

Shakeout Ahead in Consumer Electronics

By Ed Sperling -- *Electronic News*, 8/16/2006

The consumer electronics industry appears to be heading for a shakeout, driven in part by aggressive retail chains that are commanding a greater share of the profit and in part by the influx of Chinese companies that are beginning to sell their products outside of China.

The control that retail chains have gained in the consumer electronics space is somewhat ironic, given the fact that most of them were created at the behest of the original equipment manufacturers. For decades, many retailers complained loudly about slim margins while manufacturers took home the vast majority of the profits.

Globalization and the rise of manufacturers in multiple competing low-cost labor markets have flipped the tables on that business arrangement. And the Internet—once considered a threat to retailers—has actually worked in their favor by allowing customers to shop for the best prices from the comfort of their home office and to examine the product in person.

The result is that the average net margins among giants such as Sony, Samsung, Philips and Sharp is now hovering around 3.5 percent while large retailers are reporting record numbers. And while the slim margins for OEMs may be enough for smaller companies in developing markets, they are not high enough for large companies in established markets looking to satisfy their shareholders.

“The first attempt by these large companies to solve this problem was to create new devices,” said George Bailey, general manager for electronics consulting at IBM. “That doesn’t work because when Wal-Mart puts a product on the shelf, the manufacturer has less than six months before some competitor comes in with a lower price or a newer model.”

Bailey said the threat is greatest for entrenched Japanese companies, which took over the consumer electronics market from the United States and Europe by undercutting competitors’ prices and offering more reliable products. While reliability of Chinese products is too new to judge, the country’s development costs are significantly lower than those in Japan due to cheap and plentiful labor.

“You’re going to see a lot of companies entering the market with Chinese names,” he said, noting that consolidation has started inside of China, as well. “At one point there were 700 different cell phone brands in China.”

To some extent, that influx already has begun. Costco, Fry's and other retailers already are offering substantially less expensive Chinese brands next to established Japanese and Korean brands. Probably the best known is Lenovo, which was widely known inside of China before it bought IBM's PC unit in 2005. It has used the purchase as a springboard to brand itself in established markets.

"There certainly is a tremendous amount of competition at Best Buy, Wal-Mart and Costco," said Jim Feldhan, president of Semico Research. He pointed to the recent win of Samsung among retailers over Matsushita's Panasonic label as proof. "That's putting pressure on margins. We haven't predicted a shakeout yet, but China is certainly going to have a tremendous impact. The only way Japanese companies will survive and compete is to move the production offshore, and that goes against their culture. But their cost structure isn't going to be able to compete with China's."

Feldhan noted that one of the advantages that Chinese companies have today versus Japanese companies in the 1980s is the widespread availability of reference designs. "With reference designs, 80 percent of the work is done for you. It's not like 15 years ago when OEMs did a significant amount of the design."

Avnet, for one, is benefiting handsomely from this trend. The company's reference designs are being used extensively by Chinese companies for a variety of consumer electronics, including digital cameras.

"We are really getting traction in reference designs these days, particularly in Asia," said Phil Gallagher, president of Avnet Electronics Marketing for the Americas. "We either work with independent design houses, or else we build an entire product."

Avnet wins component sales plus some money for the design, but the real winner is the OEM that can build a consumer device such as a digital camera for a fraction of the cost of designing it in-house. That helps explain why new brand names are starting to show up on retailer's shelves next to established brand names—often for a fraction of the cost. And it helps explain why consumers are beginning to buy the unknown brands, relying on the retailer's customer service and service contracts to overcome the uncertainty of durability and quality.