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CONSUMER ELECTRONICS

Shootout in Gadget Land

This Christmas everyone from Dell to Virgin wants to sell you MP3 players, DVDs, and flat-screen TVs. The fight is going to be brutal.

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By Adam Lashinsky

It's a sunny Southern California evening in mid-October at the posh South Coast Plaza shopping center in Orange County, and Sony Corp. is throwing a bash. Were you to pass by the roped-off event on your way, say, from sifting through neckties at the Ermenegildo Zegna boutique to checking out pointy shoes at the Steve Madden shop, Sony's fete might look like just another invitation-only store opening. But get past the bouncers at the country's newest Sony Style store, and the tone immediately becomes clear. This isn't a celebration; it's a show of force by a company that's increasingly confronting competition where it has never seen it before.

Dick Komiya, the top U.S. executive for Sony Electronics, has jetted in from the East Coast. So has Sir Howard Stringer, chairman of Sony Corp. of America. While an alt-country band from Sony's Columbia label entertains the crowd, the execs gush about the glittering array of Sony's newest, sleekest, and priciest toys, from camcorders to digital cameras to PDAs. Movies from Sony Pictures Entertainment play on luminous Sony plasma TVs. A humanoid robot from Sony's labs, called QRIO, break dances—not too badly, either—then cuts a celebratory ribbon. The message is clear: The \$62-billion-a-year company considers itself the class act of the consumer-electronics, computer, and entertainment industries, and it wants consumers to remember as much. Says Stringer: "The customer has an expectation of Sony that we have to sustain at all costs."

Drive about an hour south to San Diego, though, and you get another idea about why Sony is sending its top people (and robots) to ribbon cuttings. In the decidedly less upscale Mission Center West strip mall, next to the Courtesy Chevrolet dealership, you'll find a retail store run by Gateway, the \$3.5-billion-a-year PC maker famous for the cows in its advertising. But just try spotting a cow print—or for that matter, a PC. The showroom looks shockingly similar to the Sony store: sleek MP3 players, a selection of digital cameras, and a dizzying collection of flat-screen TVs. The store's "hearth," meant to conjure warm images of living rooms, is reserved for Gateway's newest consumer-electronics offering, a 56-inch digital light processing, or DLP, rear-projection TV on sale for \$3,799. That's about 15% less than for a similar model sold by Samsung, the flat-screen-TV market leader, which is in talks to co-market with Sony.

There was a time when Sony and Gateway would rarely be mentioned in the same breath. Now the two are facing off. And they're not the only ones. This Christmas a massive change is coming to the \$222 billion consumer-electronics industry, pitting traditional gizmo makers against the biggest players in the computer world. Anyone in the market for anything from a digital music player to a flat-screen television will be bombarded with come-ons—on TV, in Sunday newspaper circulars, online, and at the mall. That's part of the annual shopping ritual, of course. What's new this year is the cast of characters doing the bombarding.

In the past few months companies throughout the tech industry have declared themselves to be in consumer electronics. Hewlett-Packard, best known for its market-leading printers and its "big iron" computing systems, this summer launched 158 consumer-oriented products, from scanners to cameras to a nifty gadget that quickly and easily converts old VHS tapes into DVDs. In September, Microsoft released a second, more advanced version of Windows Media Center PC, software that transforms a PC into a multimedia center that is part TiVo-like digital video recorder, part stereo system, and part movie and photo viewer. "We're taking it from geek to sleek," says Jim Allchin, Microsoft's Windows boss.

And in a move that sent tremors through the consumer-electronics industry, Dell in late October launched a complete line of consumer products and services, including a Dell-branded MP3 player that connects to a Dell online music store; a 17-inch liquid-crystal-display television/monitor; and a Wi-Fi-equipped PDA—all priced at the kind of profit-margin-killing levels that have made Dell the most feared competitor in the PC world.

It's not just computer companies belying up to the consumer bar. In June, Cisco Systems bought home-networking-equipment maker Linksys, meaning that Cisco products, gear rarely seen outside the data center or telecom closet, now compete for attention at CompUSA. Beleaguered cellphone giant Motorola in October announced plans to slap its name on TVs, a business it exited some 30 years ago. Lifestyle brand Virgin, which until now has stuck primarily to music and travel, is introducing a line of hip gadgets called Virgin Pulse. Even retailers are getting into the act. Circuit City has launched a private-label store brand called Verge and is already hawking two low-priced MP3 players. In the world of consumer electronics, there's more role-changing going on than in the dressing room of a transvestite burlesque show.

All of these players want to whip consumers into a buying frenzy, something the PC industry hasn't seen since the late 1990s. Today that market is soporific: Now just about everyone who wants a PC has one, and the days of trading in your computer each year for a faster model are a quaint memory. The business sector—once a dependable spendthrift on all things tech—has in the past few years dramatically slowed its information-technology purchases.

No wonder the focus has shifted to the home market. Consumers may be the only group primed to spend—as Apple has shown, much to the envy of its peers. In the past quarter Apple sold half as many iPods—336,000—as Macs, and a big chunk of its \$44 million in net profits came from those sleek little music machines. While business may have temporarily lost its appetite for tech, says Silicon Valley investor Roger McNamee, "consumers are interested in new stuff, and technology companies intrinsically are in the new-stuff business."

As this fight kicks off, two outcomes are certain. First, falling prices, cool new devices, and an explosion in competition means that consumers will win big. (For a sampling of prizes, see "Gearing Up.") Second, the number of companies crowding into the already packed ring means profits will prove elusive, and even some of today's leaders will get clobbered. Says Gabriel Lowy, a stock analyst at Blaylock & Partners in New York: "You're going to have some bloodied competitors who end up being also-rans."

FLAT-SCREEN DREAMS

If there's one product that embodies the computer companies' belief that they can become consumer-electronics giants, it is that ultimate consumer-electronic appliance, the TV. Not the standard bulky picture-tube kind, but the flat-screen displays that are proliferating in dens and bars. The secret to many of these sets: They're basically the same as the monitor in your laptop or on your desk, but with a TV tuner under the hood (for more, see "The Race to Make the World Flat"). "The physics of designing and engineering these things is not that complicated," says Michael Dell. "Essentially, there are very small differences. And we're already the largest seller of flat-panel monitors in the world."

Dell is also the tech world's leading seeker and destroyer of other people's margins—and it loves the fat it sees in consumer electronics. TV makers today sell their products almost exclusively through retailers, which take 35% margins, vs. the 15% they're forced to take on PC monitors, according to Ross Young, president of Austin research firm DisplaySearch. So by selling TVs, he says, "the PC makers can get to lower prices than the consumer-electronics guys and still pull in higher margins than they do on PCs."

Dell might be the best able to grab the opportunity, but every tech company wants a shot at it as well. Ted Waitt, CEO of Gateway, acts like a pirate staring at an island of gold when talking about the wealth waiting to be exploited in electronics. In the past few years Gateway, facing the flatlining of its PC business, has made a bet-the-farm shift to TVs and gizmos. "To me, the consumer-electronics business feels a lot like the PC business in the late 1980s," Waitt says. "It's an inefficient market."

Jonathan Hurd, an analyst at Adventis, a consumer-oriented research firm in Boston, notes that Sony's gross margins, at over 30%, are typically twice those of Dell, even though Dell's lean operations make it more profitable at the bottom line than Sony. "There's absolutely a collision course going on here," Hurd says.

Run-ins between the computing and the consumer-electronics industries used to be rare. Sure, they were both born from technology, but the family tree split quickly. The big computer companies like \$81-billion-in-sales IBM and \$57-billion-in-sales HP focused on sheer computing power, and their first interest was always in serving businesses. The consumer-electronics industry, meanwhile, competed on design, ease of use, and how well each company could crank out millions of parts from giant factories they owned themselves. Occasionally, over the decades, each branch has declared an era of "convergence," but the hype always proved to be just that. And so the industries have stayed out of each other's way, with computer makers delivering productivity machines—for businesses and individuals—and electronics makers dreaming up devices that keep people entertained.

Today the barriers are fast eroding, driven largely by the digital revolution. As media turn into a series of 1's and 0's—music sent over the Net, TV shows recorded on hard drives, cable going digital—the devices needed to play the content are more and more like PCs: off-the-shelf components wrapped around readily available standardized chips instead of the proprietary systems used by the traditional consumer-electronics companies. The shift to digital has jolted the manufacturing world into nothing less than a fundamental rethinking of what consumer-electronics products are, who makes them, and how they're sold.

But jumping into the business doesn't guarantee success. PC companies for years have appealed to users' inner geek, selling products based on "speeds and feeds," not design or emotion. There's a reason so many PCs are sold online, then kept under a desk. And there's a reason MP3 players are fondled in stores, then shown off like an expensive wristwatch. For the new guys in town to succeed, they'll have to understand the emotional side of selling nice-to-have—not need-to-have—gadgets.

OUT OF THE BOX

Richard Branson is gyrating onstage at Powder, a hip nightclub on the fringe of New York City's meatpacking district, and the goateed billionaire is wearing a pair of flesh-colored tights and a portable CD player to cover the family jewels. Models in dominatrix garb sway to and fro with other gadgets dangling strategically over their equally exposed body parts. This is how Branson, God bless him, chooses to publicize the launch of Virgin Pulse, a line of 15 "lifestyle electronics" products available for the time being only at Target and Virgin Megastores and online at target.com.

Not every company seeking to remake itself in consumer electronics goes to such extremes. But figuring out how to get consumers jazzed up for their products is part of the game plan of all the new entrants, as well as some of the old ones. Branson, a tycoon not afraid to plunge into Times Square connected to a crane (as he did in 2002 to announce the launch of Virgin's mobile-phone business) is not surprisingly a step ahead of the techies.

One way the computer companies are trying to add a little razzle-dazzle is design. Gateway has tapped design pioneers like Ideo out of Palo Alto to help refine its products. HP has hired archival IBM's design guru—the man behind the acclaimed ThinkPad laptop design—to be its "director of brand design and experience," rethinking its electronics line for 2004-05.

The new players are also trying to learn how to get consumers to touch, feel, and see their wares. That's why Microsoft studied Home Depot's technique of hosting free in-store bathroom-tiling classes on Saturday afternoons. Bathroom tiling? Microsoft's rationale was that if Home Depot could make a complicated procedure look easy and sell the tools to do it, surely it could do the same with electronic gadgets. Now the company, along with partner HP, is launching 16 pilot "experience centers" in Circuit City, Micro Center, CompUSA, and Office Depot stores in seven states. These showrooms within a store are staffed by technology enthusiasts trained by HP who can demonstrate how to transfer a photo from a digital camera to a PC. Such handholding is essential, says John O'Rourke, senior director of consumer strategy for Microsoft. No matter how easy to use Microsoft tries to make its software, he says, transferring photos is nowhere near as intuitive as, say, turning on a television. "Just the words 'wireless networking' might be intimidating," he says.

HP hopes the lessons might also keep customers from mixing and matching brands. "Would you buy a car without a test drive?" asks Vyomesh Joshi, executive vice president for imaging and printing and HP's point man on its consumer strategy. He shows an example of a photo from an HP digital camera reproduced by an HP photo printer on HP paper—which will last, he says, for 73 years. He hopes a similar demonstration will connect with customers at Circuit City. "You can't do this kind of selling on the web," says Joshi. "People want to touch and feel it. They're not going to make that decision until they understand what it is."

While Microsoft and HP crib from Home Depot, other competitors are mimicking Apple. The company's bright and clean retail stores in high-traffic, affluent neighborhoods are the envy of executives from Gateway, Sony, and Virgin, each of which cites Apple as an inspiration for its consumer strategy. At the Gateway store in San Diego, for example, the simple lettering and broad, inviting glass doors mimic Apple's chic and welcoming retail posture. The target here, however, isn't so much technology enthusiasts as budget-conscious families and "zoomers"—empty-nesters with disposable incomes—with relatively little technological savvy. To keep things looking fresh, Gateway CEO Waitt hired William Parker, a former Banana Republic executive, to head its retail operations. Parker will sell you a PC, but he'd rather talk about higher-margin items like flat-screen TVs and digital cameras. "One of the things Ted said to me was, 'If I see rows of PCs I'm going to quit,'" Parker says, digging his fingernails into his forehead and yanking—the international gesture for scalping.

THE DELL EFFECT

You know the PC makers are serious about connecting with consumers when even Dell is testing retail kiosks. The small stations can be found next to those pushcarts full of license plates with kids' names and customizable photo mugs in the broad hallways of shopping centers in nine states.

They're not as impressive as the Sony Style store in Orange County, but having retail at all makes the top honchos at Dell nervous. This is a company, after all, that made its reputation by virtually eliminating inventory, middlemen, and just about all consumer handholding that can't be done over the phone. Michael Dell calls the kiosk strategy "modest." President Kevin Rollins earned his stripes at Dell in the early 1990s as a consultant at Bain & Co. when he recommended that Dell get out of retailing; he calls the kiosks "an experiment to find out how important that experience is." And the company has already shuttered four kiosks that were placed inside Sears stores.

Clearly Dell is just dabbling with retail to find out what it might be missing. Its true goal is obvious: doing to consumer electronics what it did to PCs. And the road map looks mighty similar. Just peek at its website: To find the new 17-inch LCD televisions, you'll need to hunt under the category "software & peripherals." Calling a television a peripheral? That's a very personal-computer view of the world. Gateway, by contrast, files its TVs under "electronics." The geeky label signals Dell's methodical, PC-centric, almost boring approach to nibbling away at the consumer-electronics business. "We're staying with things that emanate from the computer experience," says Michael Dell.

Dell's prices, on the other hand, will be anything but boring. Its 17-inch LCD television begins selling on Oct. 28 at \$699. Circuit City has a similar Samsung on sale for \$899. Dell's 20-gigabyte MP3 player sells for \$299, after a rebate. The comparable iPod—same storage capacity but lighter and sleeker—sells on Apple.com for \$399.

The competition says Dell's strategy won't work this time. "Dell is basically saying, 'Go to our site, or talk to us by phone—and every time you call you'll talk to a different person—and we'll try to sell you whatever we have,'" says HP's Joshi. "But no matter how good their website is, customers can't touch the products." Michael Dell's response: "That's what they said ten years ago about PCs."

Gateway's answer to the Dell threat is much simpler: Try to stay a step ahead. "If Dell's going to be a fast follower, then we'll continue to innovate," says CEO Waitt. Sony, meanwhile, professes not to be scared at all: Its brand and inventiveness will protect it. "We've anticipated their entry," says Sony's Komiyama.

While Dell might be the most feared of the cost cutters, companies you've never heard of are going to be the real ones driving prices down to once-unimaginable levels.

Sean Debow has seen it firsthand. Debow, the Asia Pacific technology strategist for investment bank UBS, travels each year to Taipei from his base in Hong Kong for the Computex trade show. It's a predictable event where the big PC makers have long gone to shop for items like motherboards, which are the guts of computers. This year Debow felt disoriented. As he wandered the floor, he had an uncanny feeling he was walking in circles—he kept passing the booths of Taiwanese companies showing working prototypes of digital still cameras. It wasn't until Debow stared up at the changing row numbers that he realized he wasn't going crazy; he was seeing the ghost of Christmas future. Row after row of vendors—67 from Taiwan alone—were selling similar camera designs just waiting for a company to pick up and slap its brand on.

These little-known vendors are playing a huge role in bringing titanic shifts to the consumer-electronics industry. Known as original design manufacturers, or ODMs, and located primarily in Taiwan but also in Korea, Hong Kong, Singapore, and mainland China, the ODMs have made it easy for anyone—anyone, that is, with enough money and a marketing and distribution strategy—to get into almost any segment of consumer electronics. When Debow returned to Hong Kong, he punched into his spreadsheets the prices he'd seen in Taipei for digital cameras and came to a startling realization. Any company buying one of those ready-to-wear designs could, in theory at least, make money in the U.S. peddling a three-megapixel camera at retail for as little as \$100. A comparable camera, he figures, fetches \$189 today. Debow says the digital camera illustrates how the Asian ODMs are contributing to the "rapidly falling barriers to entry in the digital age."

Gateway's Waitt credits Asian ODMs with his company's ability to get speedily into plasma TVs and digital cameras. Richard Branson notes that there are electronics manufacturers all over Asia who are "in effect competing with Sony but don't have the brand to compete with Sony. We can come up with products that will be more exciting than what Sony is doing, only cost much less."

No company has done more to show how to knock down those barriers than Apex Digital, a no-name startup that has earned a huge name in DVD players. Apex Digital does no advertising, comes up with few product ideas, and hasn't yet been able to turn a profit despite amassing annual revenues of \$1 billion. And yet Apex Digital is credited with single-handedly destroying pricing in DVD players, a market in which it holds a share of over 15% today.

There is nothing fancy about Apex. Its headquarters are in a converted warehouse in Ontario, Calif., deep in the industrial heart of exurban Los Angeles. A permanent trade-show booth sits atop a swath of pale-blue carpeting that only partially covers the slab of concrete beneath it. Founded by two Chinese immigrants to California, David Ji and Anle Hsu, Apex Digital started making DVD players in 1998, using factories in China but forging relationships with U.S. retailers, notably Circuit City and Wal-Mart.

It's no mistake that the word "digital" is part of Apex's name, for it is this unassuming company's embrace of digital products that is making Sony and others sweat. Unlike a VCR, which has more than 100 moving parts, a DVD player uses mostly standard off-the-shelf digital components, primarily semiconductors. Brandless imitators needed more than a decade to adequately copy VCRs. But because Sony, Philips, and others agreed early in the life of DVDs about what standards would be used, it was easy for other companies to make the machines, and the product took off faster than any that had come before it. The average price fell quickly too, from more than \$700 in 1997 to \$74 this August, according to researcher NPD Group.

Apex has already moved into other areas. It sells a host of flat-screen televisions, primarily LCD models, and doesn't plan to stop there. While it doesn't invent products, it's happy to buy from those who do. A small semiconductor company called Digital 5 pitched Apex on a chip that would turn a DVD player into a device that could talk to a PC. Apex is taking the chip, marrying it with a design, and manufacturing it in its Tianjin, China, factory, and by December consumers will be able to buy a \$199 network DVD player allowing digital photos from PCs to be seen on TV. "We have big dreams," says Ji, whose prelude to selling electronics was hawking scrap metal to China. "We want to stay No. 1 in DVDs. And then we want to be No. 1 in LCDs and any other consumer-electronics product in the U.S. we can compete in."

Those are big dreams. But this tidal wave is a phenomenon Apex is part of, not one it is creating. Already Circuit City is selling a combination DVD/CD player for less than Apex's model. It's made by Amphion MediaWorks, a Chinese company few are familiar with. The pricetag: \$34.99.

HERE COMES CHRISTMAS

All the competition is creating jam-packed shelves at electronics stores nationwide. On a late-October evening at a Best Buy store in San Carlos, Calif., James Johnson is shopping, again, for a wide-screen plasma TV. The 27-year-old software salesman has been dropping by Best Buy after work for four months now, eyeing a 42-inch Philips model. "This'll be the first television I ever buy on my own," he says, and he's been doing a lot of homework. He won't buy on the web because he's unsure of the quality there. And he plans to take up Best Buy's offer of 18-month interest-free financing to buy the TV.

But he's still not ready to pull the trigger. He has watched the price on his coveted plasma set fall from \$4,344 in

June to \$3,999 today and wonders if it will decline further. Meantime, he paces back and forth between the Philips and a similar model ten feet away made by Panasonic, comparing the picture quality, admiring the design. "I really want it," he says, keeping his gaze fixed on the television screen.

Every contender from Dell to Virgin wants to make sure that desire is met—with an irresistibly priced product of theirs. Merry Christmas, James Johnson!