Pace Micro Technology plc

interim report 2003

www.pace.co.uk

Pace Micro Technology plc

for the 26 weeks ended 30 November 2002.

highlights

- Turnover decreased 61% to £83.4m (2001: £215.8m);
- Gross margin decreased to 12.7% (2001: 25.5%);
- Loss before tax and amortisation of goodwill of £15.9m (2001: profit £22.2m);
- Diluted loss per share before amortisation of goodwill of 7.3p (2001: earnings per share of 7.2p);
- No interim dividend (2001: 0.4p)
- Overhead run rate reduced to £48m p.a. (from £66m) and Pace re-organising to take advantage of new opportunities as they arise;
- Inventory reduction to £25.1m (1 June 2002: £46.7m);
- Strong net cash position £15.3m (1 June 2002: net borrowings £19.1m);
- First shipments to second US customer, Comcast Communications, in November 2002.

chairman's statement.

The Group results for the half year ended 30 November 2002 were disappointing but reflective of an industry undergoing major change and in line with the Group's trading statement issued in November 2002. Pace and its competitors have experienced difficulties as deployment of home gateways (set top boxes) around the world has fallen. In addition and despite the introduction of innovative hard disk drive and high definition technologies (both in their early stages) this fall has been compounded by a substantial fall in average selling prices. In spite of the trading difficulties, Pace generated cash over the last six months and the Group is able to report net cash of £15.3m (1 June 2002: net borrowings of £19.1m). Your Board is determined to restore the Group to profitability on the lower revenue base.

results and dividend.

Loss before tax and amortisation of goodwill was £15.9m (2001: profit £22.2m) on turnover of £83.4m (2001: £215.8m). Loss per share was 7.3p (2001: earnings per share 7.2p).

The Board has decided not to declare an interim dividend (2001: 0.4p) and will consider the position for the full year in the light of the results for the second half of the year.

trading and financial review.

Shipments of home gateways and other Pace products fell 45% to 651,000 units. The UK market has declined sharply since last year, with resultant Pace revenues falling 66% to £65.0m, although our share of the UK market remained stable at over 50%. There have been several reasons for this deterioration including a reduction in sales of gateways to our two cable customers, ntl and Telewest, and lower shipments to Sky digital, whose conversion of analogue subscribers to digital has been completed. Volumes were partially made up by growing shipments of the Sky+ personal video recorder (PVR) which has been well received by customers, by a new compact Sky Minibox and by the launch of our Digital Television Adapter (DTVA) for the new free-to-view digital terrestrial services known as Freeview.

In the US we commenced shipments to our second major cable customer, Comcast Communications, but did not make any further shipments to Time Warner Cable whilst they accelerated the roll out of existing inventories of Pace gateways to more of their operating divisions throughout the US. Further orders to satisfy demand from these operators are expected. The low level of shipments, combined with the high level of new product development and customer support, have resulted in continuing losses in our US operations.

Continental European markets proved challenging with operator and broadcaster business remaining largely dormant as they focus on balance sheet restructuring and consolidation. The contraction of the retail market resulted in a reduction in turnover for this business and a move from profit into loss.

The overall gross margin has been reduced from normal levels due to initial losses on shipping Sky+ PVRs (excluding Sky+, the margin would have been 19.1%) and low margins in the US and on the initial DTVA sales in the UK. These margins are all expected to improve in the coming months with the introduction of new products and the increasing revenue stream from the Sky+ PVR subscriptions.

As previously announced, Pace reduced its workforce in September by over 200 to 750. This and other changes have reduced the annual cost run rate by 27% from £66m to £48m. In the light of current turnover expectations, further cost reductions are now being sought. The cost of any further restructuring will be taken in the second half as an exceptional charge.

The Group, despite having to reduce overheads, remains at the leading edge of digital TV technology and is committed to producing the most competitive designs. The engineering team is central to achieving this and their work has, in the last six months, enabled us to deliver improvements in existing products and make new product launches ahead of our competition.

Overheads, net of other income and before the amortisation of goodwill, decreased by 20% to £26.3m. Engineering costs decreased to £13.4m (2001: £19.5m). Selling, General and Administrative costs decreased to £12.9m (2001: £13.4m).

Net assets decreased to £82.7m (1 June 2002: £101.6m). Within net current assets of £61.3m (1 June 2002: £65.0m), net cash was £15.3m (1 June 2002: net borrowings £19.1m). The improvement in cash has resulted principally from the significant reduction in stocks of finished products as ntl continued to take stock in line with the agreed schedule and the Group received a repayment of £10.1m of Corporation Tax paid in a previous period. Stocks have reduced to £25.1m from £46.7m in June 2002. Creditors have fallen to £32.6m (1 June 2002: £62.6m).

chairman's statement continued.

chief executive.

The Board thanks Malcolm Miller, who has been our Chief Executive, for his leadership of the Group over the last five years. The search for his replacement is ongoing and until a successor is appointed John Dyson, currently Finance Director, has taken over as Acting Chief Executive.

outlook.

The outlook for Pace differs in each of its geographic markets.

In the UK digital TV has reached 40% of consumer homes and penetration is likely to continue growing over the next few years, although in the short-term we do not expect to see any significant increase in revenues over current levels. We are protecting our market share by continuous product innovation and our focus on providing new features required by our customers.

In the US cable market we achieved a share of 3.5% during 2002. Our aim is to grow this share through our relationships with Comcast Communications and Time Warner Cable, which together account for over 50% of the US cable market, and with the introduction of new high definition and standard definition products.

Continental Europe and Asia represent opportunities for future growth. Penetration of digital TV in these markets stands at less than 15% which is still very low, regardless of constraining economic factors such as low GDP per head.

We expect to see some recovery in performance in the second half of the financial year, compared to the first half, in terms of revenue and margin improvements. Competition remains strong and there continue to be market uncertainties. However, with our leading edge technology and focus on lower product costs we remain in a good position to secure new business.

Sir Michael Bett
Chairman

13 January 2003

consolidated profit and loss account.

for the 26 weeks ended 30 November 2002.

	Note	26 Weeks Ended 30 Nov 2002 (unaudited) £000	26 Weeks Ended 1 Dec 2001 (unaudited) £000	52 Weeks Ended 1 June 2002 (audited) £000
Turnover	2	**83,408**	215,808	351,794
Cost of sales		**(72,777)**	(160,844)	(271,832)
Gross profit		**10,631**	54,964	79,962
Other operating income and charges:				
Recurring		**(26,832)**	(34,272)	(68,817)
Exceptional	3	**-**	-	(39,952)
Operating (loss)/profit		**(16,201)**	20,692	(28,807)
Net interest (payable)/receivable		**(218)**	176	(718)
(Loss)/profit on ordinary activities before taxation		**(16,419)**	20,868	(29,525)
Tax on loss/profit on ordinary activities	4	**2,289**	(6,139)	(5,317)
(Loss)/profit on ordinary activities after taxation		**(14,130)**	14,729	(34,842)
Dividends payable	6	**-**	(859)	(2,386)
Retained (loss)/profit for the financial period		**(14,130)**	13,870	(37,228)
Basic (loss)/earnings per ordinary share	5	**(7.5)p**	6.8p	(16.1)p
Diluted (loss)/earnings per ordinary share	5	**(7.5)p**	6.6p	(16.1)p
Dividend per ordinary share	6	**Nil**	0.4p	1.1p

The results of the current period derive from continuing operations.

results before amortisation of goodwill and exceptional items.

	£000	£000	£000
Operating (loss)/profit	**(15,666)**	22,033	13,862
(Loss)/profit on ordinary activities before taxation	**(15,884)**	22,209	13,144
Adjusted basic (loss)/earnings per ordinary share	**(7.3)p**	7.4p	2.9p
Adjusted diluted (loss)/earnings per ordinary share	**(7.3)p**	7.2p	2.9p

6 consolidated balance sheet.

at 30 november 2002.

	Note	30 Nov 2002 (unaudited) £000	1 Dec 2001 (unaudited) £000	1 June 2002 (audited) £000
Fixed assets				
Intangible		**30,648**	55,151	35,822
Tangible		**13,445**	18,045	15,285
Investments	7	**4,015**	22,327	4,033
		48,108	95,523	55,140
Current assets				
Stocks		**25,146**	27,177	46,719
Debtors	8	**52,752**	134,136	80,626
Cash at bank and in hand		**15,677**	26,263	-
		93,575	187,576	127,345
Creditors: amounts falling due within one year		**(32,286)**	(100,343)	(62,301)
Net current assets		**61,289**	87,233	65,044
Total assets less current liabilities		**109,397**	182,756	120,184
Creditors: amounts falling due after more than one year		**(288)**	(2,197)	(332)
Provisions for liabilities and charges	9	**(26,370)**	(19,370)	(18,293)
Net assets		**82,739**	161,189	101,559
Capital and reserves				
Called up equity share capital		**11,312**	11,292	11,312
Share premium account		**35,426**	35,123	35,426
Shares to be issued		**5,360**	19,000	10,000
Merger reserve		**17,209**	36,827	17,209
Profit and loss account		**13,432**	58,947	27,612
Total shareholders' funds		**82,739**	161,189	101,559

consolidated cash flow statement.

for the 26 weeks ended 30 November 2002.

	Note	**26 Weeks Ended 30 Nov 2002 (unaudited) £000**	26 Weeks Ended 1 Dec 2001 (unaudited) £000	52 Weeks Ended 1 June 2002 (audited) £000
Net cash inflow/(outflow) from operating activities	10	**28,858**	8,717	(18,910)
Returns on investments and servicing of finance		**(617)**	290	(201)
Taxation		**9,074**	(3,295)	(8,149)
Capital expenditure and financial investment		**(1,374)**	(6,094)	(8,984)
Net cash outflow from acquisition		**-**	-	(8,303)
Equity dividends paid		**(1,523)**	(1,503)	(2,375)
Cash flow/(outflow) before financing		**34,418**	(1,885)	(46,922)
Financing		**(49)**	(92)	(143)
Increase/(decrease) in cash in the period		**34,369**	(1,977)	(47,065)

Reconciliation of net cash flow to movement in net funds/(debt)			
Increase/(decrease) in cash in the period	**34,369**	(1,977)	(47,065)
Cash flow from decrease in debt	**49**	2	507
Movement in net funds/(debt) in the period	**34,418**	(1,975)	(46,558)
Net funds/(debt) at start of period	**(19,074)**	27,484	27,484
Net funds/(debt) at end of period	**15,344**	25,509	(19,074)

analysis of changes in net funds/(debt).

	At 1 June 2002 £000	Cashflow £000	At 30 Nov 2002 £000
Cash at bank and in hand	-	15,677	15,677
Overdrafts	**(18,692)**	18,692	-
	(18,692)	34,369	15,677
Debt due within one year	**(50)**	5	(45)
Debt due after one year	**(332)**	44	(288)
	(19,074)	34,418	15,344

8 notes.

1 basis of preparation.

The interim financial information for the 26 week period ended 30 November 2002 has not been audited, nor has the interim financial information for the 26 week period ended 1 December 2001. They comply with relevant accounting standards and have been prepared on a consistent basis using the accounting policies set out in the 2002 Annual Report and Accounts. The figures for the 52 week period ended 1 June 2002 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. 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 52 week period ending 31 May 2003.

Carrying value of stocks, debtors and goodwill

The Group has an agreement (announced 22 May 2002) to deliver to NTL Group Ltd ("ntl") 300,000 boxes (of which half had been delivered by 30 November 2002) over a 13 month period ending in May 2003. As of 30 November 2002, the Group held stocks at a cost value of £25.1m, including an amount of £6.8m produced for ntl. At the same date, debtors of £52.8m include £12.8m due from ntl, payment for which is in line with the agreement between Pace and ntl.

The US parent of ntl, NTL Incorporated, filed voluntary petitions for a joint plan of reorganisation under Chapter 11 of the US Bankruptcy Code on 8 May 2002. The stated target to approve the reorganisation plan and complete the Chapter 11 bankruptcy process was set for the third quarter of 2002. This event is still awaiting final closure.

The directors have carefully considered the Group's ability to realise value for the stocks held for ntl and debt due from ntl having regard to relevant factors, including the progress of the proposed reorganisation referred to above, the public statements relevant to the ntl UK operating companies, and the recent course of trading between ntl and the Group.

As a result of these considerations, the directors have concluded that it is appropriate to carry the stocks produced for ntl at cost and the debt due from ntl at full value. The interim financial information does not therefore include any adjustments to the carrying value of those assets that would result from the Group's inability to realise anticipated value, which might be the case if a suitable reorganisation plan of ntl's US parent is not approved.

The directors have also considered the effect of the downturn in the Group's European and Asian markets on the carrying value of the goodwill arising from the purchase of Xcom Multimedia Communications SAS. The Group's business plans for these regions have been reviewed and re-evaluated, including a consideration of the current uncertainties in these markets. The Board has concluded that the carrying value of the goodwill remains appropriate. This interim financial information does not therefore include any adjustments to the carrying value of goodwill which would result from its business plans not being achieved.

Going concern

Global markets, particularly the technology sector, are continuing to experience a high degree of volatility.

The worldwide market for home gateways (set top boxes) declined in the last twelve months and there is continued turbulence in the broadcasting industry. Slowing demand and lower selling prices are all features of current and anticipated market conditions.

These factors continue to impact the sensitivity of the judgements required to prepare the financial information.

The Group has a two year banking facility, of which eighteen months remain, based on specific covenants, some of which have been re-negotiated over the last six months. Following the return to positive cash flow the size of the facility has been halved to £20m, at the Company's request.

The Board has built all of these factors into their working capital forecasts and has modeled various business scenarios. Based on these, the Board has concluded, whilst recognising there is some uncertainty, that the Group has appropriate existing banking arrangements and that, in the event it should need to, it will be able to take action to maintain such facilities.

The Board has therefore concluded it is appropriate to confirm the going concern basis of preparation of the interim financial information.

2 turnover.

	26 Weeks Ended 30 Nov 2002 (unaudited) £000	26 Weeks Ended 1 Dec 2001 (unaudited) £000	52 Weeks Ended 1 June 2002 (audited) £000
The geographical analysis of turnover by destination is as follows:			
United Kingdom	**64,999**	193,087	255,844
Europe	**4,542**	13,504	40,205
Far East (including Australasia)	**5,593**	3,032	11,072
North America	**7,287**	1,557	38,216
Rest of the World	**987**	4,628	6,457
	83,408	215,808	351,794

3 exceptional items.

	26 Weeks Ended 30 Nov 2002 (unaudited) £000	26 Weeks Ended 1 Dec 2001 (unaudited) £000	52 Weeks Ended 1 June 2002 (audited) £000
Restructuring costs	**-**	-	4,931
Impairment of own shares held in ESOP and QUEST	**-**	-	17,515
Impairment of goodwill	**-**	-	17,506
	-	-	39,952

The restructuring costs in the year ended 1 June 2002 relate to the costs of redundancies, asset write downs and office closures associated with the strategic repositioning of the business.

A provision was made in the year ended 1 June 2002 against the carrying value of the shares held by the Pace Micro Technology plc Employee Benefits Trust and QUEST.

Following an impairment review a provision was made in the year ended 1 June 2002 against the remaining carrying value of goodwill attributable to the Group's investment in VegaStream Limited.

4 tax on loss/profit on ordinary activities.

	26 Weeks Ended 30 Nov 2002 (unaudited) £000	26 Weeks Ended 1 Dec 2001 (unaudited) £000	52 Weeks Ended 1 June 2002 (audited) £000
The tax charge is based on the estimated effective rate of taxation for the period and represents:			
United Kingdom corporation tax at 30%	**129**	4,828	-
Overseas tax	**290**	831	3,411
Deferred tax (see note 8)	**(2,708)**	480	1,906
	(2,289)	6,139	5,317

5 (loss)/earnings per ordinary share.

Basic (loss)/earnings per ordinary share have been calculated by reference to the (loss)/profit before and after the amortisation of goodwill and exceptional items, and after taxation, and the average number of qualifying ordinary shares of 5p in issue of 218,180,942 (2001: 216,092,015).

Diluted (loss)/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 (loss)/earnings are the same as basic (loss)/earnings. The diluted number of qualifying ordinary shares was 218,638,976 (2001: 222,575,396).

6 dividends payable.

The directors have not declared an interim dividend (2001: 0.40p per share).

notes continued.

7 investments.

An amount of £4,015,000 (2001: £22,327,000) is held by the Pace Micro Technology Employee Benefits Trust and the QUEST in respect of own shares purchased to satisfy options granted to employees.

8 debtors.

Debtors include a deferred tax asset of £8,246,000 (2001: £6,965,000), all of which (2001: £4,734,000) is due after more than one year.

9 provisions for liabilities and charges.

	Royalties under negotiation (see note 11) £000	Onerous contracts £000	Warranties £000	Contingent cash consideration £000	Corporation Tax £000	**Total £000**
At 1 June 2002	12,593	338	2,862	2,500	-	**18,293**
Net charge for the period	408	429	2,078	-	10,087	**13,002**
Utilised	(122)	(338)	(1,965)	(2,500)	-	**(4,925)**
At 30 November 2002	12,879	429	2,975	-	10,087	**26,370**

10 net cash inflow from operating activities.

	26 Weeks Ended 30 Nov 2002 (unaudited) £000	26 Weeks Ended 1 Dec 2001 (unaudited) £000	52 Weeks Ended 1 June 2002 (audited) £000
Operating (loss)/profit	**(16,201)**	20,692	(28,807)
Exceptional items	**-**	-	39,952
Operating (loss)/profit before exceptional items	**(16,201)**	20,692	11,145
Exchange differences	**84**	19	-
Goodwill amortisation	**535**	1,341	2,717
Depreciation	**3,293**	4,199	9,013
Profit on sale of tangible fixed assets	**(29)**	(98)	(5)
Decrease/(increase) in stocks	**21,398**	12,515	(7,146)
Decrease/(increase) in debtors	**30,577**	(45,169)	6,758
(Decrease)/increase in creditors	**(18,876)**	19,184	(35,849)
Increase/(decrease) in provisions for liabilities and charges	**8,077**	(3,966)	(5,543)
Net cash inflow/(outflow) from operating activities	**28,858**	8,717	(18,910)

11 contingent liability.

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.

Independent review report by KPMG Audit Plc to Pace Micro Technology plc.

introduction.

We have been instructed by the Company to review the financial information set out on pages 5 to 10 and we have read the other information contained in the interim report and considered whether it contains any apparent misstatements or material inconsistencies with the financial information.

directors' responsibilities.

The interim report, including the financial information contained therein, is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the interim report in accordance with the Listing Rules of the Financial Services Authority, which require that the accounting policies and presentation applied to the interim figures should be consistent with those applied in preparing the preceding annual accounts except where they are to be changed in the next annual accounts in which case any changes, and the reasons for them, are to be disclosed.

review work performed.

We conducted our review in accordance with guidance contained in Bulletin 1999/4: *Review of interim financial information* issued by the Auditing Practices Board for use in the United Kingdom. A review consists principally of making enquiries of management and applying analytical procedures to the financial information and underlying financial data and, based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review is substantially less in scope than an audit performed in accordance with Auditing Standards and therefore provides a lower level of assurance than an audit. Accordingly we do not express an audit opinion on the financial information.

uncertainty arising from market conditions.

In forming our conclusion we have considered the adequacy of the disclosures made in note 1 of the financial information concerning the uncertainty relating to the valuation of stocks and debtors arising from the reorganisation currently being undertaken by NTL Incorporated, uncertainty relating to the recoverability of goodwill arising on the acquisition of Xcom Multimedia Communications SAS and the directors' consideration of the appropriateness of the going concern basis of preparation of the financial information. In view of the significance of these matters, we consider that note 1 should be drawn to your attention but our conclusion is not modified in these respects.

review conclusion.

On the basis of our review we are not aware of any material modifications that should be made to the financial information as presented for the 26 week period ended 30 November 2002.

KPMG Audit Plc
Chartered Accountants
Leeds

13 January 2003

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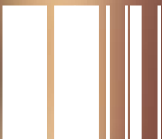

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