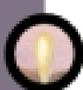
ANNUAL REPORT

1999



Financial Highlights

Five fiscal years ended April 30, 1999 *in thousands, except per share amounts*	1999	1998	1997	1996	1995
Net sales	$ 289,420	$ 166,163	$ 93,333	$ 46,632	$ 14,796
Income (loss) from operations [1]	55,126	32,658	3,083	6,000	(4,913)
Net income (loss) [2]	35,613	20,965	250	6,600	(4,764)
Net income (loss) per share, basic [2]	0.52	0.32	0.00	0.18	(0.28)
Net income (loss) per share, diluted [2]	0.46	0.29	0.00	0.10	(0.28)
Total assets	346,347	115,736	68,941	45,449	10,628
Long-term obligations	93	163	232	318	11,607
Total shareholders' equity (deficit)	$ 295,724	86,265	54,029	39,029	(5,923)

[1] *Fiscal 1997 includes the purchased in-process technology and compensation charge related to the IMC acquisition of $10,519 and the Whipsaw litigation of $4,300. See Notes 4 and 9 of the Notes to Consolidated Financial Statements.*

[2] *Fiscal 1997 includes the purchased in-process technology and compensation charge related to the IMC acquisition of $9,215 (net of taxes) and the Whipsaw litigation of $2,795 (net of taxes). See Notes 4 and 9 of the Notes to Consolidated Financial Statements.*

We pioneered the concept of the "network appliance," *extending the industry trend toward specialized devices that perform a specific function in the network. Not unlike the development of the router for network communications.*

Today we are the leading supplier of network-attached data storage and access devices, called filers. Our first product was designed to improve the storage and accessibility of data stored on a network. We then introduced our second product category in 1997, an Internet caching appliance. Designed to achieve Internet bandwidth savings, it improved performance by moving data closer to the end user. This product helps customers struggling with Web data traffic that is, according to market analysts, doubling every three months. Compared to similarly configured and competitively priced products, our filers are faster, more highly available and easier to operate. Such performance is accomplished by a specialized and patented software system optimized exclusively for file service tasks, thus providing performance advantages when compared to general-purpose computers used as file servers.

What do you think of all the attention network-centric storage is getting lately?

We recognized some time ago that data was the most important part of the computing environment. It's where the real value is for our customers. When we wrote our mission statement in 1993, we envisioned file server appliances, or filers, being pervasive worldwide by the end of this decade. Even back then, we planned for NetApp to lead a fundamental market shift away from general-purpose servers tasked with doing many different things, to an appliance model of data storage that does one thing very well — serves data.

Planning and executing are two different things, though.

Of course they are. We knew that creating a new market segment would take a product with demonstrated superiority. Something fast, reliable, cost effective. But instead of only thinking in terms of technology, we thought about what our customers would be facing. In three years. In five years. In a decade. And how our solutions would have to always accommodate them.

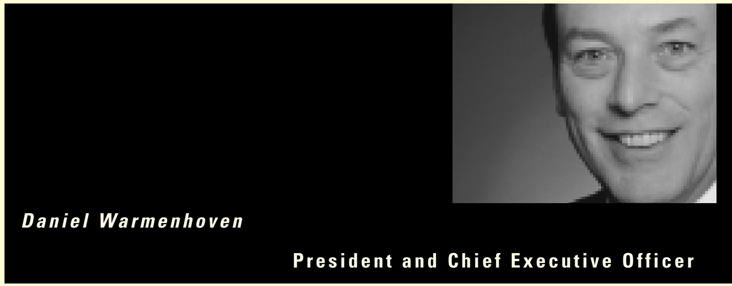
How does that work?

It takes constantly pushing for faster and simpler enterprise data storage solutions. Take our NetApp® F760 filer. Compared to its predecessor, it doubled throughput, halved response time and tripled capacity. Another good example is our NetCache™ appliance. Before last year, the caching market was relatively insignificant. But by leveraging our core technology, it took less than a year to become a recognized leader in this emerging market. Enterprises and Internet Service Providers (ISPs) must have a solution such as this to stay ahead of Internet traffic demands.

Do market leaders get all the glory?

Well, we saw the data revolution coming and we capitalized on it. We were highly gratified by the recent IDC study ranking us number one, with 41% of the Network Attached Storage (NAS) market share. Our performance has resulted in 16 consecutive quarters of greater than 70% year-over-year revenue growth and consistent earnings growth since we went public in 1995. In addition, we were added to the S&P 500 just after the close of the fiscal year.

Our OEM partnerships with Dell and Fujitsu have greatly expanded our market opportunity. Dell should help us penetrate the Windows NT® server market and Fujitsu is selling and supporting our products in Japan.

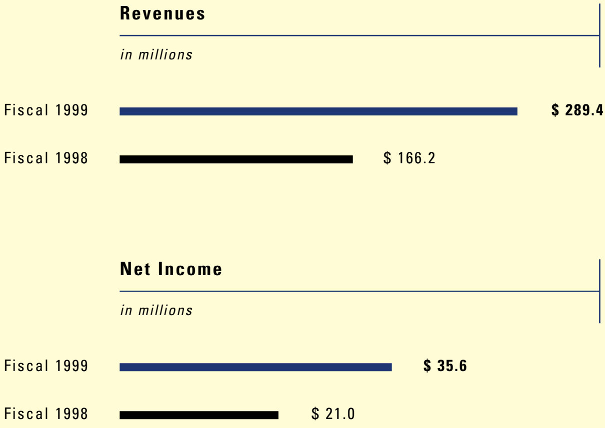


What do you think fuels your growth?

Our success has always hinged on our ability to focus on one thing, and then do that one thing well. From our inception we've been a network storage company. We recognized that data management and access are pivotal to the health of the corporate information infrastructure. We now see that reflected in our customers. In addition to being a technology-oriented purchase, our customers increasingly see our systems as a critical part of their data infrastructure.

So you think data access and storage has become a business decision more than an IT issue?

Absolutely. Companies now see how protecting, sharing and managing information is a competitive advantage. Just think about it in the context of the Internet and the emerging network-centric economy. The only way for a company to do business is to have its data accessible whenever it's needed. Everything has to operate flawlessly. That's why we concentrate on three issues — serve data fast, make it always available and simple to manage. These three things position NetApp as the information storage and access solution for the Internet-driven economy.



Warner Bros.

Darcy Antonellis
Senior VP Operations,
Technical Operations

Sometimes it all comes down to speed. For the DVD authoring wing of Warner Bros., "our processing speed has increased dramatically since NetApp filers were installed," explains Darcy Antonellis matter-of-factly. "And because of it, we've doubled our capacity per month."

INNOVATE

It's a simple maxim, really. *Focus on doing one thing, and in turn, do it very well. This singular vision has propelled not only the success of Network Appliance™ products, but the success of our company as well.*

We began working on network data access issues back in 1992. Our founders realized then that the traditional solution — general-purpose computers and disks — couldn't handle the mounting data access problem. And that ultimately it all would become cumbersome, labor intensive and costly.

So we thought beyond the traditional storage box. We pioneered the network-attached data appliance; an intuitive idea that a product concentrating only on serving data will be faster, simpler and more reliable. The idea mirrored our company's own goals. That of focusing solely on data management — and developing a more intelligent approach for companies to operate.

Every year we push further. With new Internet-based e-commerce, e-service and e-solutions being put to use daily, we must constantly search for ways to help our customers conquer their ever-increasing demand for data.

And we're on the brink of a data revolution. During the past year, the data storage needs in the typical enterprise have doubled. Internet companies see a doubling every 6 months. Forrester Research believes that new business applications for supply chain automation, e-commerce initiatives and customer self service will cause storage growth to increase 200% per year.*

We give our customers smart infrastructure. And it's why today we say Network Appliance is positioned to prepare businesses for the coming data explosion.

* *Forrester Research, Inc., Nov. 1998*

SCALE

Obviously ***there's more than one way to address data growth***. *There's the "buy more" approach, constantly adding expensive, general-purpose server computers — or additional telecommunication lines. And companies really do buy more, since in addition to hardware, they need to maintain all this technology with a cadre of IT people.*

NetApp, on the other hand, created a new breed of appliances that are well positioned for managing the exponential growth of data. We have embraced the network, the backbone of the Internet and the enterprise.

Because our appliances only concentrate on managing data well, businesses concerned with data management issues of exponential growth can easily expand capacity without affecting access to information. We call this business continuancy.

This is the kind of news that makes Internet companies take notice. It's why Network Appliance is quickly becoming a de facto standard for ISPs. During the last year, 7 out of the top 10 Web sites* depended on our filers to store and serve data to their customers.

In addition, by intelligently moving data closer to the user, our NetCache products are allowing Internet providers and enterprises to scale their network infrastructure without having to add Internet and intranet connectivity. By providing a total solution approach, we help to keep our customers prepared for the data revolution that is just around the corner.

* *Media Metrix, Inc., Jan. 1999*

The Motley Fool

Dwight Gibbs
Chief Techie Geek

"We installed it, and it's lightning fast." So says Dwight Gibbs, explaining his experience of replacing his NT file server with a NetApp F740 filer. Even adding 80 GB of storage space takes a mere 20 minutes, a "night and day" difference from his NT server. Says Gibbs, "It's the right tool for the right job."

Xerox

David Tsou
Information System Mgr., Electronics Delivery Unit

It's been four years without an interruption in service. David Tsou does remember once, though, when a failed secondary disk triggered an email to NetApp technical support. "The next morning a replacement drive was there already, before anyone even knew of the problem."

SIMPLIFY

***The** **solution to corporate data complexity is simple: consolidate**. By building on this concept, a Network Appliance solution makes it far easier to manage, maintain and back up volumes of data running through the typical company.*

Because our filers can work within UNIX,® Windows® or Web environments, IT administrators don't have to spend time or money to maintain data for these platforms separately. With this multiplatform ability, users can share information between Windows and UNIX platforms. So the IT group can consolidate the many different islands of data into one location. It's made possible by one NetApp filer doing the job of multiple, general-purpose servers.

This unique feature of sharing between multiple platforms means that corporate enterprise data is easier to manage, maintain and back up. Our appliances seamlessly integrate into a company's existing infrastructure. Even installation is simple. While a general-purpose server can take days to get up and running, our appliances get to work in less than an hour. Once up, they run very fast and efficiently — a byproduct of simply concentrating on serving data.

Finally, for those global enterprises where centralization is just not practical, NetApp helps again. With extremely high reliability and an appliance design, hardware maintenance is as easy as replacing a light bulb. Simple data distribution completes the picture and allows remote deployment to be much more practical and cost effective.

PERFORM

Data swirling around companies can only become a competitive weapon if it can be accessed and processed quickly. *That's often not the case on the Web, where traffic bogs down networks, slows user response time and constantly demands extra bandwidth. ISPs and enterprises can lose their marketplace edge, even as they continuously reinvest in costly network infrastructure.*

Network Appliance products accelerate how an enterprise works both internally and externally. In the last year we strengthened our position as a leader in Web-centric appliances, such as NetCache, that improve Web performance while lowering costs.

NetCache appliances enjoyed rapid growth in fiscal 1999. During that time this product cached the Internet backbone for numerous countries, including Australia, France, Hong Kong, Israel, Singapore, South Africa and the U.K. Corporations are also adopting our caching appliances to improve Internet and intranet performance, and as a valuable cost-saving measure.

Whether Internet or intranet, NetCache appliances intelligently move frequently viewed Web content close to the user. Because of this, end-users experience much faster Web response time while businesses use less bandwidth.

Our F700 series of filers introduced last year also provide enhanced productivity. By offloading much of the data access and storage function, tasks are completed in a fraction of the time that they would normally take. And that's time saved that can make the difference between winning and losing in today's business environment.

PSINet

Michael Mael
VP, Applications
and Web Services

With John Glenn's space shuttle set to launch in 2 weeks, PSINet had little time to scale their infrastructure to support the inevitable load on the NASA space shuttle Web site. "NetApp really rose to the occasion," says Michael Mael. "The installation was flawless and their technology never blinked, even though the site was one of the most popular on the Web."

Human Genome Sciences

Michael Fannon
VP, and Chief Information Officer

"Modern drug discovery requires high-speed access to vast amounts of scientific data," explains Michael Fannon. Human Genome Sciences stores data from millions of sequencing runs and results from analysis and biological experiments. "Our NetApp filers give us the performance and reliability to maintain leadership in developing drugs from genomic research."

RELY

***It's all about data availability**. An increasingly important issue with businesses trying to meet the needs of the new Internet-based e-economy, where data needs to be accessible 24 hours a day, every day.*

Just think of what being unavailable for even 10 minutes could do to international financial transactions or a commodities trading firm. How long could a large company function with its information systems down?

Day in and day out, Network Appliance filers give our customers unparalleled uptime. Still, we persistently seek even better solutions. Like our introduction of SnapMirror™ and SnapRestore™ software. These two products continue our legacy of innovative appliance-approach solutions for the continuous availability of large amounts of data. Products like these help ensure that mission-critical business systems keep running, no matter what.

In those few cases where problems occur, recovery can be accomplished in minutes rather than hours. Less planning and testing is required, fewer opportunities for mistakes exist and less highly skilled technical personnel need to be involved. The CIO both saves money and feels confident when appliances store his data.

That reliability, elegantly combined with simplicity and blazing performance, has made NetApp a leader in the network-centric storage market. We've opened the door for countless companies to better manage their data and improve their information access in a way that will give them a competitive advantage today, tomorrow and beyond.

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The following Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) contains forward-looking statements that involve risks and uncertainties. Our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled "Factors Affecting Operating Results" as well as risk factors discussed throughout our Annual Report on Form 10-K, including the section entitled "Item 1. Business" and other sections. We refer you to the documents that we file with the Securities and Exchange Commission, such as Form 10-Q and Form 10-K reports. These documents identify important factors that could cause actual results to differ from our current expectations and the forward-looking statements contained in this annual report. In addition, the following discussion of our results of operations and financial condition should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included elsewhere herein.

OVERVIEW

We pioneered the concept of the "network appliance," an extension of the industry trend toward specialized devices that perform a specific function in the network, similar to the adoption of the router for network communications. Today we are the leading supplier of network attached data storage and access devices, called filers.

We derive a substantial portion of our revenue from the sale of our network filer products. As a result, a reduction in the demand for filer products due to increased competition, a general decline in the market for network file servers or other factors could materially adversely affect our operating results. In fiscal 1998, we initiated product shipments of NetCache appliances and in the second quarter of fiscal 1999 began shipments of the second generation of our NetCache appliances. We expect that NetCache product sales will become a larger percentage of net sales.

Our gross margin may vary based on the configuration of systems that are sold. Highly configured systems typically generate lower overall gross margin percentages due to greater disk drive and memory content. As we sell more highly configured systems with greater disk drive content, overall gross margin percentages will be negatively affected. Consequently, we believe we will experience a modest decline in gross margin and pre-tax income as a percentage of net sales in fiscal 2000.

Our gross margin has been and may continue to be affected by a variety of other factors, including:

- competition
- direct versus indirect sales
- the mix and average selling prices of products, including software licensing
- new product introductions and enhancements
- the cost of components and manufacturing labor

Operating results have not been materially adversely affected by seasonality in the past. However, because of the significant summer seasonal effects experienced within the industry, particularly in Europe, our future operating results could be adversely affected by seasonality.

For the year ended April 30, 1999, approximately 30.7% of our net sales were derived from international customers (including United States exports). Accordingly our future operating results could be materially adversely affected by a variety of factors, some of which are beyond our control. For more information on risks associated with our international operations, see "Factors Affecting Operating Results-Risks inherent in our international operations could have a material adverse effect on our operating results."

The following table sets forth certain consolidated statements of income data as a percentage of net sales for the periods indicated:

Years Ended April 30	1999	1998	1997
Net Sales	100.0%	100.0%	100.0%
Cost of Sales	40.8	40.7	40.8
Gross Margin	59.2	59.3	59.2
Operating Expenses:			
Sales and Marketing	26.1	25.7	26.0
Research and Development	10.5	10.0	9.6
General and Administrative	3.5	3.9	4.4
Purchased In-Process Technology and Related Compensation Charge	—	—	11.3
Litigation Settlement	—	—	4.6
Total Operating Expenses	40.1	39.6	55.9
Income From Operations	19.1	19.7	3.3
Other Income, Net	0.6	0.5	1.0
Income Before Income Taxes	19.7	20.2	4.3
Provision for Income Taxes	7.4	7.6	4.0
Net Income	12.3%	12.6%	0.3%

FISCAL 1999 COMPARED TO FISCAL 1998

Net sales increased by 74.2% to $289.4 million in fiscal 1999 from $166.2 million in fiscal 1998. This increase was primarily attributable to a higher volume of units shipped, as compared to the corresponding period of the prior fiscal year. Factors impacting unit growth include:

- expansion of our direct sales force
- increased unit shipments principally due to the successful launching of our F700 filer product family during the second quarter of fiscal 1999
- increased worldwide shipment of NetApp cluster failover and NetCache solutions
- increased multiprotocol software licensing, software subscription and service revenues due to a growing installed base, and increased sales of multiprotocol systems

Net sales growth was also positively impacted by a higher average selling price of the newly introduced F700 filer product family due primarily to the increase in storage content. Factors which partially offset overall net sales growth include declining unit sales of our older product family and decreases in base prices of our older product line due to competitive forces.

International net sales (including United States exports) grew by 116.3% for fiscal 1999 as compared to fiscal 1998. International net sales were $88.8 million, or 30.7%, of total net sales for fiscal 1999. The increase in international sales for fiscal 1999 was primarily a result of European sales growth due to increased headcount in the direct sales force, indirect channel sales through resellers, shipments of filers and sales of our new NetApp cluster failover solutions and NetCache appliances. Asia Pacific net sales growth for fiscal 1999 was also driven by indirect sales through resellers, increased headcount in the direct sales force, increased shipments of filers and the sale of NetCache appliances, as compared to fiscal 1998.

We cannot assure you that our net sales will continue to increase in absolute dollars or at the rate at which they have grown in recent fiscal periods.

Gross Margin — Gross margin remained relatively flat decreasing slightly to 59.2% of net sales for fiscal 1999 as compared to 59.3% for fiscal 1998. The consistency in gross margin for fiscal 1999 as compared to fiscal 1998 was primarily attributable to the increase in product volume, lower costs of key components, increased manufacturing efficiencies, increased market acceptance of our product line with the continuance of the cost-reduced designs introduced in the second quarter of fiscal 1999, the introduction of the F700 filer product family and NetApp cluster failover system during the second quarter of fiscal 1999 and the revenue growth from sales of NetCache appliances. Gross margin was also favorably impacted by the licensing of multiprotocol software and support contracts, and by growth in software subscription and service revenues due to a larger installed base. Primary factors negatively impacting gross margin were the increase in the sales volume of the F700 product family, which has higher incremental costs associated with greater disk drive and memory content, and the effect of base system price reductions across the full range of older generation filers.

Our gross margin has been and will continue to be affected by a variety of factors, including:

- competition
- product configuration
- direct versus indirect sales
- the mix and average selling prices of products, including software licensing
- new product introductions and enhancements
- the cost of components and manufacturing labor

Our gross margin may also vary based upon the configuration of systems that are sold and whether they are sold directly or through indirect channels. Highly configured systems have historically generated lower overall gross margin percentages due to greater disk drive and memory content.

Sales and Marketing — Sales and marketing expenses consist primarily of salaries, commissions, advertising and certain promotional expenses and customer service and support costs. In fiscal 1999, sales and marketing expenses of $75.5 million reflect an increase of 76.5% over fiscal 1998. These expenses were 26.1% and 25.7% of net sales for fiscal 1999 and 1998, respectively. The increase in absolute dollars was primarily related to the continued expansion of our sales and marketing organization, including growth in the domestic and international direct sales forces and increased commission expenses. We expect to continue to increase our sales and marketing expenses in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels and increase product and company awareness. We believe that our continued growth and profitability is dependent in part on the successful expansion of our international operations, and therefore, have committed significant resources intended to increase international sales.

Research and Development — Research and development expenses consist primarily of salaries and benefits, prototype expenses and fees paid to outside consultants. Research and development expenses increased 82.9% to $30.5 million in fiscal 1999 from $16.6 million in fiscal 1998. These expenses represented 10.5% and 10.0% of net sales, respectively, for those periods. Research and development expenses increased in absolute dollars, primarily as a result of increased headcount, ongoing support of current and future product development and enhancement efforts and prototyping expenses associated with the development of new products, including the NetApp F700 series filers and the NetApp C700 family, the second generation of our NetCache appliances. We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness and meet an expanding range of customer requirements. We intend to continuously expand our existing product offerings and to introduce new products. Consequently, we expect that such expenditures will continue to increase in absolute dollars. For both fiscal 1999 and 1998, no software development costs were capitalized.

General and Administrative — General and administrative expenses increased 56.1% to $10.2 million in fiscal 1999 from $6.5 million in fiscal 1998. These expenses represented 3.5% and 3.9% of net sales, respectively, for those periods. Increases in absolute dollars were primarily due to increased headcount, and increases to the allowance for doubtful accounts and outside service fees. We believe that our general and administrative expenses will increase in absolute dollars as we continue to build our infrastructure.

Other Income, Net — Other income, net, was $1.9 million and $0.9 million in fiscal 1999 and 1998, respectively. The increase was due primarily to interest income earned on the net proceeds of $138.8 million from our March 1999 follow-on public offering and cash flow from operations, but was partially offset by foreign currency exchange losses recorded in fiscal 1999.

Provision for Income Taxes — Our effective tax rate was 37.5% for both fiscal 1999 and 1998.

Fiscal 1998 Compared to Fiscal 1997

Net Sales — Net sales increased by 78.0% to $166.2 million in fiscal 1998 from $93.3 million in fiscal 1997. The increase in net sales was principally attributable to a higher volume of filers shipped. The increase in unit shipments resulted primarily from expansion of our direct sales force and the introduction of new products during June and July 1997, particularly the enterprise-class NetApp F630, the NetApp F520 and the NetApp F230. Net sales for fiscal 1998 were also positively impacted by a shift in product mix toward higher-end systems, primarily due to the introduction of new products, leading to higher average selling prices for filers than in the previous fiscal year. Net sales also grew as a result of increased multiprotocol system shipments, the licensing of multiprotocol software to pre-existing customers and increased service and software subscription revenues due to a growing installed base.

International net sales (including U.S. exports) were $41.1 million and $17.3 million, for fiscal 1998 and 1997, respectively. The increase in international net sales was primarily a result of European sales growth due to increased headcount in the direct sales force over the prior fiscal year and to the introduction of the new products in June and July 1997.

Gross Margin — Gross margin remained relatively flat increasing slightly to 59.3% of net sales for fiscal 1998 compared to 59.2% of net sales for fiscal 1997. This increase in gross margin was primarily attributable to the increase in product volume, lower costs of key components, increased manufacturing efficiencies and by the sale of our new product with cost-reduced designs first introduced in June and July 1997. Gross margin was also favorably impacted by the licensing of multiprotocol software and by growth in software subscription and service revenues due to a growing installed base. Factors contributing to gross margin growth were partially offset by the sale of 4 gigabyte drives at reduced prices in fiscal 1998.

Our gross margin has been and will continue to be affected by a variety of factors, including competition, product configuration, direct versus indirect sales, the mix and average selling prices of products, new product introductions and enhancements and the cost of components and manufacturing labor. In particular, our gross margin varies based upon the configuration of systems that are sold and whether they are sold directly or through indirect channels. Highly configured systems typically generate lower overall gross margin percentages due to greater disk drive and memory content.

Sales and Marketing — Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses and customer service and support costs. Sales and marketing expenses increased 76.3% to $42.8 million in fiscal 1998, compared to $24.3 million in fiscal 1997. These expenses were 25.7% and 26.0% of net revenues for fiscal 1998 and 1997, respectively. The increase in absolute dollars was primarily related to the expansion of our sales and marketing organization, including growth in the domestic and international direct sales forces and increased commission expenses. During the quarter ended January 23, 1998, we launched an advertising campaign which contributed to absolute dollar growth in sales and marketing expenses for fiscal 1998. We expect to continue to increase our sales and marketing expenses in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels and increase product and company awareness. We believe that our continued growth and profitability is dependent in part on the successful expansion of our international operations, and therefore, we have committed significant resources to international sales.

Research and Development — Research and development expenses consist primarily of salaries and benefits and prototype expenses. Research and development expenses increased 85.6% to $16.6 million in fiscal 1998, compared to $9.0 million in the prior fiscal year. These expenses represented 10.0% and 9.6% of net sales in fiscal 1998 and 1997, respectively, and increased as a result of headcount growth, prototyping expenses associated with the development of new products and ongoing support of current and future product development and enhancement efforts. We believe that significant investments in research and development will be required to remain competitive and expect that such expenditures will continue to increase in absolute dollars.

General and Administrative — General and administrative expenses were $6.5 million in fiscal 1998, compared to $4.1 million in fiscal 1997, an increase of 57.9%. These expenses represented 3.9% and 4.4% of net sales for such periods and increased in absolute dollars primarily as a result of headcount growth, increased professional services fees and an increase to the allowance for doubtful accounts. We believe that our general and administrative expenses will increase in absolute dollars as we continue to build our infrastructure.

Litigation Settlement — In July 1994, we and certain of our former employees were named as defendants in a lawsuit which alleged that one of our founders, who left the company in March 1995, misappropriated confidential information prior to the company's founding in April 1992. In August 1996, we entered into a settlement with the plaintiff which resulted in a charge to earnings of $4.3 million in the first quarter of fiscal 1997, which included a $3.5 million payment to the plaintiffs and $0.8 million of legal fees. As the payment released us from all liabilities associated with the case, we have no future obligations to the plaintiffs. We deny any wrongdoing on our part or on the part of the founder.

Purchased In-Process Technology and Related Compensation Charge — On March 17, 1997, we acquired all outstanding shares and options to purchase shares of Internet Middleware Corporation (IMC) common stock by issuing 748,092 shares of our common stock and options to purchase shares of our common stock. In connection with the acquisition, intangible assets of $8.4 million were acquired, of which $7.4 million was reflected as a one-time charge to operations for the write-off of in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. The remaining intangible assets of $1.0 million, consisting of existing technology and goodwill, are included in other assets in the accompanying consolidated balance sheets and are being amortized over their estimated useful lives of five years.

Certain key employees of IMC who continued as our employees were also granted vested options to purchase shares of our common stock at a discount to the market price of our common stock immediately preceding the acquisition. In connection with the granting of these options, we recorded a compensation charge of $3.2 million in the fourth quarter of fiscal 1997.

The acquisition was accounted for as a purchase and, accordingly, the results of operations of IMC from the date of acquisition forward have been included in our consolidated financial statements. IMC results of operations included in our consolidated financial statements for fiscal 1997 were not significant. See Note 4 of Notes to Consolidated Financial Statements for pro forma financial information.

Other Income, Net — Other income, net, was $0.9 million and $1.0 million in fiscal 1998 and 1997, respectively. Other income, net, decreased over the corresponding period of the prior year due primarily to foreign currency exchange losses recorded in fiscal 1998.

Provision for Income Taxes — Our effective tax rate for fiscal 1998 was 37.5% compared to 93.8% for fiscal 1997. The fiscal 1997 tax rate was primarily affected by the one-time charge to operations of $7.4 million for the write-off of purchased in-process research and development related to the IMC acquisition which was not deductible for income tax purposes. Excluding the net effect of the IMC acquisition, the fiscal 1997 effective tax rate would have been 35%. The higher effective tax rate in fiscal 1998, compared to the fiscal 1997 effective tax rate, exclusive of the IMC acquisition, relates to increased earnings, which reduce the impact of research and development and other tax credits on the effective tax rate. Additionally, fiscal 1997 included a benefit for the reversal of a valuation allowance previously provided against deferred tax assets which did not occur in fiscal 1998. As of April 30, 1998 and 1997, a valuation allowance was deemed unnecessary as management determined that it is more likely than not that the net deferred tax asset is realizable.

Liquidity and Capital Resources

As of April 30, 1999, as compared to the April 30, 1998 balances, our cash, cash equivalents and short-term investments increased by $179.0 million to $227.1 million. The increase was primarily due to net proceeds of $138.8 million from our March 1999 follow-on public offering. Working capital increased by $195.2 million to $264.8 million, impacted primarily by increases in cash and cash equivalents, accounts receivable, inventories, prepaid expense and other and deferred taxes, partially offset by increases in accounts payable, deferred revenue, accrued compensation and related benefits, other accrued liabilities and a decrease in short-term investments. We generated cash from operating activities totaling $45.9 million and $22.7 million in fiscal 1999 and fiscal 1998, respectively. Net cash provided by operating activities in fiscal 1999 principally related to net income of $35.6 million, increases in accounts payable, income taxes payable, accrued compensation and related benefits, deferred revenue and other accrued liabilities, coupled with depreciation and amortization which are non-cash expenses, partially offset by increases in accounts receivable, inventories, prepaid expenses and other assets and deferred income taxes.

We used $15.5 million and $8.0 million of cash during fiscal 1999 and 1998, respectively, to purchase property and equipment. We were provided with $5.0 million during fiscal 1999 from net short-term investment redemptions and used $3.9 million during 1998 for net short-term investment purchases.

Financing activities provided $155.5 million and $6.9 million during fiscal 1999 and 1998 respectively. The increase in cash provided by financing activities in fiscal 1999, compared to fiscal 1998, was due to a follow-on common stock offering in March 1999 yielding net proceeds of approximately $138.8 million, an increased quantity of stock options exercised at a higher average exercise price and a greater number of employees participating in the employee stock purchase plan.

In June 1998, we executed an agreement to acquire 5.9 acres of land in Sunnyvale, California and the accompanying 127,000 square foot building. Under terms of the agreement, we paid $5.5 million of the $33.8 million purchase price as a nonrefundable deposit. In January 1999, we assigned our rights and obligations under the agreement to a third-party entity and in exchange received back our $5.5 million deposit.
We subsequently entered into an operating lease for this property. Our lease payments will vary based on the London Interbank Offered Rate (LIBOR) plus a spread and are currently estimated to be approximately $2.9 million on an annual basis over the lease term. The lease is for five years and can be renewed for two five-year periods, subject to the approval of the third-party entity. At the expiration or termination of the lease, we have the option to either purchase the property for $44.0 million, or arrange for the sale of the property to a third party for at least $44.0 million with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for an additional lease payment of approximately $37.0 million.

In June 1998, we signed a 25-year operating lease requiring annual lease payments of $3.1 million commencing in October 1999, for a 6.2-acre plot in Sunnyvale, California and an option agreement to purchase the 6.2 acres of land. Under terms of the option agreement, we paid a $4.5 million nonrefundable deposit. The option allows us to purchase the land, within a 90-day period, commencing in December 1999 at a purchase price of $23.7 million. This agreement was subsequently amended in June 1999 to a 25 year and three month term commencing in July 1999. In June 1999, we assigned our rights and obligations under the agreement to a third-party entity. We subsequently entered into an operating lease for this property. Our lease payments will vary based on the LIBOR plus a spread and are currently estimated to be approximately $3.1 million on an annual basis over the lease term. The lease is for five years and can be renewed for two five-year periods, subject to the approval of the third-party entity. At the expiration or termination of the lease, we have the option to either purchase the property for $48.0 million, or arrange for the sale of the property to a third party for at least $48.0 million with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for an additional lease payment of approximately $43.9 million.

In August 1998, we entered into an agreement to acquire 6.0 acres of land in Sunnyvale, California and the accompanying 79,000 square foot building. Under terms of the agreement, we paid $2.5 million of the $16.8 million purchase price as a deposit. In May 1999, we assigned our rights and obligations under the agreement to a third-party entity and in exchange received back our $2.5 million deposit. We subsequently entered into an operating lease for this property. Our lease payments will vary based on the LIBOR plus a spread and are currently estimated to be approximately $2.3 million on an annual basis over the lease term. The lease is for five years and can be renewed for two five-year periods, subject to the approval of the third-party entity. At the expiration or termination of the lease, we have the option to either purchase the property for $36.0 million, or arrange for the sale of the property to a third party for at least $36.0 million with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for an additional lease payment of approximately $32.6 million.

In July 1998, we negotiated a $5.0 million unsecured revolving credit facility with a domestic commercial bank. Under terms of the credit facility, which expires in July 1999 (subsequently renewed through October 1999), we must maintain various financial covenants. Any borrowings under this agreement bear interest at either LIBOR plus 1% or at the lender's "prime" lending rate, such rate determined at our discretion. In December 1998, we drew a $2.5 million letter of credit against our line of credit to facilitate requirements associated with the acquisition of land in Sunnyvale, California and the accompanying 79,000 square foot building. In June 1999, the letter of credit was relieved upon completion of the acquisition of the land and building.

All three of the operating leases and the revolving credit facility mentioned above require us to maintain specified financial covenants with which we were in compliance as of April 30, 1999.

Excluding the commitments related to the aforementioned properties, which we have assigned to third parties and established as operating leases, we currently have no significant commitments other than commitments under operating leases. We believe that our existing liquidity and capital resources, including the available amounts under the $5.0 million line of credit, are sufficient to fund our operations for at least the next twelve months.

Year 2000

The Year 2000 issue refers to computer programs which use two digits rather than four to define a given year and which therefore might read a date using "00" as the year 1900 rather than the year 2000. As a result, many companies' systems and software may need to be upgraded or replaced in order to function correctly after December 31, 1999.

We are currently conducting a general software upgrade and replacement program to enhance our computer systems and applications, in particular those systems and applications related to our manufacturing, distribution and financial operations. As part of this larger program we are addressing the critical areas of our internal computer systems, products and relationships with external organizations for Year 2000 compliance. We are addressing Year 2000 compliance for both our information technology ("IT") and non-IT systems, which typically include embedded technology such as microcontrollers.

As part of our general systems upgrade we have evaluated and selected various significant computer software applications which are represented by vendors as Year 2000 compliant. We expect to complete installation of such software in our domestic operations by the end of the first quarter of fiscal 2000 followed by installation in our international operations throughout fiscal 2000. Most of our existing business applications are already supported by Year 2000 compliant software. With the system changes implemented to date and other planned changes, we anticipate that our internal computer software applications will be Year 2000 compliant prior to December 31, 1999. We believe that our current products are Year 2000 compliant, and our new products are being designed to be Year 2000 compliant.

We rely on numerous third-party vendors for certain products and services. We are communicating with our principal service providers and suppliers to assess their Year 2000 readiness. Responses indicate that our significant service providers currently have compliant versions of their systems available or are well into the renovation and testing phases with completion scheduled prior to December 31, 1999. We are still assessing the effect Year 2000 issues will have on our service providers and suppliers, however, our principal service providers and suppliers have represented to us that they are Year 2000 compliant. We can give you no guarantee that the systems and products of these service providers and suppliers on which we rely are, or will be, Year 2000 compliant.

Our contingency planning for Year 2000 issues relates primarily to the efforts of our third-party vendors. In the event of any Year 2000 disruptions related to third-party software, we expect to follow the individual vendor's contingency directives. With respect to suppliers, we will consider alternative sources as a contingency plan, if necessary. Contingency planning will continue throughout 1999 and our plans will be modified based upon the progress of our remediation efforts, system updates and installations and based upon our communications with selected suppliers. We have determined that our "worst case" scenario relates to Year 2000 compliance problems of our third-party vendors and suppliers and other external organizations which if not remedied could materially adversely affect our operating results.

The costs we expect to incur in connection with our overall general systems upgrade program, including both internal and third-party costs, are primarily external costs for software licenses, and implementation and consulting services. These systems and applications were selected primarily for features and functionality in addition to Year 2000 compliance. Accordingly, we do not itemize costs of Year 2000 compliance separately.

Our expectations regarding the impact of Year 2000 issues are forward looking statements and actual results could vary due to the factors discussed in this section. While we believe that the estimated cost of becoming Year 2000 compliant will not be significant to our operating results, failure to complete all the work in a timely manner could materially adversely affect our operating results. While we expect all planned work to be completed, we cannot guarantee that all systems will be in compliance by the Year 2000, the systems of suppliers and other companies and government agencies on which we rely will be Year 2000 compliant, or that our contingency planning will be able to fully address all potential interruptions. Therefore, Year 2000 issues could cause delays in our ability to produce or ship our products, process transactions or otherwise conduct business in any of our markets. Year 2000 issues could lower demand for our products while increasing our costs. The occurrence of one or more of these factors could materially adversely affect our operating results.

New Accounting Standards

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which defines derivatives, requires that all derivatives be carried at fair value, and provides for hedging accounting when certain conditions are met. This statement is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On a forward-looking basis, although we have not fully assessed the implications of this new statement, we do not believe adoption of this statement will have a material impact on our consolidated financial position, results of operations or cash flows.

Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk related to fluctuations in interest rates and in foreign currency exchange rates. We use certain derivative financial instruments to manage these risks. We do not use derivative financial instruments for speculative or trading purposes. All financial instruments are used in accordance with board-approved policies.

Market Interest Risk

Short-term Investments — As of April 30, 1999, we had short-term investments of $5.8 million. These short-term investments consist of highly liquid investments with original maturities at the date of purchase between three and six months. These investments are subject to interest rate risk and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at April 30, 1999, would cause the fair value of these short-term investments to decline by an immaterial amount. Because we have the ability to hold these investments until maturity we would not expect any significant decline in value of our investments caused by market interest rate changes. Declines in interest rates over time will, however, reduce our interest income.

Foreign Currency Exchange Rate Risk — We hedge risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward contracts to hedge trade and intercompany receivables and payables. These contracts reduce the exposure to fluctuations in exchange rate movements, as the gains and losses associated with foreign currency balances are generally offset with the gains and losses on the hedge contracts. All hedge instruments are marked to market through earnings every period.

We do not anticipate any material adverse effect on our consolidated financial position utilizing the current hedging strategy. All contracts have a maturity of less than one year and we do not defer any gains and losses, as they are all accounted for through earnings every period.

We do not expect to experience a material foreign exchange loss based on a hypothetical 10% adverse change in the price of the foreign currency against the U.S. dollar. The hypothetical changes and assumptions discussed above will be different from what actually occurs in the future. Furthermore, such computations do not anticipate actions that may be taken by management, should the hypothetical market changes actually occur over time. As a result, the effect on actual earnings in the future will differ from those described above.

The following table provides information about our foreign exchange forward contracts outstanding on April 30, 1999, (in thousands):

Currency	Buy/ Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
GBP	Buy	3,500	$ 5,643	$ 5,630
GBP	Sell	6,100	$ 9,802	$ 9,813
EUR	Buy	1,534	$ 1,631	$ 1,621
EUR	Sell	11,900	$ 12,825	$ 12,574

Factors Affecting Operating Results

Factors beyond our control could cause our quarterly results to fluctuate — Although we have experienced significant revenue growth in recent periods, this growth may not be indicative of our future operating results. As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. Many of the factors that could cause our quarterly operating results to fluctuate significantly in the future are beyond our control and include the following:

- the level of competition in our target product markets
- the size, timing and cancellation of significant orders
- product configuration and mix
- market acceptance of new products and product enhancements
- new product announcements or introductions by us or our competitors
- deferrals of customer orders in anticipation of new products or product enhancements
- changes in pricing by us or our competitors
- our ability to timely develop, introduce and market new products and enhancements
- supply constraints
- technological changes in our target product markets
- the levels of expenditure on research and development and expansion of our sales and marketing programs
- seasonality
- general economic trends

In addition, sales for any future quarter may vary and accordingly be inconsistent with our plans. We generally operate with limited order backlog because our products are typically shipped shortly after orders are received. As a result, product sales in any quarter are generally dependent on orders booked and shipped in that quarter. Product sales are also difficult to forecast because the network file server market is rapidly evolving and our sales cycle varies substantially from customer to customer.

Due to all of the foregoing factors, it is possible that in one or more future quarters our results may fall below the expectations of public market analysts and investors. In such event, the trading price of our common stock would likely decrease.

Our gross margins may vary based on the configuration of our products — We derive a significant portion of our sales from the resale of disk drives as components of our filers, and the resale market for hard disk drives is highly competitive and subject to intense pricing pressures. Our sales of disk drives generate lower gross margin percentages than those of our filer products. As a result, as we sell more highly configured systems with greater disk drive content, overall gross margin percentages will be negatively affected. Consequently, we believe we will experience a modest decline in gross margins and pre-tax income as a percentage of net sales in fiscal 2000.

Our gross margins have been and may continue to be affected by a variety of other factors, including:

- competition
- direct versus indirect sales
- the mix and average selling prices of products, including software licensing
- new product introductions and enhancements
- the cost of components and manufacturing labor

A significant percentage of our expenses are fixed which could affect our net income — Our expense levels are based in part on our expectations as to future sales and a significant percentage of our expenses are fixed. As a result, if sales levels are below expectations, net income may be disproportionately affected.

Our future financial performance depends on growth in the network file server market and any lack of growth will have a material adverse effect on our operating results — All of our filer products address the network file server market. Accordingly, our future financial performance will depend in large part on continued growth in the network file server market and on emerging standards in this market. We cannot assure you that the market for network file servers will continue to grow or that emerging standards in the network file server market will not adversely affect the growth of UNIX and Windows NT server markets. If the network file server market grows more slowly than anticipated or if network file servers based on emerging standards other than those adopted by us become increasingly accepted by the market, our operating results could be materially adversely affected.

The success of our NetCache appliance products depends upon market acceptance of caching technology and continued growth in the caching appliance market — In late 1997, we released our NetCache appliance products, a new category of hardware-based Internet caching appliances designed to speed the delivery of information stored on the Web. However, hardware-based caching technology is still in its infancy.

Our future financial performance will depend in part on the acceptance of caching technology and the acceptance of our NetCache appliance products. We cannot assure you that the caching appliance market will continue to grow at its current rate, or at all.

If we are unable to introduce new products, or if our new products do not achieve market acceptance, our operating results could be materially adversely affected — We derive a substantial portion of our revenue from the sale of our network filer products. As a result, a reduction in the demand for our filer products due to increased competition, a general decline in the market for network file servers or other factors could materially adversely affect our operating results. As part of our ongoing development process, we initiated production shipments of four new filers in fiscal 1998 and in fiscal 1999 we launched our F700 filer and C700 NetCache appliance product families as well as enterprise software offerings with SnapMirror, SnapRestore and cluster failover software. We expect to derive a substantial portion of our revenue from sales of our F700 filer and C700 NetCache appliance product families and these major data management software products. Additional product introductions in future periods are expected to impact the sales of existing products. If we are unable to introduce new products in a timely manner, effectively manage the introduction of new products and any related inventory transitions or if such products do not achieve market acceptance, our operating results could be materially adversely affected.

If we fail to manage our expanding business effectively our operating results could be materially adversely affected — We have experienced rapid growth. Our future operating results depend to a large extent on management's ability to successfully manage expansion and growth, including but not limited to expanding international operations, forecasting revenues, addressing new markets, controlling expenses, implementing infrastructure and systems and managing our assets. In addition, an unexpected decline in the growth rate of revenues without a corresponding and timely reduction in expense growth or a failure to manage other aspects of growth could materially adversely affect our operating results.

We depend on attracting and retaining qualified technical and sales personnel — Our continued success depends, in part, on our ability to identify, attract, motivate and retain qualified technical and sales personnel. Because our future success is dependent on our ability to continue to enhance and introduce new products, we are particularly dependent on our ability to identify, attract, motivate and retain qualified engineers with the requisite education, backgrounds and industry experience. Competition for qualified engineers, particularly in Silicon Valley, is intense. The loss of the services of a significant number of our engineers or sales people could be disruptive to our development efforts or business relationships and could materially adversely affect our operating results.

Risks inherent in our international operations could have a material adverse effect on our operating results — We conduct business internationally. For the year ended April 30, 1999, approximately 30.7% of our net sales were to international customers (including United States exports). Accordingly, our future operating results could be materially adversely affected by a variety of factors, some of which are beyond our control, including regulatory, political or economic conditions in a specific country or region, trade protection measures and other regulatory requirements and government spending patterns.

Our international sales are denominated in U.S. dollars and in foreign currencies. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and, therefore, potentially less competitive in foreign markets. For international sales and expenditures denominated in foreign currencies, we are subject to risks associated with currency fluctuations. We hedge risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward contracts to hedge trade and intercompany receivables and payables. All hedge contracts are marked to market through earnings every period. We do not anticipate any material adverse effect on our consolidated financial position utilizing the current hedging strategy.

Additional risks inherent in our international business activities generally include, among others, longer accounts receivable payment cycles, difficulties in managing international operations and potentially adverse tax consequences. Such factors could materially adversely affect our future international sales and, consequently, our operating results.

Although operating results have not been materially adversely affected by seasonality in the past, because of the significant seasonal effects experienced within the industry, particularly in Europe, our future operating results could be adversely affected by seasonality.

We believe that continued growth and profitability will require successful expansion of our international operations and sales and therefore we have committed significant resources to such expansion. In order to successfully expand international sales in future periods, we must strengthen foreign operations, hire additional personnel and recruit additional international distributors and resellers. This will require significant management attention and financial resources and could materially adversely affect our operating results. To the extent that we are unable to effect these additions in a timely manner, our growth, if any, in international sales will be limited, and our operating results could be materially adversely affected. In addition, we cannot assure you that we will be able to maintain or increase international market demand for our products.

An increase in competition could materially adversely affect our operating results — The network file server market is intensely competitive and characterized by rapidly changing technology. We compete with specialized network file server companies such as Auspex Systems, Inc. We also compete against traditional suppliers of UNIX-based general purpose computers that are used as network file servers including Sun Microsystems, Inc., Hewlett-Packard Company, Silicon Graphics, Inc. and IBM Corporation, among others. Many of our current and potential competitors have significantly greater financial, technical, marketing and other resources than we do. In addition, certain of these large traditional suppliers of general purpose computers may in the future offer specialized file server products which are more directly competitive with our products. We also encounter competition from manufacturers of PC-based file servers utilizing Windows NT and emerging standards, as well as competition from manufacturers of open systems storage solutions such as EMC Corporation and Data General Corp. Our NetCache appliances compete against a number of software and hardware solutions, from companies ranging from small start-ups to larger systems vendors, including Cisco Systems, Inc., Inktomi Corp., Cacheflow, Inc. and Novell, Inc.

Increased competition could result in price reductions, reduced gross margins and loss of market share, any of which could materially adversely affect our operating results. As a result, our competitors may be able to respond more quickly than we can to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, promotion, sale and support of their products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or future competitors. Competitive pressures we face could materially adversely affect our operating results.

We believe that the principal competitive factors affecting our market include product features such as response time, scalability, ease of use, price, multiprotocol capabilities and customer service and support. Although we believe that our products currently compete favorably with respect to these factors, we cannot assure you that we can maintain our competitive position against current and potential competitors, especially those with significantly greater financial, marketing, service, support, technical and other resources.

We rely upon a limited number of suppliers and any disruption or termination of these supply arrangements could delay shipment of our products and could materially adversely affect our operating results — We rely upon a limited number of suppliers of several key components utilized in the assembly of our products. We purchase most of our disk drives through a single supplier. We purchase computer boards and microprocessors from a limited number of suppliers. Our reliance on a limited number of suppliers involves several risks, including:

- a potential inability to obtain an adequate supply of required components because we do not have long-term supply commitments
- price increases
- timely delivery
- component quality

In the future, we intend to increasingly rely on contract manufacturers to assemble our products. If our contract manufacturers' operations were interrupted for any reason, our ability to meet scheduled product deliveries to customers would be adversely affected.

Component quality is particularly significant with respect to our supplier of disk drives. In order to meet product performance requirements, we must obtain disk drives of extremely high quality and capacity. In addition, there are periodic supply and demand issues for disk drives, microprocessors and for semiconductor memory components, which could result in component shortages, selective supply allocations and increased prices of such components. We cannot assure you that we will be able to obtain our full requirements of such components in the future or that prices of such components will not increase. In addition, problems with respect to yield and quality of such components and timeliness of deliveries could occur. Disruption or termination of the supply of these components could delay shipments of our products and could materially adversely affect our operating results. Such delays could also damage relationships with current and prospective customers.

We cannot assure you that our OEM relationships with Dell Computer Corporation and Fujitsu Limited will generate significant revenue — While our agreements with Dell Computer Corporation and Fujitsu Limited are an element of our strategy to increase penetration in the Windows NT market, neither Dell Computer Corporation nor Fujitsu Limited have made purchase commitments for our products. In addition, since these agreements are new, we do not have a history upon which to base an analysis of their future success. Currently we do not, and cannot assure you that we will, generate significant revenue from these agreements.

We do not have exclusive relationships with our distributors and accordingly there is a risk that those distributors may give higher priority to products of other suppliers which could adversely affect our operating results — Our distribution customers generally offer products of several different companies, including products of our competitors. Accordingly, there is risk that these distributors may give higher priority to products of other suppliers, which could adversely affect our operating results.

We depend upon our research and development efforts to develop and introduce new products and any failure to develop and introduce new products successfully could materially adversely affect our operating results — Our future growth depends upon the successful development and introduction of new hardware and software products. We cannot assure you that these or other new products will be introduced on a timely basis or attain market acceptance. Due to the complexity of network file servers and Internet caching devices, and the difficulty in gauging the engineering effort required to produce new products, new products are subject to significant technical risks. We cannot assure you that new products will be introduced on a timely basis or at all. In the past, we have experienced delays in the shipments of our new products principally due to an inability to qualify component parts from disk drive and other suppliers, resulting in delay or loss of product sales. If new products are delayed or do not achieve market acceptance, our operating results will be materially adversely affected.

We face risks of technological changes that affect our products — The markets we serve are characterized by rapid technological change, changing customer needs, frequent new product introductions and evolving industry standards. The introduction of products embodying new technologies and the emergence of new industry standards could render our existing products obsolete and unmarketable. Our future success will depend upon our ability to develop and introduce new products (including new software releases and enhancements) on a timely basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers. We cannot assure you that we will be successful in developing and marketing new products that respond to technological changes or evolving industry standards. If we are unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, our operating results will be materially adversely affected.

Undetected software errors or failures found in new products may result in loss of or delay in market acceptance of our products which could materially adversely affect our operating results — Our products may contain undetected software errors or failures when first introduced or as new versions are released. Despite testing by us and by current and potential customers, errors may not be found in new products until after commencement of commercial shipments, resulting in loss of or delay in market acceptance, which could materially adversely affect our operating results.

If we are unable to protect our intellectual property we may be subject to increased competition which could materially adversely affect our operating results — Our success depends significantly upon our proprietary technology. We currently rely on a combination of copyright and trademark laws, trade secrets, confidentiality procedures, contractual provisions and patents to protect our proprietary rights. We seek to protect our software, documentation and other written materials under trade secret, copyright and patent laws, which afford only limited protection. We have registered trademarks including our “Network Appliance” name and logo, “FAServer,” “FilerView” and “NetApp” trademarks. We will continue to evaluate the registration of additional trademarks as appropriate. We generally enter into confidentiality agreements with our employees and with our resellers and customers. We currently have multiple U.S. and international patent applications pending and one U.S. patent issued. The pending applications may not be approved and if patents are issued, such patents may be challenged. If such challenges are brought, the patents may be invalidated. We cannot assure you that we will develop proprietary products or technologies that are patentable, that any issued patent will provide us with any competitive advantages or will not be challenged by third parties, or that the patents of others will not materially adversely affect our ability to do business.

Litigation may be necessary to protect our proprietary technology. Any such litigation may be time-consuming and costly. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to as great an extent as do the laws of the United States. We cannot assure you that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology, duplicate our products or design around patents issued to us or other intellectual property rights of ours.

We are subject to intellectual property infringement claims. We may, from time to time receive claims that we are infringing third parties' intellectual property rights. In fiscal 1997, we settled litigation related to the alleged infringement of third party rights and other claims, which resulted in a pre-tax expense of $4.3 million ($3.5 million in payments to the plaintiffs and $0.8 million in legal fees). Third-parties may in the future claim infringement by us with respect to current or future products, patents, trademarks or other proprietary rights. We expect that companies in the appliance market will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims could be time-consuming, result in costly litigation, cause product shipment delays, require us to redesign our products or require us to enter into royalty or licensing agreements, any of which could materially adversely affect our operating results. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all.

The market price for our common stock has fluctuated significantly in the past and will likely continue to do so in the future and any broad market fluctuations may materially adversely affect the market price of our common stock — The market price for our common stock has been volatile in the past, and several factors could cause the price to fluctuate substantially in the future. These factors include:

- fluctuations in our operating results
- fluctuations in the valuation of companies perceived by investors to be comparable to us
- a shortfall in revenues or earnings compared to securities analysts' expectations
- changes in analysts' recommendations or projections
- announcements of new products, applications or product enhancements by us or our competitors
- changes in our relationships with our suppliers or customers

In addition, the stock market has experienced volatility that has particularly affected the market prices of equity securities of many high technology companies and that often has been unrelated to the operating results of such companies. As a result, the market price of our common stock may fluctuate significantly in the future and any broad market fluctuations may adversely affect the market price of our common stock. Due to all of the foregoing, the current market price of our common stock may not be indicative of future market prices.

Protective anti-takeover provisions in our charter and bylaws could materially adversely affect stockholders — Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. Further, certain provisions of our bylaws pertaining to the future elimination of cumulative voting and shareholder action by written consent, and the requirement that shareholders may call a special meeting of shareholders only upon a request of shareholders owning at least 50% of our common stock, could delay or make more difficult a proxy contest involving us, which could adversely affect the market price of our common stock.

To the Shareholders of Network Appliance, Inc.:

We have audited the accompanying consolidated balance sheets of Network Appliance, Inc. and its subsidiaries as of April 30, 1999 and 1998, and the related consolidated statements of income, shareholders' equity and comprehensive income and cash flows for each of the three years in the period ended April 30, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Network Appliance, Inc. and its subsidiaries as of April 30, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended April 30, 1999 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

Deloitte & Touche LLP
San Jose, California
May 14, 1999
(June 17, 1999 as to the fourth paragraph of Note 3)

April 30 *in thousands*	1999	1998
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 221,284	$ 37,315
Short-term investments	5,800	10,800
Accounts receivable, net of allowances of $1,886 in 1999 and $811 in 1998	57,163	34,313
Inventories	13,581	8,707
Prepaid expenses and other	7,384	2,524
Deferred taxes	10,134	5,280
Total current assets	315,346	98,939
Property and Equipment, net	19,271	12,217
Deposits	7,000	—
Other Assets	4,730	4,580
	$ 346,347	$ 115,736
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 15,126	$ 10,041
Income taxes payable	1,108	1,782
Accrued compensation and related benefits	15,189	8,485
Other accrued liabilities	7,633	4,201
Deferred revenue	11,474	4,799
Total current liabilities	50,530	29,308
Long-term Obligations	93	163
	50,623	29,471
Commitments and Contingencies (Note 3)		
Shareholders' Equity:		
Preferred stock, no par value; 5,000 shares authorized; shares outstanding: none in 1999 and 1998	—	—
Common stock, no par value; 220,000 shares authorized; shares outstanding: 72,831 in 1999 and 67,296 in 1998	240,807	66,422
Deferred stock compensation	(714)	(498)
Retained earnings	55,954	20,341
Cumulative other comprehensive loss	(323)	—
Total shareholders' equity	295,724	86,265
	$ 346,347	$ 115,736

See notes to consolidated financial statements.

Years Ended April 30 *in thousands, except per share amounts*	1999	1998	1997
Net Sales	$ 289,420	$ 166,163	$ 93,333
Cost of Sales	118,120	67,549	38,061
Gross margin	171,300	98,614	55,272
Operating Expenses:			
Sales and marketing	75,526	42,779	24,268
Research and development	30,457	16,649	8,968
General and administrative	10,191	6,528	4,134
Purchased in-process technology and related compensation charge	—	—	10,519
Litigation settlement	—	—	4,300
Total operating expenses	116,174	65,956	52,189
Income from Operations	55,126	32,658	3,083
Other Income (Expense):			
Interest income	2,645	1,097	1,048
Other expense	(781)	(208)	(88)
Total other income, net	1,864	889	960
Income Before Income Taxes	56,990	33,547	4,043
Provision for Income Taxes	21,377	12,582	3,793
Net Income	**$ 35,613**	$ 20,965	$ 250
Net Income per Share: [1]			
Basic	**$ 0.52**	$ 0.32	$ 0.00
Diluted	**$ 0.46**	$ 0.29	$ 0.00
Shares Used in per Share Calculations: [1]			
Basic	**68,435**	64,914	60,978
Diluted	**77,931**	71,902	68,804

[1] *Share and per share amounts have been adjusted to reflect the two-for-one stock split which was effective December 21, 1998.*
See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity and Comprehensive Income

in thousands	Common Stock Shares	Common Stock Amount	Deferred Stock Compensation	Retained Earnings (Accumulated Deficit)	Cumulative Other Comprehensive Loss	Total
Balances, April 30, 1996	64,560	$ 40,286	$ (383)	$ (874)	$ —	$ 39,029
Net income and comprehensive income	—	—	—	250	—	250
Issuance of common stock	1,166	1,730	—	—	—	1,730
Repurchase of common stock	(752)	(52)	—	—	—	(52)
Amortization of deferred stock compensation	—	—	85	—	—	85
Reversal of deferred stock compensation due to employee termination	—	(244)	244	—	—	—
Income tax benefit from employee stock transactions	—	2,487	—	—	—	2,487
Common stock issued for IMC acquisition	690	7,350	—	—	—	7,350
Compensation charge for IMC acquisition	—	3,150	—	—	—	3,150
Balances, April 30, 1997	65,664	54,707	(54)	(624)	—	54,029
Net income and comprehensive income	—	—	—	20,965	—	20,965
Issuance of common stock	1,654	6,937	—	—	—	6,937
Repurchase of common stock	(22)	(1)	—	—	—	(1)
Deferred stock compensation	—	714	(714)	—	—	—
Amortization of deferred stock compensation	—	—	270	—	—	270
Income tax benefit from employee stock transactions	—	4,065	—	—	—	4,065
Balances, April 30, 1998	67,296	66,422	(498)	20,341	—	86,265
Components of comprehensive income:						
Net income	—	—	—	35,613	—	35,613
Currency translation adjustment	—	—	—	—	(323)	(323)
Total comprehensive income						35,290
Issuance of common stock	2,681	16,942	—	—	—	16,942
Repurchase of common stock	(21)	(280)	—	—	—	(280)
Issuance of common stock at $50.50 per share pursuant to follow-on public offering, net	2,875	138,834	—	—	—	138,834
Deferred stock compensation	—	916	(916)	—	—	—
Amortization of deferred stock compensation	—	—	667	—	—	667
Reversal of deferred stock compensation due to employee termination	—	(33)	33	—	—	—
Other stock compensation expense	—	230	—	—	—	230
Income tax benefit from employee stock transactions	—	17,776	—	—	—	17,776
Balances, April 30, 1999	**72,831**	**$ 240,807**	**$ (714)**	**$ 55,954**	**$ (323)**	**$ 295,724**

See notes to consolidated financial statements.

Years Ended April 30 *in thousands*	1999	1998	1997
Cash Flows from Operating Activities:			
Net income	$ 35,613	$ 20,965	$ 250
Adjustments to reconcile net income to net cash			
provided by operating activities:			
Depreciation and amortization	8,146	5,548	2,866
Other stock compensation expense	230	—	—
Purchased in-process technology and related compensation charge	—	—	10,519
Provision for doubtful accounts	1,075	481	—
Deferred income taxes	(5,084)	(1,749)	(2,794)
Deferred rent	(70)	(36)	(69)
Loss on disposal of equipment	1,221	—	—
Changes in assets and liabilities:			
Accounts receivable	(24,188)	(20,883)	(8,573)
Inventories	(4,934)	1,213	(5,095)
Prepaid expenses and other	(5,060)	(1,484)	(1,031)
Accounts payable	5,085	5,626	2,295
Income taxes payable	17,102	4,823	3,010
Accrued compensation and related benefits	6,704	3,819	2,636
Other accrued liabilities	3,432	1,921	338
Deferred revenue	6,675	2,482	1,917
Net cash provided by operating activities	45,947	22,726	6,269
Cash Flows from Investing Activities:			
Purchases of short-term investments	(18,680)	(15,050)	(17,770)
Redemptions of short-term investments	23,680	11,166	13,836
Purchases of property and equipment	(15,474)	(7,971)	(7,124)
Other assets	—	(2,000)	—
Cash acquired from IMC purchase	—	—	11
Payment of deposits, net	(7,000)	—	—
Net cash used in investing activities	(17,474)	(13,855)	(11,047)
Cash Flows from Financing Activities:			
Repayments of long-term obligations	—	(12)	(17)
Proceeds from sale of common stock, net	16,662	6,936	1,678
Proceeds from follow-on common stock offering, net	138,834	—	—
Net cash provided by financing activities	155,496	6,924	1,661
Net Increase (Decrease) in Cash and Cash Equivalents	183,969	15,795	(3,117)
Cash and Cash Equivalents:			
Beginning of year	37,315	21,520	24,637
End of year	$ 221,284	$ 37,315	$ 21,520

See notes to consolidated financial statements.

Dollar and share amounts in thousands, except per-share data

1 THE COMPANY

Network Appliance, Inc., incorporated in the state of California in April 1992, and its subsidiaries operate in a single industry segment and are involved in the design, manufacturing, marketing and support of high performance network attached data storage and access devices which provide fast, simple, reliable and cost-effective file service for data-intensive network environments.

2 SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year — We operate on a 52-week or 53-week year ending on the last Friday in April. For presentation purposes we have indicated in the accompanying consolidated financial statements that our fiscal year end is April 30. Fiscal 1999 was a 53-week fiscal year. Fiscal 1998 and 1997 were 52-week years.

Basis of Presentation — The consolidated financial statements include the company and its wholly-owned subsidiaries. Intercompany accounts and transactions are eliminated in consolidation. Certain amounts from prior years have been reclassified to conform to current-year presentation. These reclassifications did not change previously reported total assets, liabilities, shareholders' equity or net income.

Cash and Cash Equivalents — We consider all highly liquid debt investments with original maturities of three months or less to be cash equivalents.

Short-term Investments — Our short-term investments consist of securities with original maturities ranging between three and six months. All of our investments are classified as available-for-sale, and are stated at amortized cost, which approximates fair market value. Short-term investments consist of $5,800 and $10,800 of municipal securities as of April 30, 1999, and April 30, 1998, respectively.

Inventories — Inventories are stated at the lower of cost (first-in, first-out basis) or market.

Inventories consist of the following:

April 30	1999	1998
Purchased components	$ 5,316	$ 4,494
Work in process	1,727	1,889
Finished goods	6,538	2,324
	$ 13,581	$ 8,707

Property and Equipment — Property and equipment is stated at cost and is depreciated on a straight-line basis over estimated useful lives which range from two to five years. Leasehold improvements are amortized over their estimated useful lives or the life of the lease, whichever is shorter.

Property and equipment consists of the following:

April 30	1999	1998
Computers, related equipment and purchased software	$ 28,619	$ 16,979
Furniture and fixtures	2,236	1,962
Leasehold improvements	3,104	2,782
	33,959	21,723
Accumulated depreciation and amortization	(14,688)	(9,506)
	$ 19,271	$ 12,217

Revenue Recognition — In the first quarter of fiscal 1999, we adopted Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended. Adoption of this statement did not have a material impact on our consolidated financial position, results of operations or cash flows. We recognize revenue and record estimated product return and warranty reserves upon shipment if the collectibility of the receivable is deemed to be probable, an executed agreement has been signed, the fee is fixed and determinable and vendor specific objective evidence exists to allocate a portion of the total fee to any undelivered elements of the arrangement. Service and software subscription revenues are recognized over the terms of the related contractual periods. Service revenues were less than 10% of net sales in fiscal 1999, 1998 and 1997. Software subscription revenues were also less than 10% of net sales in fiscal 1999, 1998 and 1997.

Advertising Costs — Advertising costs are charged to operations when incurred. Advertising expenses for fiscal 1999, 1998 and 1997 were approximately $1,072, $1,000 and $100, respectively.

Software Development Costs — We capitalize eligible computer software development costs, which include software enhancement costs, upon the establishment of technological feasibility, which occur upon the completion of a working model. Software development costs capitalized have not been significant.

Foreign Currency Translation and Foreign Exchange Contracts — Prior to fiscal 1999, the functional currency of our foreign subsidiaries was the U.S. dollar. Accordingly, all monetary assets and liabilities were translated at the current exchange rate at the end of the year, nonmonetary assets and liabilities were translated at historical rates and net sales and expenses were translated at average exchange rates in effect during the period. Transaction gains and losses, which are included in other income (expense) in the accompanying consolidated statements of income, have not been significant.

In the first quarter of fiscal 1999, we determined that the functional currencies of certain of our foreign subsidiaries had changed from the U.S. dollar to the local currencies. Accordingly, for fiscal 1999, assets and liabilities of our foreign subsidiaries are translated in U.S. dollars at the exchange rates in effect as of the balance sheet date, and results of operations for each subsidiary are translated using average rates in effect for the period presented. Translation adjustments have been included within shareholders' equity as part of cumulative other comprehensive loss. The effect of the change in functional currencies did not have a material impact on our consolidated financial position, results of operations or cash flow.

Foreign currency transaction gains and losses, which are included in the consolidated statements of income, have not been material in any of the three years presented. We utilize forward exchange contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets or liabilities denominated in foreign currencies. The gains or losses on these contracts are included in income as the exchange rates change. Management believes that these forward contracts do not subject us to undue risk due to foreign exchange movements because gains and losses on these contracts are offset by losses and gains on the underlying asset and transactions being hedged.

Certain Significant Risks and Uncertainties — The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

We are subject to certain risks, including without limitation, risks relating to fluctuating operating results, customer and market acceptance of new products, dependence on new products, rapid technological change, litigation, dependence on growth in the network file server market, expansion of international operations, product concentration, changing product mix, competition, management of expanding operations, dependence on high-quality components, dependence on proprietary technology, intellectual property rights, dependence on key personnel, volatility of stock price, shares eligible for future sale, effect of certain anti-takeover provisions, dilution and the Year 2000 Issue.

Concentration of Credit Risk — Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash equivalents, short-term investments and accounts receivable. Cash, cash equivalents and short-term investments consist primarily of municipal securities, cash accounts held at various banks and a money market fund held at a single financial institution. We sell our products primarily to large organizations in different industries and geographies. Credit risk is further mitigated by our credit evaluation process and limited payment terms. We do not require collateral or other security to support accounts receivable. In addition, we maintain an allowance for potential credit losses. In entering into forward foreign exchange contracts, we have assumed the risk that might arise from the possible inability of counterparties to meet the terms of their contracts. The counterparties to these contracts are major multinational commercial banks, and we do not expect any losses as a result of counterparty defaults.

Comprehensive Income — During fiscal 1999, we adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" ("SFAS 130"), which requires an enterprise to report, by major components and as a single total, the change in net assets during the period from nonowner sources. Comprehensive income for the years ended April 30, 1999, 1998 and 1997 has been disclosed within the consolidated statements of shareholders' equity and comprehensive income. Total comprehensive income was equal to net income for the years ended April 30, 1998 and 1997.

Net Income Per Share — Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for that period. Diluted net income per share is computed giving effect to all dilutive potential shares that were outstanding during the period. Dilutive potential common shares consist of incremental common shares subject to repurchase and common shares issuable upon exercise of stock options. All prior-period net income per-share amounts have been restated to reflect the two-for-one stock split which was effective December 21, 1998 (see Note 6).

The following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations for the periods presented:

Years Ended April 30	1999	1998	1997
Net Income (Numerator):			
Net Income, basic and diluted	$ 35,613	$ 20,965	$ 250
Shares (Denominator):			
Weighted average common shares outstanding	68,765	66,400	64,658
Weighted average common shares outstanding subject to repurchase	(330)	(1,486)	(3,680)
Shares used in basic computation	68,435	64,914	60,978
Weighted average common shares outstanding subject to repurchase	330	1,486	3,680
Common shares issuable upon exercise of stock options	9,166	5,502	4,146
Shares used in diluted computation	77,931	71,902	68,804
Net Income per Share:			
Basic	$ 0.52	$ 0.32	$ 0.00
Diluted	$ 0.46	$ 0.29	$ 0.00

Statements of Cash Flows — Supplemental cash flow and noncash investing and financing activities are as follows:

Years Ended April 30	1999	1998	1997
Supplemental Cash Flow Information:			
Income taxes paid	$ 7,985	$ 9,402	$ 3,809
Noncash Investing and Financing Activities:			
Deferred stock compensation	883	714	(244)
Income tax benefit from employee stock transactions	17,776	4,065	2,487
Common stock issued for IMC acquisition	—	—	7,350
Deferred stock compensation charge for IMC acquisition	—	—	3,150

Geographic Operating Information — During fiscal 1999, we adopted Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" ("SFAS 131"), which establishes annual and interim reporting standards for an enterprise's business segments and related disclosures about its products, services, geographic areas and major customers. We operate in one reportable segment (Note 8).

Stock-Based Compensation — We account for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees."

Accounting for Long-Lived Assets — We evaluate the impairment of long-lived assets, certain identifiable intangibles and goodwill related to those assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Recently Issued Accounting Standards — In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," which defines derivatives, requires that all derivatives be carried at fair value, and provides for hedging accounting when certain conditions are met. This statement is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. On a forward-looking basis, although we have not fully assessed the implications of this new statement, we do not believe adoption of this statement will have a material impact on our consolidated financial position, results of operations or cash flows.

3 COMMITMENTS

In June, July and August 1998, we executed agreements to acquire approximately 18 acres of land in Sunnyvale, California and to develop 393,000 square feet of buildings. All of our principal activities will relocate to Sunnyvale in phases beginning in June 1999. Our manufacturing and research and development facilities remain located in approximately 120,000 square feet of space in Santa Clara, California until the Sunnyvale facilities are fully completed. The Santa Clara facilities are leased under various operating leases with 100,000 square feet of space expiring in June 2000, and the remainder expiring in fiscal 2003. We lease other sales offices throughout the United States and internationally. These sales offices are also leased under operating leases which expire through fiscal 2013. We are responsible for certain maintenance costs, taxes and insurance under these leases.

In June 1998, we executed an agreement to acquire 5.9 acres of land in Sunnyvale, California and the accompanying 127,000 square foot building. Under terms of the agreement, we paid $5,500 of the $33,750 purchase price as a nonrefundable deposit. In January 1999, we assigned our rights and obligations under the agreement to a third-party entity and in exchange received back our $5,500 deposit. We subsequently entered into an operating lease for this property. Our lease payments will vary based on the LIBOR plus a spread. Our lease payments are estimated to be approximately $2,860 on an annual basis over the lease term and are included in the minimum annual lease payments schedule below. The lease is for five years and can be renewed for two five-year periods, subject to the approval of the third-party entity. At the expiration or termination of the lease, we have the option to either purchase the property for $44,000, or arrange for the sale of the property to a third party for at least $44,000 with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for an additional lease payment of approximately $36,960.

In June 1998, we signed a 25-year operating lease requiring annual lease payments of $3,084 commencing in October 1999, for a 6.2-acre plot in Sunnyvale, California and an option agreement to purchase the 6.2 acres of land. Under terms of the option agreement, we paid a $4,500 nonrefundable deposit. The option allows us to purchase the land, within a 90-day period, commencing in December 1999 at a purchase price of $23,745.

In June 1999, the agreement referred to in the preceding paragraph was amended to a 25 year and three month term commencing in July 1999. In June 1999, we assigned our rights and obligations under the agreement to a third-party entity. We subsequently entered into an operating lease for this property. Our lease payments will vary based on the LIBOR plus a spread. Our lease payments are estimated to be approximately $3,120 on an annual basis over the lease term. The lease is for five years and can be renewed for two five-year periods, subject to the approval of the third-party entity. At the expiration or termination of the lease, we have the option to either purchase the property for $48,000, or arrange for the sale of the property to a third party for at least $48,000 with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for an additional lease payment of approximately $43,912.

In August 1998, we entered into an agreement to acquire 6.0 acres of land in Sunnyvale, California and the accompanying 79,000 square foot building. Under terms of the agreement, we paid $2,500 of the $16,750 purchase price as a deposit. In May 1999, we assigned our rights and obligations under the agreement to a third-party entity and in exchange received back our $2,500 deposit. We subsequently entered into an operating lease for this property. Our lease payments will vary based on the LIBOR plus a spread. Our lease payments are estimated to be approximately $2,340 on an annual basis over the lease term. The lease is for five years and can be renewed for two five-year periods, subject to the approval of the third-party entity. At the expiration or termination of the lease, we have the option to either purchase the property for $36,000, or arrange for the sale of the property to a third party for at least $36,000 with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for an additional lease payment of approximately $32,610.

All three of the operating leases mentioned above require us to maintain specified financial covenants with which we were in compliance as of April 30, 1999.

Future minimum annual lease payments as of April 30, 1999, are as follows:

Years Ending April 30	
2000	$ 6,737
2001	4,940
2002	4,585
2003	4,046
2004	2,914
Thereafter	1,361
Total lease payments	**$ 24,583**

Rent expense was $5,963, $4,278 and $1,195 for the years ended April 30, 1999, 1998 and 1997, respectively. Rent expense under certain of our facility leases is recognized on a straight-line basis over the term of the lease. The difference between the amounts paid and the amounts expensed is classified as long-term obligations in the accompanying consolidated balance sheets.

The total of minimum rental payments to be received through fiscal 2000 under non-cancelable subleases is $373 as of April 30, 1999.

4 Acquisition

On March 17, 1997, we acquired all outstanding shares and options to purchase shares of IMC common stock by issuing 748 shares of our common stock and options to purchase shares of our common stock. The purchase price related to the common stock and options to purchase shares of our common stock was $7,350. IMC was founded in 1996 to develop and commercialize Internet/intranet proxy caching software.

Certain key employees of IMC who continued as our employees were also granted vested options to purchase shares of our common stock at a discount to the market price of our common stock immediately preceding the acquisition. In connection with the granting of discounted options to purchase our common stock, we recorded a compensation expense of $3,150 in the fourth quarter of fiscal 1997. We also recorded a deferred income tax benefit of $1,304, primarily related to the compensation charge.

The acquisition was accounted for as a purchase and, accordingly, the results of operations of IMC from the date of acquisition forward have been included in our consolidated financial statements. In connection with the acquisition, intangible assets of $8,362 were acquired, of which $7,369 was reflected as a one-time charge to operations for the write-off of purchased in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. The $10,519 combined one-time charge for purchased in-process technology and compensation expense has been reflected in our fiscal 1997 consolidated statement of income within operating expenses. The remaining intangible assets of $993, consisting of existing technology and goodwill, are included in other assets in the accompanying consolidated balance sheets and are being amortized over their estimated useful lives of five years.

In connection with the acquisition, net assets acquired were as follows:

Current assets	$ 21
Property and equipment, net	46
Intangible assets, including purchased in-process technology	8,362
Current liabilities assumed	(1,079)
Net assets acquired	**$ 7,350**

The following unaudited pro forma information shows the results of operations for fiscal 1997 as if the IMC acquisition had occurred at the beginning of fiscal 1997 and at the purchase price established in March 1997. The results are not necessarily indicative of what would have occurred had the acquisition actually been made at the beginning of fiscal 1997 or of future operations of the combined companies. The pro forma results for fiscal 1997 combine our results of operations for the fiscal year ended April 30, 1997, with the results of IMC for the period from inception (May 6, 1996) through the date of acquisition and include the $10,519 charge for purchased in-process technology and the related compensation charge, as well as the related tax benefits and the straight-line amortization of intangible assets over a period of five years.

Year Ended April 30	1997
Net Sales	$ 93,552
Net Loss	(390)
Net Loss per Share, Basic	(0.01)
Net Loss per Share, Diluted	(0.01)

5 Line of Credit

In July 1998, we negotiated a $5,000 unsecured revolving credit facility with a domestic commercial bank. Under terms of the credit facility, which expires in July 1999, we must maintain various financial covenants. Any borrowings under this agreement bear interest at either LIBOR plus 1% or at the lender's "prime" lending rate, such rate determined at our discretion. In December 1998, we drew a $2,500 letter of credit against our line of credit to facilitate requirements associated with the acquisition of land in Sunnyvale, California and the accompanying 79,000 square foot building.

We also have foreign exchange facilities used for hedging arrangements with several banks that allow us to enter into foreign exchange contracts of up to $55,000, of which $25,099 was available at April 30, 1999.

6 SHAREHOLDERS' EQUITY

Follow-on Public Offering — In March 1999, we completed a public offering of 2,875 shares of our Common Stock and received net proceeds of $138,834.

Stock Split — On December 21, 1998, the Company effected a two-for-one stock split of the outstanding shares of common stock. All share and per share amounts in these consolidated financial statements have been adjusted to give effect to the stock split.

Preferred Stock — Our Board of Directors has the authority to issue up to 5,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders.

Stock Option Plans — We adopted the 1993 Stock Option/Stock Issuance Plan (the "1993 Plan") in April 1993. In September 1995, we adopted the 1995 Stock Incentive Plan (the "1995 Plan"). The 1995 Plan replaced the 1993 Plan, and provides for the grant of options and the issuance of common stock under terms substantially the same as those provided under the 1993 Plan, except that the 1995 Plan does not allow for the exercise of options prior to vesting. Accordingly, all options and shares issued under the 1993 Plan were incorporated into the 1995 Plan upon the effectiveness of our initial public offering.

Under the 1995 Plan, the Board of Directors may grant to employees, directors and consultants options to purchase shares of our common stock. The exercise price for an incentive stock option and a nonqualified stock option cannot be less than 100% and 85%, respectively, of the fair market value of our common stock as determined by the Board of Directors on the date of grant. Options granted under the 1995 Plan generally vest at a rate of 25% on the first anniversary of the vesting commencement date and then ratably over the following 36 months. Options expire as determined by the Board of Directors, but not more than ten years after the date of grant.

In April 1997, the Board of Directors adopted the Special Non-Officer Stock Option Plan (the "Non-Officer Plan") which provides for the grant of options and the issuance of common stock under terms substantially the same as those provided under the 1995 Plan, except that the Non-Officer Plan allows only for the issuance of nonqualified options to non-officer employees.

A summary of the combined activity under our stock option plans and agreements is as follows:

	Shares Available for Grant	Outstanding Options: Number of Shares	Outstanding Options: Weighted Average Exercise Price
Balances, April 30, 1996 (392 options exercisable)	7,090	6,386	$ 2.32
Shares reserved for IMC acquisition	516	—	—
Options granted (weighted average fair value of $3.30)	(6,676)	6,676	7.42
Options exercised	—	(836)	0.83
Options canceled	948	(948)	2.68
Balances, April 30, 1997 (3,994 options exercisable)	1,878	11,278	5.42
Shares reserved for plan	8,000	—	—
Options granted (weighted average fair value of $4.56)	(5,448)	5,448	11.76
Options exercised	—	(1,240)	4.23
Options canceled	1,148	(1,148)	6.91
Balances, April 30, 1998 (5,012 options exercisable)	5,578	14,338	7.79
Shares reserved for plan	5,400	—	—
Options granted (weighted average fair value of $9.84)	(6,323)	6,323	25.14
Options exercised	—	(2,243)	6.18
Options canceled	925	(925)	10.71
Balances, April 30, 1999 (6,587 options exercisable)	**5,580**	**17,493**	**$ 14.11**

Options for the purchase of 6,177 shares of common stock were vested as of April 30, 1999. Unvested common shares issued under the 1993 plan of 69 are subject to repurchase by the company as of April 30, 1999

Additional information regarding options outstanding as of April 30, 1999, is as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at April 30, 1999	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.03 – $ 2.75	2,144	6.24	$ 1.51	2,123	$ 1.52
2.95 – 7.13	1,873	7.31	5.63	1,153	5.78
7.28 – 7.78	1,827	7.95	7.58	805	7.58
7.88 – 9.75	1,866	7.81	9.27	874	9.17
9.81 – 12.69	2,040	8.18	11.07	855	10.91
12.81 – 17.13	1,759	8.73	14.80	467	14.03
17.38 – 18.03	1,818	9.20	17.67	101	17.86
18.04 – 21.06	1,835	9.17	19.32	209	18.04
21.88 – 42.00	1,809	9.55	32.13	—	—
45.00 – 56.50	522	9.80	52.95	—	—
$ 0.03 – $56.50	17,493	8.24	$ 14.11	6,587	$ 6.90

Employee Stock Purchase Plan — Under the Employee Stock Purchase Plan, employees are entitled to purchase shares of our common stock at 85% of the fair market value at certain specified dates. Of the 1,800 shares authorized to be issued under this plan, 797 shares were available for issuance at April 30, 1999, and 273 and 402 shares were issued in fiscal 1999 and 1998, respectively, at a weighted average price of $11.21 and $4.21, respectively.

Pro Forma Information — As discussed in Note 2, we continue to account for our stock-based awards using the intrinsic value method in accordance with APB No. 25, "Accounting for Stock Issued to Employees" and its related interpretations. Accordingly, no compensation expense has been recognized in the financial statements for employee stock arrangements with the exception of $667, $270 and $85 in fiscal 1999, 1998 and 1997, respectively, which consists of the amortization of deferred stock compensation related to the granting of nonqualified stock options at exercise prices below market.

In fiscal 1999, we recorded $230 compensation expense for the fair value of options granted to an independent contractor.

SFAS 123 requires the disclosure of pro forma net income and net income per share had we adopted the fair value method as of the beginning of fiscal 1996. Under SFAS 123, the fair value of stock awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradeable, fully transferable options without vesting restrictions, which significantly differ from our stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. Our calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions:

Years Ended April 30	1999	1998	1997
Expected Life (in years)	3.07	2.94	2.90
Risk-free interest rate	5%	6%	6%
Volatility	50%	50%	50%
Expected dividend	—	—	—

Our calculations are based on a multiple option valuation approach and forfeitures are recognized as they occur. If the computed fair values of the awards issued beginning in fiscal 1996 had been amortized to expense over the vesting period of the awards, pro forma net income (loss) and net income (loss) per share would have been as follows:

Years Ended April 30	1999	1998	1997
Net income (loss)	$ 12,163	$ 8,677	$ (4,661)
Net income (loss) per share, basic	0.18	0.13	(0.08)
Net income (loss) per share, diluted	0.16	0.12	(0.07)

However, the impact of outstanding non-vested stock options granted prior to fiscal 1996 has been excluded from the pro forma calculations; accordingly, the fiscal 1999, 1998 and 1997 pro forma adjustments are not indicative of future period pro forma adjustments, when the calculation will apply to all applicable stock options.

Deferred Stock Compensation — In May 1995, we issued stock options for the purchase of 2,126 shares of common stock at $0.07 per share. We recognized $515 of deferred compensation in May 1995 equal to the difference between the option price as determined by the Board of Directors and $0.32 (the deemed fair value for financial reporting purposes) for each option. We are amortizing the deferred compensation expense ratably over the four-year period in which the options vest.

We recorded $916 and $714 of deferred compensation in fiscal 1999 and 1998, respectively, primarily related to the grant of stock options to certain highly compensated employees. Under terms of the 1995 Stock Option Plan, highly compensated employees as defined by our management are eligible to contribute between $15 to $75 in annual salary for the rights to be granted nonqualified stock options. The discount from fair market value which is equal to the amount of salary contributed has been recorded as deferred compensation expense. We are amortizing the deferred compensation expense ratably over a one-year period.

7 Income Taxes

The provision for income taxes consists of the following:

Years Ended April 30	1999	1998	1997
Current:			
Federal	$ 20,094	$ 12,132	$ 5,062
State	3,098	2,199	1,525
Foreign	3,269	—	—
Total current	26,461	14,331	6,587
Deferred:			
Federal	(4,078)	(1,597)	(2,394)
State	(1,006)	(152)	(400)
Total deferred	(5,084)	(1,749)	(2,794)
Provision for income taxes	**$ 21,377**	$ 12,582	$ 3,793

Deferred income taxes result from differences in the timing of certain expense items for tax and financial reporting purposes.

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate as follows:

Years Ended April 30	1999	1998	1997
Tax computed at federal statutory rate	$ 19,947	$ 11,741	$ 1,415
State income taxes, net of federal benefit	2,850	1,482	764
Earnings subject to foreign taxes at lower rates	(1,280)	—	—
Non-deductible acquisition charges related to the IMC acquisition	—	—	2,904
Research and experimentation credit	(1,095)	(555)	(410)
State credits	(707)	—	—
Benefit of foreign sales corporation	(142)	(489)	(105)
Tax exempt interest	(547)	(281)	(184)
Change in valuation allowance	—	—	(673)
Business meal exclusion	156	100	45
Other	2,195	584	37
Provision for income taxes	**$ 21,377**	$ 12,582	$ 3,793

The income tax benefits associated with dispositions from employee stock transactions reduced taxes currently payable by $17,776, $4,291 and $2,487, respectively, for fiscal 1999, 1998 and 1997.

Income before income taxes is as follows:

Years Ended April 30	1999	1998	1997
Domestic	$ 45,617	$ 33,175	$ 3,983
Foreign	11,373	372	60
Total	$ 56,990	$ 33,547	$ 4,043

Current net deferred tax assets are $10,134 and $5,280, as of April 30, 1999, and April 30, 1998, respectively. Non-current net deferred tax assets at April 30, 1999 and 1998 of $1,593 and $1,363, respectively, are included in other assets within the accompanying consolidated balance sheets.

The components of our net deferred tax assets are as follows:

Years Ended April 30	1999	1998
Reserve and accruals not deductible for tax purposes	$ 7,774	$ 4,599
Research and development credits, Federal & State	2,227	—
Tax benefit of options issued in IMC acquisition	913	1,074
Depreciation	585	197
Deferred rent	37	66
Other	191	707
Deferred tax assets	$ 11,727	$ 6,643

As of April 30, 1999, we had federal and state research and development credit carryforwards of approximately $2,227 available to offset future taxable income. These carryforwards expire in various years through 2019.

8 Segment, Geographic and Customer Information

We adopted SFAS 131 at April 30, 1999. SFAS 131 establishes annual and interim reporting standards for an enterprise's operating segments and related disclosures about its products, services, geographic areas and major customers. Under SFAS 131, we operate in one reportable industry segment: the design, manufacturing and marketing of high-performance network attached data storage and access devices. For the years ended April 30, 1999, 1998 and 1997, we recorded revenue from customers throughout the United States and Canada; Europe; Latin America, Australia and Asia Pacific.

The following presents net sales for the years ended April 30, 1999, 1998, and 1997 by geographic area and long-lived assets as of April 30, 1999 and 1998, by geographic area.

Years Ended April 30	1999	1998	1997
Net Sales:			
United States	$ 200,627	$ 125,108	$ 76,018
International	88,793	41,055	17,315
Total net sales	**$ 289,420**	$ 166,163	$ 93,333
Long-lived Assets:			
United States	$ 29,198	$ 15,982	
International	1,803	815	
Total assets	**$ 31,001**	$ 16,797	

Net sales above are attributed to regions based on where products are shipped to.

International sales include export sales primarily to Germany, United Kingdom, Japan, France, Sweden, Canada and Australia. No single foreign country accounted for 10% or more of net sales in fiscal 1999, 1998 and 1997.

No customer accounted for 10% or more of net sales in fiscal 1999, 1998 or in fiscal 1997.

9 LITIGATION

The computer industry is characterized by frequent litigation regarding intellectual property rights. During fiscal 1995 a lawsuit of this nature was filed against us and two of our shareholders (the "Whipsaw Litigation"). During fiscal 1997, we settled the Whipsaw litigation and recorded a pre-tax expense of $4,300 ($3,500 in payments to the plaintiffs and $800 in legal fees). In connection with the settlement, the Whipsaw group released us from all liabilities. We deny any wrongdoing on our part or on the part of the founder.

10 FINANCIAL INSTRUMENTS FAIR VALUE DISCLOSURE

The following disclosures are made in accordance with the provisions of Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments" ("SFAS 107"), which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate the value. Fair value is defined in SFAS 107 as the amount at which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. None of the financial instruments are held or issued for trading purposes.

At April 30, 1999, we had $29,638 of outstanding foreign exchange contracts in British Pounds and European Currency Units. These foreign exchange contracts are adjusted to the fair value at the end of every month. There were no foreign exchange contracts in the prior year. Unrealized gains or losses on foreign exchange contracts were not significant at April 30, 1999. Other than foreign exchange contracts, we have not entered into any other material financial derivative instruments.

The fair values of cash and cash equivalents and short-term investments reported in the balance sheets approximate their carrying value. The fair value of short-term investments and foreign exchange contracts is based on quoted market value.

11 EMPLOYEE BENEFIT PLAN

We have established a 401(k) tax-deferred savings plan ("Savings Plan"). Employees meeting the eligibility requirements, as defined, may contribute specified percentages of their salaries. We contributed $314, $202 and $119 for fiscal 1999, 1998 and 1997, respectively.

12 SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Year Ended April 30, 1999	Q1	Q2	Q3	Q4
Net sales	$ 57,375	$ 65,625	$ 75,616	$ 90,804
Gross margin	34,136	38,744	44,798	53,622
Net income	7,097	8,376	9,394	10,746
Net income per share, basic	0.11	0.12	0.14	0.15
Net income per share, diluted	0.10	0.11	0.12	0.13

Year Ended April 30, 1998	Q1	Q2	Q3	Q4
Net sales	$ 33,420	$ 38,401	$ 43,984	$ 50,358
Gross margin	19,850	22,655	26,104	30,005
Net income	4,221	4,885	5,555	6,304
Net income per share, basic	0.07	0.08	0.08	0.10
Net income per share, diluted	0.06	0.07	0.08	0.09

STOCK PRICES AND DIVIDEND POLICY

	Fiscal 1999		Fiscal 1998	
	High	Low	High	Low
First Quarter	$ 25.13	$ 16.56	$ 10.25	$ 7.00
Second Quarter	30.22	17.38	14.16	9.94
Third Quarter	55.50	27.38	17.75	12.06
Fourth Quarter	63.50	39.63	18.13	13.66

Our common stock commenced trading on the Nasdaq National Market on November 21, 1995 and is traded under the symbol "NTAP." As of May 28, 1999, there were 334 holders of record of the common stock. The table above sets forth for the periods indicated the high and low closing sale prices for our common stock as reported on the Nasdaq National Market, adjusted to reflect the effect of the December 21, 1998, two-for-one stock split.

We believe that a number of factors may cause the market price of our common stock to fluctuate significantly. See "Factors Affecting Operating Results."

We have never paid cash dividends on our capital stock. We currently anticipate retaining all available funds, if any, to finance internal growth and product development. Payment of dividends in the future will depend upon our earnings and financial condition and such other factors as the directors may consider or deem appropriate at the time.

Directors

Donald Valentine (Chairman)
Founder
Sequoia Capital

Sanjiv Ahuja
President and Chief Operating Officer
Telcordia Technologies, Inc.

Carol Bartz
Chairman, Chief Executive Officer
Autodesk, Inc.

Larry Carter
Senior Vice President Finance
and Chief Financial Officer
(Principal Financial and Accounting Officer)
Cisco Systems, Inc.

Michael Hallman
President
The Hallman Group

Robert Wall
President
On Point Developments, LLC

Daniel Warmenhoven
President and Chief Executive Officer
Network Appliance, Inc.

Corporate Officers

Daniel Warmenhoven
President and Chief Executive Officer

Jeffry Allen
Senior Vice President, Finance and Operations
Chief Financial Officer and Secretary

Helen Bradley
Senior Vice President, Engineering

Thomas Mendoza
Senior Vice President, Worldwide Sales and Marketing

Charles Simmons
Vice President, Corporate Development

Other Vice Presidents

Mark Jon Bluth
Vice President, Manufacturing Operations

Christabel Carlton
Vice President, Human Resources

Dave Hitz
Vice President and Founder

Steven Kleiman
Vice President, Research

Scot Klimke
Vice President, Information Technology and
Chief Information Officer

Larry Kubo
Vice President, Marketing

Chris Liotta
Vice President, Customer Satisfaction

James Lau
Vice President,
Chief Technical Officer and Founder

Mark Santora
Vice President, North American Sales

Transfer Agent and Registrar

The Harris Trust and Savings Bank
Chicago, Illinois

Independent Auditors

Deloitte & Touche LLP
San Jose, California

Annual Meeting

The Annual Meeting of Shareholders will take place at 3:00 p.m. local time on Tuesday, October 26, 1999, at the Company's headquarters.

SEC Form 10-K

If you would like a copy of our Annual Report on Form 10-K, filed with the Securities and Exchange Commission, you may obtain it without charge. Please direct your request to:

Network Appliance, Inc.
Attn: Investor Relations
495 East Java Drive
Sunnyvale, CA 94089

Or, fill in a request on the World Wide Web:
www.netapp.com/IR/

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