

SIMLETECH INC
Form 10-Q
November 13, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2001

or

o TRANSITION REPORT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 000-31623

SIMLETECH, INC.

(Exact name of Registrant as specified in its charter)

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CALIFORNIA

(State or other jurisdiction of incorporation or organization)

33-0399154

(I.R.S. Employer Identification No.)

3001 Daimler Street

Santa Ana, CA

(Address of principal executive offices)

92705-5812

(Zip Code)

(949) 476-1180

(Registrant's telephone number, including area code)

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

The number of shares outstanding of the Registrant's common stock, par value \$0.001, as of September 30, 2001 was 38,254,198.

SIMLETECH, INC.

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QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001**

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Except as otherwise noted in this report, SimpleTech, the Company, we, us and our collectively refer to SimpleTech, Inc.

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements**

SimpleTech, Inc.

Consolidated Balance Sheets

(in thousands, except share amounts)

(unaudited)

| | September 30, 2001 | December 31, 2000 |
|---|-------------------------------|------------------------------|
| ASSETS: | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 45,786 | \$ 33,747 |
| Accounts receivable, net of allowances of \$1,040 at September 30, 2001 and \$972 at December 31, 2000 | 13,312 | 28,103 |
| Inventory, net | 8,595 | 31,052 |
| Deferred income taxes | 2,060 | 2,060 |
| Other current assets | 3,971 | 1,069 |
| Total current assets | 73,724 | 96,031 |
| Furniture, fixtures and equipment, net | 8,642 | 6,926 |
| Deferred income taxes | 329 | 329 |
| Total assets | \$ 82,695 | \$ 103,286 |
| LIABILITIES AND SHAREHOLDERS' EQUITY: | | |
| Current Liabilities: | | |
| Accounts payable | \$ 5,871 | \$ 25,950 |
| Current maturities of long-term debt | 811 | 761 |
| Current maturities of capital lease obligations | 487 | 801 |
| Accrued and other liabilities | 2,755 | 4,219 |
| Total current liabilities | 9,924 | 31,731 |
| Long-term debt | 468 | 1,083 |
| Capital lease obligations | 227 | 560 |
| Total liabilities | 10,619 | 33,374 |
| Shareholders' Equity: | | |
| Preferred stock, \$0.001 par value, 20,000,000 shares authorized, no shares issued and outstanding | --- | --- |
| Common stock, \$0.001 par value, 100,000,000 shares authorized, 38,254,198 shares issued and outstanding as of September 30, 2001; 37,572,667 shares issued and outstanding as of December 31, 2000 | 38 | 38 |

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| | | | | |
|--|----|--------|----|---------|
| Additional paid-in capital | | 64,857 | | 63,911 |
| Unearned stock-based compensation | | (26) | | (63) |
| Retained earnings | | 7,207 | | 6,026 |
| Total shareholders' equity | | 72,076 | | 69,912 |
| Total liabilities and shareholders' equity | \$ | 82,695 | \$ | 103,286 |

See accompanying notes to unaudited consolidated financial statements.

SimpleTech, Inc.

Consolidated Statements of Operations

(in thousands, except per share amounts)

(unaudited)

| | Three Months | | Nine Months | |
|---|----------------------------|-------------|----------------------------|-------------|
| | Ended September 30, | | Ended September 30, | |
| | 2001 | 2000 | 2001 | 2000 |
| Net revenues | \$ 33,177 | \$ 84,709 | \$ 128,660 | \$ 217,356 |
| Cost of revenues | 27,526 | 66,409 | 101,928 | 169,646 |
| Gross profit | 5,651 | 18,300 | 26,732 | 47,710 |
| Sales and marketing | 4,057 | 5,312 | 13,962 | 14,773 |
| General and administrative | 2,354 | 2,394 | 8,707 | 8,659 |
| Research and development | 984 | 1,069 | 3,247 | 2,582 |
| Non-recurring expense | - | 1,885 | - | 1,885 |
| Total operating expenses | 7,395 | 10,660 | 25,916 | 27,899 |
| Income (loss) from operations | (1,744) | 7,640 | 816 | 19,811 |
| Interest expense | 46 | 666 | 163 | 1,471 |
| Interest income | (392) | (1) | (1,306) | (1) |
| Income (loss) before provision (benefit) for income taxes | (1,398) | 6,975 | 1,959 | 18,341 |
| Provision (benefit) for income taxes | (555) | (1,251) | 778 | (1,076) |
| Net income (loss) | \$ (843) | \$ 8,226 | \$ 1,181 | \$ 19,417 |
| Pro forma data: | | | | |
| Income before provision for income taxes | \$ | 6,975 | \$ | 18,341 |
| Provision for income taxes | | 2,651 | | 6,970 |
| Pro forma net income | \$ | 4,324 | \$ | 11,371 |
| Net income (loss) per share (pro forma in 2000): | | | | |
| Basic | \$ (0.02) | \$ 0.14 | \$ 0.03 | \$ 0.37 |
| Diluted | \$ (0.02) | \$ 0.13 | \$ 0.03 | \$ 0.34 |
| Weighted average shares outstanding: | | | | |
| Basic | 38,302 | 30,759 | 38,080 | 30,654 |
| Diluted | 38,302 | 33,768 | 39,462 | 33,531 |

See accompanying notes to unaudited consolidated financial statements.

SimpleTech, Inc.

Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

| | Nine Months Ended September 30, | |
|---|--|-------------|
| | 2001 | 2000 |
| Cash flow from operating activities: | | |
| Net income | \$ 1,181 | \$ 19,417 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,614 | 2,106 |
| Loss on sale of furniture, fixtures and equipment | 11 | 1 |
| Accounts receivable provision | 1,945 | 675 |
| Inventory excess and obsolescence expense | 1,898 | 715 |
| Deferred income taxes | - | (1,354) |
| Compensation related to stock options vesting | 37 | 67 |
| Foreign currency translation adjustment | - | 97 |
| Change in operating assets and liabilities: | | |
| Accounts receivable | 12,846 | (6,295) |
| Inventory | 20,559 | (23,953) |
| Other assets | (2,902) | (383) |
| Accounts payable | (20,079) | 8,009 |
| Accrued and other liabilities | (1,464) | 3,071 |
| Net cash provided by operating activities | 16,646 | 2,173 |
| Cash flows from investing activities: | | |
| Purchase of furniture, fixtures and equipment | (4,589) | (1,725) |
| Proceeds from sale of furniture, fixtures and equipment | 248 | 228 |
| Net cash used in investing activities | (4,341) | (1,497) |
| Cash flows from financing activities: | | |
| Deferred offering costs | - | (1,615) |
| Borrowings under line of credit, net | - | 7,605 |
| Repayment of borrowings from banks | (565) | (517) |
| Payment on capital lease obligations | (647) | (693) |
| Repayment of loans to related parties, net | - | 40 |
| Distributions to shareholders | - | (9,891) |
| Stock repurchase | (94) | - |
| Proceeds from exercise of stock options | 1,040 | 672 |
| Net cash used in financing activities | (266) | (4,399) |

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| | | | | |
|--|----|--------|----|---------|
| Net increase (decrease) in cash | | 12,039 | | (3,723) |
| Cash and cash equivalents at beginning of period | | 33,747 | | 3,779 |
| Cash and cash equivalents at end of period | \$ | 45,786 | \$ | 56 |
| Supplemental Schedule of noncash activities: | | | | |
| Issuance of common stock for IPO proceeds receivable | \$ | - | \$ | 65,104 |
| Declaration of dividend payable | \$ | - | \$ | 25,148 |

See accompanying notes to unaudited consolidated financial statements.

SIMPLETECH, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 - Basis of Presentation

The accompanying interim consolidated financial statements of SimpleTech, Inc., a California corporation (the Company), are unaudited and have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal and recurring accruals) considered necessary for a fair presentation of the consolidated financial position of the Company at September 30, 2001, the consolidated results of operations for the three and nine months ended September 30, 2001 and 2000, and the consolidated statements of cash flows for the nine months ended September 30, 2001 and 2000, have been included. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the Annual Report on Form 10-K filed with the SEC. The December 31, 2000 balances reported herein are derived from the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2000. The results for the interim periods are not necessarily indicative of results to be expected for the full fiscal year.

The consolidated financial statements of the Company include the accounts of the Company's subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Note 2 - Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities (e.g., bad debt reserves and inventory reserves), 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.

Note 3 - Net Income Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to additionally reflect the effect of potentially dilutive securities. For the quarter ended September 30, 2000, and the nine months ended September 30, 2001 and 2000, potentially dilutive securities consisted solely of options and resulted in potential common shares of 3,009,091, 1,382,077 and 2,876,496, respectively. No potential common shares were included in the diluted per share amount for the three months ended September 30, 2001, as the effect would have been anti-dilutive due to the net loss.

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For the three and nine months ended September 30, 2000, pro forma net income was computed using an effective tax rate of 38% to reflect the estimated income tax expense of the Company as if it had been subject to C corporation federal and state income taxes for the period, instead of S corporation income taxes.

Note 4 - Supplemental Balance Sheet Information

Inventory consists of the following:

| (In thousands) | | September 30, 2001 | | December 31, 2000 |
|-------------------------------------|----|--------------------|----|-------------------|
| Raw materials | \$ | 6,101 | \$ | 24,768 |
| Work-in-progress | | 407 | | 759 |
| Finished goods | | 5,249 | | 9,652 |
| | | 11,757 | | 35,179 |
| Reserve for excess and obsolescence | | (3,162) | | (4,127) |
| Inventory, net | \$ | 8,595 | \$ | 31,052 |

Furniture, fixtures and equipment consist of the following:

| (In thousands) | September 30, 2001 | | December 31, 2000 | |
|--|--------------------|----------|-------------------|----------|
| Furniture and fixtures | \$ | 299 | \$ | 294 |
| Equipment | | 20,883 | | 16,769 |
| | | 21,182 | | 17,063 |
| Accumulated depreciation | | (12,540) | | (10,137) |
| Furniture, fixtures and equipment, net | \$ | 8,642 | \$ | 6,926 |

Note 5 DPAC Technologies, Inc. Litigation

On February 7, 2001, the Court ruled on pending summary judgment motions in the lawsuit the Company filed in September 1998 against DPAC Technologies, Inc, formerly Dense-Pac Microsystems, Inc. In this lawsuit filed in Federal Court in Santa Ana, the Company alleged that DPAC Technologies infringed the Company's IC Tower stacking patent, U.S. Patent No. 5,514,907. DPAC Technologies counterclaimed for infringement of its stacking patent, U.S. Patent No. 4,956,694. The Company sought damages and an injunction against infringement of its patent by DPAC Technologies. DPAC Technologies denied the infringement and asserted a defense of patent invalidity and a counterclaim against the Company alleging infringement of its stacking patent.

In the Court's summary judgment rulings, the Court found non-infringement by DPAC Technologies as to the Company's patent and non-infringement by the Company as to DPAC Technologies' patent. The Company has appealed the adverse summary judgment ruling to U.S. Court of Appeals for the Federal Circuit in Washington, D.C. DPAC Technologies has not appealed the Court's ruling that the Company did not infringe the DPAC Technologies patent, and that ruling is now final.

On February 21, 2001, the Company filed a new lawsuit against DPAC Technologies in Federal Court in Santa Ana for infringement of its IC Tower stacking patent, U.S. Patent No. Re. 36,916 (a reissue of U.S. Patent No. 5,514,907 referenced above). The Company is seeking damages, an injunction against further infringement, and related costs. DPAC Technologies filed its answer on March 13, 2001, denying infringement, asserting a defense of patent invalidity, and alleging technology misappropriation by the Company. Trial has been set for October 22, 2002.

Note 6 Segment Information:

The Company designs, manufactures and markets a comprehensive line of memory, storage and connectivity products used in high performance computing, networking and communications, consumer electronics and industrial applications. The Company provides technology solutions for two reportable operating segments, Industrial (formerly termed Original Equipment Manufacturer or OEM) and Commercial (formerly termed Aftermarket), based on DRAM, SRAM and Flash memory technologies.

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Beginning in 1999, after completion of management information system enhancements, the Company used net sales and gross profit as the basis for evaluating the performance of its operating segments. The Company does not allocate operating expenses, interest or income taxes to operating segments. Due to the similarity of products manufactured for customers within each operating segment, the Company does not maintain separate records to identify assets by operating segment.

Summarized financial information regarding the Company's reportable segments is shown in the following table:

| (in thousands) | Three Months Ended September 30, 2001 | | | Three Months Ended September 30, 2000 | | |
|------------------|--|------------|--------------|--|------------|--------------|
| | Industrial | Commercial | Consolidated | Industrial | Commercial | Consolidated |
| Net revenues | \$ 9,561 | \$ 23,616 | \$ 33,177 | \$ 41,817 | \$ 42,892 | \$ 84,709 |
| Cost of revenues | 8,559 | 18,967 | 27,526 | 31,492 | 34,917 | 66,409 |
| Gross profit | \$ 1,002 | \$ 4,649 | \$ 5,651 | \$ 10,325 | \$ 7,975 | \$ 18,300 |

| | Nine Months Ended September 30, 2001 | | | Nine Months Ended September 30, 2000 | | |
|------------------|---|------------|--------------|---|------------|--------------|
| | Industrial | Commercial | Consolidated | Industrial | Commercial | Consolidated |
| Net revenues | \$ 42,186 | \$ 86,474 | \$ 128,660 | \$ 89,507 | \$ 127,849 | \$ 217,356 |
| Cost of revenues | 30,245 | 71,683 | 101,928 | 65,646 | 104,000 | 169,646 |
| Gross profit | \$ 11,941 | \$ 14,791 | \$ 26,732 | \$ 23,861 | \$ 23,849 | \$ 47,710 |

For the three months ended September 30, 2001 and 2000, and the nine months ended September 30, 2001 and 2000, international sales comprised 15.5%, 11.7%, 16.0% and 14.3% of the Company's revenues, respectively. During these periods, no single foreign country accounted for more than 10.0% of total revenues. All international sales during these periods were shipped domestically to the Company's foreign customers.

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

Cautionary Statement

Certain statements in this report, including statements regarding the Company's strategy, financial performance and revenue sources, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and are subject to the safe harbors created by those sections. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled "Risk Factors" set forth in this Form 10-Q and similar information in filings with the Securities and Exchange Commission made from time to time, including, but not limited to, other quarterly reports on Form 10-Q and our Annual Report on Form 10-K, discuss some of the important risk factors that may affect our business, results of operations and financial condition.

The following discussion should be read in conjunction with the Company's consolidated financial statements and notes thereto.

Overview

Incorporated in 1990, SimpleTech designs, manufactures and markets a comprehensive line of memory, storage and connectivity products used in high performance computing, networking and communications, consumer electronics and industrial applications. Our memory and storage products are based on dynamic random access memory, or DRAM, static random access memory, or SRAM, and Flash memory technologies. In addition, we offer a line of high-density memory products using our three-dimensional IC Tower stacking technology that allows multiple memory chips to be stacked together to increase the capabilities of memory modules without increasing the product footprint.

We provide technology solutions for two operating segments, Industrial (formerly termed Original Equipment Manufacturer or OEM) and Commercial (formerly termed Aftermarket). We sell our products to Commercial customers through our value added reseller (VAR), mail order and retail channels. We do not allocate operating expenses, interest or income taxes to operating segments. Due to the similarity of products manufactured for our customers within each operating segment, we do not maintain separate records to identify assets by operating segment.

From 1999 to 2000, combined Industrial and Commercial operating segment revenues grew 60.1% due primarily to increased Flash memory and IC Tower stacking product sales. Industrial customer revenues grew 190.7% from 1999 to 2000 due to strong growth in sales of Flash drives and IC Tower stacking products to Industrial customers in the networking and communication industries. Retail channel revenues increased 70.5% due to increased focus on this sales channel and an increase in demand for Flash cards used in consumer applications. During 1999, we aggressively expanded our presence in the VAR channel, experienced rapid growth in sales through the mail order channel and penetrated the retail channel with customers such as Best Buy and Costco Wholesale.

Historically, a relatively small number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 57.2% of our total revenues in the first nine months of 2001 and 53.9% of our total revenues in the first nine months of 2000. Our ten largest Industrial customers accounted for an aggregate of 73.8% of our Industrial revenues or 24.2% of our total revenues in the first nine months of 2001 and 79.7% of our Industrial revenues or 32.8% of our total revenues in the first nine months of 2000. Our largest Industrial customer in the first nine months of 2001, Unisys, accounted for 40.5% of our Industrial revenues or 13.3% of our total revenues. Our largest Industrial customer in the first nine months of 2000, Cisco Systems, accounted for 24.3% of our Industrial revenues or 10.0% of our total revenues. Our ten largest Commercial customers accounted for an aggregate of 61.3% of our Commercial revenues or 41.2% of our total revenues in the first nine months of 2001 and 51.4% of our Commercial revenues or 30.2% of our total revenues in the first nine months of 2000. Our largest Commercial customer, CDW Computer Centers, accounted for 29.2% of our Commercial revenues or 19.6% of our total revenues in the first nine months of 2001 and 31.4% of our Commercial revenues or 18.5% of our total revenues in the first nine months of 2000. Other than Unisys, Cisco Systems and CDW Computer Centers, no customer accounted for more than 10.0% of our total revenues in the first nine months of 2001 or 2000. The composition of our major customer base changes from quarter to quarter as market conditions fluctuate and we expect this variability will continue in the future. We expect that sales of our products to a small number of customers will continue to contribute materially to our revenues in the foreseeable future and believe that our financial results will depend in significant part upon the success of our customers' business.

International sales of our products constituted 16.0% of our revenues for first nine months of 2001 and 14.3% of our revenues in the first nine months of 2000. No single foreign country accounted for more than 10.0% of our revenues in the first nine months of 2001 or 2000. During the first nine months of 2001 and 2000, over 95.0% of our international sales were denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive, which could result in a reduction of sales in a particular country. In addition, we purchase substantially all of the integrated circuit (IC) components used in our products from local distributors of Japanese, Korean and Taiwanese suppliers. Although our purchases of IC components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of IC components. Our international sales also could be adversely affected by risks including regulatory risks, tariffs and other trade barriers.

In the past we have been impacted by seasonal purchasing patterns resulting in higher sales in the third and fourth quarters of each calendar year. Our ability to adjust our short-term operating expenses in response to fluctuations in revenues is limited. As a result, if revenues are lower than expected in any given period, our results of operations could be harmed.

Substantially all of our revenues are recognized at the time of shipment. A majority of our sales through Commercial channels include limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. We have had to write down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were approximately \$1.9 million for the first nine months of 2001 and \$715,000 in the first nine months of 2000. The increase in inventory write-downs resulted from significant declines in the price of DRAM and Flash components from the fourth quarter of 2000 through the third quarter of 2001. In addition, we offer some of our Commercial customers limited price protection rights for inventories of our products held by them. If we reduce the list price of our products, these customers may receive credits from us. We incurred price protection charges of approximately \$1.3 million in the first nine months of 2001 and \$413,000 in the first nine months of 2000. Price protection charges increased in the first nine months of 2001 due primarily to increased component price volatility and an expansion of retail sales, which are subject to price protection charges.

From formation in March 1990 to September 26, 2000, we elected for federal and state income tax purposes to be treated as an S corporation under Subchapter S of the Internal Revenue Code. Under this election, our shareholders, rather than SimpleTech, were subject to federal income taxes on their respective share of our taxable income. We also had elected similar treatment for California franchise tax purposes which, in addition, requires a state income tax at our level of 1.5%. On September 26, 2000, we terminated our Subchapter S election. Subsequent to the termination, we are required to pay federal and state corporate-level income taxes.

Results of Operations - Comparison of the third quarter of 2001 to the third quarter of 2000

Net Revenues. Our revenues were \$33.2 million in the third quarter of 2001 compared to \$84.7 million in the same period in 2000. Sales of Flash and IC Tower stacking products accounted for 29.0% of total revenues in the third quarter of 2001, compared to 43.7% in the same period in 2000. This decline resulted from a decreased concentration of Industrial segment revenues, which are typically comprised of a significantly higher mix of Flash and IC Tower stacking products. Industrial segment revenues declined from 49.4% of total revenues in the third quarter of 2000 to 28.8% of total revenue in the third quarter of 2001. Total revenues declined due primarily to a decrease in average sales price from \$146 in the third quarter of 2000 to \$50 in the third quarter of 2001, partially offset by an increase in unit volume of 15.1%. The decrease in our average sales price resulted from significant declines in DRAM and Flash component prices from late 2000 through the third quarter of 2001. We experienced unit volume increases of 71.1% for standard memory products and 7.7% for Flash products, offset partially by unit volume decreases of 89.4% for IC Tower stacking products and 77.3% for non-DRAM, non-Flash products such as SRAM, hard drive upgrade kits and connectivity products. The increase in unit shipments resulted primarily from the expansion of our retail channel market share. We have approximately doubled our retail store presence in the past year. The mix of products sold and sales channels varies from quarter to quarter and may vary in the future, affecting our overall average sales prices and gross margins.

Our Industrial segment revenues declined 77.0% from \$41.8 million in the third quarter of 2000 to \$9.6 million in the third quarter of 2001. The decrease in revenues resulted primarily from a 76.9% reduction in unit volume. Our Commercial segment revenues declined 45.0% from \$42.9 million in the third quarter of 2000 to \$23.6 million in the third quarter of 2001. Commercial revenues declined primarily due to a decrease in average sales price from \$107 in the third quarter of 2000 to \$38 in the third quarter of 2001, partially offset by an increase in unit volume of 56.7%. The decrease in average sales price for both our Industrial and Commercial segments resulted from significant declines in DRAM and Flash component prices from late 2000 through the third quarter of 2001. In the third quarter of 2001, Commercial segment revenues were also negatively impacted by the September 11, 2001 terrorist attacks on the United States. The attacks resulted in significantly lower demand for our consumer products in the two weeks following September 11th, which caused reduced revenues and earnings in the quarter.

Our combined backlog was \$5.1 million as of September 30, 2001, consisting of \$4.0 million for the Industrial segment and \$1.1 million for the Commercial segment. Our combined backlog was \$48.8 million as of September 30, 2000, consisting of \$46.7 million for the Industrial segment and \$2.1 million for the Commercial segment. The decrease in Industrial segment backlog between these periods was due primarily to the push out and cancellation of orders by our Industrial customers in the networking and communication industries as a result of a global economic slowdown and a build-up of their inventory levels. Commercial segment backlog is typically nominal since substantially all Commercial customer orders are filled on a same day or next day basis. We include in our backlog only those customer orders for which we have accepted purchase orders and to which we have assigned shipment dates within the upcoming nine months. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues.

Gross Profit. Our gross profit was \$5.7 million in the third quarter of 2001, compared to \$18.3 million in the same period in 2000. Gross profit declined due primarily to the overall decrease in revenues, an inventory write-down of approximately \$980,000 during the quarter and the impact of the September 11, 2001 terrorist attacks on the United

States. Gross profit as a percentage of revenues was 17.2% in the third quarter of 2001, compared to 21.6% in the same period in 2000. Gross profit as a percentage of revenues for our Industrial segment was 10.5% in the third quarter of 2001, compared to 24.7% in the third quarter of 2000. The decline in gross profit as a percentage of revenues for our Industrial segment in the third quarter of 2001 resulted from pricing concessions made in order to sell through stale Industrial inventory. We expect gross profit as a percentage of revenues for our Industrial segment to return to normalcy in future quarters. Gross profit as a percentage of revenues for our Commercial segment increased from 18.6% in the third quarter of 2000 to 19.7% in the third quarter of 2001.

Sales and Marketing. Sales and marketing expenses are comprised primarily of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers' representatives, shipping costs and marketing programs. Sales and marketing expenses were \$4.1 million in the third quarter of 2001, compared to \$5.3 million in the same period in 2000. Sales and marketing expenses decreased during this period due primarily to a decrease in commission expense. Sales and marketing expenses as a percentage of revenues were 12.3% in the third quarter of 2001, compared to 6.3% in the same period in 2000. The increase in sales and marketing expenses as a percentage of revenues resulted primarily from reduced revenues.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were flat at \$2.4 million in both the third quarters of 2001 and 2000. General and administrative expenses as a percentage of revenues were 7.2% in the third quarter of 2001, compared to 2.8% in the same period in 2000. The increase in general and administrative expenses as a percentage of revenues resulted primarily from reduced revenues.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were \$1.0 million in the third quarter of 2001, compared to \$1.1 million in the same period in 2000. Research and development expenses as a percentage of revenues were 3.0% in the third quarter of 2001, compared to 1.3% in the same period in 2000. The increase in research and development expenses as a percentage of revenues resulted primarily from reduced revenues.

Non-Recurring Expenses. Non-recurring expenses were comprised of a \$1.9 million litigation settlement reached in the third quarter of 2000 with Interactive Flight Technologies, Inc. There were no litigation settlement charges in the third quarter of 2001.

Interest Expense and Income. Interest expense is comprised of interest related to our line of credit and equipment financing. Interest expense was \$46,000 in the third quarter of 2001, compared to \$666,000 in the same period in 2000. The decrease in interest expense in the third quarter of 2001 resulted from the pay down of our line of credit to zero in October 2000. Interest income was \$392,000 in the third quarter of 2001, compared to \$1,000 in the same period in 2000. This increase in interest income in the third quarter of 2001 resulted from the investment of cash received in October 2000 from our initial public offering.

Pro Forma Provision for Income Taxes. From our formation in March 1990 to September 26, 2000, we elected for federal and state income tax purposes to be treated as an S corporation under Subchapter S of the Internal Revenue Code. Under this election, our shareholders, rather than SimpleTech, were subject to federal income taxes on their respective share of our taxable income. We also had elected similar treatment for California franchise tax purposes which, in addition, requires a state income tax at our level of 1.5%. On September 26, 2000, we terminated our Subchapter S election. Subsequent to the termination, we are required to pay federal and state corporate-level income taxes.

Net loss. Net loss was \$843,000 in the third quarter of 2001. The September 11, 2001 terrorist attacks on the United States had a negative impact on our earnings in the third quarter of 2001, causing significantly reduced consumer demand for our products in the two weeks following the attacks. Assuming the termination of our S corporation status, pro forma net income would have been \$4.3 million in the third quarter of 2000.

Results of Operations - Comparison of the first nine months of 2001 to the first nine months of 2000

Net Revenues. Our revenues were \$128.7 million in the first nine months of 2001, compared to \$217.4 million in the same period in 2000. Sales of Flash and IC Tower stacking products accounted for 33.2% of our revenues in the first nine months of 2001, compared to 37.2% in the same period in 2000. Revenues decreased due to a decline in average sales price from \$120 in the first nine months of 2000 to \$66 in the first nine months of 2001, which was partially offset by a 7.8% unit volume increase. The decrease in our average sales price resulted from significant declines in DRAM and Flash component prices from late 2000 through the third quarter of 2001. We experienced unit volume increases of 28.8% for standard memory products and 8.9% for Flash products, partially offset by decreases of 69.4% for IC Tower stacking products and 43.0% for non-DRAM, non-Flash products such as SRAM, hard drive upgrade kits and connectivity products. The mix of products sold varies from period to period and may vary in the future, affecting our overall average sales prices and gross margins.

Our Industrial segment revenues decreased 52.8% from \$89.5 million in the first nine months of 2000 to \$42.2 million in the first nine months of 2001. The decrease in revenues resulted primarily from a 51.1% reduction in unit volume. The decline in product shipments resulted primarily from a build-up of excess inventory by our Industrial customers in the second half of 2000. Our Commercial segment revenues declined 32.3% from \$127.8 million in the first nine months of 2000 to \$86.5 million in the first nine months of 2001. Commercial revenues declined due to a reduction in average sales price from \$95 in the first nine months of 2000 to \$50 in the first nine months of 2001, offset by an increase in unit volume of 28.1%. The decrease in average sales price for our Commercial segment revenues resulted from significant declines in DRAM and Flash component prices from late 2000 through the third quarter of 2001.

Gross Profit. Our gross profit was \$26.7 million in the first nine months of 2001, compared to \$47.7 million in the same period in 2000. Gross profit as a percentage of revenues decreased from 21.9% in the first nine months of 2000 to 20.7% in the first nine months of 2001. Gross profit as a percentage of revenues for our Industrial segment was 28.3% in the first nine months of 2001, compared to 26.7% in the same period in 2000. This increase in gross profit as a percentage of revenues for our Industrial segment resulted from shift in mix toward higher margin product lines. Gross profit as a percentage of revenues for our Commercial segment decreased from 18.7% in the first nine months of 2000 to 17.1% in the first nine months of 2001. The decrease in gross profit as a percentage of revenues for our Commercial segment resulted primarily from relatively flat fixed production expenses versus reduced revenues and inventory write-downs recorded during the period.

Sales and Marketing. Sales and marketing expenses are comprised primarily of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers' representatives, shipping costs and marketing programs. Sales and marketing expenses were \$14.0 million in the first nine months of 2001, compared to \$14.8 million in the same period in 2000. The decrease in sales and marketing expenses resulted from reduced commissions related to lower revenues. Sales and marketing expenses as a percentage of revenues were 10.9% in the first nine months of 2001, compared to 6.8% in the same period in 2000. The increase in sales and marketing expenses as a percentage of revenues resulted primarily from reduced revenues.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were flat at \$8.7 million in both the first nine months of 2001 and 2000. General and administrative expenses as a percentage of revenues were 6.8% in the first nine months of 2001, compared to 4.0% in the same period in 2000. The increase in general and administrative expenses as a percentage of revenues resulted primarily from reduced revenues.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were \$3.2 million in the first nine months of 2001, compared to \$2.6 million in the same period in 2000. The increase in research and development expenses resulted from increased personnel costs related to the expansion of our engineering staff. Research and development expenses as a percentage of revenues were 2.5% in the first nine months of 2001, compared to 1.2% in the same period in 2000. The increase in research and development expenses as a percentage of revenues resulted from the expansion of our engineering staff and reduced revenues.

Non-Recurring Expenses. Non-recurring expenses were comprised of a \$1.9 million litigation settlement reached with Interactive Flight Technologies, Inc. in the first nine months of 2000. There were no litigation settlement charges in the first nine months of 2001.

Interest Expense and Income. Interest expense is comprised of interest related to our line of credit and equipment financing. Interest expense was \$163,000 in the first nine months of 2001, compared to \$1.5 million in the same period in 2000. The decrease in interest expense in the first nine months of 2001 resulted from the pay down of our line of credit to zero in October 2000. Interest income was \$1.3 million in the first nine months of 2001, compared to \$1,000 in the same period in 2000. This increase in interest income in 2001 resulted from the investment of cash received in October 2000 from our initial public offering.

Pro Forma Provision for Income Taxes. From our formation in March 1990 to September 26, 2000, we elected for federal and state income tax purposes to be treated as an S corporation under Subchapter S of the Internal Revenue Code. Under this election, our shareholders, rather than SimpleTech, were subject to federal income taxes on their respective share of our taxable income. We also had elected similar treatment for California franchise tax purposes which, in addition, requires a state income tax at our level of 1.5%. On September 26, 2000, we terminated our Subchapter S election. Subsequent to the termination, we are required to pay federal and state corporate-level income taxes.

Net income. Net income was \$1.2 million in the first nine months of 2001. Assuming the termination of our S corporation status, pro forma net income would have been \$11.4 million in the first nine months of 2000.

Liquidity and Capital Resources

As of September 30, 2001, we had working capital of \$63.8 million including \$45.8 million of cash and cash equivalents. As of December 31, 2000, we had working capital of \$64.3 million including \$33.7 million of cash and cash equivalents. In addition, we had unused availability of \$27.5 million at September 30, 2001 and December 31, 2000 under our line of credit with Comerica Bank. We had no outstanding principal balance under our line of credit at September 30, 2001 and December 31, 2000. There is no unused line fee under our line of credit agreement with Comerica Bank. As a result of our initial public offering on September 29, 2000, Comerica Bank has the option to reduce our available line of credit to a range between \$15.0 million to \$20.0 million as determined in their sole and absolute discretion.

Net cash provided by operating activities was \$16.6 million in the first nine months of 2001. Net cash provided by operating activities in the first nine months of 2001 resulted primarily from net income of \$1.2 million, a decrease in accounts receivable of \$12.8 million and a decrease in inventory of \$20.6 million, offset partially by a decrease in accounts payable of \$20.1 million. Accounts receivable, inventory of and accounts payable levels decreased due to declining sequential revenues.

Net cash used in investing activities was \$4.3 million in the first nine months of 2001, attributable primarily to purchases of furniture, fixtures and equipment. We expect to spend approximately \$3.0-5.0 million during the next 12 months, primarily for the purchase of manufacturing, testing and engineering equipment.

Net cash used in financing activities totaled \$266,000 in the first nine months of 2001. Net cash used in financing activities in the first nine months of 2001 resulted primarily from \$1.2 million in payments related to equipment loans and capital lease obligations, offset partially by \$1.0 million in proceeds from the exercise of stock options.

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We have several capital leases and loans to finance manufacturing and testing equipment, including leases and loans with companies affiliated with our executive officers and directors as described under "Certain Relationships and Related Transactions-MDC Land Corporation and MDC Land LLC" in our Annual Report on Form 10-K filed with the SEC on April 2, 2001. Our obligations under capital leases were \$714,000 on September 30, 2001 and \$1.4 million on December 31, 2000, with interest rates ranging from 8.1% to 9.6% per annum. Our equipment financing loan balances were \$1.3 million on September 30, 2001 and \$1.8 million on December 31, 2000, with interest rates ranging from 8.4% to 9.1% per annum. One of the equipment note payable agreements contains various nonfinancial covenants that, among other things, limit distributions and dividends to our shareholders without the prior written consent of the lender, and requires the equipment to remain unencumbered by other liens. As of September 30, 2001, we were in compliance with all covenants under the equipment note payable agreements.

We believe that our existing cash, cash equivalents, investments on hand, existing assets, anticipated debt and expected cash flow from operations will be sufficient to fund our operations for the next 12 months. Thereafter, we may require additional sources of funds to continue to support our business. Such funds, if needed, may not be available or may not be available on terms acceptable to us.

Risk Factors

You should carefully consider the following risks before you decide to buy shares of our common stock. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties, including those risks set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations above, may also adversely impact and impair our business. If any of the following risks actually occur, our business, results of operations or financial condition would likely suffer. In such case, the trading price of our common stock could decline, and you may lose all or part of the money you paid to buy our stock.

This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about us and our industry. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

Declines in our average sales prices may result in declines in our revenues and gross margins.

In the past nine months, overcapacity in the memory product market has negatively impacted our average selling prices. We expect this overcapacity to continue to have a negative impact our revenues and profitability until at least the end of 2001 if not longer. Declines in semiconductor prices could affect the valuation of our inventory, which could harm our business. Our ability to maintain or increase revenues will depend upon our ability to increase unit sales volumes of existing products and to introduce and sell new products in quantities sufficient to offset declines in sales prices. Our efforts to reduce costs and develop new products to offset the impact of further declines in average sales prices may not be successful. Declines in average sales prices also would result in more memory being built into products by Industrial customers, which would favor our largest competitors and reduce the demand for our Commercial memory products.

We are subject to the cyclical nature of the semiconductor industry and changes from the current point in the cycle could adversely affect our business.

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns, often connected with, or in anticipation of, maturing product cycles of both semiconductor companies' and their customers' products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. Since the end of 2000, the semiconductor industry has suffered a severe downturn. Industrial and Commercial customers have scaled back their purchases of memory products and have relied on their excess memory inventory to meet their needs and have moved to reduce their overall

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inventory levels. Consequently, the slowdown continues to have a negative impact on our business. The continued downturn in our industry could have a material adverse effect on our business and operating results. Furthermore, any upturn in the semiconductor industry could result in increased demand for, and possible shortages of, components we use to manufacture and assemble our ICs. Such shortages could have a material adverse effect on our business and operating results.

Because we depend on a small number of suppliers for IC components, any disruption in our supply relationships could harm our ability to fulfill orders.

We have no long-term supply contracts and are dependent on a small number of suppliers to supply DRAM components, which represent approximately 95% of the component costs of our DRAM memory products. Our dependence on a small number of suppliers and our lack of long-term supply contracts expose us to several risks, including the inability to obtain an adequate supply of components, price increases, late deliveries and poor component quality. Elpida, Hyundai Electronics, Micron and Samsung Semiconductor currently supply a majority of the DRAM components used in our DRAM-based memory products. A disruption in or termination of our supply relationship with any of these significant suppliers by natural disaster or otherwise, or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers, and would increase our costs and/or prices.

Sales to a small number of customers represent a significant portion of our revenues and the loss of any key customer would materially reduce our sales.

Our dependence on a small number of customers means that the loss of a major customer or any reduction in orders by a major customer would materially reduce our sales. Historically, a relatively small number of customers have accounted for a significant percentage of our revenues. Our ten largest Industrial segment customers accounted for an aggregate of 85.5% of our Industrial revenues or 24.6% of our total revenues in the third quarter of 2001 and an aggregate of 73.8% of our Industrial revenues or 24.2% of our total revenues in the first nine months of 2001. Our largest Industrial customer, Unisys, accounted for 60.8% of our Industrial revenues or 17.5% of our total revenues in the third quarter of 2001 and 40.5% of our Industrial revenues or 13.3% of our total revenues in the first nine months of 2001. No other Industrial segment customer accounted for more than 10.0% of our total revenues in the third quarter or first nine months of 2001. Our ten largest Commercial segment customers accounted for an aggregate of 66.1% of our Commercial revenues or 47.0% of our total revenues in the third quarter of 2001 and an aggregate of 61.3% of our Commercial revenues or 41.2% of our total revenues in the first nine months of 2001. Our largest Commercial customer, CDW Computer Centers, accounted for 29.2% of our Commercial revenues or 20.8% of our total revenues in the third quarter of 2001 and 29.2% of our Commercial revenues or 19.6% of our total revenues in the first nine months of 2001. No other Commercial segment customer accounted for more than 10.0% of our total revenues in the third quarter or first nine months of 2001. Consolidation in some of our customers' industries may result in increased customer concentration and the potential loss of customers as a result of acquisitions. In addition, the composition of our major customer base changes from quarter to quarter as the market demand for our customers' products changes and we expect this variability will continue in the future. We expect that sales of our products to a small number of customers will continue to contribute materially to our revenues in the foreseeable future and believe that our financial results will depend in significant part upon the success of our customers' products.

Three of our beneficial shareholders have substantial influence over our operations and can significantly influence matters requiring shareholder approval.

Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, each of whom is an executive officer and director of SimpleTech, are brothers and beneficially own approximately 80.0% of our common stock. As a result, they have the ability to control all matters requiring approval by our shareholders, including the election and removal of directors, approval of significant corporate transactions and the ability to control the decision of whether a change in control will occur.

We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more parties to preserve our intellectual property rights. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties' proprietary rights, which claims could result in litigation. Such litigation would likely result in significant expense to us and divert the efforts of our technical and management personnel. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. Such a license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license or our failure to obtain a license on commercially reasonable terms could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross profit.

We are currently a party to two lawsuits regarding intellectual property as further described below under Part II Other Information Item I - Legal Proceedings. The outcome of litigation is inherently uncertain and we cannot predict the outcome of these lawsuits with certainty. These lawsuits have diverted, and are expected to continue to divert, the efforts and attention of our key management and technical personnel. In addition, we have incurred, and expect to continue to incur, substantial legal fees and expenses in connection with these lawsuits. As a result, our defense of these lawsuits, regardless of their eventual outcomes, has been, and will continue to be, costly and time consuming. In addition, if our IC Tower stacking patent is found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products to our IC Tower stacking products would cease. In addition, if we are found to infringe valid patents of others, we may be excluded from using the infringed technology without a license, which may not be available on commercially reasonable terms, if at all.

We may be unable to maintain a steady supply of components.

The electronics industry has experienced in the past, and may experience in the future, shortages in IC components, including DRAM, static random access memory, or SRAM, and Flash memory. We have experienced and may continue to experience delays in component deliveries and quality problems which have caused and could in the future cause delays in product shipments and have required and could in the future require the redesign of some of our products. In addition, industry capacity has, from time to time, become constrained such that some vendors which supply components for our products have placed their customers, ourselves included, on allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner.

If industry sales of products using Flash memory do not grow, our revenues, gross margins and profitability would be harmed.

The market for consumer electronics incorporating Flash memory is relatively new and emerging. The success of our Flash business will depend largely on the level of consumer interest in consumer electronics utilizing Flash memory, such as digital cameras, MP3 digital audio players and personal digital assistants, or PDAs, many of which have only recently been introduced to the market. If sales of products using Flash memory do not increase, we will be unable to grow our Flash business. In addition, if we are unable to anticipate and fulfill customer demand for our products, we may lose sales to our competitors.

Demand for our products would decline if the market for Flash memory does not develop, or if a competing technology displaces Flash memory.

There is currently an absence of a single Flash memory standard. It is possible that Flash memory standards other than those to which our products conform will emerge as the industry standard. If we are unable to anticipate and adequately allocate our resources in a timely and efficient manner toward the production and development of industry-standard Flash memory products, we may experience significant delays in releasing new and commercially viable products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Some of our competitors are in a better financial and marketing position from which to influence industry acceptance of a particular Flash memory standard or competing technology than we are. In particular, a primary source of competition may come from companies that offer alternative technologies such as ferroelectric random access memory products. If a competing technology replaces or takes significant market share from the Flash memory market, we would not be able to sell our Flash products.

The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our growth. The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer, Mike Moshayedi, our President, and Mark Moshayedi, our Chief Operating Officer, Chief Technical Officer and Secretary. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would prevent us from executing our growth strategy.

Our proprietary technology and intellectual property may not be adequately protected, which could harm our competitive position.

Our proprietary technology and other intellectual property are critical to our success. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

prevent the challenge, invalidation or circumvention of our existing patents;

result in patents that lead to commercially viable products or provide competitive advantages for our products;

prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;

prevent third-party patents from having an adverse effect on our ability to do business;

result in patents with claims that are sufficiently broad to preclude competition;

provide adequate protection for our intellectual property rights;

prevent disputes with third parties regarding ownership of our intellectual property rights;

prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

result in patents from any of our pending applications.

As part of our confidentiality procedures, we enter into non-disclosure and invention assignment agreements with all of our employees and attempt to control access to and distribution of our technology, documentation and other proprietary information. However, if such agreements are found to be unenforceable, we may be unable to adequately protect our intellectual property rights. In addition, despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies.

We have not applied and do not expect to apply for patent protection in foreign countries. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in some foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.

We currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless certain of our customers and suppliers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages. Our insurance does not cover intellectual property infringement.

Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.

We intend to pursue selective acquisitions to complement our internal growth. If we make any future acquisitions, we could issue stock that would dilute our shareholders' percentage ownership, incur substantial debt or assume contingent liabilities. We have limited experience in acquiring other businesses, product lines and technologies. In addition, the attention of our small management team may be diverted from our core business if we undertake an acquisition. Potential acquisitions also involve numerous risks, including, among others:

Problems assimilating the purchased operations, technologies or products;

Costs associated with the acquisition;

Adverse effects on existing business relationships with suppliers and customers;

Risks associated with entering markets in which we have no or limited prior experience;

Potential loss of key employees of purchased organizations; and

Potential litigation arising from the acquired company's operations before the acquisition.

Our inability to overcome problems encountered in connection with such acquisitions could divert the attention of management, utilize scarce corporate resources and harm our business. In addition, we are unable to predict whether or when any prospective acquisition candidate will

become available or the likelihood that any acquisition will be completed.

Product returns, price protection and order cancellations could reduce our revenues.

To the extent we manufacture products in anticipation of future demand that does not materialize, or in the event a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory. A lack of consumer demand for our products may also cause increased product returns. A majority of our sales through Commercial segment channels include limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. The inventory write-down for the first nine months of 2001 was \$1.9 million. In addition, we offer some of our Commercial customers limited price protection rights for inventories of our products held by them. If we reduce the list price of our products, these customers may receive credits from us. We incurred price protection charges of approximately \$1.3 million in the first nine months of 2001.

We are also subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, we may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of September 30, 2001, we have not been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that we will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately \$1.0 million in the first nine months of 2001.

We have no long-term volume commitments from our customers. Sales of our products are made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships. Customers may change, cancel or delay orders with limited or no penalties. We have experienced cancellations of orders and fluctuations in order levels from period-to-period and we expect to continue to experience similar cancellations and fluctuations in the future which could result in fluctuations in our revenues.

We may not be able to maintain or improve our competitive position because of the intense competition in the memory industry.

We conduct business in an industry characterized by intense competition, rapid technological change, evolving industry standards, declining average sales prices and rapid product obsolescence. Our competitors include many large domestic and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be able to respond better to new or emerging technologies or standards and to changes in customer requirements. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

We expect to face competition from existing competitors and new and emerging companies that may enter our existing or future markets that have similar or alternative products which may be less costly or provide additional features. In addition, some of our significant suppliers are also our competitors, many of whom have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise due to the development of cooperative relationships among our current and potential competitors or third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance and improved pricing, any of which could cause a decline in sales or loss of market acceptance of our products. In addition, our competitors may develop enhancements to or future generations of competitive products that may render our technology or products obsolete or uncompetitive.

Recent terrorist activities and the continued threat of terrorism could adversely affect our business.

Recent terrorist attacks in the United States, as well as continued threats of terrorism within the United States and abroad and current and future military responses to them, have created many economic and political uncertainties that make it extremely difficult for us, our customers and our suppliers to accurately forecast and plan future business activities. This reduced predictability challenges our ability to grow our business. In particular, it is difficult to develop and implement strategies, efficient operations, and effectively manage capacity and supply-chain relationships. In addition, the continued threats of terrorism and the heightened security measures in response to such threats have and may continue to cause significant disruption to commerce throughout the world. Disruption in air transportation in response to these threats or future attacks may result in transportation and supply-chain disruptions, increase our costs for both receipt of inventory and shipment of products to our customers, and cause customers to defer their purchasing decisions. Disruptions in commerce could also cause consumer confidence and spending to decrease or result in increased volatility in the United States and worldwide financial markets and economy. They could also result in economic recession in the United States or abroad. Any of these occurrences could have a significant impact on our operating results, revenues and costs and may result in the volatility of the market price of our common stock and on the future price of our common stock.

We may lose our competitive position if we fail to develop new and enhanced products and introduce them in a timely manner.

The high performance computing, networking and communications, consumer electronics and industrial markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

We have experienced, and may in the future experience, delays in the development and introduction of new products. Our product development is inherently risky because it is difficult to foresee developments in technology, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments, could result in delays in market acceptance of these products. Delays in developing, manufacturing or marketing new or enhanced products could give our competitors an advantage, hurt our reputation and harm our business, financial condition and results of operations. Such products, even if introduced, may not gain market acceptance. In addition, we may not be able to respond effectively to new technological changes or new product announcements by others.

We rely on a continuous power supply to conduct our operations, and California's current energy crisis could disrupt our operations and increase our expenses.

All of our manufacturing operations are located in our facility in Santa Ana, California. California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event power reserves for the State of California fall to a critically low level, California has on some occasions implemented, and may in the future continue to implement, rolling power blackouts throughout the state of California. We currently do not have backup generators or alternate sources of power in the event of a blackout, and our current insurance does not provide coverage for any damages we may suffer as a result of any interruption in our power supply. If blackouts interrupt our power supply, we would be temporarily unable to continue operations. Any such interruption in our ability to continue operations would delay the manufacture and development of our products, disrupt communications with our customers and suppliers and delay product shipment. Power interruptions could also damage our reputation and could result in lost revenue. Any loss of power could have a material adverse effect on our business, operating results and financial condition. Furthermore, shortages in wholesale electricity supplies have caused power prices to increase. If electricity prices continue to increase, our operating expenses will likely increase which will have a negative effect on our operating results.

Obtaining additional capital to fund our operations and finance our growth could impair the value of your investment.

If we expand more rapidly than currently anticipated or if our working capital needs exceed our current expectations, we may need to raise additional capital through public or private equity offerings or debt financings. Our future capital requirements depend on many factors including our research, development, sales and marketing activities. We do not know whether additional financing will be available when needed, or will be available on terms favorable to us. If we cannot raise needed funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements. To the extent we raise additional capital by issuing equity securities, our shareholders may experience substantial dilution and the new equity securities may have greater rights, preferences or privileges than our existing common stock.

We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales of our products accounted for 15.5% in the third quarter of 2001 and 16.0% in the first nine months of 2001. No single foreign country accounted for more than 10.0% of our revenues in the third quarter or first nine months of 2001. In the third quarter and first nine months of 2001, over 95.0% of our international sales were denominated in U.S. dollars. However, if there is a significant devaluation of the currency in a specific country, the prices of our products will increase relative to that country's currency and our products may be less competitive in that country. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations which could harm our business. We do not hedge against foreign currency exchange rate risks.

In addition, we purchase substantially all of the IC components used in our products from local distributors of foreign suppliers. Although our purchases of IC components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of IC components.

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Our international sales also are subject to certain other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the United States or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

Disruption of our operations in our Santa Ana, California manufacturing facility would substantially harm our business.

All of our manufacturing operations are located in our facility in Santa Ana, California. Due to this geographic concentration, a disruption of our manufacturing operations, resulting from sustained process abnormalities, human error, government intervention or natural disasters such as earthquakes, fires or floods could cause us to cease or limit our manufacturing operations and consequently harm our business, financial condition and results of operations.

Compliance with environmental laws and regulations could harm operating results.

We are subject to a variety of environmental laws and regulations governing, among other things, air emissions, waste water discharge, waste storage, treatment and disposal, and remediation of releases of hazardous materials. Our failure to comply with present and future requirements could harm our ability to continue manufacturing our products. Such requirements could require us to acquire costly equipment or to incur other significant expenses to comply with environmental regulations. The imposition of additional or more stringent environmental requirements, the results of future testing at our facilities, or a determination that we are potentially responsible for remediation at other sites where problems are not presently known to us, could result in expenses in excess of amounts currently estimated to be required for such matters.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At any time, fluctuations in interest rates could effect interest earnings on our cash and cash equivalents and interest expense on our existing variable rate debt. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. At September 30, 2001, our cash and cash equivalents were \$45.8 million and our variable rate debt, consisting of term loans for equipment, was \$1.3 million. In 2001, we have not utilized our floating rate debt under our revolving credit facility.

If interest rates were to decrease 1%, the result would be an annual decrease in our interest income related to our cash and cash equivalents of approximately \$458,000. Conversely, if interest rates were to increase 1%, the result would be an annual increase in our interest expense related to our variable rate debt of approximately \$13,000. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such action. Further, this analysis does not consider the effect of the change in the level of overall economic activity that could exist in such an environment.

Over 95% of our sales to foreign customers are denominated in U.S. dollars and as such we have no material foreign currency fluctuation risk.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

Reference is made to our Annual Report on Form 10-K filed with the SEC on April 2, 2001 under the heading "Legal Proceedings" for a discussion of litigation involving the Company relating to patent litigation with DPAC Technologies, Inc.

DPAC Technologies, Inc. -- Patent Litigation

There has been no material change regarding the Company's patent litigation with DPAC Technologies, Inc., formerly Dense-Pac Microsystems, Inc., since the information set forth in our Quarterly Report on Form 10-Q filed with the SEC on August 14, 2001.

Item 2. Changes in Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) None.

(b) A Current Report on Form 8-K was filed by SimpleTech with the Securities and Exchange Commission on October 3, 2001 to report under Item 5 the press release issued to the public on September 27, 2001 announcing a stock repurchase program.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SIMPLETECH, INC.,
a California corporation

Date: November 9, 2001

/s/ MANOUCH MOSHAYEDI
Manouch Moshayedi
Chief Executive Officer and Chairman of the Board of Directors

Date: November 9, 2001

/s/ DAN MOSES
Dan Moses
Chief Financial Officer (Principal Financial and Accounting Officer) and
Director

EXHIBIT INDEX

None.