SUN MICROSYSTEMS INC
Form 10-Q
February 14, 2001

1

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(X) Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2000

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: 0-15086

SUN MICROSYSTEMS, INC.
(Exact Name of registrant as specified in its charter)

DELAWARE	94-2805249
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

901 SAN ANTONIO ROAD, PALO ALTO, CA 94303
(Address of principal executive offices with zip code)

(650) 960-1300
(Registrant's telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES (X) 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 practical date.

CLASS OUTSTANDING AT DECEMBER 31, 2000

Common Stock - $0.00067 par value	3,259,867,598

2

INDEX

2

3

PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

SUN MICROSYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited)
(in millions, except per share amounts)

	Three Months Ended		Six Mo
	December 31, 2000	December 26, 1999	December 31 2000

Net revenues:			
Products	$ 4,317	$ 2,997	$ 8,660
Services	798	557	1,500
Total net revenues	5,115	3,554	10,160
Cost of sales:			
Cost of sales - products	2,153	1,370	4,306
Cost of sales - services	518	349	980
Total cost of sales	2,671	1,719	5,286
Gross margin	2,444	1,835	4,874
Operating expenses:			
Research and development	497	398	987
Selling, general and administrative	1,236	941	2,478
Purchased in-process research and development	71	-	71
Total operating expenses	1,804	1,339	3,536
Operating income	640	496	1,338
Gain on sale of investments	1	-	1
Interest income, net	91	32	166
Income before income taxes	732	528	1,505
Provision for income taxes	309	174	572
Net income	$ 423	$ 354	$ 933
Net income per common share - basic	$ 0.13	$ 0.11	$ 0.29
Net income per common share - diluted	$ 0.12	$ 0.10	$ 0.27
Shares used in the calculation of net income per common share -basic	3,229	3,148	3,217
Shares used in the calculation of net income per common share -diluted	3,430	3,382	3,433

See accompanying notes.

3

4

SUN MICROSYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions)

	December 31, 2000	June 30, 2000
	(unaudited)	
ASSETS		
Current assets:		

Cash and cash equivalents	$ 1,403	$ 1,849
Short-term investments	737	626
Accounts receivable, net	3,215	2,690
Inventories	792	557
Deferred tax assets	808	673
Prepaid expenses and other current assets	785	482
Total current assets	7,740	6,877
Property, plant and equipment, net of accumulated depreciation of $1,796 and $1,597 as of December 31 and June 30, respectively	2,382	2,095
Long-term investments	5,302	4,496
Intangible assets, net	2,110	205
Other assets, net	546	479
	$ 18,080	$ 14,152
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings	$ 2	$ 7
Accounts payable	1,219	924
Accrued payroll-related liabilities	621	751
Accrued liabilities and other	1,718	1,366
Deferred revenues and customer deposits	1,454	1,289
Income taxes payable	134	422
Total current liabilities	5,148	4,759
Long-term debt and other obligations	2,183	2,084
Total stockholders' equity	10,749	7,309
	$ 18,080	$ 14,152

See accompanying notes.

SUN MICROSYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in millions)

	Six Months Ended	
	December 31, 2000	December 26, 1999
Cash flows from operating activities:		
Net income	$ 933	$ 625
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	445	357
Tax benefits from employee stock plans	621	261

Purchased in-process research and development	71	4
Gain on sale of investments	(1)	-
Changes in operating assets and liabilities:		
Accounts receivable, net	(516)	278
Inventories	(233)	(251)
Other current and long-term assets	(462)	(210)
Accounts payable	292	(83)
Other current and long-term liabilities	106	183
Net cash provided by operating activities	1,256	1,164
Cash flows from investing activities:		
Purchases of investments	(5,646)	(4,199)
Proceeds from sales and maturities of investments	4,676	2,534
Acquisition of property, plant and equipment	(572)	(432)
Acquisition of spare parts and other assets	(54)	(45)
Payments for acquisitions, net of cash acquired	(24)	(75)
Net cash used in investing activities	(1,620)	(2,217)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	-	1,500
Decrease in borrowings and other obligations	(15)	(18)
Proceeds from issuance of common stock, net	124	32
Acquisition of treasury stock	(311)	(389)
Proceeds from employee stock purchase plans	120	138
Net cash (used in) provided by financing activities	(82)	1,263
Net (decrease) increase in cash and cash equivalents	(446)	210
Cash and cash equivalents, beginning of period	1,849	1,101
Cash and cash equivalents, end of period	$ 1,403	$ 1,311
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 56	$-
Income taxes	$ 331	$ 226

See accompanying notes.

6

SUN MICROSYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Continued)
(unaudited)
(in millions)

Six Months Ended

	December 31, 2000	December 26, 1999
Supplemental schedule of non-cash investing activities:		
In conjunction with the Company's acquisitions, liabilities were assumed as follows:		
Fair value of net assets acquired	$ 2,055	$ 84
Cash paid for assets	(29)	(75)
Stock issued and vested options assumed	(2,024)	(1)
Liabilities assumed	$ 2	$ 8

See accompanying notes.

SUN MICROSYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

Sun Microsystems, Inc. ("Sun" or the "Company") is a provider of products, services, and support solutions for building and maintaining network computing environments. Sun sells scalable computer systems, high-speed microprocessors, and a line of high-performance software for operating networks, computing equipment, and storage products. Sun also provides a full range of services including support, education, and professional services. The Company markets its products primarily to business, government, and education customers and operates in various product segments across geographically diverse markets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year

Sun's first three quarters in fiscal 2001 end on October 1, December 31 and April 1 (in fiscal 2000 the quarters ended on September 26, December 26 and March 26). The fourth quarter ends on June 30.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany accounts and transactions have been eliminated. Certain amounts from prior years have been reclassified to conform with the current year presentation.

On December 5, 2000, the Company effected a two-for-one split of its common stock paid in the form of a stock dividend. All share and per share data herein has been adjusted to reflect the split for all periods presented.

While the quarterly financial information is unaudited, the financial statements included in this report reflect all adjustments (consisting of normal recurring adjustments) that the Company considers necessary for a fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for the interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated balance sheet as of June 30, 2000 has been derived from the audited consolidated balance sheet as of that date. The information included in this report should be read in conjunction with the Company's Annual Report on Form 10-K for fiscal 2000.

Derivative Financial Instruments

The Company uses derivatives to moderate the financial market risks of its business operations. Derivative products, such as forward and option contracts, are used to hedge the foreign currency market exposures underlying certain assets and liabilities and forecasted transactions with customers and vendors. The Company also enters into interest rate swap agreements to modify the interest characteristics of its outstanding long-term debt. The Company's accounting policies for these instruments are based on its designation of such instruments as hedging transactions. An instrument is designated as a hedge based in part on its effectiveness in risk reduction and one-to-one matching of derivative instruments to underlying transactions. The Company records all derivatives on the balance sheet at fair value.

For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting gain or loss on the hedged item attributable to the hedged risk are recognized in earnings in the current period. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure of variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of Other comprehensive income (OCI) in stockholders' equity and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any, is recognized in current earnings during the period of change. For derivative instruments not designated as hedging instruments, changes in their fair values are recognized in earnings in the current period.

For currency forward contracts, effectiveness is measured by using the forward-to-forward rate compared to the underlying economic exposure. For currency option contracts, effectiveness is measured on an intrinsic basis using only the current forward rate and the strike price for both the currency option contract (either put or call option) and the underlying transaction. All time value and volatility changes are deemed ineffective and are immediately recognized in earnings. For interest rate swap agreements, the Company assumes no ineffectiveness as each interest rate swap meets the short-cut method conditions required under Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities" (see Note 5, "Derivative Financial Instruments").

Computation of Net Income Per Common Share

Basic net income per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist primarily of stock options.

Recent Pronouncements

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 101 (SAB 101), "Revenue Recognition in Financial Statements". SAB 101 summarizes certain of the SEC's views in applying generally accepted accounting principles to revenue recognition in financial statements. In October 2000, the SEC issued additional written guidance to further supplement SAB 101. Accordingly, Sun is continuing to evaluate the potential impact of SAB 101 on the Company's results of operations and financial position. The Company is required to adopt SAB 101 in the fourth quarter of fiscal 2001.

3. BUSINESS COMBINATIONS

Purchase Combinations

The Company completed several acquisitions in fiscal 2001 that were accounted for under the purchase method of accounting. See the Company's Form 10-Q for the quarterly period ended on October 1, 2000 for information on acquisitions completed during the first quarter of fiscal 2001. The Company completed two acquisitions in the second quarter of fiscal 2001, as discussed below. The consolidated financial statements include the operating results of each business from the date of acquisition. Pro forma results of operations have not been presented because the effects of these acquisitions were not material on either an individual or a year-to-date aggregate basis.

The Company calculates amounts allocated to in-process research and development (IPRD) using established valuation techniques in the high-technology industry and expenses such amounts in the quarter that the related acquisition was consummated if technological feasibility of the in-process technology has not been achieved and no alternate future uses have been established. Research and development costs to bring the products from the acquired companies to technological feasibility are not expected to have a material impact on the Company's future results of operations or cash flows. The Company computed its valuations of IPRD for the acquisitions discussed in the following paragraphs using a discounted cash flow analysis on the anticipated income stream to be generated by the IPRD with consideration given to the in-process technology's stage of completion.

The excess purchase price over the estimated value of the net tangible assets and IPRD was allocated to various intangible assets, consisting primarily of developed technology and goodwill, as well as other intangible assets, such as customer base, trade name or trademark, and assembled workforce. The value of developed technology was based upon future discounted cash flows related to the existing products' projected income streams. The value of the customer base was determined based upon the value of existing relationships and the expected revenue streams. The value of the assembled workforce was based upon the cost to replace that workforce. Intangible assets, including goodwill, are being amortized on a straight line basis over periods not exceeding five years.

On November 7, 2000, the Company acquired all of the interest in grapeVINE Technologies, LLC (a U.S. limited liability company organized under the laws of Delaware) (grapeVINE), from grapeVINE Australia Pty. Ltd., a wholly-owned subsidiary of grapeVINE Technologies, Ltd. (an Australian corporation) for total cash consideration of $9.4 million. grapeVINE is a producer of collaborative knowledge management software. This transaction was accounted for as a purchase, with the excess of the purchase price over the estimated fair value of the net tangible assets being allocated to various intangible assets, including goodwill ($7.6 million), developed technology ($1.0 million), assembled workforce ($0.3

million) and in-process research and development ($0.5 million).

On December 7, 2000, the Company acquired Cobalt Networks, Inc. and its wholly-owned subsidiaries (Cobalt) in a stock-for-stock merger. Cobalt is a provider of server appliances for Internet Service Providers, Application Service Providers, and small-to medium-sized businesses. Under the terms of the merger agreement, each share of Cobalt common stock was converted into the right to receive one share of Sun's common stock. The Company issued approximately 30.5 million shares at a value of $58.302 per share in exchange for all of Cobalt's outstanding common stock, assumed all of Cobalt's 5.6 million outstanding options at an estimated fair value of $283.0 million, and incurred $2.0 million in acquisition costs, resulting in an aggregate purchase price of approximately $2,061.0 million. This transaction was accounted for as a purchase, with the excess of the purchase price over the estimated fair value of the net tangible assets ($93.9 million) being allocated primarily to various intangible assets, including goodwill ($1,690.0 million), developed technology ($93.5 million), customer base ($41.9 million), assembled workforce ($10.7 million), trade name

9

10

($5.9 million) and in-process research and development ($70.8 million). In addition, $54.3 million of the purchase price was allocated to deferred compensation, which represents the pro-rata portion of the intrinsic value of Cobalt's unvested options assumed at the date of the acquisition.

4. BALANCE SHEET DETAILS

Inventories are comprised of the following (in millions):

	December 31, 2000	June 30, 2000
Raw materials	$ 339	$ 169
Work in process	109	82
Finished goods	344	306
	$ 792	$ 557

Long-term investments are comprised of the following (in millions):

	December 31, 2000	June 30, 2000
Long-term investments:		
Marketable securities	$ 4,882	$ 3,961
Strategic equity investments	420	535
Total	$ 5,302	$ 4,496

Marketable securities consist primarily of corporate bonds, floating-rate notes, and asset-backed and mortgage-backed securities with original maturities greater than one year from the balance sheet date. Strategic equity investments consist of marketable strategic equity securities and preferred stock and other strategic equity holdings. Marketable strategic equity securities represent equity holdings in public companies. Preferred stock and other strategic equity holdings represent equity holdings in nonpublic companies and investments in venture capital funds.

Marketable securities and marketable strategic equity securities are considered available-for-sale and are reported at fair value with changes in unrealized gains and losses, net of applicable taxes, recorded in stockholders' equity. Gross unrealized gains and losses related to the marketable strategic equity securities were $19 million as of December 31, 2000 ($210 million as of June 30, 2000). Preferred stock and other strategic equity holdings are carried at the lower of cost or net realizable value due to their illiquid nature. Realized gains and losses for all investments are calculated based on the specific identification method.

5. DERIVATIVE FINANCIAL INSTRUMENTS

On July 1, 2000, the Company adopted SFAS 133 which requires that all derivatives be recorded on the balance sheet at fair value. Changes in the fair value of derivatives that do not qualify for hedge treatment, as well as the ineffective portion of a particular hedge, must be recognized currently in earnings. Upon adoption on July 1, 2000, the cumulative transition adjustment was insignificant.

Foreign Exchange Exposure Management. The Company has significant international sales and purchase transactions in foreign currencies and continues its policy of hedging forecasted and actual foreign currency risk with purchased currency options and forward contracts that expire within 12 months. These derivative instruments are employed to eliminate or minimize certain foreign currency exposures that can be confidently identified and quantified. In accordance with SFAS 133, hedges related to anticipated transactions are designated and documented at the inception of the respective hedge as cash flow hedges and evaluated for effectiveness quarterly. As the terms of the forward contract and the underlying transaction are matched at inception, forward contract effectiveness is calculated by comparing the fair value of the contract to the change in the forward value of the anticipated transaction, with the effective portion of the gain or loss on the derivative instrument reported as a component of OCI in stockholders' equity and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Option contract effectiveness is calculated by comparing the intrinsic value of the instrument to any degradation of the anticipated transaction against the forward adjusted strike price with the effective portion of changes in fair value accumulated in OCI. Any residual change in fair value of the instruments, including option time value or other ineffectiveness are recognized immediately in Selling, general and administrative expense. Ineffectiveness in the first half of fiscal 2001 is not significant.

To meet SFAS 133 entity hedging requirements and to protect U.S. dollar margins, U.S. dollar functional subsidiaries hedge foreign currency revenues and non-U.S. dollar functional subsidiaries selling in foreign currencies hedge U.S. dollar inventory purchases. OCI associated with hedges of foreign currency sales is recognized in Revenue upon shipment and OCI related to inventory purchases is recognized in Cost of sales upon shipment. All values reported in OCI at December 31, 2000 will be reclassified to earnings within 12 months.

Additionally, the Company enters into foreign currency forward contracts to hedge the gains and losses generated by the remeasurement of monetary assets and liabilities in a non-functional currency. Changes in the fair value of these fair value hedges (as defined in SFAS 133) are recognized in Selling, general and administrative expense immediately as an offset to the changes in the fair value of the assets or liability being hedged.

Interest Rate Risk Management. The Company is exposed to interest rate risk from both investments and debt. The Company offsets the risk in variable rate interest earnings from investments by converting the existing fixed rate debt (with maturities of 3 years, 5 years, 7 years, and 10 years) of $1.5 billion into variable rate debt with 12 fixed-to-variable interest rate swaps. The Company assumes no ineffectiveness as each interest rate swap meets the short-cut method conditions required under SFAS 133 for fair value hedges of debt instruments. Accordingly, no gains or losses were recorded in income relative to the Company's underlying interest rate swaps.

Accumulated Derivative Gains or Losses. The following table summarizes activity in OCI related to derivatives held by Sun during the period from July 1, 2000 through December 31, 2000 (in millions):

Cumulative effect of adopting SFAS 133	$-
Increase in fair value of derivatives	53
Gains reclassified from OCI, net, into:	
Revenues	(37)
Cost of sales	(9)
Accumulated derivative gain, December 31, 2000	$ 7

6. COMPREHENSIVE INCOME

The components of comprehensive income, net of related taxes, are as follows (in millions):

	Three Months Ended		Six Mo
	December 31, 2000	December 26, 1999	December 31, 2000
Net income	$ 423	$354	$933
Change in unrealized value of investments, net	(126)	383	(76)
Change in unrealized fair value of derivative instruments	(10)	-	7
Translation adjustments	(13)	2	(19)
Comprehensive income	$ 274	$739	$845

The components of accumulated other comprehensive income, net of related taxes, are as follows (in millions):

	December 31, 2000	June 30, 2000
Unrealized gain on investments, net	$ 49	$125
Unrealized gains on derivative instruments	7	-
Cumulative translation adjustments	(69)	(50)
Accumulated other comprehensive income	$(13)	$ 75

7. NET INCOME PER COMMON SHARE

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

	Three Months Ended		Six Months Ended	
	December 31, 2000	December 26, 1999	December 31, 2000	December 1999
Net income	$ 423	$ 354	$ 933	$ 6
Denominator:				
Weighted average common shares - basic	3,229	3,148	3,217	3,1
Effect of dilutive securities (primarily stock options)	201	234	216	2
Weighted average common shares - diluted	3,430	3,382	3,433	3,3
Net income per common share - basic	$ 0.13	$ 0.11	$ 0.29	$ 0.
Net income per common share - diluted	$ 0.12	$ 0.10	$ 0.27	$ 0.

8. OPERATING SEGMENTS

Sun designs, manufactures, markets, and services network computing systems and software solutions that feature networked desktops and servers. The Company is organized by various product groups. The following product groups are the only reportable segments under the criteria of SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information": (1) System Products and Network Storage and (2) Enterprise Services. Products in the System Products and Network Storage segment include a broad range of desktop systems, servers, storage, and network switches, incorporating the UltraSPARC (TM) processors and Solaris(TM) Operating Environment. In the Enterprise Services segment, the Company provides a full range of services and support to existing and new customers, including education, professional services, and systems integration.

Effective July 1, 2000, Sun consolidated its sales and manufacturing functions into organizations known as the Global Sales Operations (GSO) and Worldwide Operations (WWOPS), respectively. The GSO manages most of the Company's field sales organizations and all field marketing organizations. Sales generated through the sales and marketing efforts of the GSO are recorded as revenues by the various product groups. Operating expenses (primarily sales and marketing) related to the GSO are not allocated to the product groups and, accordingly, are included under the Other segment. WWOPS manages all operations, supply chain and purchasing functions. WWOPS manufacturing costs are allocated as cost of sales to the various product groups.

The following table presents revenues, interdivision revenues, and operating income (loss) for the Company's segments. The Other segment consists of certain operating product groups, which did not meet the requirements for a reportable segment as defined by SFAS 131, such as Sun's Software Systems Group, and other miscellaneous functions, such as Corporate and the GSO.

Three Months Ended:

	System Products and Network Storage	Enterprise Services	Other	Total
DECEMBER 31, 2000				
Revenues	$3,834	$798	$ 483	$5,115
Interdivision revenues	-	118	(118)	-
Operating income (loss)	1,465	170	(995)	640
DECEMBER 26, 1999				
Revenues	$2,739	$557	$ 258	$3,554
Interdivision revenues	-	95	(95)	-
Operating income (loss)	1,062	115	(681)	496

Six Months Ended:

	System Products and Network Storage	Enterprise Services	Other	Total
DECEMBER 31, 2000				
Revenues	$7,779	$1,500	$ 881	$10,160
Interdivision revenues	-	226	(226)	-
Operating income (loss)	3,024	295	(1,981)	1,338
DECEMBER 26, 1999				
Revenues	$5,266	$1,035	$ 399	$ 6,700
Interdivision revenues	-	177	(177)	-
Operating income (loss)	2,068	198	(1,392)	874

9. SUBSEQUENT EVENTS

On December 3, 2000, the Company entered into an agreement to acquire HighGround Systems, Inc. (HighGround) in a stock-for-stock merger. HighGround, a privately-held company, is a leading developer of storage resource management software for open systems. Under the terms of the merger agreement, the Company will issue approximately 7.9 million shares of its common stock and assume approximately 2.4 million stock options and warrants (after giving effect to the two-for-one stock split effected December 5, 2000) in exchange for all of HighGround's outstanding capital stock, options and warrants, resulting in an aggregate purchase price of approximately $400 million. The closing of the acquisition is subject to remaining regulatory approvals, HighGround stockholder approval and other customary closing conditions. The transaction will be accounted for as a purchase and the purchase price will be allocated to tangible assets and identified intangible assets, with any excess being allocated to goodwill.

On February 1, 2001, the Company entered into an agreement to acquire LSC, Incorporated (LSC) in a stock-for-stock merger. LSC is a privately-held company which designs, develops, and supports high performance file systems and data storage software. Under the terms of the merger agreement, the Company will issue up to approximately 1.7 million shares of its common stock and assume approximately 0.7 million stock options and warrants in exchange for all of LSC's outstanding capital stock, options and warrants, resulting in an

aggregate purchase price of approximately $74 million. The closing of the acquisition is subject to regulatory approvals, LSC shareholder approval and other customary closing conditions. The transaction will be accounted for as a purchase and the purchase price will be allocated to tangible assets and identified intangible assets, with any excess being allocated to goodwill.

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This quarterly report, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include statements relating to our expectations regarding product mix trends, our expectations to invest in our services business, our expectations that products gross margins will be affected by product mix, component costs, market conditions and new product introductions, our products and services gross margins expectations for the remainder of fiscal year 2001, our continuous evaluation of the competitiveness of our product and service offerings and any possible repricing actions, our plans to increase research and development spending on a dollar basis during the remainder of fiscal 2001 and research and development expenses as a percentage of net revenues, our expectations relating to selling, general and administrative expenses on a dollar basis during the remainder of fiscal 2001 and as a percentage of net revenues and our continual investment in efforts to achieve additional operating efficiencies and review and improvement of our business processes and our focus on our cost structure, our expectations to continue hiring personnel in certain areas and the rate of such hiring activities, our expected effective income tax rate for the remainder of fiscal 2001, our expectations to continue leveraging our operating EBITDA on our cost structure, our belief that we have sufficient capital to meet our requirements for at least the next twelve months, and as set forth in the section entitled "Purchased in-process research and development": statements regarding our expectations that we will not achieve a material amount of expense reductions or synergies from our acquisitions, our beliefs regarding realization of expected economic return from acquired in-process technology and resulting or related products, general availability of certain products and our ability to continue making substantial progress in the development and commercialization of acquired technologies.

These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth below and those contained in "Risk Factors," identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. Such factors include, but are not limited to, increased competition, adverse changes in general economic conditions in the U.S. and internationally, including adverse changes in the specific markets for our products, adverse business conditions, adverse changes in customer order patterns, lack of acceptance of new products, pricing pressures, lack of success in technological advancements, risks associated with foreign operations, failure to reduce costs or improve operating efficiencies, our ability to attract, hire and retain key and qualified employees, and risks associated with acquiring companies.

With respect to risks related to purchased in-process research and development, we cannot assure you that any new technologies will be developed into products, that such products will achieve either technological or commercial success, or that we will receive any economic benefit from such products as a result of delays in the development of the technology or release of such products into the market, the complexity of the technology, our ability to successfully manage product introductions, lack of customer acceptance, competition and changes in technological trends, and fluctuations in market or general economic conditions.

16

17
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RESULTS OF OPERATIONS

NET REVENUES
(dollars in millions)

	Three Months Ended December 31, 2000	Three Months Ended December 26, 1999	Change	Six Months Ende December 31, 2000	Decemb 19
Products net revenue	$ 4,317	$ 2,997	44.0%	$ 8,660	$ 5
Percentage of total net revenues	84.4%	84.3%		85.2%	
Services net revenue	$ 798	$ 557	43.3%	$ 1,500	$ 1
Percentage of total net revenues	15.6%	15.7%		14.8%	
Total net revenues	$ 5,115	$ 3,554	43.9%	$10,160	$ 6

Products net revenue

Products net revenue is comprised of revenue generated from the sales of our scalable computer systems and storage, high-speed microprocessors, and our line of high-performance software for operating network computing equipment. For the second quarter of fiscal 2001, products net revenue increased by $1,320 million, or 44.0% to $4,317 million, over the corresponding period of fiscal 2000. For the first half of fiscal 2001, products net revenue increased by $2,995 million, or 52.9% to $8,660 million, over the corresponding period of fiscal 2000. Growth in enterprise and workgroup server product lines accounted for more than 60% of the total increase in products net revenue in the second quarter and first half of fiscal 2001. In addition, increased revenues generated by our storage products, network service provider and iPlanet offerings also contributed to our increase in products net revenue. As a result of the strong demand for our servers, desktop system revenue as a percentage of products net revenue has declined for the three and six months ended December 31, 2000, as compared to the corresponding periods of fiscal 2000. We expect these product mix trends to continue through the remainder of fiscal 2001.

Services net revenue

Services net revenue is comprised of revenue generated from the sales of a full range of services, including support, education, and professional services. For the second quarter of fiscal 2001, services net revenue increased by $241 million, or 43.3% to $798 million, over the corresponding period of fiscal 2000. For the first half of fiscal 2001, services net revenue increased by $465 million, or 44.9% to $1,500 million, over the corresponding period of fiscal 2000. The increase in services net revenue is primarily the result of: (1) a continuing shift towards premium service and support contracts generated from a larger installed base of high-end server products and an overall shift in customer expectations to higher levels of support; (2) a larger base of product units related to the increase in product unit sales and installations; and (3) an increase in revenues associated with our educational and professional services.

Net revenues by geographic area
(dollars in millions)

	Three Months Ended			Six Months Ended	
	December 31, 2000	December 26, 1999	Change	December 31, 2000	December 26, 1999
Domestic	$ 2,438	$ 1,822	33.8%	$ 5,137	$ 3,506
Percentage of net revenues	47.7%	51.3%		50.6%	52.3%
International	$ 2,677	$ 1,732	54.6%	$ 5,023	$ 3,194
Percentage of net revenues	52.3%	48.7%		49.4%	47.7%
Total net revenues	$ 5,115	$ 3,554	43.9%	$10,160	$ 6,700

Domestic net revenues increased by 33.8% and 46.5% in the second quarter and first half of fiscal 2001, respectively, over the corresponding periods of fiscal 2000. In December 2000, we experienced an unexpected and significant decline in U.S. demand primarily for our products. We cannot assure you that this decline in U.S. demand will not continue to affect future operating results. In U.S. dollars, international net revenues increased by 54.6% and 57.3% in the second quarter and first half of fiscal 2001, respectively, over the corresponding periods of fiscal 2000. The revenue growth in international net revenues is primarily due to continued strong demand for our network computing products and services. To a lesser degree, the increase in international revenues is due to our expanded presence in numerous emerging countries. We experienced revenue growth in all European, Middle Eastern, African (EMEA) and rest of world (ROW) regions during the second quarter and first six months of fiscal 2001, as compared to the corresponding periods of fiscal 2000. The United Kingdom, Germany, Northern Europe, and Japan regions accounted for more than 50% of the total increase in international net revenues for the second quarter and first half of fiscal 2001.

Fluctuations in exchange rates reduced total net revenues in the second quarter of fiscal 2001 by approximately 8% due to the impact of exchange rate movements. This reduction was principally driven by weakness in the Euro, the British pound and to a lesser extent the Japanese yen. Although we have experienced U.S. dollar revenue growth in the domestic and international marketplaces on a year-over-year basis, we cannot assure you that such trends will continue. In particular, if capital spending declines in certain countries or any such countries experience changes in their economic environment, our results of operations and cash flows could suffer.

18

19

GROSS MARGIN
(dollars in millions)

	Three Months Ended December 31, 2000	Three Months Ended December 26, 1999	Change	Six Months E December 31, 2000
Products gross margin	$ 2,164	$ 1,627	33.0%	$ 4,354
Percentage of products net revenues	50.1%	54.3%		50.3%
Services gross margin	$ 280	$ 208	34.6%	$ 520
Percentage of services net revenues	35.1%	37.3%		34.7%
Total gross margin	$ 2,444	$ 1,835	33.2%	$ 4,874
Percentage of net revenues	47.8%	51.6%		48.0%

Products gross margin

Products gross margin was 50.1% and 50.3% in the second quarter and first half of fiscal 2001, respectively, as compared to 54.3% and 54.5% for the corresponding periods in fiscal 2000. Most of the products gross margin decline is due to the increased cost of various components. For the remainder of fiscal 2001, we expect products gross margin will continue to be affected by product mix, component costs, market conditions and new product introductions. During the second half of fiscal 2001, we expect products gross margin to be in a similar range, or improve slightly to what we reported for the first half of fiscal 2001.

Services gross margin

Services gross margin was 35.1% and 34.7% in the second quarter and first half of fiscal 2001, respectively, as compared to 37.3% and 36.8% for the corresponding periods in fiscal 2000. The decrease in services gross margin is primarily due to the impact of: (1) increased expenditures for both fixed and variable costs in supporting infrastructures; (2) capital and operating expenditures related to acquisition and deployment of service delivery technologies and processes; and (3) increasing field service delivery headcount to support increased customer service expectations and expected future growth in the services business. We expect to continue investing in our services business by hiring field service delivery employees, increasing availability of spare parts inventory to improve customer service response time, and evaluating other infrastructure-related initiatives. We are currently expecting our services gross margin to remain in the mid-30% range for the remainder of fiscal 2001.

We continuously evaluate the competitiveness of our product and service offerings. These evaluations could result in repricing actions in the near term. Our future operating results would be adversely affected if we reduced prices and we were unable to mitigate the resulting margin pressure by maintaining a favorable mix of systems, software, service, and other products, or if we were unsuccessful in achieving component cost reductions, operating efficiencies, and increasing volumes.

OPERATING EXPENSES
(dollars in millions)

	Three Months Ended			Six Months End	
	December 31, 2000	December 26, 1999	Change	December 31, 2000	Decem 1
Research and development	$ 497	$ 398	24.9%	$ 987	$
Percentage of net revenues	9.7%	11.2%		9.7%	
Selling, general and administrative	$1,236	$ 941	31.3%	$2,478	$1
Percentage of net revenues	24.2%	26.5%		24.4%	
Purchased in-process research and development	$ 71	-	100%	$ 71	$
Percentage of net revenues	1.4%	-		0.7%	

Research and development expenses

Research and development (R&D) expenses, as a percentage of net revenues, decreased to 9.7% in the second quarter and first half of fiscal 2001 from 11.2% and 11.3% in the corresponding periods of fiscal 2000. The relative decline was the result of the increase in net revenues. The dollar increase in R&D expenses reflects our continued development of a broad line of scalable and reliable systems, including servers, workstations, storage technologies, and SPARC(TM) microprocessors, as well as software products which utilize the Java(TM) platform, Solaris Operating Environment software, and Jini (TM) connection technology. Furthermore, R&D expenses have increased due to additional development of products acquired through acquisitions and increased compensation and compensation-related costs related to higher levels of R&D staffing. The increases in R&D spending reflect our belief that to maintain our competitive position in a market characterized by rapid rates of technological advancement, we must continue to invest significant resources in new systems, software, and microprocessor development, as well as continue to enhance existing products. All R&D is expensed as incurred. We are planning to continue to increase our R&D

spending on a dollar basis during the remainder of fiscal 2001, but expect R&D expenses for fiscal 2001 to continue to be in the 9% to 10% range of annual net revenues.

Selling, general and administrative expenses

Selling, general, and administrative (SG&A) expenses, as a percentage of net revenues, decreased to 24.2% and 24.4% in the second quarter and first half of fiscal 2001, respectively, from 26.5% and 27.4% in the corresponding periods of fiscal 2000, as a result of higher revenues and operating efficiencies. The dollar increase in SG&A expenses is primarily attributable to: (1) increased headcount, principally in the global sales organization; (2) higher average employee compensation; (3) increased commissions and bonuses; and (4) increased marketing costs related to promotional programs. We also made additional investments aimed at improving our internal business processes for the remainder of fiscal 2001, and therefore, expect SG&A expense to increase in dollars as compared to fiscal 2000. We plan on continuing to invest in efforts to achieve additional future operating efficiencies through the continual review and improvement of business processes. In addition, we expect to continue to hire sales and marketing personnel as well as financial service and support personnel. However, we anticipate hiring at a slower rate for the remainder of fiscal 2001 and will continue to focus on our cost structure, gradually decreasing our level of SG&A expenses, as a percentage of total net

revenues, on a year-over-year basis (excluding the impact of intangible asset and deferred compensation amortization for mergers and acquisitions).

Purchased in-process research and development expenses

Overview

In the second quarter of fiscal 2001, we acquired (1) grapeVINE Technologies, LLC (grapeVINE) and (2) Cobalt Networks, Inc. and its wholly-owned subsidiaries (Cobalt). Purchased in-process research and development expenses (IPRD) of $71.3 million in the first half of fiscal 2001 represents the write-off of in-process technologies associated with our acquisitions of grapeVINE ($0.5 million) and Cobalt ($70.8 million). Purchased IPRD of $4.0 million in the first half of fiscal 2000 represents the write-off of in-process technologies associated with our acquisitions of Star Division Corporation (Star Division) and certain assets and liabilities of Star Division Software-Entwicklung und Vertriebs GmbH (Star Company), a related party of Star Division. All of these business combinations are known collectively as "Acquired Companies." At the date of each acquisition noted above, the projects associated with the IPRD efforts had not yet reached technological feasibility and the IPRD had no alternative future uses. Accordingly, these amounts were expensed on the respective acquisition dates of each of the Acquired Companies. Also, see Note 3 of "Notes to Condensed Consolidated Financial Statements (Unaudited) - Business Combinations".

See "Purchased In-Process Research and Development," in our Annual Report on Form 10-K for fiscal 2000 for additional discussion on our valuation of IPRD, overview of purchased IPRD and overall status of IPRD and intangible assets acquired during fiscal 2000, 1999, and 1998.

Valuation of IPRD

We used independent third-party sources to calculate the amounts allocated to IPRD. In calculating IPRD, the independent third party used established valuation techniques accepted in the high-technology industry. These calculations gave consideration to relevant market sizes and growth factors, expected industry trends, the anticipated nature and timing of new product introductions by us and our competitors, individual product sales cycles, and the estimated lives of each of the products' underlying technology. The value of the IPRD reflects the relative value and contribution of the acquired research and development. We gave consideration to the R&D's stage of completion, the complexity of the work completed to date, the difficulty of completing the remaining development, costs already incurred, and the projected cost to complete the project in determining the value assigned to IPRD.

The values assigned to developed technologies related to each acquisition were based upon discounted cash flows related to the existing products' projected income stream. Elements of the projected income stream included revenues, cost of sales (COS), SG&A expenses, and R&D expenses. The discount rates used in the present value calculations were generally derived from a weighted average cost of capital, adjusted upward to reflect the additional risks inherent in the development life cycle, including the useful life of the technology, profitability levels of the technology, and the uncertainty of technology advances that are known at the date of each acquisition. Since each acquired entity's IPRD is unique, the discount rate, revenue, COS, R&D and SG&A assumptions used varied on a case-by-case basis. We did not expect to achieve a material amount of expense reductions or synergies, therefore the valuation assumptions did not include significant anticipated cost savings.

21

22

Valuation Assumptions

The following table summarizes the significant assumptions underlying the valuations related to the IPRD for the six months ended December 31, 2000 (dollars in millions, except percentages):

						--PERCENTAGE
ACQUIRED COMPANY/ BUSINESS	IPRD	ESTIMATED COST TO COMPLETE TECHNOLOGY AT TIME OF ACQUISITION	PERCENTAGE COMPLETE AT TIME OF ACQUISITION	AVERAGE REVENUE GROWTH RATE	AVG. COS	A S
Cobalt	$ 70.8	$ 1.5	67%	50%	49%	
grapeVINE	$ 0.5	$ 0.3	83%	10%	18%	

Overview of Significant Purchased IPRD in the six months ended December 31, 2000

Included below are further details regarding the nature of the significant amounts of purchased technology acquired during the six months ended December 31, 2000.

Given the uncertainties of the commercialization process, we cannot assure you that deviations from our estimates will not occur. We believe there is a reasonable chance of realizing the economic return expected from the acquired in-process technology. However, there is risk associated with the realization of benefits related to commercialization of an in-process project due to rapidly changing customer needs, complexity of technology and growing competitive pressures. Therefore, we cannot assure you that any project will meet with commercial success. Failure to successfully commercialize an in-process project would result in the loss of the expected economic return inherent in the fair value allocation. Additionally, the value of our intangible assets acquired may become impaired.

On December 7, 2000, we acquired all of the outstanding capital stock of Cobalt in a stock-for-stock transaction valued at approximately $2,061.0 million. This transaction was accounted for as a purchase, with the purchase price being allocated to tangible assets, intangible assets, and IPRD.

At the acquisition date, Cobalt was engaged in development activity associated with development of its Cobalt(TM) RaQ XTR, Qube ML and CacheRaQ server appliance products as well as related software. As of the acquisition date, Cobalt had made substantial progress in the areas of product definition, architecture design and coding. Remaining efforts necessary to complete these server appliance products relate primarily to additional coding, testing and implementation. We released certain general availability versions of these products in late January 2001 and will continue releasing general availability versions of the remaining products through March 2001, at which time the Company expects to begin to realize economic benefits associated with these server appliance products.

Overall Status of Business Combinations Prior to Fiscal 2001

With respect to acquisitions completed prior to fiscal 2001, we believe that the projections we used in performing our valuations for each acquisition are still valid in all material respects; however, we cannot assure you that the projected results will be achieved. We continue to make substantial progress related to the development and commercialization of acquired technologies. Although we have experienced delays in the completion of certain of our development efforts and their related commercialization, the expected total costs to complete such technologies have not materially increased, individually or in the aggregate. We periodically evaluate our product development timeline and modify our overall business plan in response to various factors.

Modifications to our business plan include the reallocation of resources among various alternative development projects. The impact of delays in the realization of economic benefits related to acquired technologies, individually or in the aggregate, has not been material to our overall consolidated financial position or results of operations as of and for the quarter ended December 31, 2000.

INTEREST INCOME, NET
(dollars in millions)

	Three Months Ended			Six Months Ended		
	December 31, 2000	December 26, 1999	Change	December 31, 2000	December 26, 1999	Change
Interest income, net	$ 91	$ 32	184.4%	$ 166	$ 61	172.1%
Percentage of net revenues	1.8%	0.9%		1.6%	0.9%	

The increase in interest income (net of interest expense) of 184.4% and 172.1%

in the second quarter and first half of fiscal 2001, as compared to the corresponding periods in fiscal 2000, is primarily due to higher average balances of cash and marketable securities, partially offset by interest expense related to our issuance of the $1.5 billion of unsecured debt securities in August 1999.

Our interest income and expenses are sensitive to changes in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect the interest earned on our cash equivalents and marketable securities. In addition, to mitigate the impact of fluctuations in U.S. interest rates on our fixed-rate unsecured debt securities, we have entered into interest rate swap transactions so that the interest associated with these debt securities effectively becomes variable.

INCOME TAXES
(dollars in millions)

	Three Months Ended			Six Months Ended		
	December 31, 2000	December 26, 1999	Change	December 31, 2000	December 26, 1999	Change
Provision for income taxes	$ 309	$ 174	77.6%	$ 572	$ 310	84.5%
Percentage of income before income taxes	42.2%	33.0%		38.0%	33.2%	

Our effective tax rate was 42.2% and 38.0% for the second quarter and first half of fiscal 2001, as compared to 33.0% and 33.2% for the corresponding periods a year ago. The change in our effective tax rate is primarily due to the nondeductibility of certain accounting charges associated with our merger and acquisition activities, such as IPRD and goodwill. Excluding these accounting charges, our effective tax rate was 33.6% for the second quarter and first half of fiscal 2001 as compared to 32.1% for the corresponding periods in fiscal 2000. The remaining increase in the effective tax rate is primarily due to proportionately greater forecasted earnings in higher tax rate jurisdictions.

We currently expect our effective tax rate will be approximately 33.6% for the remainder of fiscal 2001. This excludes the impact of accounting charges associated with our merger and acquisition activities. Our expected rate is based on current tax law and current estimates of earnings, and is subject to change. While our effective tax rate under generally accepted accounting principles for the remainder of fiscal 2001 is expected to be

23

24

approximately 36.3%, this rate may change upon the completion of new mergers and acquisitions, such as the pending acquisitions of HighGround Systems, Inc. (HighGround) and LSC, Incorporated (LSC), or changes in the amount of goodwill amortization we recognize.

OPERATING EBITDA
(dollars in millions)

	Three Months Ended		Six Months Ended	
	December 31,	December 26,	December 31,	December 26,

	2000	1999	Change	2000	1999	Change
Operating EBITDA	$ 948	$ 666	42.3%	$ 1,854	$ 1,235	50.1%
Percentage of net revenues	18.5%	18.7%		18.2%	18.4%	

Operating EBITDA represents earnings before interest, income taxes, depreciation, amortization (including amortization of stock-based compensation), and other non-operating items, such as gain on sale of investments and IPRD. We believe that operating EBITDA is a useful measure of operating performance which provides focus on business fundamentals that track critical longer term trends. Though operating EBITDA as a measure of performance is significantly more cash-like, it is not intended to represent, nor does it represent, cash flows for the period, or funds available for dividends, reinvestment or other discretionary uses. Operating EBITDA has been presented as a useful supplement, not as a substitute, for measures of performance prepared and presented in accordance with generally accepted accounting principles.

During the second quarter and first half of fiscal 2001, operating EBITDA as a percentage of net revenues has remained essentially flat as compared to the corresponding periods in fiscal 2000. Despite the decline in total gross margin as a percentage of net revenues in the second quarter and first half of fiscal 2001, our operating EBITDA has remained consistent due to our ability to grow revenues without incurring proportionate increases in operating expenses. We are continuing to focus on improving this leverage on our cost structure.

24

25

LIQUIDITY AND CAPITAL RESOURCES
(dollars in millions)

	December 31, 2000	June 30, 2000
Cash, cash equivalents, and investments	$7,442	$6,971
Percentage of total assets	41.2%	49.3%
Days sales outstanding (DSO)	57	48
Inventory turns	14.2	17.5

	Six Months Ended December 31, 2000	December 26, 1999
Net cash provided by operating activities	$1,256	$1,164
Net cash used in investing activities	($1,620)	($2,217)
Net cash (used in) provided by financing activities	($82)	$1,263

At December 31, 2000, cash, cash equivalents and investments increased $471 million from June 30, 2000. The increase in the six months ended December 31, 2000 is due to cash flows generated from operating activities of $1,256 million, which represents our principal source of cash. Cash flows provided by operating activities were generated primarily from net income as adjusted for income tax benefits from employee stock plans and depreciation and amortization, which were partially offset by decreases in working capital. The cash flows provided by operating activities were offset by the following investing and financing activities: (1) capital spending of $572 million for real estate development and equipment additions to support increased headcount, primarily in our services, engineering and marketing organizations and (2) acquisition of treasury stock for $311 million.

The decrease in working capital was primarily generated by increases in accounts receivable (net) and inventory. Accounts receivable (net) increased to $3,215 million at December 31, 2000 from $2,690 million at June 30, 2000. The increase in accounts receivable (net) and DSO are primarily due to increased revenues and the timing of payments by customers. Inventory increased to $792 million at December 31, 2000 from $557 million at June 30, 2000. The increase in inventory and decline in inventory turns is primarily due to Sun's decision to carry more inventory to better meet customer demand and provide better customer service.

We have a $500 million revolving credit facility ("Facility") with a syndicate of commercial banks. The Facility is available subject to compliance with certain covenants, with which we are currently in compliance. No amounts were outstanding under the Facility at December 31, 2000.

We currently have effective shelf registration statements on file with the Securities and Exchange Commission that permit us to offer up to $4.0 billion of debt securities and common and preferred stock in one or more separate series, in amounts, at prices, and on terms to be set forth in the prospectus contained in these registration statements and in one or more supplements to the prospectus. On August 4, 1999, we issued $1.5 billion in unsecured debt securities in four tranches (the "Senior Notes") under these registration statements. The Senior Notes are due at various times between August 2002 and August 2009.

We believe that the liquidity provided by existing cash, cash equivalents, and investments, along with the borrowing arrangements described above and cash generated from operations, will provide sufficient capital to meet our requirements for at least the next twelve months. We believe the level of financial resources is a significant competitive factor in our industry and we may choose at any time to raise additional capital through debt or equity financing to strengthen our financial position, facilitate growth, and provide us with additional flexibility to take advantage of business opportunities that may arise.

RISK FACTORS

IF WE ARE UNABLE TO COMPETE EFFECTIVELY WITH EXISTING OR NEW COMPETITORS, OUR RESULTING LOSS OF COMPETITIVE POSITION COULD RESULT IN PRICE REDUCTIONS, FEWER CUSTOMER ORDERS, REDUCED REVENUES, REDUCED MARGINS, REDUCED LEVELS OF PROFITABILITY, AND LOSS OF MARKET SHARE.

We compete in the hardware and software products and services markets. These markets are intensely competitive. If we fail to compete successfully in these markets, the demand for our products would decrease. Any reduction in demand could lead to a decrease in the prices of our products, fewer customer orders, reduced revenues, reduced margins, reduced levels of profitability, and loss of market share. These competitive pressures could adversely affect our business and operating results.

Our competitors are some of the largest, most successful companies in the world. They include Hewlett-Packard Company (HP), International Business Machines Corporation (IBM), Compaq Computer Corporation (Compaq), and EMC Corporation (EMC). Our future competitive performance depends on a number of factors, including our ability to: continually develop and introduce new products and services with better prices and performance than those offered by our competitors; offer a wide range of products and solutions from small single-processor systems to large complex enterprise-level systems; offer solutions to customers that operate effectively within a computing environment that includes hardware and software from multiple vendors; offer products that are reliable and that ensure the security of data and information; create products for which third party software vendors will develop a wide range of applications; and offer high quality products and services.

We also compete with systems manufacturers and resellers of systems based on microprocessors from Intel Corporation (Intel) and Windows operating system software from Microsoft Corporation (Microsoft). These competitors include Dell Computer Corporation (Dell), HP, and Compaq, in addition to Intel and Microsoft. This competition creates increased pressure, including pricing pressure, on our workstation and lower-end server product lines. We expect this competitive pressure to intensify considerably during fiscal year 2001, with the anticipated releases of new software products from Microsoft and new microprocessors from Intel.

The computer systems that we sell are made up of many products and components, including workstations, servers, storage products, microprocessors, the Solaris Operating Environment and other software products. In addition, we sell some of these components separately and as add-ons to installed systems. If we are unable to offer products and services that compete successfully with the products and services offered by our competitors or that meet the complex needs of our customers, our business and operating results could be adversely affected. In addition, if in responding to competitive pressures, we are forced to lower the prices of our products and services and we are unable to reduce our component costs or improve operating efficiencies, our business and operating results would be adversely affected.

Over the last several years, we have invested significantly in our storage products business with a view to increasing the sales of these products both on a stand-alone basis to customers using the systems of our competitors, and as part of the systems that we sell. The intelligent storage products business is intensely competitive. EMC is currently the leader in this market. To the extent we are unable to penetrate this market and compete effectively, our business and operating results could be adversely affected. In addition, we will be making significant investments to develop, market, and sell software products under our alliance with America Online, Inc. (AOL) and have agreed to significant minimum revenue commitments. These alliance products are targeted at the e-commerce market and are strategic to our ability to successfully compete in this market. If we are unable to successfully compete in this market, our business and operating results could be adversely affected.

26

27

THE PRODUCTS WE MAKE ARE VERY COMPLEX AND IF WE ARE UNABLE TO RAPIDLY AND SUCCESSFULLY DEVELOP AND INTRODUCE NEW PRODUCTS, WE WILL NOT BE ABLE TO SATISFY CUSTOMER DEMAND.

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop and introduce new products that our customers choose to buy. If we are unable to develop new products, our business and operating results could be adversely affected. We must quickly develop, introduce, and deliver in quantity new, complex systems, software, and hardware products and components. These include products we plan to introduce later in fiscal 2001 which incorporate our new UltraSPARC(TM) III architecture, the Solaris Operating Environment, our Sun StorEdge(TM) storage products, and other software products, such as those products under development or to be developed under our alliance with AOL. The development process for these complicated products is very uncertain. It requires high levels of innovation from both our product designers and our suppliers of the components used in our products. The development process is also lengthy and costly. If we fail to accurately anticipate our customers' needs and technological trends, or are otherwise unable to complete the development of a product on a timely basis, we will be unable to introduce new products into the market on a timely basis, if at all, and our business and operating results would be adversely affected. In addition, the successful development of software products under our alliance with AOL depends on many factors, including our ability to work effectively within the alliance on complex product development and any encumbrances on the licensed technology that may arise from time to time may prevent us from developing, marketing, or selling these alliance software products. If we are unable to successfully develop, market, or sell the alliance software products or other software products, our business and operating results could be adversely affected.

Software and hardware products such as ours may contain known as well as undetected errors, and these defects may be found following introduction and shipment of new products or enhancements to existing products. Although we attempt to fix errors that we believe would be considered critical by our customers prior to shipment, we may not be able to detect or fix all such errors, and this could result in lost revenues and delays in customer acceptance, and could be detrimental to our business and reputation.

The manufacture and introduction of our new hardware and software products is also a complicated process. Once we have developed a new product we face several challenges in the manufacturing process. We must be able to manufacture new products in high enough volumes so that we can have an adequate supply of new products to meet customer demand. We must be able to manufacture the new products at acceptable costs. This requires us to be able to accurately forecast customer demand so that we can procure the appropriate components at optimal costs. Forecasting demand requires us to predict order volumes, the correct mixes of our software and hardware products, and the correct configurations of these products. We must manage new product introductions like the introduction of our new UltraSPARC III architecture during fiscal 2001, so that we can minimize the impact of customers delaying purchases of existing products in anticipation of the new product release. We must also try to reduce the levels of older product and component inventories to minimize inventory write-offs. Additionally, we may decide to adjust prices of our existing products during this process in order to try to increase customer demand for these products. If we are introducing new products at the same time or shortly after the price adjustment, this will complicate our ability to anticipate customer demand for our new products.

If we are unable to timely develop, manufacture, and introduce new products in sufficient quantity to meet customer demand at acceptable costs, or if we are unable to correctly anticipate customer demand for our new and existing products, our business and operating results could be materially adversely affected.

OUR RELIANCE ON SINGLE SOURCE SUPPLIERS COULD DELAY PRODUCT SHIPMENTS AND INCREASE OUR COSTS.

We depend on many suppliers for the necessary parts and components to manufacture our products. There are a number of vendors producing the parts and components that we need. However, there are some components that can only be purchased from a single vendor due to price, quality, or technology reasons. For example, we depend on Sony for various monitors, and on Texas Instruments for our SPARC microprocessors. If we were unable to purchase the necessary parts and components from a particular vendor and we had to find a new supplier for such parts and components, our new and existing product shipments could be delayed, severely affecting our business and operating results.

OUR FUTURE OPERATING RESULTS DEPEND ON OUR ABILITY TO PURCHASE A SUFFICIENT AMOUNT OF COMPONENTS TO MEET THE DEMANDS OF OUR CUSTOMERS.

We depend heavily on our suppliers to timely design, manufacture, and deliver the necessary components for our products. While many of the components we purchase are standard, we do purchase some components, specifically color monitors and custom memory integrated circuits such as static random access memories (SRAMS) and video random access memories (VRAMS), that require long lead times to manufacture and deliver. Long lead times make it difficult for us to plan component inventory levels in order to meet the customer demand for our products. In addition, in the past, we have experienced shortages in certain of our components (specifically dynamic random access memories (DRAMS) and SRAMS). If a component delivery from a supplier is delayed, if we experience a shortage in one or more components, or if we are unable to provide for adequate levels of component inventory, our new and existing product shipments could be delayed and our business and operating results could be adversely affected.

SINCE WE ORDER OUR COMPONENTS (AND IN SOME CASES COMMIT TO PURCHASE) FROM SUPPLIERS IN ADVANCE OF RECEIPT OF CUSTOMER ORDERS FOR OUR PRODUCTS WHICH INCLUDE THESE COMPONENTS, WE FACE A SUBSTANTIAL INVENTORY RISK.

As part of our component inventory planning, we frequently pay certain suppliers well in advance of receipt of customer orders. For example, we often enter into noncancelable purchase commitments with vendors early in the manufacturing process of our microprocessors to make sure we have enough of these components for our new products to meet customer demand. Because the design and manufacturing process for these components is very complicated it is possible that we could experience a design or manufacturing flaw that could delay or even prevent the production of the components for which we have previously committed to pay. We also face the risk of ordering too many components, or conversely, not enough components, since the orders are based on the forecasts of customer orders rather than actual orders. If we cannot change or be released from the noncancelable purchase commitments, we could incur significant costs from the purchase of unusable components, due to a delay in the production of the components or as a result of inaccurately predicting component orders in advance of customer orders. Our business and operating results could be adversely affected as a result of these increased costs.

DELAYS IN PRODUCT DEVELOPMENT OR CUSTOMER ACCEPTANCE AND IMPLEMENTATION OF NEW PRODUCTS AND TECHNOLOGIES COULD SERIOUSLY HARM OUR BUSINESS.

Generally, the computer systems we sell to customers incorporate hardware and software products that we sell, such as UltraSPARC microprocessors, the Solaris Operating Environment and Sun StorEdge storage products. Any delay in the development of the software and hardware included in our systems could delay our shipment of these systems. Delays in the development and introduction of our products may occur for various reasons. For example, delays in software development could delay shipments of related new hardware products.

In addition, if customers decided to delay the adoption and implementation of new releases of our Solaris Operating Environment this could also delay customer acceptance of new hardware products tied to that release. Adopting a new release of an operating environment requires a great deal of time and money for a customer to convert its systems to the new release. The customer must also work with software vendors who port their software applications to the new operating system and make sure these applications will run on the new operating system. As a result, customers may decide to delay their adoption of a new release of an operating system because of the cost of a new system and the effort involved to implement it. Such delays in product development and customer acceptance and implementation of new products could adversely affect our business.

IF WE ARE UNABLE TO CONTINUE GENERATING SUBSTANTIAL REVENUES FROM INTERNATIONAL SALES OUR BUSINESS COULD BE ADVERSELY AFFECTED.

Currently, approximately half of our revenues come from international sales. Our ability to sell our products internationally is subject to the following risks: general economic and political conditions in each country could adversely affect demand for our products and services in these markets; currency exchange rate fluctuations could result in lower demand for our products, as well as currency translation losses; changes to and compliance with a variety of foreign laws and regulations may increase our cost of doing business in these jurisdictions; trade protection measures and import and export licensing requirements subject us to additional regulation and may prevent us from shipping products to a particular market, and increase our operating costs.

WE EXPECT OUR QUARTERLY REVENUES AND OPERATING RESULTS TO FLUCTUATE FOR A NUMBER OF REASONS.

Future operating results will continue to be subject to quarterly fluctuations based on a wide variety of factors, including:

SEASONALITY. Our sequential quarterly operating results usually fluctuate downward in the first quarter of each fiscal year when compared to the immediately preceding fourth quarter.

INCREASES IN OPERATING EXPENSES. Our operating expenses will continue to increase as we continue to expand our operations. Our operating results could suffer if our revenues do not increase at least as fast as our expenses.

ACQUISITIONS/ALLIANCES. If, in the future, we acquire technologies, products, or businesses, or we form alliances with companies requiring technology investments or revenue commitments (such as our alliance with AOL), we will face a number of risks to our business. The risks we may encounter include those associated with integrating or comanaging operations, personnel, and technologies acquired or licensed, and the potential for unknown liabilities of the acquired or combined business. Also, we will include amortization expense of acquired intangible assets in our financial statements for several years following these acquisitions. Our business and operating results on a quarterly basis could be adversely affected if our acquisition or alliance activities are not successful.

SIGNIFICANT CUSTOMERS. Sales to a single customer accounted for approximately 19% and 15% of our fiscal 2000 and 1999 net revenues, respectively. The major customer revenues in fiscal 2000 and 1999 were primarily generated by two subsidiaries of an international organization: (1) a reseller (16% and 14% of net revenues in 2000 and 1999, respectively), acquired by the international organization in fiscal 1999; and (2) a finance/leasing company (3% and 1% of net revenues in fiscal 2000 and 1999, respectively). Revenue is generated with the finance/leasing company whenever a Sun customer elects to lease equipment; in such cases, Sun sells the equipment to the leasing company. Our business could suffer if these customers or any other

significant customer terminated its business relationship with us or significantly reduced the amount of business it did with us.

OUR ACQUISITION AND ALLIANCE ACTIVITIES COULD DISRUPT OUR ONGOING BUSINESS.

We intend to continue to make investments in companies, products, and technologies, either through acquisitions or investment alliances. For example, we have purchased several companies in the past and have also formed alliances, including our alliance with AOL. Acquisitions and alliance activities often involve risks, including: difficulty in assimilating the acquired operations and employees; difficulty in managing product codevelopment activities with our alliance partners; retaining the key employees of the acquired operation; disruption of our ongoing business; inability to successfully integrate the acquired technology and operations into our business and maintain uniform standards, controls, policies, and procedures; and lacking the experience to enter into new markets, products, or technologies.

Failure to manage these alliance activities effectively and to integrate entities or assets that we acquire could affect our operating results or financial condition.

WE DEPEND ON KEY EMPLOYEES AND FACE COMPETITION IN HIRING AND RETAINING QUALIFIED EMPLOYEES.

Our employees are vital to our success, and our key management, engineering, and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. The expansion of high technology companies in Silicon Valley and Colorado, as well as many other cities, has increased demand and competition for qualified personnel. We may not be able to attract, assimilate, or retain highly qualified employees in the future. These factors could adversely affect our business.

BUSINESS INTERRUPTIONS COULD ADVERSELY AFFECT OUR BUSINESS.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure and other events beyond our control. A substantial portion of our facilities, including our corporate headquarters and other critical business operations, are located near major earthquake faults. In addition, many of our facilities are located on filled land and, therefore, may be more susceptible to damage if an earthquake occurs. We do not carry earthquake insurance and do not self insure for earthquake-related losses. Our facilities in the State of California, including our corporate headquarters and other critical business operations, are currently subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts continue or increase in severity, they could disrupt the operations of our affected facilities. In addition, we do not carry business interruption insurance or carry financial reserves against business interruptions arising from earthquakes or intentional electrical blackouts. If a business interruption occurs, our business could be seriously harmed.

OUR MARKETABLE STRATEGIC EQUITY SECURITIES ARE SUBJECT TO EQUITY PRICE RISK AND THEIR VALUE MAY FLUCTUATE.

From time to time, we make equity investments for the promotion of business and strategic objectives with publicly traded and non-publicly traded companies. The market price and valuation of the securities that we hold in these companies may fluctuate due to market conditions and other circumstances over which we have little or no control. Many of the companies in which we have invested have experienced significant volatility in their stock prices. We typically do not attempt to reduce or eliminate this equity price risk, through hedging or similar techniques, and market price and valuation fluctuations could impact our financial results. To the extent

that the fair value of these securities was less than our cost over an extended period of time, our net income would be reduced. Also, refer to Item 3 - Quantitative and Qualitative Disclosures about Market Risk.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk related to changes in interest rates, foreign currency exchange rates, and equity security prices. To mitigate some of these risks, we utilize derivative financial instruments. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at December 31, 2000. Actual results may differ materially.

Interest Rate sensitivity

Our investment portfolio consists primarily of fixed income instruments with an average duration of less than 1.50 years. The primary objective of our investments in debt securities is to preserve principal while maximizing yields, without significantly increasing risk. These available-for-sale securities are subject to interest rate risk and will decrease in value if market interest rates increase. The sensitivity analysis applied to this investment portfolio was based on a modeling technique that measures the hypothetical market value changes that would result from a parallel shift in the yield curve of plus 150 basis points (BPS). The hypothetical 150 BPS increase in interest rates would result in an approximate $104 million decrease in the fair value of our investments in debt securities as of December 31, 2000.

We also entered into various interest-rate swap agreements to modify the interest characteristics of the Senior Notes so that the interest associated with the Senior Notes effectively becomes variable and thus matches the variable interest rate associated with our cash and marketable securities.

Foreign Currency Exchange Risk

The majority of our revenue, expense, and capital purchasing activities are transacted in U.S. dollars. However, since a portion of our operations consists of manufacturing and sales activities outside of the U.S., we enter into transactions in other currencies, primarily the Japanese yen, the British pound and the Euro. We enter into foreign exchange forward and option contracts to hedge certain balance sheet exposures and intercompany balances against future movements in foreign exchange rates. The gains or losses on the forward and option contracts are largely offset by gains or losses on the underlying transactions and, consequently, a sudden or significant change in foreign exchange rates is not expected to have a material impact on future net income or cash flows. Based on our foreign currency exchange instruments outstanding at December 31, 2000, we estimate a maximum potential one-day loss in fair value of approximately $26 million, using a Value-at-Risk (VAR) model. The VAR model estimates were made assuming normal market conditions and a 95% confidence level. We used a Monte Carlo simulation type model that valued foreign currency instruments against a thousand randomly generated market price paths. Anticipated transactions, firm commitments, receivables, and accounts payable denominated in foreign currencies were excluded from the model. The VAR model is a risk estimation tool, and as such is not intended to represent actual losses in fair value that will be incurred by us. Additionally, as we utilize foreign currency instruments for hedging anticipated and firmly committed transactions, a loss in fair value for those instruments is generally offset by increases in the value of the underlying exposure. Foreign currency fluctuations did not have a material impact on our results of operations and financial position for the first six months of fiscal 2001. Also, refer to Note 5 of "Notes to Condensed Consolidated Financial Statements (Unaudited) Derivative Financial Instruments" for additional discussion.

Euro Conversion

On January 1, 1999, certain member countries of the European Union established fixed conversion rates between their existing currencies and the Euro. The transition period for the introduction of the Euro ends June 30, 2002. Issues facing us as a result of the introduction of the Euro include converting information technology systems, reassessing currency risk, negotiating and amending licensing agreements and contracts, and processing tax and accounting records. We continue to address these issues and do not currently expect the Euro conversion to have a material effect on our financial conditions or results of operations.

Equity Security Price Risk

We are exposed to price fluctuations on the marketable portion of equity securities included in our portfolio of strategic investments. These investments are generally in companies in the high-technology industry sector, many of which are small capitalization stocks. We typically do not attempt to reduce or eliminate the market exposure on these securities. A 20% adverse change in equity prices would result in an approximate $32 million decrease in the fair value of our available-for-sale marketable strategic equity securities as of December 31, 2000. At December 31, 2000, three equity securities represented approximately $89 million of the total reported fair value of the marketable strategic equity securities of $158 million. Also, refer to Note 4 of "Notes to Condensed Consolidated Financial Statements (Unaudited) Balance Sheet Details" for additional discussion on Sun's marketable strategic equity securities.

PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

On January 23, 2001, Sun and Microsoft Corporation agreed to settle the litigation initiated by Sun on October 7, 1997 regarding Sun's Java technology. Under the terms of the settlement agreement, Microsoft agreed to pay Sun $20 million and to terminate its license of the Java technology. In addition, Microsoft was permanently enjoined from using Sun's JAVA COMPATIBLE(TM) trademark and Sun agreed to grant Microsoft a new limited and conditional license to continue shipping, essentially as is, its currently shipping implementations of the 1.1.4 version of the Java technology. This new license covers only the products that already contain the 1.1.4 version of the Java technology and successor versions of those products, and lasts for seven years.

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

On November 8, 2000, the Annual Meeting of Stockholders of the Company was held in Santa Clara, California. The share numbers contained in this Item 4 do not reflect the Company's two-for-one stock dividend paid on December 5, 2000. The results of voting of the 1,385,693,540 shares of common stock represented at the meeting or by proxy are described below.

An election of directors was held with the following individuals being elected to the Board of Directors of the Company:

Name	Shares Voted For	Votes Withheld
Scott G. McNealy	1,376,034,949	9,658,591
James L. Barksdale	1,375,702,034	9,991,506
L. John Doerr	1,176,883,446	208,810,094
Judith L. Estrin	1,376,015,015	9,678,525
Robert J. Fisher	1,375,977,343	9,716,197
Robert L. Long	1,375,976,455	9,717,085
M. Kenneth Oshman	1,375,992,992	9,700,548
Naomi O. Seligman	1,374,184,942	11,508,598

The eight nominees who received the highest number of votes (all of the above individuals) were elected to the Board of Directors.

The stockholders approved an amendment to the Company's Restated Certificate of Incorporation to increase the number of authorized shares of common stock from 3,600,000,000 to 7,200,000,000 shares. There were 1,371,316,107 votes cast for the amendment, 9,531,256 votes cast against the amendment, 4,846,177 abstentions and no broker non-votes.

The stockholders approved an amendment to the Company's 1990 Long-Term Equity Incentive Plan in order to increase the number of shares of common stock authorized for issuance thereunder by 7,000,000 shares of common stock to an aggregate of 558,600,000 shares. There were 837,990,961 votes cast for the amendment, 541,210,871 votes cast against the amendment, 6,491,708 abstentions and no broker non-votes.

The stockholders approved an amendment to the Company's Bylaws in order to increase the number of directors to serve on the Company's Board of Directors to no less than six (6) nor more than eleven (11), with the exact number to be set by the Board within such range from time to time. There were 938,006,556 votes cast for the

amendment, 6,327,436 votes cast against the amendment, 4,987,985 abstentions and 436,371,563 broker non-votes.

ITEM 5 - OTHER INFORMATION

SCHEDULE OF SALES BY EXECUTIVE OFFICERS DURING THE QUARTER

The following is a summary of all sales of our common stock by our executive officers and directors who are subject to Section 16 of the Securities Exchange Act of 1934, as amended, during the fiscal quarter ended December 31, 2000 (the numbers below do not reflect Sun's two-for-one stock dividend paid on December 5, 2000):

OFFICERS AND DIRECTORS	DATE OF TRANSACTION	PRICE	NUMBER OF SHARES SOLD
Judith L. Estrin	10/24/00	$118.3048	298,000 sale
H. William Howard	10/24/00	$119.1875	40,000 same-day-sale
William N. Joy	11/27/00	$87.1625	150,000 same-day-sale
	11/28/00	$84.7531	60,800 same-day-sale
	11/28/00	$85.4750	100,000 same-day-sale
	11/28/00	$84.7531	39,200 same-day-sale
	11/28/00	$83.8417	150,000 same-day-sale
	11/30/00	$73.9375	100,000 same-day-sale
	11/30/00	$76.0141	200,000 same-day-sale
Michael E. Lehman	10/31/00	$105.0000	128,000 same-day-sale
M. Kenneth Oshman	10/24/00	$121.0141	300,000 same-day-sale
Gregory M. Papadopoulos	11/1/00	$108.9375	40,000 same-day-sale
	11/2/00	$108.0000	20,000 same-day-sale
Michael L. Popov	11/1/00	$107.0000	48,000 same-day-sale
Janpieter T. Scheerder	11/7/00	$111.2798	42,000 same-day-sale
John C. Shoemaker	10/24/00	$120.0000	24,000 same-day-sale
	11/7/00	$110.4793	48,000 same-day-sale
Patricia C. Sueltz	11/2/00	$109.0000	20,000 same-day-sale

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

3.2 Registrant's Bylaws, as amended November 8, 2000.

3.5 Certificate of Amendment of Registrant's Restated Certificate of Incorporation filed November 8, 2000.

3.6(1) Amended Certificate of Designations filed December 20, 2000.

10.66 Registrant's 1990 Long-Term Equity Incentive Plan, as amended on August 16, 2000.

(1) Incorporated by reference to Exhibit 2.2 to Amendment No. 9 to Registrant's Registration Statement on Form 8-A, filed

with the Securities and Exchange Commission on December 20, 2000.

(b) Reports on Form 8-K

The Company filed a report on Form 8-K with the Securities and Exchange Commission on December 8, 2000, announcing its completion of the acquisition of Cobalt Networks, Inc.

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.

SUN MICROSYSTEMS, INC.

BY

/s/ Michael E. Lehman

Michael E. Lehman
Executive Vice President, Corporate Resources
and Chief Financial Officer
(Principal Financial Officer)

/s/ Michael L. Popov

Michael L. Popov
Vice President and Corporate Controller
(Chief Accounting Officer)

Dated: February 14, 2001

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION

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10.66	Registrant's 1990 Long-Term Equity Incentive Plan, as amended on August 16, 2000.

(1) Incorporated by reference to Exhibit 2.2 to Amendment No. 9 to Registrant's Registration Statement on Form 8-A, filed with the Securities and Exchange Commission on December 20, 2000.