TRANSAMERICA INCOME SHARES, INC.
Form DEF 14A
May 30, 2008

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SCHEDULE 14A
(Rule 14a-101)
INFORMATION REQUIRED IN PROXY STATEMENT
SCHEDULE 14A INFORMATION
Proxy Statement Pursuant to Section 14(a) of the
Securities Exchange Act of 1934

Filed by the Registrant þ
Filed by a Party other than the Registrant o
Check the appropriate box:

o Preliminary proxy statement.
þ Definitive proxy statement.
o Definitive additional materials.
o Soliciting material pursuant to Rule 14a-11(c) or Rule 14a-12.

o Confidential, for use of the Commissioner only (as permitted by Rule 14a-6(e)(2).

Transamerica Income Shares, Inc.

(Name of Registrant as Specified in its Charter)

N/A

(Name of Person(s) Filing Proxy Statement, if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box):

þ No fee required.

o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies: **N/A**

(2) Aggregate number of securities to which transaction applies: **N/A**

(3) Per unit price or other underlying value of transaction computed pursuant to Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined): **N/A**

(4) Proposed maximum aggregate value of transaction: **N/A**

(5) Total fee paid: **$0**

o Fee paid previously with preliminary materials.

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid: **N/A**

(2) Form, Schedule or Registration Statement No.: **N/A**

(3) Filing Party: **N/A**

(4) Date Filed: **N/A**

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TRANSAMERICA INCOME SHARES, INC.
570 CARILLON PARKWAY
ST. PETERSBURG, FLORIDA 33716
NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
To Be Held July 17, 2008

To the Shareholders of Transamerica Income Shares, Inc.:

Notice is hereby given that the Annual Meeting of Shareholders of Transamerica Income Shares, Inc. (the Fund) will be held on July 17, 2008, at 570 Carillon Parkway, St. Petersburg, Florida 33716, beginning at 11:00 a.m., Eastern Time, or as adjourned from time to time (the Meeting). At the Meeting, shareholders of the Fund will be called upon to consider the following proposals:

PROPOSAL 1: To elect ten Directors to the Board of Directors; and

PROPOSAL 2: To conduct such other business as may properly come before the Meeting.

After careful consideration, the Directors of the Fund unanimously approved and recommend that you vote FOR Proposal 1. Shareholders of record as of the close of business on May 2, 2008 are entitled to vote at the Meeting. Each share is entitled to one vote, with fractional votes for fractional shares.

By Order of the Board of Directors of Transamerica Income Shares, Inc.,

Dennis P. Gallagher, Esq.

Vice President, General Counsel and Secretary

May 30, 2008

Your vote is very important regardless of the number of shares that you owned on the Record Date. Shareholders who do not expect to attend the Meeting are requested to complete, sign, date, and return the accompanying Proxy in the enclosed envelope, which needs no postage if mailed in the United States, or follow the enclosed instructions relating to Internet or telephone voting. Instructions for the proper execution of the Proxy are set forth in the enclosed materials. It is important that proxies be returned promptly. Whether or not you plan to attend the Meeting, please complete the enclosed Proxy, or vote using the Internet or by telephone. If you vote via the Internet or by telephone, please do not return your Proxy unless you later decide to change your vote.

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PROXY STATEMENT
TRANSAMERICA INCOME SHARES, INC.
ANNUAL MEETING OF SHAREHOLDERS
July 17, 2008

INTRODUCTION

This Proxy Statement is furnished in connection with the solicitation of Proxies by the Board of Directors (the Board or Directors) of Transamerica Income Shares, Inc. (the Fund or TIS), a closed-end management investment company organized as a Maryland corporation, for use at the Annual Meeting of Shareholders of the Fund to be held at 11:00 a.m. on July 17, 2008, at 570 Carillon Parkway, St. Petersburg, Florida 33716, and any adjournments thereof (the Meeting). The Board is soliciting Proxies from shareholders of the Fund with respect to the proposals set forth in the accompanying Notice. A Proxy also accompanies this Proxy Statement. It is anticipated that the Proxy and Proxy Statement will first be mailed to shareholders on or about May 30, 2008.

Shareholder Reports. The Fund s most recent annual report for the year ended March 31, 2008, is available to you upon request without charge from the Fund s transfer agent, Mellon Investor Services, LLC, Newport Office Center VII, 480 Washington Boulevard, Jersey City, New Jersey 07310; telephone toll free: 1-800-454-9575. For the hearing and speech impaired (TDD): 1-800-231-5469 or www.mellon-investor.com.

PROPOSAL 1
ELECTION OF DIRECTORS

Shareholders are asked to consider the election of ten Nominees as Directors of the Fund. Each Nominee currently serves as a Director of the Fund. Nine of the ten Nominees were elected as Directors by Fund shareholders at the special shareholder meeting held on October 30, 2007. Sandra N. Bane, who is also a Nominee, was appointed by the Board at their Board meeting held on December 4, 2007. Ms. Bane s appointment was effective on March 1, 2008. Each Nominee has indicated his or her willingness to serve as Director, if elected.

The persons named as proxies intend to vote to elect the Nominees, unless authority to vote for the election of all or specified Nominees is withheld by so marking the Proxy. If any Nominees are unable to serve, the persons named as proxies may vote for other persons or vote to fix the number of Directors at less than ten. Election is by a majority vote of the shares represented at the Meeting.

The term fund complex in the tables below consists of the Fund, Transamerica Funds, Transamerica Series Trust (TST), Transamerica Investors, Inc. (TII), Transamerica Partners Funds Group (TPFG), Transamerica Partners Funds Group II (TPFG II), Transamerica Partners Portfolios (TPP), and Transamerica Asset Allocation Variable Funds (TAAVF). The mailing address of each Nominee is 570 Carillon Parkway, St. Petersburg, Florida 33716. The name, age and principal occupation for the past five years of the Nominees are:

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Independent Director Nominees*:

Name, Address and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation or Employment in the Past 5 Years	Number of Portfolios in Fund Complex Overseen by Nominee for Director	Other Directorships Held by Nominee For Director
Sandra N. Bane (DOB: 6/15/52)	Director	Since 2008	Retired KPMG (1999 present); Trustee, TST, Transamerica Funds, TPP, TPFG, TPFG II and TAAVF (February 2008 present); Director, TIS (February 2008 present); Director, TII (2003 Present).	173	Big 5 Sporting Goods (2002 present); AGL Resources, Inc. (an energy services holding company) (2008 present).
Leo J. Hill (DOB: 3/27/56)	Director	Since 2002	Principal, Advisor Network Solutions, LLC (business consulting) (2006 - present); Trustee, TPP, TPFG, TPFG II and TAAVF (2007 - present); Director, TIS (2002 - present); Trustee, Transamerica Funds (2002 - present); Director, TII (February 2008 - present); TST (2001 - present); Owner and President, Prestige Automotive Group (2001-2005); President, L. J. Hill & Company (1999 present); Market President, Nations Bank of Sun Coast Florida (1998 1999); President and Chief Executive Officer, Barnett Banks of Treasure Coast Florida (1994 1998); Executive Vice President and Senior Credit Officer, Barnett Banks of Jacksonville, Florida (1991 1994); Senior Vice President and Senior Loan Administration Officer, Wachovia Bank of Georgia (1976 1991).	173	N/A

* Independent director (the Independent Directors) means a director who is not an interested person (as defined under the Investment Company Act of 1940, as amended (the 1940 Act), of the Fund

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Name, Address and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation or Employment in the Past 5 Years	Number of Portfolios in Fund Complex Overseen by Nominee for Director	Other Directorships Held by Nominee For Director
Neal M. Jewell (DOB: 2/12/35)	Director and Lead Independent Chairperson	Since 2002	Retired (2004 present); Trustee and Lead Independent Trustee, Transamerica Funds and TST (2007 present); Director and Lead Independent Director, TIS (2007 - present); Director, TII (February 2008 - present); Trustee and Lead Independent Trustee, TPP, TPFG, TPFG II, and TAAVF (1993 - present); Independent Trustee, EAI Select Managers Equity Fund (a mutual Fund) (1996 2004).	173	N/A
Russell A. Kimball, Jr. (DOB: 8/17/44)	Director	Since 2002	General Manager, Sheraton Sand Key Resort (1975 - present); Trustee, TPP, TPFG, TPFG II and TAAVF (2007 - present); Director, TIS and Trustee, Transamerica Funds (2002 - present); Director, TII (February 2008 - present); Trustee, TST (1986 - present).	173	N/A
Eugene M. Mannella (DOB: 2/1/54)	Director	Since 2007	Self-employed consultant (2006 - present); President, Arapain Partners LLC (limited purpose broker-dealer) (1998 present); Trustee, Transamerica Funds and TST (2007 present); Director, TIS (2007 - present); Director, TII (February 2008 - present); Trustee, TPP, TPFG, TPFG II	173	N/A

and TAAVF (1994 - present);
President, International Fund
Services (alternative asset
administration) (1993   2005).

Name, Address and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation or Employment in the Past 5 Years	Number of Portfolios in Fund Complex Overseen by Nominee for Director	Other Directorships Held by Nominee For Director
Norm R. Nielsen (DOB: 5/11/39)	Director	Since 2006	Retired (2005 - present); Trustee, TPP, TPFG, TPFG II and TAAVF (2007 - present); Director, TIS (2006 - present); Director, TII (February 2008 - present); Trustee, Transamerica Funds and TST (2006 - present); Director, Iowa City Area Development (1996 - 2004); Director, Iowa Health Systems (1994 2003); Director, U.S. Bank (1987 1988); President, Kirkwood Community College (1979 2005).	173	Buena Vista University Board of Trustees (2004 - present).
Joyce Galpern Norden (DOB: 6/1/39)	Director	Since 2007	Retired (2004 - present); Trustee, Transamerica Funds and TST (2007 - present); Director, TIS (2007 - present); Director, TII (February 2008 - present); Trustee, TPP (2002 - present); Trustee, TPFG, TPFG II and TAAVF (1993 -present); Vice President, Institutional Advancement, Reconstructionist Rabbinical College (1996 2004).	173	Board of Governors, Reconstructionist College (2007-present).
Patricia L. Sawyer (DOB: 7/1/50)	Director	Since 2007	President and Executive Search Consultant, Smith & Sawyer LLC (consulting) (1989 - present); Trustee, Transamerica Funds and TST (2007 - present); Director, TIS (2007 - present); Director, TII (February 2008 - present); Trustee, TPP, TPFG, TPFG II and TAAVF (1993 - present).	173	N/A

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Name, Address and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation or Employment in the Past 5 Years	Number of Portfolios in Fund Complex Overseen by Nominee for Director	Other Directorships Held by Nominee For Director
John W. Waechter (DOB: 2/25/52)	Director	Since 2004	Attorney, Englander & Fischer, P.A. (2008 present); Retired (2004 - 2008); Trustee, TPP, TPFG, TPFG II and TAAVF (2007 - present); Director, TIS (2004 - present); Director, TII (February 2008 - present); Trustee, Transamerica Funds (2005 - present) and TST (2004 - present); Executive Vice President, Chief Financial officer and Chief Compliance Officer, William R. Hough & Co. (securities dealer) (1979 -2004); Treasurer, The Hough Group of Funds (1993 - 2004).	173	N/A

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Interested Director Nominee:**

Name, Address and Age	Position(s) Held with Fund	Term of Office and Length of Time Served	Principal Occupation or Employment in the Past 5 Years	Number of Portfolios in Fund Complex Overseen by Nominee for Director	Other Directorships Held by Nominee For Director
John K. Carter (DOB: 4/24/61)	Chairman, Director, Chief Executive Officer and President	Since 2006	Chairman and Director (2008 present); President (2007 present), Chief Executive Officer; (2006 present), Vice President, Secretary and Chief Compliance Officer (2003 - 2006), TII; Chairman and Trustee, President and Chief Executive Officer, (2007-present); TPP, TPFG, TPFG II and TAAVF; Chairman (2007 present); Trustee (2006 present), President and Chief Executive Officer (2006 - present), Senior Vice President (1999 2006), Chief Compliance Officer, General Counsel and Secretary (1999 - 2006),Transamerica Funds and TST; Chairman (2007 present); Director (2006 present); President and Chief Executive Officer (2006 present), Senior Vice President (2002 2006), General Counsel, Secretary and Chief Compliance Officer (2002 2006), TIS; President and Chief Executive Officer (2006 present); Senior Vice President (1999 2006), Director (2000 present); General Counsel and Secretary (2000 2006), Chief Compliance Officer (2004 2006), TAM; President and Chief Executive Officer (2006 - present), Senior Vice	173	N/A

President (1999 2006), Director (2001 - present), General Counsel and Secretary (2001 2006), Transamerica Fund Services, Inc. (TFS); Vice President, AFSG Securities Corporation (2001 - present); Senior Vice President, General Counsel and Secretary, Transamerica Index Funds, Inc. (TIF) (2002 2004); Vice President, Transamerica Investment Services, Inc. (TISI) (2003 2005) and Transamerica Investment Management, LLC (TIM) (2001 2005).

** Mr. Carter is an interested person of the Fund as that term is defined in the 1940 Act due to his employment with the Fund s investment advisor and certain of its affiliates.

The Board of Directors met six times during the fiscal year ended March 31, 2008. Each Director attended at least 75% of all meetings of the Board and of all meetings of committees of the Board on which he or she served as a regular member.

The Fund does not have a policy with regard to attendance at the Fund s annual shareholder meeting, and no Director attended last year s annual shareholder meeting.

Nominee Ownership of Equity Securities

The table below gives the dollar range of shares of the Fund beneficially owned by each Nominee, as well as the aggregate dollar range of shares of all funds in the fund complex overseen by each Nominee as of December 31, 2007. Messrs. Jewell and Mannella and Ms. Norden and Ms. Sawyer became Directors on October 30, 2007. Ms. Bane became a Director on March 1, 2008.

Name of Nominee	Dollar Range of Equity Securities in the Fund	Aggregate Dollar Range of Equity Securities in all Funds Overseen by Nominee in Family of Investment Companies*
Sandra N. Bane	$ 0	None
John K. Carter**	$ 0	Over $100,000
Leo J. Hill	$ 0	Over $100,000
Neal M. Jewell	$ 0	Over $100,000
Russell A. Kimball, Jr.	$ 0	Over $100,000
Eugene M. Mannella	$ 0	$ 50,001-$100,000
Norm R. Nielsen	$ 0	Over $100,000
Joyce Galpern Norden	$ 0	$ 50,001-$100,000
Patricia L. Sawyer	$ 0	Over $100,000
John W. Waechter	$ 10,000 - $50,000	Over $100,000

* The family of investment companies consists of all funds in the fund complex.

** Mr. Carter is an interested person of the Fund, as discussed above.

None of the Nominees who are Independent Directors or their immediate family members had any interest in the investment adviser, sub-advisers or distributor of the Fund, or any person controlling, controlled by or under common control with such persons. For this purpose, immediate family member includes the Nominee s spouse, children residing in the Nominee s household and dependents of the Nominee.

Remuneration of Directors

Independent Directors receive a total annual retainer fee of $124,000 from the funds that make up the fund complex, as well as total fees of $8,800 per meeting (assumes five meetings annually), of which the Fund pays a pro rata share based on its relative assets compared to those of the fund complex. The Lead Independent Chairperson of the Board also receives an additional retainer of $40,000 per year. The Audit Committee Chairperson receives an additional retainer of $15,000 per year. The Fund pays a pro rata share allocable to the Fund based on the relative assets of the Fund for the Lead Independent Chairperson and Audit Committee Chairperson retainers. Any fees and expenses paid to a Director who is an affiliate of Transamerica Asset Management, Inc. (TAM) or Transamerica Capital, Inc. (TCI) are paid by TAM and/or TCI and not by the Fund.

For the fiscal year ended March 31, 2008, the Independent Directors, as a group, received compensation in the amount of $54,155 from the Fund.

The following table sets forth the compensation paid to each Independent Director of the Fund for the fiscal year ended March 31, 2008. Directors who are interested persons of the Fund do not receive any compensation from the Fund.

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Name	Aggregate Compensation from Fund	Pension or Retirement Benefits Accrued as Part of Fund Expenses	Estimated Annual Benefit Upon Retirement	Total Compensation from Fund and Fund Complex Paid to Directors*
Sandra N. Bane**	$ 0	N/A	N/A	$ 28,225
Peter R. Brown***	$ 6,000	N/A	N/A	$ 156,000
Daniel Calabria***	$ 6,000	N/A	N/A	$ 126,000
Janice B. Case***	$ 6,000	N/A	N/A	$ 126,000
Charles C. Harris***	$ 6,000	N/A	N/A	$ 126,000
Leo J. Hill	$ 5,371	N/A	N/A	$ 168,400
Neal M. Jewell	$ 504	N/A	N/A	$ 191,054
Russell A. Kimball, Jr.	$ 5,371	N/A	N/A	$ 168,400
Eugene M. Mannella	$ 704	N/A	N/A	$ 149,734
Norm R. Nielsen	$ 5,371	N/A	N/A	$ 168,400
Joyce Galpern Norden	$ 704	N/A	N/A	$ 151,734
Patricia L. Sawyer	$ 734	N/A	N/A	$ 167,234
William W. Short, Jr.***	$ 6,000	N/A	N/A	$ 126,000
John W. Waechter	$ 5,396	N/A	N/A	$ 176,734

* The amounts reflected are the aggregate compensation received from the Fund and other funds in the fund complex. The fund complex is composed of 173 funds.

** Ms. Bane was appointed by the Board of Directors on December 4, 2007. Her appointment was effective on March 1, 2008.

*** These individuals

ceased serving as Directors of the Fund as of October 30, 2007.

Committees

The Audit Committee

The Board has a standing Audit Committee, that currently consists of Sandra N. Bane, Leo J. Hill, Neal M. Jewell, Russell A. Kimball, Jr., Eugene M. Mannella, Norm R. Nielsen, Joyce Galpern Norden, Patricia L. Sawyer, and John W. Waechter, each of whom is an Independent Director and qualifies as an independent director for purposes of New York Stock Exchange Listing Standards. Mr. Waechter currently serves as chairperson of the Audit Committee. The functions performed by the Audit Committee include the approval and recommendation for appointment of the independent public accountants for the Fund, the review of the scope and results of audit services, the review of the adequacy of internal accounting and financial controls, determining the independence of the public accounting firm and ensuring the rotation of its partners, meeting with the Fund s internal auditor, frequent meetings with Management to discuss the financial statements of the Fund, and the review of material changes in accounting principles and practices and other matters when requested from time to time by the Board. The Audit Committee also overseas the Fund s compliance with legal and regulatory requirements and prepares the audit committee report required to be included in the proxy statement relating to each annual meeting of the Fund. The Audit Committee met two times during the fiscal year ended March 31, 2008. The Board has adopted a written charter for the Fund s Audit Committee, which appears as Appendix B to this Proxy Statement.

Audit Committee Report

The Audit Committee reports that it (i) has reviewed and discussed the audited financial statements for the fiscal year ended March 31, 2008, with Fund management, (ii) has discussed with the Fund s independent public accountant the matters required to be addressed by Statement on Auditing Standards No. 61, and (iii) has received written disclosures and the letter required by Independence Standards Board No. 1 from the Fund s independent public accountant and has discussed with the independent public accountant its independence. Based on the foregoing, the Audit Committee recommended to the Board of Directors that the Fund s audited financial statements be included in the Fund s Annual Report for the fiscal year ended March 31, 2008, for filing with the U.S. Securities and Exchange Commission (the SEC).

SUBMITTED BY THE AUDIT COMMITTEE OF THE FUND S BOARD OF DIRECTORS

Sandra N. Bane	Russell A. Kimball, Jr.	Joyce Galpern Norden
Leo J. Hill	Eugene M. Mannella	Patricia L. Sawyer
Neal M. Jewell	Norm R. Nielsen	John W. Waechter, Chairperson

The Nominating Committee

The Board s Nominating Committee recommends nominations for membership on the Board. The Nominating Committee nominates and evaluates Independent Director candidates. The Nominating Committee meets periodically, as necessary, and is solely responsible for the selection and nomination of potential candidates to serve on the Board. The members of the Fund s Nominating Committee are Sandra N. Bane, Leo J. Hill, Neal M. Jewell, Russell A. Kimball, Jr., Eugene M. Mannella, Norm R. Nielsen, Joyce Galpern Norden, Patricia L. Sawyer and John W. Waechter, each of whom is an Independent Director and qualifies as an independent director for purposes of the New York Stock Exchange Listing Standards. Ms. Sawyer currently serves as chairperson of the Nominating Committee. The Board has a Nominating Committee charter, a copy of which is included as Appendix C to this Proxy Statement.

While the Nominating Committee is solely responsible for the selection and nomination of potential candidates to serve on the Board, the Nominating Committee may consider and evaluate nominations properly submitted by shareholders of the Fund. Nominations proposed by shareholders will be properly submitted for consideration by the Committee only if shareholders submit their considerations in accordance with the qualifications and procedures set forth in the charter of the Nominating Committee. It is in the Nominating Committee s sole discretion whether to seek corrections of a deficient submission or to exclude a nominee from consideration.

A candidate for nomination as Director submitted by a shareholder will not be deemed to be properly submitted to the Committee for the Committee s consideration unless the following requirements have been met and procedures followed:

1. Each eligible shareholder or shareholder group may submit no more than one nominee each calendar year.

2. The nominee must satisfy all qualifications provided herein and in the Fund s organizational documents, including qualification as a possible Independent Director if the nominee is to serve in that capacity.

   The nominee may not be the nominating shareholder, a member of the nominating shareholder group or a member of the immediate family of the nominating shareholder or any member of the nominating shareholder group.(1)

   Neither the nominee nor any member of the nominee s immediate family may be currently employed or employed within the year prior to the nomination by any nominating shareholder entity or entity in a nominating shareholder group.

   Neither the nominee nor any immediate family member of the nominee is permitted to have accepted directly or indirectly, during the year of the election for which the nominee s name was submitted, during the immediately preceding calendar year, or during the year when the nominee s name was submitted, any consulting, advisory, or other compensatory fee from the nominating shareholder or any member of a nominating shareholder group.

(1) Terms such as immediate family member and control shall be interpreted in accordance with

the federal
securities laws.

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The nominee may not be an executive officer, director or person fulfilling similar functions of the nominating shareholder or any member of the nominating shareholder group, or of an affiliate of the nominating shareholder or any such member of the nominating shareholder group.

The nominee may not control the nominating shareholder or any member of the nominating shareholder group (or, in the case of a holder or member that is a fund, an interested person of such holder or member as defined by Section 2(a)(19) of the 1940 Act).

A shareholder or shareholder group may not submit for consideration a nominee which has previously been considered by the Committee.

3. In order for the Committee to consider shareholder submissions, the following requirements must be satisfied regarding the shareholder or shareholder group submitting the proposed nominee:

Any shareholder or shareholder group submitting a proposed nominee must beneficially own, either individually or in the aggregate, more than 5% of the Fund s securities that are eligible to vote both at the time of submission of the nominee and at the time of the Board member election. Each of the securities used for purposes of calculating this ownership must have been held continuously for at least two years as of the date of the nomination. In addition, such securities must continue to be held through the date of the meeting. The nominating shareholder or shareholder group must also bear the economic risk of the investment.

The nominating shareholder or shareholder group must also submit a certification which provides the number of shares which the person or group has (a) sole power to vote or direct the vote; (b) shared power to vote or direct the vote; (c) sole power to dispose or direct the disposition of such shares; and (d) shared power to dispose or direct the disposition of such shares. In addition the certification shall provide that the shares have been held continuously for at least two years.

4. Shareholders or shareholder groups submitting proposed nominees must substantiate compliance with the above requirements at the time of submitting their proposed nominee as part of their written submission to the attention of the Fund s Secretary, who will provide all submissions to the Committee. This submission to the Fund must include:

the shareholder s contact information;

the nominee s contact information and the number of applicable Fund shares owned by the proposed nominee;

all information regarding the nominee that would be required to be disclosed in solicitations of proxies for elections of directors required by Regulation 14A under the Securities Exchange Act of 1934; and

a notarized letter executed by the nominee, stating his or her intention to serve as a nominee and be named in the Fund s proxy statement, if so designated by the Committee and the Fund s Board.

5. The Committee will consider all submissions meeting the applicable requirements stated herein that are received by December 31 of the most recently completed calendar year.

The Nominating Committee met one time during the fiscal year ended March 31, 2008.

Shareholder Communications with the Board

Shareholders may mail written communications to the Board, addressed to the care of the Secretary of the Fund, at the Fund s address. Each shareholder communication must (i) be in writing and be signed by the shareholder, and (ii) identify the full name of the Fund. The Secretary is responsible for collecting, reviewing and organizing all properly

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submitted shareholder communications. Except as provided below, with respect to each properly submitted shareholder communication, the Secretary will either (i) provide a copy of the communication to the Board at the next regularly scheduled Board meeting, or (ii) if the Secretary determines that the communication requires more immediate attention, forward the communication to the Board promptly after receipt. The Secretary may, in good faith, determine that a shareholder communication should not be provided to the Board because the communication, among other things, (i) does not reasonably relate to the Fund or its operations, management, activities, policies, service providers, Board, officers, shareholders or other matters relating to an investment in the Fund, or (ii) is ministerial in nature (such as a request for Fund literature, share data or financial information).

Fund Officers

The following table shows the executive officers of the Fund, their age, positions with the Fund and principal occupations during the past five years:

Name, Address* and Age	Position(s) Held with Fund	Term of Office and Length of Time Served**	Principal Occupation during the Past Five Years
John K. Carter (DOB: 4/24/61)	Director, Chairman, President and Chief Executive Officer	2006 present	See table above.
Dennis P. Gallagher (DOB: 12/19/70)	Vice President, General Counsel and Secretary	2006 present	Vice President, General Counsel & Secretary, Transamerica Funds, TST and TIS (2006 present); Vice President, General Counsel and Secretary , TPP, TPFG, TPFG II and TAAVF (2007 present); Director, Senior Vice President, General Counsel and Secretary, TAM and TFS (2006 present); Assistant Vice President, TCI (2007 present); Director, Deutsche Asset Management (1998 2006).
Elizabeth L. Belanger (DOB: 1/7/72)	Deputy General Counsel, Assistant Secretary and Conflicts of Interest Officer	2007 present	Deputy General Counsel, Assistant Secretary and Conflicts of Interest Officer, Transamerica Funds, TST and TIS (2007 present); Deputy General Counsel and Conflicts of Interest Officer (2007 present); Assistant Secretary (2005 present), TPP, TPFG, TPFG II and TAAVF; Vice President and Senior Counsel, Diversified Investment Advisors, Inc. (Diversified) (2005 present) ; Director, TFLIC (2006 present); Director of Compliance, Domini Social Investments LLC (2003 2005); Associate, Bingham McCutchen LLP (1997 - 2003).

Name, Address* and Age	Position(s) Held with Fund	Term of Office and Length of Time Served**	Principal Occupation during the Past Five Years
Joseph P. Carusone (DOB: 9/8/65)	Vice President, Treasurer and Principal Financial Officer	2007 present	Vice President, Treasurer and Principal Financial Officer, Transamerica Funds, TST and TIS (2007 present); Vice President (2007 present): Treasurer and Principal Financial Officer (2001 present); TPP, TPFG, TPFG II and TAAVF; Senior Vice President, TAM and TFS (2007 present); Vice President Diversified (1999 present); President, Diversified Investors Securities Corp. (DISC) (2007 - present); Director, TFLIC (2004 present); Treasurer, Diversified Actuarial Services, Inc. (2002 present).
Christopher A. Staples (DOB: 8/14/70)	Vice President and Chief Investment Officer	2007 present	Vice President and Chief Investment Officer, (2007 present); Vice President, Investment Administration (2004 2007), TII; Vice President (2007 present), Chief Investment Officer (2007 present), Senior Vice President (2007 2007), Senior Vice President Investment Management (2006 2007), Vice President Investment Management (2004 2006), Transamerica Funds, TST and TIS; Vice President and Chief Investment Officer, TPP, TPFG, TPFG II and TAAVF (2007 - present); Director, Senior Vice President Investment Management and Chief Investment Officer, TAM (2006 present); Director, TFS (2005 present); Assistant Vice President, Raymond James & Associates (1999 2004).
Rick B. Resnik (DOB: 1/24/67)	Vice President and Chief Compliance Officer	2008 present	Vice President and Chief Investment Officer, (2007 present); Vice President, Investment Administration (2004 2007), TII; Vice President (2007 present), Chief Investment Officer (2007 present), Senior Vice President (2007 2007), Senior Vice President Investment Management (2006 2007), Vice President Investment Management (2004 2006), Transamerica Funds, TST and TIS; Vice President and Chief Investment Officer, TPP, TPFG, TPFG II and TAAVF (2007 - present); Director, Senior Vice President Investment Management and Chief Investment Officer, TAM (2006 present); Director, TFS (2005 present); Assistant Vice President, Raymond James & Associates (1999 2004).
Michael A. Masson (DOB: 1/21/71)	Assistant Treasurer	2007 present	Assistant Treasurer, (2007 present); Assistant Vice President (2005 2007), TII; Assistant Treasurer, (2007 present), Assistant Vice President (2005 2007), Transamerica Funds, TST and TIS; Assistant

			Treasurer, TPP, TPFG, TPFG II and TAAVF (2007 present); Director of Financial Reporting, TFS and TAM (2005 present); Assistant Vice President, JPMorgan Chase & Co. (1999 - 2005).
Suzanne Valerio-Montemurro (DOB: 8/13/64)	Assistant Treasurer	2007 present	Assistant Treasurer, Transamerica Funds, ATST and TIS (July 2007 present); Assistant Treasurer, TPP, TPFG, TPFG II and TAAVF (July 2007 - present); Vice President, Diversified (1998 - present).

* The business address of each officer is 570 Carillon Parkway, St. Petersburg, Florida 33716.

** The executive officers are elected and appointed by the Directors and hold office until they resign, are removed or are otherwise disqualified to serve.

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The Board of Directors of the Fund, including the Independent Directors, recommends that shareholders vote For Proposal 1.

OTHER BUSINESS

The Board and Fund management know of no business to be presented to the Meeting other than the matters set forth in this Proxy Statement, but should any other matter requiring a vote of shareholders arise, the proxies will vote thereon according to their best judgment.

OTHER INFORMATION

Information on Independent Registered Certified Public Accounting Firm. PricewaterhouseCoopers LLP (PwC) has been selected by the Board as the independent registered certified public accounting firm to examine the financial statements of the Fund for the fiscal year ending March 31, 2009. Representatives from PwC are not expected to attend the Meeting or be available to respond to questions during the Meeting, but they will have the opportunity to issue a statement in advance of the Meeting if they desire to do so.

Fees

The following table sets forth the aggregate fees billed for professional services rendered by PwC to the Fund during the two most recent fiscal years:

Fiscal Year Ended	Audit Fees	Audit-Related Fees	Tax Fees	All Other Fees	Totals
March 31, 2008	$38,187	$ 0	$2,120	$ 0	$40,307
March 31, 2007	$39,670	$ 0	$2,000	$ 0	$41,670

All of the services described in the table above were approved by the Audit Committee pursuant to its pre-approval policies and procedures listed below.

Non-Audit Service

For the fiscal years ended March 31, 2008, and March 31, 2007, PwC did not provide any non-audit services to the Fund (other than tax services), the Fund s investment adviser, Transamerica Asset Management, Inc. (TAM or the Adviser) or any entity controlling, controlled by or under common control with TAM.

Pre-approval Policies and Procedures

The pre-approval policies and procedures of the Fund contained in the Fund s Audit Committee Charter require that the Fund s Audit Committee pre-approve all audit services and non-audit services provided by PwC or any other independent public accountant engaged by the Fund (the Auditor). The Audit Committee must pre-approve any engagement of the Auditor to provide non-audit services to (i) the Adviser, and (ii) any entity controlling, controlled by, or under common control with the Adviser that provides ongoing services to the Fund (entities in (i) and (ii), hereinafter Service Affiliates) if the services directly relate to the operations and financial reporting of the Fund (Covered Non-Audit Services). The policies and procedures permit the Audit Committee to pre-approve the provision of types or categories of non-audit services to the Fund and Covered Non-Audit Services to the Service Affiliates. The Chairperson of the Audit Committee is authorized to give such pre-approvals on behalf of the Audit Committee.

The Audit Committee pre-approved 100% of the audit and non-audit fees listed in the table above.

Compliance with Section 16(a) of the Securities Exchange Act of 1934. Applicable laws require the Fund s officers, Directors and the Adviser, the affiliated persons of the Adviser, and the beneficial owners of more than 10% of the Fund s shares (collectively, Reporting Persons) to file initial reports of ownership and reports of changes in ownership with the SEC and the New York Stock Exchange, and to provide copies of these reports to the Fund. Based solely on its review of the copies of such forms received by it and written representations of certain Reporting Persons, the Fund believes that during the fiscal year ended March 31, 2008, no person owned beneficially more than 10% of its shares and that its Reporting Persons complied with all applicable filing requirements.

Fund Service Providers. The Fund s Adviser, TAM, is located at 570 Carillon Parkway, St Petersburg, Florida 33716. The Fund s investment sub-adviser, Transamerica Investment Management, LLC (TIM), is located at 1111 Santa Monica Boulevard, Suite 820, Los Angeles, California 90025. The Fund s Administrator, Transamerica Fund Services, Inc, is located at 570 Carillon Parkway, St. Petersburg, Florida 33716.

VOTING INFORMATION

Proxy Solicitation. In order to obtain the necessary quorum at the Meeting, in addition to solicitations of proxies by mail, proxy solicitations may also be made by telephone, e-mail or personal interviews conducted by officers of the Fund, regular employees of TAM, or other representatives of the Fund. The Fund has retained The Altman Group (Altman) as the Fund s proxy solicitor for the Meeting.

Expenses. The expense of preparing, printing and mailing the accompanying Proxy, the Notice and the Proxy Statement will be borne by the Fund. The cost of retaining Altman as the Fund s proxy solicitor for the Meeting is expected to cost approximately $15,000.

Shareholder Voting. The Board has fixed the close of business on May 2, 2008, as the record date (the Record Date) for the determination of Fund shareholders entitled to notice of and to vote at the Meeting. Shareholders of record, as to any matter on which they are entitled to vote, will be entitled to one vote per share on all business of the Meeting and an appropriate fraction of a vote for each fractional share. There were 6,318,771 shares outstanding on the Record Date.

Appendix A sets forth the shareholders entitled to cast 5% or more of the Fund s votes. To the best of the Fund s knowledge, as of the Record Date, no shareholder was entitled to cast 5% or more of the Fund s votes, except as stated in Appendix A. As of the Record Date, the officers and the Directors of the Fund as a group beneficially owned less than 1% of the Fund s shares.

A quorum constituting a majority of the Fund s shares outstanding as of the Record Date represented in person or by proxy, must be present for the transaction of business at the Meeting. If a quorum is not present at the Meeting, or if a quorum is present but sufficient votes to approve a proposal are not received, the persons named as proxies on the enclosed Proxy may propose one or more adjournments of the Meeting to permit further solicitation of Proxies. In determining whether to adjourn the Meeting, the following factors may be considered: the nature of the proposals that are the subject of the Meeting, the percentage of votes actually cast, the percentage of negative votes actually cast, the nature of any further solicitation and the information to be provided to shareholders with respect to the reasons for the solicitation. Any adjournment will require the affirmative vote of a majority of those shares represented at the Meeting in person or by proxy. A shareholder vote may be taken on the proposal in this Proxy Statement if sufficient votes have been received for approval.

Voting. In order that your shares may be represented at the Meeting, you are requested to:

- indicate your instructions on the enclosed Proxy;
- date and sign the Proxy;
- mail the Proxy promptly in the enclosed envelope, which requires no postage if mailed in the United States; and
- allow sufficient time for the Proxy to be received on or before 5:00 p.m., Eastern Time, June 27, 2008.

If the enclosed Proxy is properly executed and returned in time to be voted at the Meeting, the shares represented by the Proxy will be voted in accordance with the instructions marked therein. Unless instructions to the contrary are marked on the Proxy, it will be voted FOR the matters listed in the accompanying Notice and Proxy. Any shareholder who has given a Proxy has the right to revoke it at any time prior to its exercise either by attending the Meeting and voting his or her shares in person, or by submitting a letter of revocation or a later-dated Proxy to the Fund at the above address prior to the date of the Meeting. However, attendance at the Meeting, by itself, will not revoke a previously-tendered Proxy.

You may also vote via the Internet, or by telephone. Instructions are enclosed in these materials. If you elect to vote using one of these methods, do not return your Proxy unless you later elect to change your vote.

Broker-dealer firms holdings shares of the Fund in street name for the benefit of their customers and clients will request the instructions of such customers and clients on how to vote their shares on Proposal 1 before the Meeting. If you beneficially own shares that are held in street name through a broker-dealer, and if you do not give specific voting instructions for your shares, they may not be voted at all or they may be voted by the broker-dealer in a manner that you may not intend. Therefore, you are strongly encouraged to give your broker-dealer specific instructions as to how you want your shares to be voted.

Required Vote. Approval of Proposal 1, election of the Directors, requires an affirmative vote of a majority of shares present at the Meeting in person or by Proxy. Fund shareholders will vote together as a single class on Proposal 1. Abstentions and broker non-votes will be counted as present at the Meeting. Accordingly, assuming the presence of a quorum, abstentions and broker non-votes have the effect of a negative vote on Proposal 1. Broker non-votes occur when the Fund receives a Proxy from a broker or nominee who does not have discretionary power to vote on a particular matter and the broker or nominee has not received instructions from the beneficial owner or other person entitled to vote the shares represented by the Proxy.

Shareholders Proposals. Shareholders wishing to submit proposals for inclusion in a Proxy Statement for a subsequent shareholders meeting should send their written proposals to the Secretary of the Fund at 570 Carillon Parkway, St. Petersburg, Florida 33716. The Fund shall not be required to consider for inclusion in the Fund s Proxy statement and form of Proxy relating to the Fund s 2009 annual meeting of shareholders any proposal received later than January 30, 2009. However, timely submission of a proposal does not necessarily mean that the proposal will be included in the Fund s Proxy Statement. If a shareholder fails to give timely notice, then the persons named as proxies in the proxies solicited by the Board for the Fund s annual meeting of shareholders in 2009 may exercise discretionary voting power, to the extent not prohibited by the SEC or New York Stock Exchange rules, with respect to any proposal received by the Fund after April 7, 2009.

The Fund is required to hold annual meetings of shareholders. To ensure the presence of a quorum at the Meeting and to help save the cost of follow-up mailings, prompt execution and return of the enclosed Proxy is requested.

By Order of the Board of Directors,
Dennis P. Gallagher, Esq.
Vice President, Secretary and General Counsel
May 30, 2008

APPENDIX A
SHAREHOLDERS ENTITLED TO CAST 5% OR MORE OF FUND VOTES

Name and Address of Shareholder	Number of Votes	% of Fund
A.G. Edwards 1431 Kingsland Avenue Pagedale, MO 63133	597,329	9.45%
Wilmington Trust Company 1100 N. Market Street Wilmington, DE 19801-1243	479,575	7.59%
Charles Schwab & Co., Inc. 211 Main Street San Francisco, CA 94105	422,450	6.69%
UBS Financial Services Inc. 1200 Harbor Blvd., 3rd Floor Weehawken, NJ 07086	370,264	5.86%
National Financial Services LLC 200 Liberty Street One World Financial Tower, 5th Floor New York, NY 10281	331,920	5.25%

Robert W. Baird & Co., Inc.	326,750	8,782	$ 12,397	$ 15,506	$ 20,674
Automotive glass	9,367	4,817	17,374	9,773	
Architectural	3,797	3,714	6,779	7,590	
Total net revenues	$ 21,946	$ 20,928	$ 39,659	$ 38,037	

The following is a summary of net revenues by geographic area for the first quarter of 2001 and 2000 respectively.

	Three Months Ended July 1, 2001	Three Months Ended July 2, 2000	Six Months Ended July 1, 2001	Six Months Ended July 2, 2000
United States	$ 2,216	$ 2,534	$ 5,427	$ 5,380
South America	181	70	317	303
Pacific Rim	3,472	3,584	5,444	6,095
Japan	7,382	9,278	12,371	15,652
Europe	8,568	4,923	15,863	10,028
Canada	127	539	237	579
Total net revenues	$ 21,946	$ 20,928	$ 39,659	$ 38,037

Note 8 Contingencies:

The company is a defendant in an action filed on April 5, 1996, Four Seasons Solar Products Corp vs. Black & Decker, Bostik, Inc. and Southwall Technologies, Inc., No. 5 CV 1695, 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 co-defendant is defective, asserts causes of action for breach of contract, unfair competition, and fraudulent concealment, and seeks monetary damages of approximately $36.0 million for past and future replacement costs, loss of customer goodwill, and punitive damages against all defendants. The Company has filed a motion to dismiss. The Court has dismissed the unfair competition and fraudulent concealment claims against the Company. It still has under advisement the Company's motion to dismiss the breach of contract claim. The Company believes the claim to be without merit and will vigorously defend the action, should the breach of contract claim survive the motion to dismiss.

The Company was named a defendant in a class action lawsuit filed on March 9, 1998 by Richard McKernan in the Superior Court of California, County of Santa Clara. The Company has reached a settlement with plaintiffs in the amount of $3.75 million. The entire amount will be funded by Southwall's insurance carrier. That settlement received final approval and statutory approval as a good faith settlement from the Court on February 22, 2001. The time to appeal that order has lapsed. Claims under the settlement will be processed up to and until August 22, 2001. The insurance carrier has not indicated whether it intends to pursue Southwall for reimbursement of the settlement amount. The defense of the McKernan action is being paid by the Company's insurer.

The Company's German subsidiary is a defendant in a lawsuit filed by one of its suppliers on March 21, 2000 in a German court to seek payment of $0.9 million for engineering services rendered in connection with developing the initial plans for the German facility. The Company issued letters of award to the plaintiff amounting to $0.3 million prior to terminating plaintiff's services for not meeting the Company's expectations. The plaintiff claims fees for services rendered, including the costs of significant modifications and revisions requested by the Company calculated in accordance with the German Federal Schedule of Architects' fees. The plaintiff further alleges that the Company utilized plaintiff's planning work in further developing the plant. The Company believes that the suit is without merit and intends to vigorously defend its position. Although the Company believes that it will prevail, a $0.3 million portion of the claim was accrued as a liability on the December 31, 2000 balance sheet as it is likely that this amount will be awarded to the plaintiff.

In August 2000, the Company, its Chief Executive Officer, Thomas G. Hood, and former Chief Financial Officer, Bill R. Finley, were named as defendants in seven lawsuits, all filed in the United States District Court for the Northern District of California (Docket Nos: C-00-2792-MMC; C-00-2795-BZ; C-00-2834-SC; C-00-20856-EAI; C-00-3007-EDL; C-00-3027-JCS; and C-00-3079-MMC) (the "Actions") all alleging violations of the federal securities laws. Each of the plaintiffs in the Actions alleges that he purchased shares of the Company's common stock and seeks to represent a class of shareholders who purchased shares during the period July 26, 2000 through August 1, 2000, such dates constituting the period from the Company's release of its financial results for the first quarter of FY 2000, to the date that it issued its press release announcing that it would be restating its financial statements for that quarter. The substantive allegations in each of the Actions are essentially the same, i.e., that the defendants knew, or were reckless in not knowing, that the Company's first quarter financial statements were in error and violated Generally Accepted Accounting Principles, and that as a result the putative class members purchased stock at artificially inflated prices and were damaged. The parties have reached agreement on a settlement, in the amount of $4.2 million, which has received preliminary approval from the court. A hearing on final approval of the settlement is scheduled for September 14, 2001. The negotiated settlement will be paid entirely by the Company s insurers.

In October 2000, the Company was served with a complaint entitled Hurd Millwork, Inc. v. Southwall Technologies, Inc., et. al., United States District Court, Northern District of California, Case No. C00-3820 (CRB). Hurd is a manufacturer of insulated glass units which incorporate Heat Mirror® film. Hurd alleges that various failures and deficiencies associated with the insulated glass units give rise to warranty and other consumer claims. Hurd is seeking monetary damages for past and future replacement costs, litigation expenses, and punitive damages. The complaint alleges $32 million in damages and $25 million in restitution. The Company believes Hurd's action to be without merit and intends to strenuously defend against it. The Hurd action is still in the early discovery phase and the Company is awaiting receipt of Hurd s production of relevant documents to support the suit. The Court has scheduled the trial for March 4, 2002. The defense of the Hurd action is being paid, in part, by the Company s insurers. Southwall has agreed to pay the difference between its agreed rate structure and the insurance company s rate structure. No amount has been accrued, however, we believe the differences in the fee structures will be immaterial.

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 its consolidated financial position or results of operations.

Note 9 Going Concern and Loan Covenants

Loan Covenants

Pursuant to the guaranty, the German bank loans, and lease agreements listed above, and related terms, conditions and covenants the Company requested waivers from Teijin Limited, the German banks and the leasing company as discussed below, related to the Company's default, or event of default pursuant to these respective agreements or otherwise arising in connection with the Company's requirement to restate prior financial periods, the financial position of the Company reflected in such restated financial statements, the Company's failure to file its Form 10-Q for the second quarter of 2000 in a timely manner and trading halts or other actions taken or threatened to be taken by NASDAQ, or any law suits filed or threatened to be filed in connection with such restatements or late filings.

On September 7, 2000, Teijin provided Southwall with a letter waiving any defaults through October 1, 2001 arising out of the Company's failure to comply with the Minimum Quick Ratio and Maximum Debt-to-Tangible Net Worth financial covenants. Further, Teijin waived any Event of Default related to the Company's requirement to restate prior financial periods, the financial position of the Company to be reflected in such restated financial statements, the Company's failure to file its Form 10-Q for the second quarter of 2000 in a timely manner, any trading halts or other actions taken or threatened by NASDAQ, or any lawsuits filed or threatened in connection with such restatements or late filings or otherwise. Teijin has not agreed to extend this waiver beyond the October 1, 2001 date. As a result, the Company has reclassified the Sanwa Loan, to which this guaranty applies, from long-term to current liabilities in the balance sheet.

The Company received in October, 2000 from the German banks a waiver of the Events of Default pursuant to the agreements but the German banks did not provide a waiver of the Events of Default or any rights it may have with respect to any further material adverse change in the financial condition of the Company resulting from the Events of Default and the German banks have reserved the right to terminate the loan agreements if the expectations relating to turnover and profit as provided by the Company do not occur and provide a cause for termination. The Company cannot currently determine with reasonable certainty whether it will be able to comply with these provisions and accordingly has reclassified these loans from long-term to current liabilities in the balance sheet.

In November, 2000, the Company received from the leasing company for the sale-leaseback agreements dated July 19, 1999 and October 19, 1999 a partial waiver of the Events of Default pursuant to the agreements. However it reserved its right to declare an Event of Default based on the Company's financial condition. Accordingly, the Company has reclassified these agreements from long-term to current liabilities in the balance sheet.

Going Concern

These consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has experienced recurring losses from operations, has significant current and long-term debt containing certain covenants, with which the Company has not complied, requiring the Company to obtain waivers and to classify, as a current liability, the debt for which waivers have not been obtained. The Company must meet certain commitments for debt service payments that raise substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. As a result of this uncertainty, the Company may not be able to meet its debt service obligations without additional financing. However, the Company can give no assurances it will be successful in obtaining the required additional financing and cash from operations.

Note 10 Subsequent Events

On July 12, the Company entered into a Sublease agreement with Digeo, Inc., under the Company s Master Lease dated October 14, 1999, with C&J Development Co.. Digeo, Inc. will sublease office space located at the Company s Palo Alto facility for a rent of $0.2 million per year. The agreement will expire on December 31, 2002.

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

Except for the historical information contained herein, certain matters discussed in this Form 10-Q Report are forward-looking statements that involve risks and uncertainties, including those discussed below under Risk Factors and in the Company's Annual Report on Form 10-K/A. Actual results may differ materially from those projected. These forward-looking statements represent the Company's judgment as of the date of the filing of this Form 10-Q Report. The Company disclaims, however, any intent or obligation to update these forward-looking statements.

General

We are a designer and manufacturer of technologically advanced thin-film coatings that selectively absorb, reflect or transmit light and electromagnetic and infrared emissions. Our products are used in a number of electronic, automotive and building products to enhance optical and thermal performance characteristics, improve user comfort and reduce energy costs. From our founding in 1979 through the early 1990's, we developed and produced thin-film coated substrates primarily for residential and commercial buildings, and for military applications. In the early 1990's, we began to develop products for the electronic display and automotive markets.

In 1996, we realized our first material revenue from the electronic display and automotive markets. For the six months ended July 1, 2001 the automotive sector account for 44% of our revenues, with the electronic display products contributing 39% of our revenues and the

Architectural market accounting for the balance. We expect most of our revenue growth to come from the electronic display and automotive markets.

Several factors affect our gross margins, including manufacturing efficiencies, product mix, product differentiation, inventory management, volume pricing, and the start-up of equipment and new plants. Over the past several years, each of these factors has contributed to margin volatility as we have added new capacity to meet the demand of our electronics and automotive markets.

Three Months Ended July 1, 2001 Compared with Three Months Ended July 2, 2000

Net revenues

Net revenues increased by $1.0 million, or 4.8%, to $21.9 million for the second quarter of 2001, from $20.9 million for the second quarter of 2000. Sales to the Automotive market increased by $4.6 million, or 95.8%, to $9.4 million for second quarter of 2001, from $4.8 million for the second quarter of 2000. This increase was primarily attributable to the fact that, in the second quarter of 2001, the Company realized revenues of $4.3 million from its German operations. Sales to the Electronic Display market decreased by $3.6 million, or 29.0%, to $8.8 million for the second quarter of 2001, from $12.4 million for the second quarter of 2000. The decrease was the result of an on-going, worldwide slowdown in the sale and manufacture of personal computers. Sales to the Architectural market increased $0.1 million, or 2.7%, to $3.8 million for the second quarter of 2001, from $3.7 million for the second quarter of 2000. The decrease was primarily the result of the diversion of manufacturing capacity, previously used to produce products for the Architectural market, to manufacture products for the Automotive market.

Cost and expenses

Cost of sales. Cost of sales expense consists primarily of materials, production labor and machine overhead. Cost of sales decreased $0.6 million, or 3.6%, to $16.3 million for the second quarter of 2001, from $16.9 million in the second quarter of 2000. As a percentage of net revenues, cost of sales decreased to 74.4% of net revenues for the second quarter of 2001, from 80.9% of net revenues in the second quarter of 2000. The higher costs in 2000, as a percentage of revenues, was due to greater start-up costs in the Company s Tempe and German operations, and higher display revenues which have higher costs.

Research and development expenses. Research and development spending decreased $0.4 million, or 25.0%, to $1.2 million in the second quarter of 2001, from $1.6 million in the second quarter of 2000. Research and development expenses decreased to 5.5% of net revenues for the second quarter of 2001, from 7.7% of net revenues for the second quarter of 2000. The reduction was the result of cost containment measures taken by the Company.

Selling, general and administrative expenses. Selling, general and administrative expenses normally consist primarily of corporate and administrative overhead, selling commissions, advertising costs and occupancy costs. Year over year, these expenses remained flat at $3.1 million. Selling, general and administrative expenses decreased to 14.2% of net revenues for the second quarter of 2001, from 14.8% of net revenues for the second quarter of 2000. The decrease in the second quarter 2001, over last year, was due to cost containment measures taken by the Company.

Income (loss) from operations

The Company realized a profit of $1.4 million for the second quarter of 2001, compared to a loss of $1.1 million for the second quarter of 2000. The profit was due to improved manufacturing efficiency, largely attributable to the Company s German operations, and cost savings resulting from the reduction in force of the Tempe and Palo Alto operations during Q1 of 2001.

Interest (expense), net

The Company incurred interest expense on borrowings of $0.8 million and $1.3 million in the second quarter of 2001 and 2000, respectively, and capitalized interest incurred in connection with construction in process of $0.0 million and $0.7 million for the second quarter of 2001 and 2000, respectively. The increase in interest expense principally results from the completion of construction in process related to the German plant in late 2000.

Other income (expense), net

Other income (expense), net includes rental income, interest income and foreign exchange transaction gains and losses. The Company recorded other income of $0.5 million in the second quarter of 2001 compared with $0.08 million in the corresponding 2000 period. Certain transactions with foreign suppliers are denominated in foreign currencies rather than U.S. dollars. As exchange rates fluctuate relative to the U.S. dollar, exchange gains and losses occur.

Income (loss) before provision for income taxes

The Company reported a pre-tax profit of $1.1 million for the second quarter of 2001, compared to a pre-tax loss of $1.6 million for the second quarter of 2000. The improvement in performance was primarily due to additional revenue generated by the Company s German operations, tighter cost controls and foreign currency gains.

Legal Settlement. In the second quarter of 2000, a settlement in the amount of $0.4 million was reached on a legal matter.

Six Months Ended July 1, 2001 Compared with Six Months Ended July 2, 2000

Net revenues

Net revenues increased $1.7 million, or 4.5%, to $39.7 million for the first six months of 2001, from $38.0 million for the first six months of 2000. Sales to the Automotive market increased by $7.6 million, or 77.6%, to $17.4 million for the first six months of 2001, from $9.8 million for the first six months of 2000. This increase is primarily attributable to the fact that in the first six months of 2001, the Company realized revenues of $6.3 million from its German operations, which began limited production of commercial automotive product in December 2000. Sales to the Electronic Display market decreased by $5.2 million, or 25.1%, to $15.5 million for the first six months of 2001, from $20.7 million for the first six months of 2000. The decrease was the result of the worldwide slowdown in the sale and manufacture of personal computers. Sales to the Architectural market decreased $0.8 million, or 10.5%, to $6.8 million for the first six months of 2001, from $7.6 million for the first six months of 2000 The decrease was primarily the result of the loss of a North American manufacturer that represented approximately 6% of the Company s Heat Mirror sales, and the diversion of manufacturing capacity previously used to produce products for the Architectural market, to manufacture products for the Automotive market.

Cost of sales. Cost of sales expense consists primarily of materials, production labor and machine overhead. Cost of sales decreased $0.5 million, or 1.6%, to $31.2 million for the first six months of 2001, from $31.7 million in the first six months of 2000. As a percentage of net revenues, cost of sales decreased, to 78.6% of net revenues for the first six months of 2001, from 83.4% of net revenues in the first six months of 2000. The higher costs in 2000, as a percentage of revenues, was due to greater start-up costs in the Company s Tempe and German operations, and higher display revenues, which generally yield lower margins as a result of outside processing costs.

Research and development expenses. Our research and development spending decreased $0.5 million, or 16.1%, to $2.6 million in the first six months of 2001, from $3.1 million in the first six months of 2000. Research and development expenses decreased to 6.6% of net revenues for the first six months of 2001, from 8.2% of net revenues for the first six months of 2000. The decrease in the first six months of 2001 was primarily attributable to reduced headcount and cost control measures introduced by the Company.

Selling, general and administrative expenses. Selling, general and administrative expenses consist primarily of corporate and administrative overhead, selling commissions, advertising costs and occupancy costs. These expenses increased $0.6 million, or 11.8%, to $5.7 million in the second quarter of 2001, from $5.1 million in the first six months of 2000. Selling, general and administrative expenses, as percentage of revenue, increased , to 14.4% for the first six months of 2001, from 13.4% for the first six months of 2000. The increase in the first six months of 2001 was primarily related to higher personnel costs in the Company s German operations, and higher consulting costs incurred in the first quarter of 2001.

Income (loss) from operations. Income from operations was $0.2 million for the first six months of 2001 compared to a loss of $2.3 million for the first six months of 2000, due to improved manufacturing efficiency, largely attributable to the Company s German operation, partially offset by severance payments resulting from the reduction in force of the Tempe and Palo Alto operations.

Interest (expense), net

The Company incurred interest expense on borrowings of $1.6 million and $2.4 million for the first six months of 2001 and 2000, respectively, and capitalized interest incurred in connection with construction in process of $0.04 million and $1.5 million for the first six months of 2001 and 2000, respectively. The increase in net interest expense principally results from the completion of construction in process related to the German and Tempe plants in late 2000.

Other income (expense), net

Other income (expense), net includes rental income, interest income and foreign exchange transaction gains and losses. The Company recorded other income of $1.4 million for the first six months of 2001, compared with $0.02 million in the corresponding 2000 period. Certain transactions with foreign suppliers are denominated in foreign currencies rather than U.S. dollars. As exchange rates fluctuate relative to the U.S. dollar, exchange gains and losses occur.

Income (Loss) before provision for income taxes

The Company incurred a pre-tax profit of $0.01 million for the first six months of 2001, compared to a pre-tax loss of $3.3 million for the first six months of 2000, due to additional revenue generated by the Company s German operations, higher revenues from the Automotive market, partially offset by a decrease in revenue from the Electronic Display market.

Legal Settlement. In the second quarter of 2000, the Company accrued $0.4 million in settlement of a legal matter.

Liquidity and Capital Resources

Capital expenditures

Since 1998, we have used borrowings, German government grants and cash from operations to fund our capital expenditures. During 1999, we invested approximately $24.0 million in capital expenditures, including approximately $13.5 million of progress payments for our new manufacturing facility and first production machine (PM8) in Germany, approximately $7.5 million for two new production machines (PM6 and PM7) and leasehold improvements for our Tempe facility, and approximately $2.5 million for the upgrade of two production machines (PM1 and PM2) in Palo Alto. These investments were financed by $13.6 million of short and long-term debt, $4.9 million in German government grants, $4.5 million of cash from operations, and cash on hand. The German government grants subject us to a number of covenants. (See Note 5 to Notes to Consolidated Financial Statements.)

We spent approximately $12.9 million for capital expenditures in 2000, including $9.8 million in our German facility, of which $7.0 million represented final progress payments on our two new production machines (PM8 and PM9) in Germany and the completion of our German facility. We financed our capital expenditures in Germany primarily through the receipt of $4.0 million of additional bank loans and $1.0 million of subsidies from the German government and the release of $2.6 million of cash restricted by the German government to use in financing the completion of our German facility. The German government may reclaim the grants if we fail to meet any of the covenants. (See Note 6 to Notes of the Consolidated Financial Statements.) We invested an additional $3.1 million in our Tempe and Palo Alto operations for leasehold improvements, computer equipment and improvements on our production machines.

In the first quarter of 2000, our second machine at Tempe (PM6) began to produce limited amounts of film for commercial use. An additional machine (PM7) was delivered to Tempe in the third quarter of 2000. Additionally, we took possession of our new facility in Germany in May 2000, where PM8 was installed in the third quarter and the PM9 installation is expected to be completed in 2001. PM8 commenced production of commercial product in December, and PM9 began limited commercial production in the second quarter of 2001. The Company expects that the remaining installments on the machines will be paid from committed German bank loans. The Company does not currently have financing in place to purchase a third machine in Germany and it has postponed the placing of this order until financing can be secured. Presently, the Company can not predict the total investment that will be made in the German facility and is in the process of reviewing the total investment and timing thereof. The Company believes that it will not meet all of the conditions to the Grant. The Company is unable to predict the outcome of discussions with the Saxony government, and the impact, if any, on the Company s obligations under the grant. See "Risk Factors - Our ability to meet future cash requirements may depend on our ability to retain grants received to date from the German Government."

In the first six months of 2001, the Company spent approximately $1.0 million in capital expenditures, primarily in its German operations on PM9. The Company s total capital expenditures in 2001 are expected to be less than $4.0 million, and the expenditures are expected to be used to expand production capacity, acquire personal computers for additional employees and upgrade the Company s computer network.

Liquidity

Operating activities used $2.1 million during the first six months of 2000. In the first six months of 2001, operating activities generated $4.2 million in cash. Included in capital lease obligations on the balance sheets are $1.0 million of proceeds from a sale-leaseback transaction in 1999. This amount was withheld by the lessor and classified in Other Assets , and will not be released until the Company meets certain financial covenants. Furthermore, 50% of the proceeds from a $1.6 million loan from a German bank are restricted in an escrow account for the duration of the loan period and are classified in "Other Assets." The Company has reclassified to "Restricted Cash" that portion of cash, $0.4 million, that is restricted to payments for the facility in Germany.

The following table sets forth the material terms of our short and long-term indebtedness at July 1, 2001:

Description	Rate	Maturity	Balance at July 1, 2001	Remaining Annual Principal Amortization	Start Date
Financing Line of Credit			$ 7,247		-
Long-term debt					
Promissory note dated May 6, 1997	LIBOR +.4375	(1)	8,750	$ 1,250	May 2001
Sales-leaseback agreement dated July 19, 1999	13.0%	(2)	2,321	711	April 2000
Sales-leaseback agreement dated October 19, 1999	13.0%	(3)	2,446	1,374	March 2000
German bank loan dated May 12, 1999	6.1%	(4)	2,450	144	March 2001
German bank loan dated May 28, 1999	7.1%	(5)	2,114	-	December 2009
German bank loan dated May 28, 1999	3.8%	(6)	1,328	121	March 2001
German bank loan dated December 1, 1999	7.2%	(7)	1,794	50	December 2001
German bank loan dated August 14, 1999	5.8%	(8)	1,427	-	June 2009
German bank loan dated June 29, 2000	5.8%	(9)	548	84	June 2001
German bank loan dated July 20, 2000	7.1%	(10)	396	72	June 2001
Other equipment financings			19	3	
Total long-term debt			23,593	3,809	
Less current portion			7,150		
Less long-term portion-reclassified to current (11)			16,443		
Long-Term Debt			$ 0		

(1) We are required to make equal semi-annual repayments from May 2001 through November 2004.

(2) We are required to make equal monthly principal payments over the 36-month term of this financing.

(3) We are required to make equal monthly principal payments over the 24-month term of this financing.

(4) We are required to make equal quarterly principal payments over the 9-year repayment term of this financing starting March 31, 2001.

(5) We are required to make equal semi-annual principal payments for ten years from December 2009 through June 2019.

(6) We are required to make semi-annual principal payments for six years from March 2001 through September 2006.

(7) We are required to make equal quarterly principal payments for nine years from December 2001 through September 2010.

(8) We are required to make one principal payment on June 2009.

(9) We are required to make equal quarterly principal payments for three years from July 2001 through June 2005.

(10) We are required to make equal quarterly principal payments for three years from June 2001 through July 2004.

(11) Represents the portion of long-term debt that has been reclassified into current liabilities as a result of lenders not granting waivers for failure to meet certain covenants.

We have granted the lender of the financing line of credit a security interest in our receivables, inventory and other assets not otherwise collateralized. Our loans from German banks also subject us to covenants, including covenants relating to the progress of and investment in the development of our Dresden facility and the minimum number of our employees at Dresden by 2002. We have granted the German banks security interests in our Dresden facility and the assets located at the facility.

The promissory note dated May 6, 1997 is payable to a bank and guaranteed by Teijin Limited, a stockholder and one of our suppliers. The Teijin guarantee is collateralized by certain equipment in the Company's Tempe manufacturing facility, and our inventory to the extent necessary to cover 120% of the outstanding loan balance based on the net book value of the inventory. The guarantee subjects us to certain financial and other covenants, including covenants relating to our tangible net worth, our debt to tangible net worth, profitability and the ratio of our cash, cash equivalents and short term investments to our total current liabilities. At December 31, 2000, we were not in compliance with the financial covenants relating to our minimum net worth, the ratio of our debt to equity, the ratio of our cash, cash equivalents and short-term investments to current liabilities, and the requirement that Company be profitable. The Company received a waiver for failure to comply with these covenants through October 1, 2001. Teijin did not extend the waiver. Accordingly, the Company has reclassified the long-term balance from long-term debt to current liabilities in the balance sheet. Beginning in 2001, the Company is obligated to make two principal payments of $1.25 million each in May and November. The Company made the first principal payment of $1.25 million on May 7, 2001, and will pay the second installment of $1.25 million in November 2001. The Company will also make principal payments of $2.5 million each in 2002, 2003 and 2004.

We have provided the lessor under our sales-leaseback financings a $0.5 million irrevocable standby letter of credit to collateralize our obligations under the sales-leaseback agreements. The letter of credit will not expire before January 1, 2002. In addition, $1.0 million of the amount to be received from the lessor was withheld pending our meeting certain financial conditions.

Loan Covenants

Pursuant to the guaranty, the German bank loans, and lease agreements listed above, and related terms, conditions and covenants the Company requested waivers from Teijin Limited, the German banks and the leasing company as discussed below, related to the Company's default, or event of default pursuant to these respective agreements or otherwise arising in connection with the Company's requirement to restate prior financial periods, the financial position of the Company reflected in such restated financial statements, the Company's failure to file its Form 10-Q for the second quarter of 2000 in a timely manner and trading halts or other actions taken or threatened to be taken by NASDAQ, or any law suits filed or threatened to be filed in connection with such restatements or late filings.

On September 7, 2000, Teijin provided Southwall with a letter waiving any defaults through October 1, 2001 arising out of the Company's failure to comply with the Minimum Quick Ratio and Maximum Debt-to-Tangible Net Worth financial covenants. Further, Teijin waived any Event of Default related to the Company's requirement to restate prior financial periods, the financial position of the Company to be reflected in such restated financial statements, the Company's failure to file its Form 10-Q for the second quarter of 2000 in a timely manner, any trading halts or other actions taken or threatened by NASDAQ, or any lawsuits filed or threatened in connection with such restatements or late filings or otherwise. Teijin has not agreed to extend this waiver beyond the October 1, 2001 date. As a result, the Company has reclassified the Sanwa Loan, to which this guaranty applies, from long-term to current liabilities in the balance sheet.

The Company received in October 2000 from the German banks a waiver of the Events of Default pursuant to the agreements but the German banks did not provide a waiver of the Events of Default or any rights it may have with respect to any further material adverse change in the financial condition of the Company resulting from the Events of Default and the German banks have reserved the right to terminate the loan agreements after the third and fourth quarter of 2000 if the expectations relating to turnover and profit as provided by the Company do not occur and provide a cause for termination. The Company cannot currently determine with reasonable certainty whether it will be able to comply with these provisions and accordingly has reclassified these loans from long-term to current liabilities in the balance sheet.

In November 2000, the Company received from the leasing company for the sale-leaseback agreements dated July 19, 1999 and October 19, 1999 a partial waiver of the Events of Default pursuant to the agreements. However it reserved its right to declare an Event of Default based on the company's financial condition. Accordingly, the Company has reclassified these agreements from long-term to current liabilities in the balance sheet.

Going Concern

These consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has experienced recurring losses from operations, has significant current and long-term debt containing certain covenants, with which the Company has not complied, requiring the Company to obtain waivers and to classify, as a current liability, the debt for which waivers have not been obtained. The Company must meet certain commitments for debt service payments that raise substantial doubt about its ability to continue as a going concern. These consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. As a result of this uncertainty, the Company may not be able to meet its debt service obligations without additional financing. However, the Company can give no assurances it will be successful in obtaining the required additional financing and cash from operations.

Item 3 Quantitative and Qualitative Disclosures about Market Risk

The Company is exposed to the impact of interest rate changes, foreign currency fluctuations, and changes in the market values of its investments.

FINANCING RISK. The Company's exposure to market rate risk for changes in interest rates relates primarily to the Company's term loans which are tied to the London Interbank Offered Rate ("LIBOR") and bank line of credit which is tied to the prime rate. The Company's German subsidiary also has several fixed-rate term loans that are denominated and repayable in Deutschemarks. Fluctuations in interest rates may adversely impact the interest expense expected for the Company. At July 1, 2001, the Company had one loan with a variable interest rate. The effect of a 10% fluctuation in the interest rate for this loan would have an adverse impact of less than ($0.1) million. The effect of interest rate fluctuations on the Company during the first six months of 2001 was not material.

INVESTMENT RISK. The Company invests its excess cash in certificates of deposit and money market accounts and, by policy, limits the amount of exposure to any one institution. Investments in both fixed rate and floating rate interest earning instruments carries a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted 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 an adverse impact of less than $0.1 million.

FOREIGN CURRENCY RISK. International revenues amounted to 86% of the Company's total sales in the first six months of 2001 and, by policy, the Company limits foreign currency risk by requiring all sales to be denominated in U.S. dollars. Sales from the German subsidiary are currently denominated in U.S. dollars, but will likely be denominated in EUROs beginning in 2002. The Company's international business is subject to risks typical of an international business, including, but not limited to differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility. Accordingly, the Company's future results could be materially adversely impacted by changes in these or other factors.

RISK FACTORS

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:

- manufacturing and operational difficulties that may arise due to, among other things, expansion of our production capacity, the transfer of equipment and personnel to our international manufacturing facility, and the hiring and training of additional staff;
- our possible ability to introduce new products and technologies on a timely basis, and the increased research, development and engineering costs and marketing expenses associated with new product introductions;
- fluctuating customer demand, which is influenced by a number of factors, including general economic conditions in the sputtered thin-film coatings industry, market acceptance of our products and the products of our customers and end-users, changes in the product mix demanded and offered, and the timing, cancellation or delay of customer orders and shipments;
- 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; and
- the timing of our recognition of revenues from product orders which can materially affect our operating results on a quarterly basis due to the size of a particular order.

Future growth of our business may place a strain on our financial, management and production resources.

In order to grow, we must expand our manufacturing capacity by adding additional production machines, which will place a strain on our financial resources. Unless the Company secures additional financing, it will not be able to expand its manufacturing capacity. We will need to finance a large portion of these future expenditures through external sources, including borrowings. We do not have credit facilities in place to provide this financing. We cannot assure you that we will be able to secure credit facilities or other sources of financing that will address our future capital needs or that such credit facilities will not be on terms less favorable to us than we have budgeted.

In addition, growth of our business will increase the work load and responsibilities of our existing management and require us to expand our management team. We cannot assure you that the present size of our management team will enable us to expand our business or that we will be able to recruit enough experienced managers.

Many of our machines are the only manufacturing sources for certain of our products and are running at or near capacity. We do not have plans to develop redundancy for much of our production capability. Therefore, a breakdown or catastrophic damage to certain machines would severely and adversely affect our business. In addition, it can take up to 12-18 months to replace certain production machines. If our plans to expand our manufacturing capacity are not implemented on a timely basis, we could face production shortfalls. Rapid increases in production levels to meet unanticipated demand could result in higher costs and other expenses. These higher expenditures could lower our profit margins. Further, if production is increased rapidly, there may be decreased manufacturing yields, which may also lower our margins.

Our ability to meet our future cash requirements may depend on our ability to retain grants received to date from the German government.

The Company has an agreement to receive a grant award (the "Grant"), which was approved by the State Government of Saxony in Germany (the "Grantor") in May 1999. The agreement provides for investment grants to a maximum amount of $9.9 million (DM 20.3 million). As of July 1, 2001, the Company had received approximately $4.9 million (DM 9.7 million) under this Grant and accounted for the Grant by applying the proceeds received against the cost of the German manufacturing facility. The Company has received $0.9 million of Grants that has been recorded as an advance until the Company earns this portion of the Grant through future expenditures.

The Company believes that it may fail to meet certain requirements in connection with the grants (see Note 6 - Government Grant), in which event the Grantor would have the right to reclaim the Grant. In particular, the Company can not determine whether the total investment that will be made in the German facility will satisfy the condition to the Grant, but expects that it will not and is in the process of reviewing the total investment and timing thereof with the Grantor. The Company has had informal discussions with the Saxony government, but is unable to predict the outcome of these discussions, and the impact, if any, on the Company's obligations under the grant. If the Company breaches the covenants under the Grant, the Grantor may withhold the remaining portions of the Grant, or seek repayment of amounts previously granted. Either event would have a material, adverse effect on the Company.

We may not be able to bring new machines online effectively in our manufacturing operations to meet increasing capacity requirements.

We expanded our manufacturing capacity through the purchase of two new productions machines for our Tempe facility in 1999, one of which began production in the first quarter of 2000 and the other of which is scheduled to begin production in the second half of 2001. The first machine in our new Dresden manufacturing facility began commercial production in the fourth quarter of 2000. The second machine began production in the second quarter of 2001. In the past, we have experienced significant problems during the initial phases of operating a new machine. We have taken substantial write-offs of inventory and incurred substantial expenses in connection with the resolution of these problems. If we encounter similar problems with new machines, our production capability and our operating results will suffer.

Our success will depend on our ability to service our borrowings and maintain credit facilities.

We have financed a large portion of our capital expenditures through borrowings and expect to continue to do so. 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 or to secure additional borrowings. In addition, our current credit facilities contain, and our future credit facilities will contain, financial and operating covenants that will limit our discretion with respect to business matters. Among other things, these covenants will restrict our ability to incur additional indebtedness, create liens or other encumbrances, and make certain payments including dividends and investments. These credit facilities will also contain financial covenants and 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 adversely affect us. You should read the sections entitled "Loan Covenants"; "Liquidity"; and "Going Concern" in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" for more information.

We depend on a small number of customers for a substantial portion of our sales, and the loss of a large customer could hurt our revenues or operating results.

Our ten largest customers accounted for approximately 74%, 69% and 85% of net product sales in 1998, 1999 and 2000, respectively. During 2000, our three largest customers were Mitsubishi Electric Corporation, Sekurit St. Gobain and Samsung, each of which accounted for more than 10% of our net product sales. We expect to continue to derive a significant portion of our net product sales from a 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 small number of customers could materially damage our revenue and operating results in any period. In addition, we do not have long-term contracts or purchase orders with many of our customers, and customers may cancel their orders, change production quantities from forecast volumes or delay production for any reason.

We depend on our OEM customers for the sale of our products and for information relating to the development of new 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 shipping dates or volume of products shipped by our OEM customers, and we cannot be certain that our OEM customers will continue to ship products that incorporate our products at current levels or at all. 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.

In addition, 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 our end-user markets. 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 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. Certain of these materials are obtained from a limited number of sources. For example, the substrates we use in the manufacture of our Heat Mirror product is only currently available only from one qualified source, Teijin, holder of approximately 8.2% of our common stock. The substrates used in the manufacture of our anti-reflective film is currently available from only two qualified sources, Teijin and Di Nippon Printing. The loss of either of these current sources could adversely affect our ability to meet our scheduled product deliveries to customers. In addition, any interruption in the operations of vendors of certain other materials could also adversely affect our ability to meet our scheduled product deliveries to customers. If we are unable to obtain a sufficient supply of materials from our current sources, we could experience difficulties in obtaining alternative sources quickly or in altering product designs to use alternative materials. In the case of several materials, it takes a great deal of time to qualify new suppliers. Delays or reductions in product shipments could damage our relationships with our customers. Further, a significant increase in the price of one or more of these materials 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.

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 have a material adverse effect on our business.

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

The market for thin-film coated glass and coating equipment is characterized by rapid change, especially in the electronic display market. 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. Technological changes, process improvements, or operating improvements that could adversely affect us include:

- the development of new technologies that improve the manufacturing efficiency of our competitors;
- changes in product requirements of our customers;
- changes in the way coatings are applied to alternative substrates such as tetra acetate cellulose, or TAC;
- the development of new materials that improve the performance of thin-film coated glass; and
- improvements in the alternatives to the sputtering technology we use to produce our products, such as plasma enhanced chemical vapor deposition, or PECVD.

We may not have sufficient funds to devote to research and development, or 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.

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. 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. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address customer needs.

Electronic Information Display Market. Competitors in the anti-reflective coatings market include customers who have the capability to use wet coating technology, as well as competitors, who supply sputter coated films similar to those produced by us. One of the largest manufacturers of flat-face computer display tubes, or CDTs, Sony Corporation of Japan, has its own sputter coating film technology which is used to provide anti-reflective characteristics on its own CDTs. Customers' selection of anti-reflective products is driven by quality, price and capacity.

Automotive Glass Market. Solar control products in the automotive OEM market are provided by large, worldwide glass laminators who typically have divisions also selling products to the commercial flat glass industry. Several of these companies, such as PPG, Pilkington PLC, Sekurit St. Gobain, Asahi, Guardian, and Glaverbel, have direct to glass sputtering capability. In the applied film segment of the automotive market, companies such as 3M, Material Sciences Corporation, CP Films, and Courtaulds PLC produce competitive solar control products that are widely accepted in the market.

Residential and Commercial Window Market. Products that provide solar control and energy conservation have been available to this market for almost 20 years. Since our introduction of our Heat Mirror suspended film product in 1979, large glass producers like Guardian, PPG, Viracon, Glaverbel, and Asahi, have produced their own direct-to-glass sputtered products that perform similarly to our Heat Mirror product.

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 to recruit qualified personnel to move to the location of our in 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, and Robert Freeman, our Chief Financial Officer, and other personnel. We do not have any key person life insurance covering any officer or employee. Competition for 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.

Our success depends in part upon our ability to protect our intellectual property, but we may not be able to do so adequately.

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. In addition, we seek to avoid disclosure of our know-how and trade secrets through a number of means, including requiring those persons with access to our proprietary information to execute nondisclosure agreements with us. We seek to protect our technology, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. We have 28 patents and 6 patent applications pending in the United States that cover materials, processes, products and production equipment. We also have patents and patent applications pending in various foreign countries covering the same technology. Some foreign countries in which we may do business provide significantly less patent and proprietary rights protection than the United States.

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. 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. Our means of protecting our proprietary rights may not be adequate. In addition, our competitors may independently develop similar technology, duplicate our products, 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 68%, 77% and 86% of our net revenues during 1998, 1999 and 2000, respectively. The distance between California and Dresden create 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 or foreign laws and regulatory requirements;
- currency exchange rate fluctuations;
- tariffs, export controls and other trade barriers;
- longer accounts receivable payment cycles and difficulties in collecting accounts receivable;
- difficulties in managing and staffing international operations;
- potentially adverse tax consequences, including restrictions on the repatriation of earnings; and
- global economic turbulence and political instability.

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 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. These fluctuations could also cause prospective customers to delay orders because of the increased relative cost of our products.

We expect that, within the next twelve months, the customers of our Dresden operation will begin to make payments in EUROs or other foreign currencies. In addition, in the future, other of our customers may also make payments in foreign currencies. Such transactions may require us to begin to hedge foreign currencies in order to reduce the risk to us of fluctuating exchange rates.

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

We manufacture our electronic display and automobile glass 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;
- reduced orders;
- additional warranty and service expenses; and
- higher manufacturing costs.

We may face costly damages or litigation costs if a third party claims that we infringe its intellectual property.

It is possible that third parties may claim that we or our current or potential future products infringe upon their intellectual property. Any claims, with or without merit, could be time consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could seriously harm our business.

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

We use hazardous chemicals in producing our products. 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 or cessation of operations.

We rely on our international and domestic sales representatives, without whom our sales may suffer.

We sell our products in Japan, China and Korea through sales representatives. We also market and sell our Heat Mirror products in North America primarily through sales representatives. These sales representatives could reduce or discontinue sales of our products. They may not devote the resources necessary to provide effective sales and 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 sell. We believe that our success will continue to depend upon these sales representatives. If some or all of our sales representatives experience financial difficulties, or otherwise become unable or unwilling to promote and sell our products, our business could be harmed.

Our stock price could fluctuate widely in response to various factors, many of which are beyond our control.

The trading price of our common stock may be highly volatile. Our stock price could fluctuate widely in response to factors such as the following:

- actual or anticipated variations in our quarterly revenues or operating results;
- announcements of new products or services by us or our competitors, or new competing technologies;
- our addition or loss of significant customers;
- changes in financial estimates or recommendations by securities analysts;
- announcements by us of significant acquisitions or strategic partnerships;
- additions or departures of our key personnel;
- future equity or debt offerings by us or our announcements of such offerings; and
- general market and economic conditions.

In addition, in recent years the stock markets in general, and the Nasdaq National Market and the market for technology companies in particular, have experienced large price and volume fluctuations. These fluctuations have often been seemingly unrelated or disproportionate to the operating performance of these technology companies. These market and industry factors may materially and adversely affect our stock price, regardless of our operating performance. In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its stock. Securities litigation could result in substantial costs or large judgments against us and divert management's attention and resources.

Recent accounting pronouncements

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133,"Accounting for Derivatives and Hedging Activities" ("SFAS 133"). SFAS 133 was effective for all fiscal quarters beginning with the quarter ending June 30, 1999. SFAS 133 establishes accounting and reporting standards of derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. In July 1999, the Financial Accounting Standards Board issued SFAS No. 137 "Accounting for Derivative Instruments and Hedging Activities Deferral of the Effective Date of FASB Statement No. 133" ("SFAS 137"). SFAS 137 deferred the effective date until the first fiscal quarter for fiscal years beginning after June 15, 2000. The Company has not engaged in hedging activities or invested in derivative instruments.

PART II OTHER INFORMATION

Item 1-Legal Proceedings and Other Matters

Litigation filed against the Company was described under Item 3 in the Company's Form 10-K/A filed on April 11, 2001. Subsequent to such filing, no 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 or its consolidated financial position or results of operations.

Item 2-Changes in Securities

On April 23, 2001, the Company issued to GMX Associates, a Singapore company, 422,119 shares of the Company s common stock for $1.0 million in cash in reliance on the exemption to registration provided by Section 4(2) of the Securities Act of 1933 as amended (the Act). The securities sold to GMX have not been registered under the Act, or under the securities laws of any other jurisdictions. The securities sold to GMX may not be transferred or resold except as permitted under the Act and the applicable state securities laws, pursuant to registration or exemption therefrom. In connection with the issuance, the Company agreed to provide GMX certain rights with respect to the registration for resale of the shares purchased. The shares purchased by GMX represents approximately 5.2% of the outstanding shares of the Company.

Item 3-Defaults upon Senior Securities

Not applicable

Item 4-Submission of Matters to a Vote of Stockholders

No matters were submitted to a vote of security holders during the quarter ended July 1, 2001.

Item 5-Other Information

Not applicable

Item 6-Exhibits

(a) Exhibits

Exhibit Number	Item
11	Digeo, Inc. sublease agreement.

(b) Reports on Form 8-K None

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: August 8, 2001 Southwall Technologies Inc.

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