KPMG

KPMG International Annual Review 2005

Section 5 Insight and understanding

KPMG INTERNATIONAL

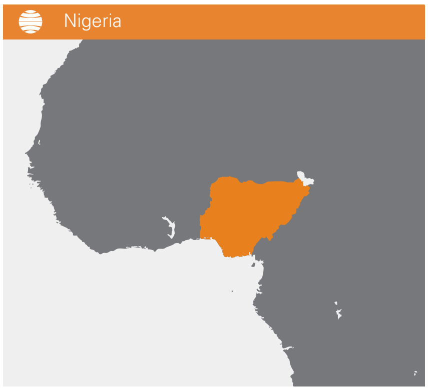
AUDIT ▪ TAX ▪ ADVISORY

Insight
and understanding

Across the world, KPMG member firms aim to offer their clients the right support in making sense of new growth opportunities and in dealing with threats as they emerge.

We focus on industry sectors because we believe this is the best way to offer valuable advice based on real market insight, combining a truly global presence with deep local knowledge. Our global market teams also constantly share knowledge with each other to create high value, cross-sector services to help clients deal with key challenges like outsourcing, mergers and acquisitions, intellectual property and supply chain management.

We constantly challenge clients to look at themselves and their markets in new ways. Last year we produced no fewer than 59 thought leadership publications and staged or sponsored 42 conferences and seminars. Feedback from clients and other organizations suggest that these documents and events are highly valued.



KPMG in Nigeria supports the work of a large non-governmental organization called the Fate Foundation. Its work includes a valuable role as a business incubator for aspiring entrepreneurs.

+17%

Composite revenues of Financial Services activities in KPMG member firms in 2005 were U.S.$3.86 billion

Financial Services

The structure and dynamics of the financial services industry have changed significantly over the last 10 to 15 years. Economic stability, consolidation, capital generation within the industry and improving standards of regulation have made the industry stronger. The last period of relative economic weakness (2001/2) did not significantly threaten the industry.

The trend to consolidation, increased scale and strength among the major players has continued and a relatively small group of major players has emerged. Citigroup, Bank of America, HSBC, AIG and JP Morgan Chase are arguably now in a league of their own in terms of market value, geographic spread and service offering. At the same time there is a large group of relatively smaller entities that have seen the success of the majors and are pursuing their own growth strategies.

With the industry reaching new levels of competition, globalization and complexity, the majors and their smaller, more localized competitors are challenging for market share across the world.

Global demand for financial services is evolving rapidly. In developed countries, aging populations are demanding more sophisticated savings and pensions products, while the rapid economic development of China and India is opening up attractive new markets.

Perhaps the most important challenge of all—and the one most commonly left to last—is people.

The industry therefore faces significant challenges. Efficiency and cost management are priorities as companies involved in mergers and acquisitions seek to realize cost savings and compete for cost advantage by moving operations around the globe in search of lower cost or higher quality. Technology has proved a double-edged sword—efficient deployment and management of technology is critical to manage costs, but the need for increasingly sophisticated, multi channel technology means higher IT costs.

Risk and capital management is receiving much greater focus, both from the regulators and from management teams. Companies are under pressure to improve their corporate governance and reporting to ensure the effective management of large and diverse organizations. The role of the regulator is growing. There is a tendency towards harmonization of regulation across borders. The clearest example is the EU Financial Services Action Plan, but there are also positive developments in capital requirements (Basel II and Solvency), money laundering and IFRS. Harmonization will boost cross-border activity.

Competition for skilled people is intense at almost every level in the industry. A complex industry, highly dependent on new technology, facing multiple regulatory challenges and spread across the globe, requires talented, well-managed people with appropriate rewards. Career development and clear succession planning are vital in an industry with high attrition rates.

In the next five years we expect to see still further consolidation, both across borders and in-market, particularly in those countries (like Germany) where this process has not yet run its course.
The major global players are now genuinely protected from the risk of downturn in any single geography or service line and we expect them to continue to grow.

www kpmg.com/review2005

+20%

Composite revenues of Industrial Markets activities in KPMG member firms in 2005 were U.S.$3.48 billion

Industrial Markets

KPMG's Industrial Markets team covers three main sectors: Industrial and Automotive, Chemicals and Pharmaceuticals, and Energy and Natural Resources, including oil, gas, the utilities, mining and forestry.

Many of these industries face significant investment challenges in the years ahead.

The rapid rise of oil prices in the last year has been fueled by a massive growth in demand—notably from the U.S., China and India—and an acute shortage of refining capacity. Neither problem will ease soon. Indeed, over the last 20 years virtually no new refining capacity has been built in key regions like the U.S. and Western Europe— a fact exposed by this summer's hurricanes.

The International Energy Authority (IEA) has estimated that investment of U.S.$16 trillion will be required up to 2030 to meet the world's energy needs but that only about 40 percent will be provided by the capital markets. While the IEA considers that the world has plentiful energy supplies, it points to the environmental dangers of a growing reliance on fossil fuels, notably oil, gas—whose share of primary energy needs is set to double—and coal.

The share of energy demand met by alternatives—namely nuclear and renewables—is forecast to rise, but their market share is likely to remain small. With the rise in demand for gas as the fuel of choice for electricity generation, the importance of key markets, notably Russia, will quickly increase.

A significant investment challenge faces utility companies, particularly the former state-owned electricity companies now mostly operating in deregulated markets. Major blackouts in the U.S. and Europe in recent years underlined the vulnerability of aging grids and the need for new spending in a market where decent returns are hard to come by.

As in most other sectors, the manufacturing companies we work with are dealing with a shift of activity to emerging markets, notably China, India and Eastern Europe, where reduced labor costs offer significant savings particularly in the production of low and medium technology goods. Research carried out for KPMG's Industrial Markets team last year by the Economist Intelligence Unit underscored this trend. Some 172 executives of companies headquartered in the EU member states were surveyed. The majority said increasing competition would force them to shift production and R&D from Western Europe to new low-cost locations, 65 percent citing the need to reduce labor costs.

But the outlook for manufacturing in the EU member states is not all bleak. Although in key sectors like car-making, many leading players have said they are planning to build new plants only in low-labor-cost markets, others continue to make the high pay/high productivity equation work closer to home.

The shift in production poses significant logistical, regulatory, tax and investment challenges to the world's established and growing manufacturers. But the shift is fully underway and probably unstoppable.

Global chemical markets continue to show economic recovery with strong demand and continuing industry rationalization. The emergence of the new China market has seen significant investment by the major petrochemical producers much of which will be absorbed by local demand. The Pharmaceutical sector is seeing continued slow growth due to increasing price pressure, government healthcare spending concerns and increasing generic manufacturer competition.

www kpmg.com/review2005

Tanzania

KPMG in Tanzania was the first firm in East Africa to manage a fraud hotline on behalf of a client. The hotline is a whistle-blowing mechanism for the national power company, Tanesco.

+14%

Composite revenues of Information, Communications and Entertainment activities in KPMG member firms in 2005 were U.S.$3.28 billion

Information, Communications and Entertainment

The Information, Communications and Entertainment (ICE) industries are being shaped by the relentless drive of convergence and the commoditization of products and services.

Powerful technological and commercial forces are propelling convergence of IT, telecoms and the media. Nevertheless, content providers and technology companies can find themselves in conflict over intellectual property, in a world where new technologies and devices are transforming the way information and entertainment are accessed and consumed. We believe a collaborative approach would encourage the key players to develop new pricing and distribution models that reflect each industry's strengths and potential for innovation. But such models must recognize the fact that consumers want to access and pay for content in new ways—the winners will be those that manage platforms and distribution channels in innovative ways to meet these demands best. The rapid evolution of digital technology is having a significant effect on the media business. Wireless distribution, increased bandwidth availability and speed, on-demand technologies, limitless storage and advanced consumer electronics devices are increasingly making media products ever-present and always available. Consumers will soon be able to get immediate access to any content they want for a reasonable fee, whether by subscription or other pricing models.

These developments are placing tremendous pressure on the telecoms, media, software and IT industries. We are seeing two main responses: a search for greater scale and an attempt to develop new business models for growth.

So, media companies are rapidly developing business models based on accessing rather than owning content. But this raises some important questions. Will consumers value media differently? How will this influence the interactions between the various industries that bring media to consumers? How will consumers react to these changes? Size and innovation matter more than ever in the telecoms and technology industries. In enterprise software the majors are on the acquisition trail, led by Microsoft, Oracle and SAP, motivated by the need to change their existing business strategies so they can expand and secure their customer bases. Similarly, in the telecoms industry, we have seen increased consolidation such as the recent deals between Verizon Communications and MCI, SBC and AT&T and Sprint and Nextel. Fixed and mobile carriers continue to seek greater scale in the relatively fragmented communications services markets, both to cover investments in next-generation networks and to capitalize on the accelerating convergence of fixed and mobile services.

In future, it will become increasingly necessary for all players in the ICE markets to collaborate in developing sustainable business models that are strong and innovative. With their understanding of consumer needs and technological possibilities, companies in these sectors are much better positioned to determine the future landscape than government regulators.

www kpmg.com/review2005

+16%

Composite revenues of Consumer Markets activities in KPMG member firms in 2005 were U.S.$1.96 billion

Consumer Markets

KPMG's Consumer Markets team focuses on three main sectors: Retail, Consumer Products, and Food and Drink. Across these sectors KPMG member firms' clients face some consistent opportunities and challenges—rapidly changing consumer habits, constant pressure on costs and prices, new trends in buying, increasingly complex supply chains, constraints on growth in established markets, increased regulation and the rapid rise of a powerful new consumer class in emerging markets.

The impulse for retailers in developed markets to look to these new growth centers is obvious. With their home markets reaching saturation point, they have less and less opportunity to achieve strong organic growth. Product and system innovation can help and cost-cutting is a constant theme, leading to a grueling battle for advantage between retailers and suppliers, in which, so far, the retailers have the upper hand. But clearly this will only get them so far. With constraints on new space a problem, acquisition is another route to growth. But here competition authorities are increasingly vigilant about dominant market power and few large mergers will escape the net.

It is therefore perhaps surprising that more haven't looked to enter new markets. Consumer spending in countries like Brazil, Russia, India and China is growing far faster than GDP as more and more people join the affluent middle-classes. Yet only a few European retailers have made big inroads into new markets and even fewer U.S. organizations. This is likely to change; but not quickly. The search for profitable growth is not straightforward and there are legal and logistical barriers to entry to overcome.

New thinking is important too. In the battle between retailers and their suppliers for cost efficiency and lower prices, we believe successful partners will increasingly seek a more collaborative approach to help maximize the rewards of efficiency.

None of this is easy territory and there are no simple answers as different companies in different sectors seek growth. The dilemma for a drinks manufacturer trying to establish a handful of powerful global brands is entirely different to that of a supermarket trying to build a presence in an emerging market. But in both, consumers are in the driving seat and their tastes are increasingly contradictory—at one time looking to trade down for convenience and functionality and yet happy to trade up for luxury. Gaining the attention of demanding and changeable consumers will increase the importance of managing new sales channels, like the Internet, in innovative ways.

Sophisticated management of complex supply chains and regulation is called for if companies are to achieve compliance and create value.

For manufacturers of food, drink and consumer products, ethical demands are a growing feature—whether it be about the responsible management of supply chains, environmental management, pricing, trends towards health and diet-conscious products or traceability. Regulatory pressures are growing as authorities and consumers make their moral choices clearer. Protectionist pressures have emerged this year to challenge new low-cost sourcing routes for key products, notably clothing. The flexibility of these is being put to the test.

www kpmg.com/review2005

Infrastructure, Government & Healthcare

Across the world, KPMG member firms are providing a wide range of support for governments and other public sector organizations helping them to meet the growing demand for the efficient delivery of services, tight cost management and greater accountability. We expect demand for such support, already particularly strong in key markets such as the U.S. and U.K., to grow rapidly in the years ahead.

Performance improvement, the introduction of new technology, re-engineering of business processes, risk control and recruitment and retention of skilled people are all key growth areas. We are blending our understanding of the challenges of operating in the public sector with knowledge of best practice in the private sector to provide help and advice.

KPMG member firms are working in a wide range of areas including health, education, transport, infrastructure, housing and defense. Last year for instance our teams worked on major transport projects for the U.K. Highways Agency and, in the U.S., the Texas Transportation Department and provided advice on the prestigious Dubailand project.

Private Equity

The recent growth in Private Equity (PE) activity has been phenomenal. Activity is being driven by the availability of debt, while low interest rates are continuing to keep merger and acquisition prices high. We believe it would take a significant macro-economic jolt—or a significant revaluation of share prices—to slow PE growth.

Increasingly PE investment flows are global with substantially increased volumes of capital available. Houses face well run and extremely competitive auction processes when seeking to invest particularly in the larger cross-border opportunities. Even purely domestic deals are becoming more competitive. Judgments exercised by PE professionals are increasingly driven by difficult commercial, financial or structural considerations. Clients have to make complex judgments and rely on advisers who can combine both global reach and in-depth specialist knowledge.

We expect PE deals to grow particularly quickly in the European and Asian markets in the coming years. The trend among the major PE houses is to increase their geographic diversity, with most notably significant investments emerging in India, China and key Asia Pacific locations in 2005.

Japanese Practice

KPMG's Japanese Practice is a special focus group of professionals from KPMG member firms that supports Japanese companies with their expansion and global operations, offering dedicated resources to address their unique needs around the world.

The Japanese Practice consists of 400 Japanese-speaking professionals operating in 50 major cities around the world. The Practice spans diverse sectors, including information technology, communications, automotive, industrial products and financial services.

KPMG in Japan has grown due to the recent merger with Asahi & Co., so client retention has been a major focus in 2005. We successfully gained the global sole auditor position for renowned global clients such as Matsushita Electric Industrial, Honda Motor Co., Ltd., and Mitsubishi Electric Corporation. Adding the composite revenues of KPMG in Japan with those for the Japanese Practice team from member firms elsewhere in the world means close to U.S.$1 billion is now earned in revenues from Japanese companies globally.

www kpmg.com/review2005

kpmg.com

 Publication name: KPMG International Annual Review 2005 Publication number: 213887 Publication date: December 2005