

## Adapting to survive

Considerations for electronics and components companies in the economic downturn

INFORMATION, COMMUNICATIONS & ENTERTAINMENT

Electronics and components manufacturers face a tough year ahead, with many confronting a decline in orders and more intense price competition. Many companies are already taking dramatic steps at a global level to restructure or dispose of assets, or to cut back key capital expenditures.

Electronics and components companies are not typically seen as the first to be hit during a recession. However, recent months have seen large scale layoffs at electronics companies around the world.

Regional manufacturers that rely on exports to North American and European markets may be entering a particularly challenging time, with semiconductor orders hitting a five-year low.<sup>1</sup> The trend was confirmed by a global survey of 85 semiconductor executives conducted by KPMG in November 2008, in which 52 percent expected revenue to fall in 2009, while 70 percent expected some staff layoffs in their company.<sup>2</sup>

Companies with exposure in a single product area could be especially vulnerable. For example, producers of Flash and DRAM chips for use in consumer electronics are grappling with a glut of supply and rapid price erosion. DRAM chip makers PowerChip Semicon, Nanya Technology and Inotera Memories all recorded losses during the first three quarters of 2008.<sup>3</sup>

Components suppliers to recession-hit industries such as retail, automotive and construction also need to reassess their strategies. Many are looking to sustain growth through opportunities in other more recession-proof sectors, such as healthcare, energy and other green technologies, as well as shifting their geographic focus. In the current environment, emerging markets are widely seen as the only area of growth for products such as mobile handsets.

IT spending can be another indicator for performance in the sector. Corporate spending on big IT projects is typically an early casualty during a period of belt-tightening. However, many organisations have invested heavily in upgraded

<sup>1</sup> SYWG Research, quoting Semiconductor Equipment and Materials International (SEMI), December 2008

<sup>2</sup> "Semiconductor execs offer volatile outlook on 2009 revenue growth," KPMG press release, 18 December 2008

<sup>3</sup> "Chip makers to pull back from China," *SinoCast China Business Daily News*, 29 October 2008



software platforms over recent years and now have an opportunity to use those IT systems to realise efficiencies, cut head count and better monitor performance. In China, financial institutions have been mandated to relocate their data centres within the country, providing a further impetus for continued spending.

The research firm Gartner believes there is still room for growth in global IT spending in 2009, although it has cut its growth forecast from 5.8 percent to 2.3 percent.<sup>5</sup> As companies seek to leverage new IT platforms for efficiency and performance, new or additional investment in data storage and other upgrades to legacy hardware systems may be necessary. As Intel CEO Paul Otellini puts it, "I'm of the opinion that technology will do well during a downturn because of the simple fact that we sell tools for productivity."<sup>4</sup>

### Checklist for manufacturers in China

Over the past two decades, China, like many other parts of Asia, has increasingly relied on electronics and components manufacturing as a driver of growth and economic development.

By the end of 2008, the electronic and component manufacturing sector in China was still growing, but at a dramatically lower rate than during 2007, particularly for mobile phones, microcomputers and integrated circuits.<sup>6</sup>

Many businesses may not be fully prepared to deal with any further slowdown in trading conditions and face challenges in implementing the necessary strategies for survival. KPMG China believes companies need to assess their position in the following areas:

- **Keep looking for opportunities**

Many electronics companies have large capital investments that may be under-utilised. They may need to explore opportunities for key assets to be redeployed, in order to maintain utilisation, while avoiding reliance on commoditised products with weakening margins.

- **Preserve cash**

Due to increased stakeholder pressure, reduced access to finance and increased costs of finance, companies need to look to their own balance sheet to preserve and generate cash. Cash and working capital management techniques should aim to increase visibility over cash flows and reliability of cash flow forecasts. This can highlight funding deficiencies and provide management with greater awareness to plan and renew the financing arrangements they need.

- **Review costs**

The downturn has relieved the inflationary pressure on many of the costs of production including energy, transportation, rents and raw materials, providing an opportunity to review and even renegotiate many operating costs. This review process can lead to a better understanding of the dynamics of the cost base and form part of a longer-term cost optimisation strategy.

<sup>4</sup> "Cash reserves still flowing through IT sector," *The Irish Times*, 17 October 2008

<sup>5</sup> "Gartner slashes 2009 tech spending forecast," *Reuters*, 13 October 2008

<sup>6</sup> "Review and Forecast on China's Electronic Information Industry," *Reuters*, 29 December 2008

## R&D incentives in China

Companies can take advantage of the longstanding R&D tax concessions in China. These incentives aim to encourage R&D innovation and have become a key point of focus for the Chinese government.

All industries can benefit from a 150 percent tax deduction on qualified R&D expenses. Import VAT and customs duty exemptions on qualified R&D equipment can be either expensed immediately or depreciated on an accelerated basis depending on the value.

Special economic zones also offer their own incentives for technology-focused R&D, including subsidies and VAT refunds. The new corporate income tax regime, introduced in January 2008, offers a lower rate of 15 percent for 'high and new technology areas,' as opposed to 25 percent for most companies.

- **Assess relationships, risks and dependencies**

Electronics companies typically exhibit a high degree of interdependence, which can lead to additional risks when a partner company or supplier is in distress. While companies are looking for ways to streamline business and reduce their fixed cost base through outsourcing and partnering, it is more important than ever to introduce checks and balances to ensure the stability of those arrangements. A downturn brings increased risk of improper earnings management. It can include financial reporting that "smooths" or otherwise under-reports the financial volatility that another business unit or partner may be experiencing. Desperate times can lead to desperate measures, with increased risk of fraudulent activities by employees.

- **Look for possible impairment**

Impairments are increasingly likely when pricing levels are falling. Recording and reporting the impairment of an asset is never a step to be taken lightly and any impairment decision needs to be managed and communicated carefully. For companies that have made acquisitions in recent years, the value (based on the assessment of future cash flows) may no longer justify the price paid. The value attributed to long-life assets, intangibles and goodwill may need to be reassessed.

- **Reassess tax obligations**

Where a company is expecting to post an operating loss, it should ensure that tax obligations are managed and minimised. Losses may be challenged by tax authorities if they consider that the assets or activities that incurred the losses should be attributed to another jurisdiction. New transfer pricing documentation rules were recently unveiled, which require the submission of detailed reporting on related-party transactions by the end of May each year.

## Opportunities

The electronics industry is a mature, globalised and competitive business, and as a whole is well-positioned to weather the current economic storm. The relative homogeneity of many electronics products across different markets allows companies to reconfigure their operations relatively easily and thereby continually seek efficiencies. However, that homogeneity can also lead to the commoditisation of previously innovative products.

As the mainland is the world's largest consumer electronics production site, with its share of electronic equipment production increasing from 9 percent in 2000 to 27 percent in 2007,<sup>7</sup> China's role in the industry is sure to remain critical, despite the downturn.

In recent months, a number of global electronics companies have scaled back operations globally in line with weaker demand. To date, China seems to have been spared in much of this restructuring activity. The climate for manufacturers in China is likely to get worse before it improves, but there are reasons to believe that China may ultimately come through the slowdown in a stronger position.

Operating costs in China have risen markedly over the past five years, but from a global perspective the country remains a relatively low-cost operating environment. The government's tax and investment policies have supported

<sup>7</sup> "World factory faces chips demand boom," *South China Morning Post*, 21 November 2008

China's move up the value chain, with many China-based contract manufacturers adding value in areas such as design and procurement.

At the same time, China's authorities are increasingly seeking to ensure that companies are taxed appropriately, particularly as more of this intellectual property and intangible value is created within China.

Opportunities exist for companies to sustain their growth where they can diversify their production across different product lines. While the contract manufacturing sector already exhibits a degree of consolidation, some companies are well-positioned to strengthen their market share, including through further merger and acquisition activity. KPMG China continues to see many smaller or mid-market transactions occurring, particularly in situations where the acquirer is relatively cash-rich or where the capital-raising requirements are less complex.

## Contact us

KPMG China has a long track record working with distressed companies as well as companies seeking to improve their performance and better manage risks.

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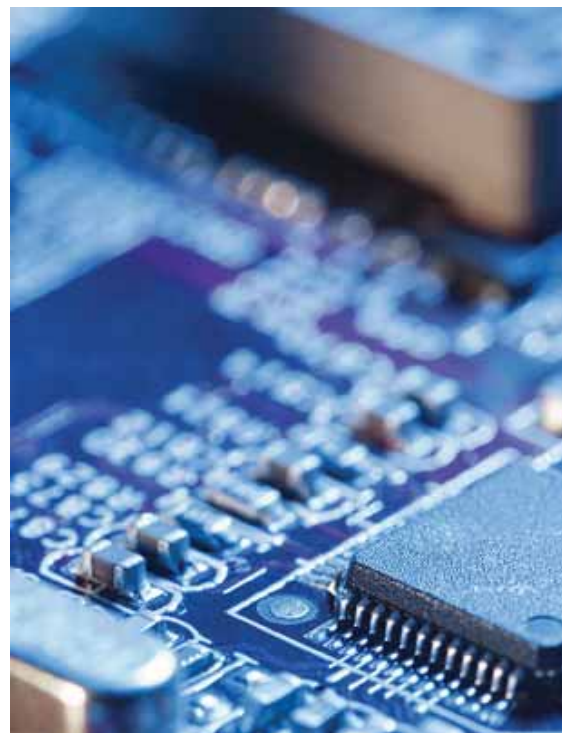
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