

COFFIN COMMUNICATIONS
DIGITAL VIDEO SYSTEMS, INC.
2003 Third Quarter Financial Results

Moderator: Sean Collins
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3:15 pm CT

Operator: Good afternoon. My name is (Dashanta), and I will be your conference facilitator today.

At this time I would like to welcome everyone to the Digital Video Systems Third Quarter Earnings 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.

Mr. Collins, you may begin your conference.

Sean Collins: Thank you, Operator.

Good afternoon, everyone. Welcome to Digital Video Systems Third Quarter Fiscal 2003 conference call. My name is Sean Collins, a partner with CCG

Investor and Strategic Communications, the company's investor relations' counsel.

Digital Video released a press release outlining its third quarter financial results on Friday. In a few moments you will hear from and have an opportunity to ask questions of the company's CEO, Doug Watson, and the company's Chief Financial Officer, Bob Baker.

Now let me remind you that during the course of the conference call management may state beliefs and make projections or other forward-looking statements regarding future events and the future financial performance of the company. We wish to caution you that such statements are just projections and expectations that actual events or results may differ materially. I refer you to the Safe Harbor statement that's included in today's press release and to the company's annual report on Form 10-K, quarterly reports on Form 10-Q, and to the company's press releases and documents filed with the SEC.

That said, we can begin. It's now pleasure to turn the call over to the CEO of DVS, Doug Watson – Doug.

Douglas Watson: Hi. Good afternoon or whatever Time Zone everyone may be in.

For those of you new to Digital Video System's story here's a brief overview. Digital Video System's is successfully making a transition from areas of DVD technology where gross margins are declining into forefront technologies, applications and markets that we project will bring us healthier margins and new growth potential.

We are currently a leader in systems components and other technologies in DVD players. And our line of loaders and players is currently our bread and

butter product line. Loaders are the most technologically complex system within the player and is, in essence, the guts of the machine. DVS has an established position in this market and several technical advantages over its competitors. In fact, we believe we are the market share leader in this product category among independent, non-captive producers. With approximately 20% of the worldwide market this gives us a large potential customer base for new products, which have just begun to ship in our fourth quarter.

Demand for DVD players remains high and still increasing from 68 million in 2003 to 85 million units in 2007 (sic). It is said that household penetration of DVD players in the US is still less than 50% suggesting that over half the US households have VCRs but have not purchased DVD players yet. There is still considerable room to increase the supply of DVD loaders as well as players.

As we'll discuss later, we are taking the initiatives to anticipate the industry's milestones that will make DVD players universal, as VCRs have been, namely recordable, rewritable versions. Also DVD players will also replace the CD audio market as well as the CD car market.

With a string of technology breakthroughs to our credit and an estimated 20% of the non-captive DVD loader market, DVS is a clear leader in both volume and technology. However, with competition mounting and precipitous decline in the end user prices for DVD players' gross margins for DVD loaders have fallen to unacceptable levels. As is typical with consumer electronic products, gross margins are inversely proportional to the growth in unit shipments. To put it another way, the loader market is (unintelligible).

With this decline in gross margins for our current product offering DVS is consciously shifting gears to focus on its real strength, the ability to continue

to innovate and develop leading edge technologies and commercialization of new products. To enter new markets DVS is leveraging its accumulated wealth of knowledge and experience and developing newer, bolder, and more advanced products that will provide DVS with higher margins and a sustainable competitive advantage.

One measure of our commitment to keeping our growth strategy current and viable is our investment in R&D, which has increased year-over-year, good news for the long term but a contributor to bottom line losses in the third quarter.

As disclosed in more detail in Form 10-Q, the company's consolidated spends around R&D for the quarter ended September 30, 2003 was 1.4 million reflecting an increase of approximately 400,000 over the 950,000 invested in R&D during the same period in 2002. For the first nine months of 2003 R&D investments have totaled 4 million up from the 2.6 for the corresponding period of 2002. The company will seek to sustain and capitalize on its commitment to R&D as the company and its subsidiaries focus their resources on new product opportunities. With its partners the company is working towards the development of products such as automotive DVDs, both before market and after market, rewritable recordable devices, and software to engineer existing DVD technology for the demands of high definition television or HDTV.

We're now going to move on to financial results. And I'd like to introduce our CFO, Mr. Robert Baker.

Robert Baker: Thank you, Doug.

Good afternoon, everyone. I'm going to read just a little bit from the press release and then talk about some of the key variables of our company.

(Unintelligible) Digital Video Systems posted their consolidated net results of 19.7 million for the third quarter ended September 30 in revenues compared to 47.8 for the same quarter a year ago.

Our consolidated loss for the quarter ended September 30 was 1.6 million or 20 cents per basic and diluted share, compared to consolidated net income of 1.8 million or 31 cents per share for the quarter ended September 30.

I think it's significant to note that in the third quarter the company sustained a consolidated net loss of 1.1 million in currency translation expense, which equates to 14 cent per basic and diluted share.

For the nine months ended September 30 the Company posted consolidated revenues of 70.6 compared to 113.2 for the same period the prior year.

The consolidated loss for the nine months ended September 30 was 4.5 million or 63 cents per basic and diluted share compared to the consolidated net losses of 951 or 16 cents per share for the nine months ended September 30, 2002.

In looking at what's happening in our company we'll talk a little bit about the margins where we're quite happy with the progress that we're making in the rate of gross margins as measured by percentage of sales. In first quarter of this year it was 2.6. In the second and third quarter it was averaged a little over 11%, and the variation from quarter-to-quarter was simply mix and not significant.

Looking back into the previous year for the third and fourth quarter we were well under 10% on average. So this gives us some satisfaction that the move that has been made to get away from shipping loaders where the margins had become intolerable and getting to the point of shipping components where the margins are better, but more important starting our new product introductions, which in the third quarter ended September 30 were almost 10% of our total sales. So we began to move much higher rate (unintelligible). So as we look forward, we're encouraged.

On the operating expenses we've noted before that the R&D is up 40%. And we think that's exactly where it ought to be as we develop new products in the automotive sector in the player portable sector as well as maintain software efforts that we've begun with Jeecom and Mobile Touch USA and Mobile Touch Korea.

On the SG&A spending is down from the first quarter, which is what we think it should have been adjusting to the revenue decline but at the same time preserving the spending that's required to generate a whole new product lineup.

The inventory – on the balance sheet side the inventory is high. We were a little disappointed. We thought that we had projected our inventory needs a little bit closer than that. But the reduction in the sales of assembled loaders has been more rapid than expected. So our inventory of product for that product line is higher than we think it should be at this point. Our management of the subsidiary assures us that that inventory will be utilized and it will just slow the turn down as we go.

In addition to that, as we build up these new products in the automotive sector and the recordable sector, we get a bubble in our inventory getting ready for

the onset to the market. So it's slow, not as slow as we'd hoped it would be. But we don't see any need for panic at this point.

Looking at the receivables, our receivable turns every 27 days on average, which is a little down from our previous period. But the competitor situation has not put us in a position of extending credit terms whereas before we really were shifting our limits on credit. So it's slower than it was, but at 27 days it's pretty good.

The cash position is down from December 31 about \$4 million. And as we look at the big items that have led to that obviously we've lost money, and the cash loss from operations is a little over 4 million. We paid down our accounts payable by 2.7 million. We have increased our inventory 700,000. A big item – we have picked up 3.1 million in property and equipment. That (unintelligible) balance for the product tooling on the new automotive line. It includes 1.2 million for the building in Korea that we purchased in the year 2003 as well as leasehold improvements in our new China factory and lastly some factory and some computer equipment for the increase in the activities particularly in the new product.

And that kind of covers the big chunks of what's happening. I will talk to you just a moment on the exchange gain. It does indeed contribute significantly to the loss of the third quarter. But that is an up and down item. In this quarter it hurt us. But if we look back one year to the same quarter a year ago, it hurt us by ironically the same amount of money. So it's not something that should overly alarm, but obviously it's something to keep your eye on.

And that's about it. I'll wait for the question and answers to address any questions you might have.

All right, Doug?

Douglas Watson: All right. During the third quarter we initiated marketing activities in India, and our work expanded in manufacturing there as well. Our goal in the coming year is to sell a minimum of several hundred thousand units from our Indian subsidiary at an average selling price of between 80 to \$100 per unit. And we're comfortable with that goal.

Since the close of the quarter we're pleased to announce that a prominent executive of India's expanding electronics industry, Lalit Ahuja, has been named Managing Director and a member of the Board of Directors of DVS Electronics India. The former Managing Director of NDS India, a News Corp subsidiary, Mr. Ahuja brings to DVSE expertise gained in more than 20 years commercial electronics and software experience. He is a former country head of India, President and Manage Director of LG Soft India Private, Ltd., which is part of the sole-base LG Group, formerly Lucky-Goldstar. And while at Lucky-Goldstar Lalit took the company from zero on revenues to \$1 billion in a four-year period. Mr. Ahuja will be responsible for all sales and marketing activities of the newly wholly-owned venture of DVS and will report to Bob Kondamoori, Chairman of DVSE and Co-Chairman of DVS.

The company's management is excited about the opportunities presented by the expansion in India and believes this is a logical extension of our existing operations in both Korea and Indo-China. We continue to maintain sole control over the Indian subsidiary and do not anticipate reducing ownership to below 80%, if we reduce it at all.

Other material events we have announced involve changes in the company's Board of Directors. Bob Kondamoori and Dr. Rayapati have been elected to

fill Board vacancies following the resignations of Grant Jasmin and In Baik Jeon.

Bob Kondamoori brings over 20 years digital video, semiconductor, telecommunications experience to DVS. Mr. Kondamoori is currently a partner at Charter Ventures, a \$400 million Silicon Valley venture capital firm.

Dr. Rayapati currently serves as the Chief Technology Officer and Chief Operating Officer of Exalted Networks and has over 20 years of experience in semiconductor design, audio and video data compressing transmission.

For further information on their bios you can visit our Website at dvsystems.com. It will also give you a link to the Indian Website as well as the Korean Website.

Turning to our Korean operations on September 8th the Board of Directors of DVS Korea announced the election of Dr. Song Sim as President and CEO of DVS Korea. Dr. Sim, a founder of DVS Korea and Chief Technology Officer, joined the management team in 1998 when DVS Korea was formed by spinning off Hyundai's DVD player unit and DVD-ROM business. At that time Dr. Sim had almost a decade of engineering experience in optical storage technologies. He's been directly involved with the evolution of DVD technology since the inception of that product in Hyundai laboratories. Dr. Sim has headed up the 60 engineering R&D department for three years, and since April of this year he has also supervised the sales, marketing, and purchasing departments. He's extremely well liked and admired by the entire DVS team and has a respected track record as an engineering manager.

As I commented for the record, I doubt that anyone alive today can claim a longer history of pioneer DVD products than Dr. Sim. I fully expect him to accelerate the development of new products and technologies and take full advantage of our combined resources in Korea, China, the US, and into India.

The positions that Dr. Sim was elected to were formerly held by Mr. B.H. Lee. It is anticipated that Mr. Lee will now serve as CEO of Mobile Touch, a subsidiary of DVS Korea, which is involved in the videoconferencing technology.

On July 8th the company announced it closed a private placement of common stock units (unintelligible) generated gross proceeds of approximately \$1.74 million and net proceeds of approximately 1.53 million to the company. The company sold a total of approximately 1,246,000 units.

On July 22nd the company announced that the Securities and Exchange Commission, the SEC, declared effective DVS's registration statement on Form S-3, which covers the sale of 711,128 shares of restrictive common stock of DVS by existing shareholders and upon exercise of warrants.

Also during the third quarter the company announced it dropped a lawsuit filed in 2001 against Ernst & Young, LLP, which has served as the company's independent auditor for seven years. The company expects to see a benefit of 350,000 under the settlement the company reached. This figure reflects an undisclosed cash payment as well as the extinguishment of the debt.

On our strategies going forward, DVS's growth strategy continues to be a two-pronged approach. We will continue to enhance our current products and find new applications for our current technology. These efforts will include expanding and enhancing the current (Legacy) products, primarily the DVD

loader. DVS intends to continue to systematically release new, higher margin products that counter the affects of gross margin declines for our more mature products.

One overrunning factor in our growth strategy is the development of technology based on the MPEG4 AVC standard, which will allow DVS to create products for the high definition DVD market as well as products and applications for mobile wireless marketplace.

This will solve the problem that current compression technology has that will not allow a full-length AC TV program to record on a single disk. There are many solutions to this problem including blue lasers, but the most promising is the emerging MPEG4 AVC standard because it allows consumers to watch HDTV programming on DVD players based on existing low cost red laser technologies.

All other current alternatives to provide HDTV quality video on disk include blue lasers, which would require significant retooling, and authorizing disk manufacturing, and player manufacturing, and rely on expensive new technologies. The new MPEG4 AVC standard, although based on complex software technology, will require only minor changes in the existing offering, content production, and consumer electronics manufacturing supply chain. This is why DVS is convinced this will be the new standard for video and audio compression.

On our old products we see increased sales next year into the US marketplace directly, not through Chinese OEMs. And new products on the DVS agenda include DV-RW, which we now have orders for and are shipping in the fourth quarter, HDTV player, HDTV ready player, recordable HDTV player, personal entertainment communicator kiosk system, automotive applications

both in the before market in-dash installation and in the after market. And the after market products are being sold now.

We believe that the HDTV players will gain quick mass acceptance as the proliferation of HDTV sets and programs increase. A prototype player based on MPEG4 will be launched at the end of 2003. Another player that's HDTV ready, meaning it is backwards compatible and plays all other previous formats in addition to HDTV, will be launched separately. The practical implications of these new technologies are profound with 100% or more compression involvement over current MPEG4 technology. For example, MPEG4 AVC could allow a ten-fold increase in the amount of DVD quality video stored in a typical DVD disk, allow full-length HDTV programming on current DVDs without resorting to new hardware based on blue laser technologies, provide the compression needed to stream high quality video to mobile phones over the existing GPRS network, or enable DVD quality video over current broadband connections.

A prototype of the backward compatible HDTV ready player will be available by the end of 2005. A recordable version of the HDTV ready player will be introduced later and will utilize end coder technology from a technology partner. As this product is not expected to be commercialized within the next few years, it will not be included in any of our sales projections for now.

Personal entertainment communicator kiosks – this product is part of the ongoing partnership between DVS and Jeecom developed software that allows mobile wireless users to access data, video, audio, and other services from their remote PC. The software platform is very flexible and allows a wide variety of business, personal, and entertainment applications to be created.

The initial products focus primarily on consumer oriented entertainment applications. The product allows mobile wireless users to access photographs, MP3 audio, and video content from their personal computer. With the convergence of digital audio, digital video, and the trend towards even more capable multimedia PCs means that individual users are like to have more and more personal multimedia content on their home machines.

DVS is further encouraged by the proliferation of wireless networks in hotels, airports, and traditional business locations and Intel's new push towards promoting wireless enabled PCs. Other applications include providing the user with home control and monitoring functions. This software will be put onto smart phones and other mobile devices such as PDAs and incorporate the MPEG4 AVC technology for audio and video compression. The new standards will provide the means to extend digital video and digital audio more efficiently and much more economically to mobile phones and other devices. Video can finally be viewed on mobile devices without unnatural or jerky movements using a current GPRS network of approximately 40 KBPs.

An adoption of this technology may involve existing physical kiosks. But the kiosk systems will serve as servers and wireless LAN environment and can provide entertainment to customers that are currently limited to being in front of a kiosk screen. Although still in preliminary discussions, implementation of these systems can take place as early as spring of 2004.

On September 29th we announced that DVS Korea began shipping its Model DRL100 DVD+RW rewritable loader product, the preliminary component for DVD+RW recorders and players. The first shipments are part of a US \$4.5 million purchase order from Ellion Digital, a supplier of DVD+RW players to Hyundai Corporation and is scheduled to be fully shipped at the end of December.

We believe that our loader is the most robust, featuring the quickest access times and competitive pricing. It also is highly accurate recording of digital media with low acoustic noise, superior resistance to shock, and a patented error correction system capabilities. The company anticipates that this new DVD+RW loader will be used as the key system component by a wide range of recorder player suppliers.

We also believe the penetration of the recordable DVD player market is expected to explode once the price comes down to regional end user in the 200 to \$300 range. It is with the (unintelligible) of affordable recordable DVD products that VCRs will disappear from the household. According to a recent report from Taiwan based (Phosonics) Industry and Technology and Development Association, PDIA, some 120 million recordable DVDs were shipped in 2002. And for the year 2003 worldwide demand for DVD-R/-RW and DVD+R/+RW units will reach 300 million.

The vast majority of these recordable drives were shipped to the PC market primary as a high capacity data storage device but alternative to the current CD-R. Very few standalone DVD recorders were shipped in the home market for video recording implying the market for home DVD recording devices is yet to begin. Many analysts believe that the replacement of home VCRs with disk branded recorders is inevitable and could result in a market with revenues in the billions of dollars in the coming years.

In the automotive DVD market production on the DVS 800-series of the car DVD loaders and the VXM 2000-series of portable car DVD players began in late July with shipments to Asia and US OEM customers expected to exceed 50,000 units by the end of December. Following the loaders and players an exciting new series of car AM/FM/RDS/DVD receivers combining the

features of a car DVD player and a full function AM/FM radio is now in test production with commercial qualities planned for late November.

We introduced our new line of car DVD products at the key SEMA 2003 Expo in Las Vegas November 4th and 7th. And we have received excellent feedback from that show. We are in discussions with both after market and OEM prospects based on the appearance at SEMA and see strong leads for the near term sales for both loaders and players.

Featured products, which are manufactured by our Korean subsidiary, include portable as well in-dash DVD players and the VXD-2000 in-dash car DVD/CD/MP3/AM/FM receiver, which functions both as a car DVD player and as an AM/FM radio. These feature rich DVD units utilize our patented air correction technology and superior vibration resistance, which particularly is beneficial in the SUVs.

DVD has an advantage over its competitors in this area because of our unique anti-skipping feature. It is likely the growing number of vehicles, such as sports utility vehicles and sedans geared towards families, will be equipped with DVD players as standard options.

In addition, the audio component of DVDs both in home entertainment and car DVD players typically has a broader range than traditional CD players. The DVD format has been adopted by the music industry and is expected to create demand for the DVD players as replacements for CD players as well.

Home entertainment centers have a much higher margin than traditional players and shifted (unintelligible) focus to these new areas can contribute to improving gross margins for the company.

So to provide some guidance in the fourth quarter of fiscal year 2004 let me give you a couple of highlights. A lot is going on for us. A lot is in development. And it isn't practical for me to cite specific terms. We do expect to regain profitability in the fourth quarter of this year. And we have great hopes for the coming year.

As I mentioned earlier for our India subsidiary we have set a goal to sell several hundred thousand players and loader units in 2004 and are projecting the ASP on this units of between 80 to \$100 each.

There is too much uncertainty to give you specific earnings per share forecasts, but overall we are looking for a big 2004 in terms of revenues (unintelligible).

So at this point we're willing to open up for any questions the audience may 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.

At this time there are no questions.

Your first question comes from (Scott Seer).

(Scott Seer): Hi, Doug. How are you doing?

Just a couple of questions in regard to the revenue mix as you look forward to the December quarter – you've indicated your rewritable product shipping and some initial products to the auto market going out the door. What percentage

of the mix do you expect to be higher margin product? And if you could give us an idea in terms of revenue sequentially – we're, you know, five to six weeks into the quarter – would you expect revenues to be up in December? And maybe give us an idea as to the magnitude of gross margins in the fourth quarter. And then I had a quick follow-up.

Douglas Watson: Yeah, right now they're working with the OEMs in China to get out the rewritables as we speak. Those are substantially higher margin products that they're going to ship we hope the first week in December. So, you know, we expect to see maybe a 20% mix – Bob, if you think that's off...

But, I mean, next year we're gearing towards probably a 50/50 mix of the margins between high margin products and are standard loader semi knockdown kit.

Does that answer your question?

(Scott Seer): Yeah. And in terms of sequentially from a revenue standpoint, do you expect revenues to be up sequentially and an idea as to where gross margins will shake out?

Douglas Watson: What do you think, Bob?

(Unintelligible)

Douglas Watson: Yeah, because we're expecting – I was talking to Bob just going through some of the numbers based on what we're getting feedback from both our subsidiary and both from India. You know, the 20 to 30% margins we feel pretty confident the new products will reach that on the combined rate. We don't see the loader business having an increase in margins until they're

actually producing those in India to be put into players. And that probably won't happen until the second quarter of next year.

Robert Baker: Does that answer the question?

Douglas Watson: I hate to get into revenues projections at this time because we feel really comfortable with the sales volume, it's just we're not sure how big the volume's going to be.

Robert Baker: Okay. And just two other follow-ups – I think something was mentioned earlier as it relates to inventory. Could you just detail that a little bit more in terms of finished goods, what specifically those products are, are they some of the new products that have possibly been slower to go out the door, and is there any sort of risk of an inventory write down?

And also just clarification on the currency impact, where that's being reflected in the P&L – is that going into gross margins? Thanks.

Douglas Watson: Do you want me to address the inventory and you take the – well the inventory – we've already got a – I feel pretty comfortable on the inventory basis based on, one, is the after market car can use up a lot of that inventory. So, you know, that they feel pretty comfortable with. And they've also got some pretty large negotiations going on for a large part of that inventory already that will be used in a final loader product.

So Korea doesn't feel any need to write down that inventory. And after discussions with Korea we feel pretty comfortable that inventory's going to be totally used out, but maybe, like Bob said in the conference call, not as fast to turn as he anticipated.

Robert Baker: And the bulk of that inventory is in raw materials, which reflects the buying to get ready to service the automotive market.

Douglas Watson: Aftermarket.

Robert Baker: The aftermarket portion – so we feel fairly comfortable. We just had expected it to come down a bit quicker.

(Scott Seer): And just lastly on the currency front in terms of the impact of that 1.1 million, where is that being reflected in the P&L? I know it's...

Robert Baker: Yeah, that's below the line, other income and expenses.

(Scott Seer): Okay.

Robert Baker: And I think it shows .7 million, 1.1 million in loss on exchange and a 300,000 plus pick up on the settlement with Ernst & Young.

(Scott Seer): Thank you.

Robert Baker: Okay.

Operator: Once again, if you would like to ask a question, please press Star then the Number 1 on your telephone keypad.

At this time there are no further questions.

Robert Baker: Thank you.

Douglas Watson: Are we done?

Operator: Thank you. This concludes today's conference call. You may now disconnect.

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