VTech's performance for the first six months of the 2002 financial year shows a return to profitability, despite the difficult market conditions that prevailed during the period.

The improvement in our bottom line, which we had committed to achieve, reflects the progress VTech has made in cutting costs and rationalizing our operations during the six months. We have divested non-core businesses and reduced staff overheads. We have focused on our three core businesses of consumer telephone products, electronic learning products (ELPs) and contract manufacturing services (CMS). This tighter focus on what we do best has enabled us in turn to pursue more effectively our strategy of concentrating on the higher margin segments of each business, which is also benefiting the bottom line.

MANAGEMENT DISCUSSION AND ANALYSIS

Group Results

Group turnover decreased by 25.3% to US$529.6 million over the same period of last year as a result of the softness in the US market, as growth in consumer demand slowed down during the early part of the year. More significantly, the reduction reflects the success of our rationalization efforts and the focus on gross margins rather than sales.

The resulting profit attributable to shareholders of US$3.3 million for the half year represents an improvement to the bottom line of US$2.5 million over the corresponding period of last year.

Liquidity and Financial Resources

In line with the improvement in our cost structure, VTech's financial position has continued to improve and the Group has been able to meet all of its payment obligations in a timely manner.

Net cash inflow from operating activities during the period under review was US$55.6 million, reversing last year's net outflow. This is mainly due to changes in working capital.

Total debts decreased by 26.7% from US$217.8 million to US$159.6 million. Long-term borrowings decreased to US$109.5 million, which represents 130.2% of the capital employed as compared to 49.8% at 30th September 2000. A majority of the Group's borrowings are on a floating rate basis except for term loans of US$3.1 million which are at fixed rates. The maturity profile of indebtedness is contained in note 13 to the financial statements. A small portion of the borrowings is secured against land and buildings which amounts to approximately US$6.4 million. With internal sources and banking facilities, the Group has adequate working capital to meet its working capital requirements.

Treasury Policies

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

Contingent Liabilities

The Group has been advised that certain accusations of infringements of patents, trademarks and tradenames have been lodged against the Company and its subsidiaries. In the opinion of legal counsel, it is too early to evaluate the likelihood of unfavourable results. The Group is of the opinion that even if the accusations are found to be valid, there will be no material adverse effect on the financial position of the Group and that adequate provisions have been made.

REVIEW OF OPERATIONS

Consumer Telephone Products

Turnover at the consumer telephone business decreased by 18.8% to US$358.1 million compared to the corresponding period of last year. By volume, sales of phones amounted to 9.9 million units as compared to 10.4 million units as we reduced production of entry-level products.

Throughout the period, VTech has continued to make progress in focusing the consumer telephone products business on higher margin products, resulting in lower turnover and higher profitability. Completion of the restructuring of operations, as outlined in our 2001 annual report, also began to yield benefits.

Profitability improved due to strong demand for the higher-margin 2.4GHz cordless phones. Sales in Europe of our digital enhanced cordless telephones (DECT) also continued to perform well. Given the strong market response, we expect 2.4GHz phones to continue to be a major growth driver.

Several other factors have buoyed profitability. The critical component shortage we faced last year has eased and component cost prices have been lowered. Component integration in product development processes has reduced the number of different components used in production, lowering production costs. Tighter cost control and greater economies of scale, following the closure of the two Mexico factories and the consolidation of our production in China, also improved margins.

During the period under review, VTech has completed most of the restructuring actions announced in March 2001. These include the consolidation of the US consumer telephone offices in New Jersey to VTech facilities in Beaverton, Oregon, the outsourcing of distribution and call centre operations in San Antonio, Texas and St. Louis, Missouri respectively, as well as the integration of the information appliances business into the consumer telephone business unit. The sale of the facility in Reynosa, Mexico was also completed in August 2001, realizing US$7.9 million. Part of the building in Guadalajara was sold at a price of US$12.4 million and out of which the Group had already received US$4.8 million and the sale is targeted for completion in Mid 2002. We are now looking for buyers for the remaining part of the building in Guadalajara.

Mirage C100 DECT Phone

900MHz Cordless Phone

The lawsuit VTech filed in January 2001 against Lucent Technologies Inc. for alleged fraud in connection with our acquisition of the assets of its consumer telephone business is proceeding as expected.

To bring fresh marketing expertise to the Group and expand the global reach of the business, in September 2001 VTech appointed a new CEO to head the consumer telephone business unit.

Electronic Learning Products

The Electronic Learning Products business continued to suffer from a highly competitive market environment, which we sought to counter through tight cost controls and improved products. Turnover in ELPs decreased by 27.7% to US$115.9 million compared to the corresponding period last year.

The negative impact on profits of the decline in turnover was partially offset by cost saving measures, including the consolidation of sales offices in Europe and a reduction in administrative expenses. The Group has continued to streamline the ELP operations in Hong Kong and Dongguan in China.

To improve the competitiveness of our product range, we have been placing greater emphasis on a segmented marketing approach. In addition, by integrating technology features, such as PC and internet connectivity, we aim to raise the proportion of higher-margin sales in all categories, from infant toys to ELPs for the early school-aged market.

Contract Manufacturing Services

During the period under review, contract manufacturing services saw a slight decline in turnover as end-market activities slowed down across all sectors, leading to a decline in demand from our customers.

Turnover of CMS decreased by 6.4% to US$54.3 million compared to the corresponding period of last year. Despite the fall in turnover, CMS continued to make progress in other areas that positions us well for the future. In June 2001, our core contract manufacturing facility in Dongguan was awarded ISO14000 certification. Our long-term strategy is to diversify our customer base and offer a full service, flexible and high quality solution to companies' outsourcing needs.

Crazy Legs Noodle Bug™

Sing'n Learn™ CD Player

Other Businesses
Mobile phones continued to be a cost centre for VTech and recorded a loss. During the six month period, we closed the UK research unit and transferred the technology and know-how to our engineering office in Calgary, Canada.

We have downsized and re-organized eBusiness related services. Our aim is to use them in support of our core businesses, helping them achieve higher sales and an improved market profile.

The proposed spin off of VTech eLearning remains on hold, owing to adverse market conditions. Nevertheless, the learning website is operational and has little effect on revenues.

Employees
As at 30th September 2001, the Group had approximately 18,000 employees. The majority of these employees work in Hong Kong and China. The Group has established incentive bonus schemes which are designed to motivate and reward employees at all levels. A new share option scheme has been adopted in August 2001.

OUTLOOK

There seems little doubt that the second half of the financial year will be challenging, not just for VTech but for many companies. The US economy looks almost certain to record negative economic growth over the next two quarters, as consumer sentiment has weakened in the wake of the events of September 11. How quickly the unprecedented cuts in interest rates by the US Federal Reserve Board will stimulate demand is difficult to predict.

With 79% of Group sales to the United States, VTech clearly will be affected by adverse developments in the US consumer market. On the positive side, however, the Group has taken steps to reduce overheads earlier than many other companies, which has increased our ability to weather any downturn. In addition, recent figures from the United States suggest that any sustained reduction in consumer demand will affect mainly the luxury and travel related sectors, which are at the opposite end of the spectrum from VTech products.

In the longer term, VTech has a clear strategy based on extensive market research that will allow us to exploit growth opportunities through the adaptation of new technologies and by entering new geographical markets. China's entry to the World Trade Organization (WTO), for example, should over the course of the coming five years create significant new opportunities for investment and commerce. As a Group with already a long and successful history of operating in the mainland, and headquartered in Hong Kong, VTech is unusually well placed to make the most of this development.

We will support our initiatives by a much greater emphasis on marketing and branding, a feature of our operations that will begin to become apparent during the course of 2002. We will make greater use of market research, launch new marketing campaigns and introduce radically redesigned packaging. Together, this should enable us to maintain sales momentum while increasing the proportion of higher margin products.

Consumer Telephone Products

Despite probably difficult overall market conditions, we expect generally positive developments in sales of our consumer telephone products in the second half of the financial year. VTech is strong in applied technology and a market leader in the development of high frequency cordless phones such as the 2.4GHz model and multi-feature 900MHz models, for which demand in the United States remains robust as households upgrade. We intend to build on the strong momentum we are currently experiencing by leveraging our two brands, VTech and AT&T, to segment the market in a way that should improve margins further. Sales of our products in Europe are also expected to expand, given the success of our DECT products in that market. Geographical expansion in the European markets will be a future growth driver.

Electronic Learning Products

The ELP business continues to face competitive pressures, especially in the United States.

VTech has an excellent R&D and manufacturing platform that has allowed us to develop high quality products that are well received by consumers. However, as the market changes, we recognize the need to adjust our product development and marketing strategies.

2.4GHz Cordless Phones

Vapor™

Beginning in 2002 our goal is to place a much greater emphasis on these two areas to ensure our innovative products respond to our customers' needs and wants, so increasing our market share.

More effort will be devoted to market research to ensure we are responding to the changes in the industry and providing viable benefits to our customers. We will be much more targeted in marketing these new products, both to the children who use them and to the parents and family members who have a strong influence on the purchase decision.

Contract Manufacturing Services

To reduce time-to-market and lower production costs, early this year, VTech established a New Product Introduction team that works in close strategic partnership with our customers. With long experience and know-how in the manufacturing industry, the VTech engineers who comprise this team can recommend the technology appropriate to customers' specific needs during the product design phase.

To increase our share of the outsourced market further, we have added new surface mounting equipment lines at our facilities in Dongguan and opened a new factory dedicated to contract manufacturing next to our existing facilities in Dongguan.

MESSAGE TO SHAREHOLDERS

VTech is strong in applied technology and has built size, expertise in cost efficient manufacturing, strong brands, deep customer relationships and a diversified product portfolio. With a focus on three core product areas that offer growth potential both geographically and through the introduction of new technologies, we believe our long-term future is positive.

More immediately, our success in cutting costs and shifting the focus of our operations to more stable margin products leaves us confident in the future. In the absence of a serious deterioration in global economic fortunes, VTech will continue to build on the current improvement in profitability in the second half of the financial year. By the 2003 financial year, the full benefits of our restructuring will be apparent.

Allan WONG Chi Yun
Chairman
Hong Kong, 28th November, 2001