

**DIGITAL VIDEO SYSTEMS**

**Moderator: Tom Spanier**  
**August 17, 2004**  
**12:00 pm CT**

Operator: Good afternoon. My name is Jody and I will be your conference facilitator today. At this time I would like to welcome everyone to the Digital Video Systems Second Quarter Financial Results conference call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question and answer period. If you would like to ask a question during this time, simply press star then the number 1 on your telephone keypad.

If you would like to withdraw your question, press the pound key. Thank you.

I would now like to turn the call over to Mr. George Neil with CCG Investor Relations. Please go ahead sir.

George Neil: Thank you (Jody).

Good morning or good afternoon everyone, depending on where you're located. Welcome to Digital Video Systems Second Quarter Fiscal 2004

Financial Results conference call. I am George Neil, as the operator said, with CCG Investor Relations, the company's investor relations council.

In a few moments you will hear from and have an opportunity to ask questions of the company's Chairman and CEO, Tom Spanier.

Please note that any statements made in this presentation that are not historical facts, contain forward-looking statements that involve risks and uncertainties. These forward-looking statements include but are not limited to statements with respect to the Company's strategy; expected operating results including gross margins; revenues and expected losses; proposed introduction of new products including anticipated features, functionality and timing thereof; and expected impact on the Company's gross margins for such new product introductions; the markets for the Company's products; the development of the Company's products and the rates of inventory and receivable turns.

These forward-looking statements are subject to risks including, but not limited to the uncertainty of market acceptance of read/write and automotive DVD loaders and systems and other Company products; continued availability of adequate capital for operations; planned growth of the Company's operations; dependence on a limited number of suppliers of certain components used in the Company's operations; risks associated with rapid technological change and obsolescence in product development; timeliness of new product and reductions; the difficulties of conducting business in foreign countries such as China, South Korea and India; and the competitive market for the Company's products, as well as other risks described in Form 10-Q for the quarter ended June 30, 2004 under the section headed "factors that may affect future results," as well as in other documents the Company has filed from time to time with the Securities and Exchange Commission.

That said, we can begin. Allow me to introduce to you the Chairman and CEO of Digital Video Systems, Tom Spanier.

Thomas Spanier: Thank you George. Today I'll review our Q2 04 results and then discuss an important segment of our business. During our last conference call on June 15, we discussed the automotive DVD business, which is our primary long-term focus, and the transcript of that conference call is available on our website.

Today we'll discuss the DVD recordable or "R/W" business, which has been the primary contributor to our substantial revenue growth during the second quarter just reported. As we previously discussed, the R/W business has the potential to be a substantial contributor to our business looking forward. So we'd like to share our views on this important market.

But first, we'll review the Q2 04 results. Overall, we've reported substantially improved revenues and margins, primarily due to the DVD/RW business growth. We reported revenues of \$33 million, which is a sequential increase of 87% over the first quarter of '04.

It's also an increase of 41% over the second quarter of '03. As I mentioned, this growth is due primarily due to sales of recordable players and loaders. Our significant customers were Kaixinda a very large manufacturer in China and Ellion, a Korean marketing company with primary sales in Europe.

In May we also began shipping automotive DVD products to Visteon, a major Tier 1 automotive supplier.

We reported gross profit of \$2.5 million, a margin of 7.5%. This is a substantial improvement from a negative gross profit of a loss of million and a

negative 6% for the first quarter of '04. This is after increasing our reserves by \$500,000 for slow inventory in the second quarter.

The improved margin reflects the higher margins of the R/W and automotive products and the reduced proportion of commodity DVD player products and components in our sales mix. We incurred operating expenses of \$5.3 million during the second quarter of 2004.

This is up slightly from \$5 million incurred in the first quarter, and [higher than] the \$3.6 million [incurred] in Q2 of '03. Essentially our operations are very similar to last year. The increase over the first quarter of 2004 is primarily attributable to non-cash warrant and stock option expense.

The increase over the second quarter of last year is due to these non-cash expenses, plus the addition of operations in India, which began in the third quarter last year, [plus] legal fees, bad debt provision and the reversal of professional fees, that was incurred in the second quarter of '03.

We reported an operating loss of \$3.3 million versus a \$6 million loss in the first quarter. Our net loss was \$2.4 million, or roughly half of the \$4.7 million net loss reported in the first quarter. These are substantial improvements.

For the first six months of 2004 our revenues of \$50 million were roughly equivalent to the \$51 million for the first half of 2003. Gross profits were \$1.5 million versus \$3.5 million in the first half of 2003. Our gross margin of 2.9% versus the 7% of the first half of 2003 was largely affected by the negative gross margin of the first quarter.

For the first six months we reported a net loss of \$7.1 million, versus \$2.9 million for the first half of 2003. Moving on to the balance sheet, at June 30,

2004 we reported available cash of \$1.9 million with restricted cash of \$6.7 million.

Our accounts receivable of \$3.3 million represents nine days sales outstanding. Our net inventories of \$15.6 million or roughly 43 days is down from \$19 million on March 31, roughly 90 days of inventory at that time.

This is due to shipments of R/W products and nets out the reserve of \$2 million that we have accumulated for the legacy DVD player business. Our bank borrowings were \$19.9 million as of June 30, 2004. With regards to working capital, some of our Korean bank lines were renewed during the quarter and our line of credit balance at July 28, 2004 was \$22.3 million.

In June we repaid \$4.8 million of notes in China and in July borrowed \$3.6 million from a new bank in Shanghai under a one-year term. We're presently seeking equity financing to satisfy our current needs.

Now looking forward we continue to see softness with our customers for R/W products, and the end-customer demand during Q2 did not meet our customers' expectations.

Consequently, our customers are working down high inventory levels before placing new orders. Because of the high level of volatility in this business, we're not able to point to -- at this point, to provide -- revenue guidance, except that we expect R/W revenues in Q3 to be substantially below the very high Q2 levels.

Gross profit margins, on the other hand, which we really are focusing on, will depend on our sales mix. With increasing volume of certain auto DVD products providing the highest margins, followed by R/W and high-end DVD loader products, with legacy DVD products furnishing limited margins. Due

to these factors, I'm sure you can appreciate the difficulty in pinpointing the magic date in the future when we can predict break-even. But I assure that we're working hard to achieve and surpass that point.

The results we have reported for Q2 reflect the initial stage of our turnaround strategy. We're moving the Company, from [being] a components manufacturer in a volatile commodity business where there's little competitive advantage for our engineering and product quality, to a company where competitive advantages can be sustained through our engineering, quality and customer service.

We're moving the Company to markets that offer longer, different product life cycles and greater margins. And this progression will take some time, but we believe [it] will result in a strong, growing company. During this transition the essential elements of our turnaround are -- number one -- stop expenditure on any low margin legacy product except for inventory liquidation. We don't want to beat a dead horse.

Number two, we [plan to] leverage our competitive advantages, which are product strengths, product quality and market relationships, in markets and on products and customers that generate good margins with sustainable growth. We have previously outlined these business areas as automotive DVD, recordable or R/W DVD and the emerging market in India.

Number three, reduce costs and focus on the business at hand. We are [not] going to spend a lot of time looking at new ventures and different businesses that stray from our core business in hand.

Number four, structure business relationships to reduce working capital requirements and enhance market position. For example, contract

manufacturing, improved sales trends to reduce accounts receivable days outstanding, improved purchasing terms, [and] co-marketing and joint product development.

We're working hard in all these areas and we're pleased with the improvements we see so far. And we're very encouraged by the longer-term outlook.

I'd like to present some further information on the recordable DVD market, also called the "read-write" or "R/W" market. As we previously stated, we see the R/W market as representing a substantial near-term opportunity for us as we move away from DVD loaders for home entertainment players.

The player market loaders have for the most part become commodities with unacceptable gross margins. The market for players is huge, estimated at 110 million units this year, but the average manufacture price of around \$40 is contributing only about a \$1 per unit to manufacturers.

We're early into the market for recordable products and believe that it will provide a good earnings opportunity -- actually great earnings opportunity -- while we grow our other long-term automotive DVD business. We estimate the market for DVD R/W at about 8 million units this year, roughly double last year's volume, and growing to 18 million [next] year. This is our own internal estimates.

While this is a fast-growing market, it's volatile. And so it's difficult for retailers and manufacturers, who we supply, to estimate volumes at this early stage of the market. And prices are subject to substantial future reductions as new generations of solutions become available from the chip manufacturers.

Lower price points, driven by cost-reducing technology improvements, will strongly influence the adoption of R/W products, increasing volumes and reducing costs further due to scale. This is good for sustained margins as well. Likewise, the growth of digital TV will drive the demand for DVD R/W as consumers wish to capture and play back the high-quality [images] available on digital TV.

These technology and market dynamics will continue to influence the market for at least the next year. Consequently it will be difficult for us to provide meaningful quarterly guidance on the R/W business. But suffice it to say that this is a large and growing business opportunity and we are actively engaged in this business opportunity, as many of the integrated circuit manufacturers are developing solutions and we are working with them.

We intend to sustain a significant participation in this business while good margins are available. Why do we believe we compete in this business?

DVSK, our Korean operation, has established a strong reputation in China for high-quality DVD player product. China is where roughly where 80% of the world's DVD players are produced. We have a reliable stable mechanism and our error resilience sets world standards. These same qualities are important in entering the new R/W market.

The product is more complicated and there is need for excellent servo-mechanical engineering, which is really our forte. Our front-end firmware that provides the servo control is excellent. And our engineering team is working on the front-end firmware solutions for leading chip vendors to provide a more highly integrated and improved solutions in the future, where early participants in the market have well-developed relationships with some of the largest manufacturers in the business.

Now with respect to competition the competitive field, the R/W business is smaller than the DVD player field because of the complexity of the product and because the DVD consortium companies, such as Phillips, are applying more stringent control on licensing. But there's significant competition in R/W businesses. That's why we have to rely on our engineering expertise to obtain our share of the market. We anticipate that in the next one to two years, single-chip solutions will become available to all the manufacturers that will reduce our role to role to competing for the mecha unit, the mechanical pickup hardware which is driven by the chip.

And we are recognized, of course, for being excellent in that field. As with the DVD player business, we expect that the active R&D role in chip companies that provide chip reference designs that can be manufactured in China will ultimately drive margins down. But meanwhile, we will seek to be part of the solution recommended by the chip companies, and drive to minimize the manufacturing costs in China. And consequently, ride the wave.

I hope this gives you a taste for the R/W business as we see it and why we believe it's an important part of our growth strategy. Recognizing that we're shifting from a low-margin commodity business to the long-term higher-margin automotive DVD business, a process that we believe will continue through the next two years.

The R/W market offers a window of opportunity that leverages our customer base and reputation, as well as our engineering expertise and talent, to gain a profitable competitive advantage in the DVD field.

Now, shifting to organizational development, we have a five-member Board with one vacancy. The Board of Directors now consists of myself, Tom

Spanier, and Doug Watson, John Fuller and Venkat Rayapati. Unfortunately, Bob Lishman has had to resign, due to a new policy established by the investment firm he's with, so that consequently we are seeking a new independent director.

Finally, we are planning to hold our annual stockholder meeting on October 28 of this year. Notices and proxies will be sent to shareholders in September. That concludes my presentation. I'm now happy to address any questions that you might have.

Operator: At this time I would like to remind everyone in order to ask a question, please press star then the number 1 on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

There are no questions at this time sir.

Thomas Spanier: Hello?

Operator: There are no questions at this time.

Thomas Spanier: Okay. Thank you. Really appreciate your attendance.

Operator: This concludes today conference call. You may now disconnect.

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