Credit Research Initiative
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Competition of smartphone market intensifies

by Victor Liu

After Apple's iPhone hit the market in the middle of 2007, consumers' preferences have been gradually shifting from feature phones towards smartphones. As Figure 1 shows, the shipments of feature phones have begun an obvious downward trend since the second half of 2012, while the ones of smartphones have climbed up in the same period. Smartphones began to dominate the handset market from 2013.

Nevertheless, leading smartphone players in the industry are still struggling to make money in a cut-throat market due to intensified competition from low-price Chinese smartphone makers. Recently, Samsung, the currently world's biggest smartphone maker by shipment, reported a 49% slump in its 3rd quarter net profits as Chinese low-price phone makers ate into its market share. Samsung's market share declined to 25% in the 3rd quarter of 2014 from 30% at the end of 2012; Apple, the 2nd largest player, also lost its market share, falling to 12% from 19% during the same period. Figure 1 indicates the growth of Chinese and other smartphone makers breaking into the market and taking away market shares from the industry leaders. The sector-wise EBITDA margin, an indicator which reflects a company's core profitability, has been dragged down to 7% in the first half of 2014 from 11% in 2012, making the smartphone industry a less attractive business than before.

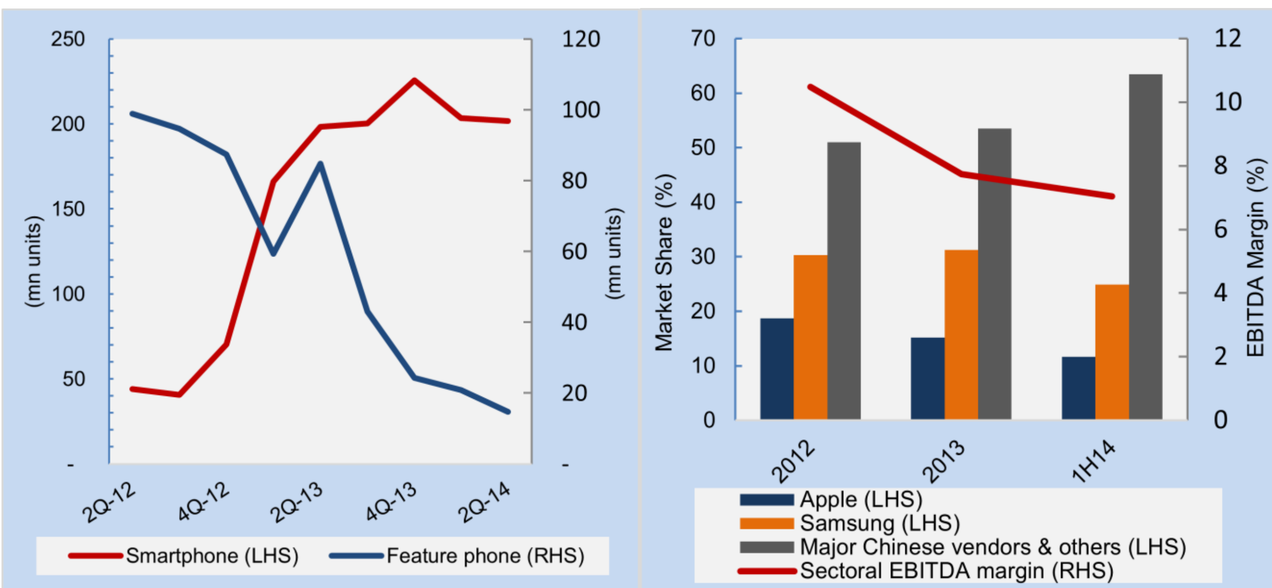

Figure 1: (1) Handset shipments (mn units) and (2) Market share & Sectoral EBITDA margin for smartphone industry. Source: *Risk Management Institute, Bloomberg*

The emergence of low-price Chinese phone vendors not only hurt the market share and profitability of smartphone players but pushed traditional phone makers to exit from the industry. As Table 1 shows, after low-price Chinese smartphone makers broke into the market in 2010, the top 3 traditional phone makers exited from the handset market one by one and turned to other niche business. The RMI 1-year probability of default (RMI 1-year PD) for the 3 players all improved after they cut their handset business.

	Event	RMI 1-year PD (bps) as on announcement date	RMI 1-year PD (bps) as on Nov 3, 2014
Nokia	Microsoft bought Nokia handset business -- completed on Apr 25, 2014	7 (Sep 3, 2013)	1.74
Motorola	Motorola spun off its handset business -- completed on Jan 4, 2011	6 (Nov 30, 2010)	0.01
Ericsson	Sony acquired Ericsson's share of the handset joint venture -- completed on Feb 16, 2012	7 (Oct 27, 2011)	1.29

Table 1: The event effect on RMI 1-year PD for traditional phone makers. Source: *Risk Management Institute*

Nokia, once the crème de la crème of the mobile phone market, also witnessed an improvement in RMI 1-year PD after it sold its mobile phone business to Microsoft and became a pure network equipment maker. Figure 2 shows that the RMI 1-year PD for Nokia has gone down to 1.74bps (Nov 3, 2014) from 84.64bps since the 2nd quarter of 2012 as it slowly reduced its reliance on handset business. On Sep 3, 2013, Nokia announced its sales of the mobile device business to Microsoft and the transfer was completed in Q1 2014. During the same period, its market capitalization (Mkt Cap) has increased from USD 7.7bn to USD 31.3bn. In the 3rd quarter of this year, Nokia turned back to profit and witnessed its first YoY sales growth since 2011. Thus, Nokia has currently become the No.3 network equipment company with 22% market share, after 37% of Ericsson and 23% of Huawei, a Chinese private company. The lower and declining RMI 1-year PD for Nokia reflected its successful business focus shift from handsets to network equipment and services.

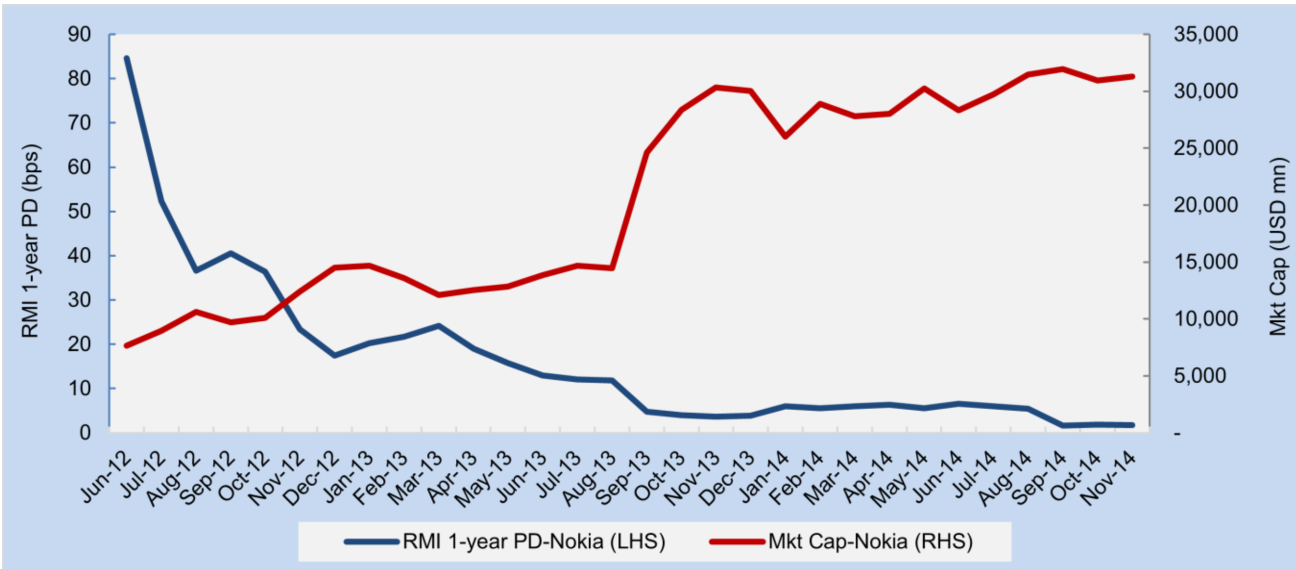

Figure 2: RMI 1-year PD and Market Cap for Nokia (USD mn). Source: *Risk Management Institute, Bloomberg*

On top of earlier preparation for business transformation, Nokia's success can be largely attributed to the opportunity that the telecom carriers rolled out 4G-LTE service to support the increased use of data-hungry smartphones, especially in the US, where its Chinese peers faced restriction on entry as a result of the accusation of cyberespionage. The global mobile data traffic by smartphone increased from 923,361 TB per month in 2013 to 1,684,096 TB per month in 2014. It is expected that Nokia's network business could be supported by the ongoing growth of data and video traffic over communication networks.

Source:

Has Samsung Lost Its Grip to Chinese Smartphones (WSJ)
Samsung, Apple Lose Ground to China Smartphone Makers (WSJ)
Nokia Gives Bullish Outlook as It Swings Back to Profit (WSJ)
Nokia's broadband gamble pays off (FT)
Huawei reportedly decides to abandon the US market (CNET)

Credit News

JP Morgan faces US currency trading probe

Nov 04. US Department of Justice (DOJ) had launched a criminal investigation over currency trading on JP Morgan Chase, the largest bank in the US. The possible losses for JP Morgan Chase for all legal proceedings could total USD 5.9bn. At the same time, a number of other bank in the US, including HSBC, RBS and Barclays, have recently set aside sums to cover similar probes. Global lenders, such as Citigroup and UBS, are also being investigated over the alleged rigging of foreign-exchange rates. (BBC)

HSBC hit by USD 1.7bn of provisions

Nov 04. HSBC Holdings PLC posted weak third-quarter results as it set aside USD 1.7bn to cover-off charges, including USD 378mn to cover a potential settlement in the UK Financial Conduct Authority's probe of foreign-exchange markets. In addition to this charge, HSBC took a USD 701mn provision to compensate customers for missold products and USD 550mn for a settlement with the Federal Housing Finance Authority. (WSJ)

Mainland Chinese banks' bad loans on the rise

Oct 30. Two of the mainland's biggest banks, Bank of Communication and Industrial and Commercial Bank of China, reported biggest quarterly increase in bad loans levels in two year for the third quarter on Oct 29, with one adding that a credit crunch squeezing small companies in export-oriented eastern provinces might be spreading westwards. The mainland's listed banks are expected to report an overall 15% YoY drop in revenues for the third quarter, according to Reuters. (SCMP)

Samsung Life told to brace for 96-year life spans

Oct 30. Korea's Financial Supervisory Service will require insurers to boost capital to prepare for an aging population, as the United Nations predicts an average life expectancy of 95.5 years by the end of the century. Insurers are facing higher capital requirements as the government seeks to improve the financial health of the companies to protect policyholders. Nine too-big-to-fail insurers including AIG, Allianz SE and Met Life Inc. must start reporting their capital ratios in 2015. Companies which do not meet the capital requirements will have to issue more securities. (Daily Herald)

Monte Paschi eyes EUR2.6bn capital increase to plug shortfall (Reuters)

Sprint to cut 2,000 jobs after major earnings miss (Forbes)

Collapse of Moneual reveals Korea banks' inability (KoreaHerald)

Regulatory Updates

Eurozone bank regulator to follow up on stress tests

Nov 03. The head of the ECB's new bank supervisory arm acknowledged that the methods used to conduct the stress tests were not rigorous enough. When the central bank tested the banks' ability to withstand hypothetical economic shocks, it did not look at what would happen if the Eurozone suffered deflation, which is possibly the largest threat to be faced by many European economies. The shortcomings of the tests would be addressed when the Single Supervisory Mechanism assumes authority as it has the power to inspect the banks' books and compel banks to change their business conduct. (NYT)

The banking industry needs more effective regulatory reform

Nov 03. A study by Stanford university says that excessive indebtedness in banking endangers and distorts the economy. Banks are simply financing their investments with too much debt. Banks should instead use more equity as this would stabilize the financial system and reduce the harm of inefficient boom and bust cycles and reduce the likelihood of financial crises. Lenders should withhold dividend payments until they build up their equity levels, use their profits to issue new loans or pay off some of their debt. (Stanford News)

Fed revises risk management policy for clearing, settlement firms

Oct 28. The Federal Reserve has revised its risk management standards for banks, which brings the updated policy in line with international rules. The new law requires over-the-counter derivatives to be centrally cleared, a process in which a central clearinghouse helps to guarantee trades between two parties. Moving forward, international regulators will monitor the clearinghouses more closely as the new rule concentrates more risk to the clearinghouses. (Reuters)

Europe continues its long journey to a banking union (Risk.Net) (Subscription required)

FSB warns of spillovers from new bank structures (Risk.Net) (Subscription required)

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