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Nortel: "Here to Stay"
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Complaints are down, sales and orders are up—the gearmaker can thrive if it stays focused on its core business.

When Peter Currie took over as chief financial officer at Nortel 18 months ago, he fielded a lot of calls from customers who were worried about the state of the biggest North American phone-equipment vendor. Some even fretted that Nortel, plagued by accounting missteps, falling sales, and management upheaval, would go under. "That's dropped off sharply in the past 12 months," he says. "Customers realize we are here to stay."

Customers are still calling Nortel (NT), but lately they've called to place orders. Verizon Wireless, the joint venture of Verizon (VZ) and Vodafone (VOD), and luxury automaker Rolls-Royce purchased equipment and services in recent months. Business like that helped Nortel return to revenue growth in the second quarter, after a year-over-year decline in the first three months of the year, and gave company executives cause for an upbeat outlook for the second half.

Sales rose 4.8% to $2.7 billion in the three months that ended in June, Nortel said Aug. 3. That missed some analysts' estimates slightly. Still, it's on top of a year-earlier quarter when sales were unusually high because of one-time software upgrades, the company said.

BRIGHT SALES OUTLOOK. What's more, orders grew 22% and Nortel finished the quarter with a backlog of $5.9 billion. Sales will pick up in the second half, increasing more than 10% in the current period and finishing the year in the high single digits growth, the company said. "We are starting to see nice traction with customers," Nortel Chief Executive Mike Zafirovski said during a conference call with analysts after results were released.

The numbers suggest Nortel is gaining share in an increasingly competitive phone-equipment arena, says Albert Lin, an analyst at American Technology Research. "That's impressive in this environment," he says. Alcatel (ALA) has acquired Lucent (LU), and Nokia (NOK) and Siemens (SIE) are combining their phone-equipment businesses (see BusinessWeek.com, 4/3/06, "Alcatel and Lucent: A Global Logic", and 6/20/06, "Nokia, Siemens Point the Way").

More orders could be forthcoming. Sprint (S), which reported disappointing results on Aug. 3 (see BusinessWeek.com, 8/4/06, "Sprint Nextel: Way Off the Hook"), may step up the pace of network upgrades to do a better job keeping and attracting customers, say analysts at Cowen & Co. Sprint increased its capital spending budget to $7 billion to $7.1 billion this year, compared with an earlier forecast of $6.3

billion to $6.4 billion. In the short term, Nortel could also make hay while Alcatel absorbs Lucent and Nokia and Siemens integrate their venture, says Ed Snyder, an analyst with Charter Equity Research.

NEED BETTER MARGINS. Still, Nortel is by no means out of the woods. While revenue growth is a step in the right direction, Nortel has yet to show it can make money on these sales. "Unprofitable revenue is not good," says Gus Papageorgiou, an analyst with Scotia Capital. "The company has good products and good prospects, but they need to capitalize on them" (see BusinessWeek.com, 6/07/06, "At Nortel, Silence Isn't Golden").

In the second quarter, the gearmaker reported profit of $366 million, reflecting a $510 million increase related to the recovery of certain legal costs. Without the gain, Nortel would have booked a loss. Due to pricing pressure from much-larger rivals like Alcatel, Nortel also missed a target of 40% gross margins. That's the main reason investors punished the stock, sending Nortel's shares down 2.45%, to $1.99, following the earnings announcement. Nortel is expected to return to profitability in 2007.

While Nortel execs promise to increase margins from the current 38.8% to 40% by yearend through cost cuts, pricing pressure from the likes of Alcatel and Nokia could keep such higher margins out of Nortel's reach, says Lin.

TIME TO DIVEST. To stand out, Nortel has to turn into a more focused market player, divesting smaller, unprofitable businesses. Already, the company is considering selling its so-called UMTS wireless infrastructure business. A sale could fetch between $800 million and $900 million, according to RBC Capital Markets. And more product and unit divestitures could be forthcoming. Paul Sagawa, an analyst with Sanford C. Bernstein, believes Nortel's annual revenues could plunge from about $10 billion to between $4 billion and $5 billion, as Nortel turns into a tightly focused shop like Ciena (CIEN) and stops competing with diversified giants like Alcatel on all fronts. Nortel wouldn't comment on any possible divestitures.

The gearmaker should instead focus on strongholds like Internet protocol (IP) equipment, say analysts. A recent strategic alliance with software giant Microsoft (MSFT), under which the companies will collaborate on everything from business communications-related marketing to product development, should help fuel Nortel's future revenue growth as well. Nortel expects to book more than $1 billion in incremental sales as a result of this deal over the next three years.

Clearly, Nortel still has a lot to prove. "Fundamentally, [after the latest round of industry consolidation] it's a company that lacks the scale to compete against much-larger companies it competes with," says Sagawa.

But as it slims down and concentrates on its strengths like IP and makes the most of partnerships like the one with Microsoft, it could start proving the naysayers wrong. And Currie can keep focusing on the numbers instead of calls from concerned customers.