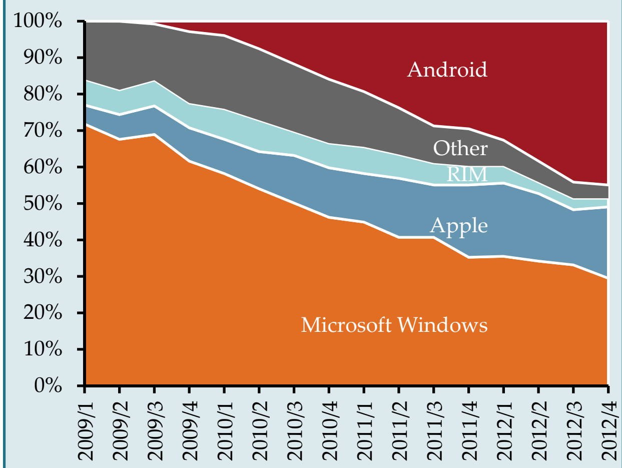
2 PC, Smartphone and Tablet Operating Systems Together




Source: Business Insider, Gartner, IDC, Strategic Analytics, company filings.

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ruled out due to "speculative" contractual reasons and obligations.

Upon his arrival at *Nokia*, CEO *Elop* had to choose the least-worse strategy – the good ones had been exhausted by his predecessors. With its rapid cash burn rate, *Nokia* was in a vertical tailspin, so he needed something fast. At that time *Android*'s winning streak was far from obvious and one's opportunities to differentiate with that ecosystem seemed slim.

## What Was Actually Acquired?

*Microsoft* is acquiring *Nokia's Mobile Phones* and *Smart Devices* business units including *Nokia's* design team and its operations, all related production facilities, sales and marketing functions, and related activities. In total, *Nokia* transfers 32,000 employees to *Microsoft*, of which 4,700 in Finland.

*Microsoft* licenses, but does not acquire, non-related *Nokia* IPRs: a non-exclusive license of patents for 10 years, right to the *Nokia* brand for 10 years, and certain rights in relation to HERE services. *Nokia* is restricted in the use of its own brand in mobile devices for 30 months or until the beginning of year 2016, but the deal announced today does NOT prevent *Nokia* from making mobile devices carrying other brands.

The cash price of the deal is €5.44 billion (of which licenses and future options account for €1.65 billion), and it is to be closed in the first quarter of 2014 pending *Nokia's* shareholders and regulatory approval. The sales of the acquired unit were €14.9 billion in 2012, almost half of *Nokia's* net sales.

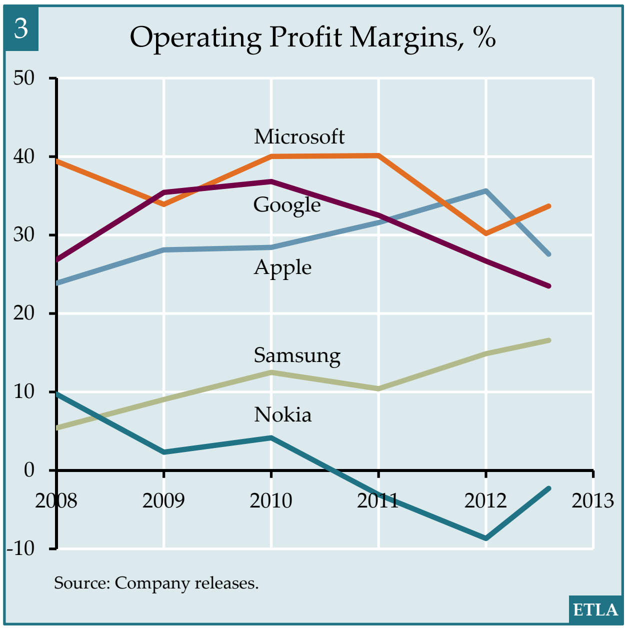
*Nokia* is left with NSN, its digital content services carrying the HERE brand (including digital maps and navigation it gained after acquiring *Navteq*), a considerable portfolio of patents and other intellectual property related to, *e.g.*, 2G and 3G telecommunications standards, and *Nokia Research Center*.

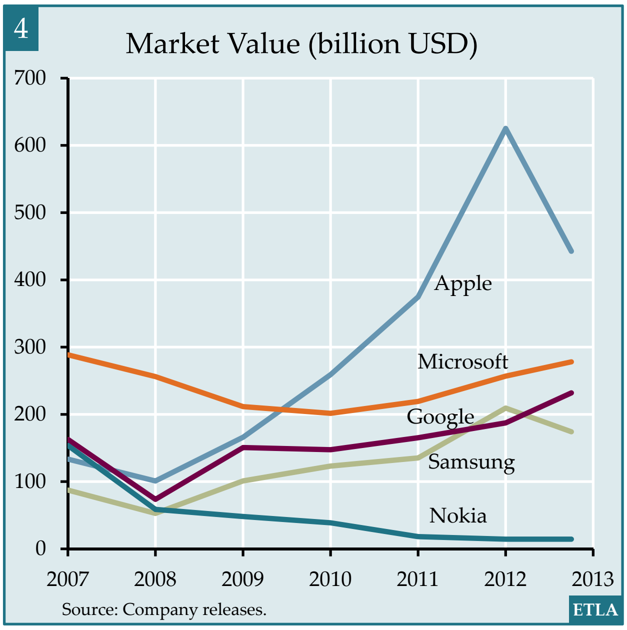
## Why Did Nokia Sell?

At this point there are few good answers to why *Nokia* sold the businesses. The answer may simply be that it was running out of cash. Obviously the board of *Nokia* lost faith in its *Windows* OS strategy and, with the still binding contractual obligations, was lacking good alternatives. One should note that, with the assets it still retains, *Nokia* remains a force in mobile communications. To our knowledge it *can* still make mobile phones, using any OS, as long as they are not marked under the *Nokia* brand.

## What Does the Post-Acquisition Nokia Look Like?

*Nokia*'s communications network business as well as its *Navteq* acquisition and other HERE businesses are doing reasonably well. *Nokia*'s IPR portfolio should provide a steady revenue stream, roughly €0.5 billion annually as Mr. *Siilasmaa* indicated in the press conference. While the new *Nokia* is only a shadow of the *Nokia* in



the early 2000s, it has all the potential to succeed, even though good growth opportunities are scarce.

It should be noted that due to this deal, *Nokia's* loss streak has come to an end and the company obtained more than €5 billion in cash. Due to the improved financial standing, *Nokia* has plenty to spend on new businesses via, for instance, acquisitions or in-house development.

## Microsoft Still Has a Few Aces Up Its Sleeve

The strongest and the most binding lock-in *Microsoft* retains over its customers relates to its *Office* application suite. While particularly corporate professionals' reliance on *Excel* and *PowerPoint* is not to be underestimated, this strength is undeniably eroding with alternatives such as *Google Apps*.

Furthermore, *Microsoft* continues to be a leading provider of corporate IT solutions. MS continues to hold up reasonably well in the client-server architectures segment. Here the threat comes from cloud computing rather than from more direct competition.

Since full support and update services for *Microsoft's Office* and server solutions are provided on its own *Windows* operating system, it has extra staying power that complements its huge installed base and unmatched variety of third-party PC applications.

In our view *Microsoft's* current strategy rests on three cornerstones:

- Roll out one nearly identical, seamless, and synchronized interface across all digital devices (*i.e.*, *Xbox*, *Lumia* phones, *Surface* tablets, and computers).
- Provide a solution that effortlessly stores all aspects of one's digital life (*i.e.*, *SkyDrive*).
- Offer manageable and secure back-end solutions to support the above in all desirable configurations (local infrastructure, public *vs* private cloud, *etc*.).

Microsoft has a fair chance in succeeding with the above strategy, but so far it has been unable to make the right moves in a timely manner.

As the examples of *Apple* and *Google* show, the key to a successful digital ecosystem is to attract third-party application and content providers. End-users also appreciate the ability to mix-and-match their favorite applications/content across platforms. *Microsoft* has not been particularly strong in *neither* attracting developers *nor* nurturing openness of its offerings. For instance, *Windows Phone* users are locked into *Microsoft's Internet Explorer* and to a large extent also to its *Bing* search engine. As far as end-users are concerned, these issues may be important, as a strong preference for a particular solution – say for *Google* search – may determine the choice of one's preferred digital ecosystem.

## The Acquisition from Microsoft's Vantage

*Apple* and *Google* have an increasing presence in hardware. *Microsoft's* own phones and tablets have failed so far. *Nokia Lumia*s have accounted for over 80% of *Windows Phones* and currently have a nice line up of offerings. *Microsoft* had the cash and *Nokia's* assets were available at fire sale prices, so why not? First and foremost this seems like an incarnation of MS's "me too" strategy, however.

*Nokia's* success in handsets has been crucial to the whole *Windows* ecosystem, but it has been insufficient to turn the ecosystem into a real third alternative. With the acquisition *Microsoft* is undeniably, albeit only marginally, in a stronger position in building the *Windows* ecosystem. The move fits to MS's overall strategy but is hardly enough in itself.

After a few years of gloomy news, *Nokia* has shown positive signs this fall. One has to ask why *Nokia's* board abandoned the strategy now, unless of course *Nokia*'s cash crisis is even deeper than anticipated. In the coming months we'll know whether *Microsoft* timed its move perfectly. Even if not, the damage to its pocketbook was not too severe.

As for the industry at large, the acquisition has hardly any immediate and, most likely, only minor long-term effects.

## Impacts on Finland as a Country

The acquisition significantly affects *Nokia's* impact on the Finnish economy. At the peak of *Nokia*'s success in 2000, the company accounted for 1% of the total employment in Finland. In June 2013, *Nokia's* share of the country's total employment was 0.4–0.5%. Due to the divestment of the *Devices & Services* unit, in 2014 *Nokia's* will employ approximately 6,100 in Finland which is about 0.2% of the total employment in Finland (Figure 5).

A similar effect is expected to hit *Nokia's* share of R&D expenditures in Finland. *Nokia's* share of corporate R&D in Finland remained stable at slightly over 40% until 2009. Subsequently the share declined. In 2012, *Nokia* accounted for 31% of corporate R&D in Finland. After the acquisition the share will drop to approximately 17%.

The effects the deal has on *Nokia's* contributions to employment and R&D do not necessarily impact the Finnish economy as a whole. For instance, if *Microsoft* retains all 4,700 *ex-Nokia* employees, the impact of the deal on the employment on a national level is potentially negligible (Figure 6). Thus, the total impact on the national economy depends on choices made after the acquisition. The key issues to be considered are: Will *Microsoft* succeed in its mobile phone business? Will *Microsoft* maintain employees in Finland? Would the long-term fate of these 4,700 individuals be any different if the deal had never happened? Will *Nokia* invest its new cash reserves at least partially in Finland?

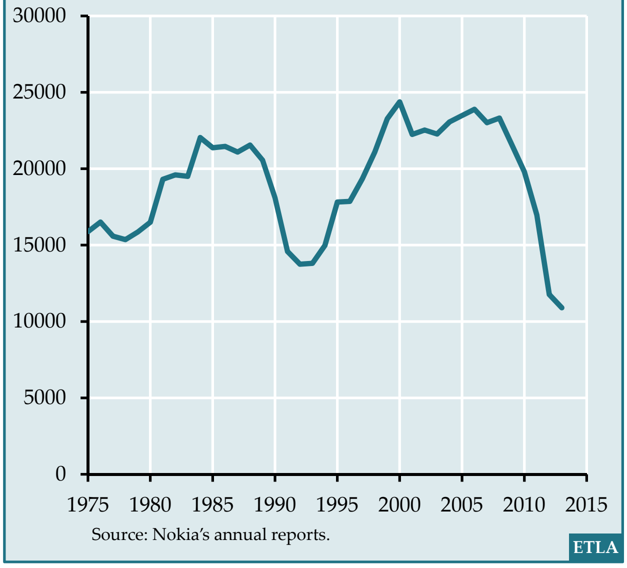
Be that as it may, the exceptional period when a single company dominated a remarkably big share of the Finnish GDP is over (Figure 7). In the early 1990s, Finland transformed from being one of the least information and communication technology -specialized countries to becoming the single most specialized one in the world. The success of *Nokia* was one of the major factors in pulling Finland out of the most severe economic crisis in any OECD country since World War II. As a result, *Nokia's* share of the Finnish GDP increased rapidly. But since 2007 the share declined as fast as it rose ten years before. In 2012, *Nokia's* share of the Finnish GDP was actually *negative*.

The counter-intuitive observation calls for further explanation. When we calculate *Nokia's* (including NSN) value added in Finland as the sum of

- local labor costs,
- local depreciation,
- local rents, and
- the operating profit (or loss) recorded in Finland,

we obtain a negative figure. Due to *Nokia's* heavy losses recorded in Finland, in particular, the value added of *Nokia* in Finland was nega-

5 Nokia's Employment in Finland




Source: Nokia's annual reports.

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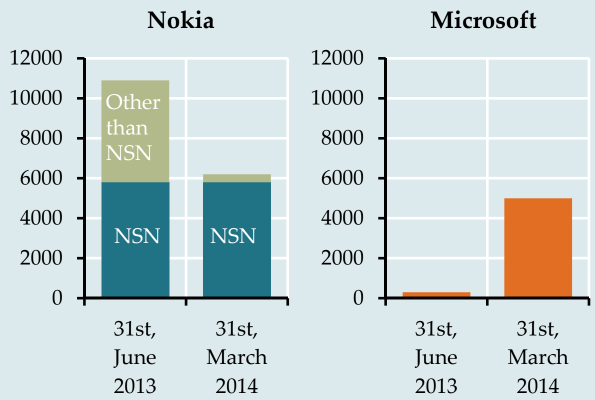
6 The Employment of Nokia and Microsoft in Finland




Source: ETLA, Company releases.

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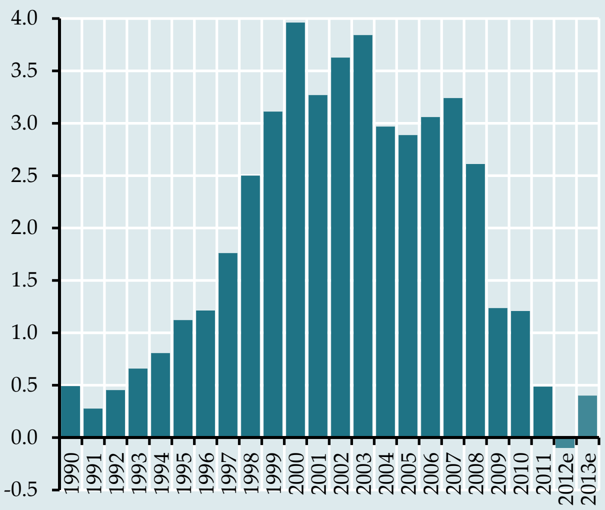
7 Nokia's Share of Finnish GDP, %




Source: Ali-Yrkkö, ETLA. GDP = Value added = Operating profit (shown in Finland) + Depreciation + Labor costs + Rent

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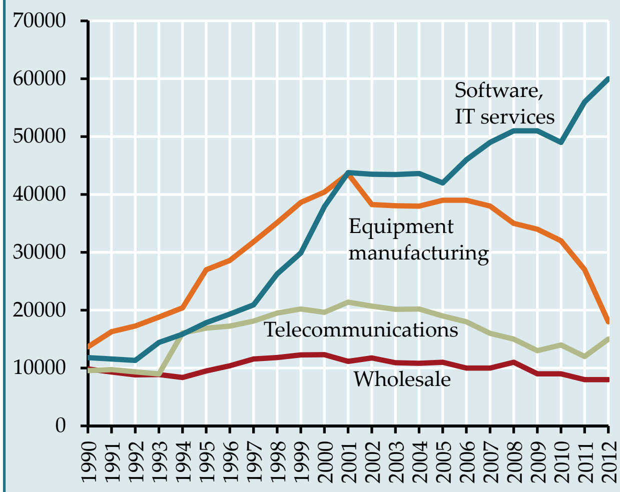
tive. From a technical viewpoint the procedure is correct: Finland is *Nokia*'s global profit-and-loss center – in better times the operations in Finland enjoyed "excess profits" and in worse times they suffered "excess losses".

Despite *Nokia*'s misfortunes in recent years, ICT sector employment in Finland has not decreased drastically. As Figure 8 shows, software and IT services have largely filled the void. The analysis reveals that a dramatic structural change has occurred within the ICT sector. While ICT hardware manufacturers have shed their workforce, software firms have recruited more staff in Finland. Thus, the Finnish ICT sector does not rely only on *Nokia* anymore.

The past few years have witnessed the birth and growth of new ICT companies. The most visible of those are game makers *Rovio* and *Supercell*. But there are also thousands of other software companies in Finland.

The vitality of the Finnish ICT sector requires not only new establishments but also *successful* divestments of existing operations. Only the future will tell the total impact of the *Microsoft–Nokia* deal on the Finnish economy.

8 ICT Sector Employment by Sub-categories in Finland




Data: Statistics Finland.

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