



Telecom 101: Focusing On Core Competencies

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A spate of announcements during the past six months has riveted the telecom world, and prompted soul-searching about the state of the industry. Major assets of once sterling names in the PBX space - Mitel, Executone, Comdial, Nitsuko, and Picazo - are changing hands or being eliminated. Are PBX and comms server makers, observers ask, succumbing to an economic downturn that already plagues carrier equipment providers? Or do the recent developments reflect a necessary restructuring that will ultimately benefit the VAR channel? We hold the latter view.

A Flurry of Deals

If you've tuned out the news, you might have missed these developments:

In January, Mitel stunningly spun off its Communications Systems Division to Terry Matthews, the man that co-founded the company (and later Newbridge Networks). The deal, valued at \$350 million (in cash, notes, and equity) turns over Mitel's PBX and IP assets, including the IP-based Ipera line to Matthews' latest creation - March Networks Corporation. Mitel and March Networks will remain partners: The agreement, finalized this month, gives Mitel a 10% stake in March Networks; and it calls on Mitel, now a pure-play semiconductor company, to continue supplying IC components to the spun-off unit.

NEC America formed a new company that consolidates switch manufacturer Nitsuko with NEC's Key Telephone Systems Group. The deal, which has NEC buying a majority stake in the new outfit, gives Tokyo-based NEC a combined 8% of the key and hybrid key/PBX market.

Continuing its acquisition spree, PBX maker Inter-Tel swallowed up Executone's CPE business, including some 100 distributors that will sell and maintain Executone's AXXENT systems. Inter-Tel also made an unsuccessful bid for Comdial.

Speaking of Comdial, in December the outfit gave pink slips to 150-plus staffers, many of them employed by the PBX maker's manufacturing arm. The company intends to subcontract equipment manufacturing to focus on R&D and marketing. The move, say observers, also aims to stem Comdial's mounting red ink, which for its third-quarter, (which ended Oct. 1) totaled \$5.2 million.

And, in December, Telecor acquired the Picazo VS1 server-based PBX from Intel's Dialogic division. The purchase boosts Telecor's line of vertical market-oriented voice/data solutions, including paging, conferencing, and IP products.

What's Going On Here?

The factors forcing these actions, while varying by company, have a common thread. To wit: If PBX and other communications manufacturers are to survive and thrive in a cutthroat convergence marketplace, they've got to focus on core competencies.

That fact is especially clear in Mitel's case, long a standard bearer of the communications industry. Mitel, company execs acknowledged in a January conference call with analysts, has experienced a "softening" of demand for PBXs. And Mitel expects the trend to continue for the next 12 to 18 months. Lackluster PBX sales contrast with the more robust semiconductor market, where the Kanata, ON-based company shines. For its second fiscal quarter of 2001, Mitel secured \$194.3 million in semiconductor revenue, a 39% gain over the \$139.4 million from last year. Compare these figures with second-quarter revenue for PBX and other communications equipments' total of \$165.5 million. That's down 21% from \$209.4 million reported for the year-ago quarter.

Mitel, analysts and company execs agree, would do better to focus its substantial R&D expenditures (\$85.6 million for the sixth months ended Sept. 29th) in the more profitable semiconductor line. Mitel is also betting that Matthews' March Networks, a developer of IP multimedia broadband applications and delivery platforms, can better leverage Mitel's IP product line than could Mitel's semiconductor unit. Indeed, say analysts, Mitel failed to generate much synergy between the two very independent divisions.

Mitel's focusing on semiconductors parallels last year's slimming down by telecom behemoth Lucent Technologies. Recall that Lucent spun off its Enterprise Networking Unit - including its Merlin Magix and Partner ACS lines - to the newly formed Avaya. (Lucent, which is now focusing on high-end, and purportedly more profitable, networking equipment, continues nonetheless to experience mounting troubles. In late January, the company reported that first-quarter revenue plunged 28% to \$5.8 billion from \$8.1 billion; and Lucent announced a restructuring that would eliminate 16,000 jobs.)

In Comdial's outsourcing of equipment manufacturing, we see a trend that has become widespread among telecom makers and, indeed, the datacom world. Fact is, for all but the most complex equipment, OEMs are better off outsourcing manufacturing to a contract electronics manufacturer (CEM). That is, in part, because the CEMs enjoy greater economies of scale. Also, many CEMs - SCI Systems, Solectron, Flextronics, Celestica, among other industry titans - can shift production among worldwide manufacturing plants

as seasonal and macroeconomic conditions require.

Today, such flagship PBX makers as Nortel, Samsung, Toshiba, Avaya, and others, outsource much, if not all, of their manufacturing. Yes, outsourcing affords these OEMs less control over manufacturing than when they retain the capability in-house. But the CEM industry, which is growing at a healthy 25% compounded annual growth rate, has amply demonstrated its worth and reliability. For telecom OEMs, the risk of outsourcing (in terms of reduced product quality) is small compared with the potential benefits: the ability to intensify product design, development, and marketing efforts.

Nor has the value of concentrating on core competencies, and leveraging economies of scales been lost on the NEC/Nitsuko and Dialogic/Telecor dealmakers. In the first instance, Nitsuko's former product development group clearly will enjoy greater R&D and marketing resources of the larger NEC, which is taking a majority stake in the newly formed company. As to the second announcement, the Picazo sale enables Dialogic to better position itself in the market for communications server components (voice boards, etc. - the company's well-recognized fort ). And the Picazo line, from our vantage point, fits snugly into Telecor's fast-budding convergence portfolio.

Good Deals for Interconnects?

In total, we think, the aforementioned announcements are a net gain for VARs. Certainly such wheeling and dealing among OEMs can entail disruptions for the people that have a stake in their products, including telephony VARs. And, as numerous studies have shown, a slow transition (e.g., in communicating corporate objectives and methods under new management etc.), can adversely impact business - particularly if the old management leaves things hanging.

(Regarding Inter-tel's buyout of Executone's CPE unit, for example, the transition took upwards of five months. But that was no fault of Inter-Tel, says Inter-Tel CEO, Steve Mihaylo. Executone, he says, left its manufacturing facilities in "deplorable condition" after Executone announced its intent to sell the CPE unit. Result: the 80-plus Executone VARs that Inter-Tel acquired had only a sporadic supply of product for weeks.)

But the various moves, we're confident, will yield more attractive products, and competitive suppliers, in a marketplace that is fast consolidating. Unless you, the interconnect, are hitching up with new management that cares little for the indirect channel (we see little sign of this; quite to the contrary), then you likely have much to cheer.

