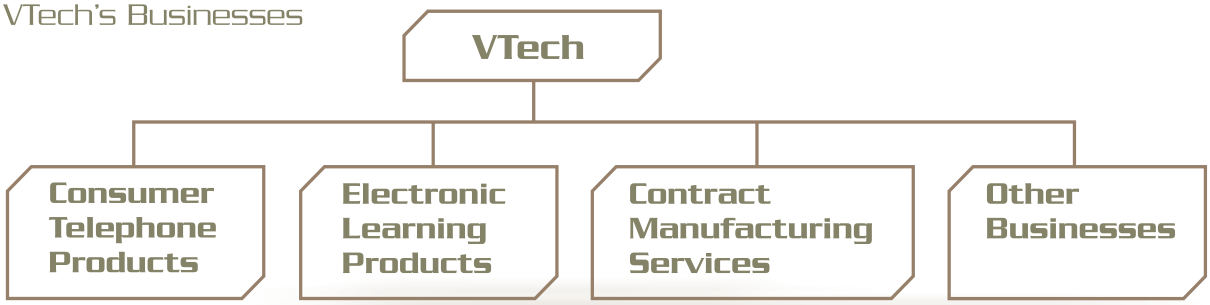
Review of Operations

Restructuring of Operations

In the final quarter of the financial year 2001, VTech launched a detailed seven-point restructuring plan to reduce costs, raise efficiency and increase both the focus of the Group's worldwide operations and synergies among them. Through the restructuring, VTech has streamlined its workforce by approximately 16.0% worldwide and will reduce operating costs by approximately US$30.0 million annually. We will also increase our emphasis on higher margin products.

The wide-reaching changes will be completed by the end of the calendar year 2001.

VTech's Businesses



The key features of the plan are:

- Senior management is being strengthened through the appointment of a new Chief Operating Officer to oversee the restructuring, ensure adherence to schedules and targets, strengthen financial control and seek further ways to raise the efficiency of the Group.
- The consumer telephone operations in the United States are being rationalized and consolidated into locations at Beaverton, Oregon and San Antonio, Texas. The R&D structure has been reorganized to achieve greater cost efficiencies and the New Jersey and UK centres have been closed. Factories in Mexico, which were acquired from Lucent in 2000 in connection with the consumer telephone business, have been closed down and premises are being sold.
- The electronic learning products (ELP) operations in Europe are being centralized under one regional management to boost efficiency. The operations in Hong Kong and Dongguan in mainland China are being streamlined.
- The information appliances business has been integrated into the consumer telephone business unit, to leverage joint technology, marketing and sales channels.
- The multimedia communication products unit has been merged with the contract manufacturing services unit.
- e-Business related services, which are long-term investments and have not yet contributed to Group results, are being downsized and re-organized to achieve synergies with other Group companies.
- Executive Directors have agreed voluntarily to reduce their pay by 20%.

Group Performance

Group turnover increased by 27.6% over the financial year 2000 to US$1,334.9 million. The increase is due to sales of AT&T branded products acquired from Lucent. Nevertheless, the Group recorded a loss of US$215.0 million for the year ended 31st March 2001.

As advised in our profit warning announcement on 26th March 2001, the losses were primarily due to the poor performance and unfavourable business conditions of the Lucent consumer telephone business which we acquired last year. This led to working capital constraint which resulted in broad-based business restructuring and consolidation costs as well as adjustments to certain intangible assets. External factors, including the weak Euro and component shortages also affected the performance of the Group. The costs of our restructuring have largely been recognized in the financial year 2001 and, together with the associated asset impairment charges amount to US$110.4 million. The principal items are: severance costs of US$36.0 million; fixed asset impairment charges of US$17.2 million as a result of the pending divestiture of the Mexico factory and repair facilities; intangible impairment charges of US$25.2 million in respect of the research and development acquired for the development of mobile phones; inventory write-downs on discontinued products of US$17.1 million and other closure costs of US$14.9 million.

The focus of the consumer telephone business is now firmly on higher margin products such as advanced technology 2.4GHz cordless phones and more feature-rich 900MHz cordless phones, which are expected to boost earnings.

Consumer Telephone Products

The consumer telephone products business remains the core of VTech's operations, in the financial year 2001 accounting for 61.7% of total Group turnover. Turnover of the product line increased 50.1% to US$823.8 million, which included US$319.8 million for sales of AT&T branded phones. Profitability of this business area, however, was adversely affected by the unfavourable condition of the Lucent business and its excessive inventory levels in relation to demand. These factors also constrained our working capital and had negative impact on the Group's other operations. We have worked hard to remedy these matters during the year.

In addition, the industry faced a shortage of critical components VTech needed for its 2.4GHz phones. As a result, in the first half of the year, we were unable to increase production to meet what has proven to be robust demand for these products. There was also an increase in sell-through costs, including rebates and discounts.

We suffered substantial losses in connection with the business acquired from Lucent. The adverse changes in the condition of the business were not fully disclosed to us and sales of the AT&T branded phones acquired with the acquisition greatly under-performed our original forecast. On 25th January 2001, VTech 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 Consumer Products, L.P. for fraud and breach of the Agreement for the Purchase and Sale of Stock and Assets.

The poor performance of the Lucent business and the high inventory level led to significant working capital constraint which resulted in broad-based business restructuring and consolidation, including asset impairment, employee terminations, streamlining the research and development function, divesting the facilities in Mexico and consolidating our US consumer telephone operations. This working capital constraint has also negatively impacted the Group's other operations.

We are cutting costs and increasing the efficiency of manufacturing, sales and distribution operations. The majority of the consumer telephone business operations in the US have been consolidated into Beaverton, Oregon. The distribution and call centre operations were consolidated and out-sourced to third parties in San Antonio, Texas and St. Louis respectively. We have also reorganized the R&D structure and are divesting the factories in Mexico, moving production and repair to mainland China.

Simultaneously, VTech has integrated the information appliances business into the consumer telephone business unit to leverage joint technology, marketing and sales channels. This new business area is in a development stage and incurred loss in the financial year 2001.

The focus of the consumer telephone business is now firmly on higher margin products such as advanced technology 2.4GHz cordless phones and more feature-rich 900MHz cordless phones, which are expected to boost earnings.

We are now revitalizing the business through a series of far-reaching initiatives that are cutting costs, improving the product range and bringing greater focus to marketing.

Electronic Learning Products

Sales of our electronic learning products (ELP) decreased by 16.4% over the financial year 2000 to US$291.2 million. The fall in turnover was especially severe in the first half of the year and was partly attributable to component shortages and delivery delays. This affected our ability to meet orders, which remained reasonably buoyant. The weak Euro also affected sales growth, as 43.0% of our ELP sales in Europe are denominated in the currency, which was not hedged. These factors and rise in the price of parts and materials should not repeat in the financial year 2002.

We are now revitalizing the business through a series of far-reaching initiatives that are cutting costs, improving the product range and bringing greater focus to marketing.

VTech has streamlined the ELP operations in Hong Kong and Dongguan, China. New “cell production” and “cell engineering” concepts have been introduced to improve efficiency, by breaking down production teams into small self-contained “project cells”. Under this system, the job scope of each cell member is widened, allowing the size of each project team to be reduced and eliminating middle tiers of co-ordinators. This reduces costs and optimizes the types of development projects undertaken.

In marketing, we are increasing our emphasis on segmenting our target markets and using well-known icons such as “ Bob the Builder” in Europe. We are also focusing more on the infant and pre-school toys that have great market potential.

We have strengthened the senior management through the appointment of a worldwide CEO of ELP, whose role is to expand VTech’s position as the leading provider of interactive learning products for children from birth to pre-teenhood. The new CEO will focus on building VTech’s business in the ever-changing ELP industry and help to strengthen the global reach of our ELP. In addition, the ELP operations in Europe are being centralized under one regional management to boost efficiency. Country managers now oversee operations, enabling us to penetrate local markets more aggressively and reduce operating cost.

Our contract manufacturing services continue to show steady growth, on the back of VTech's reputation and know-how in manufacturing telecommunication products.

Contract Manufactu Services

Our contract manufacturing services continue to show steady growth, on the back of VTech's reputation and know-how in manufacturing telecommunication products. Turnover increased by 90.6% over the financial year 2000 to US$127.1 million. As a result, total turnover at the contract manufacturing services and multimedia communication products units rose 50.0% to US$208.2 million.

North America is still the major market for our contract manufacturing services, accounting for 45.9% of turnover. Our growing reputation for reliability in both the quality of our production and our ability to meet deadlines, even in the most difficult market environment, is being rewarded with an expanding base of major clients. The business focus of the unit is directed towards the manufacture of

telecommunication products where VTech occupies a niche that allows us to command better margin.

As part of the Group-wide restructuring, VTech merged the multimedia communication business unit into contract manufacturing services. The majority of this unit's revenue derives from the manufacture of set-top boxes on an OEM basis and hence presents obvious synergies. The merger will save operational costs by restructuring various functions and eliminating overlap.

Production costs of the multimedia communication products increased due to initial set up costs at our Mexico facility. We hired consultants to study the validity of the business model, incurring professional fees. We also made full provision for the components inventory of our DVD venture, which has been discontinued.

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Mobile Phones

Our mobile phone business is still in the development stage, following our acquisition of UK-based Sensei in September 2000. As we have decided to close the R&D centre in the UK as part of our overall restructuring, we have fully written off the intangible assets purchased as part of the Sensei acquisition, including writing down the older GSM components inventory.

e-Business Related Services

During the financial year 2001, losses on investment in new businesses, including losses from our Internet-service provider (ISP) in the US have adversely affected our performance for the year.

The change in market sentiment has affected our intention, announced in October 2000, to spin off VTech's eLearning business, which combines physical and virtual methods of delivering high quality learning. Although we have postponed the initial public offering, we continue to make progress in this business. In February 2001, we entered into a strategic alliance with Longman Hong Kong Education, to provide a new e-Education channel for schools and students via the Internet. Losses were incurred from this business during the year.

As part of the restructuring, we are now scaling down our e-Business investments and re-organizing them, to focus more on achieving synergies with other group companies. Our business-to-business website, Chinacommercer.com, which we launched in October 2000 and the co-operative agreement with South China University of Technology to form SCVTech, an application services provider and consulting firm, offer the prospect of exploiting opportunities in the e-commerce software market in China, in particular providing "one-stop" e-commerce solution for business in mainland China. The cost of these investments expensed in the year was US$0.7 million.

Corporate Affairs

Liquidity and Financial Resources

Net cash outflow from operating activities during the year increased by US$49.6 million over last year's US$10.3 million net cash inflow. This was mainly resulted from the decrease in operating profit and change in working capital.

The acquisition of the Lucent consumer telephone business increased the Group's long-term borrowings to US$136.9 million, which represented 169.6% of the capital employed, as compared to 57.0% last year. Total interest bearing liabilities increased from US$185.9 million to US$249.6 million.

In line with our restructuring plan, we expect our debt position to improve in the financial year 2002 being achieved from rapidly improving cost structure of all our operations and sale of certain assets as described in note 14 to the financial statements. A majority of the Group's borrowings are on a floating rate basis except for term loans of US$7.0 million which interest is charged on fixed rates.

The maturity profile of indebtedness is contained in note 17 to the financial statements. A small portion of the borrowings are secured against land and buildings. With cash on hand and available banking facilities at year end, the Group has adequate working capital to meet its future working capital requirements.

Other Businesse

Treasury Policies

The objective of the Group's treasury policies is to manage its exposure to fluctuation in foreign currency exchange rates on specific transactions. It is our policy not to engage in speculative activities.

Investors

In our investor relations programme, we were active in explaining developments of VTech to global investors. During the year, we participated in five investment conferences in Hong Kong, New York and Singapore and held roadshows in the US and Europe in July 2000 and again in Europe in December 2000.

We also maintain contact with the investment community on a regular basis through one-on-one investor meetings, plant visits and analyst presentations. Our annual and interim results presentations as well as the important restructuring announcement, which were held in Hong Kong, were complemented by international teleconferences, giving international investors the opportunity to speak directly with VTech's senior management.

Employees

Good employee relations are a hallmark of VTech as a company. Remuneration is reviewed regularly to ensure it remains competitive and appropriate for the particular markets in which we operate. The Group also provides benefits including provident fund, insurance and medical benefits. We have implemented a discretionary bonus program and a share option scheme for employees, in which benefits are determined according to the performance of the group and individual employees.

Despite the rationalization of the workforce during the restructuring, we have continued to enjoy the support of employees at all levels.

We continue to invest in training and development to maintain the skill base we need to achieve our business objectives. We encourage employees' continuing education and provide all individuals, regardless of position, with equal opportunities for self-development.

In Hong Kong and China, our Training & Development section works closely with all business units to identify training programme that offer the most value in meeting VTech's business objectives. Numerous training programme are provided to our staff, in areas such as management leadership, software and language skills, technical seminars and workshops, as well as joint post-graduate and diploma courses offered in conjunction with reputable mainland Chinese universities.

Customers

One of VTech's strengths is our enduring customer relationships. As a consumer-focused technology company, introducing the right product for the right market at the right time is vital to success, and only by getting close to our customers can we determine market trends, improve our products and build brand loyalty.

In addition to a number of consumer awareness campaigns, marketing of new products and product development focus groups, we also offer a number of feedback channels for consumers including customer reply cards, the VTech websites and telephone hotlines.

Our business strategy is based on a customer-centered philosophy that is designed to create a complete range of products that reinforce brand loyalty throughout the consumer's lifetime and across generations.

Community

Social responsibility and progress in education have been core values of VTech for decades and give us a high level of involvement with local communities wherever we operate. During the year, the Group made charitable and other donations of US$0.2 million.

We work with universities in Hong Kong and China on research and development projects. These programme provide the universities with "real life" projects to challenge the young talent of tomorrow. VTech also participates in academic bodies and offers sponsorships for university students in Hong Kong.