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Why emerging markets hold the key to smartphone success for Microsoft-Nokia

Microsoft announced yesterday that it is acquiring Nokia Devices & Services for $7.2 billion, a bold move by the software giant aimed at strengthening the position of Windows Phone in a smartphone market that continues to be dominated by devices running Android and iOS. This deal is expected to close in Q1 2014 subject to shareholder and regulatory approval.

In this analysis, we look at the strategic rationale for the acquisition, focusing on the next wave of mobile growth driven by demand for data services in fast-growing markets, and assess how well Microsoft-Nokia is positioned to benefit from it.

What is the strategic rationale behind Microsoft-Nokia?

From a Microsoft point-of-view, there are two main reasons for the acquisition, which are intricately intertwined. The first is to consolidate its mobile position. For many years it has articulated the importance of being firmly in the mobile space, but has largely been unsuccessful throughout a number of platform iterations, leaving it increasingly irrelevant in the post-PC era (which, of course, it dominated during the 1990s and 2000s). Its share of global smartphone sales (through Windows Phone) languishes under 5%. Nokia has been its principal supporter since the formation of their strategic partnership in February 2011. Both firms have essentially bet their respective futures in consumer mobile on this, so we see the acquisition as a logical extension from partnership to full integration.

The company has positioned itself for the future as a 'devices and services' business. While this can be read a number of ways, we believe the most prescient is in a mobile context where it seeks to control an integrated ecosystem of hardware, software and content/services to challenge the ecosystems of Apple and Google. While it can claim to have control over two of these without Nokia, this deal provides it the missing piece in hardware. In addition, Nokia provides a ready-made, proven capability in supply chain management, marketing and distribution. The alternative (if it was even considered) of investing in all of these on its own would have been extremely difficult and costly, and a particularly unpalatable option for Microsoft given an increasingly impatient investor base looking for clear success in mobile.

The second, and directly related, driver behind the deal from a Microsoft perspective is the need to expand its presence in emerging markets. Microsoft's mobile presence is largely in Europe and the US via Nokia's Lumia smartphone range. While these are high value markets, in many ways they are also the most challenging as it has a very low market share despite smartphone penetration having already passed 50% (leaving it to play catch up, not lead); it is trying to compete in the mid and low tiers where there is entrenched competition from Android; and the lock-in mechanisms employed by other ecosystems are enhanced by high mobile operator subsidies.

The situation is very different in the developing world. Mobile penetration is still under 50% overall, with smartphone penetration under 10%. Internet penetration is just under 30% and rising fast, with much of this driven by mobile, specifically featurephones (often still using 2G networks). Given the vast population in these regions, even if internet penetration were to plateau at 60% of the population (for context, it is now around 80% in the developed world), this implies an incremental increase of around 2 billion internet users on current levels – more than double the number that currently exist across the entire developed world. The twin forces of economic growth (and rising real incomes) and declining device prices are likely to combine with the utility benefits of using the internet to persuade basic and featurephone owners to migrate to smartphones over the next 3-5 years (see Scaling Mobile for Development: harness the opportunity in the developing world). Of course, quite aside from design and pricing, this will require intensive and sustained marketing. Microsoft has little consumer brand awareness and usage in many developing countries (due to low PC penetration). In contrast, Nokia is a relatively well known and established brand, with Microsoft seeking to leverage this by positioning Nokia's featurephones as an 'on ramp' to the higher-end Windows Phone.

Lastly, Microsoft will acquire the right to license a stable of Nokia patents (valued at EUR 1.65 billion through the deal for an initial 10 year period). While these lack the headline-grabbing ability of the wider Devices & Services acquisition, they represent both an important technology enabler (in designing its own products and features) and defensive buffer (from competitor licensing agreements) for Microsoft, particularly those that are required for core mobile communications, common smartphone feature sets, and that have long validity periods.

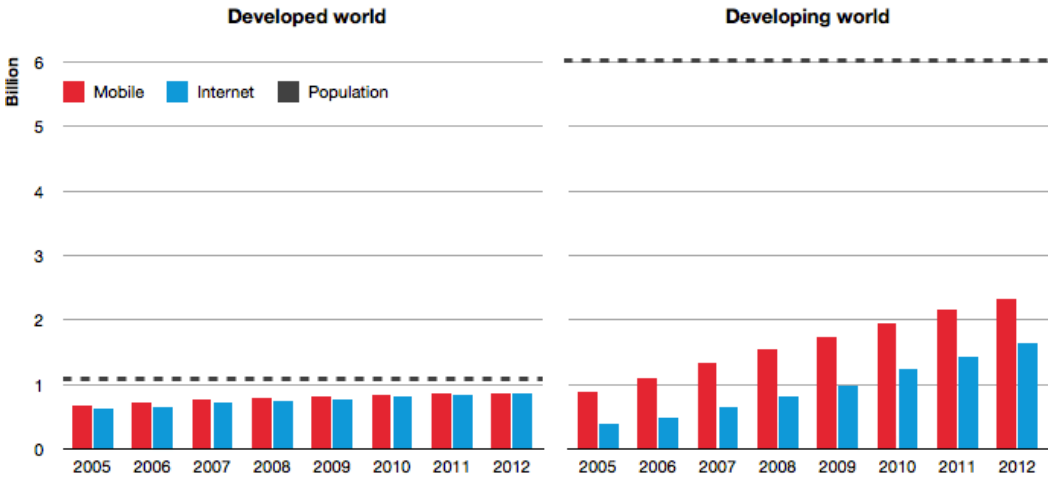

Figure 1: Global mobile and internet users
Source: GSMA Intelligence, ITU

What does it means for the mobile ecosystem?

We believe that Microsoft should focus on disrupting the mid to low-end mass-market space where Android is in a stronger position than iOS (at least until the rumoured low-cost iPhone appears).

The need for more affordable smartphones is a key priority for mobile operators in both developed and developing regions. This trend is notably illustrated by Bharti Airtel's call for $50 smartphones targeting emerging markets and MetroPCS's 4G for All initiative in the US. The wider availability of more affordable smartphones would not only attract high consumer demand (further boosting market share) but would also help operators to reduce subsidies and increase data revenues (in turn helping to preserve margins).

Prior to Nokia's acquisition, Microsoft's interest in low-cost smartphones was evidenced by its 4Afrika initiative, which led to a partnership with Huawei to deliver low-cost smartphones (priced at around $150) to a number of countries on the continent. It is important to note that Vodafone's operations in Africa (through its Vodacom subsidiary) are now generating a joint

EBITDA greater than its operations in Southern Europe, underlining the importance for handset manufacturers to focus on demand in fast-growing markets.

Android is the de-facto operating system that encompasses a wide range of affordable smartphones that have fallen well under the sub-$150 price mark – a 'sweet spot' that Chinese OEMs in particular are focusing on. Microsoft could boost the adoption of affordable smartphones based on Windows Mobile by betting on Nokia's experience in developing affordable devices. Traditionally, Microsoft has been a 'high volume – low price' player while conversely Apple has been a 'low volume – high price' player. To compete against iOS and Android, Microsoft should therefore compete in the lower prices segment that is Nokia's stronghold – one where margins have been relatively healthy as well. Windows-based Lumia smartphones are already available around the $200 price point and well-positioned with first-time buyers.

Last year, Microsoft revealed that it was providing Nokia with financial backing to develop smartphones cheaper than the Lumia 610 to compete with Android. At the time, such decisions were seen as a move to regain momentum in large countries such as China or Russia where Nokia's market share halved year-on-year. According to MTS in Russia, Nokia's share of smartphone volumes in the country dropped from 32% in Q1 2012 to 14% in Q1 2013, yet Nokia's lower cost Asha range was the second most popular OS for mobile devices (behind Android) with 8.4% share in Q1 2013 against 8% for iOS. According to the operator, the share of Windows Phone also increased by one percentage point to 5.7% in Q1 2013 in a country where smartphone retail prices averaged $327, twice the average price of a mobile phone at $170. This example in Russia reflects the momentum that Microsoft-Nokia could build if Windows-based smartphones were falling under the $100 mark.

If Microsoft-Nokia sticks to its 'high volume - low price' philosophy to address mass-market demand and build market share in fast-growing markets, it does have a chance to get close to its 15% market share target of an anticipated 1.7 billion smartphone market in 2018.

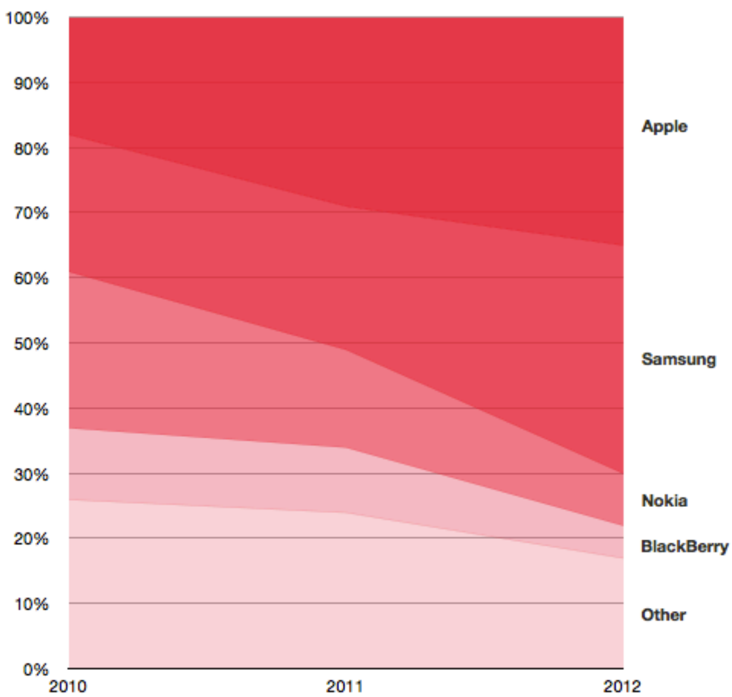

Figure 2: Revenue share by handset manufacturer[1]
Source: GSMA Intelligence

[1] Other includes HTC, Huawei, LG, Sony Mobile and TCL Communication