Pace Micro Technology plc

Interim Report 2005

10 January 2005

Pace Micro Technology plc

for the 27 weeks ended 4 December 2004

SALIENT POINTS

- Shipments increased to 2.1 million set-top boxes (2003: 1.0 million);
- Turnover increased 36% to £150.5m (2003: £110.4m);
- Profit before tax of £3.1m (2003: £0.8m);
- Diluted earnings per share of 3.6p (2003: 0.6p) (adjusted earnings per share 1.4p: 2003: 0.6p);
- Net cash position £11.4m (29 May 2004: £20.4m);
- Business performance significantly improved.

Pace Micro Technology's Chairman Sir Michael Bett commented:

“Pace’s results for the first half are significantly ahead of last year within what has been a highly competitive market. A wider geographical spread has been achieved with non-UK customers representing 61% of our total revenues, complementing our existing strong UK market position. Markets remain competitive and the Group continues to address these by rigorous management controls, adapting new technologies and adjusting product mix.

“We are confident that the Group’s underlying performance and recovery trend will continue, although, as indicated in our market update issued on 16 December 2004, this recovery may take longer than was initially anticipated.“

Chairman’s Statement

Pace’s results for the twenty seven weeks ending 4 December 2004 show further recovery in Group performance and the Board is pleased to report that revenues, volumes and profit were all significantly ahead of last year. Group strategy continues to be focussed on growing market share while addressing the competitive challenges of the current market place. We aim to improve net margins by sustaining a rigorous approach to the management of all business costs and by seeking additional, more consistent, revenue streams.

Results

Profit before tax improved to £3.1m (26 weeks to 29 November 2003: £0.8m) on turnover of £150.5m (2003: £110.4m). Basic and diluted earnings per share were 3.6p (2003: 0.6p). After eliminating the impact of a one off taxation credit taken in the period, the basic and diluted earnings per share were 1.4p (2003: 0.6p).

An interim dividend is not declared (2003:nil), although it is the Board’s intention to review its dividend policy at the time of the Group’s results for the full year.

Trading review

During the period the volume of Pace shipments doubled to 2.1 million set-top boxes, a new record for the Group (2003: 1.0m), as it took advantage of increased demand for set-top box products from payTV operators. This growth, which has resulted in a 36% increase in turnover, has been driven, in part, by an ongoing decline in average selling prices (ASPs). As a result of the lower pricing and a greater proportion of lower-cost, lower-margin set-top boxes being shipped, gross margin declined to 16.8% (2003: 19.1%).

We have continued to establish a wider geographic spread for the Group’s business with sales to non-UK customers making up 61% of our total revenues (2003: 47%). In the period Pace has shipped products to over 25 customers, with payTV operators in Continental Europe and Asia Pacific playing an important role. Sky Italia was a particularly important customer in the period, for which we began shipments of our second-generation product.

In Germany and Scandinavia more set-top boxes were shipped to some of our most recent new customers, Premiere and KDG in Germany and Viasat in Scandinavia. At the same time we announced an important new contract with Premiere for PVR, which we expect to deliver during 2005. In the UK, a more mature market for digital TV, BSkyB remains an important customer as its Sky+ service continues to expand. We also shipped product to our cable customers Ntl and Telewest.

In Australia, we built on our successful relationship with Foxtel, providing its standard digital set-top box and we are working with them on its first PVR platform, due in 2005. Outside of Australia, the Asia Pacific market remains relatively small and highly competitive, but we are actively addressing the market place.

In the US we have increased our penetration with the cable operators. We are currently shipping our high definition set-top box, with our high definition PVR now in the final stages of development. In profit terms, our business is still not at breakeven but we aim to improve this position in the second half.

We are increasing our use of outsource partners. Pace now has over 75 software engineers at Tata Elxsi in Bangalore, India and we are developing new relationships with Far Eastern hardware engineering houses.

Net operating expenses increased by 9.5% to £22.4m (2003: £20.4m), but as a percentage of revenue fell to 14.9% (2003: 18.5%). Engineering costs increased to £11.8m (2003: £10.8m). Non-engineering overheads increased to £10.6m (2003: £9.6m) to support the growth in worldwide activity.

Net assets improved to £57.8m (29 May 2004 as restated: £49.5m). Net current assets rose to £57.4m (29 May 2004: £54.1m). Within net current assets, debtors increased to £71.8m (29 May 2004: £64.7m), creditors increased to £43.7m (29 May 2004: £41.4m) and stocks increased to £17.6m (29 May 2004: £10.0m). The debtors balances included insured balances of £36.2m (29 May 2004: £38.5m). Net cash balances at the period-end were £11.4m (29 May 2004: £20.4m), mainly due to higher levels of finished stocks for delivery over the next few months.

Included within the tax charge is a credit of £4.9m relating to the agreement with the Inland Revenue in the UK of a disputed balance in respect of a prior year, the cash effect of which was received in the year ended 31 May 2003.

As previously announced, the Company is a party to a reference to the Financial Services and Markets Tribunal. The Company is unfortunately prohibited under the Financial Services and Markets Act 2000 from providing any further information regarding this reference until the matter is resolved.

Future technologies

The demand for more sophisticated set-top box products is growing and Pace is well positioned to lead in this field, providing innovation with, for example, our new advanced codec high definition PVR products and our mobile PVR product, PVR2GO, designed for payTV customers, as well as products for multiroom viewing.

The demand for PVR and high definition set-top boxes is growing and Pace is exploiting this positive trend on two fronts. Firstly by developing relationships with existing customers and working with them as they grow their service offerings to include more profitable PVR and high definition products. Secondly by applying our technological expertise in new markets through our knowledge of home networking and our ability to create platforms with the capability to deliver interactive services over broadband networks. These provide opportunities in the potential market for the Intelligent Home, where we can apply Pace's engineering and product delivery skills to develop additional business streams and applications that can gain us access to a wider customer base.

In addition we are active in broadband video, the delivery of digital television over telephone lines, and have worked on some of the world's most successful live deployments. With more large-scale telecommunications companies now looking at broadband video we have increased our activity in this arena.

Board changes

Two Board members retired during the period. David Hood, one of Pace's founders and a non-executive director for the last six years, retired at the Annual General Meeting on 8 September 2004. Marvin Jones, a non-executive director for the past four and a half years, retired from the Board at the end of December 2004.

The Board would like to extend their thanks to both David and Marvin for the important contribution they have made to the development of Pace's business. The Nominations Committee of the Board is presently interviewing candidates as additional non-executive directors.

Outlook

The expected timescale of Pace's recovery has extended since the update at our last Annual General Meeting and, as indicated in our market update issued on 16 December 2004, revenues in the second half are expected to be lower than in the first half. However, we do expect higher margins in the second half.

Pace is a major player in the UK market, where the penetration of digital payTV is continuing to grow, albeit at a slowing rate as the market matures. In the longer term, Continental Europe and Asia Pacific represent big opportunities for growth, as more payTV operators go digital and others progress to higher specification PVR and high definition TV platforms. However, short-term revenues are likely to reduce as shipments to both Italy and Germany slow down following customers' high volume launch phases.

Our expectations for the US market contain certain engineering design revenues, including a material amount relating to a re-negotiation of existing commitments with Comcast. Subject to a positive outcome, we expect our revenues and market share in the US to increase in the second half.

We are pursuing a number of new business opportunities throughout the world, but it is too early to predict how and when these opportunities will be translated into business wins. The Board remains confident that Pace is well positioned in this highly competitive market.

Sir Michael Bett
Chairman
10 January 2005

CONSOLIDATED PROFIT AND LOSS ACCOUNT

FOR THE 27 WEEKS ENDED 4 DECEMBER 2004

	Note	27 weeks ended 4 Dec 2004 (unaudited) £000	26 weeks ended 29 Nov 2003 (unaudited) £000	52 weeks ended 29 May 2004 (audited) £000
Turnover	2	150,547	110,412	239,949
Cost of sales		(125,227)	(89,314)	(194,425)
Gross profit		25,320	21,098	45,524
Net operating expenses:				
Before exceptional item		(22,368)	(20,433)	(40,350)
Exceptional item	3	-	-	(1,500)
Operating profit		2,952	665	3,674
Net interest receivable		119	109	206
Profit on ordinary activities before taxation		3,071	774	3,880
Tax credit on profit on ordinary activities	4	4,896	486	4,186
Retained profit for the financial period		7,967	1,260	8,066
Basic earnings per ordinary share	5	3.6p	0.6p	3.7p
Diluted earnings per ordinary share	5	3.6p	0.6p	3.6p
Adjusted basic earnings per ordinary share	5	1.4p	0.6p	3.7p
Adjusted diluted earnings per ordinary share	5	1.4p	0.6p	3.6p

The results from the current period derive from continuing operations.

CONSOLIDATED BALANCE SHEET
AT 4 DECEMBER 2004

	Note	4 Dec 2004 (unaudited)	29 Nov 2003 (unaudited) As restated (note 8)	29 May 2004 (audited) As restated (note 8)
		£000	£000	£000
Fixed assets				
Intangible		9,155	9,661	9,436
Tangible		6,618	8,747	7,010
Investments		200	-	-
		15,973	18,408	16,446
Current assets				
Stocks		17,611	14,325	10,006
Debtors	6	71,826	56,153	64,724
- due within one year		*67,868*	*50,997*	*60,912*
- due after more than one year		*3,958*	*5,156*	*3,812*
Cash at bank and in hand		11,688	14,154	20,705
		101,125	84,632	95,435
Creditors: amounts falling due within one year		(43,720)	(34,109)	(41,378)
Net current assets		57,405	50,523	54,057
Total assets less current liabilities		73,378	68,931	70,503
Creditors: amounts falling due after more than one year		(242)	(257)	(246)
Provisions for liabilities and charges	7	(15,362)	(26,029)	(20,748)
Net assets		57,774	42,645	49,509
Capital and reserves				
Called up equity share capital		11,347	11,316	11,339
Share premium account		35,671	35,434	35,647
Profit and loss account		10,756	(4,105)	2,523
Total shareholders' funds		57,774	42,645	49,509

CONSOLIDATED CASH FLOW STATEMENT

FOR THE 27 WEEKS ENDED 4 DECEMBER 2004

	Note	27 weeks ended 4 Dec 2004 (unaudited) £000	26 weeks ended 29 Nov 2003 (unaudited) £000	52 weeks ended 29 May 2004 (audited) £000
Net cash (outflow)/inflow from operating activities	9	(7,015)	6,470	14,165
Returns on investments and servicing of finance		52	101	136
Taxation		(69)	758	391
Capital expenditure and financial investment		(1,817)	(1,477)	(2,665)
Acquisitions and disposals		(200)	(5,093)	(4,936)
Cash (outflow)/inflow before financing		(9,049)	759	7,091
Financing		32	(15)	204
(Decrease)/increase in cash in the period		(9,017)	744	7,295

Reconciliation of net cash flow to movement in net funds			
(Decrease)/increase in cash in the period	(9,017)	744	7,295
Cash flow from decrease in debt	5	26	34
Movement in net funds in the period	(9,012)	770	7,329
Net funds at start of period	20,406	13,077	13,077
Net funds at end of period	11,394	13,847	20,406

ANALYSIS OF CHANGES IN NET FUNDS

	At 29 May 2004 £000	Cashflow £000	At 4 Dec 2004 £000
Cash at bank and in hand	20,705	(9,017)	11,688
Debt due within one year	(53)	1	(52)
Debt due after one year	(246)	4	(242)
	20,406	(9,012)	11,394

NOTES

1 Basis of preparation

The interim financial information for the 27-week period ended 4 December 2004 has not been audited, nor has the interim financial information for the 26-week period ended 29 November 2003. They comply with relevant accounting standards and have been prepared on a consistent basis using the accounting policies set out in the 2004 Annual Report and Accounts (as referred to in note 8, an adjustment has been made to comply with UITF Abstract No 38 "Accounting For ESOP Trusts", which has been adopted in the current period). The figures for the 52-week period ended 29 May 2004 do not constitute the Group's statutory accounts for that period but have been extracted from the statutory accounts, which have been filed with the Registrar of Companies and then restated to reflect the adoption of the provisions of UITF Abstract No 38 "Accounting For ESOP Trusts". The auditors have reported on those accounts and that report was unqualified and did not contain a statement under Section 237(2) or (3) of the Companies Act 1985. The accounts for the full year will be for the 53-week period ending 4 June 2005.

Financial Position and Market Conditions

The performance of the Group has continued to improve in this period. Unit volumes and turnover have increased and the geographical diversity continues to widen. However, pressure on selling prices continues and the net profit margin remains low.

The risks in the digital broadcasting industry involve the application of new and evolving technologies and the nature of Pace's activities, which are characterised by large individual sales orders to a limited range of customers, are unchanged. Some customers are incurring losses as they implement their business plans and others continue to review the timing and nature of their plans.

These factors, particularly in the context of the level of net profitability, increase the sensitivity of the judgements required to prepare the financial statements. However, a consistent approach has been applied using all available information.

The Group ended the period with net cash balances of £11.4m and has uncommitted banking facilities in an amount of £20m, which are available until 30 September 2005.

The Board has built the above circumstances into their working capital forecasts and has modelled various business scenarios. Based on these, the Board has concluded it is appropriate to confirm the going concern basis of preparation for the financial information.

2 Turnover

	27 weeks ended 4 Dec 2004 (unaudited) £000	26 weeks ended 29 Nov 2003 (unaudited) £000	52 weeks ended 29 May 2004 (audited) £000
The geographical analysis of turnover by destination is as follows:			
United Kingdom	58,043	58,191	138,275
Continental Europe	71,118	41,915	56,812
Asia Pacific	11,760	1,241	19,986
North America	9,245	6,925	22,252
Rest of the World	381	2,140	2,624
	150,547	110,412	239,949

3 Exceptional item

	27 weeks ended 4 Dec 2004 (unaudited) £000	26 weeks ended 29 Nov 2003 (unaudited) £000	52 weeks ended 29 May 2004 (audited) £000
Cost regarding reference to Financial Services and Markets Tribunal	-	-	1,500
	-	-	1,500

The Company is party to a reference to the Financial Services and Markets Tribunal and the exceptional charge made in the year ended 29 May 2004 reflects the estimated costs, including legal fees associated with this matter. Discussions continue with insurers in respect of potential recoveries of legal costs.

4 Tax credit on profit on ordinary activities

	27 weeks ended 4 Dec 2004 (unaudited) £000	26 weeks ended 29 Nov 2003 (unaudited) £000	52 weeks ended 29 May 2004 (audited) £000
The tax credit is based on the estimated effective rate of taxation on trading for the period and represents:			
United Kingdom corporation tax at 30%	-	909	8,214
Overseas tax	(110)	(39)	44
Adjustment in respect of a prior year (see below)	4,860	-	-
Deferred tax (see note 6)	146	(384)	(4,072)
	4,896	486	4,186

Following the agreement of an outstanding Corporation Tax matter with the Inland Revenue in the UK, a one-off tax credit has been taken in respect of a prior year.

5 Earnings per ordinary share

Basic earnings per ordinary share have been calculated by reference to the profit after taxation, and the average number of qualifying ordinary shares of 5p in issue of 219,057,810 (2003: 218,251,847).

Adjusted earnings per share calculations reflect the profit after taxation excluding the impact of the one-off tax credit referred to in note 4.

Diluted earnings per ordinary share vary from basic earnings per ordinary share due to the effect of the notional exercise of outstanding share options. The diluted earnings are the same as basic earnings. The diluted number of qualifying ordinary shares was 224,548,028 (2003: 223,912,904).

6 Debtors

Debtors include a deferred tax asset of £3,958,000 (2003: £7,500,000), all of which is due after more than one year (2003: £5,156,000).

7 Provisions for liabilities and charges

	Royalties under negotiation (see below) £000	Onerous contracts £000	Warranties £000	Corporation Tax (note 4) £000	Total £000
At 29 May 2004	7,864	1,828	5,696	5,360	20,748
Charge/(credit) for the period	597	-	3,081	(5,360)	(1,682)
Utilised	(66)	(378)	(3,260)	-	(3,704)
At 4 December 2004	8,395	1,450	5,517	-	15,362

The owners of patents covering technology allegedly used by the Group have indicated claims for royalties relating to the Group's use (including past usage) of that technology. Whilst negotiations over these liabilities continue, they are not concluded. The directors have made provision for the potential royalties payable based on the latest information available. Having taken legal advice, the Board considers that there are defences available that should mitigate the amounts being sought. The Group will vigorously negotiate or defend all claims but, in the absence of agreement, the amounts provided may prove to be different from the amounts at which the potential liabilities are finally settled.

8 Prior year adjustment

At 4 December 2004 the Pace Micro Technology Employee Benefits Trust and QUEST held shares in the Company which cost £21,434,000 (2003: £21,530,000). These shares are held to satisfy options granted to employees.

In line with the requirements of UITF Abstract No 38 "Accounting For ESOP Trusts", such amounts have been reclassified to show the Company's purchases of own shares as deductions from the Profit and Loss Account reserve in arriving at Shareholders' Funds. The previous treatment was to classify such amounts, net of impairment provisions, as assets in Fixed Asset Investments. The comparative figures in the financial information have been restated to reflect this change with a resulting impact on the balance sheets as follows.

	29 Nov 2003 £000	29 May 2004 £000
Decrease in Investments and Net Assets	(2,515)	(2,436)
Net decrease in Profit and Loss Account and Shareholders' Funds	(2,515)	(2,436)

There is no impact on the Profit and Loss Account for the year ended 29 May 2004 or the 26-week period to 29 November 2003 resulting from the above restatement.

9 Net cash (outflow)/inflow from operating activities

	27 weeks ended 4 Dec 2004 (unaudited) £000	26 weeks ended 29 Nov 2003 (unaudited) £000	52 weeks ended 29 May 2004 (audited) £000
Operating profit	2,952	665	3,674
Goodwill amortisation	281	282	564
Depreciation	2,198	2,681	5,317
Loss on sale of tangible fixed assets	-	178	317
(Increase)/decrease in stocks	(7,605)	1,642	5,961
(Increase)/decrease in debtors	(6,890)	796	(11,540)
Increase in creditors	2,075	528	10,728
Decrease in provisions for liabilities and charges	(26)	(302)	(856)
Net cash (outflow)/ inflow from operating activities	(7,015)	6,470	14,165