# market monitor

## Focus on consumer electronics/ICT performance and outlook

May 2012

# The future seems to be bright, but…

Walk into any immaculate Apple store and you'll see immediately why the consumer electronics industry seems to be bucking the trend of many other struggling sectors. It's the same story in many other high street home entertainment retailers too: with shoppers lining up to try – and buy – the latest smartphone, tablet computer or LCD TV.

As this edition of Market Monitor shows, while across the globe the outlook for fast-moving and constantly changing equipment of this kind is booming - consumer electronics/ICT sales are expected to grow 4.3% worldwide – the sector as a whole is not without its downside.

In France, for instance, while the sale of tablets rose by a massive 160% last year, for many small and medium sized companies in the industry profit margins are tiny. And, in the UK, low consumer confidence in the overall economy is taking the edge off demand.

In fact, many of the consumer electronics/ICT markets reviewed this month cannot escape the effects of an uncertain global economy. Even in China, the IT industry may feel the effects in the slower pace of its exports, but at least its burgeoning domestic market is compensating, with growing demand for all manner of electronic products, boosted by the rural subsidy programme and product innovation. India's IT service sector too is adapting its focus, in the light of Europe's declining share of market demand, by growing its business in the Asia-Pacific region.

The characteristics that make this such a dynamic and successful industry are also, ironically, the source of its risks and weaknesses. As our report on Germany mentions, because the industry is by nature entrepreneurial and innovative, that leads inexorably to steep competition, price erosion and low margins –even in a market with good growth prospects.

# France

## Some structural weaknesses in all subsectors

**IT**

In 2011, sales in the French IT hardware market increased 3.5% year-on-year, driven by private demand: sales of notebooks increased 7% and tablets a massive 160%, while IT hardware sales to businesses rose a modest 1.5%. However, after a good performance in Q3 of 2011, hardware sales deteriorated sharply in Q4. This left high stock levels at the end of the year which needed to be cleared out during Q1 of 2012. In addition, the November 2011 floods in Thailand led to a temporary stop in production – mainly of hard-drives - which, by January and February 2012, had created worldwide shortfalls. Software sales were quite resilient in 2011, with 4% growth of Enterprise Resource Planning (ERP) and management software.

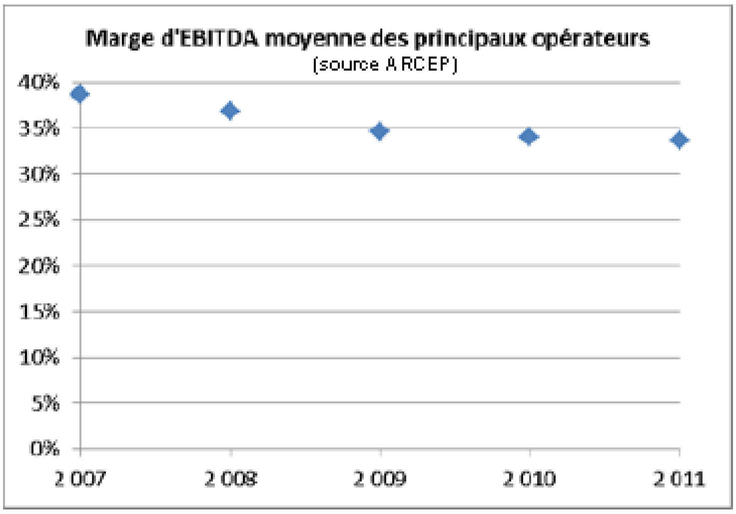
The French IT market is dominated largely by international groups such as Ingram, Tech-data and Actebis for hardware; IBM and HP for services; and Oracle, Microsoft and SAP for software. While there are some large French-based companies, such as Cap Gemini and Bull, the many small French companies generally have weaker financial strength. With tiny operating margins (less than 5%) and limited capitalisation (below 25%), many of those IT businesses need to be carefully monitored.

**Telecommunications**

With its high entry barriers, the French telecommunications market is highly concentrated around four operators. In the last 12 years, production rose 85% at constant prices, while service prices decreased 15% over the same period. 2011 was an exceptional year in terms of investment, which rose 8% to EUR 8 billion: mainly directed at infrastructure to upgrade the networks.

Mobile virtual network operators (MVNOs) are trying to gain market share with professional or private consumers, while thousands of small and fragile private companies are surviving on sub-contracts. 90% of businesses in this subsector have less than five employees, while just 1.8% of companies have more than 50 employees. Competition has become fierce since Free Mobile entered the market in 2009. Its low cost policy has pressured other operators to reduce their prices and unsurprisingly, in this competitive environment, earnings before interest, taxes, depreciation, and amortization (EBITDA) have eroded, dipping below 35% of revenue in 2011, from 39% of revenue in 2007 (see chart overleaf). Free Mobile's low-cost policy and MVNOs growing market share (11.3% in 2011: up 6% year-on-year) will underscore this trend in the coming years.

Operators' financial performance is generally still strong, but we are monitoring the long-term impact of eroded EBIDTA compared to cash generation. MVNOs are constantly monitored as they face direct competition from Free Mobile: they need at least five years to reach break-even, during which they will be extremely vulnerable at a time when they are 'burning cash'. That said, despite unbalanced financial structures and sometimes deep losses, French MVNOs are often owned either by financial institutions or powerful shareholders, mitigating the risks. The riskiest parts of the telecommunications subsector are the small sub-contractors, as in general their solvency is weak.




Source: ARCEP

**Consumer electronics**

As in many other markets, last year's tsunami in Japan caused a shortfall in consumer electronics production in France. While the subsequent catch-up effect led to solid growth, according to market researchers GfK sales decreased 14% year-on-year in Q4 of 2011. Overall consumer electronics sales in 2011 increased 1% in France, with a million tablets sold over the year (450,000 in 2010) and smart phone sales up 21% year-on-year in Q4 alone. That said, sales of TVs and video games have been impacted directly by decreasing private consumption (estimated to record zero growth in 2012) and by a lack of innovation. In Q1 of 2012, TV sales fell 24% by volume and 34% by value. Video games decreased 25%, due to poor releases (i.e. no 'blockbusters') and increasing online gaming.

All distribution channels within this subsector face a drop in sales, although the extent of the drop ranges from 10% to 25%, depending on their product mix.

- The purchasing power of large wholesalers enables them to maintain positive - if slight - margins (5%).
- Medium-sized players, often poorly capitalised, will struggle to counter the long-term effect of decreasing sales.
- National retailers (such as Fnac) also face declining sales and have launched redundancy plans in early 2012. However, shareholder support and good equity strength allow them to withstand a downturn.
- Independent and poorly capitalised retailers face major difficulties.

Finally, internet pure-players are performing well, thanks to their ability to win market share from traditional shops and their flexible cost structures.

## Lower growth expected

International Data Corporation (IDC) expects French ICT market growth to slow to 1.2% in 2012, driven mainly by private demand (up 5% to EUR 4.3 billion), while commercial demand will grow by just 0.7%: to EUR 42.8 billion. Software sales will remain flat, growing 0.5% to EUR 2.2 billion. Hardware demand will feel the effects of cost-saving measures and may therefore decline in 2012. If the economic situation deteriorates further, companies will cut or postpone investment and development projects, hurting the IT sector. Meanwhile, cloud computing is becoming easier to implement and is sometimes necessary for businesses, signalling continued growth prospects.

Private consumption will remain flat, due to the many uncertainties surrounding future economic developments, and this will dampen demand for consumer electronics. Businesses in this subsector will continue to face poor demand, tougher competition from internet pure-players, and mass-market discount policies. Consumer electronics' retailing and retail chains will have to adapt quickly, as consumers will often browse for a product in a local store but then order it on-line. This signals a fundamental shift in consumers' perception of value. The video games market has also engaged in the painful transition to virtual gaming, meaning that physical support will disappear in the coming year. Consequently, sales will again decrease in 2012, with no blockbusters on the horizon to boost consumption.

## Rising insolvencies in 2012

Under French law, payment terms must not exceed 60 days. Although it is difficult to distinguish between subsectors, because of the scarcity of accurate statistics on the topic, it is estimated that 40% of French businesses exceeded this legal limit in Q1 of 2012. As far as consumer electronics/ICT is concerned, we have seen no signs of either general deterioration or improvement of payment behaviour in recent months. Q1 is structurally a good period, in terms of cash, as stock levels will be low and all payments from end-of-year sales will have been received. However, it is the longevity rather than the intensity of the economic stagnation that is causing the most damage, as companies have been drawing from their resources since 2009. Therefore, with a subdued 2012 outlook for the French economy, payment delays are likely to increase in the coming months.

On average, compared to other French industries, the consumer electronics/ICT sector's insolvency rate is high. But in 2011 the default rate in the IT subsector decreased by 5% year-on-year. As ICT service companies profited from solid demand from large groups (financial or telecommunication companies), their default rate actually decreased 18%: to 301 businesses from 369 in 2010). In the ICT sector, fewer new companies were registered in 2011, automatically limiting the number of failures, since the youngest firms are often the weakest. While Q1 figures tend to confirm a stabilization of the number of insolvencies, we expect business failures in the sector to increase in 2012. For several months we have noted that the insolvency rate of mid-sized and larger businesses (with turnover exceeding EUR 20 million and /or more than 50 employees) is higher than a year ago.

Due to structural deficiencies and decreasing growth in the sector, we have a cautious underwriting approach to ICT and consumer electronics. We request the latest financial updates from companies and undertake regular portfolio reviews. We assess their ability to manage their stock and their cost structures, and their dependency on both suppliers and customers. Our information is augmented by regular visits to companies by our agents across France and through links to banks that can sometimes help us anticipate issues affecting the companies that we underwrite.

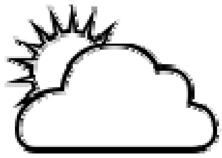
As the consumer electronics market is losing both volume and value, we pay particular attention to this subsector.

### French consumer electronics/ICT sector

| STRENGTHS | WEAKNESSES |
|---|---|
| Innovative industry | Slowdown of growth and private consumption |
| Cloud computing provides growth potential | Very competitive market |
| | Many small players with tiny margins |

# Germany

## Growth will rebound in 2012



Since a sharp decrease during the 2008/2009 economic crisis, the German consumer electronics/ICT market has recorded yearly growth. However, according to the German Federal Association for Information Technology, Telecommunications and New Media (BITKOM), sales growth slowed to 0.5% year-on-year in 2011 (see chart below). The information technology subsector recorded a 3.1% decrease, while both consumer electronics and telecommunication decreased: 6.3% and 0.7% respectively.

In general, businesses in all subsectors (information technology, telecommunications, and consumer electronics) have below-average equity strength. Profit margins are tight due to fierce competition – with very high price competition. Innovation is key to business success and there is an enduring process of consolidation in the market. The general solvency and liquidity position of ICT businesses varies from tight to sufficient, with companies often using factoring as a means of financing.

| **Comsumer electronics/ICT - Market Germany** | **Market Volume (in billion EUR)** | | | | | **Growth Rates** | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **2008** | **2009** | **2010** | **2011** | **2012** | **09/08** | **10/09** | **11/10** | **12/11** |
| **Total ICT + Digital Consumer Electronics** | **147.4** | **142.2** | **147.8** | **148.6** | **151.0** | **-3.5 %** | **3.9 %** | **0.5 %** | **1.6 %** |
| Digital Consumer Electronics | 13.1 | 13.5 | 13.5 | 12.7 | 12.5 | 3.1 % | 0.1 % | -6.3 % | -0.9 % |
| ICT | 134.3 | 128.7 | 134.3 | 135.9 | 138.5 | -4,1 % | 4,3 % | 1.2 % | 1.9 % |
| | | | | | | | | | |
| **Information Technology** | **68.3** | **63.1** | **68.1** | **70.2** | **72.4** | **-7.6 %** | **8.0 %** | **3.1 %** | **3.1 %** |
| IT – Hardware | 19.1 | 16.3 | 19.7 | 20.0 | 20.6 | -14.6 % | 20.6 % | 1.3 % | 3.0% |
| Software | 14.8 | 14.3 | 15.4 | 16.2 | 16.9 | -3.3 % | 7.9 % | 5.1 % | 4.4 % |
| IT – Services | 34.4 | 32.5 | 33.0 | 34.1 | 34.9 | -5.6 % | 1,7 % | 3.2 % | 3.5 % |
| | | | | | | | | | |
| **Telecommunication** | **66.0** | **65.6** | **66.1** | **65.7** | **66.1** | **-0.5 %** | **0.8 %** | **-0.7 %** | **0.6%** |
| TC - Terminals | 4.9 | 6.3 | 6.9 | 7.0 | 7.3 | 29.8 % | 9.9 % | 0.3 % | 5.2 % |
| TC - Infrastructure | 5.8 | 5.5 | 5.5 | 5.7 | 5.8 | -5.0 % | 0.3 % | 3.2 % | 2.7 % |
| TC - Services | 55.3 | 53.9 | 53.7 | 53.1 | 52.9 | -2.7 % | -0.3 % | -1.2 % | -0.3 % |

Source: Bitkom, EITO; February 2012

According to BITKOM, consumer electronics/ICT turnover of products and services will increase 1.6% in 2012: exceeding EUR 150 billion (see chart above). To date, the Eurozone crisis does not appear to have damaged German ICT sectors in any way. Order books were well filled at the beginning of 2012 and sales of IT hardware, software and services are set to increase 3.1%: to EUR 72.4 billion. The market for IT hardware is expected to increase 3 % to EUR 20.6 billion. While sales of desktop PCs will fall by 4.4 %, and smaller netbooks by as much as 31%, sales of tablet PCs are expected to increase 19%: to EUR 1.3 billion. The software market is forecast to increase by 4.4 %, to almost EUR 17 billion, while IT services such as outsourcing and maintenance are expected to rise 3.5 % to EUR 34.9 billion, as demand from German business remains robust. Cloud computing services will increase by 47% this year.

Telecommunications sales will increase 0.6%, with competition in this subsector remaining high. Thanks to the popularity of smart phones, the market for mobile phones will grow 6.2%: to EUR 6.7 billion. Consumer electronics will decrease 0.9% in 2012, after a fall of 6.3% in 2011. Major sports events like the UEFA EURO championships and the Olympic Games this summer will boost sales of flat screen TVs, but fierce price competition will lead to lower turnover.

On average, payments in the consumer electronics/ICT industry take between 30 and 60 days. We have seen no increase in payment delays over the past couple of months and, with a positive outlook for 2012, we expect this to remain unchanged.

In 2009, consumer electronics/ICT insolvencies increased 19.9% year-on-year: far higher than the overall level of German business insolvencies (11.6%). After another slight increase in 2010 (0.7%), consumer electronics/ICT insolvencies decreased 8.0% in 2011, compared to a 5.9% drop in overall business insolvencies. We expect the sector’s insolvency rate to be lower than the average, levelling off this year while overall German business insolvencies increase by up to 5%.

## The dynamics of the market require a sensible underwriting stance

Consumer electronics/ICT is a very fast and innovative industry, with generally good growth prospects, but is also characterised by low margins, sharp price erosion and steep competition: all of which engender the ongoing trend of consolidation. Unless they are well-established in niche-products, smaller companies are and will be the losers in this cut-throat competition.

Against this background, our underwriting approach is selective, and we require a high degree of information on each company we underwrite. If we are to approve credit limits we need to have the most recently available insight into the company’s performance, including:

- annual accounts
- interim accounts (not older than 3 months)
- overview of liquidity status (including credit facilities provided by banks)
- business forecasts.

Generally, we are very restrictive when covering companies that have operated for less than one year, unless they are part of, or a spin-off from, a larger group. Retention of title is mandatory. Normally we hold annual reviews, with additional reviews of problematic sub-sectors or in cases where we perceive difficulties. Because of the dynamic nature of this market, we need to react immediately to negativity in a company's creditworthiness or operating results.

### German consumer electronics/ICT sector

| STRENGTHS | WEAKNESSES |
|---|---|
| Fast product innovation leads to new customer demand | High innovation pressure: therefore a focus on stock turnover, as high investments have to be financed |
| Complete service packages, which can be offered in addition to the products, may be key to a positive purchase decision or to customer retention | The increasing interchangeability of products makes it difficult for companies to distinguish themselves from their competitors |
| No dependency on specific customer sectors | High competition, high pressure on prices, leading to low margins |

# United Kingdom

## The rebound levelled off in H2 of 2011

The British ICT sector had experienced a reasonable recovery through much of 2011, after a flat and uncertain trading period in 2010. This rebound was fuelled by the reinstatement of many IT projects after reduced IT capital expenditure during the previous two years. However, the rebound began to level off in the second half of 2011. IT project spending earlier in the year was led by the Finance & Banking sector: coming at an opportune time, as the effects of public sector cutbacks were nervously awaited. The impact of the much-reported austerity measures (the British government announced a number of austerity measures throughout 2009/10, many of which focused on public sector ICT spending) does not appear to have been that hard felt, with most of the cutbacks falling on a few very large projects, such as BSF (Building Schools for the Future). General IT spending, typically on upgrades and renewals, still went ahead.

In the second half of 2011, uncertainty over the deteriorating economic situation in Europe was one of the biggest obstacles to continued recovery in most sectors - and IT was no exception. Economic confidence plays a major role in any business's willingness to invest.

Software remains a fairly robust subsector. Throughout the economic downturn, many organisations opted not to upgrade their hardware: instead investing in software that would allow them to gain an operational advantage. What we have seen is a convergence of offerings from IT companies as, to enable them to attract a reasonable margin, they have to offer hardware, software and maintenance/services from a 'one stop shop'.

Telecommunications is a fairly stable subsector, dependent on a number of large Original Equipment Manufacturers (OEM) in the UK and on capital expenditure. New infrastructure is limited and differs from region to region. For example, investment is artificially high in London at the moment due to the forthcoming Olympics. Generally the trend is towards system upgrading rather than on the installation of new infrastructure.

Consumer demand for IT and electronic products continues to be affected by the increase in VAT and higher inflation, and this area remains a cause for concern, with retailers still going through a very tough time. Consumer confidence remains low, with the high street one of the biggest worries for the economy. IT and electronics activity into this area is a real concern, although innovative new products still seem to be holding up well.

## Pressure on margins continues

For the past three to four years, competition in the sector has been very aggressive, as businesses have sought to hold on to market share. This has led to continued pressure on average selling prices and, as a result, we have seen gross margins come under pressure. For instance, there is persistent pressure on the price of hardware, with many distributors making minimal margins on kit: indeed, in many instances, it is only due to OEM support that distributors are able to make any margin at all. The pressure on margins has led to ICT businesses introducing more service-focused activities with the aim of boosting margins and customer retention. From an operating margin perspective, many ICT businesses are flexible: balance sheets do not contain properties, and most premises are leased, so that the largest operational cost remains that of the workforce.

General equity strength remains a major concern in the industry, historically characterised by entrepreneurs that have sought 'get rich quick' schemes. While the channel is now far more mature, the industry remains dominated by a number of businesses run by shareholders who consider it the norm to extract large dividends. This is of concern, as balance sheets remain modest compared to the scale of operations.

The main source of liquidity for ICT businesses is bank debt: and in particular Invoice Discounting (ID) facilities. From an analysis point of view, there is less concern where an ID line is used to fund the working capital of a business. However, concern increases where ID lines are used to fund the strategy of the business - for example, funding acquisitions or property purchase - as this leaves the business susceptible to a downturn in trade causing a liquidity pinch, and this is often the point where vendors turn to credit insurers for additional support.

## No large-scale insolvencies expected

On average, payments in the consumer electronics ICT/industry take between 30 and 45 days. If a payment slips by as little as one day, it will receive special attention, while in the event of a few days' delay the account will be put on stop. 60 days are considered to be the maximum terms in the industry. ICT equipment has a very short shelf life and the prospect of debt collection once a debt passes the 60 day point is minimal. We expect payment delays to increase and payment terms to be extended in the coming months.

There have been few large scale insolvencies in recent years, thanks to the level of consolidation in the sector. As such, weaker players are acquired rather than left to fail. However, the level of insolvencies has been kept artificially low throughout the recession, with many businesses taking advantage of the 'time to pay' scheme. Her Majesty's Revenue and Customs (HMRC) is currently supporting an estimated 80,000 companies that under normal circumstances may well have failed. While this scheme has now ceased, there can be no doubt that, when many businesses faced liquidity issues, this was a vital life line.

In Q4 of 2011 we saw an increase in smaller insolvencies. What we have noted is that, where a business has become insolvent, it is a last resort, as usually a business will be acquired out of a pre-pack administration. Those that do become insolvent are often viewed as having no value to others in the channel. We expect the next six months to be fairly flat with some smaller losses at the lower end of the scale.

The industry as a whole continues to be dominated by a high level of fraudulent activity, as is the case with any industry related to fast moving consumer goods.

## Impacts of public spending cuts still unclear

The next six months will see a continued trend of falling hardware sales and decreasing margins, while software will remain buoyant as clients upgrade rather than replace. This also works in favour of greater focus on maintenance of systems, with longevity becoming of critical importance.

A major ongoing concern remains the potential impact that public spending cuts could have on the sector. Many IT businesses had concentrated much of their sales efforts in recent years on the seemingly secure public sector, and any cuts are likely to have consequences for them. However, the concrete impact remains difficult to predict, and the UK public sector ICT spend still stands at £650 million a year.

We underwrite the ICT sector in the context of the economic picture as a whole and, with the UK economy technically back in recession (preliminary figures of the UK Statistics Office showed that in Q1 of 2012 GDP shrank 0.2% on the previous quarter after -0.3% in Q4 of 2011), we are taking a cautious approach. We are especially cautious in the case of any business focused heavily on the education sector, because of public spending cuts, but will also take the opportunity to understand their pipeline and contingency plans through our comprehensive visit schedule.

The ICT sector has endured various economic downturns and, as a result, the industry as a whole understands the importance of transparency if we are to underwrite its risks accurately, This is especially important now, in view of the market turmoil in the Eurozone, since ICT is a pan-European sector. Because customers and buyers generally understand the importance of open communication and the provision of up-to-date accounts, we are able to give a high level of vital support to the sector. Recent management information – no older than six months - allows us to make the most informed decisions. Because of our commitment to the channel and the relationships built over the years, many buyer companies provide us with information on a regular basis. Clarity over supply lines is also important, and we therefore advise buyers to provide us with details of their future purchasing trends.

As mentioned, we operate a comprehensive visit schedule, with a particular emphasis on risks of greater complexity. With the large concentration of customers that we have in this sector, we recognise our key role in helping to maintain our customers' cash flow and to ensure that, where insurance can be underwritten, it will be.

### UK consumer electronics/ICT sector

| STRENGTHS | WEAKNESSES |
|---|---|
| The channel is well developed | Dependent on OEMs |
| Large availability of business information | Credit line constraints |
| | Obtaining new funding lines can be difficult |

# United States

## Retailers have to meet the challenge

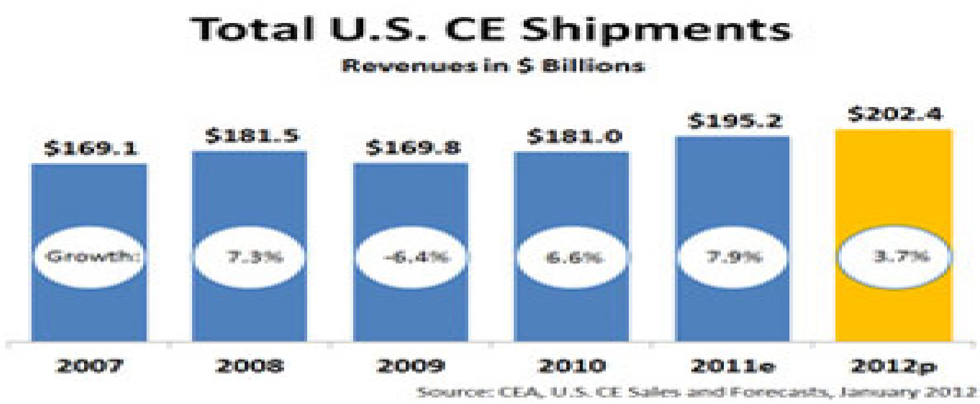
**Consumer electronics**

In the US, sales of consumer electronics in 2012 are expected to grow 4.1%: to US$ 249 billion, with tablets and smartphones (+12% each) maintaining their dominance of the marketplace. As consumers continue to integrate these mobile connected devices into their everyday lifestyles, there will be an increase in ownership of all-in-one devices and related content. However, TV sales are expected to grow by just 1%.

The average household will still own electronic devices, but there will be a decrease in overall spending as consumers seek out bargains, deals and discounts on these devices, taking advantage of declining price points for certain product categories. Average prices of flat panel TVs and smartphones have decreased, putting revenues and margins under pressure. In the US, the average price of a LCD TV set is now below US$ 600, while the average price of smartphones continues to fall as new manufacturers enter the market with lower priced products. Mature markets in many product segments mean vendors will continue to rely on product innovation to drive growth. If consumer confidence rises, 3D TV sets and smartphones may benefit. However, if oil prices continue to rise, it could be bad news for disposable income and will probably have a negative impact on overall consumer electronics sales in 2012.

In an effort to offset difficult conditions in consumer electronics and appliances, retailers are broadening their product range. New product offerings from some consumer electronics retailers include furniture, mattresses, housewares, play items and hand tools, as retailers look to increase revenues and profit margins while coping with soft demand in their core consumer electronics and appliance sectors.

Research indicates that US online retail sales will directly account for 8% of total retail sales and will influence 53% of all retail sales by 2014. Media and entertainment space in consumer electronics retail establishments will be irrevocably changed by the digital content revolution. The digital medium is replacing CDs and DVDs. It is therefore imperative for consumer electronics retailers to expand their mobile and e-commerce channels of distribution. The ‘bricks and mortar’ retail model will probably continue to move towards a smaller, low cost model as well as making use of a mix of offline and digital channels for their transactions. Retailers will be required to offer more multi-channel options to compete with online retailers.

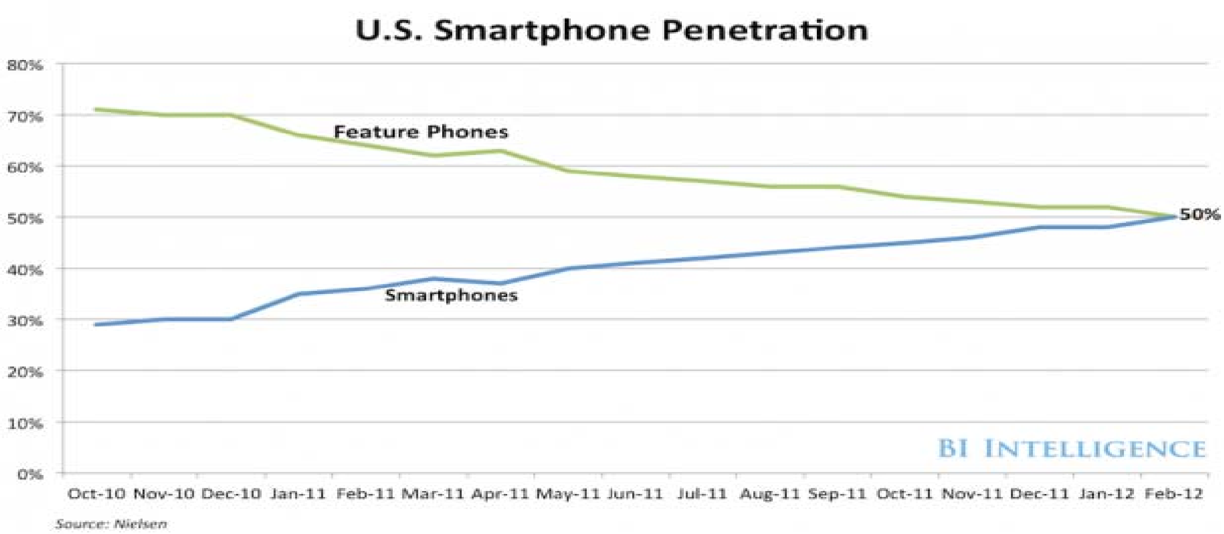


**Computer hardware**

The computer hardware sector will continue to struggle as it works to recover from the supply chain constraints within the hard disk drive industry caused by the devastating flooding experienced in Thailand during late 2011. This impact is expected to affect the industry into 2013. However, given the US economic growth forecast of 2.1% for 2012, the computer hardware industry is likely to perform satisfactorily.

**Telecommunications**

The telecommunications sector is expected to continue to lead ICT spending in 2012, as consumer demand for mobile devices remains strong. Overall spending and capital expenditure from the large US carriers, such as Verizon, AT&T and Sprint, will continue to remain at elevated levels in order to expand 3G and 4G (LTE) networks. The increased internet and mobile traffic caused by continued smartphone adoption is leading to shortages of capacity (spectrum) and putting pressure on carriers to invest in infrastructure. This was highlighted by AT&T's recent bid to acquire T-Mobile. AT&T was looking to obtain additional spectrum capacity from T-Mobile, which would have alleviated pressure on its increasingly crowded network. The rise in the popularity of tablet computers, including the iPad, continues to put increased pressure on wireless networks. Since 2009, the American Recovery and Reinvestment Act has distributed US$ 1.58 billion in contract, grant and loan programmes through the 'Broadband Technology Opportunities Program', an initiative of the National Telecommunication and Information Administration. These funds have been used in large part to extend broadband access and to increase the strength of wireless infrastructures.




**Semiconductor industry**

The Semiconductor Industry Association in Washington D.C. reported worldwide semiconductor sales of US$ 299.5 billion in 2011: a year-on-year increase of 0.4%. However, sales of semiconductors fell 5.3% year-on-year in Q4 of 2011. Over the course of the year, the industry recognized strong demand in optoelectronic, sensor, and microprocessor devices. Micro electromechanical systems, which are increasingly being used in smartphones and tablets, saw particularly strong growth in 2011. Due to the tsunami in Japan, flooding in Thailand, and the generally weak state of the US economy during 2011, the industry experienced major challenges throughout the year. Several large semiconductor companies have announced plans for new facilities and significant R&D investment. In September

2011, Intel Corp, IBM, GlobalFoundries, Samsung, and Taiwan Semiconductor Manufacturing Company agreed to a joint US$ 4.4 billion five year investment to develop new computer chip technologies in New York. This investment is expected to result in 2,500 new technology jobs. The subsector is expected to grow by 3.7% in 2012 and 5.8% in 2013.

**Personal computers (PC)**
The PC market struggled throughout 2011, as consumers moved towards more mobile computing options including tablets and smartphones. Gartner reported a 5.9% drop in US PC shipments during Q4 of 2011 (down 1.4% globally). Preliminary figures for 2011 show less than 1% growth in total worldwide PC vendor unit shipments. Not including tablets, HP continues to lead the global PC market with 17.2% market share, followed by Lenovo with 13.0%, Dell with 12.1% and Acer Group with 11.2% market share. Fuelling the decline in the traditional PC market is Apple's iPad, which accounted for 73.4% of tablet sales in 2011. In Q4 of 2011 alone, Apple sold 15.43 million iPads: a 111% unit increase year-on-year. With the release of the iPad 3, Apple sold three million in the opening weekend: almost twice the estimated sales of the iPad 2's first weekend. This is evidence of the increasing popularity of the tablet computing option. As major manufacturers such as HP recognize the declining PC market, they continue to move towards fully integrated, full service enterprise solutions, which maximize the hardware systems offered by the company.

## No increase in payment delays

The consumer electronics/ICT sector's insolvency rate continues to be below the average of US industries generally. We have not seen any significant insolvencies over the course of 2011 and do not expect the situation to change in the next six months. Total credit insurance claims in the sector were down significantly on the previous year. Payment terms are generally between 30 and 90 days within the industry, and notifications of non-payment have remained essentially flat on a year-on-year basis.

When payment delays do occur within the sector, they are generally between manufacturers and retailers, wholesalers and distributors, arising from disputes over product pricing. Manufacturers often offer 'price protection' or discounts on products in order to move inventory because of the rapid innovation of technology experienced within today's market. This can lead to disputes and ultimately an increase in non-payment until the issues can be resolved. Supply chain constraints, such as those experienced due to the recent natural disasters in Japan and Thailand, can also lead to increased disputes.

## A cautious outlook for consumer electronics

Overall, we maintain a cautious outlook for the consumer electronics subsector. While manufacturers continue to bring a steady stream of new and innovative products to market, the current state of the US economy continues to put pressure on consumers' discretionary spending. The economy is still dogged by elevated unemployment, stagnant wages, high gas prices, and a depressed housing market, leading to increased price competition amongst retailers and pressurized promotional activity. In addition, traditional brick-and-mortar retailers continue to be hit by the growing e-commerce sector: especially Amazon. The pending online sales tax legislation under review in multiple states should be closely monitored. Due to falling prices and depressed margins, we expect to see a continued product shift among the traditional retailers: from flat screen televisions, DVDs and video games towards service-oriented product lines including mobile and broadband offerings.

The outlook for the computer hardware, telecommunications, and semiconductor sectors remains positive, as significant capital investment is being made in R&D, resulting in a steady stream of new and innovative products. Investment in infrastructure remains strong within the telecom sector, as wireless providers look to expand network capabilities and improve service offerings. While the computer hardware industry will continue to be affected by the natural disasters in Japan and Thailand, most major manufacturers have begun restoring operations to pre-disaster capacity levels or have shifted to suppliers in other locations. But mobile computing and tablet computers are likely to continue to erode the market share of traditional PC manufacturers.

**US consumer electronics/ICT sector**

| STRENGTHS | WEAKNESSES |
|---|---|
| Semiconductors are used in a multitude of products, and the end users/markets are very diverse across a wide array of industries | US macroeconomic factors, such as high unemployment, stagnant wages, high fuel prices, and a depressed housing market continue to affect consumer spending and enterprise IT expenditures, putting increased pressure on both manufacturers and retailers |
| Product innovation high within the US. Apple remains a strong example with products including the iPhone and iPad | Highly competitive industry leading to increased pricing pressures |
| Strong demand for mobile technology and network capacity has led to increased private, public, and government spending on network infrastructure and broadband capabilities | Capital intensive - requiring heavy research and development to keep pace with the industry's technological advancements |

# China

## Large growth rates in all subsectors

**IT (hardware, software and services)**

According to the Chinese Ministry of Industry and Information Technology (MIIT), Chinese IT industry turnover increased 20% year-on-year in 2011: to CNY 9.3 trillion (EUR 1.1 trillion).Thanks to government stimulus packages and a recovering economy, hardware achieved revenue of CNY 7.49 trillion (EUR 0.9 trillion) in 2011: up 17.1%. The cost-efficiencies of cloud solutions offered a significant opportunity to penetrate this segment. As the world centre for original equipment manufacture, China contributed over 90% of total PC production worldwide in 2011, with PC output reaching 320.4 million units in 2011: up 30.3% year-on-year.

Software and services are a national strategic sector, attracting preferential treatment such as VAT return and fiscal and tax benefits. In 2011, this segment achieved sales of CNY 1.85 trillion (EUR 0.2 trillion): up 35.9% year-on-year.

According to the International Data Corporation (IDC), Chinese PC shipments increased 24.1% in 2011: to 322.6 million units. In the domestic market, relatively low PC penetration in smaller towns and rural areas became the key impetus for PC consumption. IT spending was driven by commitment to modernisation in sectors such as education, healthcare and manufacturing as well as growing demand for services from banks and telecoms. Fast growth in its home market helped Lenovo to ride out the global economic downturn better than many of its rivals.

In addition, spearheaded by Apple's iPad entering the Chinese market, the tablet provided a new PC market growth area, with a triple-digit increase. Servers in China have grown at more than eight times the rate of the worldwide average over the past five years, making the country the world's second-largest data centre market.

According to MIIT, IT hardware's gross profit margin reached 11.3% in 2011 - a year-on-year increase of 0.6% - with the profit margin remaining stable at around 4.4%. Rising costs and falling prices squeezed this margin, but new products (e.g. iPad) and high-end items with wider margins helped to offset the negative impact.

Thanks to those profits, the general equity strength of the subsector increased last year. As for IT distributors and retailers, apart from the large-scale general distributors (like Digital China, Synnex, Ingram Micro, ECS, etc) and chain stores (Suning, Gome, etc), equity was usually small to avoid the Tax Bureau's attention.

The IT subsector records better solvency and liquidity than other industries, such as steel and real estate, because of the comparatively low fixed assets investment and short payment terms. Retailers are usually better placed than manufacturers and distributors as their sales are on a cash basis. Software developers and system integrators generally report slower capital movement due to long project periods.

**Telecommunications (hardware, infrastructure and services)**

China's telecommunications market continued to report steady growth in 2011, particularly in the mobile and broadband sectors, despite the steady decline in the fixed-line market. Mobile subscribers reached 975.7 million in 2011, and 3G subscribers accounted for 13.1% of the country's total mobile subscriber base, indicating considerable room for growth. Broadband subscribers numbered 156.5 million: a net addition of 30.2 million from 2010. The fixed-line industry has been experiencing significant pressure, reporting a year-on-year 3.1% decline, to 285.12 million subscribers in 2011. Penetration for mobile and fixed-line was 73.6% and 21.3% of population respectively.

According to MIIT, telecom hardware sales increased 15.6% in 2011, to CNY 1.17 trillion (EUR 0.14 trillion). As a result of licence awards in 2009, 3G equipment spending fuelled telecom capital expenditure. Telecom services realised revenue of CNY1.07 trillion (EUR 0.13 trillion) in the first 11 months of 2011: up 15.6% year-on-year, and 3G network expansion and broadband upgrade to fibre were the main focus.

Due to higher research & development costs and labour expenses, the gross profit margin for telecom equipment manufacturers decreased from 19.25% to 16.43%, while the profit margin fell from 5.77% to 4.79% in 2011.

China's three major telecom operators - China Mobile, China Unicom and China Telecom – are all state-owned, entitling them to government support and beneficial financing facilities. In addition, their listed subsidiaries can obtain sufficient funding from the stock exchange. For the small and medium-sized players without government backing, and listed bodies, bank loans have been the most common way to ease the capital pressure. However, in 2011, Chinese banks maintained their restrictive policies on new loans as the government tried to cool the economy. There was government encouragement for foreign investment as another source of finance and, under the revised rules, the minimum capital required for foreign-financed companies to offer basic national and local services has been reduced by 50% to US$ 145.9 million and US$ 14.5 million respectively. However, the state has restricted foreign ownership to 49% of a company offering basic telephone services and 50% for value-added service providers.

**Consumer electronics**

China's consumer electronics market, which includes computing devices, AV (video, audio and gaming products) and mobile handsets, showed steady growth in 2011, with demand for computers and TV sets in rural areas and tier-three to tier-six cities a key driver, along with the increased popularity of high-end items such as tablet computers, flat-screen TV sets, 3G mobile handsets and smartphones. According to Business Monitor International (BMI), China witnessed consumer electronics turnover of US$ 181.5 billion in 2011.

Computers (including notebooks and accessories) accounted for around 40% of total consumer electronics spending in 2011, with the government's rural computer subsidy programme and falling prices acting as significant incentives. AV devices accounted for about 39% of total spending and LCD TV showed strong double-digit growth, as Chinese consumers demonstrated a preference for larger screen sizes and internet-enabled TV sets. According to MIIT, China's colour TV output grew 3.4% year-on-year - to 122.3 million units in 2011 - contributing 48.8% of total production worldwide.

Mobile handset sales accounted for around 21% of total spending. With more than 1 billion subscribers, China is the world's largest market for mobile phones. The rural market will be the main source of future subscriber growth, while vendors will also focus on the rapidly expanding 3G handset market and demand for smartphones, which currently accounts for about 20% of Chinese handset sales. China's mobile output grew 13.5% year-on-year to 1,132.6 million units in 2011, contributing 70.6% of total production worldwide. According to MIIT, the profit margin of China's computing devices grew 0.9% to 3% and AV grew 1.2% to 3.5% in 2011. The improved margin was the result of vendors focusing more on product innovation than price competition to win market share and the increased popularity of high-end items. As with the IT subsector, the general equity strength of consumer electronics increased in 2011. This subsector has a better solvency and liquidity situation than many other Chinese industries.

## Payment behaviour continues to improve

On average, payments in the Chinese consumer electronics/ICT industry take between 30 and 60 days. Since the Chinese government started to apply a tighter monetary policy to cool down the economy in late 2010, pressure on ICT companies' short-term liquidity has increased. Some businesses struggled for a few months and the weaker ones failed during 2011. Now that the industry has reorganised, surviving companies have a better cash situation and payment delays have decreased in the last 6 months. We expect this trend to continue into the second half of 2012 as:

1) consumer electronics/ICT companies that survived the tight bank policies report better cash positions;
2) China will start to ease its monetary policy again as the economy slows down; and
3) suppliers have learned valuable lessons from last year and have improved their credit control.

The Chinese consumer electronics/ICT sector's insolvency rate is worse than that of other industries. Despite the overall good business performance, the main reason for this is that the sector has low entry barriers and, for ICT traders and retailers (the part of the industry mainly affected by defaults), margins are slim. However, we expect insolvencies to decrease in the coming months, as 2012 growth prospects are good: the industry reshuffle has, as stated, enabled stronger companies to survive and bank lending is set to increase.

## A satisfactory outlook

We still expect double-digit growth for the Chinese IT subsector in 2012, but the pace may slow as Chinese economic growth cools down and uncertainty about the global economic situation persists. Factors such as the vast rural areas and commercial market needs continue to drive demand for IT hardware, while the growing global ambitions of Chinese companies and the still booming domestic market will fuel investments in software. In the services segment, growing interest in cloud computing will drive further vendor investment and attract new players into the market. The market outlook for the Chinese telecommunications sector is also promising. Network expansion and upgrade will further fuel hardware investment, while the strong demand for mobile and broadband items will easily offset the downward trend of fixed-line business. Operators continue to widen their network infrastructure and rural subscribers will remain the main source of growth.

Consumer electronics sales should continue to grow in 2012, boosted by the rural subsidy programme and product innovation. Demand for computers, TV sets and mobiles in rural areas and tier-three to tier-six cities will remain the key driver, although this has placed pressure on prices. The increased popularity of high-end items such as tablet computers, LED/3D TV sets, 3G mobile handsets and smartphones will boost replacement.

## A prudent underwriting approach continues

Our underwriting policy for Chinese consumer electronics/ICT businesses is dependent on several factors. As well as the information shared with us by our customers and their buyers, our main underwriting focus is on the business portfolio and financial performance. While we are cautious in the case of SMEs with large external borrowings, in view of concerns over tighter banking policies, there is less restriction on large companies, strong groups and state-owned companies (SOE) with sufficient exposure capacity. However, we are cautious where larger groups and SOEs have poorer financials. While we are generally more relaxed in the case of companies focused on the domestic market, we see more risks for export-oriented business because of the uncertain global economic situation and currency appreciation.

Most manufacturers of consumer electronics/ICT are the production bases of larger groups that are located in China. Attention needs to be paid to their group strength, their relationship with the group, and the group's history of support for its subsidiaries. High gearing is reasonable if it can be regarded as the group's internal funding or bank loans with a group guarantee.

Distributors and retailers usually have slim profitability, quick stock and capital turnover and low equity levels. We can agree credit limits on highly geared buyers if bank loans are subject to external collateral. For smaller distributors and retailers, internal financials and detailed explanation of several accounts (e.g. other receivables/payables, loans) are often available. Personal guarantees, although not a condition of our cover, are also a plus and can be taken into consideration.

**Chinese IT subsector (hardware, software, services)**

| STRENGTHS | WEAKNESSES |
|---|---|
| Projected double-digit growth for China's IT industry | Growth pace of IT industry in both global and domestic markets moderates |
| Low cost of manufacturing; world centre for original equipment manufacturers | Severe competition in the IT market |
| Major opportunities for expansion in under-penetrated rural and Western areas | |
| Technology innovation (tablets, cloud computing, etc) brings huge market potential | |

## Chinese telecommunications (hardware, infrastructure, services)

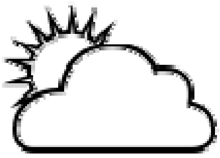
| STRENGTHS | WEAKNESSES |
|---|---|
| Government determination to invest in China's telecommunications industry, ensuring that it becomes innovative | Fixed-line demand continues to fall due to the appeal of alternative technologies such as mobile and internet |
| Significant room for mobile sector growth in the rural areas and 3G market | Increasing rural penetration has a negative effect on ARPU (average revenue per user) levels |
| Strong demand for internet and broadband services due to greater accessibility of services and increasing affordability | Intensifying competition in the telecommunications industry |

## Chinese consumer electronics subsector

| STRENGTHS | WEAKNESSES |
|---|---|
| Huge domestic market and projected double-digit growth in some key products such as tablets, LED flat-panel TV sets and smartphones | China GDP growth slowdown may affect consumer spending |
| Rising rates of penetration for key products such as computers and digital TV | Severe competition in consumer electronics market |
| Major opportunities for expansion in under-penetrated rural and Western areas | |
| Technology innovation (tablets, LED/3D TVs, smartphones, etc) bears huge market potential | |

# India

## High domestic demand drives growth



**IT Software, Services & Business Process Outsourcing (BPO)**

According to the Indian Ministry of Communications and Information Technology, Indian software and services exports (including BPO exports) will have an estimated value of US$ 68.7 billion in the fiscal year (April 1st-March 31st) 2011-12, compared to US$ 59 billion in 2010-11: an increase of 16.4%. IT services will contribute 58% of total IT-BPO exports in 2011-12, followed by BPO (23%) and software products/engineering services (19%). The US market continues to drive IT-BPO exports growth. Export revenue from the US is likely to grow over 17% in 2011-12, with sales to the US retaining their leading share of the overall market: at 62%. Continental Europe and the UK, the second largest markets for Indian IT-BPO exports, have seen their share decline in the last three years. In 2010-12, their combined share is set to be around 28%, with the UK accounting for US$ 12 billion and Continental Europe for US$ 8 billion.

Indian service providers have been aggressively growing business in the Asia-Pacific market. Aimed at reducing their geographic dependency and spread currency risks, sales in this region are growing fastest: by around 18%. Asia-Pacific's share of total IT-BPO exports is expected to increase to nearly 8%. Revenues from the domestic market (IT Services, software products and BPO) are expected to grow 9.8%: from US$ 17.3 billion in 2010-11 to US$ 19 billion in 2011-12. IT services are one of the fastest growing segments in the Indian domestic IT market.

**Hardware**

The IT hardware market in India continues to expand rapidly, with significant IT adoption plans by key clients such as telecom, BFSI (banking, financial services and insurance), ITeS (information technology enabled services), education, small office / home office (SOHO), manufacturing sectors, small and medium-sized enterprises (SMEs), e-governance and households. Production of computer hardware is estimated to increase 10%: worth US$ 3.16 billion.

**Consumer electronics**

In India, the consumer electronics market has been witnessing tremendous growth over the last few years. A number of companies are offering customised or India-specific products to lure domestic consumers. In addition, media influence, affordable pricing and a shift in lifestyles have been instrumental in changing consumer spending patterns.

In value terms, growth is fuelled by the sale of flat panel LCD/LED TVs, which is increasing exponentially. The market has increased from 2.8 million units in 2010 to 4 million units in 2011 and is projected to increase further: to 5.5 million units in 2012. Falling prices and high penetration levels are the main reasons for the growth of this segment. Conversely, the conventional CRT TV segment is showing negative growth, as the trend has turned towards LCD/LED TVs. The DVD player market continued to decline - from 4.5 million units in 2010 to 4 million units in 2011 - while the Home Theatre segment continued to grow - from 0.30 million units in 2010 to 0.33 million units in 2011 - and is expected to grow 21% in 2012.

In 2011-12, the total production value of consumer electronics industry is estimated to increase 7.2%, to US$ 6.58 billion. Price competition has become fiercer, with companies using different devices (discounts, ′freebies′. etc.) to attract customers.

## IT hardware resellers show weaker solvency

Overall, Indian consumer electronics/IT businesses show quite healthy financials, while profit margins differ from business to business. Hardware/electronics manufacturers´ or resellers´ margins are typically lower with high volumes, whereas in software/services the value proposition comes into play - i.e. a smaller client base but niche offerings leading to better margins and healthy profitability. The major concern in this segment is currency fluctuations, as exports account for most of the revenues.

All the major companies are publicly listed (TCS, Infosys, Wipro etc.) or operate as private limited companies, with the parent company holding a majority shareholding (e.g. Sony India, LG, Samsung). Additionally, many Indian IT companies are listed on NASDAQ.  Issues with liquidity and solvency typically arise with IT hardware resellers, which are mostly proprietorship/partnership companies working on very low margins.

The consumer ICT/electronics sector is prone to mergers and acquisitions (M&A), with big players obtaining companies which are either private limited companies/proprietorships or mid-size enterprises with a core competency in a specific area (e.g. IGate acquired Patni Computers). The Indian Technology sector saw M&A deals worth US$ 1.7 billion in 2009-10.

On average, payments in the consumer electronics/IT industry take between 45 and 60 days. We have seen no change in payment behaviour in the recent past, and do not expect any deterioration in the short-term future. On average (compared to other Indian industries) the consumer electronics/IT insolvency rate is relatively high. India does not have a high insolvency rate, partly because of the length of time it takes for a company legally to become insolvent.

## High growth in the consumer electronics subsector will continue

In 2012, spending on linking applications to mobile devices is likely to be a driver for enterprise spending. Over the next two years, vendors are expected to compete for a share of significant spending on major public sector IT projects, such as ID cards, e-government and railway modernisation. There are an increasing number of large projects, particularly from the government, but also from other key sectors such as banks, telecoms, defence, manufacturing and retail.

Although spending on projects is expected to increase, vendors report greater concerns about the return of investment following the economic slowdown in India. Interest in technologies such as virtualisation and cloud computing promise cost savings and vendors have responded by enhancing their capabilities in areas such as managed services, virtualisation, and data centre solutions. The Indian consumer electronics industry is anticipated to grow at a compound annual growth rate (CAGR) of around 18% between 2011 and 2014.

Our underwriting approach combines hard evidence (e.g. financials) with non-financial information, and we remain relaxed in our underwriting approach towards this sector. Partnerships/proprietorships are not obliged to file their annual accounts with the Registrar of Companies (ROC) nor are they usually willing to share them with agencies or clients: an issue that poses some difficulties. Private limited companies file accounts with the ROC, but delays in filing are not uncommon and so we do sometimes need to request financials via our clients.

We will consider the following when underwriting smaller IT resellers:

- Is most of the debt in the business sourced from family or friends to avoid taxes?
- Is the company a sister concern of a stronger buyer?
- Trading experience – this plays a key role in establishing past track record
- Are there stronger end-users which are known to us?
- Length of establishment
- Properties – Is the office owned?

## Indian consumer electronics/ICT sector

| STRENGTHS | WEAKNESSES |
|---|---|
| Good growth prospects | Non availability of financials for IT resellers which are proprietor/ /partnership firms |
| Reasonably good credit mechanism at clients place (i.e. post dated cheques, buyer due diligence done, credit teams in place) | Buyers are usually highly leveraged |
| Strong focus on R&D | Capacity constraints (i.e. same set of buyers for multiple vendors |
| Low penetration rate | |

# Snapshots
## Market performance at a glance

# Russia
## Good growth rates in 2011 and 2012

According to the European Information Technology Observatory (EITO), sales of consumer electronics and ICT in Russia increased 10% in 2011: to EUR 53.3 billion. This increase was driven by higher economic growth (4.3%) and private consumption (6.4%), increased public spending, and an overall improvement in the performance of main industries and companies.

According to the Russian Ministry of Economy, the domestic IT market increased 6.6% in 2011, reaching RUB 649 billion (EUR 16 billion). Additionally, the number of PCs in Russia rose by 20% to 74 million units and internet penetration reached 50%.

The Russian retail market for computers increased 27% in 2011, according to market research company GFK, reaching RUB 577 billion (EUR 14.4 billion). The fastest growing segments were smartphones, laptops, accessories and consumer software, which grew more than 30%. The sales of smartphones alone rose 80% in 2011, with a total market value of EUR 2 billion.

Payment behaviour has been very good over the past 12 months. We have registered a few smaller payment default cases - mainly by regional distributors - but all overdue debts were paid in a relatively short time. However, the financial standing of some companies, especially distributors and retailers, has raised some concerns due to their poor disclosure of profitability and large gearing. Nevertheless, payments to our insured clients from their customers are usually made on time.

We monitor significant investments and consolidation in the market. For instance, Evroset (the leading mobile retailer) is controlled by the Beeline/Alfa Group, while PPF (the Czech investment group) consolidated its control over Eldorado (the second largest chain of electronics hypermarkets). Major wholesalers represent the weakest link in the supply chain, but recently there have been positive developments in this segment.

Our outlook for 2012 is moderately positive. According to EITO, the consumer electronics/ICT sector will grow by around 9%. As our existing customers have ambitious growth plans in the Russian market, we will do our utmost to support them.

# Brazil
## Growth is driven by an emerging middle class

From January to September 2011, turnover in the Brazilian IT equipment subsector grew 10% year-on-year, thanks to the availability of consumer credit, a rise in the average income and low unemployment. Sales of computers grew at double-digit rates and, according to IBOPE Nielsen Online, in 2011 there were 63.4 million people in Brazil with internet access – 47.5 million of whom were active users - out of a total population of 198.7 million.

Consumer electronics/ICT imports grew 13.1% last year, reaching a value of US$ 2.71 billion, as a consequence of the appreciation of the Brazilian real, and the mobile telephone market grew by 6.2%.

On average, payments in the Brazilian consumer electronics/ICT industry take 45days. We have not seen any increase in payment delays during the last couple of months and expect payment behaviour to remain stable for the rest of 2012.

With a satisfactory outlook for the Brazilian economy (IHS Global Insight expects GDP to grow 3.2% in 2012 and 5.0% in 2013), prospects for sales of consumer electronics/ICT goods remain very optimistic, as there are no signs of a drop in domestic demand. In fact, private consumption is expected to increase by 5.0% in 2012 and 5.4% in 2013.

Expectations for cell phone and computer sales are also favourable for 2012, as these are in great demand by Brazil's so-called "class C" (the emerging middle class whose monthly average income is now US$1,200). Demand is driven both by the need for replacement of equipment and because the size of Brazil's middle class is constantly growing.

Sales of smartphones are set to increase in the coming years. New models, lower prices and more affordable mobile internet plans can keep Brazilians connected at any time or place, thus boosting revenues for the carriers. In the telecommunications subsector, markets such as broadband, which still show low rates of penetration in the country, are likely to continue to grow: with sales up 3.5% in 2012 and 2.6% in 2013.

However, we maintain a cautious underwriting approach for the industry, as it is very dynamic, competitive and sensitive to currency fluctuations (depreciation of the Brazilian Real against the US$ would result in a strong price increase in imported consumer electronics/ICT products).

Therefore, we monitor companies in this sector closely: periodically checking their financial situation, including solvency, indebtedness level and profitability. As publication of financial statements is not mandatory for all companies in Brazil, it is vital that we use our own direct underwriting actions and information from our customers to obtain the most recent financial data available.

# The Netherlands

## Consumer electronics will be the "problem child" in 2012

The consumer electronics/ICT market remained stable in 2011 (see chart below), generating turnover of EUR 6.5 billion (excluding telecommunications). However, the various subsectors showed remarkable differences, with strong growth in telecommunications (driven by high smartphone sales) and IT product markets, while turnover in consumer electronics decreased sharply, due to both lower prices and lower volumes.

**Turnover development consumer electronics/ICT**

| | 2009 | 2010 | 2011 |
|---|---|---|---|
| **Consumer electronics** | -15.9% | -2.1% | -14.3% |
| **IT-products** | -4.6% | 4.6% | 11.4% |
| **Telecommunications*** | 1.6% | 9.2% | 17.2% |
| **Digital cameras** | -10.6% | -2.2% | -6.3% |
| **Large electrical household appliances** | -7.3% | -1.0% | -0.6% |
| **Small electrical household appliances** | -0.4% | 1.6% | 1.7% |
| **Total**** | -10.0% | 1.0% | 0.0% |

Source: HBD, UNETO-VNI, GfK

*volume (not turnover) ** excl. telecommunications

As elsewhere, an important development in the market is the strong growth in online sales, which increased to EUR 9 billion in 2011. The total market share of online sales will rise to around 25% by 2020 and some analysts even expect large 'bricks-and-mortar' retail chains in consumer electronics to gradually disappear over the next 5 to 10 years.

In general, our payment experience in the sector has been satisfactory. Since the insolvency of Impact Retail (the parent company of consumer electronics chain It's & Prijstopper) in early 2011, we have not seen further serious problems in the consumer electronics sector. Indeed, payment behaviour in the whole consumer electronics/ICT sector has remained stable, although we have noted that some companies - mainly in the IT subsector - are heavily reliant on the goodwill of their creditors. However, now we expect that performance to deteriorate, especially in consumer electronics, as economic conditions in the Netherlands are rapidly declining. The Dutch economy has recently entered recession, and Consensus Economics expects GDP to shrink 0.6% in 2012, with private consumption decreasing 1.0%. Consumer confidence is at a historically low level and, in view of the negative economic news and the austerity measures planned by the Dutch Government, any improvement is unlikely in the short-term.

Against this backdrop, and in an intensely competitive environment, we expect this segment to continue to suffer in the coming 12 to 18 months. The likelihood is that the number of insolvencies in consumer electronics - particularly smaller shops - will increase and our underwriting stance will therefore remain cautious. In the case of the IT subsector, we will monitor more closely how business and turnover increase is financed, i.e. whether companies are trying to find alternatives to an unhealthy dependence on their creditors.

# Japan
## A very modest performance in 2012

The current market conditions are difficult for Japanese manufacturers of hardware and consumer electronics, due to the appreciation of the Yen - which is hampering global exports, competition with Korean manufacturers - especially in the consumer electronics segment, the economic downturn in the EU, and a fragile recovery in the US. Following last year's tsunami, the IT subsector has been helped by the Business Continuity Planning (BCP) investment of Japanese businesses. However, increased electricity prices resulting from the suspension of nuclear plants could have some negative impact on the profitability of manufacturers in the ICT sector as a whole.

**The state of the Japanese electronics/ICT industry (2011 and early 2012)**

| | Turnover/ production | Orders | Profit margins | Equity strength | Solvency/ liquidity |
|---|---|---|---|---|---|
| **IT (hardware, software, services):** | | | | | |
| **Hardware (semiconductor/electric parts)** | Decreasing | Decreasing | Decreasing | Average | Average |
| **Hardware (others)** | Stable | Stable | Stable | Average | Average |
| **Software** | Stable | Stable | Stable | Average | Average |
| **Services** | Stable | Stable | Stable | Average | Average |
| **Telecommunications (hardware, infrastructure, services)** | Stable | Stable | Stable | Above average | Above average |
| **Consumer electronics** | Decreasing | Decreasing | Decreasing | Average | Average |

Source: Atradius

On average, payments in the consumer electronics/ICT industry take between 30 and 180 days, depending on the business set up, the products sold and whether sales are domestic or export. In general, Japanese companies pay on time unless business disputes or serious financial difficulties emerge. Despite the rather difficult business environment, we have seen no significant increase in non-payments over the past 6 months. The number of insolvencies is average compared to other sectors.

The European Information Technology Observatory (EITO) expects Japanese domestic consumer electronics/ICT market sales, which account for 9% of global sales, to increase a modest 1.1% in 2012. A positive factor is stable demand for smart-phones and table PCs, and the expected further spread of cloud computing. Performance of IT software and services and telecommunications (hardware, infrastructure and services) subsectors will generally level off. However, for IT hardware (semiconductors and electric parts) and consumer electronics, difficulties will continue for a while. In general, when underwriting companies in the consumer electronics/ICT sector, we have no special criteria. As with other trade sectors, we check sales trends, profitability, solvency, liquidity, cash flow, level of debts, suppliers/customers, and payment history. Larger ICT manufacturers in the main have relatively strong fundamentals, but we exercise more caution with SMEs, especially those that do not disclose financial information on a regular basis and are not part of a larger group. Currently we monitor companies in the consumer electronics subsector more closely.

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