



## Finding opportunities in a crisis: case studies from China

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Beginning with an assessment of the global economic situation, Ted outlines up-to-the-minute data on developments across China and their significance within the global context. Where are the long and short-term opportunities? What are the hidden pitfalls and cultural hurdles for the unwary? The evolving relationships between politics and business... and more.

First, to talk about the crisis. I wanted to set up the last year we have, and so I was doing some research. And I pulled together newspaper clippings of this horrendous year of the financial crisis we've had. And I thought about using that in a slide. And then I dug up, I found a list of IT companies that have gone bankrupt over the last year and I thought about using that. And I found a list of layoffs in our industry and I thought about using that. And with each Google search I became more and more depressed.

So I thought I would really spare you a rehash of the challenging year we've had. We've all sort of lost this past year in the global economy, since the bankruptcy of Lehman and had to watch how the economy played out. And certainly in our own business in Beijing, up until the crisis, the economy was doing very, very well.

And so we went and 15 months ago, the best business we'd ever had, to say nine or 12 months ago some of the worst business we'd ever had and wondering if this was a one-year trend or a five-year trend or how this would play out. And I'll talk a little bit about the recovery in China. But we're back where we were, the best business we've had. So it's been a kind of a whiplash year. And I think probably many people in the room, in their industries or in their reporting, have seen the sort of troubling and challenging economy that we've all faced. So I'm not going to spend a whole lot of time running through that.

I think we've all lived and read that story for the past year. And instead we'll talk about some of the opportunities that we see.

There's a lot of data that I could have pulled out. And to be honest, these aren't the best data points but they're some that I had readily available. And the reason I put up this slide, this is telecom services revenues broken down by emerging markets in developed countries and then carrier CapEx at a few carriers. This is by no means a comprehensive list of carriers. And there are in fact global carriers that have increased their CapEx this year. But I put these up to show that it's been a challenging year. If you work at NSN and you're the Vodafone account

manager, you're pulling your hair out when you see these numbers. This has been a very difficult year for a lot of people in this industry.

The other point I would make though, looking at the left-hand side of the slide, is that the trends that we see in this industry, whether they're driven by technology, or they're driven by competition or there are other things going on in the industry, predate Lehman, the slowdown in growth in the industry is not only a financial crisis story, there are dynamics internally to the industry which have at least made parts of the ICT industry tough places to be. There's some really exciting areas as well, but certainly parts of the ICT industry that have been pretty challenging places to be just because of things going on in the industry. Never mind the financial crisis, if Huawei didn't exist, Ericsson and NSN and some of the big international vendors, their lives would be a lot easier. And that's a long-term competitive trend that's unrelated to the financial crisis. I've set this up with the financial crisis, but I don't want to make that the focus of what we're talking about.

So where do we see some of the opportunities and some of the signs of recovery? This is certainly emerging markets. It's almost a cliché to say that China has come out of the financial crisis better than most, whether you're talking geopolitically, and you can see that with President Obama in Beijing this week, as a matter of fact, or their management of the stimulus package in China, or the economic numbers that we see coming out of China. But that's not only a China story. And I think the broad trends and broad growth in Asia-Pacific, in emerging markets generally, still look very good. In those emerging markets wireless still continues to be a growth story. And I'll have some numbers on that.

And then broadly defined, and in 20 minutes I may not be able to get more detailed than that broad definition, there are areas, services and applications which are really attractive, really high-growth areas. It's a tough environment to be selling boxes. If you are selling gear, if you're Ericsson, if you're NSN, if you're Alcatel Lucent, these are no question a tough environment to be in. But I'll talk a little bit about each of these areas.

Now you may wonder what this photograph is. And it depends on whether you're an optimist or a pessimist what you might think of that, as that sort of looking back at the storm we've just passed. That's actually the photograph from the eye of a hurricane. So the question, I'm not a macroeconomist so I can't answer the question of whether the rest of the storm is still ahead of us or whether we're looking at that in the rear-view mirror. But I found that online and was struck by this as a pretty remarkable photograph. But also we don't quite know, as we look ahead at the economy and certainly the economy in the US and in developed markets, how much more is to come. But certainly it has been a challenging environment. And I'll leave it to economists to answer what exactly that photo should mean for us.

So I think of all the places we could be, let's just thank each other that we're in Asia. Asia-Pacific has certainly been a bright spot. This is, again, a little bit of the data. I'll bring this up to date in some of the next slides. But Asia-Pacific, a centre where there has been continued CapEx growth, that's Asia-Pacific broadly defined. These numbers would be stronger still if you were to break that out and look at emerging markets. And then the point I would make on the right-hand side is as the industry has felt a slowdown, it's only the Asia-Pacific region that's continued to stay positive over this time period in terms of positive growth in the industry. So it continues to be an attractive market and attractive place to be.

This is to bring it a little bit more up to date, and I mentioned wireless is an area we're focused on. This is monthly new mobile subscribers in China and India. So the city of New

York is about 8 million people. So for those of you visiting from other parts of the world, this is monthly new subscribers in each of these markets, so still tremendous growth in these growth markets. But the point I would make here is you don't see a lot of economic crisis impact in the raw growth that we're experiencing in these markets.

And that's not to look at profitability, there are challenges in these markets. Operators here have a tough competitive market as well. Not every vendor that sells into these markets is doing well. But the raw growth story in emerging markets looks pretty darn good and looks pretty good irrespective of the financial crisis. And so, if anything, Indian growth over the last 12 months in mobile subscribers has accelerated even through the crisis.

In China, as we look back at the end of last year, and the number fell from 7.9 million per month to 7.4 million per month, there was a lot of equity research and a lot of analysis hand wringing that this was a sign of the financial crisis hitting China. I think a lot of what was happening was internal dynamics in the industry before the telecom operators in China restructured. And so really, again, an internal story, irrespective of the financial crisis. And then, as we've seen, once the carriers did restructure, once they launched new marketing plans post restructuring, very, very strong growth. So actually, again, these have been pretty attractive places to be doing business in the mobile environment.

I'm going to spare you, I don't know how thirsty you all are, but I'm going to move that over so you're not thinking about drinks while you hear from me. This is looking at China Mobile as just one case study of a carrier, a wireless carrier in emerging markets. And again, even in financial crisis period, even when GDP growth in China actually did decelerate, you still see telecom services revenues all across the board, not service by service, but overall 8.9% telecom services revenues growth at China Mobile, which is actually growing faster than GDP.

The other point I'd make is where is it growing. And so usage charges and that growth is driven largely by all these new subscribers who are coming online. But then the value-added services portion of this, so 14% growth in that business, and adding about \$1b of value-added services revenues in the six-month period. So carriers have still been able to do well and do well in emerging markets, and then value-added services being one of the areas that has driven their growth.

So if this is the region that you would want to be in the world, if you'd want to be in Asia-Pacific, if you'd want to be in emerging markets, potentially you'd want to be in China, what I thought I would do is focus on one company that has done well in these markets in particular and has really put pressure on the global equipment vendors. And that is Huawei, China's largest telecom equipment vendor. Now, some of what I'll say, and I think some of what I'll say about the opportunities that they are pursuing, are true for many vendors. And so they're very general opportunities that any vendor or anyone who's looking at this market might pursue.

There's no question that there are some Huawei or China-specific advantages about being based in China and support they get from the Chinese government. And I will talk about those as well. I don't want to make this out that this is a completely general story that any vendor could pursue. There's no question that you'd get support from the Chinese government.

But so to think back about the crisis year we've had and the challenging environment we've had and falling telecom CapEx and falling revenues at most vendors, and then this is the story at Huawei. And I should point out that the second from the right bars here are first half data. So there's been no dip in revenue. This is just they had a very strong first half and then their full year data is at the right of that bar chart, and forecasting 28% year-on-year, or excuse me, they've had 28% year-on-year growth in the first half.

Forecasting very strong growth for the full year. They have come out and said they were trying to hit \$30b of contract revenues. They probably won't get there. But clearly they've had a very, very strong year in a very challenging environment. And of course they've probably made the environment more challenging for some of their competitors. So what are some of the things that are driving that growth? One thing we'll talk about is 3G, and specifically in their home market in China, new technologies that they're well positioned in, so things like LTE, I was just at the GSMA event in Hong Kong. A lot of talk about LTE. PON, passive optical networks. Also in an environment where operators are scaling back their CapEx and looking for cost savings, Huawei looks like a very good alternative. And so they're actually, in some cases, benefiting from the pressure that their customers are feeling. And then finally the Huawei-specific factor, or the thing that other foreign vendors can't turn to, is there's no question they get support from the Chinese government, and I'll talk a little bit about that.

But first, let's look at 3G. And this is clearly an opportunity that Huawei is pursuing. But they're not the only company that's doing that. China issued 3G licenses a little less than a year ago. They'll now have about \$60b over a three-year period of new investment in those networks. And that's really the opportunity that people are pursuing today.

Subscriber numbers for 3G are still very small in China. But if you look out over the next couple of years, we'll start to see bigger opportunities for handset vendors, chipset vendors, other players in this ecosystem who are pursuing the 3G opportunity in China. And obviously we look ahead to a similarly large opportunity in India as well. So clearly the growth of 3G in big emerging markets, like China, has been one of the main drivers behind Huawei's growth. And they're winning a significant portion of this investment from carriers. I mentioned LTE, and this is more of a global story. This is just a list of carriers who have plans for this. This is a little bit out of date actually.

But there was a lot of talk again at GSMA about LTE. And often you think of Huawei or you think of Chinese vendors as technology followers, that they will win market share, some market share with low cost in a mature technology, but actually in LTE they're reasonably well positioned. They're probably the number three WCDMA equipment vendor in the world today. And they are in many of these LTE trials, LTE shortlists, so well positioned to win a significant share of this business. And again, this is certainly an opportunity that many, Ericsson and others, are focusing on quite a bit as well.

Passive optical networks, I don't want to spend a whole lot of time on this, but again just making the point that even we're looking at new generations of technology or new waves of investment that carriers are making, Huawei is well positioned, in part because of the base of business they've built up in China where they are the leading player there, but also targeting the much broader global opportunity for technologies, like passive optical networks.

And then I mention there's no question that there are some China-specific advantages, and the China-Inc advantage behind Huawei. They have been extended by China Development Bank a series of lines of credit. The most recent was a new, I think it was a \$5b in total line of credit. And there's no question that especially in this environment, where it's even tougher for carriers to get financing, and the financing environment is just so much more difficult because of the financial crisis, that this is a big advantage as Huawei goes into some emerging markets.

And I've listed just a couple of the contracts here. And you can see the level of support that Huawei is able to offer. So when they can come to the table to a company like Reliance, Reliance could probably find its own funding, but when they can come to an emerging market operator and say here's several hundred million dollars of financing that I can bring to the table as part of this and provide at preferential terms, they're in a very good position to win some of this emerging market business. And so clearly I don't mean to belittle the share of or the role of government support in this overall growth story that Huawei is feeling.

It's also, there's no question, that Huawei does face real challenges. It's a pretty amazing company and amazing story. I've been to their corporate campus a number of times in Shenzhen. It's a beautiful facility. It would make many international vendors or companies of any sort gel us with just the infrastructure that they have built up there. But it is a company that faces real challenges. And so unquestionably just the fact that it's a tough environment for telecom equipment vendors everywhere that CapEx is declining, it's going to have an impact on Huawei, even though they've been able to continue growth over this past year. There's real pressure on margins.

Global vendors, I think, feel a much more – three or four years ago global vendors could push Huawei to the back of their mind and think well, we're losing a little bit of business in China, we're losing a little bit of business in Africa, but we're really not going to focus on Huawei as a competitive threat. That's clearly no longer the case. And so there's a lot of focus from foreign vendors of thinking of them as the most clear and present danger to their business and they're fighting back aggressively. And Huawei does face also competition from other Chinese vendors. And so ZTE has come in and actually given Huawei some of its own medicine, cut its price below Huawei's price to get into the market and win business.

When many global vendors are building up more robust professional services businesses, this is an area that Huawei really lags in and one that's going to be very difficult for them to build up. I think it's a long-term project for them to figure out how to provide professional services to global carriers. And that's going to take quite a bit of time and investment.

I talked a little bit, in just pressure on margins, about the competition from Ericsson, but also the fact that Ericsson purchased Nortel's wireless business, puts them in a strong position to continue to compete with Huawei. And then also there are, and the US is a big part of this, there are markets where it's just very politically sensitive for Huawei to go into and so they're going to be much, much slower in North America than they are in emerging markets, or even in Europe, I think.

But even with that, even with those challenges, Huawei's on track to become the number two equipment vendor in the world. It's going to be very tough for them to catch up to Ericsson in any kind of realistic timeframe. But they will jump over Alcatel Lucent and, in fact, Nokia Siemens networks.

So here's a company that again, ten years ago, was selling into Iran and the Sudan and people just put it to the back of their mind and five years ago was maybe selling to Africa and Southeast Asia and a few emerging markets and international equipment vendors put it to the back of their mind. And today will probably be the number two, or will in fact be the number two equipment vendor in the world. So a really tremendous growth story. And clearly they are also closing this gap faster, in part because big global vendors are actually shrinking in size at the same time that Huawei has been able to sustain this growth.

So a couple of quick predictions. I think I'm coming to the end and I want to make sure I leave time for questions, but as I said, they're going to be number two in the world and they're here to stay. This is a very impressive company and one that we see really beating up the competition and putting pressure on major global vendors. They have had a pretty significant success breaking into the Vodafones and the Telefonicas and the Oranges in Europe. And we think they're going to expand that presence in Europe. It's not an easy market for them. They've got lots to learn about dealing with global equipment vendors today, but they are making progress.

But North America, as I mentioned, is going to continue to be a challenging market, both for political reasons as well as because Ericsson and after the Nortel acquisition is in just a very, very strong position there. We think they're going to be a leader in wireline for telcos. They'll be number two in wireless after Ericsson. Professional services will continue to be a significant challenge.

And then the margin story is interesting with Huawei. They're actually each year their cost per employee has continued to rise at the company. And as they internationalise, as they go into mature markets and need to hire up people who understand those markets and can do business there, their cost structure starts to look a lot more like global equipment vendors everywhere. And so that's one story behind it. But then they're also working as hard as they can to not only be the low-cost provider but to come in with the same generation of technology where they compete a bit more aggressively, or don't have to compete as aggressively on pricing. So we'll be certainly watching their margins going forward, but an interesting story there.

I think the one other point I would make on Huawei is you can't fault them for their ambition. They are competing head to head with Cisco. They are competing head to head with Ericsson. They still have a mobile handset business so they are competing with Nokia in a sense. And if I were to put up one question over Huawei going forward is at some point they have to pick who they want to be. Do they want to be China's Ericsson or do they want to be China's Cisco. They probably can't be everything. They probably can't continue to sustain the kind of investment it takes to do all those things, and so that's a real question for the company. But this is going to be a big player on the market and a big factor that everyone in the industry has to look at as a supplier or a competitor or a partner but figure it into their strategies.

That's as far as I wanted to go.

**By  
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