The VTech Management Team

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Highlights

- Turnover increased 27.6% to US$1,334.9 million.
- Net loss of US$215.0 million
- Broad restructuring to cut costs, improve efficiency
- Major management changes

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Rebuilding Value

The financial year 2001 was undoubtedly the most difficult VTech has faced since we began operations in 1976. A combination of factors, in particular, the problems associated with the newly acquired consumer telephone business of Lucent, led to some major operating losses and write-offs. This in turn triggered a broad restructuring of the entire group, leading to further charges against our earnings and resulting in the profit warning and restructuring announcement that was issued in March 2001. At the same time, a number of unfavourable external factors affected us during the year. These included the weak Euro and shortages of components leading to delivery delays which affected the Group's ability to meet orders, both of which led to lost sales. Market conditions for electronic learning products also deteriorated.

A contributing factor to our poor results has been our expansion. For many years, we have been aggressively growing our businesses and we successfully built VTech into a company with over US$1 billion in annual sales in the financial year 2000 while this growth was achieved through investing in new businesses and focusing on growing market share. At times, this was done at the expense of margin. The restructuring we launched earlier this year is aimed at refocusing on our core competencies, driving for maximum operational efficiencies and slashing unnecessary overhead. In doing so, we are committed to rebuilding value, regaining the confidence of the investment community and ensuring a return to strong bottom-line growth in the years ahead.

Results

Group turnover for the year rose by US$289.0 million, mainly attributable to sales from the acquired Lucent consumer telephone operation. However, the profitability and working capital of the Group were adversely affected and constrained by the poor performance and unfavourable business conditions of the Lucent operations. As a result the Group has reported a net loss of US$215.0 million for the year, including the one-off costs of the restructuring and asset write-downs. The board has not recommended a final dividend.

Restructuring

We launched a restructuring plan in March 2001 that involved laying off 4,500 people or 16% of our total employee force worldwide, winding down and restructuring non-performing business units and consolidating operations to improve efficiency. The details of our seven point plan are given later in this report. To enable the plan to be executed swiftly and with minimum legacy issues, we have appointed a new Chief Operating Officer to take charge of the whole process.

Because the losses incurred through the restructuring process were large, we have worked closely with our bankers to ensure their continued support. I am pleased to report that all of our bankers are firmly supporting our plan.

Already, the majority of the restructuring has been completed, with the remainder to be finished in the coming months. These actions will enable the Group to save over US$30.0 million a year and make VTech a much leaner and nimbler group, that will react more quickly to changes in market conditions.

Turning Around the Telephone Business

After acquired the Lucent business in April 2000, we discovered that the conditions of the business were much worse than we had been led to expect. Lucent did not disclose when we signed the Agreement for the Purchase and Sale of Stock and Assets that actual sales were considerably lower than those it had forecast while inventory levels were exceptionally high in comparison to demand. The lower sales and excessive stocks resulted in the Mexican factories being under utilized and an increase in operational losses. Our original integration plan was compromised and a new plan was immediately put in place to consolidate the operations in an effort to cut overheads and clear the excessive stocks. We attempted to negotiate with Lucent for compensation but when no agreement was reached, on 25th January 2001 we filed a complaint in the United States District Court for the Southern District of New York seeking damages in excess of US$300.0 million against Lucent Technologies Inc. and Lucent Technologies Consumer Products, L.P. for fraud and breaches of the Agreement for the Purchase and Sale of Stock and Assets. The litigation is continuing.

To accelerate the consolidation of the consumer telephone business, I took direct control of the business as an interim CEO at the beginning of the year. I immediately put in place broader measures to streamline the operation and cut further excessive inventories. The Mexican manufacturing and repair operations were closed and production was relocated to our more cost-effective facilities in mainland China. The majority of the US consumer telephone business operations were consolidated into Beaverton, Oregon from New Jersey in an effort to reduce expense. The distribution and call centre operations were consolidated and out-sourced to third parties in San Antonio and St. Louis respectively to further cut overhead. A new President has been appointed to manage the combined sales and marketing operations in North America. At the same time, I have refocused our R&D effort onto higher margin and more commercially viable products. The number of projects and platforms has been streamlined to improve efficiencies. To enable tighter project management, we have closed the New Jersey and UK R&D operations and its development activities have been assumed by our Canada, Hong Kong and mainland China-based R&D teams.

Our US and European sales strategies have also been revised with an emphasis on gross margin rather than sales volumes. A new process for order control between the sales offices and the factory has been put in place to ensure accuracy of sales forecasts and minimize inventory build-up. The goal is to increase significantly our inventory turns, so as to maximize our return on capital employed.

At this point, I am pleased to report that we are beginning to see some positive results from these changes. With the restructuring now well on its way to completion, a recruitment firm has been retained to search for a permanent CEO for the consumer telephone business unit.

Tackling Marketing Weaknesses in Electronic Learning Products

The financial year 2001 has also been a difficult one for electronic learning products (ELP), where sales fell by 16.4% to US$291.2 million, mainly due to the weak Euro, tight supply of critical components and the success of a major US competitor, Leap Frog, in taking market share from us. VTech is still the largest ELP supplier in the world, with a strong position in the ELA category. That sector, however, is shrinking mainly because of the proliferation of low-cost PCs and TV games.

Over the years, VTech's success in the ELP category has been mainly attributable to our excellent technology, innovative product design and exceptional quality. As the market becomes more and more commoditized, however, superior marketing has become a major factor in continued success. To strengthen VTech's competence in this area, we appointed a CEO to direct the entire ELP operation, including worldwide sales and marketing. Given his strong background in consumer product marketing, I strongly believe he can help reposition and grow the business.

Strong Growth in Contract Manufacturing Services

A bright spot in our businesses has been our contract manufacturing services and multimedia communication products, both of which recorded strong sales growth. To streamline these operations, they were merged in January 2001.

Other Businesses

Our newer businesses, including the mobile phone R&D centre in Aylesbury, UK that we acquired in September 2000, remained cost-centres, rather than revenue generators during the financial year. As part of the restructuring process, we will close this operation. This should save the Group over US$10.0 million a year. In light of this decision, we have also fully written-off the cost of this acquisition in the financial year 2001. To promote synergies among the Group's other business units, the PDA (personal digital assistants) and IA (information appliances) businesses are being merged into the consumer telephone business unit, further reducing R&D, manufacturing and sales costs.

During the year, the Group invested in a number of e-business initiatives. Those that are not performing will either be closed down or restructured.

Appreciation

In this difficult year, my particular thanks on behalf of the board of directors are extended to all our employees. Their hard work and continued loyalty to the Group despite the rationalization has ensured that our operations have continued smoothly during the restructuring process.

Outlook

With predicted economic uncertainties hanging over the US, our major market, it would be inappropriate to be over-optimistic for the financial year 2002. We expect the US market to remain soft for the remainder of the year, especially for our ELPs, since a number of major retailers are reducing their inventory exposure in view of the current economic uncertainty. Equally, while our restructuring is proceeding as planned, many of the benefits will not produce tangible financial gain for several months.

Nevertheless, we expect our business to improve. The costs of our various restructuring steps were largely all taken in the financial year 2001. The US$110.4 million of restructuring and impairment charges that affected our bottom line will thus not recur in the financial year 2002. The closure of the Mexico factories and the elimination of the US operations acquired from Lucent will reduce Group operating costs substantially. The current state of the market also leads us to believe that the component shortages that have affected sales and margin at our business units will not be a factor in the financial year 2002.

In addition, the rapidly improving cost structure of all our operations should increase the Group's competitiveness. In the longer term, the creation of a more marketing oriented VTech, coupled with our proven core competencies in product innovation and technology, will allow us to recapture lost market share in the ELP business.

Without question VTech is going through a very challenging period. However, I am confident that we are learning from our past misfortunes and will emerge from these tough times stronger than before, more focus on building shareholder value.

Allan WONG Chi Yun
Chairman
Hong Kong, 27th June 2001