

Deswell Industries Incorporated (DSWL): High Total Return from a Chinese Manufacturing Company



Greetings from LFS

Dear Clients and Friends:

Here is my quarterly newsletter, *Invest*. The goal of *Invest* is to keep you abreast of what is happening in the financial market, inform you about new investments and keep you informed about your current investments. I welcome any questions, comments or suggestions.

Sincerely,

Douglas Ruth

Invest

This newsletter is published by Douglas Ruth
Lenox Financial Service, Inc.
322 Alana Drive
New Lenox, IL 60451

Phone: 815-485-5559 708-481-1348
Fax: 815-485-9130 E-mail: LenoxFin@aol.com
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Conclusion:

Deswell Industries (DSWL) is a manufacturing company that generates above-average profits. The company's profit margins have trended down in recent years because DSWL was burdened by extra costs associated with keeping redundant facilities operating.

Gross and Net Profit Margins:

	Fiscal Year Ending March 31				
	2003	2004	2005	2006	2007
Gross profit margin	32.9%	32.0%	26.7%	22.1%	22.9%
Net profit margin	11.3%	15.1%	12.1%	7.6%	8.9%

In late calendar 2006, the extra facilities were closed and all associated costs were expensed during fiscal 2007. LFS expectations are that the company's profits and margins will expand in fiscal 2008.

DSWL Facts:

The company:

- Employs over 6,000 skilled staff members as of March 31, 2007.
- Has a twenty-year history of successfully offering the benefits of Chinese manufactured products to a variety of well-known, worldwide companies.
- Sales have increased nicely over the last five years as the following table shows.

**DSWL Sales
(In \$Millions)**

Fiscal Year					
2002	2003	2004	2005	2006	2007
\$83.3	\$90.9	\$97.2	\$125.6	\$115.3	\$136.8

- Assets have increased nicely over the last five years:

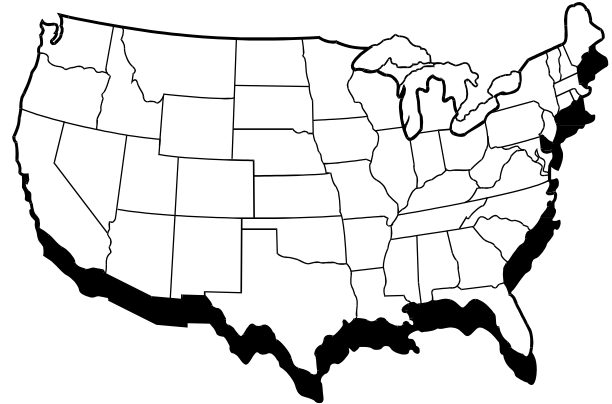
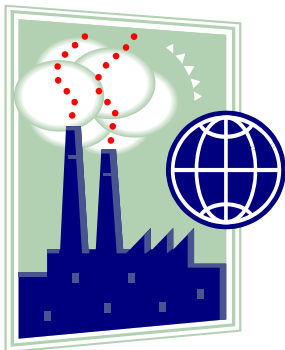
**DSWL Assets
(In \$Millions)**

Fiscal Year				
2003	2004	2005	2006	2007
\$106.2	\$113.5	\$137.0	\$130.7	\$141.2

- Expectations are that revenue growth will continue.
 - The Chinese automobile industry is expected to expand dramatically and DSWL is positioned to become a preferred supplier. Recently, DSWL was selected to supply automobile parts to a world-class manufacturer on a long-term contract.
 - With surveillance becoming more and more important throughout the world, the company's CCTV matrix/controllers and other security products could add to DSWL's future growth.
- Pays out large, regular cash dividends.
- Has spent \$58 million over the past five years to build a new state-of-the-art manufacturing facility. The entire \$58 million was paid from company earnings and with cash on hand.
- Maintains an excellent Balance Sheet, which is totally debt-free and which contains a cash balance of \$23 million as of June 30, 2007.
- Customer base includes many world-class companies that manufacturer injection-molded plastic parts, plastic components, electronic products and electrical subassemblies.

Globalization:

Purchasing DSWL stock allows investors to benefit from globalization, which has changed manufacturing in the following ways:



- Formerly, the United States was the world's largest and most prominent manufacturer.
- Over the last 10 years, Americans have watched as manufacturing jobs have shifted from the United States to the Far East, specifically China.
- Costs have been increasing in the Far East. DSWL, especially, has been affected by higher material and labor costs. On a short-term basis the company has not been able to pass these higher expenses on to its customers.
- DSWL will increase its prices in the future to offset higher costs. This should allow its profits to increase as well.

Brief History of Two Plastic Injection-Molding Facilities:

Unique Challenges:

DSWL's financial performance has been sub-par the last few years because of some unique circumstances. The company:

1. Operated two plastic injection-molding facilities.
2. Results were affected by tax and political issues.
3. Issued stock options to senior management.

1. Operating Two Facilities:

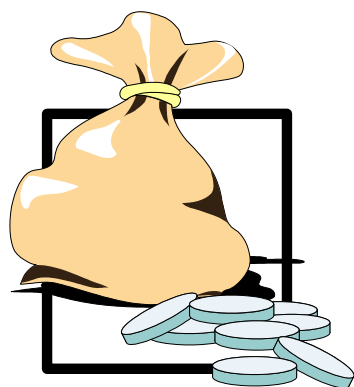
DSWL's management determined that there was an opportunity to build a larger, more efficient facility in Dongguan to replace the factories in Shenzhen. The expansion would be completed in four phases, three of which have been completed. There is no set time table when the final phase will be started. At the present time, Phase IV is not needed.

The first three phases added the following space:

Use	Square Feet
• Factory buildings	1,070,000
• Dormitories	452,000
• Office Space	133,000
• Amenities	91,000

In the third quarter of fiscal 2007, DSWL closed its high-cost manufacturing facility located in Shenzhen, China, and replaced it with the more efficient plant constructed in Dongguan. The company operated its Shenzhen facility while it built the Dongguan plant. The company estimates that it spent an additional \$1 million per year to operate both plants.

2. Tax and Political Issues:



Politics and government assessments caused substantially higher income tax expenses in fiscal 2007. The expectation is that these expenses are one-time events that will not be repeated in the future.

DSWL Income Tax Expense (Credits) (In \$Thousands)

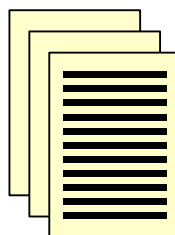
Fiscal Year	
2006	2007
(\$27) ¹	\$294 ²

1. Credit.
2. Total tax in 2007 was \$1,239.

When DSWL was ready to open its new Dongguan facility and close the Shenzhen plant, management was informed that this would create a large taxable event. Taxes would be due to the Shenzhen government. Initially, the company did not believe that there would be any tax liability.

After reviewing its options, DSWL management decided to keep the Shenzhen factory operating for a longer period of time, even though the Dongguan facility was fully functioning. This helped reduce the tax bill somewhat. The Shenzhen facility was vacated in late 2006 and the final taxes were paid in 2007.

3. Stock Options:



In February 2007, Richard Lau retired as Chief Executive Officer and Franki S.F. Tse was hired to replace him. The option expense rewarded Mr. Lau for his company tenure.

Overview:

DSWL has two major business segments:

Segment	% of 2007 Sales
Injection-molded plastic parts and components.	43.5%
Electronic products and sub-assemblies.	53.4%

A small third segment, metallic molds and accessory parts, is included in the electronics segment. 1.9%

Injection-Molded Plastic Parts and Components:

The revenue in the injection-molded plastic parts and components segment has been relatively flat for the last several years.

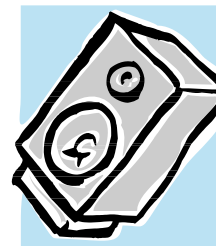
Sales, Profit, and Margin (In \$Millions)

	Fiscal Year				
	2003	2004	2005	2006	2007
Sales	\$51.0	\$54.7	\$61.5	\$49.4	\$59.6
Profit	\$12.7	\$11.7	\$11.0	\$4.5	\$10.6
Margin	24.9%	21.4%	17.8%	9.1%	17.7%

The company has worked hard to reduce its expenses and has a plan to increase its revenue. DSWL has reduced its dependence on producing low-margin commodity products and placed increased emphasis on manufacturing more complex, more profitable items.

Electronic Products and Subassemblies:

The revenue in the electronic products and subassemblies segment has been increasing nicely over the last several years. The profits have increased but the margins have decreased.

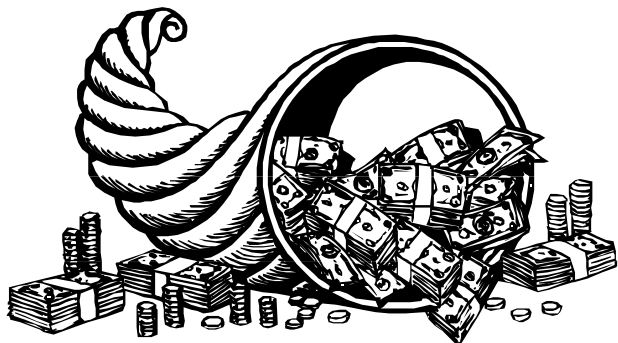


**Electronic Products and Assemblies
Sales, Profit, and Margin
(In \$Millions)**

	Fiscal Year				
	2003	2004	2005	2006	2007
Sales	\$38.2	\$40.1	\$60.5	\$66.6	\$78.0
Profit	\$3.3	\$5.4	\$6.7	\$7.3	\$3.6
Margin	8.7%	13.4%	11.0%	10.9%	4.6%

LFS believes that the profit margins can increase in the future.

Expectations:



Investors can expect the company to pay regular and fairly large dividends. In late September 2007, DSWL's dividend yield was 7.1%. Additionally, these dividends could (and should) increase in the future. The following table shows the dividends per share.

Dividends per Share

	Fiscal year				
	2003	2004	2005	2006	2007
	\$0.51	\$0.63	\$0.65	\$0.63	\$0.65

If DSWL can increase its profit margin, significant appreciation in the stock price could occur. The profit margins increased in fiscal 2007 but decreased in the first quarter of fiscal 2008.

**Sales and Net Income
(\$In Millions)**

	Fiscal year – Quarter 1 Period Ending June 30	
	2007	2008
Sales	\$31.7	\$38.5
Net Income	\$3.4	\$3.1
Margin	10.7%	8.1%

Valuation:

Fiscal 2008 financial results should be significantly improved over those in fiscal 2007 for three reasons. In fiscal 2007, Deswell incurred large expenses to:

- Close the Shenzhen plastic plant.

- Pay for stock options for senior management.
- Pay one-time tax expense.
- If DSWL's fiscal 2007 earnings were adjusted for the three extraordinary events that occurred, net income would have been \$1.97 million higher.

Adjustments to Fiscal 2007 Earnings

	In \$Millions	Per Share
Earnings as presented		\$0.81
Shenzhen expense	\$1.00	
Stock options	0.82	
One-time tax expense	0.29	
	Total	\$2.11
Less taxes @6.6%	(0.14)	
Additional earnings per share	\$1.97	\$0.13
Total earnings per share		\$0.94

Analysis Beyond the Numbers:

Fiscal 2007 was a transition year for DSWL. During a transition year, financial people often rely on "kitchen sink" accounting.

When a person rehabs a kitchen, sometimes everything is thrown out, including the kitchen sink. In finance, a similar concept is applied. The company, in effect, discloses all of its mistakes at once. Then the organization can start the following year with a clean slate. The extreme events that were discussed in the Valuation section are an example of "kitchen sink" accounting.



In addition, one unusual event occurred in fiscal 2007:

- The company bought out its minority partner in the electronics business.

The expectations are that the company should be able to improve its operating results in fiscal 2008.

Calculating Fair Value:

DSWL's fair value can be calculated in two different ways:

1. Return on equity.
2. Normalized earnings.

1. Return on Equity:

If DSWL earned the same return on equity in fiscal 2008 as it did in fiscal 2007, then this suggests that the company would earn \$0.97 per share this year.

Calculating Return on Equity

	2002	2003	2004	2005	2006	2007
Stockholders equity	\$69,651	\$81,846	\$89,730	\$104,767	\$106,768	\$111,655
Average number of shares outstanding	12,699	13,278	14,160	14,933	14,936	15,048
Book value per share	\$5.48	\$6.16	\$6.34	\$7.02	\$7.15	\$7.42
Diluted earnings per share	\$1.05	\$0.77	\$1.64	\$1.02	\$0.59	\$0.94 ¹
Return on equity		14.1%	16.9%	16.1%	8.4%	13.1% ¹

1. Adjusted by LFS.

**Fiscal 2008 Projection
Calculating Projected Earnings per Share**

\$7.42	X 13.1%	= \$0.97
Book value	Return	Projected
as of	on equity	earnings
03-31-07		per share

2. Normalized Earnings:

A simple but practical theory could be proposed for fiscal 2008. It is reasonable to suggest that fiscal 2008 results will be similar to those of last year. LFS makes the following assumptions to calculate fair value using this method of valuation:

- The first quarter of fiscal 2008 is not indicative of how the company will perform for the entire year.
- Profits will expand throughout the remainder of the year.
- The company will earn \$0.94 per share in fiscal 2008. This is the same as the adjusted earnings achieved in fiscal 2007.

Price-to-Earnings Ratio:

During fiscal 2007, DSWL traded at a price-to-earnings ratio of between 10 and 15. Suggesting that DSWL stock should trade at a price-to-earnings ratio of 13 to 1 or more is reasonable.

Fair Value:

Looking at the two methods of valuation separately suggests that the fair value of DSWL would be between \$12.22 and \$12.61 on March 31, 2008.

With the stock currently trading at approximately \$10 and a 7% dividend yield, Deswell should produce satisfactory total returns for income and growth-oriented investors. LFS expects that the fair value of DSWL could be raised if the company continues to be successful in increasing sales and profit margins.

Part 1 – Company Enterprises:

1.1 Injection-Molded Plastic Parts and Components:

The injection-molded plastic parts and components segment is the more profitable of the two DSWL enterprises.

Products:

DSWL produces a wide variety of plastic parts and components that are used in the manufacture of consumer and industrial products, using different plastic injection technologies, such as film injection, integrated (dual color) injection and insert injection. The products include:

- Cases and key tops for personal organizers and remote controls.



- Cases for flashlights, telephones, paging machines, projectors and alarm clocks.
- Grips and rods for fishing tackle.
- Toner cartridges and cases for photocopiers and printers.
- Parts for electrical products such as air-conditioning and ventilators.
- Parts for audio equipment.
- Double injection caps and baby products.
- Laser key caps.
- Automobile components.

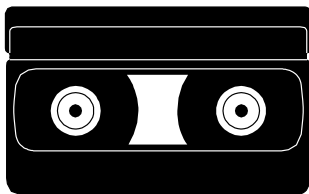
Plastic Injection-Molding Process:

DSWL’s plastic injection-molding process consists of three phases:

1. Mold design and production.
2. Plastic injection.
3. Finishing.

1.2 Electronic Products and Assemblies:

The company’s electronic segment has become a leading assembler of audio equipment. DSWL is noted for assembling:

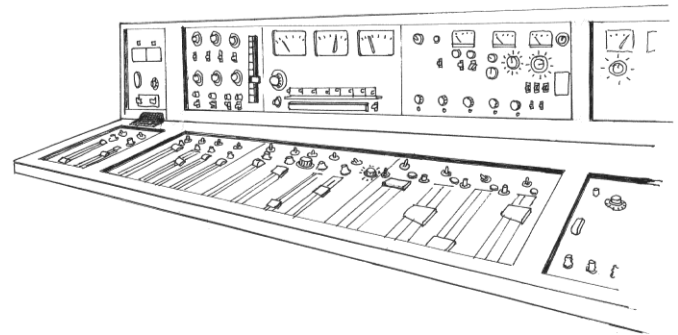


- Professional mixing consoles (sound boards).
- Amplifiers.
- Effect pedals.
- Surveillance products.

These three product lines are high-margin, low-volume niche businesses. The assembly of mixing boards utilizes both DSWL’s injection-molded

plastic parts and components and electronic products segments.

Mixing Console as defined by Wikipedia:



BBC Local Radio Mark III radio mixing desk

“In professional audio, a mixing console, digital mixing console, mixing desk (Brit.), or audio mixer, also called a sound board or soundboard, is an electronic device for combining (also called "mixing"), routing, and changing the level, tonality and/or dynamics of audio signals. A mixer can mix analog or digital signals, depending on the type of mixer. The modified signals (voltages or digital samples) are summed to produce the combined output signals.

“Mixing consoles are used in many applications, including recording studios, public address systems, sound reinforcement systems, broadcasting, television, and film post-production. An example of a simple application would be to enable the signals that originated from two separate microphones (each being used by vocalists singing a duet, perhaps) to be heard through one set of speakers simultaneously. When used for live performances, the signal produced by the mixer will usually be sent directly to an amplifier, unless that particular mixer is “powered” or it is being connected to powered speakers.”

In addition to assembling the mixing consoles, DSWL:

- Manufactures many of the circuit boards.
- Manufactures the housing, which is often made of either metal or plastic.
- Tests the finished product.
- This is a labor-intensive process requiring a high degree of precision, along with multiple quality-control checks prior to shipping.

Largest Customers:

A large portion of DSWL’s sales are made to small number of customers:

Percentage of Sales by Customer

Customer	Product	Year Ending March 31		
		2005	2006	2007
Line 6 Manufacturing	Professional audio equipment	14.9%	14.5%	15.1%
Digidesign, Inc.	Professional audio equipment	19.1%	17.4%	13.3%
Vtech Telecommunications Limited	Plastic component	12.1%	*	12.7%
Peavey Electronics Corp.	Professional audio equipment	*	*	10.4%

* Less than 10%

The history of each of DSWL’s largest customers is unique. This uniqueness could (and should) be a competitive advantage for DSWL.

Currently, it appears that emphasis is placed on price rather than quality and the ability to perform. LFS expects that this will change in the future. The company’s management team is now led by Franki S. F. Tse, who became Chief Executive Officer on February 7, 2007. Most likely, he will work to improve margins and LFS is optimistic that the company’s relations with its customers will continue to expand.

Plant, Property and Equipment (PPE):

As of March 31, 2007, DSWL’s manufacturing is performed at the following facilities:

Injection-Molded Plastic Parts and Components:

Type of Facility	Space in Square Feet
Factory	1,070,000
Amenity	91,000
Dormitory	470,000
Office Building	133,000

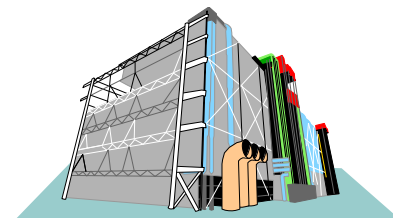
The company owns these spaces free and clear.

Electronic Products and Subassemblies:

The facilities of this business segment consist of a series of different properties that total 420,000

square feet. These properties are sometimes referred to as the Kwan Hong Building. Uses of the buildings include:

- Six blocks of dormitories.
- Canteen.
- Factory.
- Car park.
- Guard room.



The company bought the property in July 2003 for \$4.2 million and DSWL owns it free and clear.

Part 2 – Challenges and Competitive Advantages:

Studying DSWL’s financial results from the beginning of fiscal 2003 through the first quarter of fiscal 2008 has allowed LFS to understand the challenges faced by the company.

Challenges:

These are the company’s challenges:

1. Power Struggles with Customers:

DSWL has power struggles with its customers:

- Costs have increased but the company has been unable to pass these higher expenses on to customers.
- Occasionally, customers have been allowed to bully the company into submission on price. LFS is optimistic that this could change in the future.

2. Lower Profit Margins:

DSWL’s profit margins have trended lower.

Injection-Molded Plastic Parts and Components:

Wages have increased in China:

Labor Cost and Wage Increases

2006	2007
27%	14%

Electronic Products Segment:

The electronic products segment has some of the same challenges the company is experiencing in the injection-molded plastic parts and components

segment. The increasing cost of labor has also affected this segment:

- Wages have increased in China as shown in the following table.

Labor Cost and Wage Increases

2006	2007
14%	32% ¹

1. The company's disclosure is not clear. It is possible that a portion of the labor cost and wage increases in 2007 include some severance costs.

- Pricing pressure is an additional challenge faced by the electronic products segment. The company is offering volume discount pricing to both:
- Offset intense competition.
- Try to secure large orders.

3. Appreciating Chinese Currency:

With the value of hindsight, DSWL should be involved in a currency hedging program. DSWL's materials costs have increased because:

- The Chinese currency, the Renminbi, has appreciated against the U.S. dollar. (The symbol for the Renminbi, also called the Yuan, is ¥.)
- DSWL's accounting is completed in U.S. dollars, whereas the company's material purchases are completed in Yuan. The effect of this method is that material costs are increasing.



**Injection-Molded Plastic Parts and Components
Materials Cost Increase**

2004	2005
20%	14%

- In 2006, the company experienced some material shortages, which led to delays in production and shipping.

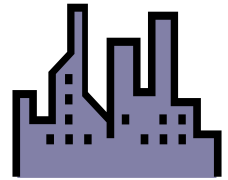
Meeting the Challenge:

DSWL's management understood what was happening and the process to remedy these situations has been a five-year ongoing journey.

- The company tried to overcome this challenge by working diligently to reduce expenses. Expense control in a manufacturing environment can be difficult to achieve. This is

how DSWL handled this challenge. The company:

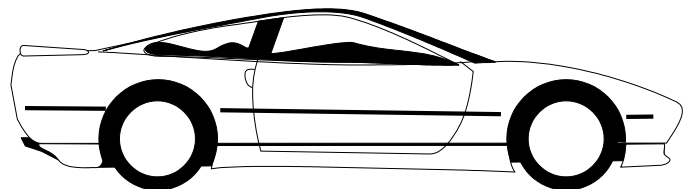
- Sold its administrative properties in Hong Kong and relocated them to Macao. The cost of doing business in Macao is lower than in Hong Kong.
- Relocated its manufacturing facilities from Shenzhen to Dongguan. The cost of doing business is lower in Dongguan.
- Spent \$58 million over the last five years building the Dongguan facility.



DSWL worked to improve profit. Specifically, the company:

- Positioned itself to increase revenues by installing new state-of-the-art clean rooms at its plastic manufacturing facilities.
- Has been moving away from lower-margin plastic assembly orders; instead, stressing DSWL's ability to produce complex and higher-margin products to very competitive quality standards.
- Successfully produced more higher-margin plastic parts for electronic games and entertainment products in 2007.
- Has purchased new equipment, which has increased production efficiency and boosted profitability.
- Bought out its minority shareholder, giving the company more control. The buyout should allow profits to expand.

Additionally, while the company has provided limited disclosure, it seems reasonable to believe that as the Chinese automotive business expands,



DSWL will grow with it. Finally, the company believes that the two businesses – injection-molded plastic parts and components, and electronic products – can work together more closely to manufacture high-quality, high-margin items.

Competitive Advantages:

The company enjoys several unique competitive advantages, including:

1. World-class manufacturing facility location.
2. Low-cost manufacturing.
3. Good location.
4. Ability to innovate and change.
5. Strong balance sheet with no debt.
6. Insider stock ownership.
7. Worldwide customers.
8. Quality control procedures.

1. World-class Manufacturing Facility Location:

The company believes its facility in Dongguan is one of the premier injection-molding facilities in the world. The facility has state-of-the-art equipment including 18 double-injection-molding machines. These machines can simultaneously inject two different color plastics into molds and are used to produce brand labels, key caps and buttons for telecommunications products.

Number of Mold-Making Machines

Type of Mold-Making Machines	Fiscal Year				
	2003	2004	2005	2006	2007
Electrical Discharge Machines (EDM)	24	26	29	32	30
Computer Numerical Control Milling Machines (CNC)	25	25	30	32	32
Numerical Control (NC)	63	78	85	86	83

2. Low-cost Manufacturing:

One of DSWL's competitive advantages is that the company can design and manufacture components at a lower cost than many of its competitors.



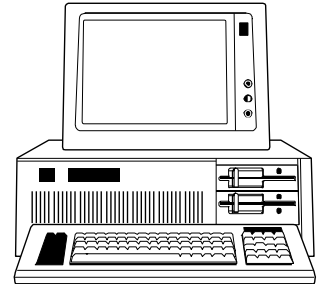
3. Good Location:

The location provides easy access to:

- Stable supplies of raw materials.
- Electricity.
- Shipping ports.

Facts about Dongguan, China:

- Dongguan, in Guangdong Province, in South China, is one of the world's fastest-growing cities.

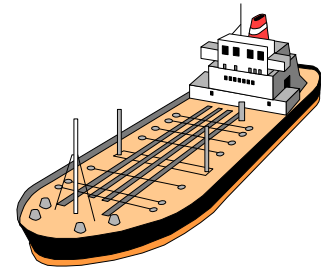


- After the economic reforms of 1979, Dongguan grew from 1 million people to more than 6.5 million today.

- The city is home to 15,000 international companies, the center of the world furniture industry, and one of the great centers for the manufacturing of PC components.

- Dongguan is situated in the south-middle part of Guangdong province and the east coast of Pearl River Delta, facing Shenzhen and Hong Kong in the south and neighboring Guangzhou in the north.

- It is the most prosperous economic region in southern China with 1.6 million local people, 6 million from outside the province, and approximately 700,000 from Hong Kong, Macao, and Taiwan.

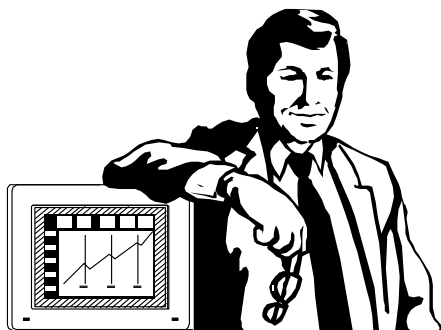


- For the past decade, Dongguan has been highly ranked among the top cities in China for exporting the most goods, particularly to the United States.

- In 2002, it ranked seventh in overall municipal competitiveness in China, ranked third in goods exported, behind Shanghai and Shenzhen, with approximately \$2.8 billion (USD) worth of goods exported worldwide.

- The city now has about 25,000 manufacturing enterprises; 10,000 of them are computer-related manufacturers, with total production equaling 40% of all international computer parts markets

4. Ability to Innovate and Change:



DSWL is willing to adapt as markets change. In recent years, the company has shown that it is willing to innovate and adapt by changing the:

- Location of its factories.
- Types of equipment it uses.
- Types of products and services it offers.

5. Strong Balance Sheet:

DSWL continues to operate according to conservative financial strategies. The company has no long- or short-term borrowing. The company spent \$58 million over five years, building its new plant – all from cash flow. On March 31, 2007, DSWL had \$24.5 million in cash.

The following table shows that the company has continued to invest in China

DSWL Identifiable Assets
(In \$Millions)

Location	Fiscal Year Ending March 31				
	2002	2003	2004	2005	2006
Hong Kong and Macao	\$53.16	\$58.58	\$43.66	\$49.63	\$41.93
China	<u>41.11</u>	<u>47.125</u>	<u>69.40</u>	<u>86.87</u>	<u>88.03</u>
Total identifiable assets	\$94.27	\$105.69	\$113.06	\$136.50	\$129.96
Goodwill	<u>0.48</u>	<u>0.48</u>	<u>0.48</u>	<u>0.48</u>	<u>0.71</u>
Total Assets	\$94.74	\$106.17	\$113.53	\$136.98	\$130.67

6. Insider Stock Ownership:

Approximately 25% to 30% of the DSWL’s common stock is owned by management. The large ownership encourages management to treat all stockholders fairly and manage the company in a prudent manner.

7. Worldwide Customers:

DSWL’s products are sold throughout the world. The following table shows Deswell’s sales by country.

Percentage of Sales by Country

Geographic Area	Year Ending March 31				
	2003	2004	2005	2006	2007
United States	28.5%	38.4%	40.5%	49.0%	42.4%
China	58.9%	51.6%	44.8%	37.5%	39.2%
Europe	8.2%	5.9%	10.9%	7.0%	11.2%
Hong Kong	3.1%	2.3%	0.8%	3.0%	3.4%
Others	<u>1.3%</u>	<u>1.8%</u>	<u>3.0%</u>	<u>3.5%</u>	<u>3.8%</u>
Total	100.0%	100.0%	100.0%	100.0%	100.0%

8. Quality Control Procedures:

DSWL maintains strict quality control procedures. At hourly intervals, quality control personnel monitor machines and molds to ensure that plastic parts are free from defects.

Plastic, electronic and metal products manufactured and assembled at the company’s facilities have a low level of product defects, and aggregate returns represented less than 3% of total net sales during each of the years ending March 31, 2005, 2006, and 2007.

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