

## Industry Outlook:

### Key Points

- 1** A strong manufacturing rebound and robust job creation contributed to U.S. GDP growth. Consumer spending is still tepid but consumer confidence is up 16% yoy – its highest level in seven years.
- 2** Total factory level sales of consumer electronics (CE) products are expected to increase 2% to \$211 billion in 2014 and another 1.2% in 2015. Smartphone and gaming console revenues are projected to grow, while mature categories are expected to register solid, though flat, sales.
- 3** U.S. CE products still benefit from exports, which continue to increase by 2% per year. The U.S. is the second largest worldwide CE exporter, selling about \$4 billion in CE products overseas.
- 4** Apple's iPhone launch and a ramp up of other product cycles including Ultra High Definition (UHD) "4K" TVs, next generation game consoles and wearables, coupled with higher consumer optimism, bode well for spending on CE products into 2015.
- 5** Price remains the most critical competitive factor in the industry. Most CE categories are mature and face longer replacement cycles while emerging categories are not yet large enough to move the profitability needle for CE retailers.



# Consumer Electronics

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## Overview – Multiple New Product Cycles Offer Growth but Beware of Rapid Commoditization and Pricing Deterioration

### An Innovative and Highly Competitive Industry

The "consumer electronics" (CE) category of products includes smartphones, computers, televisions, video game consoles, automotive technology, and many other home products as well as emerging product categories such as wearables and 3D printers. It is a rapidly changing, dynamic industry that is highly competitive and influenced by technological developments. Manufacturers are under enormous pressure to bring unique and differentiated products to market. Any successful product quickly attracts copycat products from competitors, resulting in rapid commoditization and falling prices.

### The Age of Convergence and Connectivity

Recently the two prevailing trends have been convergence – combining the functionality of many products into one – and the shift toward mobile, connected devices such as smartphones and tablets. Rapid adoption of tablets disrupted and severely cannibalized demand for notebooks, but the decline in demand appears to have bottomed as tablets still cannot perform all functions of the computer. While flat panel TVs have reached saturation, new developments such as internet connectivity have made TVs "smarter" with the ability to surf the web, download video and watch live streaming content. Ultra High Definition "4K" TV sales have been gaining momentum, driven by an increase in consumer awareness and new, lower priced models entering the market. In addition, falling prices have incited consumers to replace their once enviable 50" screens with those that are 65" and up.

### Online Channel and Pricing Transparency Make Price the Key Differentiator

From a distribution perspective, online retailing has been a major trend and has become much more prevalent within the industry. With the rise of the smartphone, comparison shopping apps and access to direct retailer sites, pricing has also become much more transparent and comparison shopping much easier. Purchasing power is in the hands of the consumer.

## Outlook – Favorable Macroeconomics and Ramping Product Cycle Challenges

The U.S. economy continues to grow, with recent performance driven by a strong manufacturing rebound and relatively robust job creation. The housing markets remain erratic, and consumption is still relatively tepid but consumer confidence is rising.

In July 2014, the Consumer Electronics Association (CEA) predicted that total industry revenues would grow 2% to \$211.3 billion in 2014 and another 1.2% in 2015. Since then, we have had two solid quarters of macroeconomic data. At the time of publication, leading indicators currently remain positive, and Euler Hermes is predicting 2% growth in GDP in 2014. In addition, recent



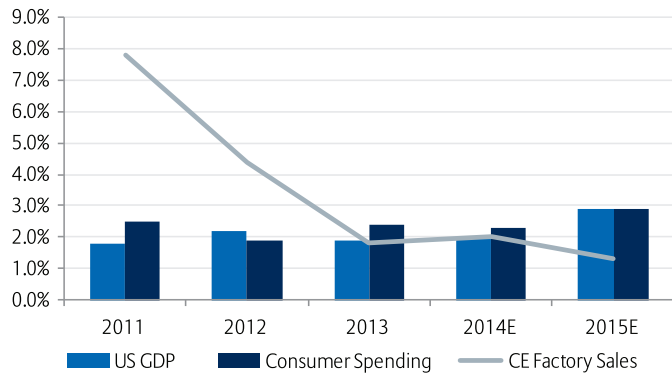
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surveys by the research firm NDP Group and the CEA have found that consumers are much more optimistic about holiday spending on CE products compared to last year. Under this scenario, we believe industry revenues could easily increase by 2% in 2014. Momentum in demand should carry into 2015, but falling prices may result in lower revenue growth.

### Slowing Growth Rates for CE Factory Sales



Sources: Euler-Hermes, Consumer Electronics Association

From a more global perspective, American CE products still attract foreign consumers and benefit from exports, which continue to increase by 2% per year. The U.S. is the second largest worldwide exporter of these products with an 8% share of total exports. In 2014, the country will export approximately \$4 billion in CE products.

Although growth rates are slowing, smartphone sales will continue to drive overall industry revenues through 2015. Smartphone revenues are expected to increase to \$48 billion in 2015 from \$43 billion in 2013. Gaming console revenues will also grow significantly with revenues projected to increase 56% to \$4.8 billion in 2014 and another 10% in 2015. Mature categories such as tablets, notebook PCs and LCD TVs are expected to register solid, though flat, sales. Finally, sales of wearables such as smart watches and health and fitness related products are expected to increase substantially over the next few years.

Within the TV category, 4K TVs will contribute an increasing share of category sales as a result of increased volumes, falling prices, and growing awareness. The PC market is no longer in freefall and looks to be stabilizing with potential for modest future growth. However, this is probably because most consumers have all the tablets they want, and notebook pricing has become more competitive with that of tablets. The tablet market itself has essentially reached saturation. In addition, the new tablet models face competition from all the larger smartphones being introduced into the marketplace.

Sony and Microsoft launched their respective next generation of video game consoles late last year. Shipments are expected to remain very strong through the holiday season but peak sometime in 2015 due to the very cyclical nature of the console market. However, average selling prices for the category will rise through 2015 as the new generation of consoles replaces the previous generation.

The multi-functionality of the mobile devices has displaced sales of digital cameras, camcorders, and GPS navigation devices. Not surprisingly, the projected growth of smartphones and video game consoles is expected to drive strong unit growth in smartphone and gaming accessories, which will offset declines in audio, video, and camera accessories.

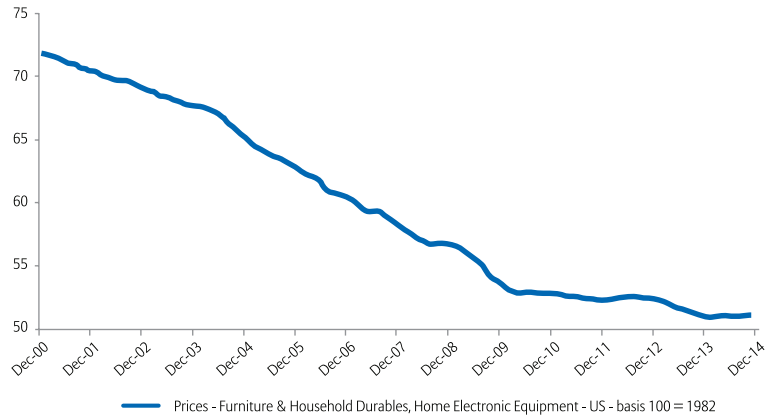
Continued strength in new car sales is expected to drive demand for factory installed electronics, including in-vehicle entertainment systems, security and remote start systems and rear view cameras.



## Challenges – Intense Competition and Pricing Transparency Threaten Margins

Manufacturers, distributors, and retailers face uncertainty with respect to product margins given intense price competition and a shift in pricing power to consumers enabled by easy online and mobile price comparison. As new products quickly become commoditized, manufacturers have been forced to bring new products to market much more quickly. However, the replacement cycle has lengthened as these new releases don't always offer enough new features to entice consumers to replace their existing devices. Such has been the case for TVs and PCs which have dragged down manufacturer profitability, causing many to restructure aggressively or exit the business and invest in new growth opportunities.

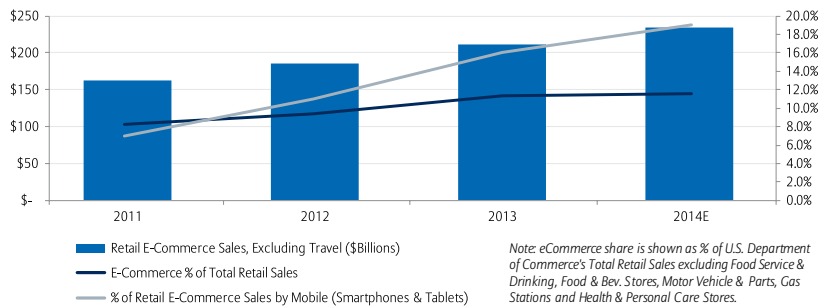
### Prices of Furniture, Household Durables, and Home Electronic Equipment



### Traditional CE Retailers Pressured by Online and Mass Merchant Discount Retailers

Pure play CE retailers continue to feel the pressure from online competitors such as Amazon, big box discounters such as Walmart and Target who are expanding their online and offline CE offerings, and key manufacturers that are increasingly taking their product directly to consumers. Wide product availability of increasingly commoditized offerings, increasing online price transparency, and the customer focus on price have enabled the online channel to take share from traditional CE retailers. According to digital analytics firm comScore Inc., online sales this holiday season are expected to grow 16% to \$61 billion. Although the U.S. Census Bureau estimates that approximately 94% of all retail business is still conducted in brick and mortar locations, many consumers are now using mobile devices to comparison shop within stores and ultimately making their purchase online if they find a more attractive price. This trend is expected to continue and, in response, many traditional CE retailers are now enhancing their online systems and implementing price matching policies to better compete.

### Online Sales Penetration



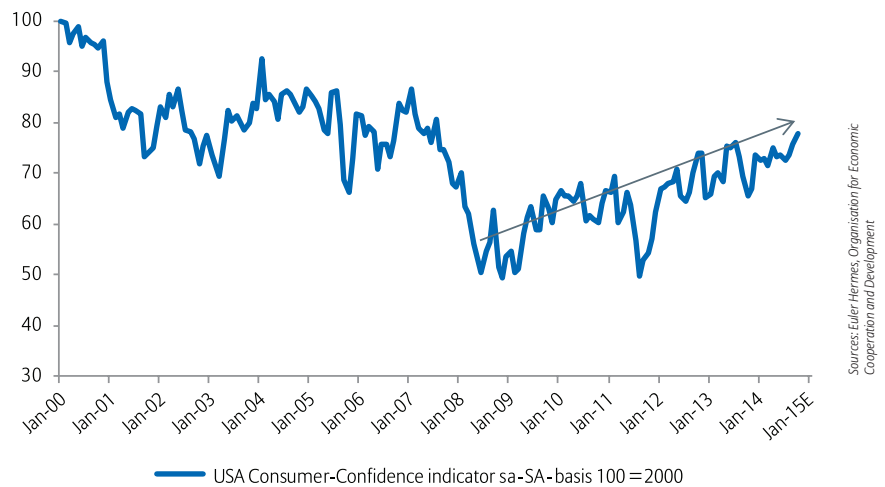


Squeezed in between the manufacturers and the retailers are the distributors who face growing pressures from the retailers for longer sales terms and volume pressures from vendors in order to get favorable prices. In addition, when manufacturers choose to start selling directly to retailers, the resulting lost revenue creates an enormous challenge.

### **Opportunities – Consumer Confidence and Spending will Continue to Improve with the Overall Economy**

Consumer confidence has been rising (up 16% yoy in October 2014) and consumers should also benefit from the recent decline in gas prices, as crude oil has declined 30% in H2 2014. These factors should result in better purchasing power for consumers this holiday season. For the CE industry, the recent launch of Apple's new iPhone 6 and meaningful ramp up of other product cycles including 4K TVs, next generation gaming consoles and wearables are encouraging for the holiday season and beyond.

#### **Consumer Confidence**



#### **About Euler Hermes**

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#### **How CE Retailers are Adapting**

Given the expected and continuing trend toward online shopping, all major CE retailers have re-organized to capitalize on the connected devices trend (smartphones, tablets, and related service plans and accessories) and the growing shift to online purchasing. Those CE retailers that can provide an effective multi-channel offering and optimize their pricing, promotions, product mix, and inventory management will be most successful in fending off competition.

#### **What this means for your business**

The ramp up of a number of product cycles (iPhone 6, 4K TVs, and next generation gaming consoles) bodes well for the CE industry over the next six to twelve months. However, CE will still be characterized by short product life cycles and rapid commoditization. Competition and pricing pressures driven by the enormous purchasing power consumers now have and their shift to online shopping makes it a significant challenge for retailers to maintain market share, margins, and profitability.

Most categories are mature or maturing and face longer replacement cycles while emerging categories are still too small to move the profitability needle for retailers. With the pressure on pricing and rising costs to promote and build their online offerings, retailers are pushing their manufacturing and distribution partners for better terms. Therefore, it remains prudent to be cautious when extending credit to distributors and retailers of CE products. The use of credit insurance can help manage risks associated with businesses selling CE products in all channels.