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Price Cuts Dull Nokia's Edge

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With the cell phone fast becoming the new PC, investors are starting to fear a replay of an all-too-familiar high-volume, price-cutting drama.

Nokia (NOK) and **Motorola** (MOT), the top two handset makers, reported numbers this week showing that both managed to gain share of the world handset market. The gains came at the expense of smaller players like **Samsung** and **LG**, two electronics giants that helped crank up the competitive climate in cell phone sales.

The strain is also starting to show at the top.

To fend off popular phone designs from Motorola, Nokia had to pump extra money into marketing efforts and slash prices again, not only in its European backyard but also in the so-called emerging markets of Latin America, India and Russia.

The effort helped Nokia push its market share up about 3 percentage points to 33%, but the net effect was a starkly disappointing second-quarter report. Nokia missed its earnings target and lowered guidance for the current quarter.

Investors were also chilled by the surprisingly large impact the race for market share had on margins. In the second quarter, gross margins narrowed to 35.7% from 38% in the first quarter.

Nokia shares fell \$1.98, or 11%, to \$15.88.

Though it is a little early in the wireless game to draw firm parallels to other tech sectors, some observers fear the glory days of lush cell phone margins may be waning.

"We're seeing better unit numbers from Nokia but lower prices. It's hard not to be reminded of what happened in the PC industry," says a money manager who owns Motorola and has no position in Nokia. "**Compaq's** margins were 45% at one time, then with mass adoption they fell to 20%."

It's becoming somewhat commonplace to see Nokia on the run again. The Finnish giant rose to dominance in the 1990s on the strength of its leading designs and lean manufacturing base. During a period of particularly rapid growth, though, fashions shifted to folding phones and Nokia was slow to respond.

To try and recapture the lost business, Nokia has had to reinvest in product development and marketing as well as engage in price wars. Nokia effectively knocked European rival **Siemens** (SI) out of the market, but Motorola has proven to be a more formidable rival with its popular Razzr phone.

"If you have the coolest, hottest phones, people pay up for the phone and all other manufacturers have to slash prices to keep share," says Charter Equity Research analyst Ed Snyder, who has a buy on Motorola and a neutral on Nokia. "Now it's Nokia's turn to slash prices, which they did, to keep share, which they did."

Motorola blew by analysts' estimates Tuesday with a strong performance from the company's cell phone unit. The No. 2 handset maker shipped about 34 million phones last quarter, and over 5 million were Razrs.

The rebounding Schaumburg, Ill., giant is the rising star in cell phones, to be sure. The stock, trading at \$20, is near its 52-week high. But Motorola isn't immune from the sting of price battles.

"Motorola is riding high, but their quarter was not without blemishes," says Sanford Bernstein analyst Paul Sagawa, who rates Nokia a buy and Motorola neutral. The company's average selling price was down \$9 "and handset margins remained stalled at 10%."

But together, says Sagawa, "I think Motorola and Nokia are really putting the heat on the smaller guys."

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