

SOUTHWALL TECHNOLOGIES INC /DE/
Form 10-Q
November 13, 2002

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

For the quarterly period ended September 29, 2002

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

For the transition period from _____ to _____

Commission File Number: 0-15930

SOUTHWALL TECHNOLOGIES INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

94-2551470

(I.R.S. Employer Identification Number)

1029 Corporation Way, Palo Alto, California

(Address of principal executive offices)

94303

(Zip Code)

Registrant's telephone number, including area code: **(650) 962-9111**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

As of November 6, 2002, there were 12,500,896 shares of the Registrant's Common Stock outstanding.

SOUTHWALL TECHNOLOGIES INC.

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements:

SOUTHWALL TECHNOLOGIES INC. CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands, except per share data)

| | September 29, 2002 | December 31, 2001 |
|--|-----------------------|----------------------|
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 9,661 | \$ 3,362 |
| Restricted cash | 896 | 1,602 |
| Accounts receivable, net of allowance for bad debts of \$264 and \$389 at September 29, 2002 and December 31, 2001, respectively | 10,849 | 9,020 |
| Inventories, net | 6,965 | 6,151 |
| Other current assets | 2,816 | 3,471 |
| | <u>31,187</u> | <u>23,606</u> |
| Total current assets | 31,187 | 23,606 |
| Property, plant and equipment, net | 49,553 | 47,841 |
| Restricted loan proceeds | 832 | 738 |
| Other assets | 1,098 | 973 |
| | <u>82,670</u> | <u>73,158</u> |
| Total assets | \$ 82,670 | \$ 73,158 |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | September 29, 2002 | December 31, 2001 |
|--|-----------------------|----------------------|
| Current liabilities: | | |
| Current portion term debt | \$ 9,845 | \$ 8,315 |
| Line of credit | 0 | 2,974 |
| Accounts payable | 7,601 | 10,338 |
| Accrued compensation | 1,873 | 2,794 |
| Other accrued liabilities | 4,194 | 5,656 |
| Total current liabilities | 23,513 | 30,077 |
| Term debt | 10,455 | 14,513 |
| Government grants advanced | 758 | 941 |
| Other | 1,149 | 1,175 |
| Total liabilities | 35,875 | 46,706 |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value, 20,000 shares authorized; issued and outstanding 12,501 and 8,332 at September 29, 2002 and December 31, 2001, respectively | 12 | 8 |
| Capital in excess of par value | 69,542 | 52,614 |
| Notes receivable | (124) | (88) |
| Other comprehensive income (loss) | | |
| Translation gain (loss) on subsidiary | 577 | (172) |
| Accumulated deficit | (23,212) | (25,910) |
| Total stockholders' equity | 46,795 | 26,452 |
| Total liabilities and stockholders' equity | \$ 82,670 | \$ 73,158 |

See accompanying notes to condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 29, 2002 | September 30, 2001 | September 29, 2002 | September 30, 2001 |
| Net revenues | \$ 16,290 | \$ 22,777 | \$ 55,235 | \$ 62,436 |
| Cost of sales | 11,682 | 15,629 | 37,061 | 46,798 |
| Gross profit | 4,608 | 7,148 | 18,174 | 15,638 |
| Operating expenses | | | | |
| Research and development | 1,888 | 1,386 | 5,725 | 3,995 |

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| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|-------------------|-----------------|
| | | | | |
| Selling, general and administrative | 2,385 | 2,688 | 9,127 | 8,401 |
| Total costs and expenses | 4,273 | 4,074 | 14,852 | 12,396 |
| Income from operations | 335 | 3,074 | 3,322 | 3,242 |
| Interest expense, net | (413) | (618) | (1,405) | (2,156) |
| Other income (loss), net | 215 | (36) | 682 | 1,328 |
| Income before provision for (benefit from) income taxes | 137 | 2,420 | 2,599 | 2,414 |
| Provision for (benefit from) income taxes | 12 | 11 | (101) | (48) |
| Net income | \$ 125 | \$ 2,409 | \$ 2,700 | \$ 2,462 |
| Net income per share: | | | | |
| Basic | \$ 0.01 | \$ 0.29 | \$ 0.28 | \$ 0.31 |
| Diluted | \$ 0.01 | \$ 0.28 | \$ 0.26 | \$ 0.30 |
| Weighted average shares of common stock and dilutive potential common stock: | | | | |
| Basic | 12,094 | 8,220 | 9,712 | 8,010 |
| Diluted | 12,169 | 8,466 | 10,338 | 8,084 |

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)
Increase (Decrease) in cash

| | Nine Months Ended, | |
|---|--------------------|--------------------|
| | September 29, 2002 | September 30, 2001 |
| Cash flows provided by (used in) operating activities: | | |
| Net income | \$ 2,700 | \$ 2,462 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,357 | 4,359 |
| Interest on employee notes receivable | (22) | |
| Change in assets and liabilities: | | |
| Accounts receivable, net | (1,829) | 1,199 |
| Inventories, net | (814) | 4,459 |
| Other current and non-current assets | 402 | 310 |
| Accounts payable, and accrued liabilities | (5,146) | (4,454) |
| Cash provided by (used in) operating activities | (352) | 8,335 |
| Cash flows from investing activities: | | |
| Restricted cash | 706 | 654 |
| | (7,531) | (4,679) |

| | Nine Months Ended, | |
|---|--------------------|----------|
| | _____ | _____ |
| Expenditures for property, plant and equipment and other assets | | |
| Net cash provided by (used in) investing activities | (6,825) | (4,025) |
| Cash flows from financing activities: | | |
| Proceeds from foreign government grants | 252 | |
| Proceeds from investment allowances | 1,044 | 2,101 |
| Proceeds from borrowings | | 1,055 |
| Principal payments on borrowings | (2,528) | (2,259) |
| Net borrowings (payments) on line of credit | (2,974) | (3,221) |
| Proceeds from sale of stock, net | 15,128 | 970 |
| Proceeds from exercise of stock options | 1,805 | 335 |
| Net cash provided by (used in) financing activities | 12,727 | (1,019) |
| Effect of foreign exchange rate changes on cash | 749 | (208) |
| Net increase in cash and cash equivalents | 6,299 | 3,083 |
| Cash and cash equivalents, beginning of year | 3,362 | 61 |
| Cash and cash equivalents, end of period | \$ 9,661 | \$ 3,144 |
| Supplemental cash flow disclosures: | | |
| Interest paid | \$ 778 | \$ 1,517 |
| Income taxes paid | \$ 72 | \$ 54 |
| Supplemental schedule of non-cash investing and financing activities: | | |
| Notes receivable issued to exercise stock options | \$ 15 | \$ 19 |

See accompanying notes to condensed consolidated financial statements.

SOUTHWALL TECHNOLOGIES INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands)
(Unaudited)

Note 1 Interim Period Reporting:

While the information presented in the accompanying condensed consolidated financial statements is unaudited, it includes all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary to present fairly the Company's financial position and results of operations, and changes in financial position as of the dates and for the periods indicated.

Certain information and footnote disclosures normally contained in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The Company suggests that these consolidated financial statements be read in conjunction with the financial statements and notes thereto contained in the Company's Form 10-K for the year ended December 31, 2001 filed with the Securities and Exchange Commission on April 1, 2002. The results of operations for the interim periods presented are not necessarily indicative of the operating results of the full year.

Note 2 Sale of Common Stock:

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On July 8, 2002, Southwall completed a follow-on public offering of 3,500,000 shares of its common stock at a price of \$4.50 per share. On August 5, 2002, the Company sold an additional 307,300 shares at a price of \$4.50 per share, when its underwriters exercised part of their over allotment option. The net proceeds to the Company from the offering and the over allotment option after deducting underwriting discounts and commission and offering expenses, were approximately \$15.1 million. The Company used approximately \$4.0 million of the net proceeds to pay down the outstanding balance on its line of credit. The Company intends to use the balance of the net proceeds of the offering as follows: \$2.5 million to prepay a portion of the loan from the Japanese bank (see Note 6); approximately \$2.0 million to install an enterprise resource planning system; approximately \$2.5 million towards the purchase of a new production machine (PM 10); and approximately \$1.5 million for production equipment and other capital expenditures. The remaining net proceeds may be used for working capital and general corporate purposes, in connection with the potential resolution of disputes with insurers, or settlement of litigation, or in connection with future acquisitions.

Note 3 Balance Sheet:

Restricted cash

Restricted cash consists of the unexpended portion of grants received from the Saxony government in Germany to co-finance the costs of the construction of the Company's Dresden facility. In the event the Company fails to meet certain conditions related to the grants, the Saxony government has the right to demand repayment of the grants. (See Note 6.)

Inventories, net

Inventories are stated at the lower of cost (determined by the first-in, first-out method) or market. Cost includes materials, labor and manufacturing overhead. Southwall establishes provisions for excess and obsolete inventories to reduce such inventories to their estimated net realizable value. Such

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provisions are charged to cost of sales. At September 29, 2002 and December 31, 2001, inventories consisted of the following:

| Inventories, net | September 29, 2002 | December 31, 2001 |
|--------------------------|-------------------------------|------------------------------|
| Raw materials | \$ 3,036 | \$ 3,545 |
| Work-in-process | 3,137 | 2,430 |
| Finished goods | 792 | 176 |
| Total inventories | \$ 6,965 | \$ 6,151 |

Government grants advanced and investment allowances

Government grants advanced and investment allowances consist of monies received from the Saxony government in Germany by the Company. Upon approval and receipt of the grants and investment allowances from the government, the funds are applied as a reduction of the costs of the Dresden facility. In the event the Company fails to meet certain conditions related to the grants and investment allowances, the Saxony government has the right to reclaim the grants and allowances. (See Note 6.)

Note 4 Net Income Per Share:

Basic net income per share is computed by dividing income available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted net income per share gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted net income per share uses the average market prices during the period. At September 29, 2002, there were 12,094,000 shares outstanding for the basic earnings per share calculation and 12,169,000 shares and dilutive potential shares outstanding for the dilutive earnings per share calculation. At September 30, 2001, there were 8,220,000 shares outstanding for the basic earnings per share calculation and 8,466,000 shares and dilutive potential shares outstanding for the dilutive earnings per share calculation. The total amount of the difference in the basic and diluted weighted average shares of common stock and common stock equivalents at September 29, 2002 and September 30, 2001 is attributable to the effect of dilutive stock options.

Note 5 Term Debt:

The Company's term debt and capital leases consisted of the following at September 29, 2002:

| Description | Rate | Balance at September 29, 2002 | Remaining Due in 2002 |
|--|----------|----------------------------------|-----------------------------|
| Line of credit | (1) | \$ | (1) |
| Term debt: | | | |
| Japanese bank loan guaranteed by Teijin | 3.14%(2) | 6,250 | \$ 3,750 |
| German bank loan dated May 12, 1999 | 6.13%(3) | 2,437 | 84 |
| German bank loan dated May 28, 1999 | 7.10% 4) | 2,465 | |
| German bank loan dated May 28, 1999 | 3.75% | 1,126 | 70 |
| German bank loan dated July 25, 2000 | 7.15%(5) | 1,860 | 58 |
| German bank loan dated August 14, 1999 (due June 30, 2009) | 5.75% | 1,664 | |
| German bank loan dated June 29, 2000 | 5.75% | 252 | 42 |
| German bank loan dated July 10, 2000 | 7.10% | 252 | 42 |
| German bank loan dated December 18, 2000 | 7.50% | 191 | 21 |
| German bank loan dated December 19, 2000 | 7.50% | 174 | 20 |
| Note payable dated September 21, 2001 | 8.00% | 220 | 150 |
| Other equipment financings | | 142 | 24 |
| Total term debt | | 17,033 | 4,261 |
| Capital leases: | | | |
| Sales-leaseback dated July 19, 1999 | 13.00% | 2,321 | 2,321 |
| Sales-leaseback dated October 19, 1999 | 13.00% | 946 | 946 |
| Total capital leases | | 3,267 | 3,267 |
| Total term debt and capital leases | | 20,300 | \$ 7,528 |
| Less current portion | | 9,845 | |
| Term debt, non current | | \$ 10,455 | |

(1) This line of credit expires in June 2003. Under the line, the Company can borrow an amount equal to 80% of eligible accounts receivable. The Company pays a finance fee per month equal to 0.88% of the average daily balance of the amount of accounts receivable against which the Company has borrowed. The Company is required to repay the lender amounts borrowed when it receives payments of these accounts receivable.

(2)

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As of September 29, 2002, the interest rate on this loan was 3.14%.

- (3) Interest rate will be reset to the then prevailing market rate in 2004.
- (4) Interest rate will be reset to the then prevailing market rate in 2009.
- (5) Interest rate will be reset to the then prevailing interest rate in 2005.

The Japanese bank loan, dated May 6, 1997, is guaranteed by Teijin Limited (Teijin), a Japanese company. Teijin is a stockholder of and supplier of substrate materials to the Company. In consideration of the guarantee, Teijin also received warrants in 1997 to purchase 158,000 shares of Southwall's common stock at \$9 per share. These warrants were not exercised and expired on May 30, 2000. The Teijin guarantee is collateralized by certain equipment located in Southwall's Tempe manufacturing facility and inventory, to the extent necessary to provide 120% net book value coverage

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of the outstanding loan balance. The interest rate on the loan is re-set semi-annually at LIBOR plus 1.0%, (5.25% at September 30, 2001, and 3.14% at September 29, 2002). The Company is also subject to certain financial covenants under the guarantee. The Company pays Teijin semi-annually a loan guarantee service fee equal to 0.5625% of the outstanding balance. The loan requires semi-annual payments of interest only during the first four years, followed by semi-annual installments plus interest, beginning in May 2001, for the remaining three and one half year term. At December 31, 2001, the Company was not in compliance with certain of the financial covenants with Teijin pertaining to this promissory note. Southwall has received a waiver from Teijin and the Japanese bank of any defaults that may exist through and including September 30, 2003 arising out of its failure to comply with the financial covenants of the guarantee agreement relating to minimum quick ratio, tangible net worth and maximum debt/tangible net worth. The waiver was conditioned on the Company's agreement to prepay \$2.5 million of the debt from the proceeds of its public offering. (See Note 2.) As a result, the Company will prepay \$2.5 million, in addition to the next scheduled principal payment of \$1.25 million, on November 6, 2002. All payments due on the loan have been paid when due (including the scheduled principal payment of \$1.25 million due and paid in May 2002), and the Company is current in all principal and interest payments due under the loan. At September 29, 2002, the Company was in compliance with all of the financial covenants specified in the Teijin loan guarantee. The Company classified \$1.25 million as long-term debt on the balance sheet at September 29, 2002.

During 1999, Southwall entered into a master equipment sale-leaseback agreement with a leasing company ("lessor"). Because the Company has an option to purchase the equipment at a price to be determined between Southwall and the lessor at the end of the lease period, the sale-leaseback agreements have been treated as a financing. One lease has a lease term of three years and the other lease has an initial lease term of two years with an option to extend it for an additional year. At September 29, 2002, the Company had a total of \$3.3 million outstanding and due under these leases. The leased equipment and certain other production equipment owned by the Company collateralize the sale-leaseback agreements. The effective interest rate of both is approximately 13% per annum and the leases are repayable over the lease term commencing in May 2000. The Company is in dispute with the lessor over interpretation of certain terms of the lease agreement and has withheld lease payments due since March 2001. The lessor has notified the Company that it considers the Company to be in default and in January 2002 drew down on a letter of credit in the amount of \$0.5 million that collateralized the Company's obligations; in May, 2002, a suit was filed against the Company demanding payment of unpaid lease payments and alleged residual values. (See Note 8.) The Company classified the \$3.3 million due under the leases, net of a \$1.0 million holdback not funded by the lessor, as a current liability in the accompanying balance sheet at September 29, 2002.

On May 12, 1999, the Company entered into a loan agreement with a German bank that provides for borrowings up to euros 3.1 million (\$3.1 million). Under the terms of this agreement, the funds were used solely for the purpose of capital investment by Southwall's German subsidiary. The term of the loan is for a period of 10 years and the principal is repayable in euros after the end of one year in 36 quarterly payments. The loan bears interest at 6.125% per annum for the first five years, and will be revised to the prevailing rate at the end of the fifth year. The Company is current in all principal and interest payments due under the loan; the agreement contains various covenants with which the Company was in compliance at September 29, 2002. Of the borrowings outstanding of \$2.4 million under this bank loan at September 29, 2002, \$2.2 million was classified as noncurrent in the accompanying balance sheet.

On May 28, 1999, the Company entered into a general loan agreement with a German bank. Under the terms of the loan agreement, funds were made available in three tranches, and were used solely for the purpose of capital investment by the Company's German subsidiary. The agreement contains various covenants with which the Company was in compliance at September 29, 2002; the Company is current with respect to all principal and interest payments due under the loan agreement.

Under the first tranche, the Company borrowed euro 2.5 million (\$2.5 million) for a term of twenty years beginning on May 28, 1999. The principal is repayable in euros beginning after ten years in ten equal, semi-annual payments. The loan bears fixed interest of 7.1% per annum for the first ten years, after which time the rate will be adjusted to a current prevailing rate. Of the borrowings outstanding under this tranche of \$2.5 million at September 29, 2002, \$2.5 million was classified as noncurrent in the accompanying balance sheet. Under the second tranche, the Company borrowed euro 1.7 million (\$1.7 million) for a term of seven years beginning May 28, 1999 and the principal is repayable after one year in twelve equal, semi-annual payments. The loan bears fixed interest at 3.75% per annum for the period of seven years. At September 29, 2002, the amount due under this second tranche was \$1.1 million, and \$0.8 million was classified as a noncurrent liability. Under the third tranche, of the Company borrowed euro 2.1 million (\$2.1 million) for a term of ten years beginning on July 25, 2000, and the principal is repayable after one year, in thirty-six equal quarterly payments. The loan bears fixed interest of 7.15% per annum for the first five years, after which time the rate will be adjusted to a current prevailing market rate. At September 29, 2002, the amount due was \$1.9 million; of this amount, \$1.6 million was classified as noncurrent.

On August 14, 1999, the Company entered into a loan agreement with a German bank that provides for borrowings up to euros 1.7 million (\$1.7 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is due in a single payment on June 30, 2009 and bears interest at a rate of 5.75% per annum. The interest is payable quarterly in euros. Fifty percent of the loan proceeds are restricted in an escrow account for the duration of the loan period and are classified as non-current "Restricted loan proceeds." The agreement contains various covenants with which the Company was in compliance at September 29, 2002. The amount due under this bank loan at September 29, 2002 was \$1.7 million, which was classified as noncurrent.

On June 29, 2000, the Company entered into a loan agreement with a German bank that provides for borrowings up to euros 0.5 million (\$0.5 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is repayable in 12 quarterly payments beginning June 2001 and bears interest at a rate of 5.8% per annum. The interest is payable quarterly in euros. The agreement contains various covenants with which the Company was in compliance at September 29, 2002. The amount due under this bank loan was \$0.3 million at September 29, 2002; of this amount, \$0.1 million was classified as noncurrent.

On July 10, 2000, the Company entered into a loan agreement with a German bank that provides for borrowings up to euros 0.5 million (\$0.5 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is repayable in 12 quarterly payments beginning June 2001 and bears interest at a rate of 7.10% per annum. The interest is payable quarterly in euros. The agreement contains various covenants with which the Company was in compliance at September 29, 2002. The amount due under this bank loan was \$0.3 million; of this amount, \$0.1 million was classified as noncurrent at September 29, 2002.

On December 18, 2000, the Company entered into a loan agreement with a German bank that provides for borrowings up to euros 0.2 million (\$0.2 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is repayable in nine quarterly payments beginning March 2002 and bears interest at a rate of 7.5% per annum. The interest is payable quarterly in euros. At September 29, 2002, the amount outstanding under this bank loan was \$0.2 million; of this amount, \$0.1 million was classified as noncurrent at September 29, 2002.

On December 19, 2000, the Company entered into a loan agreement with a German bank that provides for borrowings up to euros 0.3 million (\$0.3 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The

principal balance is repayable in 12 quarterly payments beginning March 2002 and bears interest at a rate of 7.5% per annum. The interest is payable quarterly in euros. At September 29, 2002, the amount outstanding under this bank loan was \$0.2 million; of this amount, \$0.1 million was classified as noncurrent at September 29, 2002.

The preceding German bank loans are collateralized by the production equipment, building and land owned by the Company's German subsidiary. The dollar equivalent value for the preceding German bank loans has been calculated using the euro exchange rate as of September 29, 2002.

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On September 21, 2001, the Company entered into a note payable agreement with the manufacturer of one of the Company's production machines, PM 7, located at the Company's Tempe facility, for the remaining balance of \$0.96 million owed on the machine. The first installment on the note was paid on September 26, 2001 in the amount of \$0.14 million. The remaining balance of the note is payable in 16 monthly installments, with the final payment due on January 23, 2003. The note bears interest at 8.0% per annum. At September 29, 2002, the amount outstanding under this note was \$0.2 million; this entire amount was classified as current at September 29, 2002.

Other term debt consists of capitalized leases related primarily to certain computer equipment used by the Company.

Scheduled principal reductions of term debt for the balance of 2002 (which includes the \$2.5 million the Company agreed to prepay to the Japanese bank from the proceeds of the Company's follow-on public offering) and each of the four years following and thereafter, are as follows:

| Year | Amount |
|----------------|-----------|
| 2002-remaining | \$ 7,528 |
| 2003-annual | 4,011 |
| 2004-annual | 1,122 |
| 2005-annual | 850 |
| 2006-annual | 780 |
| Thereafter | 6,009 |
| Total | \$ 20,300 |

The Company incurred total interest expense of \$0.4 million and \$0.6 million in third quarters of 2002 and 2001. The Company did not capitalize any portion of these amounts as part of the costs related to the construction of new production machines and facilities or otherwise.

Note 6 Government Grant and Investment Allowances:

The Company has an agreement to receive cash grant awards (the "Grant"), which was approved by the Saxony government in May 1999. As of September 29, 2002, the Company had received approximately euros 5.6 million (\$4.7 million) under this Grant and accounted for the Grant by applying the proceeds received to reduce the cost of fixed assets of the Dresden manufacturing facility. Additionally, as of September 29, 2002, the Company has a balance remaining from the government grants received in May 1999 of euros 0.8 million (\$0.8 million) which has been recorded as an advance and held as restricted cash until the Company receives approval from the Saxony government to apply the funds to reduce its capital expenditures.

Giving the effect to an amendment of the terms of the Grant, the Grant is subject to the following requirements:

- (a) The grant was earmarked to co-finance the costs of the construction of a facility to manufacture XIR® film for the automotive glass industry.
- (b) The construction period for the project is from March 15, 1999 to June 30, 2006.
- (c) The total investment during the construction period should be at least euros 47.0 million (\$39.2 million).
- (d) The project must create at least 143 permanent jobs and 7 apprenticeships by June 30, 2006.

If the Company fails to meet the above requirements, the Saxony government has the right to demand repayment of the Grant.

In addition to the Grant, the Company is further eligible for cash investment allowances from the Saxony government calculated based on the total projected capital investment by the Company in its Dresden facility of euros 47.0 million (\$39.2 million), subject to European Union regulatory approval. During 2000, the Company received euros 1.2 million (\$1.0 million) in investment allowances from the Saxony

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government, and those proceeds were applied to reduce the capitalized construction cost of the Dresden facility. The Company received an additional euros 2.5 million (\$2.1 million) in investment allowances from the Saxony government in 2001, and those proceeds were applied to reduce the capitalized construction cost of the Dresden facility. The Company received approximately euros 1.2 million (\$1.0 million) in investment allowances in the second quarter of 2002, which were also applied to reduce the capitalized construction cost of the Dresden facility. These investment allowances are subject to the following requirements:

- (a) The movable and immovable assets, the acquisition costs of which are taken into account in determining the investment allowance, shall be employed within the subsidized territory for a period of at least five years following the acquisition or production.
- (b) The movable assets, the acquisition costs of which are taken into account in determining the increased investment allowance, shall remain in a business that is engaged in the processing industry, or in a similar production industry, for a period of at least five years following the acquisition or production.

If the Company fails to meet the above requirements, the Saxony government has the right to demand repayment of the allowances.

The Grants and investment allowances, if any, that the Company is entitled to seek from the Saxony government varies from year to year based upon the amount of capital expenditures that meet the above requirements. Generally, Southwall is not eligible to seek total investment grants for any year in excess of 33% of its eligible capital expenditures for that year. The Company cannot guarantee that it will be eligible for or receive additional grants or allowances in the future.

Note 7 Segment Reporting:

Southwall reports segment information using the management approach to determine segment information. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of its reportable segments. The Company is organized on the basis of products and services. The total net revenues for the automotive glass, electronic display, and architectural product lines were as follows:

| | Three Months Ended | | Nine Months Ended | |
|---------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 29, 2002 | September 30, 2001 | September 29, 2002 | September 30, 2001 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) |
| Automotive glass | \$ 7,010 | \$ 10,817 | \$ 20,931 | \$ 28,191 |
| Electronic display | 4,976 | 7,318 | 20,529 | 22,824 |
| Architectural | 4,304 | 4,642 | 13,775 | 11,421 |
| Total net revenues | \$ 16,290 | \$ 22,777 | \$ 55,235 | \$ 62,436 |

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The following is a summary of net revenues by geographic area (based on the location of the Company's customers) for the third quarter and first nine months of 2002 and 2001, respectively.

| | Three Months Ended | | Nine Months Ended | |
|---------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 29, 2002 | September 30, 2001 | September 29, 2002 | September 30, 2001 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) |
| United States | \$ 2,744 | \$ 3,268 | \$ 8,912 | \$ 8,695 |

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| | Three Months Ended | | Nine Months Ended | |
|---------------------------|--------------------|------------------|-------------------|------------------|
| | | | | |
| Japan | 4,730 | 6,833 | 19,193 | 19,204 |
| France | 2,962 | 5,040 | 10,816 | 14,780 |
| Pacific Rim | 2,636 | 2,429 | 7,580 | 7,873 |
| Germany | 2,077 | 3,334 | 4,772 | 6,779 |
| Rest of world | 1,141 | 1,873 | 3,962 | 5,105 |
| Total net revenues | \$ 16,290 | \$ 22,777 | \$ 55,235 | \$ 62,436 |

The Company's five largest customers accounted for net revenues in the periods below equal to the following percentages of the Company's total net revenue for each such period:

| Customer | Three Months Ended | | Nine Months Ended | |
|--------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 29, 2002 | September 30, 2001 | September 29, 2002 | September 30, 2001 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) |
| A | 17.9% | 22.1% | 19.5% | 23.6% |
| B | 15.2% | 22.8% | 17.2% | 23.2% |
| C | 13.1% | 6.1% | 15.1% | 6.2% |
| D | 14.4% | 19.7% | 10.7% | 15.9% |
| E | 12.9% | 6.7% | 9.6% | 6.6% |
| Total | 73.6% | 77.4% | 72.2% | 75.4% |

Note 8 Contingencies:

The Company is a defendant in an action entitled "Portfolio Financial Servicing Company v. Southwall Technologies Inc.," which was filed in state court in Utah on May 22, 2002. This action arises out of sale-leaseback agreements which the Company entered into with an entity formerly known as Matrix Funding Corporation, or Matrix, in 1999 in connection with the acquisition of two of the Company's production machines, as described in Note 6 to these financial statements. Matrix thereafter filed bankruptcy. In the action, the plaintiff purports to be an agent of the successor to Matrix. The plaintiff demands payment of \$6,468,534, which it alleges constitutes unpaid lease payments, plus the alleged residual value of the equipment, less monies that Matrix owes to the Company. The Company has filed a motion to dismiss the complaint and intends to defend the action vigorously.

The Company is a defendant in an action filed on April 5, 1996 entitled "Four Seasons Solar Products Corp. vs. Black & Decker Corp., Bostik, Inc. and Southwall Technologies Inc.", No. 5 CV1695, pending in the United States District Court for the Eastern District of New York. Plaintiff is a manufacturer of insulated glass units which incorporate the Company's Heat Mirror film. Plaintiff alleges that a sealant provided by the co-defendant is defective, asserts causes of action for breach of contract, unfair competition, and fraudulent concealment, and seeks monetary damages of approximately \$36 million for past and future replacement costs, loss of customer goodwill, and punitive damages against all defendants. The Company filed a motion to dismiss. The Court has dismissed the unfair competition and fraudulent concealment claims against the Company. It has denied the Company's motion to dismiss the breach of contract claim. The Company believes the claim to be without merit. The Company's insurance carrier covers defense of this action, in part, and the

Company expects that settlements, if any, will be substantially covered by its insurance policy. The action was stayed in its early stages, and remains stayed pending the court's decision on the Company's pending motion for judgment on the pleadings, thus an estimate of the Company's loss exposure cannot be made. Management plans to vigorously contest the claim.

In October 2000, the Company was served with a complaint entitled "Hurd Millwork, Inc. v. Southwall Technologies Inc., et. al.," filed in the United States District Court, Northern District of California, Case No. C00-3820 (CRB). The plaintiff is a manufacturer of installed glass

units, which incorporated the Company's Heat Mirror film. The plaintiff alleged that various failures and deficiencies associated with the installed glass units gave rise to warranty and other consumer claims. The Company reached a settlement with the plaintiffs, the terms of which are confidential. The Company's insurance carrier paid the cash portion of the settlement. The Company also agreed to provide a discount on the price of future film sales as part of the settlement. The Company did not commit to or guarantee an aggregate dollar amount that the plaintiff would be entitled to receive as a discount; the discount is entirely contingent on future purchases of architectural glass product by the plaintiff from the Company during a four-year period ending February 2006. Due to the contingent nature of the discount to be granted in the future, no amount has been recorded by the Company as a sales discount liability for the settlement at September 29, 2002.

The insurance carriers in some of the litigation related to alleged failures and defects in window products manufactured by third parties in which the Company was a defendant paid the defense and settlement costs related to such litigation. Those insurance carriers reserved their rights and have expressed their intent to proceed against the Company to recover a portion or all of such payments. As a result, those insurance carriers could seek from the Company up to an aggregate of \$12.9 million plus defense costs, although any such recovery would be restricted to claims that were not covered by the Company's insurance policies. The Company intends to vigorously defend any attempts by these insurance carriers to seek reimbursement. The Company is not able to estimate the likelihood that these insurance carriers will seek to recover any such payments, the amount, if any, they might seek, or the outcome of such attempts. As a result, no adjustment has been recorded due to the uncertainty surrounding the potential exposure. Management can give no assurance that the insurers will not assert a material claim at some future date.

In July 2002, Southwall was served with a complaint in a lawsuit captioned "Hurricane Glass v. Southwall Technologies Inc. and V-Kool, Inc." filed in the Circuit Court of the Twelfth Judicial Circuit in and for Sarasota County, Florida. The Plaintiff was a distributor of the Company's SOLIS brand window film. The Complaint alleges that the SOLIS film was not fit for its intended purpose and brings claims for breach of written and oral contract against the Company. The Complaint alleges approximately \$440,000 in damages against both defendants. We believe the claims to be without merit and intend to defend the action vigorously.

The Company has been named as a defendant, along with Bostik, Inc., in an action entitled "WASCO Products, Inc. v. Southwall Technologies Inc. and Bostik, Inc.," Civ. Action No. C 02-2926 CRB, which was filed in Federal District Court for the Northern District of California on June 18, 2002. The plaintiff has filed the matter as a purported class action on behalf of all entities and individuals in the United States who manufactured and/or sold and warranted the service life of insulated glass units manufactured between 1989 and 1999 which contained the Company's Heat Mirror film and were sealed with a specific type of sealant manufactured by the co-defendant. The plaintiff alleges that the sealant provided by the co-defendant was defective, resulting in elevated warranty replacement claims and costs, and asserts claims against Southwall for breach of an implied warranty of fitness, misrepresentation, fraudulent concealment, negligence, negligent interference with prospective economic advantage, breach of contract, unfair business practices and false or misleading business practices. The plaintiff seeks recovery of \$100 million for damages allegedly resulting from elevated warranty replacement claims, restitution, injunctive relief, and non-specified compensation for lost

profits. The Company believes all of the claims to be without merit and intends to defend the action vigorously. The Company has tendered the defense of this matter to its insurers, which the Company believes are obligated to pay the costs incurred in defending this suit and, if necessary, any resulting settlement or judgment up to the limits of the policies involved. The insurance carriers have accepted the defense of this matter while reserving their rights. The action is in the early stages, and thus an estimate of the Company's loss exposure cannot be made. The Company plans to vigorously contest the claim.

In addition, the Company is involved in certain other legal actions arising in the ordinary course of business. The Company believes, however, that none of these actions, either individually or in the aggregate, will have a material adverse effect on the Company's business or consolidated financial position, results of operations or cash flows.

Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations:

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The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes thereto appearing elsewhere in this report. This discussion and analysis contains forward-looking statements that involve risks and uncertainties, including those discussed below under "Forward-Looking Statements" and "Risk Factors" and in the Company's Annual Report on Form 10-K for the year ended December 31, 2001. You should not place undue reliance on these forward-looking statements. Actual results may differ materially from those anticipated in the forward-looking statements. These forward-looking statements represent the Company's judgment as of the date of the filing of this Form 10-Q.

General

We are a global developer, manufacturer and marketer of thin film coatings for the automotive glass, electronic display and architectural markets. We have developed a variety of products that control sunlight in automotive glass, reduce light reflection and improve image quality in electronic display products and conserve energy in architectural products. Our products consist of transparent solar-control films for automotive glass; anti-reflective films for computer screens, including flat panel displays, plasma displays, and transparent conductive films for use in touch screen and liquid crystal displays; energy control films for architectural glass; and various other coatings.

From our founding in 1979 through the early 1990s, we developed and produced thin film coated substances primarily for residential and commercial building applications, and for military applications. In the early 1990s, we began to develop products for the automotive and electronic display markets. In 1996, we realized our first material revenue from the automotive and electronic display markets. In 2001, automotive glass products accounted for approximately 45% of our revenues, electronic display products accounted for approximately 36% of our revenues, and architectural products accounted for approximately 19% of our revenues. In the first nine months of 2001, automotive glass products accounted for approximately 45% of our revenues, electronic display products accounted for approximately 37% of our revenues, and architectural products accounted for approximately 18% of our revenues. In the first nine months of 2002, automotive glass products accounted for approximately 38% of our revenues, electronic display products accounted for approximately 37% of our revenues, and architectural products accounted for approximately 25% of our revenues. Revenues from international customers accounted for 78%, 85%, 87% and 84% of our net revenues in 1999, 2000, 2001 and the first nine months of 2002, respectively.

The Company has seen a softening of orders during 2002, primarily in the automotive glass and electronic display markets. The reduction in sales to the automotive glass OEM producers is indicative of the slowdown in sales of new automobiles by certain European automobile manufacturers. The decline in the Company's sales of its electronic display products reflects the world-wide economic weakness within the computer industry. In addition, the Company implemented a workforce reduction in July 2002 of approximately 25 full-time employees to lower its costs. Southwall recorded a charge for severance costs of approximately \$0.1 million during the third quarter of 2002 for the July workforce reduction. The workforce reduction in the third quarter followed a series of measures implemented in 2001 and 2002 to control costs and improve operating efficiencies including a 10% reduction in our work force in 2001.

Three Months Ended September 29, 2002 compared with Three Months Ended September 30, 2001

Net revenues. Our net revenues decreased \$6.5 million, or 28.5%, from \$22.8 million for the third quarter of 2001 to \$16.3 million for the third quarter of 2002. Our sales to the automotive market decreased by \$3.8 million, or 35.2%, from \$10.8 million in the third quarter of 2001 to \$7.0 million in the third quarter of 2002. The decline was due to reductions in our selling prices and lower sales

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volume as a result of increased competition from coated glass manufacturers, and a slowdown in sales by several major European automobile manufacturers. We believe this slowdown in the European automobile market will continue throughout 2002 and into 2003. Our sales to the electronic display market decreased by \$2.3 million, or 31.5%, from \$7.3 million in the third quarter of 2001 to \$5.0 million in the second quarter of 2002. The decrease in sales was primarily the result of a decline in CDT revenues resulting from lower selling prices, which was partially offset by increased sales of our new plasma display film product. Our sales to the architectural market decreased \$0.4 million, or 8.5%, from \$4.7 million in the third quarter of 2001 to \$4.3 million in the third quarter of 2002. The decrease was primarily attributable to a reduction in orders from several major architectural customers. We experienced a reduction in warranty claims in the third quarter of 2002 from the third quarter of 2001, which had the effect of increasing our net revenue above what it would have been had our level of warranty claims been the same as in the third quarter of 2001.

Cost of sales. Cost of sales consists primarily of materials and subcontractor services, labor and manufacturing overhead. Cost of sales decreased \$3.9 million, or 25.0%, from \$15.6 million in the third quarter of 2001, to \$11.7 million in the third quarter of 2002, which is consistent with the reduction in the Company's revenues in the third quarter of 2002 compared to the third quarter of 2001. The higher manufacturing costs in 2001 were primarily due to start-up costs in our Dresden operation and higher material and outside processing costs incurred as a result of higher sales in the third quarter last year when compared to 2002. In addition, the Company implemented a new program in 2002 with one of its precious metal suppliers to recover expended precious metals used in production, which yielded a \$0.4 million reduction in materials costs in the third quarter of 2002 from the third quarter in the prior year. Cost of sales as a percentage of net revenue increased from

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68.4% in the third quarter of 2001, to 71.8% for the same period in 2002. Facility costs, depreciation expense and labor costs comprise the majority of the Company's manufacturing expenses. These costs are relatively fixed and do not fluctuate significantly. As a result of these fixed costs, the increase in cost of sales as a percentage of revenue, was primarily the result of lower revenues in the third quarter of 2002 as compared to the same period last year.

Gross profit and gross margin. Our gross profit decreased \$2.5 million, or 35.2%, from \$7.1 million in the third quarter of 2001, to \$4.6 million in the third quarter of 2002. Our gross margin declined from 31.1% in the third quarter of 2001, to 28.2% in the third quarter of 2002. The decreases in gross profit and gross margin in the 2002 period from the 2001 period were due to decreased revenues, combined with relatively fixed manufacturing expenses, partially offset by reduced warranty claims, the absence of start-up costs related to our Dresden operation in the 2002 period, lower material and outside processing costs associated with lower sales in the 2002 period, and the recovery of precious metals expended during production.

Operating Expenses

Research and development. Research and development spending increased \$0.5 million, or 35.7%, from \$1.4 million in the third quarter of 2001, to \$1.9 million in the third quarter of 2002. Research and development expenses increased from 6.1% of net revenues in the third quarter of 2001, to 11.7% of net revenues in the third quarter of 2002. The increase in our research and development spending during the third quarter of 2002 was primarily attributable to an increase in on-going research and development activities in the U.S. for plasma display products, and the next generation of film products designed for the automotive market.

Selling, general and administrative. Selling, general and administrative expenses consist primarily of corporate and administrative overhead, selling commissions, advertising costs and occupancy costs. These expenses decreased \$0.3 million, or 11.1%, from \$2.7 million in the third quarter of 2001, to \$2.4 million in the third quarter of 2002. The reduction in expense was primarily the result of a reduction in incentive bonus accruals, and bad debt expense, which were partially offset by

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increased sales and marketing headcount, and higher travel expenses by our sales staff. Selling, general and administrative expenses, as a percentage of revenue, increased from 11.8% in the third quarter of 2001, to 14.7% in the third quarter of 2002. The increase in these expenses, as a percentage of revenue, in 2002 was primarily due to lower revenues in the third quarter of 2002.

Income from operations. Income from operations decreased from \$3.1 million in the third quarter of 2001, to \$0.3 million for the same period in 2002. The decline in the 2002 period from the 2001 period was due to lower revenues, relatively fixed manufacturing expenses and higher research and development costs, partially offset by a reduction in warranty claims, the absence of start-up costs related to our Dresden operation in the 2002 period, lower material and outside processing costs associated with lower sales in the 2002 period, the recovery of precious metals expended during production, and a reduction in administrative expenses.

Interest expense, net. Net interest expense decreased \$0.2 million, or 33.3%, from \$0.6 million in the third quarter of 2001, to \$0.4 million in the third quarter of 2002. The reduction in interest expense was primarily attributable to the pay down of the Company's outstanding line of credit balance during the quarter, lower interest rates and the reduction of our total outstanding term debt, by \$4.9 million from \$25.2 million at September 30, 2001, to \$20.3 million at September 29, 2002.

Other income (loss), net. Other income (loss), net includes interest income and foreign exchange transaction gains and losses. We recorded other loss of a minimal amount in the third quarter of 2001, compared with \$0.2 million in the third quarter of 2002. The increase in other income was primarily attributable to foreign currency gains and higher interest income. Some of our transactions with foreign suppliers are denominated in foreign currencies, principally the Japanese yen. As exchange rates fluctuate relative to the U.S. dollar, exchange gains and losses occur.

Income before provision for income taxes. We recorded a pre-tax profit of \$2.4 million in the third quarter of 2001, compared to a pre-tax profit of \$0.1 million in the third quarter of 2002. The decline in profitability was due to lower revenues, relatively fixed manufacturing expenses and higher research and development costs, partially offset by a reduction in warranty claims, the absence of start-up costs related to our Dresden operation in the 2002 period, lower material and outside processing costs associated with lower sales in the 2002 period, the recovery of precious metals expended during production, a reduction in administrative expenses, foreign currency gains and higher interest income.

Income taxes. In 2002, the federal government enacted legislation that established a tax holiday on alternative minimum tax obligations for 2001 and 2002. As a result, the Company was able to use an operating loss carry-forward to offset fully federal income taxes incurred during the quarter.

Nine Months Ended September 29, 2002 compared with Six Months Ended September 30, 2001

Net revenues. Our net revenues decreased \$7.2 million, or 11.5%, from \$62.4 million for the first nine months of 2001 to \$55.2 million for the first nine months of 2002. Our sales to the automotive market decreased by \$7.3 million, or 25.9%, from \$28.2 million in the first nine months of 2001 to \$20.9 million in the first nine months of 2002. The decline was due to lower sales volume due to reductions in our selling prices and lower sales volume as a result of increased competition from coated glass manufacturers and a slowdown in sales by several European automobile manufacturers. Our sales to the electronic display market decreased by \$2.3 million, or 10.1%, from \$22.8 million in the first nine months of 2001 to \$20.5 million in the first nine months of 2002. We experienced a decline in revenue from our CDT products in the first nine months of 2002, which was partially offset by an increase in sales of our new plasma display film product. Our sales to the architectural market increased \$2.4 million, or 21.1%, from \$11.4 million in the first nine months of 2001 to \$13.8 million in the first nine months of 2002. The increase was primarily attributable to additional available manufacturing capacity that had been previously dedicated to the manufacture of products for the automobile market, partially offset by a reduction in orders from several major architectural customers.

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We experienced a reduction in warranty claims in the first nine months of 2002 from the first nine months of 2001, which had the effect of increasing our net revenue above what it would have been had our level of warranty claims been the same as in the first nine months of 2001.

Cost of sales. Cost of sales decreased \$9.7 million, or 20.7%, from \$46.8 million in the first nine months of 2001, to \$37.1 million in the first nine months of 2002. Cost of sales as a percentage of net revenue decreased from 75.0% in the first nine months of 2001, to 67.2% for the same period in 2002. The higher costs in 2001 in dollars, and as a percentage of revenues, were primarily due to greater start-up costs in our Dresden operation. We also realized improved manufacturing yields in our Palo Alto, Tempe and Dresden facilities during the first nine months of 2002, compared to the first nine months of 2001. In addition, we also benefited in the first nine months of 2002, compared with the same period in 2001, from producing a greater portion of our products at our Dresden plant, which generally has had lower manufacturing costs than the Company's United States facilities as a result of lower payroll and operating expenses, as well as lower depreciation charges due to the grants and investment allowances for plant and equipment provided to us by the Saxony government. Additionally, our new program to recover expended precious metals used in production resulted in a \$0.4 million reduction in material costs in the 2002 period from the 2001 period.

Gross profit and gross margin. Our gross profit increased \$2.6 million, or 16.7%, from \$15.6 million in the first nine months of 2001, to \$18.2 million in the first nine months of 2002. Our gross margin improved from 25.0% in the first nine months of 2001, to 32.9% in the first nine months of 2002. The increase in gross profit and gross margin in the 2002 period from the 2001 period was due to increased revenues from the Dresden plant with its lower cost base, cost savings and yield improvements in our Palo Alto, Tempe and Dresden facilities, a reduction in warranty claims, and the recovery of precious metals expended during production, partially offset by a reduction in revenue during the 2002 period.

Operating Expenses

Research and development. Research and development spending increased \$1.7 million, or 42.5%, from \$4.0 million in the first nine months of 2001, to \$5.7 million in the first nine months of 2002. Research and development expenses increased from 6.4% of net revenues in the first nine months of 2001, to 10.3% of net revenues in the first nine months of 2002. The increase in our research and development spending during the first nine months of 2002 was primarily attributable to the costs associated with an increase in on-going research and development activities in the U.S. and development costs incurred in our Dresden facility to qualify PM8 and PM9 for the production of Heat Mirror products.

Selling, general and administrative. Selling, general and administrative expenses increased \$0.7 million, or 8.3%, from \$8.4 million in the first nine months of 2001, to \$9.1 million in the first nine months of 2002. Selling, general and administrative expenses, as a percentage of revenue, increased from 13.5% in the first nine months of 2001, to 16.5% in the first nine months of 2002. The higher expenses in the first nine months of 2002 were mainly the result of increased outside professional fees, partially offset by a reduction in the Company's incentive bonus accruals.

Income from operations. Income from operations increased from \$3.2 million in the first nine months of 2001, to \$3.3 million for the first nine months of 2002. The improvement was due to reduced start-up costs from our Dresden operations, improved manufacturing yields, lower warranty claims, the recovery of precious metals expended during production, and a reduction in incentive bonus accruals, partially offset by lower revenues, higher development costs, and increased outside professional fees.

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Interest expense, net. Net interest expense decreased \$0.8 million, or 36.4%, from \$2.2 million in the first nine months of 2001, to \$1.4 million in the first nine months of 2002. The reduction in interest expense was primarily attributable to lower interest rates and the reduction of our overall debt,

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including under our line of credit, by \$10.4 million from \$30.7 million at September 30, 2001, to \$20.3 million at September 29, 2002.

Other income, net. We recorded other income of \$1.3 million in the first nine months of 2001, compared with \$0.7 million in the first nine months of 2002. The reduction was primarily attributable to foreign currency fluctuations. Some of our transactions with foreign suppliers are denominated in foreign currencies, principally the Japanese yen. As exchange rates fluctuate relative to the U.S. dollar, exchange gains and losses occur.

Income before provision for income taxes. We recorded a pre-tax profit of \$2.5 million in the first nine months of 2001, compared to a pre-tax profit of \$2.7 million in the first nine months of 2002. Our improvement from 2001 was due to reduced start-up costs from our Dresden operations, improved manufacturing yields in our Palo Alto, Tempe and Dresden facilities, reduced warranty claims, the recovery of precious metals expended during production, and a reduction in incentive bonus accruals, which were partially offset by a reduction in revenues, an increase in outside professional fees and a reduction in income derived from foreign currency fluctuations.

Income taxes. In 2002, the federal government enacted legislation that established a tax holiday on alternative minimum tax obligations for 2001 and 2002. As a result, we received a refund during the second quarter from the Internal Revenue Service for our 2002 alternative minimum tax payment, and we were able to use an operating loss carry-forward to offset fully the federal income taxes incurred during the period.

Liquidity and Capital Resources

Liquidity:

On July 8, 2002, Southwall completed a follow-on public offering of 3,500,000 shares of its common stock at a price of \$4.50 per share. On August 5, 2002, the Company sold an additional 307,300 shares at a price of \$4.50 per share, when its underwriters exercised a portion of their over allotment option. The net proceeds to the Company from the offering, and the over allotment option after deducting underwriting discounts and commission and offering expenses, were approximately \$15.1 million.

Our cash increased by \$6.6 million from \$3.1 million at September 30, 2001, to \$9.7 million at September 29, 2002. Cash provided by operating activities in the first nine months of 2002 declined by \$8.7 million, from \$8.3 million generated during the first nine months of 2001, to \$0.4 million expended during the first nine months of 2002. Net income improved to \$2.7 million for the first nine months of 2002 compared to \$2.5 million for the first nine months of 2001. The decline in cash provided by operating activities was primarily the result of an increase in accounts receivable and inventory, and a reduction in accounts payable and accrued liabilities. The cash used in investing activities increased by \$2.8 million, to \$6.8 million used in the first nine months of 2002, compared to cash used in investing activities of \$4.0 million in the first nine months of 2001. The increase was primarily attributable to higher capital expenditures, offset by a reduction in restricted cash. We increased cash from financing activities by \$13.7 million, to \$12.7 million provided during the first nine months of 2002, from \$1.0 million in cash used in financing activities during the first nine months of 2001. The increase was primarily attributable to cash received from the Company's follow-on public offering, through the exercise of employee stock options, and proceeds from investment allowances received from the Saxony government during the second quarter of 2002, which were partially offset by the pay down of our outstanding line of credit balance in the third quarter and principal payments on our term debt.

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We entered into an agreement with the Saxony government in May 1999 under which we receive investment grants and investment allowances. Through September 29, 2002, we had received \$4.7 million of the grants and accounted for these grants by applying the proceeds received to reduce the cost of the fixed assets at our Dresden manufacturing facility. During 2000, we also received \$1.0 million in investment allowances, which are reimbursements for capital expenditures, from the Saxony government and those proceeds were also applied to reduce the cost of the fixed assets at our Dresden manufacturing facility. We received an additional \$2.1 million in investment allowances from the Saxony government in the third quarter of 2001, and we received \$1.0 million in investment allowances in the second quarter of 2002. Those funds have been applied to reduce the cost of the fixed assets at our Dresden manufacturing facility. Additionally, we have received \$0.9 million of Saxony investment grants that have been recorded as an advance until we earn the grant through future capital expenditures. The total annual amount of investment grants and investment allowances that we are entitled to seek varies from year to year based upon the amount of our capital

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expenditures that meet certain requirements of the Saxony government. Generally, we are not eligible to seek total investment grants and allowances for any year in excess of 33% of our eligible capital expenditures at our Dresden facility for that year. We expect to continue to finance a portion of our capital expenditures in Dresden with additional grants and investment allowances from the Saxony government and additional loans from German banks, some of which may be guaranteed by the Saxony government. However, we cannot guarantee that we will be eligible for or receive additional grants or investment allowances in the future from the Saxony government, or any loans from German banks, or bank guarantees from the Saxony government.

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Borrowing arrangements:

The following table (with dollars in thousands) sets forth the material terms of our term debt and capital leases at September 29, 2002:

| Description | Rate | Balance at September 29, 2002 | Remaining Due in 2002 |
|--|----------|----------------------------------|-----------------------------|
| Line of credit | (1) | \$ | (1) |
| Term debt: | | | |
| Japanese bank loan guaranteed by Teijin | 3.14%(2) | 6,250 | \$ 3,750 |
| German bank loan dated May 12, 1999 | 6.13%(3) | 2,437 | 84 |
| German bank loan dated May 28, 1999 | 7.10%(4) | 2,465 | |
| German bank loan dated May 28, 1999 | 3.75% | 1,126 | 70 |
| German bank loan dated July 25, 2000 | 7.15%(5) | 1,860 | 58 |
| German bank loan dated August 14, 1999 (due June 30, 2009) | 5.75% | 1,664 | |
| German bank loan dated June 29, 2000 | 5.75% | 252 | 42 |
| German bank loan dated July 10, 2000 | 7.10% | 252 | 42 |
| German bank loan dated December 18, 2000 | 7.50% | 191 | 21 |
| German bank loan dated December 19, 2000 | 7.50% | 174 | 20 |
| Note payable dated September 21, 2001 | 8.00% | 220 | 150 |
| Other equipment financings | | 142 | 24 |
| Total term debt | | 17,033 | 4,261 |
| Capital leases: | | | |
| Sales-leaseback dated July 19, 1999 | 13.00% | 2,321 | 2,321 |
| Sales-leaseback dated October 19, 1999 | 13.00% | 946 | 946 |
| Total capital leases | | 3,267 | 3,267 |
| Total term debt and capital leases | | 20,300 | \$ 7,528 |
| Less current portion | | 9,845 | |
| Term debt, non current | | \$ 10,455 | |

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- (1) This line of credit expires in June 2003. Under the line, the Company can borrow an amount equal to 80% of eligible accounts receivable. The Company pays a finance fee per month equal to 0.88% of the average daily balance of the amount of accounts receivable against which the Company has borrowed. The Company is required to repay the lender amounts borrowed when it receives payments of these accounts receivable.
- (2) As of September 29, 2002, the interest rate on this loan was 3.14%.
- (3) Interest rate will be reset to the then prevailing market rate in 2004.
- (4) Interest rate will be reset to the then prevailing market rate in 2009.
- (5) Interest rate will be reset to the then prevailing interest rate in 2005.

At December 31, 2001, we were not in compliance with certain of the covenants of the guarantee by Teijin of the Japanese bank loan. Teijin and the Japanese bank waived the defaults under Teijin's guarantee of the loan that may exist for any measurement period through and including September 30, 2003 arising out of our failure to comply with the minimum quick ratio, tangible net worth and maximum debt/tangible net worth covenants. The waiver was conditioned on our agreement to prepay

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\$2.5 million of the debt out of the proceeds of our recently completed public offering, which we have agreed to do by November 6, 2002. Accordingly, the non-current portion of the amount outstanding under this loan of \$5.0 million was classified as a long-term liability at December 31, 2001. At September 29, 2002, we were in compliance with the loan covenants of the guarantee, and we have classified \$1.25 million of the amount outstanding under this loan as non-current.

We are in default under a master sale-leaseback agreement with respect to two of our production machines. We have withheld lease payments in connection with a dispute with the leasing company. As a result, we have classified all \$3.3 million outstanding under those agreements, net of the \$1.0 million holdback, as short-term capital lease liabilities, as of September 29, 2002.

Under the terms of our grant agreement with the Saxony government, we are required to meet investment and hiring targets by June 30, 2006. If we fail to meet those targets, the Saxony government is permitted to require us to repay all grants and investment allowances from the Saxony government previously received by us.

Capital expenditures

We anticipate spending approximately \$8.0 million in capital expenditures in 2002, approximately \$4.0 million of which will consist of progress payments for PM 10 in Dresden, approximately \$2.0 million to install a new enterprise resource planning system, and approximately \$1.5 million to maintain and upgrade our production facilities in Palo Alto and Tempe. For the first nine months of 2002, we incurred \$7.5 million in capital expenditures, compared to \$4.7 million in capital expenditures for the same period in 2001.

We believe that our existing liquidity sources, including our expected cash flows from operations, our existing cash reserves, and existing credit facilities will satisfy our cash requirements for the next twelve months. The Company used approximately \$4.0 million of the net proceeds to pay down the outstanding balance on its line of credit. The Company intends to use the balance of the net proceeds of the offering as follows: \$2.5 million to prepay a portion of the loan from the Japanese bank (see Note 5 to the Condensed Consolidated Financial Statements in Part I); approximately \$2.0 million to install an enterprise resource planning system; approximately \$2.5 million towards the purchase of a new production machine (PM 10); and approximately \$1.5 million for production equipment and other capital expenditures. The remaining net proceeds may be used for working capital and general corporate purposes, in connection with the potential resolution of disputes with insurers, or settlement of litigation, or in connection with future acquisitions. If our estimates prove inaccurate or the planned uses of the proceeds of our offering consume more proceeds than we anticipate, there may not be any proceeds of the offering remaining for working capital or general corporate purposes. We may need to raise additional funds, to take advantage of unanticipated opportunities.

Alternative financing sources

The Company has received a commitment letter from Wells Fargo HSBC Trade Bank N.A. ("Wells Fargo") for a \$15 million revolving line of credit. Under the facility, the Company would be able to borrow an amount up to 80% of the Company's eligible accounts receivable balances. Under the terms of the commitment letter, the line of credit would have an interest rate based on the bank's prime rate, or LIBOR, plus 2.85%, at the Company's option. The Company will be charged a fee of .15% on the unused portion of the \$15 million commitment. The Company will grant Wells Fargo a security interest in its accounts receivable and certain other assets. The credit described in the commitment letter is subject to the terms and conditions of the final loan documents to be executed by the parties, including without limitation a credit agreement, all in a form and substance satisfactory to Wells Fargo. The bank reserves the right to cancel its offer to make the credit facilities available and not to enter into the definitive agreements. No assurance can be given that definitive documentation will be entered into or

that, if entered into, such documentation will not have terms other than as described above. If the Company enters into the facility with Wells Fargo, it intends to terminate its current revolving credit facility.

Item 3 Quantitative and Qualitative Disclosures about Market Risk

We are exposed to the impact of interest rate changes, foreign currency fluctuations, and changes in the market values of its investments.

FINANCING RISK. Our exposure to market rate risk for changes in interest rates relates primarily to our term loan, specifically our loan from a Japanese bank, which is tied to the London Interbank Offered Rate ("LIBOR"), and our line of credit which bears an interest rate based on the bank's prime rate, or LIBOR, plus 2.85% at the Company's option. In addition, the interest rate on one of our German loans will be reset to the prevailing market rate in 2004 and on another of our German loans will be reset to the prevailing market rate in 2009. Fluctuations or changes in interest rates may adversely affect our expected interest expense. The effect of a 10% fluctuation in the interest rate on our loan from a Japanese bank would have had an effect of less than \$20,000 on our interest expense for the nine months ended September 29, 2002.

INVESTMENT RISK. We invest our excess cash in money market accounts and other short-term investment securities, and by practice, limit the amount of exposure to any one institution. Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. The effect of a 10% fluctuation in the interest rate of any floating rate securities would have had an adverse effect of less than \$15,000 on our net income for the nine months ended September 29, 2002.

FOREIGN CURRENCY RISK. International revenues (defined as sales to customers located outside of the United States) accounted for approximately 84% of our total sales for the first nine months of 2002. Of this amount, approximately 20% was denominated in euros relating to sales from our Dresden operation. The other 80% of our international sales were denominated in US dollars. We expect that approximately 15% to 18% of our total sales in 2002 will be denominated in euros. In addition, certain transactions with foreign suppliers are denominated in foreign currencies (principally Japanese Yen). The effect of a 10% fluctuation in the euro exchange rate would have had an effect of approximately \$0.9 million on our net revenues for the nine months ended September 29, 2002 and the effect of a 10% fluctuation in the Yen exchange rate would have had an effect of approximately \$0.8 million on our net income.

FORWARD-LOOKING STATEMENTS

This Quarterly Report contains forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995, which are subject to a number of risks and uncertainties. All statements other than statements of historical facts are forward-looking statements. These statements are identified by terminology such as "may," "will," "could," "should," "expects," "plans," "intends," "seeks," "anticipates," "believes," "estimates," "potential," or "continue," or the negative of such terms or other comparable terminology, although not all forward-looking statements contain these identifying words. Forward-looking statements are only predictions and include statements relating to:

our strategy, future operations and financial plans, including, without limitation, our plans to install and commercially produce products on new machines;

our projected need for, and ability to obtain, additional borrowings and our future liquidity;

our competition;

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our expectations with respect to future grants, investment allowances and bank guarantees from the Saxony government;

pending and threatened litigation and its outcome; and

our projected capital expenditures.

You should not place undue reliance on our forward-looking statements. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined below under "Risk Factors." These factors may cause our actual results to differ materially from any forward-looking statement. Although we believe the expectations reflected in our forward-looking statements are reasonable as of the date they are being made, we cannot guarantee our future results, levels of activity, performance, or achievements. Moreover, neither we nor any other person assumes responsibility for the future accuracy and completeness of these forward-looking statements.

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Risk Factors

Financial Risks

Covenants or defaults under our credit agreements may prevent us from borrowing or force us to curtail our operations.

As of September 29, 2002, we had total outstanding obligations under our credit agreements of \$20.3 million. Our inability to make timely payments of interest or principal under these facilities could materially adversely affect our ability to borrow money under existing credit facilities, to secure additional borrowings or to function as a going concern. Our current credit facilities contain financial covenants that will require us to meet certain financial performance targets and operating covenants that limit our discretion with respect to business matters. Among other things, these covenants restrict our ability to borrow additional money, create liens or other encumbrances, and make certain payments including dividends and capital expenditures. Many of these loans contain provisions that permit the lender to declare the loans immediately due if there is a material adverse change in our business. These credit facilities also contain events of default that could require us to pay off indebtedness before its maturity. The restrictions imposed by these credit facilities or the failure of lenders to advance funds under these facilities could force us to curtail our operations or have a material adverse effect on our liquidity.

Our ability to borrow is limited by the nature of our equipment and some of our accounts receivable.

Our equipment is custom designed for a special purpose. In addition, a large portion of our accounts receivable are from foreign sales, which are often more difficult to collect than domestic accounts receivable. As a result of the nature of our equipment and accounts receivable, lenders will generally allow us to borrow less against these items as collateral than they would for other types of equipment or domestic accounts receivable, or require us to add additional credit enhancements.

If we default under our secured credit facilities and financing arrangements, the lenders could foreclose on the assets we have pledged to them requiring us to significantly curtail or even cease our operations.

In connection with our current borrowing facilities and financing arrangements, we have granted security interests in and liens on substantially all of our assets, including our production machines and our Dresden facility, to secure the loans. We are currently being sued under a master sale-leaseback agreement with respect to two of our production machines because we have withheld lease payments in connection with a dispute with the leasing company. The leasing company holds a security interest in the production machines and may be able to repossess those machines. If the leasing company were to repossess one or more of those machines, our ability to produce product would be materially impaired. Our revenues, gross margins and operating efficiency would also be materially adversely affected. Our obligations under our secured credit facilities contain cross-default and cross-acceleration provisions and provisions that allow the lenders to declare the loans

immediately due if there is a material adverse change in our business. If we default under the credit facilities or financing arrangements the lenders could declare all of the funds borrowed thereunder, together with all accrued interest, immediately due and payable. If we are unable to repay such indebtedness, the lenders could foreclose on the pledged assets. If the lenders foreclose on our assets, we would be forced to significantly curtail or even cease our operations.

Our first quarter revenues are generally lower than revenues in the following quarters due to seasonal demand for our products.

Our revenue from the electronic display and architectural markets are affected by seasonality patterns with the highest sales occurring during the second, third and fourth fiscal quarters. During the

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past three fiscal years, 21% of our sales have occurred during the first quarter with 25%, 29% and 25% occurring during the second, third and fourth quarters, respectively. Demand in the electronic display market is generally at its highest before the holiday season, in our second and third quarters, when production of electronic goods is at its highest. Demand for architectural glass generally increases when the weather is warmer in northern climates and construction activity increases. To a lesser extent, demand for our after-market automotive glass products generally increases when weather is warmer in northern climates and the replacement of glass windows in motor vehicles increases. Lower demand for our products during the first quarter generally results in lower sales, margins and operating results during that quarter. Although our revenues have historically increased after the first quarter, the world-wide economic slow down in 2002 has negatively affected this historic trend. We have experienced a decrease of orders from the automotive market in the first nine months of 2002, as well as, a slowdown in orders from the architectural market for the third quarter of 2002. We believe the seasonality in the demand for our products, which we have experienced in prior years, will continue to affect our results in the first quarter of future years.

Our quarterly revenue and operating results are volatile and difficult to predict. If we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly.

Our quarterly revenue and operating results have varied significantly in the past and will likely vary significantly in the future. Our revenue and operating results may fall below the expectations of securities analysts or investors in future periods. Our failure to meet these expectations would likely adversely affect the market price of our common stock.

Our quarterly revenue and operating results may vary depending on a number of factors, including:

fluctuating customer demand, which is influenced by a number of factors, including market acceptance of our products and the products of our customers and end-users, changes in product mix, and the timing, cancellation or delay of customer orders and shipments;

the timing of shipments of our products by us and by independent subcontractors to our customers;

manufacturing and operational difficulties that may arise due to, among other things, quality control, capacity utilization of our production machines, unscheduled equipment maintenance, and the hiring and training of additional staff;

our ability to introduce new products on a timely basis; and

competition, including the introduction or announcement of new products by competitors, the adoption of competitive technologies by our customers, the addition of new production capacity by competitors and competitive pressures on prices of our products and those of our customers.

We expect to be subject to increased foreign currency risk in our international operations.

In 2002, we expect that 15% to 18% of our revenues will be denominated in euros, primarily related to sales from our Dresden operation, including sales to one of our largest customers, a European automotive glass manufacturer. As a result, our operating results and cash flows may vary due to fluctuations of the euro against the dollar. In addition, other customers may request to make payments in foreign currencies. Also,

certain transactions with foreign suppliers are denominated in foreign currencies, primarily yen.

The majority of our international sales are currently invoiced and collected in U.S. dollars. A strengthening in the dollar relative to the currencies of those countries in which we do business would increase the prices of our products as stated in those currencies and could hurt our sales in those

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countries. Significant fluctuations in the exchange rates between the U.S. dollar and foreign currencies could cause us to lower our prices and thus reduce our profitability and cash flows. These fluctuations could also cause prospective customers to cancel or delay orders because of the increased relative cost of our products.

Operational Risks

We depend on a small number of customers for nearly all of our sales, and the loss of a large customer could materially adversely affect our revenues or operating results.

Our ten largest customers accounted for approximately 69%, 85%, 85% and 84% of net sales in 1999, 2000, 2001 and the first nine months of 2002, respectively. We have contracts extending past 2002 with only two of these customers. We expect to continue to derive a significant portion of our net sales from this relatively small number of customers. Accordingly, the loss of a large customer could materially hurt our business, and the deferral or loss of anticipated orders from a large customer or a small number of customers could materially reduce our revenue and operating results in any period.

We must continue to develop new products or enhance existing products on a timely basis to compete successfully in a rapidly changing marketplace.

Our future success depends upon our ability to introduce new products, improve existing products and processes to keep pace with technological and market developments, and to address the increasingly sophisticated and demanding needs of our customers, especially in the electronic display and automotive markets. Technological changes, process improvements, or operating improvements that could adversely affect us include:

the development of competing technologies to our anti-reflective and silver reflector films for liquid crystal displays in the flat panel display industry;

changes in the way coatings are applied to alternative substrates such as tetra acetate cellulose, or TAC;

the development of new technologies that improve the manufacturing efficiency of our competitors;

the development of new materials that improve the performance of products that could compete with our products; and

improvements in the alternatives to the sputtering technology we use to produce our products, such as plasma enhanced chemical vapor deposition, or PECVD.

Our research and development efforts may not be successful in developing products in the time, or with the characteristics, necessary to meet customer needs. If we do not adapt to technological changes, or process or operating improvements, our competitive position, operations and prospects would be materially adversely affected.

Our ability to successfully identify suitable target companies and integrate acquired companies or technologies may affect our future growth.

A potential part of our continuing business strategy is to consider acquiring companies, products, and technologies that complement our current products, enhance our market coverage, technical capabilities or production capacity, or offer other growth opportunities. Our ability to

successfully complete acquisitions requires that we identify suitable target companies, agree on acceptable terms, and obtain acquisition financing on acceptable terms. In connection with these acquisitions, we could incur debt, amortization expenses relating to identified intangibles, impairment charges relating to goodwill, or merger related charges, or could issue stock that would dilute our current shareholders'

percentage of ownership. The success of any acquisitions will depend upon our ability to integrate acquired operations, retain and motivate acquired personnel, and increase the customer base of the combined businesses. We cannot assure you that we will be able to accomplish all of these goals. Any future acquisitions would involve certain additional risks, including:

difficulty integrating the purchased operations, technologies, or products;

unanticipated costs, which would reduce our profitability;

diversion of management's attention from our core business;

potential entrance into markets in which we have limited or no prior experience; and

potential loss of key employees, particularly those of the acquired business.

Failure to meet the volume requirements of our customers may result in a loss of business or contractual penalties.

Our long-term competitive position will depend to a significant extent on our manufacturing capacity. The failure to have sufficient capacity, to fully utilize capacity when needed or to successfully integrate and manage additional capacity in the future could adversely affect our relationships with customers and cause customers to buy similar products from our competitors if we are unable to meet their needs. For example, we believe that we lost substantial potential architectural products sales in 2001 because we did not have the capacity to manufacture the required amounts of products. Also, our failure to produce required amounts of products under some of our contracts will result in price reductions on future sales under such contracts or penalties under which we would be required to reimburse the customer for the full cost of any product not delivered in a timely manner, either of which would reduce our gross margins.

We depend on our OEM customers for the sale of our products.

We sell a substantial portion of our products to a relatively small number of original equipment manufacturers, or OEMs. The timing and amount of sales to these customers ultimately depend on sales levels and shipping schedules for the OEM products into which our products are incorporated. We have no control over the volume of products shipped by our OEM customers or shipping dates, and we cannot be certain that our OEM customers will continue to ship products that incorporate our products at current levels or at all. We currently have a long-term contract with only one of our OEM customers. Failure of our OEM customers to achieve significant sales of products incorporating our products and fluctuations in the timing and volume of such sales could be harmful to our business. Failure of these customers to inform us of changes in their production needs in a timely manner could also hinder our ability to effectively manage our business.

We rely upon our OEM customers for information relating to the development of new products so that we are able to meet end-user demands.

We rely on our OEM customers to inform us of opportunities to develop new products that serve end-user demands. If our OEM customers do not present us with market opportunities early enough for us to develop products to meet end-user needs in a timely fashion, or if the OEMs fail to anticipate end-user needs at all, we may fail to develop new products or modify our existing products for the end-user markets for our products. In addition, if our OEM customers fail to accurately anticipate end-user demands, we may spend resources on products that are not commercially successful.

We depend on a distributor for the sale of our after-market products.

We primarily use one independent distributor to sell our after-market products. We have a distribution agreement with Globamatrix Holdings Pte. Ltd., or Globamatrix, under which we granted an exclusive worldwide license to distribute our after-market applied film in the automotive and architectural glass markets. Failure of Globamatrix to achieve significant sales of products incorporating our products and fluctuations in the timing and volume of such sales could be harmful to our business. We believe that the success of our after-market products will continue to depend upon this distributor.

We face intense competition, which could affect our ability to increase our revenue, maintain our margins and increase our market share.

The market for each of our products is intensely competitive and we expect competition to increase in the future. Competitors vary in size and in the scope and breadth of the products they offer. We compete both with companies using technology similar to ours and companies using other technologies or developing improved technologies. Many of our current and potential competitors have significantly greater financial, technical, marketing and other resources than we have. In addition, many of our competitors have well-established relationships with our current and potential customers and have extensive knowledge of our industry. In fact, some of our current and potential customers currently produce, or are capable of creating, products that compete with our products.

We may not be able to expand our manufacturing capacity efficiently which could lead to lower gross margins.

We have ordered for our Dresden manufacturing facility a new production machine (PM 10), which we anticipate will begin commercial production in the first quarter of 2003. In addition, we anticipate that PM 7 in our Tempe facility will be available for commercial production during the first quarter of 2003. Additionally, PM 7 is currently being used in several, customer paid, research projects on products we expect to become commercially available in 2003. During the processes of bringing PM 7 and PM 10 up to commercial production levels, we expect to have decreased manufacturing yields and higher costs, which will lower our gross margins.

We are dependent on key suppliers of materials, which may prevent us from delivering product in a timely manner.

We manufacture all of our products using materials procured from third-party suppliers. We do not have long-term contracts with our third-party suppliers, except for an agreement with a third-party supplier to purchase Indium metal through the third quarter of 2003. Certain of the materials we require are obtained from a limited number of sources. Delays or reductions in product shipments could damage our relationships with customers. Further, a significant increase in the price of one or more of the materials used in our products could have a material adverse effect on our cost of goods sold and operating results.

We are dependent on a few qualified subcontractors to add properties to some of our products.

We rely on third-party subcontractors to add properties, such as adhesives, to some of our products. There are only a limited number of qualified subcontractors that can provide some of the services we require and we do not have long-term contracts with any of those subcontractors. Qualifying alternative subcontractors could take a great deal of time or cause us to change product designs. The loss of a subcontractor could adversely affect our ability to meet our scheduled product deliveries to customers, which could damage our relationships with customers. If our subcontractors do not produce a quality product, our yield will decrease and our margins will be lower. Further, a significant increase in the price charged by one or more of our subcontractors could force us to raise

prices on our products or lower our margins, which could have a material adverse effect on our operating results.

We are dependent on key suppliers of production machines, which may prevent us from delivering an acceptable product on a timely basis and limit our capacity for revenue growth.

Our production machines are large, complex and difficult to manufacture. It can take up to a year from the time we order a machine until it is delivered. Following delivery, it can take us, with the assistance of the manufacturer, up to six additional months to test and prepare the machine for commercial production. There are a very limited number of companies that are capable of manufacturing these machines. Our inability in the future to have new production machines manufactured and prepared for commercial production in a timely manner would prevent us from delivering product on a timely basis and limit our capacity for revenue growth.

Fluctuations or slowdowns in the overall electronic display industry have and may continue to adversely affect our revenues.

Our business depends in part on sales by manufacturers of products that include electronic displays. The markets for electronic display products are highly cyclical and have experienced periods of oversupply resulting in significantly reduced demand for our products. For example, due to the deteriorating economic environment, sales by flat panel cathode ray tube manufacturers decreased in 2001, contributing to our electronic display product revenues declining by 38% from 2000, and by 10% for the first nine months of 2002 compared to the first nine months of 2001. If the flat panel display and other electronic display markets in which we sell our products do not recover or experience further slowdowns in the future, it could cause revenues from our electronic display products to decrease.

Performance, reliability or quality problems with our products may cause our customers to reduce or cancel their orders.

We manufacture our products based on specific, technical requirements of each of our customers. We believe that future orders of our products will depend in part on our ability to maintain the performance, reliability and quality standards required by our customers. If our products have performance, reliability or quality problems, then we may experience:

delays in collecting accounts receivable;

higher manufacturing costs;

additional warranty and service expenses; and

reduced or cancelled orders.

For example, in 1998, our operating results were materially adversely affected by quality problems associated with the electronic display film produced by us for one of our largest customers.

If we fail to recruit and retain a significant number of qualified technical personnel we may not be able to develop, enhance and introduce our products on a timely basis, and our business will be harmed.

We require the services of a substantial number of qualified technical personnel. The market for skilled technical personnel is characterized by intense competition and aggressive recruiting, as well as a high-level of employee mobility. These characteristics make it particularly difficult for us to attract and retain the qualified technical personnel we require. We have experienced, and we expect to continue to experience, difficulty in hiring and retaining highly skilled employees with appropriate technical qualifications. It is especially difficult for us to recruit qualified personnel to move to the location of

our Palo Alto, California offices because of the high-cost of living. If we are unable to recruit and retain a sufficient number of qualified technical employees, we may not be able to complete the development of, or enhance, our products in a timely manner. As a result, our business may be harmed and our operating results may suffer.

We may be unable to attract or retain the other highly skilled employees that are necessary for the success of our business.

In addition to our dependence on our technical personnel, our success also depends on our continuing ability to attract and retain other highly skilled employees. We depend on the continued services of our senior management, particularly Thomas G. Hood, our President and Chief Executive Officer, Robert R. Freeman our Chief Financial Officer, Dr. Sicco W. T. Westra, our Senior Vice President, Sales and Marketing, Wolfgang Heinze, our plant manager in Dresden, and other personnel. We do not have employment contracts with any of our officers or key person life insurance covering any officer or employee. Our officers have technical and industry knowledge that cannot easily be replaced. Competition for similar personnel in our industry where we operate is intense. We have experienced, and we expect to continue to experience, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. If we do not succeed in attracting or retaining the necessary personnel, our business could be adversely affected.

If we are unable to adequately protect our intellectual property, third parties may be able to duplicate our products or develop functionally equivalent or superior technology.

Our success depends in large part upon our proprietary technology. We rely on our know-how, as well as a combination of patent, trademark and trade secret protection, to establish and protect our intellectual property rights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult. Our means of protecting our proprietary rights may not be adequate. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. During 2001, one of our U.S. patents relating to our architectural products expired. In the next three years, two more U.S. patents will expire. Expiration of these patents or our failure to adequately protect our proprietary rights may allow third parties to duplicate our products or develop functionally equivalent or superior technology. In addition, our competitors may independently develop similar technology or design around our proprietary intellectual property.

Our business is susceptible to numerous risks associated with international operations.

We have expanded our operations and hired additional personnel to address international markets for the thin film coatings industry. International revenues amounted to approximately 78%, 85%, 87% and 84% of our net revenues during 1999, 2000, 2001 and the first nine months of 2002, respectively. The distance between Palo Alto and Dresden creates logistical and communications challenges. In addition, to achieve acceptance in international markets, our products must be modified to handle a variety of factors specific to each international market as well as local regulations. We may also be subject to a number of other risks associated with international business activities. These risks include:

- unexpected changes in and the burdens and costs of compliance with a variety of foreign laws and regulatory requirements;
- potentially adverse tax consequences; and
- global economic turbulence and political instability.

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If we fail to comply with environmental regulations, our operations could be suspended.

We use hazardous chemicals in producing our products and have air and water emissions that require controls. As a result, we are subject to a variety of local, state and federal governmental regulations relating to the storage, discharge, handling, emission, generation, manufacture and disposal of toxic or other hazardous substances used to manufacture our products, compliance with which is expensive. Our failure to comply with current or future regulations could result in the imposition of substantial fines on us, suspension of production, alteration of our manufacturing processes, increased costs or cessation of operations.

We rely on our domestic sales representatives, without whom our architectural product sales may suffer.

We use independent sales representatives to promote our Heat Mirror products to architects in the United States. If some or all of our sales representatives experience financial difficulties, or otherwise become unable or unwilling to promote our products, our business could be harmed. These sales representatives could reduce or discontinue promotion of our products. They may not devote the resources necessary to provide effective marketing support to us. In addition, we depend upon the continued viability and financial resources of these representatives, many of which are small organizations with limited working capital. These representatives, in turn, depend substantially on general economic conditions and other factors affecting the markets for the products they promote. We believe that our success in this market will continue to depend upon these sales representatives.

We may experience unanticipated warranty or other claims with respect to our products which may lead to extensive litigation costs and expenses.

In the ordinary course of business, we have periodically become engaged in litigation principally as a result of disputes with customers of our architectural products. We have settled some of these suits and others are pending. We may become engaged in similar or other lawsuits in the future. For example, we have recently received a letter that threatens litigation based upon the allegation that a sealant provided by a third party and used with our film was defective, and as a result the plaintiff has suffered elevated warranty replacement claims and costs. Some of our products that have been the basis for lawsuits against us could be the basis for future lawsuits. An adverse outcome in the defense of a warranty

or other claim could subject us to significant liabilities to third parties. Any litigation, regardless of the outcome, could be costly and require significant time and attention of key members of our management and technical personnel.

We may face extensive damages or litigation costs if our insurance carriers seek to have us indemnify them for settlements of past and outstanding litigation.

Several of our insurance carriers have reserved their rights to seek indemnification from us for substantial amounts paid to plaintiffs by the insurance carriers as part of settlements of litigation relating to our architectural products. Our insurance carriers in a case in which the plaintiff alleged we were responsible for defects in window products manufactured by others have advised us that they intend to seek reimbursement for settlement and defense costs. Any claims, with or without merit, could require significant time and attention of key members of our management and result in costly litigation.

Item 4 Controls and Procedures

(a) Disclosure controls and procedures. Within 90 days before filing this Report, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures. The Company's disclosure controls and procedures are the controls and other procedures that the

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Company designed to ensure that it records, processes, summarizes and reports in a timely manner the information that it must disclose in reports that the Company files with or submits to the Securities and Exchange Commission. Thomas G. Hood, our President and Chief Executive Officer, and Robert R. Freeman, our Senior Vice President and Chief Financial Officer, reviewed and participated in this discussion. Based on this evaluation, Messrs. Hood and Freeman concluded that, as of the date of their evaluation, the Company's disclosure controls were effective.

(b) Internal Controls. Since the date of the evaluation described above, there have not been any significant changes in the Company's internal accounting controls or in other factors that could significantly affect those controls.

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PART II OTHER INFORMATION

Item 1 Legal Proceedings

In July 2002, Southwall was served with a complaint in a lawsuit captioned "Hurricane Glass v. Southwall Technologies Inc. and V-Kool, Inc." filed in the Circuit Court of the Twelfth Judicial Circuit in and for Sarasota County, Florida. The Plaintiff was a distributor of the Company's SOLIS brand window film. The Complaint alleges that the SOLIS film was not fit for its intended purpose and brings claims for breach of written and oral contract against the Company. The Complaint alleges approximately \$440,000 in damages against both defendants. We believe the claims to be without merit and intend to defend the action vigorously.

Other litigation filed against the Company was described under Item 3 in the Company's Form 10-K filed on April 1, 2002, and in the Company's registration statement no. 333-8557, filed with the Securities and Exchange Commission on July 2, 2002. No other material developments have occurred with respect to the litigation described therein.

In addition, the Company is involved in certain other legal actions arising in the ordinary course of business. The Company believes, however, that none of these actions, either individually or in the aggregate, will have a material adverse effect on the Company's business, its consolidated financial position, its results of operations, or its operating cashflows.

Item 2 Changes in Securities and Use of Proceeds

Not applicable.

Item 3 Defaults upon Senior Securities

Not applicable.

Item 4 Submission of Matters to a Vote of Stockholders

None.

Item 5 Other Information

As required by the recent Sarbanes-Oxley Act, the Company's audit committee has approved certain non-audit services provided, or to be provided by PricewaterhouseCoopers, the Company's independent accountants. These services relate to consultation, advice and other services in connection with tax planning and compliance, SEC registration statements, potential acquisitions and other transactions, application of generally accepted accounting principles and the provision of statutory audit services in foreign jurisdictions.

Item 6 Exhibits and Reports on Form 8-K

(a)
Exhibits

| Exhibit Number | Item |
|-----------------------|---|
| 99.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 99.2 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

(b)
Reports on Form 8-K

On August 9, 2002, the Company filed a Current Report on Form 8-K, disclosing under Item 5 additional information related to the anticipated effect on job cuts and near-term business expectations.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 12, 2002

By: /s/ THOMAS G. HOOD

Thomas G. Hood
President and Chief Executive Officer

By: /s/ ROBERT R. FREEMAN

Robert R. Freeman
Sr. Vice President and Chief Financial Officer

CERTIFICATIONS

I, Thomas G. Hood, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Southwall Technologies Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within ninety (90) days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or person performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
- 6.

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The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 12, 2002

/s/ THOMAS G. HOOD

Thomas G. Hood
Chief Executive Officer

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I, Robert R. Freeman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Southwall Technologies Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within ninety (90) days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or person performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6.

The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 12, 2002

/s/ ROBERT R. FREEMAN

Robert R. Freeman
Chief Financial Officer

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SIGNATURES

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