

Trias Company Memo 2009-09-01



PALTEK (7587 JASDAQ) PALTEK CORPORATION.

Business Results for the 2nd Quarter of Fiscal Year Ending December 31, 2009

Follow-Up Company Visit Summary

Following the Business Results Meeting for FY12/09 2Q, we visited PALTEK CORPORATION (hereinafter PALTEK or the Company) to interview President Tadahito Takahashi, Director Ikuko Tokunaga and IR Spokesman Yoshiki Shibasaki. The following is a summary of the interview.

[Major Changes in Our Operating Environment: The Rise of East Asia]

The changes sweeping through the technology sector are both global and dynamic. Consider the case of the telecommunications industry, in which PALTEK excels: The technology life cycle is contracting as high value added backbone system and base station technologies rapidly devolve in value because they are used by commodity terminal devices, not only shortening the period over which profits can be secured, but also squeezing the amount of profit recovered in that time. In the global market, moreover, player consolidation is accelerating and the so-called “winners” are acquiring even greater competitiveness. With the competitive edge they’ve gained, these companies—mainly from China and Korea—are entering the Japanese market and becoming major players.

The consolidation of the global telecommunication equipment market has progress significantly, with Motorola as the biggest player in North America, Nokia, Ericsson and Alcatel-Lucent in Europe, and Huawei Technologies Co., Ltd.(*1) and ATE Corp. in China. Japan is the exception, as numerous equipment manufacturers continue to compete against one another. In terms of industry consolidation, moreover, the Japanese consumer electronics market lags even further behind that found in the telecom equipment market. Such global trends are impacting the domestic market, with China’s Huawei, for instance, edging out Japanese blue-chip telecom equipment makers and Samsung Electronics—a core member of the Samsung Group and Korea’s top manufacturer of consumer electronics, electronic components and electrical equipment—expanding its presence at the expense of Japan’s largest consumer electronics makers.

(*1) A privately held maker, Huawei is headquartered in China’s Shenzhen City, Guangdong Province. Founded in 1988, it engages in a vast array of businesses, from research and development, to the manufacturing and marketing of telecom equipment, providing solutions that meet telecom carrier specifications. Net sales in FY12/08 were US\$23.3 billion (some ¥2.2 trillion @ ¥94.5/US\$), generating 75% of that through businesses conducted in more than 100 countries. In way of comparison, Huawei’s net sales in fiscal 2004 was US\$5.6 billion, of which 41% was generated overseas. Today, Huawei ranks among the five biggest telecom equipment suppliers, joining Cisco

This Memo is for reference purposes only and is not intended as a solicitation for investment. The contents contained herein are prepared based on reliable information that already exists in the public domain. The Company, however, does not guarantee complete accuracy. Any opinion or information contained in the Memo is relevant as of the day of the Information Meeting and/or Company Visit, although the views and/or facts may be altered without prior notification. Final investment decisions shall be made by investors themselves based solely on their own judgment and responsibility.

Systems, Ericsson, Alcatel and Nokia-Siemens Networks. Its clients include such mega-carriers as British Telecom, Thailand's AIS, Telefonica of Spain and Singapore Telecom, in addition to China Telecom Corporation Ltd., China Mobile Ltd., China Network Communications Group Corporation Ltd. and China Unicom (Hong Kong) Ltd. Of the 50 largest carriers in the world, 36 procure Huawei products and solutions. In Japan, E-Mobile adopted Huawei base station utilities and mobile handsets when entering the cellular phone carrier market. (Sources: Compiled by Trias Corporation based on data from the Huawei website, 2008 Annual Report and other references)

In addition to the operating environments of PALTEK's client-manufacturers, things have begun to change in the semiconductor distribution market and semiconductor industry as well. In the semiconductor distribution market, Avnet Inc. (AVT/NYSE) and Arrow Electronics, Inc. (ARW/NYSE) have been the traditional powerhouses, mainly handling products of U.S. and European semiconductor vendors. Avnet's net sales in FY12/08 was US\$17.95 billion (approx. ¥1.69 trillion), generating 19% of its sales from Asia; Arrow, meanwhile, sold US\$16.76 billion (¥1.58 trillion) worth of goods, of which 18% was generated from Asia. East Asian companies are now making major inroads in this market as well. One of the premier representatives is WPG Holdings Ltd. of Taiwan (Securities Code 3702/Taiwan Stock Exchange), with FY12/08 net sales of TW\$143.19 billion (approx. ¥408.1 billion @ ¥2.85/TW\$), exceeding both Avnet and Arrow in Asia. WPG was founded in 1987 as a trading house for electronic components, including crystal oscillators made by Epson Japan. In the 1990s, WPG expanded its product lineup from Asian vendors, particularly those in China, and has rapidly expanded its Asian business network and increased capitalization since 2000.

The latter half of the 1990s was also a time when semiconductor vendors in East Asia began rising to prominence. One example is Media Tek Inc. of Taiwan (Securities Code 2454/Taiwan Stock Exchange), which has posted an annual growth rate of 30% since it was established in 1997. A fab-less maker of chipsets for CD/DVD units, digital TVs and cell phones, Media Tek posted consolidated net sales of TW\$90.4 billion (approx. ¥257.7 billion) in FY12/08, a year-on-year increase of 12%, and an operating margin of approx. 25%. In recent years, Media Tek acquired NuCore Technology, a U.S. vendor of image processing LSIs used in digital cameras, in March 2007, while also buying a portion of Analog Devices' cell phone chipset lineup in the U.S. in September 2007. In October 2007, it launched Media Tek Japan Inc. to carry out marketing operations and upgrade its technical support structure, succeeding the Japanese subsidiary of NuCore Technology. Media Tek is closely associated with East Asian makers of cell phone related products, primarily LG Electronics and Samsung Electronics of Korea. Given its vast procurement capacity arising from its rapid business expansion, Media Tek appears to be developing its operations on a global basis.

This Memo is for reference purposes only and is not intended as a solicitation for investment. The contents contained herein are prepared based on reliable information that already exists in the public domain. The Company, however, does not guarantee complete accuracy. Any opinion or information contained in the Memo is relevant as of the day of the Information Meeting and/or Company Visit, although the views and/or facts may be altered without prior notification. Final investment decisions shall be made by investors themselves based solely on their own judgment and responsibility.

[Challenges Confronting PALTEK]

The emergence of East Asian companies in the global technology market impacts PALTEK and its business operations in a variety of ways. First among these is the shift in the way PALTEK's tech maker clients in Japan must compete. In order to win against products built by Huawei of China and Samsung Electronics of Korea, Japanese companies must refocus on a different manufacturing strategy, one emphasizing general purpose equipment with superior cost performance and the need to develop the solutions to achieve these objectives, rather than one that previously emphasized the highly value added, high-end market. If the traditional manufacturing infrastructure—which is based on domestic tech makers supplying highly value added products primarily to U.S. and European vendors—is no longer viable against East Asian companies, then providing its client-manufacturers with solutions which will enable them to survive the competition from East Asia will become paramount. Based on this assumption, PALTEK is now expanding its lineup provided to new vendors, including those in East Asia. A representative sample of this effort is GCT Semiconductor, Inc. (hereinafter GCT); Synaptics Inc. (hereinafter Synaptics); and Power Analog Microelectronics, Inc. (hereinafter PAM). GCT, for example, is a fab-less chipmaker based in Silicon Valley that National Semiconductor Corp. (NSM/NYSE; hereinafter NS) invested in at the time of its launch. In Korea, which was the first to commercialize WiMAX, GCT is developing middleware products, including chipsets for mobile terminals. Having produced the world's first chip for "one-segment" broadcasting, GCT is supplying the majority of its products to Samsung Electronics and other Korean companies. Synaptics is another NS spin-off based in San Jose, California; as a maker for input devices such as Touch Pad for mobile terminals, it commands an impressive share of the global market. PALTEK also sells Synaptics products, including remote controllers and other devices, to the major makers of consumer electronics and PCs in Japan. Meanwhile, PAM was founded by engineering and management members of Texas Instruments and NS, and while it is based in Silicon Valley, its primary operating base is Shanghai. PAM is gaining widespread acceptance among digital consumer equipment makers in Asia for its solid technology base and superior cost performance. These new vendors are characterized by the speed with which they develop solutions based on market demand and cost performance. Given PALTEK's core competence in engineering solutions that leads to client demand, the Company will further accelerate the adoption of solutions with superior cost performance.

The second transformation of the major semiconductor vendors with which PALTEK deals with is the change in business strategy. Consider the case of PALTEK's analog solution business, which relies primarily on NS products and comprises 21% of net sales that the Company forecasts for FY12/09. While PALTEK's analog solution business has struggled for several years now, one of the reasons for this is due to NS's strategic shift to more lucrative fields. Backed by a commanding position in power-supply control technology, NS is now focusing on such high-end businesses as energy related solutions for a low-carbon society. As a result, for example, NS's lineup of general-use digital consumer

This Memo is for reference purposes only and is not intended as a solicitation for investment. The contents contained herein are prepared based on reliable information that already exists in the public domain. The Company, however, does not guarantee complete accuracy. Any opinion or information contained in the Memo is relevant as of the day of the Information Meeting and/or Company Visit, although the views and/or facts may be altered without prior notification. Final investment decisions shall be made by investors themselves based solely on their own judgment and responsibility.

electronics equipment related products has weakened. In response to this strategic shift by NS, PALTEK intends to bolster its marketing efforts in PowerWise solutions, which is an energy saving product lineup and core NS strength, and medical equipment, which NS has identified as a strategic business. In addition, PALTEK will provide clients with analog solutions of East Asian vendors, which have secured a position of strength in the digital consumer market.

The third transformation is the structural change in distribution. Given the encroachment of chipmakers adopting a fab-less strategy, direct transactions between foundry makers and semiconductor vendors are increasing. The larger distributors are providing a broader array of services, from procurement to warehouse storage, on behalf of client-manufacturers. At the same time, as electronics equipment become faster and more multi-functional, the greater the difficulty in faced by product developers. The trend has brought to light demand for agencies that can have engineering support functions for niche needs. Based on its core competence in programmable logic devices (PLD), PALTEK will focus greater effort on providing product design-capable engineering support services for such high value added business fields as the broadcasting industry and medical equipment market. PALTEK, moreover, has recently begun fielding inquiries from an entirely different class of clients in such business fields as automotive electronics and sensor systems.

PALTEK has operated on the basis of a traditional business model that provides high value added solutions for applications of dedicated equipment in such fields as telecommunications, one in which relies heavily on U.S. and European vendors. Under the existing business model, the Company believes it necessary to expand its presence in targeted markets by aggressively courting new clients. At the same time, now that East Asian vendors are rapidly becoming fixtures in the market, it will also be imperative for the Company to develop a new business model, one that aims to recover and enhance the competitiveness of Japanese technology companies. For PALTEK to meet this challenge, it must further leverage its core competence—engineering expertise—and engage as promptly as possible the remedial actions to address the grave issues which confront the market today.

(Concludes Company Memo)

This Memo is for reference purposes only and is not intended as a solicitation for investment. The contents contained herein are prepared based on reliable information that already exists in the public domain. The Company, however, does not guarantee complete accuracy. Any opinion or information contained in the Memo is relevant as of the day of the Information Meeting and/or Company Visit, although the views and/or facts may be altered without prior notification. Final investment decisions shall be made by investors themselves based solely on their own judgment and responsibility.

[Reference]

PALTEK CORPORATION (Securities Code: 7587)

Key Financial Data and Business Results (Consolidated)

Key Stock Indicators (Consolidated)		
No. of Shares Issued	Dec.08	11,849,899
No. of Treasury Stock	Dec.08	189,668
Market Value (¥million)	Sep.1, 2009	3,851
BPS (¥)	Dec.08	697.9
ROE (%) ※1	Dec.08	0.7
ROA (%) ※2	Dec.08	0.6
PER (times)	FY12/09 est.	-47.4
PCFR (times) ※3	Dec.08	37.0
PBR (times)	Dec.08	0.5
Share Price (¥)	Sep.1, 2009	325

Key Financial Data (Consolidated)		
Total Assets (¥million)	Dec.08	10,322
Shareholders' Equity (¥million)	Dec.08	8,137
Interest-Bearing Debt (¥million)	Dec.08	550
Equity Ratio (%)	Dec.08	78.8
Ratio of Interest-Bearing Debt (%) ※4	Dec.08	6.8
Free Cash Flows (¥million) ※5	Dec.08	580

※1 ROE=Current Net Income ÷ Averaged Shareholders' Equity of beginning of term and term end

※2 ROA=Curent Net Income ÷ Averaged Total Assets of beginning of term and term end

※3 PCFR=Maket Value ÷ (Current Net Income+Depreciation)

※4 Ratio=Interest-Bearing Debts ÷ Shareholders' Equity

※5 Free Cash Flows (FCF) =Operating CF +Investment CF

Consolidated (¥million)	Net Sales	Operating Income	Ordinary Income	Net Income	EPS (¥)	Dividend per Share (¥)
FY12/05	17,946	541	373	243	20.5	10.0
FY12/06	14,729	△ 412	△ 42	△ 36	△ 3.1	10.0
FY12/07	20,655	△ 300	△ 222	△ 258	△ 22.1	10.0
FY12/08	20,726	131	286	59	5.1	10.0
FY12/09 1HF	6,672	△ 230	△ 185	△ 84	△ 7.2	0.0
FY12/09 f.	14,300	△ 210	△ 180	△ 80	△ 6.9	5.0

Note: FY12/09 f. is the Company's forecast announced on Aug. 11, 2009.

This Memo is for reference purposes only and is not intended as a solicitation for investment. The contents contained herein are prepared based on reliable information that already exists in the public domain. The Company, however, does not guarantee complete accuracy. Any opinion or information contained in the Memo is relevant as of the day of the Information Meeting and/or Company Visit, although the views and/or facts may be altered without prior notification. Final investment decisions shall be made by investors themselves based solely on their own judgment and responsibility.