STORAGE TECHNOLOGY CORP
Form 10-Q
August 12, 2002

Form 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 28, 2002
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _______ to ________

Commission File Number 1-7534

STORAGE TECHNOLOGY CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	84-0593263
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
One StorageTek Drive, Louisville, Colorado	80028-4309
(Address of principal executive offices)	(Zip Code)

Registrant's Telephone Number, including area code: (303) 673-5151

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Common stock ($0.10 Par Value) - 105,966,741 shares outstanding at August 5, 2002.

STORAGE TECHNOLOGY CORPORATION AND SUBSIDIARIES
INDEX TO FORM 10-Q
June 28, 2002

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED BALANCE SHEET
(In Thousands, Except Share Amounts)

	06/28/02	12/28/01
	(Unaudited)	

ASSETS		
Current assets:		
Cash and cash equivalents	$ 488,756	$ 453,217
Accounts receivable	467,832	505,630
Inventories	134,156	183,980
Deferred income tax assets	95,471	95,459
Other current assets	7,943	16,240
Total current assets	1,194,158	1,254,526
Property, plant, and equipment	263,806	232,289
Spare parts for maintenance	37,975	35,674
Deferred income tax assets	121,508	121,826
Other assets	126,763	114,568
Total assets	$ 1,744,210	$ 1,758,883
LIABILITIES		
Current liabilities:		
Credit facilities	$ --	$ 73,401
Current portion of long-term debt	699	812
Accounts payable	87,830	66,648
Accrued liabilities	356,772	361,113
Income taxes payable	206,691	212,566
Other current liabilities	27,828	--
Total current liabilities	679,820	714,540
Long-term debt	10,298	9,523
Total liabilities	690,118	724,063
Commitments and contingencies (Note 6)		
STOCKHOLDERS' EQUITY		
Common stock, $0.10 par value, 300,000,000 shares authorized; 106,158,575 shares issued at June 28, 2002, and 105,032,665 shares issued at December 28, 2001	10,616	10,503
Capital in excess of par value	895,490	875,379
Retained earnings	175,216	150,129
Accumulated other comprehensive income (loss)	(14,429)	7,642
Treasury stock, 200,643 shares at June 28, 2002, and December 28, 2001, at cost	(3,777)	(3,777)
Unearned compensation	(9,024)	(5,056)
Total stockholders' equity	1,054,092	1,034,820

Total liabilities and stockholders' equity	$ 1,744,210	$ 1,758,883

The accompanying notes are an integral part of the consolidated financial statements.

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited)
(In Thousands, Except Per Share Amounts)

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Revenue				
Storage products	$299,879	$346,271	$582,044	$651,631
Storage services	192,050	165,863	365,797	329,322
Total revenue	491,929	512,134	947,841	980,953
Cost of revenue				
Storage products	169,492	190,365	330,308	363,980
Storage services	104,890	102,000	204,295	199,934
Total cost of revenue	274,382	292,365	534,603	563,914
Gross profit	217,547	219,769	413,238	417,039
Research and product development costs	54,526	61,013	109,031	125,207
Selling, general, administrative, and other income and expense, net	136,998	140,840	270,994	279,083
Operating profit	26,023	17,916	33,213	12,749
Interest income	2,552	2,509	4,602	4,757
Interest expense	(545)	(1,825)	(1,028)	(3,460)
Income before income taxes	28,030	18,600	36,787	14,046
Provision for income taxes	(8,900)	(6,350)	(11,700)	(4,800)
Net income	$ 19,130	$ 12,250	$ 25,087	$ 9,246

EARNINGS PER COMMON SHARE

Basic earnings per share	$ 0.18	$ 0.12	$ 0.24	$ 0.09
Weighted-average shares	105,009	103,005	104,720	102,653
Diluted earnings per share	$ 0.18	$ 0.12	$ 0.23	$ 0.09
Weighted-average and dilutive potential shares	107,510	104,429	107,479	104,181

The accompanying notes are an integral part of the consolidated financial statements.

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STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)
(In Thousands)

	Six Months Ended	
	06/28/02	06/29/01
OPERATING ACTIVITIES		
Cash received from customers	$1,006,002	$1,050,105
Cash paid to suppliers and employees	(828,878)	(980,763)
Interest received	4,183	4,757
Interest paid	(844)	(2,992)
Income taxes refunded (paid)	10,289	(6,131)
Net cash provided by operating activities	190,752	64,976
INVESTING ACTIVITIES		
Purchases of property, plant, and equipment	(75,512)	(36,211)
Proceeds from sale of property, plant, and equipment	177	80
Other assets	(13,138)	(4,391)
Net cash used in investing activities	(88,473)	(40,522)
FINANCING ACTIVITIES		
Proceeds from employee stock plans	14,047	8,102
Proceeds from other debt	1,107	711
Proceeds (repayments) of credit facilities, net	(73,401)	5,375
Repayments of other debt	(1,637)	(8,045)
Net cash provided by (used in) financing activities	(59,884)	6,143
Effect of exchange rate changes on cash	(6,856)	(3,433)

Increase in cash and cash equivalents	35,539	27,164
Cash and cash equivalents - beginning of the period	453,217	279,731
Cash and cash equivalents - end of the period	$ 488,756	$ 306,895

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net income	$ 25,087	$ 9,246
Depreciation and amortization expense	47,439	60,519
Inventory writedowns	21,338	20,883
Translation gain	(1,512)	(11,600)
Other non-cash adjustments to income	(1,964)	12,643
Decrease in accounts receivable	58,161	73,515
Increase in other current assets	(4,109)	(5,845)
(Increase) decrease in inventories	30,909	(41,101)
Increase in spare parts	(11,599)	(8,744)
(Increase) decrease in deferred income tax assets	993	(292)
Increase (decrease) in accounts payable	20,107	(20,729)
Decrease in accrued liabilities	(19,099)	(22,816)
Increase in other current liabilities	4,405	336
Increase (decrease) in income taxes payable	20,596	(1,039)
Net cash provided by operating activities	$ 190,752	$ 64,976

The accompanying notes are an integral part of the consolidated financial statements.

STORAGE TECHNOLOGY CORPORATION
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(Unaudited)
(In Thousands)

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Net income	$ 19,130	$ 12,250	$ 25,087	$ 9,246
Other comprehensive income (loss), net of tax:				
Cumulative effect of change in accounting principle on adoption of Statement of Financial Accounting Standards No. 133 and 138	--	--	--	(7,535)
Net gain (loss) on foreign currency cash flow hedges	(25,614)	4,893	(25,652)	23,087
Reclassification adjustment for net (gains) losses included in net income	4,950	(4,429)	3,581	(6,393)
Other comprehensive income (loss), net of tax	(20,664)	464	(22,071)	9,159
Comprehensive income (loss)	$ (1,534)	$ 12,714	$ 3,016	$ 18,405

The accompanying notes are an integral part of the consolidated financial statements.

STORAGE TECHNOLOGY CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 - BASIS OF PREPARATION

The accompanying interim consolidated financial statements of Storage Technology Corporation and its wholly owned subsidiaries (StorageTek or the Company) have been prepared on substantially the same basis as the Company's annual consolidated financial statements and should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 28, 2001. In the opinion of management, the interim consolidated financial statements reflect all adjustments necessary for the fair presentation of results for the periods presented, and such adjustments are of a normal, recurring nature.

The consolidated results for interim periods are not necessarily indicative of expected results for the full fiscal year.

NOTE 2 - INVENTORIES

Inventories, net of associated reserves, consist of the following (in thousands of dollars):

	06/28/02	12/28/01
Raw materials	$ 19,815	$ 41,850
Work-in-process	45,386	57,641
Finished goods	68,955	84,489
	$134,156	$183,980

NOTE 3 - AGREEMENTS WITH EDS

On March 29, 2002, StorageTek and Electronic Data Systems Corporation (EDS) entered into a 10-year master secondary storage services agreement. On April 1, 2002, StorageTek and EDS entered into a 10-year agreement under which StorageTek outsourced certain internal information technology and customer call center operations to EDS. There are no cross-default provisions between the two agreements, and performance under each agreement by both StorageTek and EDS is not contingent upon performance under the other agreement. These agreements have been accounted for individually at their estimated fair values consistent with the provisions of Accounting Principles Board (APB) Opinion No. 29, "Accounting for Nonmonetary Transactions," based on management's estimates of fair value. These values are subject to change pending receipt of a third-party appraisal.

Under the terms of the secondary storage services agreement, StorageTek will provide tape storage services for certain EDS-operated data center sites within the United States. StorageTek will receive a fee for these services calculated using a monthly base service fee adjusted for certain increases and decreases in the actual amount of data stored. The agreement also provides for adjustments to the fees in the event specified service level metrics are not achieved.

The secondary storage services agreement can be renewed on an annual basis after the expiration of the initial 10-year term. The agreement can be cancelled by either party upon certain events, and can be cancelled by EDS for convenience with six months notice no sooner than two-and-one-half years from the effective date of the agreement. In the event EDS terminates the agreement for convenience, a termination fee is payable to StorageTek with the amount of the fee based upon a declining scale from the effective date.

In connection with the secondary storage services agreement, StorageTek purchased certain secondary storage equipment for a purchase price of $52,200,000. Substantially all of the purchase price paid to EDS relates to equipment previously sold by StorageTek to EDS; however, none of the equipment purchased by StorageTek was sold to EDS subsequent to the companies entering into definitive negotiations of the secondary storage services agreement. The purchase price was paid in April 2002. Because StorageTek is only responsible for delivering secondary storage pursuant to the service level agreement, StorageTek makes all decisions on secondary storage equipment additions and retirements within the data centers. Upon the expiration or termination of the agreement, EDS has the option to purchase any secondary storage equipment owned by StorageTek at the data center sites at a purchase price equal to the greater of the net book value of the equipment or the fair market value of the equipment. In limited situations, EDS also has the right to repurchase a portion of the equipment prior to expiration or termination of the agreement at an assigned value declining on a straight-line basis over five years. The estimated fair value of the equipment subject to this repurchase right was $12,271,000 as of March 29, 2002. In the event EDS exercises this repurchase right, the exercise will not affect any other terms of the agreement.

StorageTek has agreed to reimburse certain lease payments made by EDS on equipment used to deliver secondary storage services under the agreement. EDS' gross remaining lease obligation associated with this equipment, assuming no lease terminations, was approximately $8,599,000 as of March 29, 2002.

Revenue is recognized under the secondary storage services agreement as the services are rendered and billed to EDS. Costs to provide these services are generally incurred in proportion with the contracted billing schedules. The revenue and costs are included within storage services for segment reporting purposes. The purchase price of $52,200,000 payable to EDS for the secondary storage equipment has been recorded within Property, Plant, and Equipment on the Consolidated Balance Sheet. The Company is depreciating the equipment on a straight-line basis over the estimated useful lives of the assets. Useful lives were determined based on the individual characteristics of the equipment, and range from one to five years. Lease reimbursement payments made to EDS will be recognized as a reduction of service revenue.

NOTE 4 - GOODWILL

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." This statement addresses the accounting for goodwill and intangible assets subsequent to their acquisition. SFAS No. 142 requires that goodwill no longer be amortized. Under SFAS No. 142, goodwill will be tested for impairment on an annual basis or as necessary. The Company adopted SFAS No. 142 on the first day of the Company's fiscal year 2002. During the quarter ended June 28, 2002, the Company completed the initial goodwill impairment test. No accounting charge resulted from the completion of this initial impairment test.

The following table presents the adjusted net income and earnings per share had SFAS No. 142 been in effect for all periods presented (in thousands, except per share amounts):

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Reported net income	$ 19,130	$ 12,250	$ 25,087	$ 9,246
Add back: Goodwill amortization	--	1,459	--	2,917
Adjusted net income	$ 19,130	$ 13,709	$ 25,087	$ 12,163
Basic earnings per common share:				
Reported net income	$ 0.18	$ 0.12	$ 0.24	$ 0.09
Goodwill amortization	--	0.01	--	0.03
Adjusted net income	$ 0.18	$ 0.13	$ 0.24	$ 0.12
Diluted earnings per common share:				
Reported net income	$ 0.18	$ 0.12	$ 0.23	$ 0.09
Goodwill amortization	--	0.01	--	0.03
Adjusted net income	$ 0.18	$ 0.13	$ 0.23	$ 0.12

NOTE 5 - DEBT AND FINANCING ARRANGEMENTS

The Company had a financing agreement with a bank that provided for the sale of promissory notes in the principal amount of up to $75,000,000 at any one time. This agreement expired in January 2002, and all outstanding promissory notes under the agreement were repaid at that time. The Company has historically utilized foreign currency forwards embedded in borrowing commitments under this financing agreement to hedge forecasted cash flows associated with revenue denominated in foreign currencies. The Company is currently using stand-alone foreign currency options and forwards to mitigate the risk that forecasted cash flows associated with revenue denominated in foreign currencies may be adversely affected by changes in foreign currency exchange rates.

See the Company's Annual Report on Form 10-K for the year ended December 28, 2001, for additional information regarding the Company's debt and financing arrangements, and derivative instruments.

NOTE 6 - LITIGATION

In 1994, Stuff Technology Partners II, a Colorado Limited Partnership (Stuff), filed suit in Boulder County, Colorado, District Court (the District Court) against the Company. The suit alleged that the Company breached a 1990 settlement agreement that had resolved earlier litigation between the parties involving an unsuccessful optical disk drive storage development project. The suit seeks injunctive relief and damages of $2,400,000,000. In 1995, the District Court granted the Company's motion for summary judgment and dismissed the complaint. Stuff appealed to the Colorado Court of Appeals (the Court of Appeals), which reversed the District Court's judgment and remanded the case to the District Court for further proceedings. In 1999, the District Court again dismissed all of Stuff's claims against the Company, and Stuff again appealed the dismissal to the Court of Appeals. In 2000, the Court of Appeals reversed the dismissal and remanded the case to the District Court for a trial on the factual issues. The parties stipulated to a separate trial, scheduled for

September 16, 2002, on the interpretation of language in the 1990 settlement agreement. If the Company prevails in this separate trial, Stuff's claims will

be significantly reduced. Any trial to resolve the underlying liability and damages issues would likely not be scheduled before 2004. The Company continues to believe that Stuff's claims are without merit and intends to vigorously defend this suit.

The Company also is involved in various other less significant legal actions. While the Company currently believes that the amount of any ultimate potential loss would not be material to the Company's financial position, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial position or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

NOTE 7 - OPERATIONS OF BUSINESS SEGMENTS

The Company is organized into two reportable segments based on the definitions provided in SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information": storage products and storage services. The storage products segment includes sales of tape and tape automation products, disk products, and network products. The storage services segment includes maintenance and various consulting services.

The Company does not have any intersegment revenue, and segment operating performance is evaluated based on gross profit. The aggregate gross profit by segment equals the consolidated gross profit, and the Company does not allocate research and product development costs; selling, general, administrative, and other income and expense; interest income; interest expense; or benefit (provision) for income taxes to the segments. The revenue and gross profit by segment is as follows (in thousands of dollars):

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Revenue:				
Storage products	$299,879	$346,271	$582,044	$651,631
Storage services	192,050	165,863	365,797	329,322
Total revenue	$491,929	$512,134	$947,841	$980,953
Gross profit:				
Storage products	$130,387	$155,906	$251,736	$287,651
Storage services	87,160	63,863	161,502	129,388
Total gross profit	$217,547	$219,769	$413,238	$417,039

The following table provides supplemental financial data regarding revenue from the Company's storage products segment (in thousands of dollars):

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Tape and tape automation products	$235,597	$285,763	$462,764	$533,200
Disk products	35,227	25,287	55,262	51,598
Network and other products	29,055	35,221	64,018	66,833
Total storage products revenue	$299,879	$346,271	$582,044	$651,631

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NOTE 8 - EARNINGS PER COMMON SHARE

The following table presents the calculation of basic and diluted earnings per share (in thousands, except per share amounts):

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Net income	$ 19,130	$ 12,250	$ 25,087	$ 9,246
Weighted average common shares outstanding:				
Basic	105,009	103,005	104,720	102,653
Effect of dilutive common stock equivalents	2,501	1,424	2,759	1,528
Diluted	107,510	104,429	107,479	104,181
Earnings per common share:				
Basic	$ 0.18	$ 0.12	$ 0.24	$ 0.09
Diluted	$ 0.18	$ 0.12	$ 0.23	$ 0.09

For the quarters ended June 28, 2002, and June 29, 2001, options to purchase 4,580,480 and 5,822,283 shares of common stock, respectively, were excluded from the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the Company's common stock, and therefore, the effect would have been antidilutive. For the six months ended June 28, 2002, and June 29, 2001, options to purchase 4,409,426 and 7,092,452 shares of common stock, respectively, were excluded from the computation of diluted earnings per share for the same reason.

NOTE 9 - RECENT ACCOUNTING PRONOUNCEMENTS

In August 2001, the FASB issued SFAS No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets." This statement addresses the accounting for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. SFAS No. 143 is effective for the Company's financial statements for the year ending December 26, 2003. The adoption of this statement is not currently anticipated to have a material impact on the Company's financial position or results of operations.

In July 2002, the Financial Accounting Standards Board (FASB) issued SFAS No.

146, "Accounting for Costs Associated with Exit or Disposal Activities". This statement addresses the accounting for costs associated with an exit activity or with a disposal of long-lived assets. SFAS No. 146 is effective for the Company's financial statements for the year ending December 26, 2003. The adoption of this statement is not currently anticipated to have a material impact on the Company's financial position or results of operations.

STORAGE TECHNOLOGY CORPORATION AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
JUNE 28, 2002

FORWARD-LOOKING STATEMENTS

All assumptions, anticipations, expectations, and forecasts contained in the following discussion regarding the Company, its future products, business plans, financial results, performance, and future events are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The Company's actual results may differ materially because of a number of risks and uncertainties. Some of these risks are detailed below in "Factors That May Affect Future Results" and elsewhere in this Form 10-Q. Forward-looking statements can be identified by the use of words such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "intends," "potential," "continue," or the negative of such terms, or other comparable words. Forward-looking statements also include the assumptions underlying or relating to any such statements. The forward-looking statements contained herein represent a good-faith assessment of the Company's future performance for which management believes there is a reasonable basis. The Company disclaims any obligation to update the forward-looking statements contained herein, except as may be otherwise required by law.

CONSOLIDATED STATEMENT OF OPERATIONS DATA

The following table, stated as a percentage of total revenue, presents Consolidated Statement of Operations information and revenue by segment:

	Quarter Ended		Six Months Ended	
	06/28/02	06/29/01	06/28/02	06/29/01
Storage products revenue:				
Tape and tape automation products	47.9%	55.8%	48.8%	54.4%
Disk products	7.2	4.9	5.8	5.2
Network and other products	5.9	6.9	6.8	6.8
Total storage products revenue	61.0	67.6	61.4	66.4
Storage services revenue	39.0	32.4	38.6	33.6
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue	55.8	57.1	56.4	57.5
Gross profit	44.2	42.9	43.6	42.5
Research and product development costs	11.1	11.9	11.5	12.8
Selling, general, administrative, and other income and expense, net	27.8	27.5	28.6	28.4
Operating profit	5.3	3.5	3.5	1.3
Interest income, net	0.4	0.1	0.4	0.1

Income before income taxes	5.7	3.6	3.9	1.4
Provision for income taxes	1.8	1.2	1.3	0.5
Net income	3.9%	2.4%	2.6%	0.9%

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REVENUE

STORAGE PRODUCTS

The Company's storage products revenue consists of sales of tape and tape automation products, disk products, and network products for the enterprise and open-systems markets. The open-systems market consists of products designed to operate in the UNIX, NT, and other non-MVS operating environments. Storage products revenue decreased 13% and 11% during the second quarter and six months of 2002, respectively, compared to the same periods in 2001, primarily due to decreased revenue from tape and tape automation products.

Tape and Tape Automation Products

Tape and tape automation product revenue decreased 18% and 13% during the second quarter and six months of 2002, respectively, compared to the same periods in 2001, primarily due to a reduction in the number of tape and tape automation units sold. The Company believes this decline is primarily attributable to the current economic conditions and the associated weakness in information technology spending. The Company has also experienced a higher ratio of tape drives sold relative to tape libraries as customers appear to be buying only products essential to meeting their immediate storage needs. Also contributing to the decline in tape product revenue during the second quarter of 2002 was a shift from storage products revenue to storage services revenue as a result of the secondary storage services agreement signed with EDS. See "Storage Services" below for further discussion of the impact of the EDS secondary storage services agreement. These decreases were partially offset by increased revenue from enterprise and open-systems tape media products.

Disk Products

Disk product revenue increased 39% and 7% during the second quarter and six months of 2002, respectively, compared to the same periods in 2001, primarily due to increased sales of open-systems disk products. In January 2002 the Company announced a distribution agreement with LSI Logic Storage Systems (LSI). Under the terms of the agreement, StorageTek will sell LSI's full line of scalable, high performance, high availability open-systems disk products. The second quarter of 2002 was the first full quarter of activity under this agreement. The increased revenue from open-systems disk products was partially offset by decreased revenue from the Shared Virtual Array(TM) (SVA) family of products targeted for the enterprise marketplace. The Company is focusing its disk sales efforts on opportunities to sell disk products in combination with its tape, networking, and service offerings. Disk revenue continues to be affected by pricing pressures and intense competition in the disk market, as well as the worldwide slowdown in customer spending for disk storage.

Network and Other Products

Network and other product revenue decreased 18% and 4% during the second quarter and six months of 2002, respectively, compared to the same periods in 2001, primarily due to decreased sales of connectivity, software, and other miscellaneous products. The decrease was partially offset by increased sales of storage area networking (SAN) hardware, which includes the StorageNet(TM) 6000

series of domain managers and third-party equipment such as switches and bridges. Although sales of the Company's StorageNet(TM) 6000 increased during the second quarter and six months of 2002, compared to the same periods in 2001, sales unit growth has been limited by the size of the market that this product can address.

STORAGE SERVICES

The Company's storage services revenue primarily includes revenue associated with the maintenance of the Company's and third-party storage products, as well as service revenue associated with storage consulting activities. Storage services revenue increased 16% and 11% during the second quarter and six months of 2002, respectively, compared to the same periods in 2001. The growth in service revenue has been driven largely by an expanded effort to sell services that help customers successfully manage their storage requirements.

A portion of the revenue growth in the Company's storage services segment was also driven by the recently announced secondary storage services agreement with EDS. Under the terms of the agreement, StorageTek will provide tape storage services for certain EDS-operated data center sites within the United States. StorageTek will receive a fee for these services calculated using a monthly base service fee adjusted for certain increases and decreases in the actual amount of data stored. The Company recognized service revenue in connection with the secondary storage services agreement of approximately $9.1 million during the second quarter of 2002. Prior to entering into this agreement, StorageTek could have potentially sold tape and tape automation products to EDS in these data centers in order to meet their storage requirements, and earned maintenance revenue associated with those products. Historically, product sales into these data centers have varied significantly from one quarter to the next. Sales of the StorageTek products into the data centers covered within the scope of the agreement during the second quarter of 2001 were approximately $5.1 million. Service revenue recognized in connection with maintenance of equipment in these data centers during the second quarter of 2001 was approximately $2.6 million. See Note 3 of Notes to Consolidated Financial Statements for a discussion of the accounting policies associated with the secondary storage services agreement with EDS.

GROSS PROFIT

Gross profit margins increased to 44% for the second quarter and six months of 2002, compared to 43% for the same periods in 2001, primarily as a result of improvements in storage services profit margins. Gross profit margins for the storage products segment decreased to 43% for the second quarter and six months of 2002, compared to 45% and 44%, respectively, for the same periods in 2001. The decrease reflects shifts in both the distribution channels and products sold during 2002. Sales through the Company's indirect channels, which typically generate lower margins, represented 45% of the total product sales in the second quarter of 2002, as compared to 40% in the second quarter of 2001. A decrease in sales of StorageTek manufactured tape products coupled with an increase in sales of third-party manufactured open-systems disk products also contributed to the decline in product margins. Gross margins for the storage services segment increased to 45% and 44% for the second quarter and six months of 2002, respectively, compared to 39% for the same periods in 2001. The increase reflects improvements in spare parts utilization and the service delivery process. The Company is continuing to assess its service delivery processes in an effort to improve efficiencies and eliminate unnecessary costs. These improvements may require additional investments and costs that could adversely impact service margins in the second half of 2002.

RESEARCH AND PRODUCT DEVELOPMENT

Research and product development expenses decreased 11% and 13% during the second quarter and six months of 2002, respectively, compared to the same periods in 2001, primarily due to engineering initiatives designed to improve research and development productivity, increase strategic alignment, and eliminate non-essential spending. The Company continues to evaluate and prioritize research and product development programs and is focusing on the core businesses of tape automation, virtual storage, SAN products, and related services.

SELLING, GENERAL, ADMINISTRATIVE, AND OTHER INCOME AND EXPENSE

Selling, general, administrative, and other income and expense (SG&A) decreased 3% during the second quarter and six months of 2002, compared to the same periods in 2001. As a percentage of revenue, SG&A was largely unchanged from the second quarter and six months of 2001. In light of the economic downturn, the Company is intensifying its efforts to control discretionary spending and identify new opportunities to drive increased profitability.

LITIGATION

In 1994, Stuff Technology Partners II, a Colorado Limited Partnership (Stuff), filed suit in Boulder County, Colorado, District Court (the District Court) against the Company. The suit alleged that the Company breached a 1990 settlement agreement that had resolved earlier litigation between the parties involving an unsuccessful optical disk drive storage development project. The suit seeks injunctive relief and damages of $2.4 billion. In 1995, the District Court granted the Company's motion for summary judgment and dismissed the complaint. Stuff appealed to the Colorado Court of Appeals (the Court of Appeals), which reversed the District Court's judgment and remanded the case to the District Court for further proceedings. In 1999, the District Court again dismissed all of Stuff's claims against the Company, and Stuff again appealed the dismissal to the Court of Appeals. In 2000, the Court of Appeals reversed the dismissal and remanded the case to the District Court for a trial on the factual issues. The parties stipulated to a separate trial, scheduled for September 16, 2002, on the interpretation of language in the 1990 settlement agreement. If the Company prevails in this separate trial, Stuff's claims will be significantly reduced. Any trial to resolve the underlying liability and damages issues would likely not be scheduled before 2004. The Company continues to believe that Stuff's claims are without merit and intends to vigorously defend this suit.

The Company also is involved in various other less significant legal actions. While the Company currently believes that the amount of any ultimate potential loss would not be material to the Company's financial position, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial position or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

INTEREST INCOME AND EXPENSE

Interest income was largely unchanged during the second quarter and six months of 2002, compared to the same periods in 2001. Interest expense decreased $1.3 million and $2.4 million during the second quarter and six months of 2002,

respectively, compared to the same periods in 2001, primarily due to a decrease in outstanding debt.

INCOME TAXES

The Company's effective tax rate was 32% for the second quarter and six months of 2002, compared to 34% for the same periods in 2001. The decrease in the effective tax rate is primarily due to the Company's global tax strategies associated with the Company's manufacturing operations in Puerto Rico.

Statement of Financial Accounting Standards (SFAS) No. 109 requires that deferred income tax assets be recognized to the extent realization of such assets is more likely than not. Based on the currently available information,

management has determined that the Company will more likely than not realize $217.0 million of deferred income tax assets as of June 28, 2002. The Company's valuation allowance of approximately $21.4 million as of June 28, 2002, relates principally to net deductible temporary differences, tax credit carryforwards, and net operating loss carryforwards.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets." This statement addresses the accounting for goodwill and intangible assets subsequent to their acquisition. SFAS No. 142 requires that goodwill no longer be amortized. Under SFAS No. 142, goodwill will be tested for impairment on an annual basis or as necessary. The Company adopted SFAS No. 142 on the first day of the Company's fiscal year 2002. During the quarter ended June 28, 2002, the Company completed the initial goodwill impairment test. No accounting charge resulted from the completion of this initial impairment test. See Note 4 of Notes to Consolidated Financial Statements for a discussion of the financial impact on the Company's results of operations had SFAS No. 142 been in effect for all periods presented.

In August 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets." This statement addresses the accounting for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. SFAS No. 143 is effective for the Company's financial statements for the year ending December 26, 2003. The adoption of this statement is not currently anticipated to have a material impact on the Company's financial position or results of operations.

In July 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities". This statement addresses the accounting for costs associated with an exit activity or with a disposal of long-lived assets. SFAS No. 146 is effective for the Company's financial statements for the year ending December 26, 2003. The adoption of this statement is not currently anticipated to have a material impact on the Company's financial position or results of operations.

LIQUIDITY AND CAPITAL RESOURCES

Working Capital

The Company's operating activities provided cash of $190.8 million during the six months of 2002, compared to cash of $65.0 million generated from operations

during the same period in 2001. The increase in cash generated from operations during the six months of 2002, compared to the same period in 2001, was primarily a result of significantly lower purchases of inventory, as well as other efforts to more effectively manage working capital. Cash used in investing activities increased to $88.5 million during the six months of 2002 from $40.5 million during the six months of 2001, primarily due to the payment of $52.2 million to EDS in connection with the secondary storage services agreement. Cash used in financing activities was $59.9 million during the six months of 2002, compared to cash provided by financing activities of $6.1 million during the same period in 2001. This change in net cash from financing activities was primarily as a result of the repayment of borrowings under the Company's credit facilities during the six months of 2002, partially offset by increased proceeds from employee stock plans. The Company has continued to reduce its outstanding debt balance, and its debt-to-capitalization ratio was 1% as of June 28, 2002.

Sources of Liquidity and Capitalization

The Company has a $150.0 million revolving credit facility (the Revolver) that expires in October 2004. The interest rates for borrowing under the Revolver are dependent on the Company's Total Debt to rolling four quarter Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA) ratio and the term of the outstanding borrowing. The rate ranges from the applicable LIBOR plus 1.75% to 2.50% or the agent bank's base rate plus 0.00% to 0.50%. The Company had no outstanding borrowings under the Revolver as of June 28, 2002, but had outstanding letters of credit of approximately $268,000. The remaining available credit under the Revolver as of June 28, 2002, was approximately $149.7 million. The Revolver is secured by the Company's domestic accounts receivable and domestic inventory, and contains certain financial and other covenants, including restrictions on the payment of cash dividends on the Company's common stock.

The Company had a financing agreement with a bank that provided for the sale of promissory notes in the principal amount of up to $75.0 million at any one time. This agreement expired in January 2002, and all outstanding promissory notes under the agreement were repaid at that time.

The Company's cash flows from operations are currently expected to serve as the principal source of working capital. Cash flows from operations could be negatively impacted by a decrease in demand for the Company's products and services as a result of rapid technological changes and other risks described under "Factors That May Affect Future Results."

The Company believes it has adequate working capital and financing capabilities to meet its anticipated operating and capital requirements for the next 12 months. Over the longer term, the Company may choose to fund these activities through the issuance of additional debt or equity financing. The issuance of equity or convertible debt securities could result in dilution to the Company's stockholders. There can be no assurance that any additional long-term financing, if required, can be completed on terms that are favorable to the Company.

The Company's debt-to-capitalization ratio decreased from 7% as of December 28, 2001, to 1% as of June 28, 2002, primarily because of the repayment of borrowings under the Company's credit facilities. See "Working Capital" above for a discussion of cash sources and uses.

INTERNATIONAL OPERATIONS

International operations accounted for approximately 51% and 49% of the Company's revenue during the second quarter and six months of 2002,

respectively, compared to 51% during the same periods of 2001. The Company also sells products through domestic indirect distribution channels that have end-user customers located outside the United States. The Company expects that it will continue to generate a significant portion of its revenue from international operations. The majority of the Company's international operations involve transactions denominated in the local currencies of countries within western Europe, principally Germany, France, and the United Kingdom; Australia; Canada; Japan; and Korea. An increase in the exchange value of the U.S. dollar reduces the value of revenue and profits generated by the Company's international operations. As a result, the Company's operating and financial results can be materially affected by fluctuations in foreign currency exchange rates. In an attempt to mitigate the impact of foreign currency fluctuations, the Company employs a foreign currency hedging program. See "Market Risk Management" below.

The Company's international business may be affected by changes in demand resulting from global and localized economic, business, and political conditions. The Company is subject to the risks of conducting business outside the United States, including adverse political and economic conditions; impositions of, or changes in, tariffs, quotas, and legislative or regulatory requirements; difficulty in obtaining export licenses; potentially adverse taxes; the burdens of complying with a variety of foreign laws; and other factors outside the Company's control. The Company expects these risks to increase in the future as it expands its operations in eastern Europe and Asia. There can be no assurance that these factors will not have a material adverse effect on the Company's business or financial results in the future.

MARKET RISK MANAGEMENT

Foreign Currency Exchange Rate Risk

The Company's primary market risk relates to changes in foreign currency exchange rates. The functional currency for the Company's foreign subsidiaries is the U.S. dollar. A significant portion of the Company's revenue is generated by its international operations. As a result, the Company's financial position, earnings, and cash flows can be materially affected by changes in foreign currency exchange rates. The Company attempts to mitigate this exposure as part of its foreign currency hedging program. The primary goal of the Company's foreign currency hedging program is to reduce the risk of adverse foreign currency movements on the reported financial results of its non-U.S. dollar transactions. Factors that could have an impact on the effectiveness of the Company's hedging program include the accuracy of forecasts and the volatility of foreign currency markets. All foreign currency derivatives are authorized and executed pursuant to the Company's policies. The Company does not hold or issue derivatives for trading purposes.

To implement its foreign currency hedging program, the Company uses foreign currency options and forwards. These derivatives are used to hedge the risk that forecasted revenue denominated in foreign currencies might be adversely affected by changes in foreign currency exchange rates. Foreign currency forwards are also used to reduce the Company's exposure to foreign currency exchange rate fluctuations in connection with monetary assets and liabilities denominated in foreign currencies.

A hypothetical 10% adverse movement in foreign exchange rates applied to the Company's foreign currency exchange rate sensitive instruments held as of June 28, 2002, and as of December 28, 2001, would result in a hypothetical loss of approximately $53.7 million and $55.6 million, respectively. These hypothetical losses do not take into consideration the Company's underlying international

operations. The Company anticipates that any hypothetical loss associated with the Company's foreign currency exchange rate sensitive instruments would be offset by gains associated with its underlying international operations.

Interest Rate Risk

Changes in interest rates affect interest income earned on the Company's cash investments, as well as interest expense on short-term borrowings. A hypothetical 10% adverse movement in interest rates applied to cash investments and short-term borrowings held as of June 28, 2002, and as of December 28, 2001, would not have a material adverse effect on the Company's financial position, earnings, or cash flows.

Credit Risk

The Company is exposed to credit risk associated with cash investments, foreign currency derivatives, and trade receivables. The Company does not believe that its cash investments and foreign currency derivatives present significant credit

risks, because the counterparties to the instruments consist of major financial institutions, and the Company manages the notional amount of contracts entered into with any one counterparty. Substantially all trade receivable balances are unsecured. The concentration of credit risk with respect to trade receivables is limited due to the large number of customers in the Company's customer base and their dispersion across various industries and geographic areas. Although the Company has a large number of customers who are dispersed across different industries and geographic areas, a prolonged economic downturn could increase the Company's exposure to credit risk on its trade receivables. The Company performs ongoing credit evaluations of its customers and maintains an allowance for potential credit losses.

FACTORS THAT MAY AFFECT FUTURE RESULTS

New Products and Services

Short product life cycles are inherent in the high-technology market. The Company's results of operations and competitive strength depend on its ability to successfully develop, manufacture, and market innovative new products and services, as well as adapt its current products and services to new technologies. One example is that the Company is currently in the engineering and development stage with respect to providing native Fibre Connection (FICON) for certain of its enterprise tape and disk products. The Company devotes significant resources to research and product development projects and must effectively manage the risks inherent in product transitions. Developing new technologies, products, and services is complex and involves various uncertainties. In addition, the Company is still developing the necessary product modifications and professional services knowledge to successfully implement its SAN solutions in various customer operating environments.

Delays in product development, manufacturing, or in customer evaluation and purchasing decisions may make product transitions difficult. The manufacture of new products involves integrating complex designs and processes, collaborating with sole source suppliers for key components, and increasing manufacturing capacities to accommodate demand. A design flaw, the failure to obtain sufficient quantities of key components, or manufacturing constraints could adversely affect the Company's operating and financial results. The Company has experienced product development and manufacturing delays in the past that adversely affected its financial results and competitive position. There can be

no assurance that the Company will be able to successfully manage the development and introduction of new products and services in the future.

Emerging Markets

Future revenue growth is partially dependent on successfully developing and introducing products for two primary emerging markets: the open-systems market and the SAN market.

The open-systems market includes products designed to operate in the UNIX, NT, and other non-MVS operating environments. Competition in the open-systems market is aggressive and is based on functionality, technology, performance, reliability, quality, system scalability, price, product availability, customer service, and brand recognition. The open-systems market encompasses a broad range of customers, including customers outside of the Company's traditional customer base. Many of the Company's potential customers in the open-systems market purchase their storage requirements as part of a bundled product, which may provide a competitive advantage to the Company's rivals. The Company expects to address these competitive factors through the delivery of storage solutions that provide customers with superior functionality, performance, and quality. The Company's customer base continues to shift to the open-systems market, and there can be no assurance that the Company's strategy will be effective in expanding its open-systems market sales.

The current and potential market for SAN solutions and technologies is continually evolving, and is characterized by rapidly changing technology and standards. Major server and storage providers are continually introducing new SAN solutions. Customers may be reluctant to adopt new data storage standards, and competing standards may emerge that will be preferred by customers. Because this market is new and standards are still being defined, it is difficult to predict the potential size of the SAN market or the future rate of adoption of the Company's SAN solutions.

Competition

In the second quarter and six months of 2002, approximately 80% of the Company's storage products revenue was derived from sales of tape and tape automation products. Additionally, a significant portion of the Company's service revenue is derived from the service of tape and tape automation products. One of the key competitive advantages that the Company's tape and tape automation products have over the competition's disk storage products is that the Company's tape and tape automation products store digitized data at a fraction of the cost of disk storage. The cost of disk storage continues to decrease at a rapid rate due to competition and new disk drive technologies. The Company must continue to develop and introduce new tape and tape automation products that reduce the cost of storage at a rate that is similar to the decline in disk storage costs in order to maintain this competitive advantage.

Strong competition has resulted in price erosion in the past, and the Company expects this trend to continue. The disk market has been subject to particularly intense price competition. While the Company has unique competitive advantages with respect to its established customer base and a broad range of storage solution offerings, the Company's ability to compete in the disk market may be limited by the resources available for the further development of its disk products, as well as the ability to continue dropping the prices for its disk offerings to meet the competition.

Price competition for the Company's products and services may have a significant impact on the Company's gross profit margins. The Company's ability to sustain

or improve total gross margins is significantly dependent on designing, developing, and manufacturing competitive products, as well as reducing costs associated with the sourcing of production materials. This pressure on product margins is expected to increase as the Company's disk revenue shifts from its enterprise-class SVA products to open-systems products developed and manufactured by a third party. Storage product gross margins also may be affected in future periods by inventory reserves and writedowns resulting from rapid technological changes or delays in gaining market acceptance for products.

The Company continues to purchase and use third-party products in delivering storage solutions to customers. Some of these third-party products are manufactured by the Company's competitors, including LTO tape drives and certain SAN products. The Company may be at a cost disadvantage in acquiring these products, and gross margins may be adversely affected by the use of these products in storage solutions.

Indirect Channels

The Company continues to develop its indirect distribution channels, including original equipment manufacturers (OEMs), value-added distributors (VADs), value-added resellers (VARs), and other distributors. Increasing the Company's sales through these indirect channels is critical to the Company's successful expansion into the open-systems market. There can be no assurance that the Company will be successful in expanding its indirect channel sales. Furthermore, there can be no assurance that profit margins on indirect channel sales will not deteriorate due to competitive pressures. Maintenance revenue also may be

adversely affected in future periods to the extent that customers of these indirect channel partners elect to purchase maintenance services from vendors other than the Company.

The Company's ability to forecast future demand for its products may be adversely affected by unforeseen changes in demand from its indirect channel partners. The Company's worldwide indirect channel sales were adversely impacted during 2001 by the downturn in the economy. Although there was slight improvement in U.S. indirect channel sales during the six months of 2002, the Company has limited visibility to future indirect channel sales and the future financial condition of its channel partners. The Company's financial results may be negatively affected if the financial condition of one or more of these channel partners weakens or if the current slowdown in customer spending continues.

Significant Personnel Changes

The Company has experienced significant changes in its executive management team during the last two years. There can be no assurance that additional changes in the executive management team will not occur, and it may take a period of time before the new executive management team becomes fully effective.

The future success of the Company depends in large part on its ability to attract, retain, and motivate highly skilled employees. The Company faces significant competition for individuals who possess the skills required to design, develop, manufacture, and market the Company's products and services. An inability to successfully attract, retain, and motive these employees could have an adverse effect on future operating results.

Ability to Develop and Protect Intellectual Property Rights

The Company relies heavily on its ability to develop new intellectual property rights that do not infringe on the rights of others in order to remain competitive and to develop and manufacture products that are competitive in terms of technology and cost. There can be no assurance that the Company will continue to be able to develop such new intellectual property.

The Company relies on a combination of U.S. patent, copyright, trademark, and trade secret laws to protect its intellectual property rights. With respect to certain of the Company's international operations, the Company files patent and trademark registration applications with foreign governments. However, many foreign countries do not have intellectual property laws that are as well developed as those of the United States. The Company enters into confidentiality agreements relating to its intellectual property with its employees and consultants. In addition, the Company includes confidentiality provisions in license and non-exclusive sales agreements with its customers.

Despite all of the Company's efforts to protect its intellectual property rights, unauthorized parties may attempt to copy or otherwise obtain or use the Company's intellectual property. Monitoring the unauthorized use of the Company's intellectual property rights is difficult, particularly in foreign countries. There can be no assurance that the Company will be able to protect its intellectual property rights, particularly in foreign countries.

Sole Source Suppliers

The Company generally uses standard parts and components for its products and believes that, in most cases, there are a number of alternative, competent vendors for most of those parts and components. Many nonstandard parts are obtained from a single source or a limited group of suppliers. However, there are other vendors who could produce these parts in satisfactory quantities after

a period of prequalification and product ramping. Certain key components and products are purchased from sole source suppliers that the Company believes are currently the only manufacturers of the particular components that meet the Company's qualification requirements and other specifications or for which alternative sources of supply are not readily available. Imation Corporation is a sole source supplier for the 9840 and 9940 tape media, and the Company is dependent on Imation to economically produce large volumes of high-quality tape media at a cost acceptable to the Company and its customers. IBM was a sole source supplier for disk drives used in the Company's V960 and VSM products. As a result of IBM discontinuing the manufacture of these drives, the Company entered into a final purchase commitment with IBM based on forecasted requirements. The Company recognized inventory writedowns during 2001 related to the projected excess inventory levels of IBM disk drives obtained as part of the final purchase commitment. Future generation V960 and VSM products will utilize industry standard drives, for which there are a number of available suppliers.

Certain suppliers have experienced occasional technical, financial, or other problems that have delayed deliveries in the past. An unanticipated failure of any sole source supplier to meet the Company's requirements for an extended period, or the inability to secure comparable components in a timely manner, could result in a shortage of key components, longer lead times, and reduced control over production and delivery schedules. These factors could have a material adverse effect on revenue and operating results. In the event a sole source supplier was unable or unwilling to continue to supply components, the Company would need to identify and qualify other acceptable suppliers. This process could take an extended period, and no assurance can be given that any additional source would become available or would be able to satisfy production

requirements on a timely basis or at a price acceptable to the Company.

The Company is dependent on a sole subcontractor, Herald Datanetics Ltd. (HDL), to manufacture a key component used in certain tape products. HDL is located in the People's Republic of China (PRC). The Company's dependence on HDL is subject to additional risks beyond those associated with other sole source suppliers, including the lack of a well-established court system or acceptance of the rule of law in the PRC, the degree to which the PRC permits economic reform policies to continue, the political relationship between the PRC and the United States, and broader political and economic factors. To date, the Company has not experienced any material problems with HDL; however, there can be no assurance that the Company will not experience any material problems with HDL in the future.

Manufacturing

The Company manufactures a significant portion of its products in facilities located in Puerto Rico. The Company's ability to manufacture products may be affected by weather-related risks beyond the control of the Company. If the Puerto Rico manufacturing facility were affected by weather, the Company may not have an alternative source to meet the demand for its products without substantial delays and disruption to its operations. The Company carries interruption insurance to mitigate some of this risk. There is no assurance that the Company could obtain sufficient alternate manufacturing sources or repair the facilities in a timely manner to satisfy the demand for its products. Failure to fulfill manufacturing demands could adversely affect the Company's operating and financial results in the future.

From time to time, the Company has experienced delivery delays, increased lead times in ordering parts and components for its products, and rapid changes in customer demand for certain products. These longer lead times, coupled with rapid changes in product demand, could result in a shortage of parts and components, reduced control over delivery schedules, and an inability to fulfill customer orders in a timely manner. The complexities of these issues increase when the Company transitions to newer technologies and products. These factors could have a material adverse effect on revenue and operating results.

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Earnings Fluctuations

The Company's financial and operating results may fluctuate from quarter to quarter for a number of reasons. Many of the Company's customers undertake detailed procedures relating to the evaluation, testing, implementation, and acceptance of the Company's products. This evaluation process results in a variable sales cycle and makes it difficult to predict if or when revenue will be earned. Furthermore, gross margins may be adversely impacted in an effort to complete the sales cycle.

In the past, the Company's results have followed a seasonal pattern, which reflects the tendency of customers to make their purchase decisions at the end of a calendar year. During any fiscal quarter, a disproportionately large percentage of the total product sales are earned in the last weeks or days of the quarter. This effect has been compounded by the recent slowdown in the global economy.

A number of other factors also may cause revenue to fall below expectations, such as product and technology transitions announced by the Company or its competitors, delays in the availability of new products, changes in the purchasing patterns of the Company's customers and distribution partners, or adverse global economic conditions. The Company has recently experienced changes

in the purchasing patterns of its customers, both in the form of smaller purchases and delayed purchase decisions. The mix of sales among the Company's business segments and sales concentration in particular geographic regions may carry different gross profit margins and may cause the Company's operating margins to fluctuate. These factors make the forecasting of revenue inherently difficult. Because the Company plans its operating expenses on expected revenue, a shortfall in revenue may cause earnings to be below expectations in that period.

The Company's ability to generate revenue growth during 2001 and the six months of 2002 was adversely affected by the slowdown in the global economy as some customers delayed purchase decisions, reevaluated their information technology spending budgets, required higher purchase approval levels, and reduced capital expenditures by maximizing the current capacities of their data storage equipment. In light of this economic environment, the Company has implemented various cost-saving measures, including reduced discretionary spending and delayed employee merit increases. There can be no assurance that a prolonged economic downturn will not have additional adverse effects on the Company's future revenue or operating results. Furthermore, there can be no assurance that these measures will be successful or sufficient to allow the Company to continue to generate improved operating results in future periods. The Company has recognized significant restructuring charges in the past. It is possible that changes in the Company's business or its industry may necessitate restructuring activities in the future. The necessity for restructuring activities may result in expenses that adversely affect reported results of operations in the period the restructuring plan is adopted and may require incremental cash payments.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required under this Item 3 is included in the section above entitled "Market Risk Management."

STORAGE TECHNOLOGY CORPORATION AND SUBSIDIARIES
PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

In 1994, Stuff Technology Partners II, a Colorado Limited Partnership (Stuff), filed suit in Boulder County, Colorado, District Court (the District Court) against the Company. The suit alleged that the Company breached a 1990 settlement agreement that had resolved earlier litigation between the parties involving an unsuccessful optical disk drive storage development project. The suit seeks injunctive relief and damages of $2.4 billion. In 1995, the District Court granted the Company's motion for summary judgment and dismissed the complaint. Stuff appealed to the Colorado Court of Appeals (the Court of Appeals), which reversed the District Court's judgment and remanded the case to the District Court for further proceedings. In 1999, the District Court again dismissed all of Stuff's claims against the Company, and Stuff again appealed the dismissal to the Court of Appeals. In 2000, the Court of Appeals reversed the dismissal and remanded the case to the District Court for a trial on the factual issues. The parties stipulated to a separate trial, scheduled for September 16, 2002, on the interpretation of language in the 1990 settlement agreement. If the Company prevails in this separate trial, Stuff's claims will be significantly reduced. Any trial to resolve the underlying liability and damages issues would likely not be scheduled before 2004. The Company continues to believe that Stuff's claims are without merit and intends to vigorously defend this suit.

The Company also is involved in various other less significant legal actions. While the Company currently believes that the amount of any ultimate potential loss would not be material to the Company's financial position, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial position or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's Annual Meeting of Stockholders (the Annual Meeting) was held on May 23, 2002. A total of 98,179,580 shares of common stock, par value $0.10 per share (the Common Stock), were present at the Annual Meeting, either in person or by proxy, constituting a quorum. The matters voted upon at the Annual Meeting by the stockholders consisted of the four proposals set forth in the Company's definitive Proxy Statement, dated April 16, 2002.

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The first proposal related to the election of eight persons to serve on the Company's Board of Directors. The Board's nominees were each elected and received, respectively, the following votes:

Director	For	Withheld
James R. Adams	96,444,408	1,735,172
William L. Armstrong	96,445,615	1,733,965
Charles E. Foster	96,444,386	1,735,194
William T. Kerr	96,443,239	1,736,341
Robert E. La Blanc	96,442,367	1,737,213
Robert E. Lee	96,442,611	1,736,969
Patrick J. Martin	96,442,186	1,737,394
Richard C. Steadman	96,442,028	1,737,552

Each of the stockholder proposals was rejected as detailed below.

Proposal	For	Against	Abstentions	Broker Non-Votes
Proposal 2, Stockholder proposal regarding cumulative voting	26,585,952	52,027,397	6,673,318	12,892,913
Proposal 3, Stockholder proposal regarding prior notice of stockholder nominees	2,817,915	81,510,931	957,821	12,892,913
Proposal 4, Stockholder proposal regarding two nominees for each directorship position to be filled	4,050,770	80,345,836	890,060	12,892,914

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

The exhibits listed below are filed as part of this Quarterly Report on Form 10-Q or are incorporated by reference into this Quarterly Report on Form 10-Q:

3.1 Restated Certificate of Incorporation of Storage Technology Corporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)

3.2 Certificate of Amendment dated May 22, 1989, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)

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1 Contract or compensatory plan or arrangement in which directors and/or officers participate.
2 Indicates exhibits filed with this Quarterly Report on Form 10-Q.

3.3 Certificate of Second Amendment dated May 28, 1992, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)

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10.21 Security Agreement, dated as of October 10, 2001, by and among the Company, Bank of America, N.A., as Collateral Agent for itself and other Secured Parties referred to therein (previously filed as Exhibit 10.14 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)

10.22 Guaranty, dated as of October 10, 2001, by StorageTek Holding Corporation, in favor of the Banks party to a certain Credit Agreement and Bank of America, N.A., as Agent and Issuing Bank and Collateral Agent (previously filed as Exhibit 10.15 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by

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10.23(1)	Form of Executive Severance Agreement
10.24	Master Services Agreement (MSA), between each of the Company, Electronic Data Systems Corporation, and EDS Information Services L.L.C., dated as of April 1, 2002
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99.2(2)	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K.

None.

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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.

STORAGE TECHNOLOGY CORPORATION
(Registrant)

August 12, 2002	/s/ ROBERT S. KOCOL
(Date)	Robert S. Kocol Corporate Vice President and Chief Financial Officer (Principal Financial Officer)
August 12, 2002	/s/ THOMAS G. ARNOLD
(Date)	Thomas G. Arnold

Vice President and Corporate Controller
(Principal Accounting Officer)

EXHIBIT INDEX

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