STORAGE TECHNOLOGY CORP
Form 10-Q
November 01, 2004

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

## FORM 10-Q

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 24, 2004**

**or**

o **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. ý Yes o No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). ý Yes o No

The registrant had 106,565,923 shares of common stock outstanding as of October 28, 2004.

**STORAGE TECHNOLOGY CORPORATION**
**INDEX TO FORM 10-Q**
**September 24, 2004**





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

| | 09/24/04 (Unaudited) | 12/26/03 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 1,059,414 | $ 1,001,629 |
| Short-term investments | 3,213 | 14,650 |
| Accounts receivable | 442,549 | 539,334 |
| Inventories | 111,582 | 109,988 |

| | 09/24/04 | 12/26/03 |
|---|---|---|
| Deferred income tax assets | 132,994 | 139,446 |
| Other current assets | 673 | 123 |
| Total current assets | 1,750,425 | 1,805,170 |
| Long-term investments | 50,160 | 43,501 |
| Property, plant, and equipment | 180,094 | 201,647 |
| Spare parts for maintenance | 46,390 | 44,695 |
| Deferred income tax assets | 93,603 | 93,521 |
| Other assets | 123,486 | 116,712 |
| Total assets | $ 2,244,158 | $ 2,305,246 |
| **LIABILITIES** | | |
| Current liabilities: | | |
| Current portion of long-term debt | $ 1,369 | $ 1,090 |
| Accounts payable | 110,936 | 132,404 |
| Accrued liabilities | 471,035 | 483,672 |
| Income taxes payable | 247,221 | 250,818 |
| Other current liabilities | 25,669 | 64,674 |
| Total current liabilities | 856,230 | 932,658 |
| Long-term debt | 10,201 | 11,150 |
| Total liabilities | 866,431 | 943,808 |
| Commitments and contingencies (Notes 4 and 8) | | |
| **STOCKHOLDERS' EQUITY** | | |
| Common stock, $0.10 par value, 300,000,000 shares authorized; 111,583,088 shares issued at September 24, 2004, and 111,135,483 shares issued at December 26, 2003 | 11,158 | 11,114 |
| Capital in excess of par value | 987,798 | 991,273 |
| Retained earnings | 510,803 | 409,072 |
| Accumulated other comprehensive loss | (20,733) | (30,436) |
| Treasury stock, 3,923,400 shares at September 24, 2004, and 299,677 shares at December 26, 2003, at cost | (95,153) | (5,919) |
| Unearned compensation | (16,146) | (13,666) |
| Total stockholders' equity | 1,377,727 | 1,361,438 |
| Total liabilities and stockholders' equity | $ 2,244,158 | $ 2,305,246 |

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



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

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | 09/24/04 | 09/26/03 | 09/24/04 | 09/26/03 |
| Revenue: | | | | |
| Storage products | $ 299,041 | $ 312,435 | $ 882,695 | $ 906,844 |
| Storage services | 227,445 | 207,825 | 675,478 | 620,634 |
| Total revenue | 526,486 | 520,260 | 1,558,173 | 1,527,478 |
| Cost of revenue: | | | | |
| Storage products | 154,538 | 164,285 | 456,253 | 486,774 |
| Storage services | 123,706 | 118,907 | 377,643 | 353,211 |
| Total cost of revenue | 278,244 | 283,192 | 833,896 | 839,985 |
| Gross profit | 248,242 | 237,068 | 724,277 | 687,493 |
| Research and development costs | 47,847 | 49,803 | 143,395 | 150,786 |
| Selling, general, and administrative expense | 150,721 | 145,028 | 461,693 | 432,051 |
| Operating profit | 49,674 | 42,237 | 119,189 | 104,656 |
| Interest income | 4,270 | 2,556 | 10,770 | 7,564 |
| Interest expense | (327) | (486) | (1,022) | (1,353) |
| Income before income taxes | 53,617 | 44,307 | 128,937 | 110,867 |
| Provision for income taxes | (10,862) | (13,300) | (27,206) | (33,300) |
| Net income | $ 42,755 | $ 31,007 | $ 101,731 | $ 77,567 |
| **EARNINGS PER COMMON SHARE** | | | | |
| Basic earnings per share | $ 0.39 | $ 0.29 | $ 0.92 | $ 0.72 |
| Weighted-average shares | 109,030 | 108,612 | 110,085 | 107,652 |
| Diluted earnings per share | $ 0.39 | $ 0.28 | $ 0.91 | $ 0.70 |
| Weighted-average and dilutive potential shares | 110,842 | 111,502 | 112,307 | 110,273 |

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



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

**Nine Months Ended**

| | Nine Months Ended | |
|---|---|---|
| | 09/24/04 | 09/26/03 |
| **OPERATING ACTIVITIES** | | |
| Cash received from customers | $ 1,656,522 | $ 1,649,037 |
| Cash paid to suppliers and employees | (1,380,578) | (1,395,623) |
| Interest received | 9,935 | 7,123 |
| Interest paid | (811) | (960) |
| Income taxes paid | (21,263) | (9,461) |
| Net cash provided by operating activities | 263,805 | 250,116 |
| **INVESTING ACTIVITIES** | | |
| Proceeds from sale of investments | 23,965 | -- |
| Purchases of investments | (19,257) | (39,703) |
| Purchases of property, plant, and equipment | (39,118) | (31,844) |
| Proceeds from sale of property, plant, and equipment | 1,635 | 3,746 |
| Other assets | (22,661) | 1,045 |
| Net cash used in investing activities | (55,436) | (66,756) |
| **FINANCING ACTIVITIES** | | |
| Repurchases of common stock | (156,358) | -- |
| Proceeds from employee stock plans | 47,732 | 45,549 |
| Proceeds from other debt | 421 | 676 |
| Repayments of other debt | (983) | (1,382) |
| Net cash provided by (used in) financing activities | (109,188) | 44,843 |
| Effect of exchange rate changes on cash | (41,396) | 2,402 |
| Increase in cash and cash equivalents | 57,785 | 230,605 |
| Cash and cash equivalents - beginning of the period | 1,001,629 | 657,599 |
| Cash and cash equivalents - end of the period | $ 1,059,414 | $ 888,204 |
| **RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES** | | |
| Net income | $ 101,731 | $ 77,567 |
| Depreciation and amortization expense | 59,639 | 64,760 |
| Inventory writedowns | 16,373 | 18,565 |
| Translation loss | 32,210 | 21,990 |
| Other non-cash adjustments to income | 30,878 | (20,307) |
| Decrease in accounts receivable | 98,349 | 121,559 |
| (Increase) decrease in other current assets | (464) | 7,758 |
| Increase in inventories | (6,040) | (3,087) |
| Increase in spare parts | (14,627) | (13,214) |
| Increase in deferred income tax assets | (1,603) | (4,907) |
| Decrease in accounts payable | (21,654) | (26,246) |
| Decrease in accrued liabilities | (14,045) | (9,494) |
| Decrease in other current liabilities | (15,388) | (4,198) |
| Increase (decrease) in income taxes payable | (1,554) | 19,370 |
| Net cash provided by operating activities | $ 263,805 | $ 250,116 |

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

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**STORAGE TECHNOLOGY CORPORATION**
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**
(Unaudited)
(In Thousands)

| | Common Shares Issued | Common Stock | Capital in Excess of Par Value | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Unearned Compensation | Total |
|---|---|---|---|---|---|---|---|---|
| Balances, December 26, 2003 | 111,135 | $ 11,114 | $ 991,273 | $ 409,072 | $ (30,436) | $ (5,919) | $ (13,666) | $ 1,361,438 |
| Components of comprehensive income: | | | | | | | | |
| Net income | -- | -- | -- | 101,731 | -- | -- | -- | 101,731 |
| Other comprehensive income | -- | -- | -- | -- | 9,703 | -- | -- | 9,703 |
| Total comprehensive income | -- | -- | -- | 101,731 | 9,703 | -- | -- | 111,434 |
| Shares issued upon exercise of stock options | 2,331 | 233 | 39,524 | -- | -- | -- | -- | 39,757 |
| Shares issued under employee stock purchase plan | 409 | 41 | 8,083 | -- | -- | -- | -- | 8,124 |
| Shares repurchased under stock repurchase program | -- | -- | -- | -- | -- | (156,358) | -- | (156,358) |
| Restricted stock activity | 228 | 22 | 7,557 | -- | -- | -- | (2,480) | 5,099 |
| Other | (2,520) | (252) | (58,639) | -- | -- | 67,124 | -- | 8,233 |
| Balances, September 24, 2004 | 111,583 | $ 11,158 | $ 987,798 | $ 510,803 | $ (20,733) | $ (95,153) | $ (16,146) | $ 1,377,727 |

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

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

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | 09/24/04 | 09/26/03 | 09/24/04 | 06/26/03 |
| Net income | $ 42,755 | $ 31,007 | $ 101,731 | $ 77,567 |
| Other comprehensive income (loss): | | | | |
| Foreign currency hedging contracts: | | | | |
| Net loss on foreign currency cash flow hedges, net of tax benefit of $2,123, $7,719, $1,660, and $16,381 | (3,376) | (12,279) | (2,641) | (26,174) |
| Reclassification adjustment for net losses included in net income, net of tax benefit of $2,687, | | | | |

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| $6,580, $9,154, and $10,969 | 4,274 | 10,467 | 14,561 | 17,508 |
| Unrealized gain (loss) on marketable securities: | | | | |
| Holding gain (loss), net of tax expense (benefit) of $46, $(171), $(88), and $394 | 54 | (456) | (106) | 861 |
| Reclassification adjustment for net gains included in net income, net of tax expense of $75, $165, $905, and $699 | (175) | (386) | (2,111) | (1,631) |
| Other comprehensive income (loss) | 777 | (2,654) | 9,703 | (9,436) |
| Comprehensive income | $ 43,532 | $ 28,353 | $ 111,434 | $ 68,131 |

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 26, 2003. 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. Certain prior year amounts have been reclassified to conform to the current year presentation.

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

## NOTE 2 STOCK-BASED COMPENSATION PLANS

The Company accounts for stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Stock-based compensation reflected in net income is related to restricted stock.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based compensation (in thousands, except per share amounts):

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | 09/24/04 | 09/26/03 | 09/24/04 | 09/26/03 |
| Net income, as reported | $ 42,755 | $ 31,007 | $ 101,731 | $ 77,567 |
| Add: Stock-based compensation expense included in reported net income, net of related tax effects | 1,247 | 1,143 | 3,762 | 3,061 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (6,715) | (5,275) | (19,142) | (16,105) |
| Pro forma net income | $ 37,287 | $ 26,875 | $ 86,351 | $ 64,523 |

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| Earnings per share: | | | | |
| Basic, as reported | $ 0.39 | $ 0.29 | $ 0.92 | $ 0.72 |
| Basic, pro forma | $ 0.34 | $ 0.25 | $ 0.78 | $ 0.60 |
| Diluted, as reported | $ 0.39 | $ 0.28 | $ 0.91 | $ 0.70 |
| Diluted, pro forma | $ 0.34 | $ 0.25 | $ 0.78 | $ 0.60 |

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**NOTE 3 INVENTORIES**

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

| | 09/24/04 | 12/26/03 |
|---|---|---|
| Raw materials | $ 19,647 | $ 14,951 |
| Work-in-process | 20,740 | 29,740 |
| Finished goods | 71,195 | 65,297 |
| | $ 111,582 | $ 109,988 |

**NOTE 4 LITIGATION**

In August 2002, Ted Marx, a former StorageTek employee who was terminated in 2001, filed suit in California State Superior Court (Los Angeles) against StorageTek. The complaint contained claims for wrongful termination, wrongful termination in violation of the California Labor Code, breach of the covenant not to terminate without good reason, breach of contract, breach of the covenant of good faith and fair dealing, failure to pay wages under the California Labor Code, and intentional infliction of emotional distress. In September 2003, StorageTek filed its motion for summary judgment. In December 2003, the court ruled in favor of StorageTek on the claim of breach of the covenant not to terminate without good reason. The trial commenced in May 2004. In June 2004, the jury awarded approximately $2.9 million in compensatory damages and $9.0 million in punitive damages to the plaintiff. The plaintiff is also requesting certain attorney fees from the court. StorageTek is vigorously seeking to overturn and/or reduce the award. StorageTek has not accrued the damages or the attorney fees for this case, as it does not believe that these amounts represent a loss contingency that meets the definition of probable under SFAS No. 5, Accounting for Contingencies.

The Company is also involved in a number of other pending legal proceedings that arise from time to time in the ordinary course of business. Management believes that any liability as a result of adverse outcomes in such proceedings would not have a material adverse effect on the financial condition of the Company taken as a whole. However, 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 condition or 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 5 CREDIT FACILITIES**

In October 2004, the Company entered into a new unsecured $75 million revolving credit facility (the Revolver) that expires in October 2008. The interest rates for borrowing under the Revolver are based upon the Company s Consolidated Leverage Ratio, which is the ratio of Consolidated Funded Indebtedness to rolling four quarter Consolidated Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA). The rate ranges from the applicable LIBOR plus 1.00% to 2.00% or the agent bank s base rate plus 0.00% to 1.00%. The Company pays an annual commitment fee of 0.175% or 0.200% on any unused borrowings based upon the Consolidated Leverage Ratio. The Revolver contains certain financial and other covenants. The Revolver replaces a previous revolving credit facility that expired in October 2004. The Company had no outstanding borrowings under the previous revolving credit facility as of September 24, 2004.

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**NOTE 6 OPERATIONS OF BUSINESS SEGMENTS**

The Company is organized into two reportable business 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, disk, network, and other miscellaneous products. The storage services segment includes maintenance and support services, as well as professional 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 development costs; selling, general, and administrative expense; interest income; interest expense; or provision for income taxes to the segments. The following table shows revenue and gross profit by segment (in thousands):

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | 09/24/04 | 09/26/03 | 09/24/04 | 09/26/03 |
| Revenue: | | | | |
| Storage products | $ 299,041 | $ 312,435 | $ 882,695 | $ 906,844 |
| Storage services | 227,445 | 207,825 | 675,478 | 620,634 |
| Total revenue | $ 526,486 | $ 520,260 | $ 1,558,173 | $ 1,527,478 |
| Gross profit: | | | | |
| Storage products | $ 144,503 | $ 148,150 | $ 426,442 | $ 420,070 |
| Storage services | 103,739 | 88,918 | 297,835 | 267,423 |
| Total gross profit | $ 248,242 | $ 237,068 | $ 724,277 | $ 687,493 |

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

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | 09/24/04 | 09/26/03 | 09/24/04 | 09/26/03 |
| Tape products | $ 241,676 | $ 240,729 | $ 679,809 | $ 692,302 |
| Disk products | 36,914 | 38,074 | 127,318 | 117,487 |
| Network products | 12,938 | 23,776 | 48,740 | 65,852 |
| Other | 7,513 | 9,856 | 26,828 | 31,203 |
| Total storage products revenue | $ 299,041 | $ 312,435 | $ 882,695 | $ 906,844 |



**NOTE 7 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 | | Nine Months Ended | |
|---|---|---|---|---|
| | 09/24/04 | 09/26/03 | 09/24/04 | 09/26/03 |
| Net income | $ 42,755 | $ 31,007 | $ 101,731 | $ 77,567 |

Weighted average common shares outstanding:

| | Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| Basic | 109,030 | 108,612 | 110,085 | 107,652 |
| Effect of dilutive common stock equivalents | 1,812 | 2,890 | 2,222 | 2,621 |
| Diluted | 110,842 | 111,502 | 112,307 | 110,273 |
| Earnings per common share: | | | | |
| Basic | $ 0.39 | $ 0.29 | $ 0.92 | $ 0.72 |
| Diluted | $ 0.39 | $ 0.28 | $ 0.91 | $ 0.70 |

For the quarters ended September 24, 2004, and September 26, 2003, options to purchase 3,714,150 and 401,785 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 nine months ended September 24, 2004 and September 26, 2003, options to purchase 3,653,514 and 1,146,145 shares of common stock, respectively, were excluded from the computation of diluted earnings per share for the same reason.

## NOTE 8 INDEMNIFICATIONS AND WARRANTIES

Financial Accounting Standards Board (FASB) Interpretation No. 45 (FIN 45), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, requires that a liability be recorded in the guarantor s balance sheet upon issuance of certain guarantees. FIN 45 also requires additional disclosures about the guarantees an entity has issued, including a rollforward of the entity s product warranty liabilities.

In the normal course of business, the Company is party to a variety of agreements under which it may be obligated to indemnify the other party for certain matters. These obligations typically arise in contracts where the Company customarily agrees to hold the other party harmless against losses arising from a breach of representations or covenants for certain matters such as title to assets and intellectual property rights associated with the sale of products. The Company also has indemnification obligations to its officers and directors. The duration of these indemnifications varies, and in certain cases, is indefinite. In each of these circumstances, payment by the Company depends upon the other party making an adverse claim according to the procedures outlined in the particular agreement, which procedures generally allow the Company to challenge the other party s claims. In certain instances, the Company may have recourse against third parties for payments made by the Company.



The Company is unable to reasonably estimate the maximum potential amount of future payments under these or similar agreements due to the unique facts and circumstances of each agreement and the fact that certain indemnifications provide for no limitation to the maximum potential future payments under the indemnification. The Company has not recorded any liability for these indemnifications in the accompanying consolidated balance sheets; however, the Company does accrue losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is both probable and reasonably estimable.

The Company provides warranties associated with the sale of its products. The Company s standard product warranties provide for the repair or replacement of products that fail to meet their published specifications. In situations where a product fails its essential purpose to the customer, the Company may also be responsible for refunding the purchase price of the product if the Company cannot remedy the product failure. The Company establishes a warranty liability for the estimated cost of warranty-related claims at the time revenue is recognized. The following table summarizes information related to the Company s warranty reserves (in thousands):

| | Nine Months Ended | |
|---|---|---|
| | 09/24/04 | 09/26/03 |
| Balance at beginning of period | $ 49,374 | $ 41,155 |
| Accruals for warranties issued | 30,925 | 35,470 |
| Adjustments to warranties | (3,737) | 673 |
| Amortization | (35,460) | (32,696) |
| Balance at end of period | $ 41,102 | $ 44,602 |

## ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### *FORWARD-LOOKING STATEMENTS*

All assumptions, anticipations, expectations, and forecasts contained in the following discussion regarding our business, 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. Our 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 typically be identified by the use of words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, i 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 in this Form 10-Q represent a good-faith assessment of our future performance for which management believes there is a reasonable basis. We disclaim any obligation to update the forward-looking statements contained herein, whether as a result of new information, future events, or otherwise, except as may be otherwise required by law.

### *THIRD QUARTER 2004 FINANCIAL OVERVIEW*

The third quarter of 2004 represented the seventeenth consecutive quarter of year-over-year earnings growth. Total revenue for the third quarter of 2004 was $526 million, an increase of 1% compared to the same period in 2003, primarily due to an increase in service revenue. Revenue decreased 3% as adjusted to reflect constant foreign currencies. We do not expect any significant benefits during the fourth quarter of 2004 from currencies on year-over-year comparisons of revenue.

It appears the information technology market has stabilized domestically and we are beginning to see a mild recovery. North America still showed some revenue weakness in the third quarter of 2004, although we saw improvement compared to the second quarter of 2004. Our Europe, Africa, and Middle East (EAME) region continues to show improvement on a year-over-year basis. Asia and Latin America continue to perform well, with the exception of Japan and Korea.

Total gross profit margin continued to improve in the third quarter of 2004, compared to the same period in 2003, due to increases in both storage products and storage services gross profit margins. Storage product gross profit margins improved as a result of favorable product mixes. Storage services gross profit margins improved primarily as a result of a reduction in our service costs. Operating expense in the third quarter of 2004 increased approximately 2% compared to the same period in 2003.

We continued to strengthen our balance sheet and cash flows during the third quarter of 2004. Our cash flow from operations was approximately $121 million, which funded $100 million of share repurchases during the third quarter of 2004. Our operations continue to be self-funded and our debt-to-capitalization ratio remains constant at 1%.



At the beginning of the year, we anticipated that information technology spending would be flat to slightly up in 2004. We have seen this trend in the first nine months of 2004 and do not expect to see a significant change in information technology spending in the fourth quarter of 2004 other than normal seasonality. Our primary challenge for the future is to increase revenue while maintaining strong cost controls. We believe revenue growth can be achieved primarily through the successful execution of our Information Lifecycle Management (ILM) strategy, as well as through various new product launches over the next year. However, we may not be able to achieve revenue growth if we are not successful in bringing our new products to market or if information technology spending does not improve.

### *SELECTED CONSOLIDATED STATEMENT OF OPERATIONS DATA*

The following table presents Consolidated Statements of Operations data stated as a percentage of total revenue, except for segment gross profit, which is stated as a percentage of the applicable segment revenue. The table also presents the percentage change based on the dollar amounts of each of the items.

| | Percentage Increase (Decrease) |
|---|---|

| | Quarter Ended | | Percentage Based on Dollar Amounts |
|---|---|---|---|
| | 09/24/04 | 09/26/03 | Q3 2004 vs. Q3 2003 |
| **Revenue:** | | | |
| Storage products | 56.8% | 60.0% | (4.3)% |
| Storage services | 43.2 | 40.0 | 9.4 |
| Total revenue | 100.0% | 100.0% | 1.2 |
| **Gross profit:** | | | |
| Storage products | 48.3% | 47.4% | (2.5) |
| Storage services | 45.6 | 42.8 | 16.7 |
| Total gross profit | 47.2 | 45.6 | 4.5 |
| **Operating expenses:** | | | |
| Research and development costs | 9.1 | 9.6 | (3.9) |
| Selling, general, and administrative expenses | 28.6 | 27.9 | 3.9 |
| Operating profit | 9.5 | 8.1 | 17.6 |
| Interest income | 0.8 | 0.5 | 67.1 |
| Interest expense | (0.1) | (0.1) | (32.7) |
| Income before income taxes | 10.2 | 8.5 | 21.0 |
| Provision for income taxes | 2.1 | 2.6 | (18.3) |
| Net income | 8.1% | 5.9% | 37.9% |



The following table presents supplemental data for storage products revenue stated as a percentage of total storage products revenue, and the percentage change based on the dollar amounts of each of the items.

| | Quarter Ended | | Percentage Increase (Decrease) Based on Dollar Amounts |
|---|---|---|---|
| | 09/24/04 | 09/26/03 | Q3 2004 vs. Q3 2003 |
| **Supplemental data - storage products revenue** | | | |
| Tape products | 80.8% | 77.0% | 0.4% |
| Disk products | 12.4 | 12.2 | (3.0) |
| Network products | 4.3 | 7.6 | (45.6) |
| Other | 2.5 | 3.2 | (23.8) |
| Total storage products revenue | 100.0% | 100.0% | (4.3)% |

***REVENUE AND GROSS PROFIT MARGIN***

**Storage Products**

Our storage products revenue primarily consists of sales of tape, disk, and network products, including related software, for the mainframe 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 in the third quarter of 2004, compared to the same period in 2003, primarily due to decreased revenue from disk and network product sales as a result of competition in the enterprise disk and network markets. We had a slight increase in tape product sales during the third quarter of 2004, compared to the same period in 2003, due primarily to an increase in revenue from our T9840 and T9940 series tape drives. Our Virtual Storage Manager (VSM) system revenue continues to be strong, although the growth rate in VSM system revenue that we have experienced over the last year has declined significantly.

Storage products gross profit margin increased in the third quarter and nine months of 2004, compared to the same periods in 2003, primarily due to a more favorable product mix, led by strength in T9840 and T9940 series tape drive and VSM sales. Product mix, channel mix, and further operational efficiencies will be key factors for maintaining storage products gross profit margin.

**Storage Services**

Our storage services revenue primarily consists of revenue associated with the maintenance and support of StorageTek products and third-party storage products, as well as professional services revenue associated with various storage consulting activities.

Storage services revenue increased in the third quarter and nine months of 2004, compared to the same periods in 2003, primarily due to an 8% increase in maintenance and support services revenue. Professional services also performed well during the third quarter of 2004, with a 24% increase in revenue as compared to the third quarter of 2003.

Storage services gross profit margin increased slightly in the third quarter of 2004, compared to the same period in 2003, and also increased compared to the second quarter of 2004, primarily due to actions taken late in the first and early in the second quarter of 2004 in order to improve efficiencies in our service infrastructure. We believe that the impact of these actions will be sustainable through the end of 2004. The increase in storage services gross profit margin may be adversely impacted if professional services continues to become a greater portion of our service revenue, as professional services typically carry lower margins than our maintenance and support services business.



***RESEARCH AND DEVELOPMENT***

Research and development costs decreased 4% in the third quarter of 2004 compared to the same period in 2003, consistent with the trend we have experienced since 2001. The continued decreases in research and development costs have been achieved primarily through the implementation of engineering initiatives designed to improve research and development productivity, increase strategic alignment, and reduce non-essential spending. In the fourth quarter of 2004, we acquired the net assets of Storability, a software company with approximately 70 employees. The majority of these employees are involved in research and development. In total, we anticipate that research and development costs will increase approximately $3.0 million in the fourth quarter compared to the third quarter of 2004.

***SELLING, GENERAL, AND ADMINISTRATIVE EXPENSE***

Selling, general, and administrative expense (SG&A) increased slightly during the third quarter of 2004, compared to the same period in 2003 and to the second quarter of 2004. SG&A was significantly higher for the nine months of 2004 than for the same period in 2003, primarily due to unfavorable impacts of foreign currency movements on the operating expenses of our international operations in the first quarter of 2004. We continue to maintain expense controls to reduce discretionary spending and remain focused on our efforts to improve the efficiency of our operations.

***INTEREST INCOME AND EXPENSE***

Net interest income increased approximately 90% for the third quarter and 57% for the nine months of 2004, compared to the same periods in 2003, primarily due to an increase in interest rates during the third quarter of 2004. See LIQUIDITY AND CAPITAL RESOURCES for further discussion of our debt and financing arrangements.

***INCOME TAXES***

Our effective tax rate was 20.3% for the third quarter and 21.1% for the nine months of 2004, as compared to 30.2% and 30.0% for the same periods in 2003. The decrease in our effective tax rate in the third quarter was primarily due to the favorable settlement of a tax audit that occurred during the quarter. The favorable impact of the settlement was partially offset by increases to tax expense as a result of changes in income attributable to different taxing jurisdictions that have varying tax rates. We continue to recognize increased tax benefits associated with our manufacturing operations in Puerto Rico.

Based on our current estimates, we anticipate that the effective tax rate for the full year should be approximately 21%. Our effective tax rate may be impacted in the future by a variety of factors, including the overall effectiveness of our global manufacturing strategies, tax legislation, and changes in our estimates regarding the resolution of open tax matters.

We have not historically provided for taxes on cumulative undistributed earnings of our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. The American Jobs Creation Act was signed into law on October 22, 2004. This act allows for a favorable effective tax rate on the repatriation of certain qualifying foreign earnings to the United States. While no changes have been made at this time with respect to our plans to reinvest foreign earnings indefinitely, we are still evaluating the act and all associated guidance to determine whether some portion of these earnings should be repatriated. If we make a decision to repatriate earnings in the future, our provision for incomes taxes could increase significantly in the period that we make the decision.



We are subject to audits by federal, state, and foreign tax authorities. These audits may result in proposed assessments that could result in additional tax liabilities. Our income taxes payable balance as reported on the Consolidated Balance Sheet is comprised primarily of tax contingencies that we believe are both probable and reasonably estimable.

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, we have determined that we will more likely than not realize $226.6 million of deferred income tax assets, which are net of a valuation allowance of approximately $23.1 million as of September 24, 2004. Our valuation allowance relates principally to foreign net operating loss carryforwards.

***CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS***

Our critical accounting estimates and assumptions are disclosed in our Annual Report on Form 10-K for the year ended December 26, 2003. There were no significant changes to our critical accounting estimates and assumptions for the nine months ended September 24, 2004.

***LIQUIDITY AND CAPITAL RESOURCES***

**Sources and Uses of Cash**

The following table summarizes our sources and uses of cash (in thousands):

| | Nine Months Ended | |
|---|---|---|
| | **09/24/04** | **09/26/03** |
| Net cash from operating activities | $ 263,805 | $ 250,116 |
| Net cash used in investing activities | (55,436) | (66,756) |
| Net cash provided by (used in) financing activities | (109,188) | 44,843 |

Our cash and investments balance increased $53.0 million during the nine months of 2004, primarily as a result of cash flows generated by our operating activities. Days sales outstanding for the third quarter of 2004 was 76 days, which is a 7-day improvement from the third quarter of 2003. Inventory turns decreased to 5.5 turns, a slight decrease compared to the third quarter of 2003. We will continue to focus on improving our operational effectiveness and efficiency.

The cash used in financing activities during the nine months of 2004 reflects $156.4 million of share repurchases made under our share repurchase programs, which are intended to reduce dilution and return cash to shareholders. These share repurchases were offset by $47.7 million of proceeds from employee stock plans during the first nine months of 2004.

**Future Sources and Uses of Cash**

We expect that cash flows from operations will continue to serve as our principal source of liquidity, and we believe that we have adequate working capital and financing capabilities to meet our anticipated operating and capital requirements for the next 12 months. However, cash flows from operations could be negatively impacted by a decrease in demand for our products and services as a result of rapid technological changes and other risks described under FACTORS THAT MAY AFFECT FUTURE RESULTS.



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In October 2004, we entered into a new unsecured $75 million revolving credit facility (the Revolver) that expires in October 2008. The interest rates for borrowing under the Revolver are based upon our Consolidated Leverage Ratio, which is the ratio of Consolidated Funded Indebtedness to rolling four quarter Consolidated Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA). The rate ranges from the applicable LIBOR plus 1.00% to 2.00% or the agent bank s base rate plus 0.00% to 1.00%. We pay an annual commitment fee of 0.175% or 0.200% on any unused borrowings based upon the Consolidated Leverage Ratio. The Revolver contains certain financial and other covenants. The Revolver replaces a previous revolving credit facility that expired in October 2004. We had no outstanding borrowings under the previous revolving credit facility as of September 24, 2004.

We intend to fund future purchases of our common stock under our share repurchase program through cash on hand and cash flows from operations. We continue to review and evaluate alternative uses for our cash, including potential acquisitions and investments in additional technologies to strengthen our ILM offerings.

Over the longer term, we may choose to fund our operations through the issuance of additional equity or debt financing. The issuance of equity or convertible debt securities could result in dilution to our stockholders, and we cannot provide any assurance that such additional long-term financing, if required, could be completed on favorable terms.

***FACTORS THAT MAY AFFECT FUTURE RESULTS***

**We may be materially affected by global economic and political conditions**

Our ability to generate revenue growth during the last several years was adversely affected by a difficult global economy as customers delayed their purchase decisions, reduced their information technology spending budgets, increased their purchase authorization approval requirements, and reduced their capital expenditures by maximizing the current capacities of their data storage equipment. This trend has continued through the nine months of 2004, although we are beginning to see some improvement. We have implemented various cost-saving measures to help mitigate the adverse effects of the difficult global environment. We cannot provide any assurance that a prolonged weakness in information technology spending will not have additional adverse effects on our financial condition, results of operations, or our ability to generate revenue growth. Furthermore, we cannot provide any assurance that our cost-saving measures will be successful or sufficient to allow us to continue to generate improved operating results in future periods.

Our financial condition and results of operations could also be materially affected by unstable global political conditions. Terrorist attacks or acts of war could significantly disrupt our operations and the operations of our customers, suppliers, distributors, or resellers. We cannot predict the potential impact on our financial condition or results of operations should such events occur.

**We may be materially affected by a decrease in demand for our tape products or by an inability to maintain key competitive advantages in tape**

During the third quarter of 2004, approximately 81% of our storage products revenue was generated by sales of our tape products. Services associated with our tape products also represent a significant portion of our storage services revenue. For a discussion of risk associated with new products, see We may be materially affected by risks associated with new product development, below. If overall demand for tape storage products declines, or if we lose significant market share in tape, our financial condition and results of operations could be materially affected.

One of the key competitive advantages that our tape products have over competing disk products is that tape products store data at a fraction of the price of disk storage. The price of disk storage continues to decrease rapidly due to competition and decreasing manufacturing costs associated with new disk drive technologies such as Advanced Technology Attachment (ATA) disk. We must continue to develop and introduce new tape products that reduce the cost of tape storage at a rate that is similar to or greater than the decline in disk storage costs in order to maintain this competitive advantage. We cannot provide any assurance that we will be able to reduce the cost of our tape products at a rate similar to the decline in disk storage costs.

**We may be materially affected by competition and by our ability to execute our ILM strategy**

The data storage industry is highly competitive, and customers make their decisions based on a number of competitive factors. We must address each of these factors effectively in order to successfully compete. If we are unable to adapt our products and services to changes in these competitive factors, we may lose market share to our competitors.

Our principal strategy for addressing the competition and growing revenue is our ILM strategy. Our ILM strategy is intended to capitalize on our ability to deliver complete storage solutions that satisfy customer storage requirements, including tape, disk, and network products, together with associated services. We have achieved some initial success in our ILM strategy; however, we must continue to develop and deliver on this strategy in the future in order to grow revenue. We have also seen the adoption of strategies similar to our ILM strategy by our competitors. We cannot provide any assurance that we will successfully execute our ILM strategy or that this strategy will provide us with a competitive advantage in the data storage industry.

**We may be materially affected by risks associated with new product development**

New product research and development is complex and requires the investigation and evaluation of multiple alternatives, as well as planning the design and manufacture of those alternatives selected for further development. Research and development efforts could be adversely affected by any of the following:

- Hardware and software design flaws
- Product development delays
- Changes in data storage technology
- Changes in operating systems
- Changes in industry standards

In addition, we have outsourced software development for certain tape and network products. We cannot provide any assurance that research and development activities will be successful in bringing new products to market.

Manufacturing new products involves integrating complex designs and processes, coordinating with suppliers for parts and components, and managing manufacturing capacities to accommodate forecasted demand. Failure to obtain sufficient quantities of parts and components, as well as other manufacturing delays or constraints, could adversely affect the timing of new product introductions. We have experienced product development and manufacturing delays in the past that adversely affected our results of operations and competitive position.



We have introduced significant new products in the nine months of 2004 and we plan to introduce a number of other significant new products during the fourth quarter of 2004 and first half of 2005, including virtual tape products targeted for both the enterprise and open-systems markets. When we introduce new products, we must effectively manage the transition from our existing products to the new products.

If we do not manage the transition effectively, we may be subject to the following adverse effects:

- Excess or obsolete inventory
- Insufficient inventory or manufacturing capacity to meet customer demand
- Delayed customer purchases
- Lost sales if customers purchase from our competitors

In addition, sales of our new products may replace some of the sales of our existing products, and there may be a decline in sales of existing products in the periods leading up to new product introductions. We cannot provide any assurance that we will be able to successfully manage the development, introduction, or transition of new products in the future.

**We may be materially affected by the risks associated with expanding our service offerings**

Services continue to contribute an increasing amount of our total revenue. Growth in services has partially been driven by service offerings such as storage consulting services, implementation services, and storage management services. The development and delivery of these services are critical to the success of our plan to deliver complete storage solutions to our customers. We must ensure that storage service professionals have the necessary skill sets, experience, tools, and training to support these service offerings. Revenue growth from these service offerings is needed to offset possible future declines in maintenance revenue from our installed service base of products under maintenance contracts as these products are displaced by sales of new StorageTek products under warranty. Any failure to properly develop or deliver our service offerings could have a material adverse effect on our financial condition and results of operations.

**We may be materially affected by uneven sales patterns and by our ability to forecast customer demand accurately**

In the past, our 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 total product sales are earned in the last weeks or days of the quarter. We continue to experience these trends in 2004. It is difficult to predict the extent to which these historical trends will continue in the future. We cannot provide any assurance that we will be able to manage our uneven sales patterns.

We prepare and update our forecasts on a regular basis to predict customer demand for our products and services. If actual demand exceeds predicted demand, we may not be able to meet customer requirements in a timely manner due to sourcing, manufacturing, or service constraints. If actual demand is less than predicted demand, we may have excess inventory or an underutilized employee base. We cannot provide any assurance that we will be able to forecast customer demand accurately or respond quickly to changes in customer demand.

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**Our gross profit margin may be materially affected by product mix, channel mix, and resale of third-party products**

We provide a variety of solutions to meet customer needs, including tape, disk, and network products, along with associated software and services. Our products and services contribute varying gross profit margins, and the gross margin on a customer s total solution is dependent on the amounts and types of products or services involved. Gross profit margins may also be impacted by early start-up manufacturing costs associated with new products. We cannot provide any assurance that our future gross profit margin will be similar to our historical gross profit margin.

We market our solutions through a combination of a direct sales organization and indirect channel partners. Direct sales to the end-user customer usually result in higher gross profit margins than indirect channel sales. We cannot provide any assurance that changes in our channel mix will not have a material impact on gross profit margin in the future.

We sell a number of third-party products, and our gross profit margin may be adversely affected if those products become a larger portion of our total storage solutions. We may also be at a cost disadvantage in acquiring third-party products that are manufactured by competitors.

**We may be materially affected by our ability to grow our indirect channels successfully**

We are continually developing our indirect distribution channels, including original equipment manufacturers (OEMs), value-added distributors (VADs), value-added resellers (VARs), and other distributors. Indirect channel sales contributions decreased 4% during the nine months of 2004 compared to the same period in 2003, but increased 6% during the third quarter of 2004 as compared to the second quarter. Increasing our sales through these indirect channels is critical to expanding our reach into the growing open-systems market. Successfully managing the interaction of our direct and indirect channel efforts to effectively reach all of the potential customer segments for our products and services is a complex process. We cannot provide any assurance that we will be successful in expanding our indirect channel sales. Our ability to forecast future demand for our products may be adversely affected by unforeseen changes in demand from our indirect channel partners. Storage products gross profit margins may be adversely impacted to the extent we continue to receive a larger portion of our sales through our indirect channels in the future. Maintenance revenue may also be adversely affected in future periods to the extent that customers of our indirect channel partners elect to purchase maintenance services from our competitors. Our financial results may also be negatively affected if the financial condition of one or more of our channel partners weakens.

**We may be materially affected by the risks associated with sole source suppliers**

We purchase certain key parts, components, and services from sole source suppliers who we believe are currently the only providers that meet our specifications or for which alternative sources of supply are not readily available.

The following table shows our significant sole source suppliers and the products or services they provide:

| Name of supplier | Product or service provided |
|---|---|
| Imation Corporation | T9840 and T9940 series tape media |
| Sanmina-SCI Corporation | Printed circuit boards and certain other manufacturing and repair services |
| Engenio Information Technologies, Inc | Certain FlexLine disk products |
| Fujitsu Electronics America | Application-specific integrated circuits (ASICs) for various tape and disk products |
| Austria Microsystems | ASICs for various tape products |
| Herald Datanetics Ltd. (HDL) | Key component used in certain tape products |



We also obtain certain key parts and components from less significant sole source suppliers. If a sole source supplier did not continue to provide its products or services, we would need to identify and qualify other acceptable suppliers. This process could take an extended period, and we cannot provide any assurance that we could identify and qualify an alternative source on a timely basis or at an acceptable quality or price. We cannot provide any assurance that significant sole source suppliers will be able to meet our ongoing quality or delivery requirements. Failure to meet these requirements may have a material adverse impact on our financial condition and results of operations.

HDL is located in the People s Republic of China (PRC). Our 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, we have not experienced any material problems securing key components from HDL; however, we cannot provide any assurance that we will not experience material problems in the future.

**We may be materially affected by a failure to obtain quality parts and components in a timely manner or by a failure to effectively manage inventory levels**

We generally use standard parts and components for our products and believe that there are a number of alternative, competent vendors for most of those parts and components. Certain suppliers have experienced occasional technical, financial, or other problems that have delayed deliveries in the past. An unanticipated failure of one of our suppliers to meet requirements for an extended period, or the inability to secure comparable components in a timely manner, could result in a shortage of key components or products, longer lead times, reduced control over production and delivery schedules, and an inability to fulfill customer orders in a timely manner.

We have reduced our inventory levels over the past two years primarily through our lean manufacturing initiatives. As we continue to move toward a lean manufacturing environment, we will become increasingly dependent on a limited supplier base to deliver quality parts and components in a timely manner. A supplier s inability to deliver parts and components on a timely basis, or our failure to effectively manage inventory levels, could have a material adverse effect on our financial condition and results of operations.

**We may be materially affected by rapid technological change and evolving industry standards**

Short product life cycles are inherent in high-technology industries due to rapid technological change and evolving industry standards. Our financial condition and results of operations depend on our ability to respond effectively to these changes. We cannot provide any assurance that we will be able to successfully develop, manufacture, and market innovative new products or adapt our current products to new technologies or new industry standards. In addition, customers may be reluctant to adopt new technologies and standards, or they may prefer competing technologies and standards.



**We may be materially affected by the risks associated with developing and protecting intellectual property**

We depend on our ability to develop new intellectual property that does not infringe on the rights of others. We cannot provide any assurance that we will be able to continue to develop such new intellectual property.

We rely on a combination of U.S. patent, copyright, trademark, and trade secret laws to protect our intellectual property rights. We enter into confidentiality agreements relating to our intellectual property with our employees and consultants, and we include confidentiality provisions in license and non-exclusive sales agreements with our customers.

We also file 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.

Despite all of our efforts to protect our intellectual property rights, unauthorized parties may attempt to copy or otherwise obtain or use our intellectual property. Monitoring the unauthorized use of our intellectual property is difficult, particularly in foreign countries. We cannot provide any assurance that we will be able to adequately protect our intellectual property.

**We may be materially affected by the risks associated with litigation**

We are involved in a number of pending legal proceedings that arise from time to time in the ordinary course of business. We believe that any liability as a result of adverse outcomes in such proceedings would not have a material adverse effect on our financial condition. However, 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 our financial condition or 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 an inability to ship products or components found to have violated third-party patent rights.

**We may be materially affected if we are unable to attract and retain our key employees**

Our future success depends in large part on our ability to attract and retain our key employees. During the past year, several changes were made with respect to the executive management team and their organizational responsibilities. We face significant competition for individuals who possess the skills required to sell our products and services, as well as design, develop, manufacture, service, and market those products and services. An inability to successfully attract and retain these employees could have an adverse effect on our future financial condition and results of operations. Furthermore, there may be a delay between when organizational announcements are made and when the organizations are fully effective.

**We may be materially affected by the risks of conducting business outside the United States**

International operations accounted for approximately 55% of our revenue in the nine months of 2004, respectively, compared to 53% for the same period in 2003. We also sell products through U.S. indirect channel partners that have some of their end-user customers located outside the United States. We expect that we will continue to generate a significant portion of our revenue from international operations.



Our international business may be affected by changes in demand resulting from global and localized economic, business, and political conditions. We are subject to the risks of conducting business outside the United States, including the following risks:

- Adverse political and economic conditions
- Impositions of tariffs or quotas
- Changes in laws or regulations
- Difficulty in obtaining export licenses
- Potentially adverse tax or labor laws
- The burdens of complying with a variety of foreign laws
- Longer payment cycles typically associated with international sales
- Foreign currency fluctuations
- Other factors outside our control

We expect these risks to increase in the future as we expand our operations in Eastern Europe, Latin America, and Asia. We cannot provide any assurance that these factors will not have a material adverse effect on our financial condition or results of operations in the future.

**We may be materially affected by regulatory requirements**

The European Union has finalized the Waste Electrical and Electronic Equipment (WEEE) directive, which regulates the collection, recovery, and recycling of waste from electrical and electronic products, and the Restrictions on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directive, which bans the use of certain hazardous materials including lead, mercury, cadmium, chromium, and halogenated flame-retardants. Under WEEE, we will be responsible for financing operations for the collection, treatment, disposal, and recycling of past and future covered products. Because the specific legal requirements have not been finalized, we are presently unable to reasonably estimate the amount of any costs that may be necessary in order to comply with WEEE. We cannot provide any assurance that compliance with WEEE and RoHS will not have a material adverse effect on our financial condition or results of operations.

We are subject to various other regulatory requirements, including the Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act requires that we evaluate and determine the effectiveness of our internal control over financial reporting. If we or our independent registered public accounting firm determine that we have a material weakness in our internal control over financial reporting, we may not be able to prevent or detect material misstatements on a timely basis. We have dedicated a significant amount of time and resources to ensuring compliance, but we cannot provide any assurance that we or our independent registered public accounting firm will be able to complete the necessary work in a timely manner. In addition, we may need to perform additional procedures to the extent that new rules, regulations, or interpretations related to Section 404 are issued, and we or our independent registered public accounting firm may not be able to implement the new guidance in time to satisfactorily complete the required assessments.



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**Our manufacturing operations may be materially affected by weather-related risks**

We manufacture and assemble a significant portion of our products in Puerto Rico. Our ability to perform these activities may be significantly affected by weather-related risks beyond our control. We believe that if the Puerto Rico facilities were significantly affected by adverse weather, we could relocate to an alternative facility within a reasonable period of time; however, we cannot provide any assurance that we would be able to relocate to that facility without a material adverse impact on our financial condition or results of operations.

**We may be materially affected by restructuring activities**

We have recognized significant restructuring charges in the past and it is possible that changes in our business, industry, or in the global economy may necessitate restructuring activities in the future. The necessity for restructuring activities may result in expenses that adversely affect our financial condition and results of operations and may require incremental cash payments.

## ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

**Foreign Currency Exchange Rate Risk**

Our primary market risk relates to changes in foreign currency exchange rates. The functional currency for our foreign subsidiaries is the U.S. dollar. A significant portion of our revenue is generated by our international operations. The majority of our international operations involve transactions denominated in the euro, Pound Sterling, and Japanese yen. An increase in the exchange value of the U.S. dollar reduces the value of revenue and profits generated by our international operations. As a result, our financial condition, results of operations, and cash flows can be materially affected by changes in foreign currency exchange rates. We attempt to mitigate this exposure as part of our foreign currency hedging program. The primary goal of our foreign currency hedging program is to reduce the risk of adverse foreign currency movements on the reported financial results of our non-U.S. dollar transactions. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets. All foreign currency derivatives are authorized and executed pursuant to our policies. We do not hold or issue derivatives or any other financial instruments for trading or speculative purposes.

To implement our foreign currency hedging program, we use 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 our 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 our foreign currency exchange rate sensitive instruments held as of September 24, 2004, and as of December 26, 2003, would result in a hypothetical loss in fair value of approximately $61.1 million and $59.2 million, respectively. The increase in the hypothetical loss is primarily due to an increase in net outstanding derivatives. These hypothetical losses do not take our underlying international operations into consideration. We anticipate that any hypothetical loss associated with our foreign currency exchange rate sensitive instruments would be substantially offset by gains associated with our underlying international operations.



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**Interest Rate Risk**

Changes in interest rates affect interest income earned on our cash investments, as well as interest expense on short-term borrowings. A hypothetical 10% adverse movement in interest rates applied to cash investments would not have a material adverse effect on our financial condition, results of operations, or cash flows.

**Credit Risk**

We are exposed to credit risk associated with cash equivalents, investments, foreign currency options and forwards, and trade receivables. We do not believe that our cash equivalents, investments, or foreign currency derivatives present significant credit risks, because the counterparties to the instruments consist of major financial institutions, and we manage the notional amount of contracts entered into with any counterparty. Substantially all trade receivable balances are unsecured. The concentration of credit risk with respect to trade receivables is limited by the large number of customers in our customer base and their dispersion across various industries and geographic areas. Although we have a large number of customers who are dispersed across different industries and geographic areas, a prolonged economic downturn could increase our exposure to credit risk on our trade receivables. We perform ongoing credit evaluations of our customers and maintain an allowance for potential credit losses.

**ITEM 4 CONTROLS AND PROCEDURES**

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures (as defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934) as of September 24, 2004, the end of the period covered by this report. Based on their evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective.

During the fiscal quarter ended September 24, 2004, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



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**PART II**

**ITEM 1 LEGAL PROCEEDINGS**

For information regarding legal proceedings, see Note 4 of NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, included in Part 1, Item 1, of this Form 10-Q, which information is incorporated by reference into this Part II, Item 1.

**ITEM 2 CHANGES IN SECURITIES, USE OF PROCEEDS, AND ISSUER PURCHASES OF EQUITY SECURITIES**

The following table summarizes our purchases of our equity securities during the third quarter of 2004:

| | Total Number of | Approximate Dollar Value |
|---|---|---|

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2) | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (3) |
|---|---|---|---|---|
| 06/26/04 - 07/30/04 | 434,600 | $ 26.01 | 434,600 | $ 493,747,575 |
| 07/31/04 - 08/27/04 | 2,089,100 | 24.09 | 2,089,100 | 443,415,680 |
| 08/28/04 - 09/24/04 | 1,581,700 | 24.38 | 1,581,700 | 404,846,802 |
| Total | 4,105,400 | $ 24.41 | 4,105,400 | |

(1) Excludes shares withheld to satisfy minimum tax withholding requirements associated with restricted stock lapses.

(2) In January 2004, our Board of Directors authorized a stock repurchase program to acquire up to 1,000,000 shares of common stock per quarter through 2005. During the fiscal month ended July 30, 2004, we purchased 182,000 shares under this repurchase program. On July 8, 2004, our Board of Directors cancelled this repurchase program and replaced it with a new repurchase program, described below.

(3) On July 8, 2004, our Board of Directors authorized a new stock repurchase program to acquire up to $500 million of common stock. Purchases under this repurchase program may be made from time-to-time, in the open market, through block trades or otherwise, and in privately negotiated transactions. There is no fixed termination date for this repurchase program.

**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)

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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)

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)

3.4 Certificate of Third Amendment dated May 21, 1999, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 1999, filed on August 9, 1999, and incorporated herein by reference)

3.5 Restated Bylaws of Storage Technology Corporation, as amended through November 16, 2002 (previously filed as Exhibit 3.5 to the Company s Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)

4.1 Specimen Certificate of Common Stock, $0.10 par value of Registrant (previously filed as Exhibit (c)(2) to the Company s Current Report on Form 8-K dated June 2, 1989, and incorporated herein by reference)

10.1[1] Storage Technology Corporation Amended and Restated 1987 Employee Stock Purchase Plan, as amended through May 21, 2003 (previously filed as Exhibit 4.6 to the Company s Registration Statement on Form S-8 (Registration No. 333-106930) filed on July 10, 2003, and incorporated herein by reference)

10.2[1] Storage Technology Corporation Amended and Restated 1995 Equity Participation Plan, as amended through May 20, 2004 (previously filed as Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 2004, filed on August 3, 2004, and incorporated herein by reference)

10.3[1] Storage Technology Corporation 2004 Long Term Incentive Plan (previously filed as Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 2004, filed on August 3, 2004, and incorporated herein by reference)

10.4[1] Storage Technology Corporation Management by Objective Bonus Plan (previously filed as Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)

10.5[1] Storage Technology Corporation 2004 Performance-Based Incentive Plan (previously filed as Exhibit 10.5 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 2004, filed on August 3, 2004, and incorporated herein by reference)

10.6[1] Storage Technology Corporation Amended and Restated Stock Option Plan for Non-Employee Directors (previously filed as Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 1996, filed on August 12, 1996, and incorporated herein by reference)

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10.7[1] Storage Technology Corporation Flexible Option Plan, dated December 2001 (previously filed as Exhibit 10.5 to the Company s Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002, and incorporated herein by reference)

10.8[1] Severance Agreement, dated as of July 1, 2001, between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 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)

10.9[1] Offer Letter, dated May 10, 2001, from the Company to Michael McLay (previously filed as Exhibit 10.17 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)

10.10[1] Offer Letter, dated February 9, 2001, from the Company to Roger Gaston (previously filed as Exhibit 10.20 to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)

10.11[1] Offer Letter, dated July 16, 2001, from the Company to Roy Perry (previously filed as Exhibit 10.28 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)

10.12[1] Offer Letter, dated June 27, 2001, from the Company to Angel Garcia (previously filed as Exhibit 10.29 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)

10.13 Credit Agreement, dated as of October 10, 2001, among the Company, the several financial institutions thereto, Bank of America, N.A., as letter of credit issuing bank and sole administrative agent for the Banks, Key Corporate Capital, Inc. as Documentation Agent, Fleet National Bank as Syndication Agent, and Banc of America Securities LLC as sole lead arranger and sole book manager (previously filed as Exhibit 10.13 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)

10.14 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 qu