dear shareholders

Allan WONG
Chairman

at our interim results announcement, I was able to report that after the major challenges of the 2001 financial year, VTech had been able, through an aggressive restructuring, to return to a small but significant profit. I am pleased to say that the momentum has carried through, as our focus on rebuilding the bottom line and putting our finances on a much firmer footing saw further improvement to the income statement as well as the balance sheet.

This should allow VTech to now move forward with a strategy that combines proven excellence in product development and cost-effective manufacturing with a new customer-centric approach that stresses the integral importance to our operations in supply chain management, market research, customer service, branding and marketing.

Back in Profit

In line with our strategy to focus on profitability, Group turnover declined 28.1% to US$959.8 million. This reflects a 18.7% reduction in sales of our telecommunication products, as we shifted our focus to the higher margin models. It also results from a decline in sales of electronic learning products (ELPs), which faced strong competition from other producers and where we have been undertaking a comprehensive redesign of our product range.

Partly as a result of the shift in orientation, profits nonetheless rebounded. From a loss of US$215.0 million in our 2001 financial year, VTech reported net earnings of US$11.2 million for 2002. This is the result not only of our success in increasing the proportion of higher margin products in our sales, but of reducing our operating costs (excluding restructuring and impairment charges), which are now 38.7% lower than they were in our 2001 financial year. Substantially lower levels of provisions and write-downs also contributed to the improvement, as the restructuring entered its final phase. Finally, a new approach to managing the inventory cut working capital requirements, boosting cash flow.

Significant Improvement in Financial Position

The difficulties we faced in the 2001 financial year saw a deterioration of the balance sheet which is now behind us, as strong cash flows have enabled us to reduce debt dramatically to a comfortable level.

Net operating cash in-flow for the year was US$146.8 million. Total interest bearing liabilities as at 31st March 2002 stood at US$95.8 million, down by 61.6% as compared to 2001, while net debt was US$32.5 million down by 83.2%. This gives VTech a total debt to shareholders' funds of 107.2% and an interest coverage of 2.6 times.

One of the main contributors to this dramatic improvement to our financial position is the large reduction in stocks and debtors, which fell from US$382.8 million at the end of the last financial year to US$223.3 million at the end of this year. This freeing of cash-flow was the result of much hard work on the part of our telecommunication products business in particular, as it permanently reduced inventory held in our supply chain through tighter management.

Leaner and Smarter Operations

In the financial year 2002, telecommunication products remained as VTech's major source of revenue, accounting for 69.8% of the Group turnover at US$670.0 million. In order to drive bottom line growth, we cut production of loss-making models and focused on higher margin products. VTech's share of the US fixed-line telephone market remained dominant. In January 2002, we announced the launch of the industry's first 5.8GHz cordless phone model, a technological breakthrough that reaffirms our lead in R&D. This new platform would allow us to build on the success of the 2.4GHz model.

To improve profitability further, the telecommunication products business conducted a radical overhaul in the way it handles inventory, subjecting the entire supply chain to intense – indeed daily – scrutiny. This resulted in a major reduction in inventory held to the equivalent of around two month's sales, as a result of better demand forecasting. As importantly, it has improved relations with the retailers who carry our products through raising reliability of supply.

Moving further in the direction of our customers, we conducted considerable research among the retailers who purchase our products, in an effort to understand their requirements better. This has led us to reorganize our sales and marketing operations in the United States according to a new customer-centric model, with specific teams now closely serving the needs of the 20 leading customers who account for the vast majority of our sales. We are now co-operating with these business partners on sharing point-of-sale data, supply chain management, in-store arrangements and promotional programs. This will benefit sales, costs and product development.

Electronic learning products faced a tougher challenge, with turnover down 33.5% over 2001 to US$193.7 million. Although the ELP market continues to grow, as a complement to the personal computer market, VTech has recently faced strong competition in the United States. To counter this pressure, we have made a major commitment to returning to our roots in this market, in which we are the pioneers. Extensive market research we commissioned from the Omnicom Group showed that VTech retained tremendous brand equity in the 6–11 years old category that was severely underutilized. While we remain the world's leader, we had for some years failed to respond to changes in the market. We currently began to re-focus our business back towards this higher margin category, around our original concept of combining education with entertainment. The result has been the exceptionally rapid development, based on sound consumer research, of a new range of products targeting precisely this area, across the spectrum from education to entertainment. We achieved this while at the same time making substantial cost reduction through a streamlining of operations, reducing inventories and reigning in accounts receivables.

In a year when the contract manufacturing industry was severely shaken by a precipitous fall in demand, VTech's contract manufacturing services (CMS) performed extremely well, maintaining profitability on turnover which fell by 27.0% to US$92.8 million. This solid performance testifies to the high regard in which we are held by some of the world's leading brand names and the deep, co-operative relationships we have built with our customers. It also reflects the success of the New Product Introduction program that we put in place during the year,

management team *from left to right*

Albert LEE Group Deputy Chairman
VTech Holdings Ltd

James C. KRALIK Chief Executive Officer
VTech Telecommunications Ltd

Dennis W. PERRY Chief Executive Officer
VTech Electronics Ltd

Andy LEUNG Chief Executive Officer
VTech Communications Ltd

which through close involvement with customers at early design stages shortens the development cycle and reduces outturn cost.

Strengthened Management Team

Changes in personnel, management and the Board have been a significant feature of the developments that have taken place at VTech and that are laying the foundations for a new company. I wish to extend my heartfelt thanks to everyone at the Group for their co-operation during this period.

During the financial year 2002, we reduced total headcount by about 27.4%, making us a much leaner organization with a higher level of efficiency. As importantly, we have added highly experienced talent to senior management. In June 2002, I announced the appointment of Mr. Paddy LAW as the CEO of the Group. Mr. LAW has been with VTech for over 11 years and has been the CFO and COO of the Group. He has been a key person in the restructuring process from which VTech is now emerging, and as CEO, will continue to drive bottom line growth through profit improvement programs and improving supply chain management. In turn, I as Chairman can devote more time to product development and our strategy for China, which are the Group's future growth drivers.

New CEOs of both the telecommunication products and ELP businesses, with particular expertise in marketing and customer relationship management gained in the United States, are spearheading a comprehensive review of the way VTech approaches its business.

In November 2001, I appointed Mr. Albert LEE as the Deputy Chairman, a newly created position. Mr. LEE has assisted me in driving the strategy for product development and China market.

At the same time, I announced the appointment of four new directors to the Board: Dr. Raymond CH'IEN, Executive Chairman of chinadotcom corporation as well as Chairman of its subsidiary, hongkong.com corporation; Dr. William FUNG, Group Managing Director of Li & Fung Ltd; Mr. Michael TIEN, Chairman of the G2000 Group and Chairman of Kowloon-Canton Railway Corporation; and Mr. Patrick WANG, Chairman and Chief Executive of the Johnson Electric Group. They were brought in to increase the number of independent non-executive directors and give a fresh perspective on our operations and markets. They cover areas of particular relevance to VTech, including technology, marketing, manufacturing, sourcing, logistics and distribution. Six existing directors stepped down, having given much to the Group and continue to serve in key management roles.

Improved Prospects

In a fundamental sense, VTech is back on track, with a healthier balance sheet and a return to profitability.

The restructuring provisions we have taken this year should be the last we will need to make in respect of our restructuring in the wake of the Lucent acquisition. In June 2002, VTech reached a mutually satisfactory settlement with Lucent Technologies Inc. ("Lucent") relating to a dispute arising from the acquisition by the Group of Lucent's Wired Consumer Products Business in 2000. Under the terms of the settlement, Lucent has agreed to adjust the purchase price of the acquisition downward by US$50.0 million, such amount to be fully settled in cash by 3rd July 2002.

Demand for our core business areas remains positive and will be met in our 2003 financial year by a new range of AT&T branded premium phones and a completely redesigned range of ELPs. Their immediate appeal and positive research from market testing have gained an exceptional level of acceptance among customers. We have also increased the capacity of our CMS facilities in response to the growing demand from our customers. Although component prices may rise as demand in the technology sector picks up, we continue to redesign products and processes to reduce dependence on more expensive components, as well as to cement relationships with key suppliers.

We see opportunities to grow in a number of markets. Acceptance of our products in Europe is high, yet the penetration of our cordless phones is very low when compared to the United States. We are now seeing steady growth in original design manufacturing (ODM) business. Mainland China is a region of long-term potential where the cordless phone market is largely in its infancy. I have established a management team to examine the best way to approach these markets and we are exploring partnerships that would provide us with powerful distribution channels.

In this regard, VTech was able in February 2002 to agree to amended terms for its brand license agreement with AT&T. The revised agreement adds Europe and Greater China to the regions where we can use the AT&T brand in connection with the manufacture and sale