

HUB GROUP INC
Form 10-K
February 18, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(Mark One)

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2009

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File No. 0-27754

HUB GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation of organization)

3050 Highland Parkway, Suite 100

36-4007085

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

Downers Grove, Illinois 60515

(Address and zip code of principal executive offices)

(630) 271-3600

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Class A Common Stock, \$.01 par value

(Title of Class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements

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incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. X

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the Registrant’s voting stock held by non-affiliates on June 30, 2009, based upon the last reported sale price on that date on the NASDAQ Global Select Market of \$20.64 per share, was \$740,375,975.

On February 12, 2010, the Registrant had 37,405,371 outstanding shares of Class A Common Stock, par value \$.01 per share, and 662,296 outstanding shares of Class B Common Stock, par value \$.01 per share.

Documents Incorporated by Reference

The Registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on May 6, 2010 (the “Proxy Statement”) is incorporated by reference in Part III of this Form 10-K to the extent stated herein. Except with respect to information specifically incorporated by reference in this Form 10-K, the Proxy Statement is not deemed to be filed as a part hereof.

PART I

Item 1. BUSINESS

General

Hub Group, Inc. (“Company”, “we”, “us” or “our”) is a Delaware corporation that was incorporated on March 8, 1995. We are one of North America’s leading asset-light freight transportation management companies. We offer comprehensive intermodal, truck brokerage and logistics services. Since our founding in 1971, we have grown to become the largest intermodal marketing company (“IMC”) in the United States and one of the largest truck brokers.

We operate through a network of operating centers throughout the United States, Canada and Mexico. Each operating center is strategically located in a market with a significant concentration of shipping customers and one or more railheads. Through our network, we have the ability to move freight in and out of every major city in the United States, Canada and Mexico. We service a large and diversified customer base in a broad range of industries, including consumer products, retail and durable goods. We utilize an asset-light strategy in order to minimize our investment in equipment and facilities and reduce our capital requirements. We arrange freight movement for our customers through transportation carriers and equipment providers.

Services Provided

Our transportation services can be broadly placed into the following categories:

Intermodal. As an IMC, we arrange for the movement of our customers’ freight in containers and trailers, typically over long distances of 750 miles or more. We contract with railroads to provide transportation for the long-haul portion of the shipment and with local trucking companies, known as “drayage companies,” for pickup and delivery. In certain markets, we supplement third party drayage services with Company-owned drayage operations. As part of our intermodal services, we negotiate rail and drayage rates, electronically track shipments in transit, consolidate billing and handle claims for freight loss or damage on behalf of our customers.

We use our network to access containers and trailers owned by leasing companies, railroads and steamship lines. We are able to track trailers and containers entering a service area and reuse that equipment to fulfill the customers’ outbound shipping requirements. This effectively allows us to “capture” containers and trailers and keep them within our network. As of December 31, 2009, we also have exclusive access to approximately 7,355 rail-owned containers for our dedicated use on the Union Pacific (“UP”) and the Norfolk Southern (“NS”) rail networks and approximately 1,375 rail-owned containers for our dedicated use on the Burlington Northern Santa Fe (“BNSF”) and the NS rail networks. In addition to these rail-owned containers, we currently have a total of 6,225 53’ private containers for use on the UP and NS. We financed these containers with operating leases. These arrangements are included in Note 8 to the consolidated financial statements.

Our drayage services are provided by our subsidiary, Comtrak, which assists us in providing reliable, cost effective intermodal services to our customers. Comtrak has terminals in Atlanta, Bensalem (Philadelphia), Birmingham, Charleston, Charlotte, Chattanooga, Chicago, Cleveland, Columbus, Dallas, Harrisburg, Huntsville, Jacksonville, Kansas City, Memphis, Nashville, Ontario (Los Angeles), Perry, Saint Louis, Savannah, Stockton, and Tampa. As of December 31, 2009, Comtrak owned 283 tractors, leased 20 tractors, leased or owned 553 trailers, employed 301 drivers and contracted with 1,007 owner-operators.

Truck Brokerage (Highway Services). We are one of the largest truck brokers in the United States, providing customers with another option for their transportation needs. We match the customers’ needs with carriers’ capacity to provide the most effective service and price combinations. We have contracts with a substantial base of carriers

allowing us to meet the varied needs of our customers. As part of the truck brokerage services, we negotiate rates, track shipments in transit and handle claims for freight loss and damage on behalf of our customers.

Our truck brokerage operation also provides customers with specialized programs. Through the Dedicated Trucking Program, certain carriers have informally agreed to move freight for our customers on a continuous basis. This arrangement allows us to effectively meet our customers' needs without owning the equipment.

Logistics. Our logistics business operates under the name of Unyson Logistics. Unyson Logistics is comprised of a network of logistics professionals dedicated to developing, implementing and operating customized logistics solutions. Unyson offers a wide range of transportation management services and technology solutions including shipment optimization, load consolidation, mode selection, carrier management, load planning and execution and web-based shipment visibility. Our multi-modal transportation capabilities include small parcel, heavyweight, expedited, less-than-truckload, truckload, intermodal and railcar. Unyson Logistics operates throughout North America, providing operations through its main operating location in St. Louis with additional support locations in Boston, Chicago, Cleveland and Minneapolis.

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Hub Network

Our entire network is interactively connected through our proprietary Network Management System. This enables us to move freight into and out of every major city in the United States, Canada and Mexico.

In a typical intermodal transaction, the customer contacts one of our intermodal operating centers to place an order. The operating center consults with the centralized pricing group, obtains the necessary intermodal equipment, arranges for it to be delivered to the customer by a drayage company and, after the freight is loaded, arranges for the transportation of the container or trailer to the rail ramp. Relevant information is entered into our Network Management System by the assigned operating center. Our predictive track and trace technology then monitors the shipment to ensure that it arrives as scheduled and alerts the customer service personnel if there are service delays. The assigned operating center then arranges for and confirms delivery by a drayage company at destination. After unloading, the empty equipment is made available for reloading by the operating center for the delivery market.

We provide truck brokerage services to our customers in a similar manner. In a typical truck brokerage transaction, the customer contacts one of our highway operating centers to obtain a price quote for a particular freight movement. The customer then provides appropriate shipping information to the operating center. The operating center makes the delivery appointment and arranges with the appropriate carrier to pick up the freight. Once it receives confirmation that the freight has been picked up, the operating center monitors the movement of the freight until it reaches its destination and the delivery has been confirmed. If the carrier notifies us that after delivering the load it will need additional freight, we may notify the operating center located nearest the destination of the carrier's availability. Although under no obligation to do so, that operating center then may attempt to secure additional freight for the carrier.

Marketing and Customers

We believe that fostering long-term customer relationships is critical to our success. Through these long-term relationships, we are able to better understand our customers' needs and tailor our transportation services to the specific customer, regardless of the customer's size or volume. We currently have full-time marketing representatives at various operating centers and sales offices with primary responsibility for servicing local, regional and national accounts. These sales representatives directly or indirectly report to our Chief Marketing Officer. This model allows us to provide our customers with both a local marketing contact and access to our competitive rates as a result of being a large, national transportation service provider.

Our marketing efforts have produced a large, diverse customer base, with no one customer representing more than 5% of our total revenue in 2009. We service customers in a wide variety of industries, including consumer products, retail and durable goods.

Management Information Systems

A primary component of our business strategy is the continued improvement of our Network Management System and other technology to ensure that we remain a leader among transportation providers in information processing for transportation services. Our Network Management System consists of proprietary software running on a combination of platforms which includes the IBM iSeries and Microsoft Windows Server environments located at a secure offsite data center. All of our operating centers are linked together with the data center using an MPLS ("Multi-Protocol Label Switching") network. This configuration provides a real time environment for transmitting data among our operating centers and headquarters. We also make extensive use of electronic commerce ("e-Commerce"), allowing each operating center to communicate electronically with each railroad, many drayage companies, certain trucking companies and those customers with e-Commerce capabilities.

Our Network Management System is the primary mechanism used in our operating centers to handle our intermodal and truck brokerage business. The Network Management System processes customer transportation requests, tenders and tracks shipments, prepares customer billing, establishes account profiles and retains critical information for analysis. The Network Management System provides connectivity with each of the major rail carriers. This enables us to electronically tender and track shipments in a real time environment. In addition, the Network Management System's e-Commerce features offer customers with e-Commerce capability a completely paperless process, including load tendering, shipment tracking, billing and remittance processing. We aggressively pursue opportunities to establish e-Commerce interfaces with our customers, railroads, trucking companies and drayage companies.

To manage our logistics business, we use specialized software that includes planning and execution solutions. This sophisticated transportation management software enables us to offer supply chain planning and logistics managing, modeling, optimizing and monitoring for our customers. We use this software when offering logistics management services to customers that ship via multiple modes, including intermodal, truckload, and less-than-truckload, allowing us to optimize mode and carrier selection and routing for our customers. This software is integrated with Hub Group's Network Management System and our accounting system.

Our website, www.hubgroup.com, is designed to allow our customers and vendors to easily do business with us online. Through Vendor Interface, we tender loads to our drayage partners using the Internet rather than phones or faxes. Vendor Interface also captures event status information, allows vendors to view outstanding paperwork requirements and helps facilitate paperless invoicing. We currently tender substantially all of our drayage loads using Vendor Interface or e-Commerce. Through Trucker Advantage, we exchange information on available Hub loads, available carrier capacity and updates to event status information with our truck brokerage partners. Through Customer Advantage, customers receive immediate pricing, place orders, track shipments, and review historical shipping data through a variety of reports over the Internet. All of our Internet applications are integrated with the Network Management System.

Relationship with Railroads

A key element of our business strategy is to strengthen our close working relationship with the major intermodal railroads in the United States. We view our relationship with the railroads as a partnership. Due to our size and relative importance, many railroads have dedicated support personnel to focus on our day-to-day service requirements. On a regular basis, our senior executives and each of the railroads meet to discuss major strategic issues concerning intermodal transportation.

We have relationships with each of the following major railroads:

| | |
|------------------------------|----------------------|
| Burlington Northern Santa Fe | Florida East Coast |
| Canadian National | Kansas City Southern |
| Canadian Pacific | Norfolk Southern |
| CSX | Union Pacific |

We also have relationships with each of the following major service providers: CMA CGM (America) Inc., Express System Intermodal Inc., Hanjin Shipping, Hyundai Merchant Marine, K-Line America, Maersk Sea-Land, Mitsui O.S.K. Lines (America) Inc. and Pacer International.

Transportation rates are market driven. We sometimes negotiate with the railroads or other major service providers on a route or customer specific basis. Consistent with industry practice, some of the rates we negotiate are special commodity quotations (“SCQs”), which provide discounts from published price lists based on competitive market factors and are designed by the railroads or major service providers to attract new business or to retain existing business. SCQ rates are generally issued for the account of a single IMC. SCQ rates apply to specific customers in specified shipping lanes for a specific period of time, usually up to 12 months.

Relationship with Drayage Companies

We have a “Quality Drayage Program,” which consists of agreements and rules that govern the framework by which many drayage companies perform services for us. Participants in the program commit to provide high quality service along with clean and safe equipment, maintain a defined on-time performance level and follow specified procedures designed to minimize freight loss and damage. We negotiate drayage rates for transportation between specific origin and destination points.

We also supplement third-party drayage services with our own drayage operations, which we operate through our subsidiary Comtrak. Our drayage operations employ their own drivers and also contract with owner-operators who supply their own trucks.

Relationship with Trucking Companies

Our truck brokerage operation has a large and growing number of active trucking companies that we use to transport freight. The local operating centers deal daily with these carriers on an operational level. Our corporate headquarters

handles the administrative and regulatory aspects of the trucking company relationship. Our relationships with these trucking companies are important since these relationships determine pricing, load coverage and overall service.

Risk Management and Insurance

We require all drayage companies participating in the Quality Drayage Program to carry at least \$1.0 million in general liability insurance, \$1.0 million in truckman's auto liability insurance and a minimum of \$100,000 in cargo insurance. Railroads, which are self-insured, provide limited cargo protection, generally up to \$250,000 per shipment. To cover freight loss or damage when a carrier's liability cannot be established or a carrier's insurance is insufficient to cover the claim, we carry our own cargo insurance with a limit of \$1.0 million per container or trailer and a limit of \$20.0 million in the aggregate. We also carry general liability insurance with limits of \$1.0 million per occurrence and \$2.0 million in the aggregate with a companion \$50.0 million umbrella policy on this general liability insurance.

We maintain separate insurance policies to cover potential exposure from our company-owned drayage operations. We carry commercial general liability insurance with a limit of \$1.0 million per occurrence, subject to a \$2.0 million policy aggregate limit, and truckers automobile liability insurance with a limit of \$1.0 million per occurrence. Additionally, we have an umbrella excess liability policy with a limit of \$19.0 million. We also maintain motor truck cargo liability insurance with a limit of \$1.0 million per occurrence.

Government Regulation

Hub Group, Inc. and various subsidiaries are licensed by the Department of Transportation as brokers in arranging for the transportation of general commodities by motor vehicle. To the extent that the operating centers perform truck brokerage services, they do so under these licenses. The Department of Transportation prescribes qualifications for acting in this capacity, including a \$10,000 surety bond that we have posted. To date, compliance with these regulations has not had a material adverse effect on our results of operations or financial condition. However, the transportation industry is subject to legislative or regulatory changes that can affect the economics of the industry by requiring changes in operating practices or influencing the demand for, and cost of providing, transportation services.

Competition

The transportation services industry is highly competitive. We compete against other IMCs, as well as logistics companies, third party brokers, trucking companies and railroads that market their own intermodal services. Several larger trucking companies have entered into agreements with railroads to market intermodal services nationwide. Competition is based primarily on freight rates, quality of service, reliability, transit time and scope of operations. Several transportation service companies and trucking companies, and all of the major railroads, have substantially greater financial and other resources than we do.

General

Employees: As of December 31, 2009, we had 1,329 employees or 1,028 employees excluding drivers. We are not a party to any collective bargaining agreement and consider our relationship with our employees to be satisfactory.

Other: No material portion of our operations is subject to renegotiation of profits or termination of contracts at the election of the federal government. None of our trademarks are believed to be material to us. Our business is seasonal to the extent that certain customer groups, such as retail, are seasonal.

Periodic Reports

Upon written request, our annual report to the Securities and Exchange Commission on Form 10-K for the fiscal year ended December 31, 2009, our quarterly reports on Form 10-Q and current reports on Form 8-K will be furnished to stockholders free of charge; write to: Public Relations Department, Hub Group, Inc., 3050 Highland Parkway, Suite 100, Downers Grove, Illinois 60515. Our filings are also accessible through our website at www.hubgroup.com as soon as reasonably practicable after we file or furnish such reports to the Securities and Exchange Commission.

Item 1A. RISK FACTORS

Because our business is concentrated on intermodal marketing, any decrease in demand for intermodal transportation services compared to other transportation services could have an adverse effect on our results of operations.

We derived 70% of our revenue from our intermodal services in 2009 as compared to 71% in 2008 and 73% in 2007. As a result, any decrease in demand for intermodal transportation services compared to other transportation services could have an adverse effect on our results of operations.

Because we depend on railroads for our operations, our operating results and financial condition are likely to be adversely affected by any reduction or deterioration in rail service.

We depend on the major railroads in the United States for virtually all of the intermodal services we provide. In many markets, rail service is limited to one or a few railroads. Consequently, a reduction in, or elimination of, rail service to a particular market is likely to adversely affect our ability to provide intermodal transportation services to some of our customers. In addition, the railroads are relatively free to adjust shipping rates up or down as market conditions permit. Rate increases would result in higher intermodal transportation costs, reducing the attractiveness of intermodal transportation compared to truck or other transportation modes, which could cause a decrease in demand for our services. Further, our ability to continue to expand our intermodal transportation business is dependent upon the railroads' ability to increase capacity for intermodal freight and provide consistent service. Our business could also be adversely affected by a work stoppage at one or more railroads or by adverse weather conditions or other factors that hinder the railroads' ability to provide reliable transportation services. In the past, there have been service issues when railroads have merged. As a result, we cannot predict what effect, if any, further consolidation among railroads may have on intermodal transportation services or our results of operations.

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Because our relationships with the major railroads are critical to our ability to provide intermodal transportation services, our business may be adversely affected by any change to those relationships.

We have important relationships with the major U.S. railroads. To date, the railroads have chosen to rely on us, other IMCs and other intermodal competitors to market their intermodal services rather than fully developing their own marketing capabilities. If one or more of the major railroads were to decide to reduce their dependence on us, the volume of intermodal shipments we arrange would likely decline, which could adversely affect our results of operations and financial condition.

Because we rely on drayage companies in our intermodal operations, our ability to expand our business or maintain our profitability may be adversely affected by a shortage of drayage capacity.

In many of the markets we serve, we use third-party drayage companies for pickup and delivery of intermodal containers. Most drayage companies operate relatively small fleets and have limited access to capital for fleet expansion. In some of our markets, there are a limited number of drayage companies that can meet our quality standards. This could limit our ability to expand our intermodal business or require us to establish our own drayage operations in some markets, which could increase our operating costs and could adversely affect our profitability and financial condition. Also, the trucking industry chronically experiences a shortage of available drivers, which may limit the ability of third-party drayage companies to expand their fleets. This shortage also may require them to increase drivers' compensation, thereby increasing our cost of providing drayage services to our customers. Therefore, the driver shortage could also adversely affect our profitability and limit our ability to expand our intermodal business.

Because we depend on trucking companies for our truck brokerage services, our ability to maintain or expand our truck brokerage business may be adversely affected by a shortage of trucking capacity.

We derived 19% of our revenue from our truck brokerage services in 2009 as compared to 20% in 2008 and 19% in 2007. We depend upon various third-party trucking companies for the transportation of our customers' loads. Particularly during periods of economic expansion, trucking companies may be unable to expand their fleets due to capital constraints or chronic driver shortages, and these trucking companies also may raise their rates. If we face insufficient capacity among our third-party trucking companies, we may be unable to maintain or expand our truck brokerage business. Also, we may be unable to pass rate increases on to our customers, which could adversely affect our profitability.

Because we use a significant number of independent contractors in our businesses, proposals from legislative, judicial or regulatory authorities that change the independent contractor classification could have a significant impact on our gross margin and operating income.

We use a significant number of independent contractors in our businesses, consistent with long-standing industry practices. There can be no assurance that legislative, judicial, or regulatory (including tax) authorities will not introduce proposals or assert interpretations of existing rules and regulations that would change the independent contractor classification of a significant number of independent contractors doing business with us. The costs associated with potential reclassifications could have a material adverse effect on results of operations and our financial position.

We depend on third parties for equipment essential to operate our business, and if we fail to secure sufficient equipment, we could lose customers and revenue.

We depend on third parties for transportation equipment, such as containers and trailers, necessary for the operation of our business. Our industry has experienced equipment shortages in the past, particularly during the peak shipping season in the fall. A substantial amount of intermodal freight originates at or near the major West Coast ports, which have historically had the most severe equipment shortages. If we cannot secure sufficient transportation equipment at

a reasonable price from third parties to meet our customers' needs, our customers may seek to have their transportation needs met by other providers. This could have an adverse effect on our business, results of operations and financial position.

Our business could be adversely affected by strikes or work stoppages by draymen, truckers, longshoremen and railroad workers.

There has been labor unrest, including work stoppages, among draymen. We could lose business from any significant work stoppage or slowdown and, if labor unrest results in increased rates for draymen, we may not be able to pass these cost increases on to our customers. In the summer of 2008, an owner-operator work stoppage in Northern California caused us to incur an additional \$1.0 million in transportation costs. In the fall of 2002, all of the West Coast ports were shut down as a result of a dispute with the longshoremen. The ports remained closed for nearly two weeks, until reopened as the result of a court order under the Taft-Hartley Act. Our operations were adversely affected by the shutdown. A new contract was agreed to through 2014 by the International Longshoremen and Warehouse Union and the Pacific Maritime Association. In the past several years, there have been strikes involving railroad workers. Future strikes by railroad workers in the United States, Canada or anywhere else that our customers' freight travels by railroad could adversely affect our business and results of operations. Any significant work stoppage, slowdown or other disruption involving ports, railroads, truckers or draymen could adversely affect our business and results of operations.

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Our results of operations are susceptible to changes in general economic conditions and cyclical fluctuations.

Economic recession, customers' business cycles, changes in fuel prices and supply, interest rate fluctuations, increases in fuel or energy taxes and other general economic factors affect the demand for transportation services and the operating costs of railroads, trucking companies and drayage companies. We have little or no control over any of these factors or their effects on the transportation industry. Increases in the operating costs of railroads, trucking companies or drayage companies can be expected to result in higher freight rates. Our operating margins could be adversely affected if we were unable to pass through to our customers the full amount of higher freight rates. Economic recession or a downturn in customers' business cycles also may have an adverse effect on our results of operations and growth by reducing demand for our services. Therefore, our results of operations, like the entire freight transportation industry, are cyclical and subject to significant period-to-period fluctuations.

Relatively small increases in our transportation costs that we are unable to pass through to our customers are likely to have a significant effect on our gross margin and operating income.

Transportation costs represented 88% of our consolidated revenue in 2009, 87% in 2008 and 86% in 2007. Because transportation costs represent such a significant portion of our costs, even relatively small increases in these transportation costs, if we are unable to pass them through to our customers, are likely to have a significant effect on our gross margin and operating income.

Our business could be adversely affected by heightened security measures, actual or threatened terrorist attacks, efforts to combat terrorism, military action against a foreign state or other similar event.

We cannot predict the effects on our business of heightened security measures, actual or threatened terrorist attacks, efforts to combat terrorism, military action against a foreign state or other similar events. It is possible that one or more of these events could be directed at U.S. or foreign ports, borders, railroads or highways. Heightened security measures or other events are likely to slow the movement of freight through U.S. or foreign ports, across borders or on U.S. or foreign railroads or highways and could adversely affect our business and results of operations. Any of these events could also negatively affect the economy and consumer confidence, which could cause a downturn in the transportation industry.

If we fail to maintain and enhance our information technology systems, we may be at a competitive disadvantage and lose customers.

Our information technology systems are critical to our operations and our ability to compete effectively as an IMC, truck broker and logistics provider. We expect our customers to continue to demand more sophisticated information technology applications from their suppliers. If we do not continue to enhance our Network Management System and the logistics software we use to meet the increasing demands of our customers, we may be placed at a competitive disadvantage and could lose customers.

Our information technology systems are subject to risks that we cannot control and the inability to use our information technology systems could materially adversely affect our business.

Our information technology systems are dependent upon global communications providers, web browsers, telephone systems and other aspects of the Internet infrastructure that have experienced significant system failures and electrical outages in the past. Our systems are susceptible to outages from fire, floods, power loss, telecommunications failures, break-ins and similar events. Our servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems. The occurrence of any of these events could disrupt or damage our information technology systems and inhibit our internal operations, our ability to provide services to our customers and the ability of our customers and vendors to access our information technology systems. This could result in a loss of customers or a reduction in demand for our services.

The transportation industry is subject to government regulation, and regulatory changes could have a material adverse effect on our operating results or financial condition.

Hub Group, Inc. and various subsidiaries are licensed by the Department of Transportation as motor carrier freight brokers. The Department of Transportation prescribes qualifications for acting in this capacity, including surety bond requirements. Our Comtrak subsidiary is licensed by the Department of Transportation to act as a motor carrier. To date, compliance with these regulations has not had a material adverse effect on our results of operations or financial condition. However, the transportation industry is subject to legislative or regulatory changes, including potential limits on carbon emissions under climate change legislation, that can affect the economics of the industry by requiring changes in operating practices or influencing the demand for, and cost of providing, transportation services. We may become subject to new or more restrictive regulations relating to fuel emissions or limits on vehicle weight and size. Future laws and regulations may be more stringent and require changes in operating practices, influence the demand for transportation services or increase the cost of providing transportation services, any of which could adversely affect our business and results of operations.

We are not able to accurately predict how new governmental laws and regulations, or changes to existing laws and regulations, will affect the transportation industry generally, or us in particular. Although government regulation that affects us and our competitors may simply result in higher costs that can be passed to customers, there can be no assurance that this will be the case.

Our operations are subject to various environmental laws and regulations, the violation of which could result in substantial fines or penalties.

From time to time, we arrange for the movement of hazardous materials at the request of our customers. As a result, we are subject to various environmental laws and regulations relating to the handling of hazardous materials. If we are involved in a spill or other accident involving hazardous materials, or if we are found to be in violation of applicable laws or regulations, we could be subject to substantial fines or penalties and to civil and criminal liability, any of which could have an adverse effect on our business and results of operations.

We derive a significant portion of our revenue from our largest customers and the loss of several of these customers could have a material adverse effect on our revenue and business.

Our largest 20 customers accounted for approximately 40%, 36% and 36% of our revenue in 2009, 2008 and 2007, respectively. A reduction in or termination of our services by several of our largest customers could have a material adverse effect on our revenue and business.

Insurance and claims expenses could significantly reduce our earnings.

Our future insurance claims expenses might exceed historical levels, which could reduce our earnings. If the number or severity of claims increases, our operating results could be adversely affected. We maintain insurance with licensed insurance companies. Insurance carriers have recently raised premiums. As a result, our insurance and claims expenses could increase when our current coverage expires. If these expenses increase, and we are unable to offset the increase with higher freight rates, our earnings could be materially and adversely affected.

Our success depends upon our ability to recruit and retain key personnel.

Our success depends upon attracting and retaining the services of our management team as well as our ability to attract and retain a sufficient number of other qualified personnel to run our business. There is substantial competition for qualified personnel in the transportation services industry. As all key personnel devote their full time to our business, the loss of any member of our management team or other key person could have an adverse effect on us. We do not have written employment agreements with any of our executive officers and do not maintain key man insurance on any of our executive officers.

Our growth could be adversely affected if we are not able to identify, successfully acquire and integrate future acquisition prospects.

We believe that future acquisitions and/or the failure to make such acquisitions could significantly impact financial results. Financial results most likely to be impacted include, but are not limited to, revenue, gross margin, salaries and benefits, selling general and administrative expenses, depreciation and amortization, interest expense, net income and our debt level.

An economic downturn could materially adversely affect our business.

Our operations and performance depend significantly on economic conditions. Uncertainty about global economic conditions poses a risk as consumers and businesses may postpone spending in response to tighter credit, negative financial news and/or declines in income or asset values, which could have a material negative effect on demand for transportation services. We are unable to predict the likely duration and severity of the current disruptions in the

financial markets and the adverse global economic conditions, and if the current uncertainty continues or economic conditions further deteriorate, our business and results of operations could be materially and adversely affected. Other factors that could influence demand include fluctuations in fuel costs, labor costs, consumer confidence, and other macroeconomic factors affecting consumer spending behavior. There could be a number of follow-on effects from a credit crisis on our business, including the insolvency of key transportation providers and the inability of our customers to obtain credit to finance development and/or manufacture products resulting in a decreased demand for transportation services. Our revenues and gross margins are dependent upon this demand, and if demand for transportation services declines, our revenues and gross margins could be adversely affected.

Although we believe we have adequate liquidity and capital resources to fund our operations internally our inability to access the capital markets on favorable terms, or at all, may adversely affect our ability to engage in strategic transactions. The inability to obtain adequate financing from debt or capital sources could force us to self-fund strategic initiatives or even forgo certain opportunities, which in turn could potentially harm our performance.

Uncertainty about global economic conditions could also continue to increase the volatility of our stock price.

We are exposed to credit risk and fluctuations in the market values of our investment portfolio.

Although we have not recognized any material losses on our cash and cash equivalents, future declines in their market values could have a material adverse effect on our financial condition and operating results. The value or liquidity of our cash and cash equivalents could decline which could have a material adverse effect on our financial condition and operating results.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We directly, or indirectly through our subsidiaries, operate 43 offices throughout the United States, Canada and Mexico, including our headquarters in Downers Grove, Illinois and our Company-owned drayage operations headquartered in Memphis, Tennessee. All of our office space is leased. Most office leases have initial terms of more than one year, and many include options to renew. While some of our leases expire in the near term, we do not believe that we will have difficulty in renewing them or in finding alternative office space. We believe that our offices are adequate for the purposes for which they are currently used.

Item 3. LEGAL PROCEEDINGS

We are a party to litigation incident to our business, including claims for personal injury and/or property damage, freight lost or damaged in transit, improperly shipped or improperly billed. Some of the lawsuits to which we are party are covered by insurance and are being defended by our insurance carriers. Some of the lawsuits are not covered by insurance and we defend those ourselves. We do not believe that the outcome of this litigation will have a materially adverse effect on our financial position or results of operations. See Item 1 Business - Risk Management and Insurance.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of our security holders during the fourth quarter of 2009.

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Executive Officers of the Registrant

In reliance on General Instruction G to Form 10-K, information on executive officers of the Registrant is included in this Part I. The table sets forth certain information as of February 1, 2010 with respect to each person who is an executive officer of the Company.

| Name | Age | Position |
|-----------------------|-----|--------------------------------------------------------------------------------|
| David P. Yeager | 56 | Chairman of the Board of Directors and Chief Executive Officer |
| Mark A. Yeager | 45 | Vice Chairman of the Board of Directors, President and Chief Operating Officer |
| Christopher R. Kravas | 44 | Chief Intermodal Officer |
| David L. Marsh | 42 | Chief Marketing Officer |
| Terri A. Pizzuto | 51 | Executive Vice President, Chief Financial Officer and Treasurer |
| James B. Gaw | 59 | Executive Vice President-Sales |
| Dwight C. Nixon | 47 | Executive Vice President-Highway |
| Donald G. Maltby | 55 | Executive Vice President-Logistics |
| Dennis R. Polsen | 56 | Executive Vice President-Information Services |
| David C. Zeilstra | 40 | Vice President, Secretary and General Counsel |

David P. Yeager has served as our Chairman of the Board since November 2008 and as Chief Executive Officer since March 1995. From March 1995 through November 2008, Mr. Yeager served as Vice Chairman of the Board. From October 1985 through December 1991, Mr. Yeager was President of Hub Chicago. From 1983 to October 1985, he served as Vice President, Marketing of Hub Chicago. Mr. Yeager founded the St. Louis Hub in 1980 and served as its President from 1980 to 1983. Mr. Yeager founded the Pittsburgh Hub in 1975 and served as its President from 1975 to 1977. Mr. Yeager received a Masters in Business Administration degree from the University of Chicago in 1987 and a Bachelor of Arts degree from the University of Dayton in 1975. Mr. Yeager is the brother of Mark A. Yeager.

Mark A. Yeager has served as Vice Chairman of the Board since November 2008. He became the President of the Company in January 2005 and has been our Chief Operating Officer and a Director since May 2004. From July 1999 to December 2004, Mr. Yeager was President-Field Operations. From November 1997 through June 1999, Mr. Yeager was Division President, Secretary and General Counsel. From March 1995 to November 1997, Mr. Yeager was Vice President, Secretary and General Counsel. From May 1992 to March 1995, Mr. Yeager served as our Vice President-Quality. Prior to joining us in 1992, Mr. Yeager was an associate at the law firm of Grippio & Elden from January 1991 through May 1992 and an associate at the law firm of Sidley & Austin from May 1989 through January 1991. Mr. Yeager received a Juris Doctor degree from Georgetown University in 1989 and a Bachelor of Arts degree from Indiana University in 1986. Mr. Yeager is the brother of David P. Yeager.

Christopher R. Kravas has been our Chief Intermodal Officer since October 2007. Prior to this promotion, Mr. Kravas was Executive Vice President-Strategy and Yield Management from December 2003 through September 2007. From February 2002 through November 2003, Mr. Kravas served as President of Hub Highway Services. From February 2001 through December 2001, Mr. Kravas was Vice President-Enron Freight Markets. Mr. Kravas joined Enron after it acquired Webmodal, an intermodal business he founded. Mr. Kravas was Chief Executive Officer of Webmodal from July 1999 through February 2001. From 1989 through June 1999 Mr. Kravas worked for the Burlington Northern Santa Fe Railway in various positions in the intermodal business unit and finance department. Mr. Kravas received a Bachelor of Arts degree in 1987 from Indiana University and a Masters in Business Administration in 1994.

from the University of Chicago.

David L. Marsh has been our Chief Marketing Officer since October 2007. Prior to this promotion, Mr. Marsh was Executive Vice President-Highway from February 2004 through September 2007. Mr. Marsh previously served as President of Hub Ohio from January 2000 through January 2004. Mr. Marsh joined us in March 1991 and became General Manager with Hub Indianapolis in 1993, a position he held through December 1999. Prior to joining Hub Group, Mr. Marsh worked for Carolina Freight Corporation, a less than truckload carrier, starting in January 1990. Mr. Marsh received a Bachelor of Science degree in Marketing and Physical Distribution from Indiana University-Indianapolis in December 1989. Mr. Marsh has been a member of the American Society of Transportation and Logistics, the Indianapolis Traffic Club, the Council for Logistics Management and served as an advisor to the Indiana University-Indianapolis internship program for transportation and logistics. Mr. Marsh was honored as the Indiana Transportation Person of the Year in 1999.

Terri A. Pizzuto has been our Executive Vice President, Chief Financial Officer and Treasurer since March 2007. Prior to this promotion, Ms. Pizzuto was Vice President of Finance from July 2002 through February 2007. Prior to joining us, Ms. Pizzuto was a partner in the Assurance and Business Advisory Group at Arthur Andersen LLP. Ms. Pizzuto worked for Arthur Andersen LLP for 22 years holding various positions and serving numerous transportation companies. Ms. Pizzuto received a Bachelor of Science in Accounting from the University of Illinois in 1981. Ms. Pizzuto is a CPA and a member of the American Institute of Certified Public Accountants.

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James B. Gaw has been our Executive Vice President-Sales since February 2004. From December 1996 through January 2004, Mr. Gaw was President of Hub North Central, located in Milwaukee. From 1990 through late 1996, he was Vice President and General Manager of Hub Chicago. Mr. Gaw joined Hub Chicago as Sales Manager in 1988. Mr. Gaw's entire career has been spent in the transportation industry, including 13 years of progressive leadership positions at Itofca, an intermodal marketing company, and Flex Trans. Mr. Gaw received a Bachelor of Science degree from Elmhurst College in 1973.

Dwight C. Nixon has been our Executive Vice President-Highway since October 2007. Mr. Nixon previously served as Regional Vice President of Highway's Western Region from April 2004 through September 2007. Prior to joining us, Mr. Nixon was a Senior Corporate Account Executive for Roadway Express, Inc. and spent 19 years in various operational, sales and sales management positions. Mr. Nixon was also a California Gubernatorial appointee and member of the California Workforce Investment Board from November 2005 through December 2007. Mr. Nixon received a Bachelor of Science degree in Finance from the University of Arizona in 1984.

Donald G. Maltby has been our Executive Vice President-Logistics since February 2004. Mr. Maltby previously served as President of Hub Online, our e-commerce division, from February 2000 through January 2004. Mr. Maltby also served as President of Hub Cleveland from July 1990 through January 2000 and from April 2002 to January 2004. Prior to joining Hub Group, Mr. Maltby served as President of Lyons Transportation, a wholly owned subsidiary of Sherwin Williams Company, from 1988 to 1990. In his career at Sherwin Williams, which began in 1981 and continued until he joined us in 1990, Mr. Maltby held a variety of management positions including Vice-President of Marketing and Sales for their Transportation Division. Mr. Maltby has been in the transportation and logistics industry since 1976, holding various executive and management positions. Mr. Maltby received a Masters in Business Administration from Baldwin Wallace College in 1982 and a Bachelor of Science degree from the State University of New York in 1976.

Dennis R. Polsen has been our Executive Vice President-Information Services since February 2004. From September 2001 to January 2004, Mr. Polsen was Vice President-Chief Information Officer and from March 2000 through August 2001, Mr. Polsen was our Vice-President of Application Development. Prior to joining us, Mr. Polsen was Director of Applications for Humana, Inc. from September 1997 through February 2000 and spent 14 years prior to that developing, implementing, and directing transportation logistics applications at Schneider National, Inc. Mr. Polsen received a Masters in Business Administration in May of 1983 from the University of Wisconsin Graduate School of Business and a Bachelor of Business Administration in May of 1976 from the University of Wisconsin-Milwaukee. Mr. Polsen is a past member of the American Trucking Association.

David C. Zeilstra has been our Vice President, Secretary and General Counsel since July 1999. From December 1996 through June 1999, Mr. Zeilstra was our Assistant General Counsel. Prior to joining us, Mr. Zeilstra was an associate with the law firm of Mayer, Brown & Platt from September 1994 through November 1996. Mr. Zeilstra received a Juris Doctor degree from Duke University in 1994 and a Bachelor of Arts degree from Wheaton College in 1990.

Directors of the Registrant

In addition to David P. Yeager and Mark A. Yeager, the following three individuals are also on our Board of Directors: Gary D. Eppen – currently retired and formerly the Ralph and Dorothy Keller Distinguished Service Professor of Operations Management and Deputy Dean for part-time Masters in Business Administration Programs at the Graduate School of Business at the University of Chicago; Charles R. Reaves – Chief Executive Officer of Reaves Enterprises, Inc., a real estate development company, and Martin P. Slark – Vice Chairman and Chief Executive Officer of Molex, Incorporated, a manufacturer of electronic, electrical and fiber optic interconnection products and systems.

PART II

Item MARKET FOR REGISTRANTS COMMON EQUITY AND RELATED SHAREHOLDER MATTERS AND
5. ISSUER PURCHASES OF EQUITY SECURITIES

Our Class A Common Stock (“Class A Common Stock”) trades on the NASDAQ Global Select Market tier of the NASDAQ Stock Market under the symbol “HUBG.” Set forth below are the high and low closing prices for shares of the Class A Common Stock for each full quarterly period in 2009 and 2008.

| | 2009 | 2008 | | | |
|---------------------------------------------------------------------------------|------|--------------------------------|----------|------------------------------|----------|
| | | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | | 2003 | 2002 | 2003 | 2002 |
| Net income (loss): | | | | | |
| As reported | | \$ 48,739 | \$26,046 | \$91,265 | \$70,512 |
| Add: | | | | | |
| Stock-based employee compensation expense included in net income, net of tax | | 452 | | 752 | |
| | | 5 | | | |

Table of Contents**VERITAS SOFTWARE CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------------------------------------------------------------------------------------------------|--------------------------------|--------------------|------------------------------|--------------------|
| | 2003 | 2002 | 2003 | 2002 |
| Less: | | | | |
| Total stock-based employee compensation expense determined under the fair value based method for all awards, net of tax | 76,964 | 70,893 | 152,800 | 142,815 |
| Pro forma | <u>\$ (27,773)</u> | <u>\$ (44,847)</u> | <u>\$ (60,783)</u> | <u>\$ (72,303)</u> |
| Basic income (loss) per share: | | | | |
| As reported | <u>\$ 0.12</u> | <u>\$ 0.06</u> | <u>\$ 0.22</u> | <u>\$ 0.17</u> |
| Pro forma | <u>\$ (0.07)</u> | <u>\$ (0.11)</u> | <u>\$ (0.15)</u> | <u>\$ (0.18)</u> |
| Diluted income (loss) per share: | | | | |
| As reported | <u>\$ 0.11</u> | <u>\$ 0.06</u> | <u>\$ 0.22</u> | <u>\$ 0.17</u> |
| Pro forma | <u>\$ (0.07)</u> | <u>\$ (0.11)</u> | <u>\$ (0.15)</u> | <u>\$ (0.18)</u> |

For the pro forma amounts determined under SFAS No. 123, as set forth above, the fair value of each stock option grant under the stock option plans is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the three and six months ended June 30, 2003 and 2002: risk-free interest rates averaging 2.57% and 2.74% for the three and six months ended June 30, 2003, respectively, and 4.44% and 4.45% for the three and six months ended June 30, 2002, respectively; a dividend yield of 0.0% for all periods; a weighted-average expected life of 5 years for all periods; and a volatility factor of the expected market price of the Company's common stock of 0.90 for all periods.

The fair value of the employees' purchase rights under the employee purchase plan is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions for these rights granted during the three and six months ended June 30, 2003 and 2002: a dividend yield of 0.0% for all periods; an expected life ranging from 6 to 24 months for all periods; an expected volatility factor of 0.90 for all periods; and risk-free interest rates ranging from 1.20% to 1.66% and 1.87% to 2.98% for the six months ended June 30, 2003 and June 30, 2002, respectively.

5. New Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective on July 1, 2003. The Company does not expect the adoption of SFAS No. 150 to have a material effect on the Company's financial position, results of operations or cash flows.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In particular, SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (2) clarifies when

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a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No. FIN 45, *Guarantors*

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VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and (4) amends certain other existing pronouncements. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003, except for those paragraphs related to guidance in SFAS No. 133 implementation issues that have been cleared by the FASB and have been effective for fiscal quarters that began prior to June 15, 2003. Those paragraphs should continue to be applied in accordance with their respective effective dates. The Company does not expect the adoption of SFAS No. 149 to have a material effect on the Company's financial position, results of operations or cash flows.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities*, which addresses the consolidation of variable interest entities. FIN 46 provides guidance for determining when an entity that is the primary beneficiary of a variable interest entity or equivalent structure should consolidate the variable interest entity into the entity's financial statements. The provisions of FIN 46 are to be applied as of the beginning of the first interim or annual reporting period beginning after June 15, 2003 for variable interest entities created before February 1, 2003 and still existing on June 15, 2003. The Company currently has three build-to-suit operating leases, commonly referred to as synthetic leases, which were entered into prior to February 1, 2003. Each synthetic lease is owned by a trust that has no voting rights, no employees, no financing activity other than the lease with the Company, no ability to absorb losses and no right to participate in gains realized on the sale of the related property. The Company has determined that the trusts under the leasing structures qualify as variable interest entities for purposes of FIN 46. Consequently, the Company is considered the primary beneficiary and will consolidate the trusts into the Company's financial statements beginning July 1, 2003. As a result of consolidating these entities in the third quarter of 2003, the Company expects to report a cumulative effect of change in accounting principle in accordance with APB 20, *Accounting Changes*, with a charge of \$6.2 million which equals the amount of depreciation expense that would have been recorded had these trusts been consolidated from the date the properties were available for occupancy, net of tax. In addition, on July 1, 2003, the Company will record property and equipment, net of accumulated depreciation, equal to \$369.1 million, long-term debt in the amount of \$369.2 million and noncontrolling interest of \$11.4 million on the balance sheet. Future depreciation expense related to these properties will be approximately \$1.6 million per quarter and \$4.1 million per quarter of rent expense previously classified as operating expense will be classified as interest expense in the statements of operations beginning July 1, 2003.

In November 2002, the FASB issued FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 requires that the Company recognize the fair value for guarantee and indemnification arrangements issued or modified by the Company after December 31, 2002, if these arrangements are within the scope of the Interpretation. In addition, the Company must continue to monitor the conditions that are subject to the guarantees and indemnifications, as required under previously existing generally accepted accounting principles, in order to identify if a loss has occurred. If the Company determines it is probable that a loss has occurred, then any such estimable loss would be recognized under those guarantees and indemnifications. Some of the software licenses granted by the Company contain provisions that indemnify licensees of the Company's software from damages and costs resulting from claims alleging that the Company's software infringes the intellectual property rights of a third party. The Company has historically received only a limited number of requests for indemnification under these provisions and has not been required to make material payments pursuant to these provisions. Accordingly, the Company has not recorded a liability related to these indemnification provisions. The Company does not have any guarantees or indemnification arrangements other than the indemnification clause in some of its software licenses, the guarantee on a credit facility discussed in Note 14 and the guarantee on its three build-to-suit lease agreements for buildings in Mountain View, Roseville and Milpitas discussed in Note 15. The Company adopted FIN 45 effective January 1, 2003. The adoption of FIN 45 did not have a material impact on the Company's financial position, results of operations or cash flows.

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In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 supersedes Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. SFAS No. 146 addresses the recognition, measurement, and reporting of costs that are associated with exit and disposal activities. These costs include those related to terminating a contract that is not a capital lease and termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred-compensation contract. The provisions of SFAS No. 146 require that the liability for costs associated with an exit or disposal activity be recorded at fair value and that they be recognized when the liability is incurred rather than at the date of the commitment to an exit plan as prescribed under EITF Issue 94-3. SFAS No. 146 is applied prospectively for exit or disposal activities that are initiated after December 31, 2002 and accordingly, liabilities recognized prior to the initial application of SFAS No. 146 will continue to be accounted for in accordance with EITF Issue 94-3. The Company adopted SFAS No. 146 effective January 1, 2003.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development or normal use of the assets. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated asset, and this additional carrying amount is expensed over the life of the asset. The Company adopted SFAS No. 143 effective January 1, 2003. The adoption of SFAS No. 143 did not have a material effect on the Company's financial position, results of operations or cash flows.

6. Net Income per Share

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------------------------------------------------------|--------------------------------|-----------|------------------------------|-----------|
| | 2003 | 2002 | 2003 | 2002 |
| Numerator: | | | | |
| Net income | \$ 48,739 | \$ 26,046 | \$ 91,265 | \$ 70,512 |
| Denominator: | | | | |
| Denominator for basic net income per share weighted-average shares outstanding | 415,621 | 409,465 | 414,270 | 407,776 |
| Potential common shares | 12,318 | 9,254 | 10,005 | 12,513 |
| Denominator for diluted net income per share | 427,939 | 418,719 | 424,275 | 420,289 |
| Basic net income per share | \$ 0.12 | \$ 0.06 | \$ 0.22 | \$ 0.17 |
| Diluted net income per share | \$ 0.11 | \$ 0.06 | \$ 0.22 | \$ 0.17 |

For the three and six months ended June 30, 2003 and 2002, potential common shares consist of employee stock options using the treasury method. The following table sets forth the potential common shares

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that were excluded from the net income per share computations as their effect would be antidilutive (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------------------------------------|--------------------------------|--------|------------------------------|--------|
| | 2003 | 2002 | 2003 | 2002 |
| Employee stock options outstanding(1) | 34,572 | 36,684 | 38,363 | 28,018 |
| 5.25% convertible subordinated notes(2) | 6,695 | 6,695 | 6,695 | 6,695 |
| 1.856% convertible subordinated notes(2) | 12,981 | 12,981 | 12,981 | 12,981 |

(1) For the three months ended June 30, 2003 and 2002, 34,572 and 36,684 employee stock options, respectively, and for the six months ended June 30, 2003 and 2002, 38,363 and 28,018 employee stock options, respectively, were excluded from the computation of diluted net income per share because the exercise price of these options was greater than the average market price of the Company's common stock during the respective periods, and therefore the effect is antidilutive.

(2) For the three and six months ended June 30, 2003 and 2002, 6,695 potential common shares related to the Company's 5.25% convertible subordinated notes and 12,981 potential common shares related to the Company's 1.856% convertible subordinated notes, respectively, were excluded from the computation of diluted net income per share because the impact of adding back after tax interest expense associated with the convertible subordinated notes, and including the potential common shares, would be antidilutive.

The weighted average exercise prices of the employee stock options with exercise prices exceeding the average fair value of the Company's common stock was \$61.92 and \$58.45 per share for the three and six months ended June 30, 2003, respectively. The weighted average exercise prices of the employee stock options with exercise prices exceeding the average fair value of the Company's common stock was \$65.06 and \$99.27 per share for the three and six months ended June 30, 2002, respectively.

7. Business Combinations

Precise Software Solutions Ltd.

On June 30, 2003, in connection with the Agreement and Plan of Merger and Amendment No. 1 to Agreement and Plan of Merger, the Company acquired all of the outstanding common stock of Precise Software Solutions Ltd. (Precise), a provider of application performance management products. The Company acquired Precise in order to expand its product and service offerings across storage, databases and application management. The Precise acquisition was accounted for using the purchase method of accounting for total purchase consideration of \$701.0 million, which included 7.3 million shares of common stock valued at \$210.6 million, \$397.8 million of cash of which \$333.3 was paid on June 30, 2003 and \$64.5 million was paid in July 2003 and has been recorded as merger consideration payable in the balance sheet, \$79.5 million relating to the assumption of Precise options exercisable for 4.4 million shares of the Company's common stock and \$13.1 million of acquisition-related costs. The fair value of the Company's common stock issued was determined using an average price of \$28.68, which was the average trading price from June 25, 2003 through July 1, 2003, the five trading days surrounding the date the merger consideration was finalized. The fair value of the Company's stock options assumed was determined using the Black-Scholes option pricing model and the following assumptions: estimated contractual life of 6 months to 5 years, risk-free interest rate of 0.96% to 2.49%, expected volatility of 90% and no expected dividend yield. The fair value of stock options assumed is net of \$14.5 million which represents the portion of the intrinsic value of Precise's unvested options applicable to the remaining vesting period. Upon the assumption by the Company of the outstanding Precise options, each Precise option became exercisable for 0.6741 shares of the Company's common stock.

Under the purchase method of accounting, the total estimated purchase price was allocated to Precise's net tangible and identifiable intangible assets based upon their estimated fair value as of the date of the

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completion of the acquisition. Based upon an independent valuation prepared by Standard & Poor's Corporate Value Consulting, the following represents the preliminary allocation of the aggregate purchase price to the acquired net assets of Precise (in thousands):

| | |
|---------------------------------------------------|------------|
| Cash, cash equivalents and short-term investments | \$ 149,627 |
| Other current assets | 11,527 |
| Long-term assets | 8,629 |
| Current liabilities | (29,103) |
| Goodwill | 493,220 |
| Developed technology | 26,600 |
| Customer contracts | 15,200 |
| Patented technology | 11,600 |
| Other intangible assets | 7,500 |
| Unearned stock-based compensation | 14,475 |
| In-process research and development | 15,300 |
| Net deferred and other income taxes payable | (23,592) |
| | <hr/> |
| Total | \$ 700,983 |
| | <hr/> |

The Company does not expect future adjustments to the purchase price allocation to be material. Goodwill represents the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired. Goodwill is not amortized which is consistent with the guidance in SFAS No. 142, *Goodwill and Other Intangible Assets*. Developed technology, customer contracts and patented technology are being amortized over their estimated useful lives of four years and other intangible assets are being amortized over their estimated useful lives of one to four years. The weighted average amortization period for all purchased intangible assets is 3.7 years.

In connection with the acquisition of Precise, the Company allocated approximately \$15.3 million of the purchase price to in-process technology that has not yet reached technological feasibility and has no alternative future use. This amount has been expensed as a non-recurring, non-tax deductible charge in the statements of operations for the three and six months ended June 30, 2003.

In order to value purchased in-process research and development (IPR&D), research projects in areas for which technological feasibility had not been established were identified. The value of these projects was determined by estimating the expected cash flows from the projects once commercially viable and discounting the net cash flows back to their present value, using adjusted discount rates based on the percentage of completion of the in-process projects.

Net Cash Flows. The net cash flows expected from the identified projects are based on the appraiser's estimates of revenues, royalty savings, cost of sales, research and development costs, selling, general and administrative costs, royalty costs and income taxes from those projects. Revenue estimates are based on the assumptions mentioned below. The research and development costs included in the estimates reflect costs to sustain projects, but exclude costs to bring in-process projects to technological feasibility.

The estimated revenues are based on the Company's projection of each in-process project and the business projections were compared and found to be consistent with industry analysts' forecasts of growth in substantially all of the relevant markets. Estimated total revenues from the IPR&D product areas are expected to peak in the year ending December 31, 2005 and decline from 2006 into 2007 as other new products are expected to become available.

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These projections are based on the Company's estimates of market size and growth, expected trends in technology and the nature and expected timing of new project introductions by Precise.

Discount Rate. Discounting the expected net cash flows back to their present value is based on the industry weighted average cost of capital (WACC). The Company believes the industry WACC is approximately 15%. The discount rate used to discount the expected net cash flows from IPR&D is 28%. The discount rate used is higher than the industry WACC due to inherent uncertainties surrounding the successful development of IPR&D, market acceptance of the technology, the useful life of such technology and the uncertainty of technological advances which could potentially impact the estimates described above.

Percentage of Completion. The percentage of completion for in-process Precise technology was determined using costs incurred to date on each project as compared to the remaining research and development to be completed as well as major milestones to bring each project to technological feasibility. The percentage of completion for projects under development ranged from 40-65%.

If the projects discussed above are not successfully developed, the sales and profitability of the combined company may be adversely affected in future periods.

Acquisition-related costs of \$13.1 million consist of \$9.2 million associated with legal and other professional fees, \$3.3 million for terminating and satisfying existing lease commitments and \$0.6 million for severance-related costs. Total cash outlays for acquisition-related costs were approximately \$2.0 million for legal and other professional fees and no amounts for leases or severance through June 30, 2003.

The results of operations of Precise are included in the Company's consolidated financial statements from the date of acquisition. The following table presents pro forma results of operations and gives effect to the acquisition of Precise as if the acquisition was consummated on January 1, 2002. The unaudited pro forma results of operations are not necessarily indicative of what would have occurred had the acquisition been made as of the beginning of each period or of the results that may occur in the future. Net income for each period presented excludes the write-off of acquired in-process research and development of \$15.3 million and includes amortization of intangible assets related to the acquisition of \$4.7 million per quarter and amortization of deferred compensation of \$1.7 million per quarter. The unaudited pro forma information is as follows (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------------------------|--------------------------------|-----------|------------------------------|-----------|
| | 2003 | 2002 | 2003 | 2002 |
| Total net revenue | \$422,543 | \$382,910 | \$839,084 | \$770,453 |
| Net income | 35,903 | 23,268 | 75,858 | 64,769 |
| Net income per share basic | 0.09 | 0.06 | 0.18 | 0.16 |
| Net income per share diluted | 0.08 | 0.05 | 0.17 | 0.15 |

Jareva Technologies, Inc.

On January 27, 2003, the Company acquired all of the outstanding capital stock of Jareva Technologies, Inc. (Jareva), a privately held provider of automated server provisioning products that enable businesses to automatically deploy additional servers without manual intervention. The Company acquired Jareva to integrate Jareva's technology into the Company's software products to enable the Company's customers to optimize their investments in server hardware by deploying new server resources on demand. The Jareva acquisition was accounted for using the purchase accounting method for total purchase consideration of \$63.3 million, which included \$58.7 million of cash, \$1.4 million relating to the assumption of options exercisable for 426,766 shares of the Company's common stock and \$3.2 million of acquisition-related costs. The purchase price was allocated, based on an independent valuation prepared by Standard & Poor's

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Corporate Value Consulting, to goodwill of \$43.3 million, developed technology of \$9.1 million, other intangibles of \$1.9 million, in-process research and development of \$4.1 million, net deferred tax liabilities of \$4.3 million, deferred stock-based compensation of \$5.4 million and net tangible assets of \$3.8 million. The weighted average amortization period for all purchased intangible assets is 3.3 years. For the three and six months ended June 30, 2003, the Company recorded amortization of developed technology of \$0.5 million and \$0.8 million, respectively, amortization of other intangibles of \$0.3 million and \$0.5 million, respectively, and, included in research and development expense, stock-based compensation expense of \$0.7 million and \$1.1 million, respectively. The acquired in-process research and development of \$4.1 million was written off and the related charge is included in income from operations for the six months ended June 30, 2003. Acquisition-related costs consist of \$2.7 million associated with terminating and satisfying remaining lease commitments, partially offset by sublease income net of related sublease costs and direct transaction costs of \$0.5 million for legal and other professional fees. Total cash outlays for acquisition-related costs were \$0.7 million through June 30, 2003. The results of operations of Jareva are included in the Company's consolidated financial statements from the date of acquisition. The pro forma impact on the Company's results of operations for the three and six months ended June 30, 2003 and 2002 was not significant.

8. Goodwill and Other Intangible Assets

On January 1, 2002, the Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. As a result, the Company no longer amortizes goodwill, but will test it for impairment annually or whenever events or changes in circumstances suggest that the carrying amount may not be recoverable.

The following table sets forth the carrying amount of goodwill. Goodwill also includes amounts originally allocated to assembled workforce (in thousands):

| | June 30, 2003 | December 31, 2002 |
|---------------------------------|--------------------------|------------------------------|
| Goodwill: | | |
| Gross carrying amount | \$ 3,821,984 | \$ 3,285,455 |
| Accumulated amortization | 2,088,862 | 2,088,862 |
| Net carrying amount of goodwill | <u>\$ 1,733,122</u> | <u>\$ 1,196,593</u> |

As of June 30, 2003, goodwill includes \$493.2 million related to the acquisition of Precise on June 30, 2003 and \$43.3 million related to the acquisition of Jareva on January 27, 2003.

The following tables set forth the carrying amount of other intangible assets that will continue to be amortized (in thousands):

| | June 30, 2003 | | |
|----------------------------------------------|--------------------------------------|-------------------------------------|--------------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Developed technology | \$ 271,208 | \$ 226,024 | \$ 45,184 |
| Distribution channels | 234,800 | 234,800 | |
| Trademarks | 26,650 | 24,350 | 2,300 |
| Other intangible assets | 65,334 | 29,488 | 35,846 |
| Intangibles related to business acquisitions | <u>597,992</u> | <u>514,662</u> | <u>83,330</u> |

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| | | | |
|-----------------------------------------------|------------------|------------------|-----------------|
| Convertible subordinated notes issuance costs | <u>14,506</u> | <u>9,013</u> | <u>5,493</u> |
| Total other intangibles assets | <u>\$612,498</u> | <u>\$523,675</u> | <u>\$88,823</u> |

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| | December 31, 2002 | | |
|-----------------------------------------------|-----------------------------|-----------------------------|------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Developed technology | \$ 235,508 | \$ 200,140 | \$ 35,368 |
| Distribution channels | 234,800 | 210,342 | 24,458 |
| Trademarks | 24,350 | 21,813 | 2,537 |
| Other intangible assets | 29,520 | 25,737 | 3,783 |
| Intangibles related to business acquisitions | 524,178 | 458,032 | 66,146 |
| Convertible subordinated notes issuance costs | 14,506 | 8,058 | 6,448 |
| Total other intangibles assets | \$ 538,684 | \$ 466,090 | \$ 72,594 |

The total amortization expense of intangible assets related to business acquisitions is set forth in the table below (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------|--------------------------------|------------------|------------------------------|------------------|
| | 2003 | 2002 | 2003 | 2002 |
| Developed technology | \$ 10,887 | \$ 16,903 | \$ 25,985 | \$ 33,806 |
| Distribution channels | 9,783 | 14,675 | 24,458 | 29,350 |
| Trademarks | 1,015 | 1,522 | 2,537 | 3,045 |
| Other intangible assets | 1,612 | 1,919 | 3,668 | 3,737 |
| Total amortization | \$ 23,297 | \$ 35,019 | \$ 56,648 | \$ 69,938 |

For the three and six months ended June 30, 2003, total amortization expense for developed technology and other intangibles includes \$0.5 million and \$0.9 million, respectively, that is included in cost of user license fees. For the three and six months ended June 30, 2002, the total amortization expense for developed technology and other intangibles includes \$0.1 million and \$0.1 million, respectively, that is included in cost of user license fees.

The total expected future annual amortization of intangible assets related to business acquisitions is set forth in the table below (in thousands):

| Year | Future Amortization |
|------|------------------------|
| 2003 | \$ 14,487 |
| 2004 | 22,263 |
| 2005 | 19,582 |
| 2006 | 17,954 |
| 2007 | 8,873 |

| | |
|-------|-----------------|
| 2008 | 171 |
| Total | <u>\$83,330</u> |

9. Strategic Investments

The Company holds investments in common and preferred stock of several privately-held companies. The total carrying amount of the Company's strategic investments was \$5.4 million at June 30, 2003 and \$10.3 million at December 31, 2002. These strategic investments are included in other non-current assets. The

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VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company recorded no impairment losses on strategic investments for the three months ended June 30, 2003 and \$3.5 million of impairment losses for the six months ended June 30, 2003. For the three and six months ended June 30, 2002, the Company recorded impairment losses on strategic investments of \$14.8 million. The losses realized represent write-downs of the Company's carrying amount of the investments, as the Company deemed such losses to be other than temporary, and were determined by using, among other factors, the market value of the investee's stock, its inability to obtain additional private financing, its cash position and current burn rate, the status and competitive position of the investee's products and the uncertainty of its financial condition.

10. Facility Restructure Reserve

In the fourth quarter of 2002, the Company's board of directors approved a facility restructuring plan to exit and consolidate certain of its facilities located in 17 metropolitan areas worldwide related to facilities that were or are expected to be vacated. In connection with this facilities restructuring plan, the Company recorded a restructuring charge to operating expenses of \$98.2 million in the fourth quarter of 2002. This restructuring charge is comprised of \$86.9 million associated with terminating and satisfying remaining lease commitments, partially offset by sublease income net of related sublease costs, and \$11.3 million for asset write-offs. Total cash outlays under this restructuring plan are expected to be approximately \$86.9 million.

Restructuring costs will generally be paid over the remaining lease terms, ending at various dates through 2021, or over a shorter period as the Company may negotiate with its lessors. The Company expects the majority of costs will be paid by the year ending December 31, 2008.

The Company began vacating facilities during the fourth quarter of 2002 and expects to vacate all excess facilities associated with this restructuring by December 31, 2003. The Company anticipates that it will realize cost savings beginning in the third quarter of 2003. The Company is in the process of seeking suitable subtenants for these facilities. The Company's estimates of the facility restructure charge may vary significantly, depending in part, on factors that are beyond the Company's control, including the commercial real estate market in the applicable metropolitan areas, the Company's ability to obtain subleases related to these facilities and the time period to do so, the sublease rental market rates and the outcome of negotiations with lessors regarding terminations of some of the leases. Adjustments to the facility restructure reserve will be made if actual lease exit costs or sublease income differ from amounts currently expected. As a portion of the facilities restructure reserve relates to international locations, the reserve will be affected by exchange rate fluctuations. The impact of exchange rate fluctuations is recorded in accumulated other comprehensive income (loss) on the balance sheet.

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The portion of the reserve expected to be utilized through June 30, 2004 of \$25.0 million has been classified in the current portion of accrued acquisition and restructuring charges. The portion of the reserve expected to be utilized in periods subsequent to June 30, 2004 of \$66.4 million has been classified in the non-current portion of accrued acquisition and restructuring charges. The components of the restructuring reserve and movements within these components through June 30, 2003 were as follows (in millions):

| | Net Rent Commitments | Asset Write-Offs | Total |
|------------------------------|-------------------------|---------------------|--------|
| Provision accrued | \$86.9 | \$11.3 | \$98.2 |
| Cash payments | (0.2) | | (0.2) |
| Impact of exchange rates | 0.6 | 0.1 | 0.7 |
| | — | — | — |
| Balance at December 31, 2002 | 87.3 | 11.4 | 98.7 |
| Cash payments | (2.7) | | (2.7) |
| Adjustment | 0.8 | (0.8) | |
| Impact of exchange rates | (0.4) | (0.1) | (0.5) |
| | — | — | — |
| Balance at March 31, 2003. | 85.0 | 10.5 | 95.5 |
| Cash payments | (2.3) | | (2.3) |
| Asset write-offs | | (3.6) | (3.6) |
| Impact of exchange rates | 1.5 | 0.3 | 1.8 |
| | — | — | — |
| Balance at June 30, 2003. | \$84.2 | \$ 7.2 | \$91.4 |

11. Comprehensive Income

The following are the components of comprehensive income (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------------------------|--------------------------------|----------|------------------------------|----------|
| | 2003 | 2002 | 2003 | 2002 |
| Net income | \$ 48,739 | \$26,046 | \$ 91,265 | \$70,512 |
| Other comprehensive income, net of tax: | | | | |
| Foreign currency translation adjustments | (10,568) | (4,780) | (14,612) | (5,513) |
| Derivative financial instrument adjustments | (255) | 6,031 | 406 | 4,540 |
| Unrealized (gain) loss on marketable securities | (82) | (1,598) | 114 | 4,292 |
| | — | — | — | — |
| Comprehensive income | \$ 37,834 | \$25,699 | \$ 77,173 | \$73,831 |

The components of accumulated other comprehensive income (loss) are (in thousands):

| | |
|------------------|----------------------|
| June 30, 2003 | December 31, 2002 |
|------------------|----------------------|

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| | | |
|-----------------------------------------------|-----------|-----------|
| Foreign currency translation adjustments | \$ 17,625 | \$ 3,013 |
| Derivative financial instrument adjustments | (10,211) | (9,806) |
| Unrealized gain on marketable securities | 3,209 | 3,324 |
| | <hr/> | <hr/> |
| Accumulated other comprehensive income (loss) | \$ 10,623 | \$(3,469) |
| | <hr/> | <hr/> |

Table of Contents**VERITAS SOFTWARE CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. Derivative Financial Instruments**

In September 2000, the Company entered into a three-year cross currency interest rate swap transaction, or swap, for the purpose of hedging fixed interest rate, foreign currency denominated cash flows under an inter-company loan receivable. Under the terms of this derivative financial instrument, Euro denominated fixed principal and interest payments to be received under the inter-company loan will be swapped for U.S. dollar-fixed principal and interest payments. As of June 30, 2003, three monthly payments of 4.3 million remained to be swapped at a forward exchange rate of 0.89070 U.S. dollar per Euro. The fair market value of the swap at June 30, 2003 was \$(10.0) million. As a result of entering into the swap, the Company has mitigated its exposure to foreign currency exchange rate fluctuations. The gains or losses on the foreign currency loan receivable will be offset by the gains or losses on the swap. Because the Company is receiving fixed interest payments under the swap, it is still subject to fluctuations in value due to changes in U.S. dollar interest rates. As of June 30, 2003, the impact of these fluctuations was not significant. This hedge was deemed to be highly effective as of June 30, 2003.

In January 2002, the Company entered into two three-year pay fixed, receive floating, interest rate swaps for the purpose of hedging cash flows on variable interest rate debt of its build-to-suit lease agreements. Under the terms of these interest rate swaps, the Company makes payments based on the fixed rate and will receive interest payments based on the 3-month London Inter Bank Offered Rate (LIBOR). The Company's payments on its build-to-suit lease agreements are based upon a 3-month LIBOR plus a credit spread. If the Company's credit spread remains consistent and other critical terms of the interest rate swap or the hedged item do not change, the interest rate swap will be considered to be highly effective with all changes in the fair value included in other comprehensive income. If the Company's credit spread changes or other critical terms of the interest rate swap or the hedged item change, the hedge may become partially or fully ineffective, which could result in all or a portion of the changes in fair value of the derivative recorded in the statement of operations. The interest rate swaps settle the first day of January, April, July and October until expiration. As of June 30, 2003, the fair value of the interest rate swaps were \$(10.8) million. As a result of entering into the interest rate swaps, the Company has mitigated its exposure to variable cash flows associated with interest rate fluctuations. Because the rental payments on the leases are based on the 3-month LIBOR and the Company receives 3-month LIBOR from the interest rate swap counter-party, the Company has eliminated any impact to raising interest rates related to its rent payments under the build-to-suit lease agreements.

As of June 30, 2003, the total gross notional amount of the Company's forward contracts was approximately \$153.3 million, all hedging intercompany accounts of certain of its international subsidiaries. The forward contracts had a term of thirty-five days or less and settled on July 31, 2003. All foreign currency transactions and all outstanding forward contracts are marked-to-market at the end of the period with unrealized gains and losses included in other income. The unrealized gain (loss) on the outstanding forward contracts at June 30, 2003 was immaterial to the Company's consolidated financial statements.

13. Segment Information

The Company operates in one segment, storage software solutions. The Company's products and services are sold throughout the world, through original equipment manufacturers, direct sales channels and indirect sales channels. The Company's chief operating decision maker, the chief executive officer, evaluates the performance of the Company based upon stand-alone revenue of product channels and the geographic regions of the segment and does not use discrete financial information about asset allocation, expense allocation or profitability from the Company's storage software products or services.

Table of Contents**VERITAS SOFTWARE CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Geographic Information (in thousands)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------|--------------------------------|-------------------|------------------------------|-------------------|
| | 2003 | 2002 | 2003 | 2002 |
| User license fees(1): | | | | |
| United States | \$ 159,205 | \$ 161,072 | \$ 323,456 | \$ 329,461 |
| Europe(2) | 69,406 | 52,167 | 128,390 | 112,403 |
| Other(3) | 32,351 | 28,637 | 63,680 | 59,723 |
| | <u>260,962</u> | <u>241,876</u> | <u>515,526</u> | <u>501,587</u> |
| Total user license fees | | | | |
| Services(1): | | | | |
| United States | 108,598 | 94,649 | 207,379 | 181,391 |
| Europe(2) | 29,746 | 19,940 | 58,949 | 37,647 |
| Other(3) | 13,550 | 8,225 | 25,388 | 14,514 |
| | <u>151,894</u> | <u>122,814</u> | <u>291,716</u> | <u>233,552</u> |
| Total services | | | | |
| Total net revenue | <u>\$ 412,856</u> | <u>\$ 364,690</u> | <u>\$ 807,242</u> | <u>\$ 735,139</u> |

| | June 30, 2003 | December 31, 2002 |
|-----------------------|---------------------|----------------------|
| Long-lived assets(4): | | |
| United States | \$ 1,969,017 | \$ 1,429,261 |
| Europe(2) | 54,357 | 55,049 |
| Other(3) | 15,273 | 15,138 |
| | <u>\$ 2,038,647</u> | <u>\$ 1,499,448</u> |
| Total | | |

- (1) License and services revenues are attributed to geographic regions based on location of customers.
- (2) Europe includes the Middle East and Africa.
- (3) Other includes Canada, Latin America, Japan and the Asia Pacific region.
- (4) Long-lived assets include all long-term assets except those specifically excluded under SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, such as deferred income taxes. Reconciliation to total assets reported (in thousands):

| | June 30, 2003 | December 31, 2002 |
|--|------------------|----------------------|
| | <u></u> | <u></u> |

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| | | |
|---------------------------------|-----------------------------|-----------------------------|
| Total long-lived assets | \$2,038,647 | \$1,499,448 |
| Other assets, including current | 2,783,325 | 2,700,185 |
| | <u> </u> | <u> </u> |
| Total consolidated assets | \$4,821,972 | \$4,199,633 |
| | <u> </u> | <u> </u> |

For the three and six months ended June 30, 2003, Ingram Micro, Inc. a distributor that sells the Company's products and services through resellers, accounted for 10% of the Company's net revenue. No customer represented 10% or more of the Company's net revenue for the three and six months ended June 30, 2002.

Table of Contents**VERITAS SOFTWARE CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****User License Fees Information***

The Company derives its user license fees from the sale of its core technology products, including data protection and file system and volume management products and from its emerging technology products, including cluster and replication and storage area networking products. User license fees from core technology products were \$228.4 million and \$437.2 million for the three and six months ended June 30, 2003, respectively, and \$212.6 million and \$438.5 million for the three and six months ended June 30, 2002, respectively. User license fees from emerging technology products were \$32.6 million and \$78.3 million for the three and six months ended June 30, 2003, respectively, and \$29.3 million and \$63.1 million for the three and six months ended June 30, 2002, respectively.

14. Credit Facility

During 2002, the Company's Japanese subsidiary entered into a short-term credit facility with a multinational Japanese bank in the amount of 1.0 billion Japanese yen (\$8.4 million USD). At June 30, 2003, no amount was outstanding. The short-term credit facility was renewed in March 2003 and is due to expire in March 2004. Borrowings under the short-term credit facility bear interest at Tokyo Inter Bank Offered Rate (TIBOR) plus 0.5%. There are no covenants on the short-term credit facility and the loan has been guaranteed by VERITAS Software Global LLC, a wholly-owned subsidiary of the Company.

15. Commitments and Contingencies***Facilities Lease Commitments***

In 1999 and 2000, the Company entered into three build-to-suit lease agreements for office buildings in Mountain View, California, Roseville, Minnesota and Milpitas, California. The Company began occupying the Roseville and Mountain View facilities in May and June 2001, respectively, and began occupying the Milpitas facility in April 2003. The development and acquisition of the properties have been financed by a third party through a syndicate of financial institutions. The Company has accounted for these agreements as operating leases in accordance with SFAS No. 13, *Accounting for Leases*, as amended. Commencing July 1, 2003, the Company will account for these agreements in accordance with FIN 46 which will require the Company to consolidate these entities into the consolidated financial statements (see Note 5).

During 2001 and 2002, the Company amended its existing lease agreement, originally signed in 1999, for new corporate campus facilities in Mountain View, California. The facilities of 425,000 square feet provide space for sales, marketing, administration and research and development functions. The lease term for these facilities is five years beginning in March 2000, with an option to extend the lease term for two successive periods of one year each, if agreed to by the financial institutions. The Company has the option to purchase the property (land and facilities) for the termination value of \$145.2 million or, at the end of the lease, to arrange for the sale of the property to a third party while the Company retains an obligation to the owner for the difference between the sales price and the guaranteed residual value up to \$129.0 million if the sales price is less than this amount, subject to certain provisions of the lease. In addition, the Company is entitled to any proceeds from a sale of the property in excess of the termination value. The Company now occupies these facilities and began making lease payments in the second quarter of 2001.

During 2001 and 2002, the Company amended its existing lease agreement, originally signed in 2000, for its facilities in Roseville, Minnesota. The Company improved and expanded its existing facilities of 62,000 square feet and developed adjacent property adding 142,000 square feet completed in 2001. The facilities provide space for technical support and research and development functions. The lease term for these facilities is five years beginning in March 2000, with an option to extend the lease term for two successive periods of one year each, if agreed to by the financial institutions. The Company has the option to purchase the property (land and facilities) for the termination value of \$41.3 million or, at the end of the lease, to arrange

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for the sale of the property to a third party while the Company retains an obligation to the owner for the difference between the sales price and the guaranteed residual value up to \$35.1 million if the sales price is less than this amount, subject to certain provisions of the lease. In addition, the Company is entitled to any proceeds from a sale of the property in excess of the termination value. The Company now occupies these facilities and began making lease payments in 2001.

During 2001 and 2002, the Company amended its existing lease agreement, originally signed in 2000, for the lease of 65 acres of land and subsequent improvements for new research and development campus facilities in Milpitas, California. The Company plans to develop the site in two phases. The first phase of the project, comprising 466,000 square feet and consisting of one completed building and two additional structures, was completed in the third quarter of 2002. The facilities will provide space for research and development and general corporate functions. The lease term for the first phase is five years beginning in July 2000, with an option to extend the lease term for two successive periods of one year each, if agreed to by the financial institutions. The Company has the option to purchase the property (land and first phase facilities) for the termination value of \$194.3 million or, at the end of the lease, to arrange for the sale of the property to a third party while the Company retains an obligation to the owner for the difference between the sales price and the guaranteed residual value up to \$180.5 million if the sales price is less than this amount, subject to certain provisions of the lease. In addition, the Company is entitled to any proceeds from a sale of the property in excess of the termination value. The Company began paying the lease payments in the third quarter of 2002 and occupied a portion of the new campus facilities in the second quarter of 2003. The Company is currently analyzing its development schedule for the second phase of the campus, and at this time no commitments have been made with respect to the start of construction.

Lease payments under the Company's three build-to-suit lease agreements are generally paid quarterly and are equal to the termination value of the outstanding lease obligations multiplied by the Company's cost of funds, which is based on LIBOR using 30-day to 180-day LIBOR contracts and adjusted for the Company's credit spread. In January 2002, the Company entered into two three-year pay fixed, receive floating, interest rate swaps for the purpose of hedging the cash payments related to the Roseville, Minnesota and Mountain View, California lease agreements. Under the terms of these interest rate swaps, the Company makes payments based on the fixed rate and will receive interest payments based on the 3-month LIBOR rate. For the three and six months ended June 30, 2003, the Company's aggregate lease payments, including the payments on the interest rate swaps, were \$4.1 million and \$8.3 million, respectively. For the three and six months ended June 30, 2002, the payments were \$4.2 million and \$8.3 million, respectively.

The Company has evaluated the expected fair value of the properties at the end of the lease terms by reviewing current real estate market conditions and indicators of expectations for the market in the future. In the event that the Company determines it is probable that the expected fair value of any of the properties at the end of the lease terms will be less than the respective termination values, the Company will accrue the expected loss on a straight-line basis over the remaining lease term. Currently, the Company does not believe it is probable that the fair market value of the properties at the end of the lease terms will be less than the termination values.

The agreements for the facilities described above require that the Company maintain specified financial covenants, all of which the Company was in compliance with as of June 30, 2003. The specified financial covenants as of June 30, 2003 require the Company to maintain a minimum rolling four quarter EBITDA of \$400.0 million, a minimum ratio of cash and cash equivalents to current liabilities of 1.2 to 1, and a leverage ratio of total funded indebtedness to rolling four quarter EBITDA of not more than 3.0 to 1. For purposes of these financial covenants, EBITDA represents the Company's net income for the applicable period, plus interest expense, taxes, depreciation and amortization and all non-cash restructuring charges for acquisitions occurring within a four year period, less software development expenses classified as capital expenditures. In order to secure the obligation under each agreement, each of the facilities is subject to a deed of trust in favor

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of the financial institutions that financed the development and acquisition of the respective facility. Bank of America, N.A. was the agent for the syndicate of banks that funded the development of the Mountain View, California and Roseville, Minnesota facilities, and ABN AMRO Bank, N.V. was the agent for the syndicate of banks that funded the development of the Milpitas, California facility.

Acquired Technology

On October 1, 2002, the Company acquired volume replicator software technology for \$6.0 million and contingent payments of up to another \$6.0 million based on future revenues generated by the acquired technology. The payments will be paid quarterly over 40 quarters, in amounts between \$150,000 and \$300,000. The Company issued a promissory note payable in the principal amount of \$5.0 million, representing the present value of the Company's minimum payment obligations under the purchase agreement for the acquired technology, which are payable quarterly commencing in the first quarter of 2003 and ending in the fourth quarter of 2012. The contingent payments in excess of the quarterly minimum obligations will be paid as they may become due. The outstanding balance of the note payable was \$4.8 million as of June 30, 2003 and \$5.0 million as of December 31, 2002 and is included in non-current accrued acquisition and restructuring costs.

Legal Proceedings

In response to subpoenas issued by the Securities and Exchange Commission in the investigation entitled *In the Matter of AOL/Time Warner*, the Company continues to furnish information requested by the SEC, including information relating to the transactions it entered into with AOL in September 2000 and other transactions. The outcome of this investigation cannot be predicted at this time. The Company will continue its efforts to cooperate with the SEC's investigation.

After the Company announced in January 2003 that it would restate financial results as a result of transactions entered into with AOL in September 2000, numerous separate complaints purporting to be class actions were filed in the United States District Court for the Northern District of California alleging that the Company and some of its officers and directors violated provisions of the Securities Exchange Act of 1934. The complaints contain varying allegations, including that the Company made materially false and misleading statements with respect to its 2000, 2001 and 2002 financial results included in its filings with the SEC, press releases and other public disclosures. On May 2, 2003, a lead plaintiff and lead counsel were appointed. A consolidated complaint was filed by the lead plaintiff on July 18, 2003. In addition, several complaints purporting to be derivative actions have been filed in California state court against some of the Company's directors and officers. These complaints are based on the same facts and circumstances as the class actions and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately the Company's financial reporting. The state court complaints have also been consolidated. All of the complaints generally seek an unspecified amount of damages. The cases are still in the preliminary stages, and it is not possible for the Company to quantify the extent of its potential liability, if any. An unfavorable outcome in any of these cases could have a material adverse effect on its business, financial condition, results of operations and cash flow. In addition, defending any litigation may be costly and divert management's attention from the day-to-day operations of the Company's business.

On January 10, 2003, Raytheon Company sued the Company along with Brocade Communications Systems, Oracle Corporation, Overland Storage Inc., Qualstar Corp., QLogic Corporation, Ricoh Corporation and Spectra Logic Corporation in the United States District Court for the Eastern District of Texas. Raytheon is alleging infringement of US Patent No. 5,412,791, or '791 patent, entitled Mass Data Storage Library, and is seeking damages and an injunction against all defendants. The Company believes that it has numerous defenses and counterclaims to the claims of infringement asserted against it and it intends to defend itself vigorously. The Company filed an answer to Raytheon's complaint on March 7, 2003, denying all material

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

allegations in the complaint and asserting counterclaims seeking to have Raytheon's 791 patent declared invalid and not infringed by the Company. A trial date is currently scheduled for June 2004.

On October 23, 2001, Storage Computer Corporation initiated litigation against the Company in the United States District Court for the Northern District of Texas alleging infringement of one of Storage Computer Corporation's patents. Currently, Storage Computer Corporation is alleging the Company infringes two of their US patents. The Company has denied all material allegations in the complaints, has filed counterclaims for declaratory judgment of invalidity and non-infringement of the patents-in-suit and has alleged their infringement of one of the Company's patents. Storage Computer Corporation is seeking damages of approximately \$50.0 million, treble damages, costs of suit and attorneys' fees and a permanent injunction from further alleged infringement. The Company believes that it has numerous defenses and counterclaims relative to the claims of infringement and the damages claims asserted against it and intends to vigorously defend this action. A trial date is currently scheduled for November 2003.

The Company is also party to various other legal proceedings that have arisen in the ordinary course of business. While the Company currently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on its financial position or overall trends in results of operations, litigation is subject to inherent uncertainties. Were an unfavorable ruling to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the ruling occurs. The estimate of the potential impact on the Company's financial position or overall results of operations for the above legal proceedings could change in the future.

For each of the matters noted, the Company does not believe that it is probable that a liability has been incurred nor does it believe that the amount of any loss can be reasonably estimated. Accordingly, no liability has been accrued for these matters.

16. Subsequent Events

In August 2003, the Company issued \$500.0 million of 0.25% convertible subordinated notes due August 1, 2013 (the 0.25% Notes), for which the Company received net proceeds of approximately \$488.0 million, to several initial purchasers in a private offering. The Company has also granted to the initial purchasers of the 0.25% Notes an option to purchase up to an additional \$100.0 million principal amount of 0.25% Notes solely to cover over-allotments. This over-allotment option may be exercised by the initial purchasers at any time on or prior to August 28, 2003.

The 0.25% Notes were issued at their face value and provide for semi-annual interest payments of \$0.6 million each February 1 and August 1, beginning February 1, 2004. The 0.25% Notes are convertible, under the specified circumstances discussed below, into shares of the Company's common stock at a conversion rate of 21.6802 shares per \$1,000 principal amount of notes, which is equivalent to a conversion price of approximately \$46.13 per share. The conversion rate is subject to adjustment upon the occurrence of specified events. The specified circumstances under which the 0.25% Notes are convertible prior to maturity are: (1) during any quarterly conversion period (which periods begin on the eleventh trading day of each fiscal quarter and end on the eleventh trading day of the following fiscal quarter) prior to August 1, 2010, if the closing sale price of the Company's common stock for at least 20 trading days in the 30 trading day period ending on the first day of such conversion period exceeds 120% of the conversion price of the notes on that first day, (2) during the period beginning August 1, 2010 through the maturity date of the notes, if the closing sale price of the Company's common stock is more than 120% of the then current conversion price, (3) during the five consecutive business day period following any five consecutive trading day period in which the average of the trading prices for the 0.25% Notes was less than 95% of the average of the sale price of the Company's common stock multiplied by the then current conversion rate of the notes, (4) the Company's corporate credit rating assigned by Standard & Poor's falls below B- (and if Moody's has assigned a corporate credit rating to the Company and such rating is lower than B3) or if both such ratings are withdrawn, (5) the Company calls

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VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the notes for redemption or (6) upon the occurrence of corporate transactions specified in the indenture governing the notes. Upon any conversion of notes by a holder, the Company shall have the option to satisfy its conversion obligation in shares of its common stock, in cash or a combination thereof. It is the intention of the Company to satisfy the principal portion of the obligation in cash and the remainder, if any, in shares of its common stock. On or after August 5, 2006, the Company has the option to redeem all or a portion of the 0.25% Notes at a redemption price equal to 100% of the principal amount, plus accrued and unpaid interest. On August 1, 2006 and August 1, 2008, or upon the occurrence of a fundamental change involving the Company, holders of the 0.25% Notes may require the Company to repurchase their notes at a repurchase price equal to 100% of the principal amount, plus accrued and unpaid interest. Upon a fundamental change, the Company will have the option to pay the repurchase price in cash, shares of common stock or a combination thereof.

In July 2003, the Company's board of directors authorized a program to repurchase the Company's common stock in an amount of up to \$300.0 million plus the market value at the time of repurchase of any shares issued upon conversion of the 1.856% convertible subordinated notes due 2006 (1.856% Notes), which the Company has called for redemption. If all holders of the 1.856% Notes elect to convert their notes into common stock, they would receive in the aggregate approximately 13.0 million shares of the Company's common stock. On August 1, 2003, the Company repurchased 4.2 million shares of its common stock for an aggregate purchase price of approximately \$129.0 million. The Company expects to purchase additional shares of common stock under the program from time to time on the open market or in privately negotiated transactions.

In July 2003, the Company announced that it will be redeeming on August 18, 2003 all of its outstanding 5.25% convertible subordinated notes due 2004 (5.25% Notes), and all of its outstanding 1.856% Notes. On August 18, 2003, the aggregate redemption price of the 5.25% Notes will be approximately \$64.0 million and the aggregate redemption price of the 1.856% Notes will be approximately \$407.0 million. The conversion price of the 5.25% Notes is \$9.56 per share. The effective conversion price of the 1.856% Notes on August 18, 2003 will be approximately \$31.35 per share. If the market price of the Company's common stock is higher than the conversion prices of the 5.25% Notes or the 1.856% Notes on the redemption date, some or all holders of the 5.25% Notes and 1.856% Notes may elect to convert their notes into common stock in lieu of redeeming for cash. If the 1.856% Notes are redeemed for cash, the Company will record a loss on extinguishment of debt of approximately \$4.9 million in the third quarter of 2003 related to the unamortized portion of debt issuance costs. This charge would be classified as a non-operating expense in the Company's statement of operations.

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VERITAS SOFTWARE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This quarterly report on Form 10-Q contains forward-looking statements, within the meaning of the Securities Exchange Act of 1934 and the Securities Act of 1933, that involve risks and uncertainties. These forward-looking statements include statements about our revenue, revenue mix, gross margin, operating expense levels, financial outlook, commitments under existing leases, research and development initiatives, sales and marketing initiatives and competition. In some cases, forward-looking statements are identified by words such as believe, anticipate, expect, intend, plan, will, may and similar expressions. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this quarterly report on Form 10-Q. These forward-looking statements are based on information available to us at this time, and we assume no obligation to update any of these statements. Actual results could differ from those projected in these forward-looking statements as a result of many factors, including those identified below in the section titled Factors That May Affect Future Results and elsewhere. We urge you to review and consider the various disclosures made by us in this report, and those detailed from time to time in our filings with the Securities and Exchange Commission, that attempt to advise you of the risks and factors that may affect our future results.

The following discussion should be read in conjunction with our financial statements and accompanying notes, which appear elsewhere in this quarterly report on Form 10-Q. Unless expressly stated or the context otherwise requires, the terms we, our, us and VERITAS refer to VERITAS Software Corporation and its subsidiaries.

Overview

VERITAS is a leading independent supplier of storage software products and services. Storage software includes storage management, data protection and high availability software. With our recent acquisition of Precise Software Solutions Ltd., we also offer application performance management software. We develop and sell products for most popular operating systems, including various versions of Windows, UNIX and Linux. We also develop and sell products that support a wide variety of servers, storage devices, databases, applications and network solutions. Our customers include many leading global corporations and small and medium enterprises around the world operating in a wide variety of industries. We also provide a full range of services to assist our customers in assessing, architecting and implementing their storage software solutions.

We derive user license fee revenue from shipments of our software products to end-user customers through a combination of direct sales channels and indirect sales channels such as resellers, value-added resellers, distributors, original equipment manufacturers, application software vendors, strategic partner resellers and systems integrators. Some original equipment manufacturers incorporate our products into their products, some bundle our products with their products, some resell our products and some license our products to third parties as optional products. In general, we receive a user license fee for each sublicense of our products granted by an original equipment manufacturer.

Our services revenue consists of fees derived from maintenance and technical support, consulting and training services. Original equipment manufacturer maintenance agreements covering our products provide for technical and emergency support and minor unspecified product upgrades for a fixed annual fee. Maintenance agreements covering products that are licensed through sales channels other than original equipment manufacturers provide for technical support and unspecified product upgrades for an annual fee based on the number of user licenses purchased and the level of service subscribed.

International Sales and Operations

Our international sales are generated primarily through our international sales subsidiaries. International revenue, a majority of which is collectible in foreign currencies, accounted for approximately 35% of our total revenue for the three months ended June 30, 2003 and 30% of our total revenue for the three months ended June 30, 2002. Our international revenue accounted for approximately 34% of our total revenue for the six months ended June 30, 2003 and 31% of our total revenue for the six months ended June 30, 2002. Our international revenue increased 33% to \$145.1 million for the three months ended June 30, 2003 from

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\$109.0 million for the three months ended June 30, 2002. Our international revenue increased 23% to \$276.4 million for the six months ended June 30, 2003 from \$224.3 million for the six months ended June 30, 2002. For the three months ending September 30, 2003, we expect to experience a seasonal reduction in business activity in Europe which is typical during the summer months. Over the long-term, we expect that our international revenue will increase relative to total revenue as a result of the lower penetration of our products existing in these markets and our increasing focus on developing international revenue opportunities.

We believe that our success depends upon continued expansion of our international operations. We currently have sales and service offices and resellers located in North America, Europe, Asia-Pacific, South America, Africa and the Middle East, and research and development centers in India and Israel. International expansion will require us to establish additional foreign offices, hire additional personnel and recruit new international resellers, resulting in the diversion of significant management attention and the expenditure of financial resources. To the extent that we are unable to meet these additional requirements, growth in international sales will be limited, which would have an adverse effect on our business, operating results and financial condition.

Business Combinations***Precise Software Solutions Ltd.***

On June 30, 2003, we acquired all of the outstanding common stock of Precise Software Solutions Ltd., or Precise, a provider of application performance management products. We acquired Precise in order to expand our product and service offerings across storage, databases and application management. The Precise acquisition was accounted for using the purchase method of accounting for total purchase consideration of \$701.0 million, which included 7.3 million shares of common stock valued at \$210.6 million, \$397.8 million of cash of which \$333.3 was paid on June 30, 2003 and \$64.5 million was paid in July 2003 and has been recorded as merger consideration payable in the balance sheet, \$79.5 million relating to the assumption of Precise options exercisable for 4.4 million shares of our common stock and \$13.1 million of acquisition-related costs. The fair value of stock options assumed is net of \$14.5 million which represents the portion of the intrinsic value of Precise's unvested options applicable to the remaining vesting period. Upon the assumption of the outstanding Precise options, each Precise option became exercisable for 0.6741 shares of our common stock. Our balance sheet as of June 30, 2003 includes balances as a result of our acquisition of Precise. The results of operations of Precise will be included in our consolidated statements of operations beginning July 1, 2003.

Under the purchase method of accounting, the total estimated purchase price was allocated to Precise's net tangible and identifiable intangible assets based upon their estimated fair value as of the date of the completion of the acquisition. Based upon an independent valuation, the following represents the preliminary allocation of the aggregate purchase price to the acquired net assets of Precise (in thousands):

| | |
|---------------------------------------------------|------------|
| Cash, cash equivalents and short-term investments | \$ 149,627 |
| Other current assets | 11,527 |
| Long-term assets | 8,629 |
| Current liabilities | (29,103) |
| Goodwill | 493,220 |
| Developed technology | 26,600 |
| Customer contracts | 15,200 |
| Patented technology | 11,600 |
| Other intangible assets | 7,500 |
| Unearned stock-based compensation | 14,475 |
| In-process research and development | 15,300 |
| Net deferred and other income taxes payable | (23,592) |
| | <hr/> |
| Total | \$ 700,983 |
| | <hr/> |

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We do not expect future adjustments to the purchase price allocation to be material. Goodwill represents the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired. Goodwill is not amortized which is consistent with the guidance in SFAS No. 142, *Goodwill and Other Intangible Assets*. Developed technology, customer contracts and patented technology are being amortized over their estimated useful lives of four years and other intangible assets are being amortized over their estimated useful lives of one to four years. The weighted average amortization period for all purchased intangible assets is 3.7 years.

In connection with the acquisition of Precise, we allocated approximately \$15.3 million of the purchase price to in-process technology that has not yet reached technological feasibility and has no alternative future use. This amount has been expensed as a non-recurring, non-tax deductible charge in our statements of operations for the three and six months ended June 30, 2003.

Acquisition-related costs of \$13.1 million consist of \$9.2 million associated with legal and other professional fees, \$3.3 million for terminating and satisfying existing lease commitments and \$0.6 million for severance-related costs. Total cash outlays for acquisition-related costs were approximately \$2.0 million for legal and other professional fees and no amounts for leases or severance through June 30, 2003.

Jareva Technologies, Inc.

On January 27, 2003, we acquired all of the outstanding capital stock of Jareva Technologies, Inc., or Jareva, a privately held provider of automated server provisioning products that enable businesses to automatically deploy additional servers without manual intervention. We acquired Jareva to integrate its technology into our software products to enable our customers to optimize their investments in server hardware by deploying new server resources on demand. The Jareva acquisition was accounted for using the purchase accounting method for total purchase consideration of \$63.3 million, which included \$58.7 million of cash, \$1.4 million relating to the assumption of options exercisable for 426,766 shares of our common stock and \$3.2 million of acquisition-related costs. The purchase price was allocated, based on an independent valuation, to goodwill of \$43.3 million, developed technology of \$9.1 million, other intangibles of \$1.9 million, in-process research and development of \$4.1 million, net deferred tax liabilities of \$4.3 million, deferred stock-based compensation of \$5.4 million and net tangible assets of \$3.8 million. For the three and six months ended June 30, 2003, we recorded amortization of developed technology of \$0.5 million and \$0.8 million, respectively, amortization of other intangibles of \$0.3 million and \$0.5 million, respectively, and, included in research and development expense, stock-based compensation expense of \$0.7 million and \$1.1 million, respectively. The acquired in-process research and development of \$4.1 million was written off and the related charge is included in income from operations for the six months ended June 30, 2003. Acquisition-related costs consist of \$2.7 million associated with terminating and satisfying remaining lease commitments, partially offset by sublease income net of related sublease costs and direct transaction costs of \$0.5 million for legal and other professional fees. Total cash outlays for acquisition-related costs were \$0.7 million through June 30, 2003.

NSMG

On May 28, 1999, we acquired the Network Storage Management Group business of Seagate Software, Inc., or NSMG. We incurred acquisition-related costs of \$43.4 million. In addition, as a result of the NSMG acquisition, we recorded a restructure charge of \$11.0 million in 1999 related to exit costs associated with duplicative facilities that we planned to vacate. In the fourth quarter of 2002, we recorded an additional reserve of \$4.2 million due to a decline in real estate market conditions that resulted in higher actual exit costs than estimated associated with these duplicative facilities. As of December 31, 2002, we had a remaining accrual of \$10.5 million for duplicative facility related costs and for the three and six months ended June 30, 2003, cash outlays for these costs were \$0.9 million and \$1.8 million, respectively and the impact of exchange rates was \$(0.5) million and \$(0.3) million, respectively. The impact of exchange rates for the first half of 2003 is the result of transferring the acquisition and acquisition-related restructuring charge accrual to a foreign subsidiary. The remaining acquisition and acquisition-related restructuring charge accrual as of June 30, 2003 of \$9.0 million is anticipated to be utilized for servicing operating lease payments or negotiated

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buyouts of operating lease commitments, the lease terms of which will expire at various times through the year 2013.

Seagate Technology Transaction

On November 22, 2000, we completed a multi-party transaction with Seagate Technology, or Seagate, and Suez Acquisition Company (Cayman) Limited, or SAC, a company formed by a group of private equity firms led by Silver Lake Partners. The transaction was structured as a leveraged buyout of Seagate pursuant to which Seagate sold all of its operating assets to SAC, and SAC assumed and indemnified Seagate and us for substantially all liabilities arising in connection with those operating assets. We did not acquire Seagate's disc drive business or any other Seagate operating business. At the closing, and after the operating assets and liabilities of Seagate had been transferred to SAC, a wholly-owned subsidiary of ours merged with and into Seagate, following which Seagate became our wholly-owned subsidiary and was renamed VERITAS Software Technology Corporation.

We issued approximately 109.4 million shares of our common stock to the Seagate stockholders in exchange for approximately 128.1 million shares of our common stock and certain non-operating assets and liabilities held by Seagate. The transaction resulted in a decrease of approximately 18.7 million shares of our outstanding common stock. At the closing of the transaction we recorded the non-operating assets and liabilities assumed from Seagate at their fair values. In addition, we accrued \$40.0 million of direct transaction costs, of which less than \$0.1 million remain in accrued acquisition and restructuring costs as of June 30, 2003. We anticipate that the remaining acquisition-related costs will be utilized in the third quarter of 2003.

For the three and six months ended June 30, 2003 and 2002, the Seagate transaction had no significant impact on our net income.

As a result of the decrease of approximately 18.7 million shares of our common stock outstanding on the number of shares used in computing our net income per share, the transaction resulted in incremental net income per diluted share of \$0.01 for the six months ended June 30, 2003. The transaction did not affect net income per diluted share for the three months ended June 30, 2003 and 2002 and the six months ended June 30, 2002.

As of June 30, 2003 and December 31, 2002, the transaction affected our consolidated balance sheet, as follows:

other current assets included \$21.3 million of indemnification receivable from SAC;

other non-current assets included \$18.0 million of indemnification receivable from SAC;

income taxes payable included an additional \$21.3 million; and

deferred and other income taxes included an additional \$113.1 million.

As of June 30, 2003 and December 31, 2002, deferred and other income taxes payable recorded in connection with the Seagate transaction totaled \$134.4 million and related to certain tax liabilities that we expect to pay. Certain of Seagate's federal and state tax returns for various fiscal years are under examination by tax authorities. We believe that adequate amounts for tax liabilities have been provided for any final assessments that may result from these examinations. The timing of the settlement of these examinations is uncertain. To the extent the settlements of these audits and the amounts reimbursed by SAC are different from the amounts recorded, the difference will be recorded as a component of income tax expense or benefit and may significantly affect our effective tax rate for the period in which the settlements take place.

Facility Restructure Reserve

In the fourth quarter of 2002, our board of directors approved a facility restructuring plan to exit and consolidate certain of our facilities located in 17 metropolitan areas worldwide. The facility restructuring plan was adopted to address overcapacity in our facilities as a result of lower than planned headcount growth in these metropolitan areas. In connection with this facility restructuring plan, we recorded a restructuring charge

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to operating expenses of \$98.2 million in the fourth quarter of 2002. This restructuring charge is comprised of \$86.9 million associated with terminating and satisfying remaining lease commitments, partially offset by sublease income net of related sublease costs, and \$11.3 million for asset write-offs. Total net cash outlays under this restructuring plan are expected to be approximately \$86.9 million.

Restructuring costs will generally be paid over the remaining lease terms, ending at various dates through 2021, or over a shorter period as we may negotiate with our lessors. We expect that the majority of costs will be paid by the year ending December 31, 2008.

During the fourth quarter of 2002, we began vacating excess facilities and expect to vacate all excess facilities associated with this restructuring by December 31, 2003. We anticipate realizing savings beginning during the third quarter of 2003. We are in the process of seeking suitable subtenants for these facilities. Our estimates of the facility restructure charge may vary significantly, depending in part, on factors that are beyond our control, including the commercial real estate market in the applicable metropolitan areas, our ability to obtain subleases related to these facilities and the time period to do so, the sublease rental market rates and the outcome of negotiations with lessors regarding terminations of some of the leases. Adjustments to the facility restructure reserve will be made if actual lease exit costs or sublease income differ from amounts currently expected. Because a portion of the facilities restructure reserve relates to international locations, the reserve will be affected by exchange rate fluctuations.

The components of the restructuring reserve and movements within these components through June 30, 2003 were as follows (in millions):

| | <u>Net Rent Commitments</u> | <u>Asset Write-Offs</u> | <u>Total</u> |
|------------------------------|---------------------------------|-----------------------------|-------------------|
| Provision accrued | \$86.9 | \$11.3 | \$98.2 |
| Cash payments | (0.2) | | (0.2) |
| Impact of exchange rates | 0.6 | 0.1 | 0.7 |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at December 31, 2002 | 87.3 | 11.4 | 98.7 |
| Cash payments | (2.7) | | (2.7) |
| Adjustment | 0.8 | (0.8) | |
| Impact of exchange rates | (0.4) | (0.1) | (0.5) |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at March 31, 2003 | 85.0 | 10.5 | 95.5 |
| Cash payments | (2.3) | | (2.3) |
| Asset write-offs | | (3.6) | (3.6) |
| Impact of exchange rates | 1.5 | 0.3 | 1.8 |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at June 30, 2003 | <u>\$84.2</u> | <u>\$ 7.2</u> | <u>\$91.4</u> |

Critical Accounting Policies

We believe that there are several accounting policies that are critical to understanding our historical and future performance, as these policies affect the reported amounts of revenue and other significant areas that involve management's judgments and estimates. These significant accounting policies are:

Revenue recognition;

Impairment of long-lived assets;

Restructuring expenses and related accruals; and

Accounting for income taxes.

These policies and our procedures related to these policies are described in detail below and under specific areas within the discussion and analysis of our financial condition and results of operations. In addition, please

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refer to the notes to the consolidated financial statements in our most recent annual report on Form 10-K for further discussion of our accounting policies.

Revenue Recognition

We derive revenue from primarily two sources: software licenses and services. Service revenue includes contracts for software maintenance and technical support, consulting and training services.

We apply the provisions of Statement of Position, or SOP, 97-2, *Software Revenue Recognition* (as amended by SOP 98-4 and SOP 98-9) and related interpretations to all transactions to recognize revenue.

For software arrangements involving multiple elements, we allocate and defer revenue for the undelivered elements based on their relative fair value and recognize the difference between the total arrangement fee and the amount deferred for the undelivered elements as revenue. The determination of fair value of each element in multiple element arrangements is based on the price charged when the same element is sold separately. To determine the price when sold separately, for the maintenance and technical support elements, we use historical renewal rates for per-copy deals and stated renewal rates for site licenses.

A typical arrangement includes software licenses, software media and maintenance and technical support. Some arrangements include training and consulting services. Software licenses are sold as site licenses or on a per copy basis. Site licenses give the customer the right to copy the software on a limited or unlimited basis during a specified term.

Maintenance and technical support includes updates (unspecified product upgrades and enhancements) on a when-and-if-available basis, telephone support, and bug fixes or patches. Maintenance and technical support revenue is recognized ratably over the maintenance term. Training consists of courses taught by our instructors at our facility or at the customer's site. Various courses are offered specific to the license products. Training fees are based on a per course basis or on an annual value-pass, which allows for unlimited courses to be taken by one individual over a one-year term. Revenue is recognized when the customer has completed the course. For value-passes, the revenue is recognized ratably over the one-year term. Consulting consists primarily of product installation services, which does not involve customization of the software. Installation services provided by us are not mandatory and can be performed by the customer, a third party, or us. Consulting fees are based on a computed daily rate.

We have analyzed all of the elements included in our multiple-element arrangements and determined that we have fair value to allocate revenue to the maintenance and technical support, training and consulting. Accordingly, assuming all other revenue recognition criteria are met, license revenue is recognized upon delivery of the software license and media using the residual method in accordance with SOP 98-9. Revenue from maintenance and technical support is recognized ratably over the maintenance term. Revenue from consulting is recognized as the services are performed. Revenue from training is recognized as the services are performed or ratably over the term for value-passes.

We define revenue recognition criteria as follows:

Persuasive Evidence of an Arrangement Exists. It is our customary practice to have a written contract, which is signed by both the customer and us, or a purchase order prior to recognizing revenue on an arrangement.

Delivery Has Occurred. Our software is usually physically delivered to our customers with standard transfer terms as FOB shipping point. It is occasionally delivered electronically, through an FTP download or a load and leave, where a VERITAS employee physically loads the software and does not leave any tangible property with the customer. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred.

The Vendor's Fee is Fixed or Determinable. The fee our customers pay for the products is negotiated at the outset of an arrangement, and is generally based on the specific volume of product to be delivered. Therefore, except in cases where we grant extended payment terms to a specific customer, the

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fees are considered to be fixed or determinable at the inception of the arrangement. Arrangements with payment terms extending beyond 90 days from the invoice date are not considered to be fixed or determinable. Revenue from such arrangements is recognized as the fees become due and payable.

Collection is Probable. Probability of collection is assessed on a customer-by-customer basis. We typically sell to customers where we have a history of successful collection. New customers are subjected to a credit review process that evaluates the customers' financial position and ultimately their ability to pay. If it is determined from the outset of an arrangement that collection is not probable based upon our review process, revenue is recognized on a cash-collected basis.

Additionally, we generally recognize revenue from licensing of software products through our indirect sales channel when the reseller, value added reseller, hardware distributor, application software vendor or system integrator sells the software products to its customers. For licensing of our software to original equipment manufacturers, royalty revenue is recognized when the original equipment manufacturer reports to us the sale of software to an end user customer. In addition to license royalties, some original equipment manufacturers pay an annual flat fee and/or support royalties for the right to sell maintenance and technical support to the end user. We recognize revenue from original equipment manufacturer support royalties and fees ratably over the term of the support agreement.

Our arrangements do not generally include acceptance clauses. However, if an arrangement includes an acceptance provision, we defer the revenue and recognize it upon acceptance, except for government contracts, as acceptance terms are standard. Acceptance occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

Certain of our customers are also our suppliers. Occasionally, in the normal course of business, we purchase and use goods or services for our operations from these suppliers at or about the same time we license our software to them. We identify and review the significant transactions to confirm that they are separately negotiated at terms we considered to be arm's length. In cases where the transactions are not separately negotiated, we assess the fair value of either of the goods or services involved in the transaction to support the recognition of the transaction. If we cannot determine fair value of either of the goods or services involved within reasonable limits, we record the transaction on a net basis. Our non-monetary transactions have not been material to our financial statements.

Impairment of Long-Lived Assets

We review our goodwill for impairment when events indicate that its carrying amount may not be recoverable or at least once a year. We are required to test our goodwill for impairment at the reporting unit level. We have determined that we have only one reporting unit. The test for goodwill impairment is a two-step process:

Step 1 We compare the carrying amount of our reporting unit, which is the book value of our entire company, to the fair value of our reporting unit, which corresponds to our market capitalization. If the carrying amount of our reporting unit exceeds its fair value, we have to perform the second step of the process. If not, no further work is needed.

Step 2 We allocate the fair value of our reporting unit to all assets and liabilities of our reporting unit as if the reporting unit had been acquired in a business combination at the date of the impairment test. We then compare the implied fair value of our reporting unit goodwill to its carrying amount. If the carrying amount of our reporting unit's goodwill exceeds its fair value, an impairment loss will be recognized in an amount equal to that excess.

We completed this test during the fourth quarter of 2002 and were not required to record an impairment loss on goodwill.

We review our long-lived assets, including property and equipment and other intangibles, for impairment when events indicate that their carrying amount may not be recoverable. When we determine that one or more impairment indicators are present for an asset, we compare the carrying amount of the asset to net future

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undiscounted cash flows that the asset is expected to generate. If the carrying amount of the asset is greater than the net future undiscounted cash flows that the asset is expected to generate, we would compare the fair value to the book value of the asset. If the fair value is less than the book value, we would recognize an impairment loss. The impairment loss would be the excess of the carrying amount of the asset over its fair value.

Some of the events that we consider as impairment indicators for our long-lived assets, including goodwill, are:

significant underperformance of our company relative to expected operating results;

our net book value compared to our market capitalization;

significant adverse economic and industry trends;

significant decrease in the market value of the asset;

the extent that we use an asset or changes in the manner that we use it; and

significant changes to the asset since we acquired it.

We do not expect to record an impairment loss on our long-lived assets in the near future.

Restructuring Expenses and Related Accruals

We monitor and regularly evaluate our organizational structure and associated operating expenses. Depending on events and circumstances, we may decide to restructure our operations to reduce operating costs.

We applied the provisions of Emerging Issues Task Force, or EITF, No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)* and EITF No. 88-10, *Costs Associated with Lease Modification or Termination* to all of our restructuring activities initiated before January 1, 2003. For exit restructuring activities initiated on January 1, 2003 or after, we will apply the provisions of Statement of Financial Accounting Standards, or SFAS, No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, outlined in our *New Accounting Pronouncements* section in Note 5 of the notes to the condensed consolidated financial statements, which appears elsewhere in this quarterly report on Form 10-Q.

Our restructuring costs and any resulting accruals involve significant estimates made by management using the best information available at the time the estimates are made, some of which may be provided by third parties. These estimates include facility exit costs, such as lease termination costs, and timing and market conditions of sublease income and related sublease expense costs, such as brokerage fees.

We regularly evaluate a number of factors to determine the appropriateness and reasonableness of our restructuring accruals. These factors include, but are not limited to, our ability to enter into sublease or lease termination agreements and market data about lease rates, timing and term of potential subleases and costs associated with terminating certain leases on vacated facilities.

Our estimates involve a number of risks and uncertainties, some of which are beyond our control, including future real estate market conditions and our ability to successfully enter into subleases or lease termination agreements upon terms as favorable as those assumed under our restructuring plan. Actual results may differ significantly from our estimates and may require adjustments to our restructuring accruals and operating results in future periods. For example, if actual proceeds from sublease agreements were to differ from our estimate of proceeds from sublease agreements included in our facility restructuring plan by 10%, the facility restructuring charge recorded in operating expenses during the fourth quarter of 2002 would have been different by approximately \$6.0 million.

Table of Contents*Accounting for Income Taxes*

We are required to estimate our income taxes in each federal, state and international jurisdiction in which we operate. This process requires that we estimate the current tax exposure as well as assess temporary differences between the accounting and tax treatment of assets and liabilities, including items such as accruals and allowances not currently deductible for tax purposes. The income tax effects of the differences we identify are classified as current or long-term deferred tax assets and liabilities in our consolidated balance sheets. We must also assess the likelihood that deferred tax assets will be realized from future taxable income and, based on this assessment, establish a valuation allowance if required. As of June 30, 2003, we determined the valuation allowance to be \$103.1 million, which includes \$22.9 million related to the acquisition of Precise, based upon uncertainties related to our ability to recover certain deferred tax assets. The valuation allowance related to Precise deferred tax assets will be credited to goodwill when realized. These deferred tax assets are in specific geographical or jurisdictional locations or are related to losses on strategic investments that will only be realized with the generation of future capital gains within a limited time period.

Future results may vary from these estimates, and at this time it is not practicable to determine if we will need to establish an additional valuation allowance and if it will have a material impact on our financial statements.

Results of Operations*Net Revenue*

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|----------------|------------|------------------------------|----------------|------------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| User license fees | \$261.0 | \$241.9 | 8% | \$515.5 | \$501.6 | 3% |
| Services | 151.9 | 122.8 | 24% | 291.7 | 233.5 | 25% |
| Total net revenue | \$412.9 | \$364.7 | 13% | \$807.2 | \$735.1 | 10% |

Total net revenue increased 13% for the three months ended June 30, 2003 over the same period in 2002 and 10% for the six months ended June 30, 2003 over the same period in 2002. The benefit from currency rate changes accounted for approximately 3% of the change in net revenue for the three and six months ended June 30, 2003 over the same periods in 2002. The remainder of the increase is primarily due to the continued growth of our services revenue, increased penetration of international markets and the benefit of new product offerings. We believe that total net revenue will increase in the second half of 2003 due to these factors and due to our recent acquisition of Precise.

User License Fees

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|---------|----------|------------------------------|---------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| User license fees | \$261.0 | \$241.9 | 8% | \$515.5 | \$501.6 | 3% |
| As a percentage of net revenue | 63% | 66% | | 64% | 68% | |

We derive user license fees from the sale of our core technology products, including data protection and file system and volume management products, and from our emerging technology products, including cluster and replication, storage area networking and network attached storage products. Revenue from core technology products comprises the majority of user license fees and was 88% of total user license

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fees for the three months ended June 30, 2003 and 2002 and 85% and 87% for the six months ended June 30, 2003 and 2002.

The increase in user license fees in the second quarter of 2003 over the same period in 2002 reflects increases in revenue from both core and emerging technology products. The increase in user license fees in the first half of 2003 over the same period in 2002 primarily reflects an increase in revenue from emerging technologies, which was the result of increased market penetration of our emerging technology products, particularly our clustering and replication products.

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| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|----------------------------------------------|--------------------------------|----------------|-----------|------------------------------|----------------|-----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| User license fees: | | | | | | |
| Core technologies | \$228.4 | \$212.6 | 7% | \$437.2 | \$438.5 | |
| Emerging technologies | 32.6 | 29.3 | 11% | 78.3 | 63.1 | 24% |
| Total user license fees | \$261.0 | \$241.9 | 8% | \$515.5 | \$501.6 | 3% |
| As a percentage of user license fees: | | | | | | |
| Core technologies | 88% | 88% | | 85% | 87% | |
| Emerging technologies | 12% | 12% | | 15% | 13% | |
| Total percentage of user license fees | 100% | 100% | | 100% | 100% | |

The increase in user license fees from core technologies in the second quarter of 2003 over the same period in 2002 is due to the increased revenue from both our data protection products and file system and volume management products. Revenue from core technologies in the first half of 2003 was relatively consistent with the same period in 2002.

Our user license fees from original equipment manufacturers decreased 9% in the second quarter of 2003 to \$33.9 million from \$37.4 million during the second quarter of 2002 and decreased 13% to \$68.9 million for the six months ended June 30, 2003 from \$79.3 million for the six months ended June 30, 2002. The user license fees from original equipment manufacturers accounted for 13% of user license fees in the second quarter of 2003 and 16% of user license fees in the second quarter of 2002 and accounted for 13% for the six months ended June 30, 2003 and 16% for the six months ended June 30, 2002. The decrease in 2003 compared to 2002 reflects reduced hardware sales by original equipment manufacturers as their customers reduced technology spending in the weaker economic environment. We expect revenue from original equipment manufacturers to continue decreasing as a percentage of our total revenue as a result of increased offerings of competitive software products by original equipment manufacturers as well as the trend toward less bundling of storage software with storage hardware.

Service Revenue

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|---------|----------|------------------------------|---------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Service revenue | \$151.9 | \$122.8 | 24% | \$291.7 | \$233.5 | 25% |
| As a percentage of net revenue | 37% | 34% | | 36% | 32% | |

We derive our service revenue primarily from contracts for software maintenance and technical support and, to a lesser extent, consulting and training services. The increase in service revenue in the second quarter and first half of 2003 over the same periods in 2002 was due primarily to renewal of service and support contracts on existing licenses, growth in international service revenue and, to a lesser extent, an increase in demand for consulting and training services. We expect our service revenue to increase in absolute dollars primarily as a result of our continued focus on increasing renewals of maintenance and technical support contracts on existing licenses and an increasing demand for our consulting and training services.

Cost of Revenue

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| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|--------|-------------|------------------------------|---------|-------------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Cost of revenue | \$72.6 | \$70.5 | 3% | \$146.6 | \$137.8 | 6% |
| As a percentage of net revenue | 18% | 19% | | 18% | 19% | |

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Gross margin on user license fees, excluding amortization of developed technology, is substantially higher than gross margin on service revenue, reflecting the low materials, packaging and other costs of software products compared with the relatively high personnel costs associated with providing maintenance and technical support, consulting and training services. Cost of service revenue varies depending upon the mix of maintenance and technical support, consulting and training services. We expect gross margin to fluctuate in the future, reflecting changes in royalty rates on licensed technologies, the mix of license and service revenue and the timing differences between increasing our organizational investments and the recognition of revenue that we expect as a result of these investments. In the near term, we expect service revenue to grow faster than user license fee revenue, which could result in slight declines in gross margin percentages.

Cost of User License Fees (including amortization of developed technology)

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|------------------------------------------------------------------|--------------------------------|----------------|--------------|------------------------------|----------------|-------------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Cost of user license fees: | | | | | | |
| User license fees | \$ 11.7 | \$ 8.8 | 33% | \$ 23.1 | \$ 18.0 | 28% |
| Amortization of developed technology | 10.6 | 16.9 | (37)% | 25.3 | 33.8 | (25)% |
| Total cost of user license fees | \$ 22.3 | \$ 25.7 | (13)% | \$ 48.4 | \$ 51.8 | (7)% |
| Gross margin: | | | | | | |
| User license fees including amortization of developed technology | 91% | 89% | | 91% | 90% | |

Cost of user license fees consists primarily of amortization of developed technology, royalties, media, manuals and distribution costs. Amortization of developed technology is related primarily to the acquisition of NSMG and other acquisitions completed during 1999 and the first quarter of 2003. Amortization of developed technology decreased in the second quarter and first half of 2003 over the same periods in 2002 primarily due to the fact that all intangibles related to the NSMG acquisition were fully amortized in May 2003. In addition, during the fourth quarter of 2002, we sold some of our technology and wrote-off the related net book value of developed technology which impacted the decrease in the first half of 2003 over 2002. If we excluded the amortization of developed technology from the cost of user license fees, the gross margin on user license fees would have been 96% for each of the three and six months ended June 30, 2003 and 2002. The gross margin on user license fees may vary from period to period based on the license revenue mix because some of our products carry higher royalty rates than others. Excluding the amortization of developed technology, we expect gross margins on user license fees to remain relatively constant in the second half of 2003.

Cost of Service Revenue

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|---------|----------|------------------------------|---------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Cost of service revenue | \$ 50.3 | \$ 44.9 | 12% | \$ 98.1 | \$ 86.0 | 14% |
| Gross margin | 67% | 63% | | 66% | 63% | |

Cost of service revenue consists primarily of personnel-related costs in providing maintenance and technical support, consulting and training to customers. The gross margin improvement in the second quarter and first half of 2003 over the same periods in 2002 was the result of our increased productivity and higher service revenue growth due to support fees from a larger installed customer base. We expect gross margin on service revenue to remain stable or increase slightly as a result of reductions in labor costs associated with technical support services by increasing our use of lower cost personnel located in our facilities in India.

Table of Contents*Amortization of Developed Technology*

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--------------------------------------|--------------------------------|---------|----------|------------------------------|---------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Amortization of developed technology | \$ 10.6 | \$ 16.9 | (37)% | \$ 25.3 | \$ 33.8 | (25)% |
| As a percentage of net revenue | 3% | 5% | | 3% | 5% | |

Amortization of developed technology is related primarily to the acquisition of NSMG and other acquisitions completed during 1999 and the first quarter of 2003. Amortization of developed technology decreased in the second quarter and first half of 2003 over the same periods in 2002 primarily due to the fact that all intangibles related to the NSMG acquisition were fully amortized in May 2003. In addition, during the fourth quarter of 2002, we sold some of our technology and wrote-off the related net book value of developed technology which impacted the decrease in the first half of 2003 over 2002. We expect amortization of developed technology to decline in the third quarter of 2003 to approximately \$4.3 million per quarter, including the amortization related to the January 2003 acquisition of Jareva and the June 2003 acquisition of Precise.

Operating Expenses

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|----------|----------|------------------------------|----------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Operating expenses | \$ 262.1 | \$ 247.1 | 6% | \$ 516.0 | \$ 490.3 | 5% |
| As a percentage of net revenue | 63% | 68% | | 64% | 67% | |

The increase in total operating expenses in the second quarter and first half of 2003 over the same periods in 2002 is due in part to currency rate changes which accounted for approximately 3% of the change. The remainder of the increase was primarily the result of increases in research and development and general and administrative expenses and the write-off of in-process research and development related to the acquisitions of Precise and Jareva in the second quarter and first quarter of 2003, respectively, partially offset by a decrease in selling and marketing expenses and amortization of other intangibles. During the third quarter of 2003, we expect our operating margin to increase compared to the second quarter of 2003 due to the expected increase in net revenue, the absence in the third quarter of the charge to write off in-process research and development of Precise, the expected decrease in amortization of developed technology and other intangibles as a result of fully amortized intangibles and our continued effort to contain costs while investing for future growth, partially offset by an increase in operating expenses as a result of our acquisition of Precise. Our operating expenses include selling and marketing expenses, research and development expenses, general and administrative expenses, amortization of other intangibles and in-process research and development expense.

Selling and Marketing

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|----------|----------|------------------------------|----------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Selling and marketing | \$ 123.1 | \$ 126.7 | (3)% | \$ 245.2 | \$ 253.7 | (3)% |
| As a percentage of net revenue | 30% | 35% | | 30% | 35% | |

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Selling and marketing expenses consist primarily of salaries, related benefits, commissions, consultant fees and other costs associated with our sales and marketing efforts. The decrease in selling and marketing expense in the second quarter and first half of 2003 over the same periods in 2002 is primarily the result of a decrease in staffing levels, leading to a reduction in other employee costs, primarily outside recruiting and employee events, and travel and entertainment expenses. The decrease in 2003 also reflects our efforts to contain costs and control discretionary spending. For the second half of 2003, we expect selling and marketing expenses to increase in absolute dollars as a result of our recent acquisition of Precise and investments in

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international sales and marketing efforts, partially offset by recent reductions in staffing levels in the United States.

Research and Development

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|--------|-------------|------------------------------|---------|-------------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Research and development | \$72.6 | \$67.7 | 7% | \$144.0 | \$132.9 | 8% |
| As a percentage of net revenue | 18% | 19% | | 18% | 18% | |

Research and development expenses consist primarily of salaries, related benefits, third-party consultant fees, stock-based compensation expense and other engineering related costs. The increase in research and development expense in the second quarter and first half of 2003 over the same periods in 2002 is primarily the result of an increase in compensation and benefits and, to a lesser extent, costs associated with outside services, primarily for intellectual property protection. The increase in compensation and benefits for the three and six months ended June 30, 2003 also reflects additional headcount from the acquisition of Jareva in January 2003, stock-based compensation expense of \$0.7 million and \$1.1 million, respectively, resulting from the acquisition of Jareva and a general increase in compensation levels for research and development personnel. We believe that a significant level of research and development investment is required to remain competitive and expect research and development expenses to increase in absolute dollars as a result of our recent acquisition of Precise, partially offset by an increased use of research and development personnel in India, where labor costs are lower.

General and Administrative

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|--------|-------------|------------------------------|--------|-------------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| General and administrative | \$38.9 | \$34.6 | 12% | \$77.1 | \$67.7 | 14% |
| As a percentage of net revenue | 9% | 9% | | 10% | 9% | |

General and administrative expenses consist primarily of salaries, related benefits and fees for professional services, such as legal and accounting services. The increase in general and administrative expense in the second quarter and first half of 2003 over the same periods in 2002 is primarily the result of an increase in staffing levels, expenses associated with outside services, primarily legal and consulting, and increases in facility costs related to new facilities in Milpitas, California and Reading, UK in the first quarter of 2003. We expect general and administrative expenses as a percentage of total net revenue to remain relatively stable for the remainder of 2003 but to increase in absolute dollars as a result of our recent acquisition of Precise.

Amortization of Other Intangibles

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|--------|-------------|------------------------------|--------|-------------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Amortization of other intangibles | \$12.3 | \$18.0 | (32)% | \$30.4 | \$36.0 | (16)% |
| As a percentage of net revenue | 3% | 5% | | 4% | 5% | |

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Amortization of other intangibles principally represents amortization of distribution channels, trademarks and other intangibles recorded upon the acquisitions completed during 1999 and the first quarter of 2003. The estimated useful life of our other intangibles is six months to five years, with the majority of intangibles being amortized over two to four years. Other intangibles related to the 1999 acquisitions were fully amortized in May 2003. We expect amortization of other intangibles to decline in the third quarter of 2003 to approximately \$2.5 million per quarter because we will realize the full impact of fully amortized intangibles, partially offset by the impact of the January 2003 acquisition of Jareva and June 2003 acquisition of Precise.

Table of Contents*In-Process Research and Development*

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|--------------------------------------------------|--------------------------------|------|----------|------------------------------|------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Write-off of in-process research and development | \$ 15.3 | \$ | 100% | \$ 19.4 | \$ | 100% |
| As a percentage of net revenue | 4% | | | 2% | | |

In connection with the acquisition of Precise in June 2003, we allocated \$15.3 million of the purchase price to in-process technology that has not yet reached technological feasibility and has no alternative future use. In order to value purchased in-process research and development, or IPR&D, research projects in areas for which technological feasibility had not been established were identified. The value of these projects was determined by estimating the expected cash flows from the projects once commercially viable and discounting the net cash flows back to their present value, using adjusted discount rates based on the percentage of completion of the in-process projects.

Net Cash Flows. The net cash flows expected from the identified projects are based on the appraiser's estimates of revenues, royalty savings, cost of sales, research and development costs, selling, general and administrative costs, royalty costs and income taxes from those projects. Revenue estimates are based on the assumptions mentioned below. The research and development costs included in the estimates reflect costs to sustain projects, but exclude costs to bring in-process projects to technological feasibility.

The estimated revenues are based on our projection of each in-process project and the business projections were compared and found to be consistent with industry analysts' forecasts of growth in substantially all of the relevant markets. Estimated total revenues from the IPR&D product areas are expected to peak in the year ending December 31, 2005 and decline from 2006 into 2007 as other new products are expected to become available.

These projections are based on our estimates of market size and growth, expected trends in technology and the nature and expected timing of new project introductions by Precise.

Discount Rate. Discounting the expected net cash flows back to their present value is based on the industry weighted average cost of capital, or WACC. We believe the industry WACC is approximately 15%. The discount rate used to discount the expected net cash flows from IPR&D is 28%. The discount rate used is higher than the industry WACC due to inherent uncertainties surrounding the successful development of IPR&D, market acceptance of the technology, the useful life of such technology and the uncertainty of technological advances which could potentially impact the estimates described above.

Percentage of Completion. The percentage of completion for in-process Precise technology was determined using costs incurred to date on each project as compared to the remaining research and development to be completed as well as major milestones to bring each project to technological feasibility. The percentage of completion for projects under development ranged from 40-65%.

Upon the acquisition of Jareva in January 2003, we recorded a charge to IPR&D of \$4.1 million. We obtained an outside valuation for this acquisition, and values were assigned to developed technology, IPR&D and other intangibles. The fair value of the IPR&D for the acquisition of Jareva was determined using the income approach, which discounts expected future cash flows from projects under development to their net present value. Each project was analyzed to determine the characteristics and applications of the technology; the complexity, cost and time to complete the remaining development efforts; any alternative future use or current technological feasibility; and the stage of completion. Two IPR&D projects were identified and valued at the time of our acquisition of Jareva. The projected future cash flows from the projects under development were based on our estimates of revenues and operating profits related to the projects. Revenues on the projects related to IPR&D were estimated to begin in 2003 through 2007, with the majority of the revenues occurring in 2006 and 2007. Costs to complete these two research and development projects were estimated at \$1.3 million. At the date of acquisition, the development of the related products was estimated at 52%.

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complete, with an expected completion date of June 2003 for both projects. Both IPR&D projects were completed as of June 30, 2003. The risk-adjusted discount rate applied to after-tax cash flows was 38%, compared to an estimated weighted average cost of capital of 18%. We believe the amounts determined for IPR&D are representative of the fair value and do not exceed the amounts an independent third party would pay for the projects assumed.

If the projects discussed above are not successfully developed, our sales and profitability may be adversely affected in future periods.

Interest and Other Income, Net

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|---------|----------|------------------------------|---------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Interest and other income, net | \$ 11.3 | \$ 13.7 | (18)% | \$ 19.7 | \$ 26.9 | (27)% |
| As a percentage of net revenue | 3% | 4% | | 2% | 4% | |

The decrease in interest and other income in the second quarter and first half of 2003 compared to 2002 is primarily due to lower interest rates and the appreciation of the Euro against the U.S. Dollar experienced since the second quarter and first half of 2002, partially offset by the higher level of funds available for investment in 2003, which were generated primarily from the net cash provided by operating activities, and a \$2.2 million gain on sale on one of our investments.

Interest Expense

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|--------|----------|------------------------------|---------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Interest expense | \$ 7.8 | \$ 7.5 | 4% | \$ 15.5 | \$ 15.4 | 1% |
| As a percentage of net revenue | 2% | 2% | | 2% | 2% | |

Interest expense consisted primarily of interest recorded under the 1.856% convertible subordinated notes due 2006 issued in August 1999 and the 5.25% convertible subordinated notes due 2004 issued in October 1997. We expect interest expense to increase by approximately \$4.1 million per quarter in future periods as a result of the adoption of FASB Interpretation No. 46 on July 1, 2003 which requires us to consolidate the properties from the build-to-suit lease agreements and related debt in our financial statements. As a result, the payments on the debt will be recorded as interest expense. Previously, these payments were recorded as operating expenses. In addition, future interest expense will be impacted by the August 1, 2003 issuance of \$500.0 million of 0.25% convertible subordinated notes due August 1, 2013 and the expected redemption or conversion of all of our outstanding 1.856% and 5.25% convertible subordinated notes on August 18, 2003. If the 1.856% notes are redeemed for cash, we will record a loss on extinguishment of debt of approximately \$4.9 million in the third quarter of 2003 related to the unamortized portion of debt issuance costs. This charge would be classified as a non-operating expense in our statement of operations.

Loss on Strategic Investments

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|------|----------|------------------------------|------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |

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| | | | | | | |
|--------------------------------|----|--------|--------|-------|--------|-------|
| Loss on strategic investments | \$ | \$14.8 | (100)% | \$3.5 | \$14.8 | (76)% |
| As a percentage of net revenue | | 4% | | | 2% | |

With the decline in general economic conditions beginning in 2001, some of the companies in which we have invested have experienced extreme volatility and instability in their business and operating results. During the first quarter of 2003, we recognized impairment losses on our strategic investments when we determined that there had been a decline in the fair value of these investments that was other than temporary. These losses represented write-downs of the carrying amount of our investments. For the three months ended

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June 30, 2003, we determined that there was no further impairment, other than temporary, on our strategic investments.

Income Taxes

| (In millions, except percentages) | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-----------------------------------|--------------------------------|--------|----------|------------------------------|--------|----------|
| | 2003 | 2002 | % Change | 2003 | 2002 | % Change |
| Income taxes | \$32.8 | \$12.5 | 162% | \$54.0 | \$33.2 | 63% |
| As a percentage of net revenue | 8% | 3% | | 7% | 5% | |

Our effective tax rates for the three months ended June 30, 2003 and 2002 were 40% and 32%, respectively, and 37% and 32%, respectively, for the six months ended June 30, 2003 and 2002. Our second quarter and first half effective tax rates for 2003 and 2002 differed from the federal statutory rate due primarily to differences attributable to acquisition-related charges, including in-process research and development, that were non-deductible for tax purposes and to foreign earnings which are taxed at rates different from the federal statutory rate.

New Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board, or FASB, issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective on July 1, 2003. We do not expect the adoption of SFAS No. 150 to have a material effect on our financial position, results of operations or cash flows.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In particular, SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No., or FIN, 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, and (4) amends certain other existing pronouncements. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003, except for those paragraphs related to guidance in SFAS No. 133 implementation issues that have been cleared by the FASB and have been effective for fiscal quarters that began prior to June 15, 2003. Those paragraphs should continue to be applied in accordance with their respective effective dates. We do not expect the adoption of SFAS No. 149 to have a material effect on our financial position, results of operations or cash flows.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities*, which addresses the consolidation of variable interest entities. FIN 46 provides guidance for determining when an entity that is the primary beneficiary of a variable interest entity or equivalent structure should consolidate the variable interest entity into the entity's financial statements. The provisions of FIN 46 are to be applied as of the beginning of the first interim or annual reporting period beginning after June 15, 2003 for variable interest entities created before February 1, 2003 and still existing on June 15, 2003. We currently have three build-to-suit operating leases, commonly referred to as synthetic leases, which were entered into prior to February 1, 2003. Each synthetic lease is owned by a trust that has no voting rights, no employees, no financing activity other than the lease with us, no ability to absorb losses and no right to participate in gains realized on the sale of the related property. We have determined that the trusts under the leasing structures qualify as variable interest entities for purposes of FIN 46. Consequently, we are considered the primary beneficiary and will consolidate the trusts into our financial statements beginning July 1, 2003. As a result of consolidating these

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entities in the third quarter of 2003, we expect to report a cumulative effect of change in accounting principle in accordance with Accounting Principles Board Opinion, or APB, 20, *Accounting Changes*, with a charge of \$6.2 million which equals the amount of depreciation expense that would have been recorded had these trusts been consolidated from the date the properties were available for occupancy, net of tax. In addition, on July 1, 2003, we will record property and equipment, net of accumulated depreciation, equal to \$369.1 million, long-term debt in the amount of \$369.2 million and noncontrolling interest of \$11.4 million on the balance sheet. Future depreciation expense related to these properties will be approximately \$1.6 million per quarter and \$4.1 million per quarter of rent expense previously classified as operating expense will be classified as interest expense in the statements of operations beginning July 1, 2003.

In November 2002, the FASB issued FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 requires that we recognize the fair value for guarantee and indemnification arrangements issued or modified by us after December 31, 2002, if these arrangements are within the scope of the Interpretation. In addition, we must continue to monitor the conditions that are subject to the guarantees and indemnifications, as required under previously existing generally accepted accounting principles, in order to identify if a loss has occurred. If we determine it is probable that a loss has occurred then any such estimable loss would be recognized under those guarantees and indemnifications. Some of the software licenses granted by us contain provisions that indemnify licensees of our software from damages and costs resulting from claims alleging that our software infringes the intellectual property rights of a third party. We have historically received only a limited number of requests for indemnification under these provisions and have not been required to make material payments pursuant to these provisions. Accordingly, we have not recorded a liability related to these indemnification provisions. We do not have any guarantees or indemnification arrangements other than the indemnification clause in some of our software licenses, the guarantee on a credit facility discussed in Note 14 to our condensed consolidated financial statements and the guarantee on our three build-to-suit lease agreements for buildings in Mountain View, Roseville and Milpitas discussed in Note 15 to our condensed consolidated financial statements. We adopted FIN 45 effective January 1, 2003. The adoption of FIN 45 did not have a material impact on our financial position, results of operations or cash flows.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 supersedes Emerging Issues Task Force, or EITF, Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. SFAS No. 146 addresses the recognition, measurement, and reporting of costs that are associated with exit and disposal activities. These costs include those related to terminating a contract that is not a capital lease and termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred-compensation contract. The provisions of SFAS No. 146 require that the liability for costs associated with an exit or disposal activity be recorded at fair value and that they be recognized when the liability is incurred rather than at the date of the commitment to an exit plan as prescribed under EITF Issue 94-3. SFAS No. 146 is applied prospectively for exit or disposal activities that are initiated after December 31, 2002 and accordingly, liabilities recognized prior to the initial application of SFAS No. 146 will continue to be accounted for in accordance with EITF Issue 94-3. We adopted SFAS No. 146 effective January 1, 2003.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development or normal use of the assets. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated asset, and this additional carrying amount is expensed over the life of the asset. We adopted SFAS No. 143 effective January 1, 2003. The adoption of SFAS No. 143 did not have a material effect on the our financial position, results of operations or cash flows.

Table of Contents**Liquidity and Capital Resources*****Cash Flows***

Our cash, cash equivalents and short-term investments totaled \$2,371.0 million at June 30, 2003 and represented 79% of our net tangible assets. Our cash, cash equivalents and short-term investments totaled \$2,241.3 million at December 31, 2002 and represented 77% of our net tangible assets. Cash and cash equivalents are highly liquid with original maturities of 90 days or less. Short-term investments consist mainly of commercial paper, medium-term notes, corporate notes, government agency securities (taxable and non-taxable), asset-backed securities and market auction preferreds.

Operating activities, excluding the effects of business acquisitions, provided cash of \$324.9 million for the six months ended June 30, 2003, primarily due to net income of \$91.3 million, adjusted for depreciation and amortization of \$50.0 million, amortization of developed technology and other intangibles of \$55.8 million, in-process research and development expense of \$19.4 million, tax benefits from stock plans of \$11.1 million, a decrease in accounts receivable of \$44.9 million, an increase in income taxes payable of \$50.4 million and an increase in deferred revenue of \$26.1 million which were partially offset by deferred income taxes of \$22.1 million and a decrease in accrued compensation and benefits of \$11.0 million. Accounts receivable increased at June 30, 2003 compared to March 31, 2003 primarily because a greater portion of our sales for the three months ended March 31, 2003 occurred in the first two months. In contrast, sales occurred more evenly during the three months ended June 30, 2003 which is consistent with our historical, seasonal patterns for the second quarter. As a result, a higher amount of our transactions during the second quarter of 2003 was invoiced and unpaid in the third month of the quarter ended June 30, 2003 than the third month of the quarter ended March 31, 2003. Operating activities provided cash of \$339.6 million for the six months ended June 30, 2002, primarily due to net income of \$70.5 million, adjusted for depreciation and amortization of \$52.0 million, amortization of developed technology and other intangibles of \$69.8 million, tax benefits from stock plans of \$19.6 million, loss on strategic investments of \$14.8 million, a decrease in accounts receivable of \$37.2 million, an increase in accounts payable of \$14.2 million, an increase in income taxes payable of \$34.6 million and an increase in deferred revenue of \$36.6 million partially offset by deferred income taxes of \$26.3 million and a decrease in accrued compensation and benefits of \$7.7 million. We expect cash flows from operating activities to increase in the third quarter of 2003.

Investing activities used cash of \$145.1 million for the six months ended June 30, 2003, primarily due to the acquisitions of Precise and Jareva, net of cash acquired, for \$333.8 million and purchases of property and equipment of \$36.0 million, partially offset by net sales of short-term investments of \$228.9 million. Investing activities used cash of \$195.5 million for the six months ended June 30, 2002, primarily due to the net purchases of short-term investments of \$135.1 million, purchases of property and equipment of \$53.1 million and payment made for purchases of businesses and technologies of \$7.3 million.

Financing activities provided cash of \$59.0 million and \$63.6 million for the six months ended June 30, 2003 and 2002, respectively, as a result of the issuance of common stock under our employee stock plans.

In August 2003, we received net proceeds of approximately \$488.0 million from the issuance of 0.25% convertible subordinated notes due August 1, 2013, or 0.25% notes.

In July 2003, we paid an additional cash amount of \$64.5 million as part of the total purchase consideration for Precise.

In July 2003, our board of directors authorized a program to repurchase our common stock in an amount of up to \$300.0 million plus the market value at the time of repurchase of any shares we issue upon conversion of our 1.856% convertible subordinated notes due 2006, or 1.856% notes, which we have called for redemption. If all holders of the 1.856% notes elect to convert their notes into common stock, they would receive in the aggregate approximately 13.0 million shares of our common stock. On August 1, 2003, we repurchased 4.2 million shares of our common stock for an aggregate purchase price of approximately \$129.0 million. We expect to purchase additional shares of common stock under the program from time to time on the open market or in privately negotiated transactions. Depending on market conditions and other factors, these purchases may be commenced or suspended from time to time without prior notice. The stock repurchase

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program is intended to reduce the dilution resulting from our acquisition of Precise, our employee stock plans and the potential conversion of our 1.856% notes.

In July 2003, we announced that we will be redeeming on August 18, 2003 all of our outstanding 5.25% convertible subordinated notes due 2004, or 5.25% notes, and all of our outstanding 1.856% notes. On August 18, 2003, the aggregate redemption price of the 5.25% notes will be approximately \$64.0 million and the aggregate redemption price of the 1.856% notes will be approximately \$407.0 million. The conversion price of our 5.25% notes is \$9.56 per share. The effective conversion price of our 1.856% notes on August 18, 2003 will be approximately \$31.35 per share. Should the market price of our common stock be higher than the conversion prices of the 5.25% notes or the 1.856% notes on the redemption date, then some or all holders of the 5.25% notes and 1.856% notes may elect to convert their notes into common stock in lieu of redeeming for cash.

We continue to evaluate alternative uses of our cash including, but not limited to, exercising our purchase option for the properties subject to the build-to-suit lease arrangements, repurchasing additional amounts of our common stock and strategic acquisitions, any of which could reduce the amount of available cash and cash equivalents.

Convertible Subordinated Notes

In October 1997, we issued \$100.0 million of 5.25% notes, for which we received net proceeds of \$97.5 million. We and our wholly-owned subsidiary, VERITAS Operating Corporation, are co-obligors on the 5.25% notes and are unconditionally, jointly and severally liable for all payments under the 5.25% notes. As of June 30, 2003, a total principal amount of \$36.0 million had been converted into approximately 3.8 million shares of our common stock. Based on the aggregate principal amount of \$64.0 million outstanding as of June 30, 2003, the 5.25% notes provide for semi-annual interest payments of \$1.7 million each May 1 and November 1. The 5.25% notes are convertible into shares of our common stock at any time prior to the close of business on the maturity date, unless previously redeemed or repurchased, at a conversion price of \$9.56 per share, subject to adjustment in certain events, equivalent to a conversion rate of 104.65 shares of common stock per \$1,000 principal amount at maturity. The 5.25% notes are redeemable over a period of time until maturity at our option at declining premiums to par. The debt issuance costs are being amortized over the term of the 5.25% notes using the interest method. We called the 5.25% notes for redemption on August 18, 2003 on which date the aggregate redemption price of the 5.25% notes will be \$64.0 million. If the holders elect to convert their notes into common stock, they would receive in the aggregate approximately 6.7 million shares of our common stock. Because our stock price as of August 12, 2003 is significantly higher than the conversion price of the 5.25% notes, we expect that the 5.25% notes will be converted into our common stock, although there can be no guarantee that this will happen.

In August 1999, we and our wholly-owned subsidiary, VERITAS Operating Corporation, issued \$465.8 million, aggregate principal amount at maturity, of 1.856% notes, for which we received net proceeds of approximately \$334.1 million. The interest rate of 1.856%, together with the accrual of original issue discount, represent a yield to maturity of 6.5%. We, and VERITAS Operating Corporation are co-obligors on the 1.856% notes and are unconditionally, jointly and severally liable for all payments under the notes. As of June 30, 2003, a total principal amount of \$1.1 million had been converted into approximately 29,400 shares of our common stock. Based on the aggregate principal amount at maturity of \$464.7 million, the 1.856% notes provide for semi-annual interest payments of \$4.3 million each February 13 and August 13. The 1.856% notes are convertible into shares of our common stock at any time prior to the close of business on the maturity date, unless previously redeemed or repurchased. The 1.856% notes are redeemable over a period of time until maturity at our option at the issuance price plus accrued original issue discount and any accrued interest. The debt issuance costs are being amortized over the term of the 1.856% notes using the interest method. We called the 1.856% notes for redemption on August 18, 2003 on which date the aggregate redemption price of the 1.856% notes will be \$407.0 million and the effective conversion price will be approximately \$31.35 per share. If the holders elect to convert their notes into common stock, they would receive in the aggregate approximately 13.0 million shares of our common stock.

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In August 2003, we issued \$500.0 million of 0.25% notes, for which we received net proceeds of approximately \$488.0 million, to several initial purchasers in a private offering. We also granted to the initial purchasers of the 0.25% notes an option to purchase up to an additional \$100.0 million principal amount of 0.25% notes solely to cover over-allotments. This over-allotment option may be exercised by the initial purchasers at any time on or prior to August 28, 2003.

The 0.25% notes were issued at their face value and provide for semi-annual interest payments of \$0.6 million each February 1 and August 1, beginning February 1, 2004. The 0.25% notes are convertible, under the specified circumstances discussed below, into shares of our common stock at a conversion rate of 21.6802 shares per \$1,000 principal amount of notes, which is equivalent to a conversion price of approximately \$46.13 per share. The conversion rate is subject to adjustment upon the occurrence of specified events. The specified circumstances under which the 0.25% notes are convertible prior to maturity are: (1) during any quarterly conversion period (which periods begin on the eleventh trading day of each fiscal quarter and end on the eleventh trading day of the following fiscal quarter) prior to August 1, 2010, if the closing sale price of our common stock for at least 20 trading days in the 30 trading day period ending on the first day of such conversion period exceeds 120% of the conversion price of the notes on that first day, (2) during the period beginning August 1, 2010 through the maturity date of the notes, if the closing sale price of our common stock is more than 120% of the then current conversion price, (3) during the five consecutive business day period following any five consecutive trading day period in which the average of the trading prices for the 0.25% notes was less than 95% of the average of the sale price of our common stock multiplied by the then current conversion rate of the notes, (4) our corporate credit rating assigned by Standard & Poor's falls below B-(and if Moody's has assigned VERITAS a corporate credit rating and such rating is lower than B3) or if both such ratings are withdrawn, (5) we call the notes for redemption or (6) upon the occurrence of corporate transactions specified in the indenture governing the notes. Upon any conversion of notes by a holder, we shall have the option to satisfy our conversion obligation in shares of our common stock, in cash or a combination thereof. It is our intention to satisfy the principal portion of the obligation in cash and the remainder, if any, in shares of our common stock. On or after August 5, 2006, we have the option to redeem all or a portion of the 0.25% notes at a redemption price equal to 100% of the principal amount, plus accrued and unpaid interest. On August 1, 2006 and August 1, 2008, or upon the occurrence of a fundamental change involving VERITAS, holders of the 0.25% notes may require us to repurchase their notes at a repurchase price equal to 100% of the principal amount, plus accrued and unpaid interest. Upon a fundamental change, we have the option to pay the repurchase price in cash, shares of common stock or a combination thereof.

At June 30 2003, we had a ratio of long-term debt to total capitalization of approximately 12%. The degree to which we will be leveraged could materially and adversely affect our ability to obtain financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures. We will require substantial amounts of cash to fund scheduled payments of principal and interest on our indebtedness, future capital expenditures and any increased working capital requirements. If we are unable to meet our cash requirements out of cash flow from operations, we cannot assure you that we will be able to obtain alternative financing.

Commitments

Credit Facility

During 2002, our Japanese subsidiary entered into a short-term credit facility with a multinational Japanese bank in the amount of 1.0 billion Japanese yen (\$8.4 million USD). At June 30, 2003, no amount was outstanding. The short-term credit facility was renewed in March 2003 and is due to expire in March 2004. Borrowings under the short-term credit facility bear interest at Tokyo Inter Bank Offered Rate, or TIBOR, plus 0.5%. There are no covenants on the short-term credit facility and the loan has been guaranteed by VERITAS Software Global LLC, one of our wholly-owned subsidiaries.

Facilities Lease Commitments

In 1999 and 2000, we entered into three build-to-suit lease agreements for office buildings in Mountain View, California, Roseville, Minnesota and Milpitas, California. We began occupying the Roseville and

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Mountain View facilities in May and June 2001 respectively, and began occupying the Milpitas facility in April 2003. The development and acquisition of the properties have been financed by a third party through a syndicate of financial institutions. We have accounted for these agreements as operating leases in accordance with SFAS No. 13, *Accounting for Leases*, as amended. Commencing July 1, 2003, we will account for these agreements in accordance with FIN 46 which will require us to consolidate these entities into the consolidated financial statements. Please see *New Accounting Pronouncements*.

During 2001 and 2002, we amended our existing lease agreement, originally signed in 1999, for our corporate headquarters in Mountain View, California. The facilities of 425,000 square feet provide space for sales, marketing, administration and research and development functions. The lease term for these facilities is five years beginning in March 2000, with an option to extend the lease term for two successive periods of one year each, if agreed to by the financial institutions. We have the option to purchase the property (land and facilities) for the termination value of \$145.2 million or, at the end of the lease, to arrange for the sale of the property to a third party while we retain an obligation to the owner for the difference between the sales price and the guaranteed residual value up to \$129.0 million if the sales price is less than this amount, subject to the terms of the lease. In addition, we are entitled to any proceeds from a sale of the property in excess of the termination value. We occupy these facilities and began making lease payments in the second quarter of 2001.

During 2001 and 2002, we amended our existing lease agreement, originally signed in 2000, for our facilities in Roseville, Minnesota. We improved and expanded our existing facilities of 62,000 square feet and developed adjacent property adding 142,000 square feet completed in 2001. The facilities provide space for technical support and research and development functions. The lease term for these facilities is five years beginning in March 2000, with an option to extend the lease term for two successive periods of one year each, if agreed to by the financial institutions. We have the option to purchase the property (land and facilities) for the termination value of \$41.3 million or, at the end of the lease, to arrange for the sale of the property to a third party while we retain an obligation to the owner for the difference between the sales price and the guaranteed residual value up to \$35.1 million if the sales price is less than this amount, subject to the terms of the lease. In addition, we are entitled to any proceeds from a sale of the property in excess of the termination value. We occupy these facilities and began making lease payments in 2001.

During 2001 and 2002, we amended our existing lease agreement, originally signed in 2000, for the lease of 65 acres of land and subsequent improvements for new research and development campus facilities in Milpitas, California. We plan to develop the site in two phases. The first phase of the project, comprising 466,000 square feet and consisting of one completed building and two additional structures, was completed in the third quarter of 2002. The facilities will provide space for research and development and general corporate functions. The lease term for the first phase is five years beginning in July 2000, with an option to extend the lease term for two successive periods of one year each, if agreed to by the financial institutions. We have the option to purchase the property (land and first phase facilities) for the termination value of \$194.3 million or, at the end of the lease, to arrange for the sale of the property to a third party while we retain an obligation to the owner for the difference between the sales price and the guaranteed residual value up to \$180.5 million if the sales price is less than this amount, subject to the terms of the lease. In addition, we are entitled to any proceeds from a sale of the property in excess of the termination value. We began paying the lease payments in the third quarter of 2002 and occupied a portion of the new campus facilities in the second quarter of 2003. We are currently analyzing our development schedule for the second phase of the campus, and at this time no commitments have been made with respect to the start of construction.

Lease payments under our three build-to-suit lease agreements are generally paid quarterly and are equal to the termination value of the outstanding lease obligations multiplied by our cost of funds, which is based on LIBOR using 30-day to 180-day LIBOR contracts and adjusted for our credit spread. In January 2002, we entered into two three-year pay fixed, receive floating, interest rate swaps for the purpose of hedging the cash payments related to the Roseville, Minnesota and Mountain View, California lease agreements. Under the terms of these interest rate swaps, we make payments based on the fixed rate and will receive interest payments based on the 3-month LIBOR rate. For the three and six months ended June 30, 2003, our aggregate lease payments, including the payments on the interest rate swaps, were \$4.1 million and \$8.3 million, respectively. For the three and six months ended June 30, 2002, our aggregate lease payments,

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including payments on the interest rate swaps, were \$4.2 million and \$8.3 million, respectively. Our aggregate payment obligations under the three build-to-suit lease agreements for the third quarter of 2003 will be \$4.1 million.

We evaluated the expected fair value of the properties at the end of the lease terms by reviewing current real estate market conditions and indicators of expectations for the market in the future. In the event that we determine it is probable that the expected fair value of any of the properties at the end of the lease terms will be less than the respective termination values, we will accrue the expected loss on a straight-line basis over the remaining lease term. Currently, we do not believe it is probable that the fair market value of the properties at the end of the lease terms will be less than the termination values.

If we choose to exercise the purchase option for the properties subject to the three build-to-suit lease agreements, the aggregate purchase price would be approximately \$380.8 million. Payment of the purchase price for these properties would significantly reduce the amount of cash, cash equivalents and short-term investments available for funding our research and development efforts, geographic expansion and strategic acquisitions in the future.

The agreements for the facilities described above require that we maintain specified financial covenants, all of which we were in compliance with as of June 30, 2003. The specified financial covenants as of June 30, 2003 require us to maintain a minimum rolling four quarter EBITDA of \$400.0 million, a minimum ratio of cash and cash equivalents to current liabilities of 1.2 to 1, and a leverage ratio of total funded indebtedness to rolling four quarter EBITDA of not more than 3.0 to 1. For purposes of these financial covenants, EBITDA represents our net income for the applicable period, plus interest expense, taxes, depreciation and amortization and all non-cash restructuring charges for acquisitions occurring within a four year period, less software development expenses classified as capital expenditures. In order to secure the obligations under each agreement, each of the facilities is subject to a deed of trust in favor of the financial institutions which financed the development and acquisition of the respective facility. Bank of America, N.A. was the agent for the syndicate of banks that funded the development of the Mountain View, California and Roseville, Minnesota facilities, and ABN AMRO Bank, N.V. was the agent for the syndicate of banks that funded the development of the Milpitas, California facility.

We currently have operating leases for our facilities and rental equipment through 2023. In addition to our basic rent, we are responsible for all taxes, insurance and utilities related to the facilities. The table below shows our commitments related to our approximate minimum lease payments for our facilities and rental equipment as of June 30, 2003 (in millions):

| | Operating Lease Commitments |
|-------------------------------------|--------------------------------------------|
| Six months ending December 31, 2003 | \$ 41.3 |
| 2004 | 71.7 |
| 2005 | 47.8 |
| 2006 | 34.3 |
| 2007 | 32.4 |
| 2008 and thereafter | 169.9 |
| | <hr/> |
| Total commitments | \$397.4 |
| | <hr/> |

The table above includes payments on our three build-to-suit lease agreements that are currently classified as operating expenses in our statements of operations. Upon adoption of FIN 46 on July 1, 2003, we are required to record the properties as property and equipment on our balance sheet with corresponding long-term debt and noncontrolling interest, and consequently rent expense in the amount of approximately \$4.1 million per quarter previously recorded as operating expense will be recorded as interest expense in our statements of operations beginning July 1, 2003.

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Acquired Technology Commitments

On October 1, 2002, we acquired volume replicator software technology for \$6.0 million and contingent payments of up to another \$6.0 million based on future revenues generated by the acquired technology. The payments will be paid quarterly over 40 quarters, in amounts between \$150,000 and \$300,000. We issued a promissory note payable in the principal amount of \$5.0 million, representing the present value of our minimum payment obligations under the purchase agreement for the acquired technology, which are payable quarterly commencing in the first quarter of 2003 and ending in the fourth quarter of 2012. The contingent payments in excess of the quarterly minimum obligations will be paid as they may become due. The balance outstanding of the note payable was \$4.8 million as of June 30, 2003 and \$5.0 million as of December 31, 2002 and is included in non-current accrued acquisition and restructuring costs.

We believe that our current cash, cash equivalents and short-term investment balances and cash flow from operations will be sufficient to meet our working capital and capital expenditure requirements for at least the next 12 months. After that time, we may require additional funds to support our working capital requirements or for other purposes and may seek to raise such additional funds through public or private equity financing or from other sources. We cannot assure you that additional financing will be available at all or that if available, we will be able to obtain it on terms favorable to us.

Factors That May Affect Future Results

In addition to other information in this quarterly report on Form 10-Q, you should consider carefully the following factors in evaluating VERITAS and our business.

If we experience lower-than-anticipated revenue in any particular quarter, or if we announce that we expect lower revenue or earnings than previously forecasted, the market price of our securities could decline.

Our revenue is difficult to forecast and is likely to fluctuate from quarter to quarter due to many factors outside of our control. Any significant revenue shortfall or lowered forecasts could cause the market price of our securities to decline substantially. Factors that could affect our revenue include, but are not limited to:

the possibility that our customers may cancel, defer or limit purchases as a result of reduced information technology budgets or the current weak and uncertain economic and industry conditions;

the possibility that our customers may defer purchases of our products in anticipation of new products or product updates from us or our competitors;

the possibility that original equipment manufacturers will introduce, market and sell products that compete with our products;

the unpredictability of the timing and magnitude of our sales through direct sales channels, value-added resellers and distributors, which tend to occur later in a quarter than sales through original equipment manufacturers;

the timing of new product introductions by us and the market acceptance of new products, which may be delayed as a result of weak and uncertain economic and industry conditions;

the seasonal nature of our sales;

the rate of adoption and long sales cycles of storage area networks and storage resource management technology;

changes in our pricing and distribution terms or those of our competitors;

the potential impact of the Severe Acute Respiratory Syndrome, or SARS, illness upon our ability to generate revenues, particularly in the Asia-Pacific region; and

the possibility that our business will be adversely affected as a result of the threat of terrorism or military actions taken by the United States or its allies.

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You should not rely on the results of prior periods as an indication of our future performance. Our operating expense levels are based, in significant part, on our expectations of future revenue. If we have a shortfall in revenue in any given quarter, we may not be able to reduce our operating expenses quickly in response. Therefore, any significant shortfall in revenue could have an immediate adverse effect on our operating results for that quarter. In addition, if we fail to manage our business effectively over the long term, we may experience high operating expenses, and our operating results may be below the expectations of securities analysts or investors, which could cause the price of our common stock to decline.

Because we have historically derived over 80% of our license and service revenue from sales of our data protection, file system and volume management products, any decline in demand for these products could severely harm our ability to generate revenue.

We derive a substantial majority of our revenue from a small number of software products, including data protection, file system and volume management products. For the three and six months ended June 30, 2003, we derived approximately 88% and 85%, respectively, of our user license fees from these core products, and a similar percentage of our service revenue from associated maintenance and technical support. As a result, we are particularly vulnerable to fluctuations in demand for these products, whether as a result of competition, product obsolescence, technological change, budget constraints or other factors. If our revenue derived from these software products were to decline significantly, our business and operating results would be adversely affected. In addition, because our software products are concentrated within the market for data storage, a decline in the demand for storage devices, storage software applications or storage capacity could result in a significant reduction in our revenue and adversely affect our business and operating results.

If we fail to manage our multiple distribution channels effectively, or if our distributors and original equipment manufacturer customers choose not to market and sell our products to their customers, our sales could decline.

We sell our products primarily through indirect sales channels, original equipment manufacturers and direct sales channels. If we fail to manage our distribution channels successfully, our distribution channels may conflict with one another or otherwise fail to perform as we anticipate, which could reduce our sales and increase our expenses, as well as weaken our competitive position.

Indirect Sales Channels. A significant portion of our revenue is derived from sales through value-added resellers and distributors that sell our products to end-users and other resellers. This channel involves a number of special risks, including:

- our lack of control over the delivery of our products to end-users;
- our resellers and distributors are not subject to minimum sales requirements or any obligation to market our products to their customers;
- our resellers and distributors may terminate their relationships with us at any time; and
- our resellers and distributors may market and distribute competing products.

Original Equipment Manufacturers. A portion of our revenue is derived from sales through original equipment manufacturers that incorporate our products into their products. Our reliance on this channel involves many risks, including:

- our lack of control over the shipping dates or volume of systems shipped;
- the original equipment manufacturers are not subject to minimum sales requirements or any obligation to offer our products to their customers;
- the original equipment manufacturers may terminate their arrangements with us at any time;
- the development work that we must generally undertake under our agreements with original equipment manufacturers may require us to invest significant resources and incur significant costs with little or no associated revenue;

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the time and expense required for the sales and marketing organizations of our original equipment manufacturer customers to become familiar with our products make it more difficult to introduce those products to the market; and

our original equipment manufacturer customers are able to develop, market and distribute their own storage products and market and distribute storage products of our competitors, which could reduce our sales.

Direct Sales. A portion of our revenue is derived from sales by our direct sales force to end-users. This sales channel involves special risks, including:

longer sales cycles are associated with direct sales efforts;

we may have difficulty hiring, training, retaining and motivating our direct sales force; and

sales representatives require a substantial amount of training to become productive, and training must be updated to cover new and revised products.

We face intense competition, and our competitors may gain market share in the markets for our products, which could adversely affect the growth of our business and cause our revenues to decline.

We have many competitors in the markets for our products. If existing or new competitors gain market share in any of these markets, we may experience a decline in revenues, which could adversely affect our business and operating results. Our competitors include the internal development groups of original equipment manufacturers. These groups develop storage management software for the storage hardware products marketed by the original equipment manufacturer. We also face competition from software vendors that offer products that directly compete with our products or bundle their software products with storage software offered by another vendor.

Many of our original equipment manufacturer customers offer software products that compete with our products or have announced their intention to focus on developing or acquiring their own storage software products. These original equipment manufacturers may choose to offer their own products rather than offer our products to their customers or limit our access to their hardware platforms. End-user customers may prefer to purchase software and hardware that is manufactured by the same company because of perceived advantages in price, technical support, compatibility or other issues. In addition, software vendors may choose to bundle their software, such as an operating system, with their own or other vendors' storage software. They may also limit our access to standard product interfaces for their software and inhibit our ability to develop products for their platform.

Many of our competitors have greater financial, technical, sales, marketing and other resources than we do. Our future and existing competitors could introduce products with superior features, scalability and functionality at lower prices than our products, and could also bundle existing or new products with other more established products in order to compete with us. Our competitors could also gain market share by acquiring or forming strategic alliances with our other competitors. Finally, because new distribution methods offered by the Internet and electronic commerce have removed many of the barriers to entry historically faced by start-up companies in the software industry, we may face additional competition from these companies in the future.

If we are unable to develop new and enhanced products that achieve widespread market acceptance, we may be unable to recoup product development costs, and our earnings and revenue may decline.

Our future success depends on our ability to address the rapidly changing needs of our customers by developing and introducing new products, product updates and services on a timely basis. We must also extend the operation of our products to new platforms and keep pace with technological developments and emerging industry standards. We intend to commit substantial resources to developing new software products and services, including software products and services for the storage area networking market and the storage resource management market. Each of these markets is new and unproven, and industry standards for these

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markets are evolving and changing. They also may require development of new channels. If these markets do not develop as anticipated, or demand for our products and services in these markets does not materialize or occurs more slowly than we expect, we will have expended substantial resources and capital without realizing sufficient revenue, and our business and operating results could be adversely affected.

We have provided standards-setting organizations and various partners with access to our standard product interfaces through our VERITAS Enabled Program. If these standards-setting organizations or our partners do not accept our standard product interfaces for use with other products, or if our partners are able to use our standard product interfaces to improve their competitive position against us, then our business and operating results could be adversely affected.

Our international sales and operations involve special risks that could increase our expenses, adversely affect our operating results and require increased time and attention of management.

We derive a substantial portion of our revenue from customers located outside of the U.S. We have significant operations outside of the U.S., including engineering, sales, customer support and production operations, and we plan to expand our international operations. Our international operations are subject to risks, including:

potential loss of proprietary information due to piracy, misappropriation or weaker laws regarding intellectual property protection;

imposition of foreign laws and other governmental controls, including trade and employment restrictions;

fluctuations in currency exchange rates and economic instability such as higher interest rates and inflation, which could reduce our customers' ability to obtain financing for software products or which could make our products more expensive in those countries;

limitations on future growth or inability to maintain current levels of revenue from international sales if we do not invest sufficiently in our international operations;

difficulties in hedging foreign currency transaction exposures;

longer payment cycles for sales in foreign countries and difficulties in collecting accounts receivable;

difficulties in staffing and managing our international operations, including difficulties related to administering our stock option plan in some foreign countries;

difficulties in coordinating the activities of our geographically dispersed and culturally diverse operations;

seasonal reductions in business activity in the summer months in Europe and in other periods in other countries;

competition from local suppliers;

costs and delays associated with developing software in multiple languages;

the possible reduced level of general business activity, particularly in the Asia-Pacific region, as a result of the SARS illness; and

political unrest, war or terrorism, particularly in areas in which we have facilities.

In addition, we receive significant tax benefits from sales to our non-U.S. customers. These benefits are contingent upon existing tax regulations in both the U.S. and in the countries in which our international operations are located. Future changes in domestic or international tax regulations could adversely affect our ability to continue to realize these tax benefits.

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Our products may contain significant defects, which may subject us to liability for damages suffered by end users.

Software products frequently contain errors or failures, especially when first introduced or when new versions are released. Our end-user customers use our products in applications that are critical to their businesses, including for data backup and recovery, and may have a greater sensitivity to product defects than the market for software products generally. If a customer loses critical data as a result of an error in or failure of our software products or as a result of the customer's misuse of our software products, the customer could suffer significant damages and seek to recover those damages from us. Although our software licenses generally contain protective provisions limiting our liability, a court could rule that these provisions are unenforceable. If a customer is successful in proving its damages and a court does not enforce our protective provisions, we could be liable for the damages suffered by our customers, which could adversely affect our operating results.

In addition, product defects could cause delays in new product releases or product upgrades, or our products might not work in combination with other hardware or software, which could adversely affect market acceptance of our products. If our customers were dissatisfied with product functionality or performance, or if we were to experience significant delays in the release of new products or new versions of products, we could lose competitive position and revenue and our business and operating results could be adversely affected.

If we lose key personnel or fail to integrate replacement personnel successfully, our ability to manage the business effectively would be impaired.

Our future success depends upon the continued service of our key management, technical and sales personnel. Our officers and other key personnel are employees-at-will, and we cannot assure you that we will be able to retain them. Key personnel have left our company over the years, and we cannot assure you that there will not be additional departures. The loss of any key employee could result in significant disruptions to our operations, and the integration of replacement personnel could be time consuming, may cause additional disruptions to our operations and may be unsuccessful. We do not carry key person life insurance covering any of our personnel.

Whether we are able to execute effectively on our business strategy will depend in large part on how well key management and other personnel perform in their positions and are integrated within our company. We have in the past and may from time to time in the future restructure parts of our organization in order to better align our organizational structure with our business model. Significant organizational restructurings can be difficult to accomplish and can adversely affect the timeliness of product releases, the successful implementation and completion of company initiatives and the results of our operations.

If we are unable to attract and retain qualified employees and manage our employee base effectively, we may be unable to develop new and enhanced products, expand our business or increase our revenue.

Our success depends on our ability to hire and retain qualified employees and to manage our employee base effectively. If we are unable to hire and retain qualified employees, our business and operating results could be adversely affected. Conversely, if we fail to manage employee performance or reduce staffing levels when required by market conditions, our costs would be excessive and our business and operating results could be adversely affected. We may need to hire additional sales, technical and senior management personnel to support our business and to meet customer demand for our products and services. Competition for people with the skills that we require is intense, particularly in the San Francisco Bay area where our headquarters are located, and the high cost of living in this area makes our recruiting and compensation costs higher. In addition, stock-based compensation, such as stock options, has historically been an important incentive for employees in the software industry. If we are unable to get stockholder approval for future increases in the number of shares of common stock authorized under our stock plans or if changes in accounting rules cause us to reduce the amount of stock-based compensation awarded to employees, then it may become more difficult for us to attract and retain employees. We cannot assure you that we will be successful in hiring or retaining

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qualified personnel, and if we are unable to do so, our ability to manage and operate our business could be adversely affected.

We incur considerable expenses to develop products for operating systems that are owned by others and who generally are not required to cooperate with us in our development efforts. This may cause us to incur higher expenses or fail to expand our product lines and revenues.

Many of our products operate primarily on the UNIX and Windows computer operating systems. We have also redesigned, or ported, these products to operate on the Linux operating systems for both server-based and embedded solutions. We continue to develop new products for UNIX, Windows Server and Linux. We may not accomplish our development efforts quickly or cost-effectively, and it is not clear what the relative growth rates of these operating systems will be. Our development efforts require substantial capital investment, the devotion of substantial employee resources and the cooperation of the owners of the operating systems to or for which the products are being ported or developed. If the market for a particular operating system does not develop as anticipated, or demand for our products and services in such market does not materialize or occurs more slowly than we expect, we will have expended substantial resources and capital without realizing sufficient revenue, and our business and operating results could be adversely affected.

In addition, for some operating systems, we must obtain from the owner of the operating system a source code license to portions of the operating system software to port some of our products to or develop products for the operating system. Operating system owners have no obligation to assist in these porting or development efforts. If they do not grant us a license or if they do not renew our license, we may not be able to expand our product line into other areas.

We derive a large amount of revenue from one of our distributors, the loss of which could cause our revenues to decline.

We derive significant revenue from Ingram Micro, Inc., a distributor that sells our products and services through resellers. For the three and six months ended June 30, 2003, Ingram Micro accounted for 10% of our net revenue. If this distributor were to reduce purchases of our products or services, our revenues would decline unless we were able to substantially increase sales through other distributors or direct sales to customers. Our contract with Ingram Micro does not require them to purchase any specified number of software licenses from us. Accordingly, we cannot be sure that Ingram Micro will continue to market and sell our products at current levels.

Cooperating with the SEC in its investigation of our transactions with AOL Time Warner has required, and will continue to require, a large amount of management time and attention, as well as accounting and legal expense, which may reduce net income or interfere with our ability to manage our business.

In response to subpoenas issued by the Securities and Exchange Commission in the investigation entitled *In the Matter of AOL/Time Warner*, we have been cooperating with the SEC's requests for information, including information relating to transactions we entered into with AOL in September 2000 and other transactions. The investigation may continue to require significant management attention and accounting and legal resources, which could adversely affect our ability to manage our business and result in significant accounting and legal expenses. If the SEC or other governmental agency were to pursue an action against us in connection with this matter, we would be required to devote additional management attention and incur additional accounting and legal expenses, which could further adversely affect our business, results of operations and cash flows.

Following the announcement of our financial restatement, we were named as a party to several class action and derivative action lawsuits, and we may be named in additional litigation, all of which could require significant management attention and result in significant legal expenses. An unfavorable outcome in one

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or more of these lawsuits could have a material adverse effect on our business, financial condition, results of operations and cash flows.

After we announced in January 2003 that we would restate financial results as a result of transactions entered into with AOL Time Warner in September 2000, numerous separate complaints purporting to be class actions were filed in federal court alleging that we and some of our officers and directors violated provisions of the Securities Exchange Act of 1934. The complaints contain varying allegations, including that we made materially false and misleading statements with respect to our 2000, 2001 and 2002 financial results included in our filings with the SEC, press releases and other public disclosures. In addition, several complaints purporting to be derivative actions have been filed in state court against some of our directors and officers. These complaints are based on the same facts and circumstances as the class actions and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. All of the complaints generally seek an unspecified amount of damages. The cases are still in the preliminary stages, and it is not possible for us to quantify the extent of our potential liability, if any. An unfavorable outcome in any of these cases could have a material adverse effect on our business, results of operations and cash flows. In addition, the expense of defending any litigation may be costly and divert management's attention from the day-to-day operations of our business, which would adversely affect our business, results of operations and cash flows.

Our business strategy includes possible growth through business acquisitions, which involve special risks that could increase our expenses, cause our stock price to decline and divert the time and attention of management.

As part of our business strategy, we have in the past acquired and expect in the future to acquire other businesses, business units and technologies. We recently acquired Precise Software Solutions Ltd. and Jareva Technologies, Inc. Our acquisitions involve a number of special risks and challenges, including:

diversion of management's attention from our business;

integration of acquired business operations and employees into our existing business, including coordination of geographically dispersed operations, which in the past has taken longer and was more complex than initially expected for some acquired companies;

incorporation of acquired products and business technology into our existing product lines, including consolidating technology with duplicative functionality or designed on different technological architecture;

loss or termination of employees, including costly litigation resulting from the termination of those employees;

dilution of our then-current stockholders' percentage ownership;

assumption of liabilities of the acquired business, including costly litigation related to alleged liabilities of the acquired business;

presentation of a unified corporate image to our customers and our employees; and

risk of impairment charges related to potential write-down of acquired assets in future acquisitions.

Acquisitions of businesses, business units and technologies are inherently risky and create many challenges. We may be unable to close announced acquisitions, and we cannot provide any assurance that our previous or any future acquisitions will achieve the desired objectives.

As a result of the Seagate Technology leveraged buyout and merger transaction, our subsidiary may be liable to third parties for liabilities resulting from Seagate's operations before the transaction.

In November 2000, Seagate Technology became our subsidiary. As part of that transaction, Suez Acquisition (Cayman) Company, or SAC, acquired the operating assets of Seagate Technology. SAC assumed and agreed to indemnify us for substantially all liabilities arising in connection with Seagate

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Technology's operations prior to the transaction. However, governmental organizations or other third parties may seek recourse against our subsidiary or us for these liabilities. As a result, our subsidiary could receive claims related to a wide range of possible liabilities. The main area of potential liability for our Seagate Technology subsidiary relates to tax liabilities. Any such claim, with or without merit, could be time consuming to defend, result in costly litigation and divert management attention. Moreover, if SAC is unable or unwilling to indemnify us as agreed, we could incur unexpected costs. For example, the Internal Revenue Service is currently auditing past tax returns of Seagate Technology. We can predict neither the outcome of these audits, nor the amount of any liability we might incur arising from these audits.

Our effective tax rate may increase or fluctuate, which could increase our income tax expense and reduce net income.

Our effective tax rate could be adversely affected by several factors, many of which are outside of our control. Our effective tax rate is directly affected by the relative proportions of revenue and income before taxes in the various domestic and international jurisdictions in which we operate. We are also subject to changing tax laws, regulations and interpretations in multiple jurisdictions in which we operate as well as the requirements of certain tax rulings. In particular, we are subject to a number of tax rulings from the country of Israel related to the activities of Precise. Failure to comply with the terms and conditions of such rulings could significantly impact our effective tax rate. We do not have a history of audit activity from various taxing authorities and while we believe we are in compliance with all federal, state and international tax laws, there are various interpretations of their application that could result in additional tax assessments. Our effective tax rate is also influenced by the tax effects of purchase accounting for acquisitions and non-recurring charges, which may cause fluctuations between reporting periods. In addition, in November 2000, we acquired Seagate Technology, which has certain federal and state tax returns for various fiscal years under examination by tax authorities. We believe that adequate amounts for tax liabilities have been provided for any final assessments that may result from these examinations. The timing of the settlement of these examinations is uncertain. To the extent the settlements of these audits and the amounts reimbursed by SAC, as required by the Seagate acquisition agreement, are different from the amounts recorded, the difference will be recorded as a component of income tax expense or benefit and may significantly affect our effective tax rate for the period in which the settlements take place.

We incur or may incur significant accounting charges that, individually or in the aggregate, could reduce earnings and create net losses under generally accepted accounting principles.

We incur or may incur significant accounting charges that, individually or in aggregate, could create losses under generally accepted accounting principles in future periods. Examples of these charges are:

Amortization of Developed Technology and Other Intangibles. We incur significant charges related to the amortization of developed technology and other intangibles. For the quarter ended June 30, 2003, we incurred a charge of approximately \$22.8 million relating to amortization of developed technology and other intangibles and expect this charge to be approximately \$6.8 million for the quarter ending September 30, 2003, including the impact of our recent acquisition of Precise. The quarterly amortization charge could increase as a result of future business combinations or impairment of our other intangibles. While we do not expect to record other intangibles impairment charges, we cannot be sure that we will not have to record impairment in the future. As of June 30, 2003, the total net carrying amount of our other intangible assets was \$88.8 million;

Impairment of Goodwill. We do not amortize goodwill related to business combinations, but instead we test it for impairment at least annually. While we do not expect to record goodwill impairment charges, we cannot be sure that we will not have to record impairment in the future. As of June 30, 2003, the total net carrying amount of our goodwill was \$1,733.1 million;

Loss on Strategic Investments. In the third quarter of 2001, the second quarter of 2002 and the first quarter of 2003, we recorded losses on strategic investments. Future losses will depend on the results of our quarterly reviews to determine if there has been a decline in the fair value of our strategic

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investments that is other than temporary. As of June 30, 2003, the total carrying amount of our strategic investments was \$5.4 million;

Stock-based Compensation. Because the exercise price of options granted under our stock plans are generally equal to the market value of our common stock on the date of grant, we generally recognize no compensation cost for grants under our stock option plans. The FASB has voted to require companies to record a charge to earnings for employee stock option grants, but the methodology for valuing stock options and the timing for issuance of final rules have not been finalized. Any change in practice regarding accounting for stock options could result in significant accounting charges; and

Restructuring Charges. We regularly perform evaluations of our operations and activities. Any decision to restructure our operations, to exit any activity or to eliminate any excess capacity could result in significant accounting charges. Restructuring charges could also result from future business combinations. As a result of an evaluation of our facilities requirements, our board of directors approved in the fourth quarter of 2002 a restructuring plan to exit and consolidate certain of our facilities located in 17 metropolitan areas worldwide. In connection with this restructuring plan, we recorded a restructuring charge of approximately \$98.2 million during the fourth quarter of 2002. As of June 30, 2003, the total carrying amount of our facility restructure reserve was \$91.4 million.

If our assumptions about our ability to terminate or sublet our facilities prove to be unrealistic, the total costs of our facilities restructuring may be larger than we anticipated.

In the fourth quarter of 2002, our board of directors approved a restructuring plan to exit and consolidate some of our facilities based on our evaluation that our existing and planned facilities would exceed our near-term facilities needs due to slower than anticipated growth in the number of our employees as a result of weak and uncertain economic and industry conditions. In connection with this restructuring plan, we recorded a restructuring charge of approximately \$98.2 million during the fourth quarter of 2002. Our restructuring plan includes assumptions related to our ability to enter sublease and/or lease termination arrangements regarding some of our facilities. We cannot predict if, or when, we will be able to successfully enter sublease and/or lease termination arrangements for these facilities or if the actual terms of these arrangements will be as favorable as those assumed under our restructuring plan. Should we be unable to execute our restructuring plan under terms as favorable as those assumed under the restructuring plan, we may be required to materially increase our restructuring charge in future periods. We also cannot predict if our evaluation of our needs is accurate or if weak and uncertain economic and industry conditions will continue once we begin to implement our restructuring plan. We may find that our facility requirements are greater than estimated under our plan, which could necessitate procuring facilities at rates higher and at costs in addition to facilities that have been vacated by us. In addition, we cannot assure you that our restructuring program will achieve the anticipated benefits or will be completed in accordance with the contemplated timetable.

Our debt would be expensive to repay, and any default may impair our ability to borrow or raise capital.

We have called for redemption on August 18, 2003 all of our outstanding 5.25% convertible subordinated notes due 2004 and 1.856% convertible subordinated notes due 2006. The aggregate redemption price of the 5.25% notes will be approximately \$64.0 million and the aggregate redemption price of the 1.856% notes will be approximately \$407.0 million. In addition, in August 2003, we issued \$500.0 million of 0.25% convertible subordinated notes due August 1, 2013. The 0.25% notes were issued at face value and bear interest at the rate of 0.25% per annum which is payable on February 1 and August 1 of each year, beginning February 1, 2004. The 0.25% notes will mature on August 1, 2013, and on August 1, 2006 and August 1, 2008, holders of the 0.25% notes may require us to repurchase all or a portion of their notes at 100% of their principal amount plus accrued and unpaid interest to, but not including, the repurchase date. We will need to generate substantial amounts of cash from our operations to fund interest payments and to repay the principal amount of debt when

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it matures or is redeemed, while at the same time funding capital expenditures and our other working capital needs. If we do not have sufficient cash to pay interest or principal on our debts as they come due, we could be in default of those debts. For example, if we do not make timely payments, the notes could be declared immediately due and payable, in which event we would be required to immediately repay the notes in their entirety. A default under the notes could result in a reduction of our credit rating and make it more difficult for us to raise capital and adversely affect the trading price of our common stock. In addition, repayment of the notes upon a default would significantly reduce the amount of cash, cash equivalents and short-term investments available for funding our research and development efforts, geographic expansion and strategic acquisitions in the future. Our outstanding debt could also increase our vulnerability to adverse economic and industry conditions by making it more difficult for us to raise capital if needed.

If we do not protect our proprietary information and prevent third parties from making unauthorized use of our products and technology, our revenues could be harmed.

We rely on a combination of copyright, patent, trademark and trade secret laws, confidentiality procedures, contractual provisions and other measures to protect our proprietary information. All of these measures afford only limited protection. These measures may be invalidated, circumvented or challenged, and others may develop technologies or processes that are similar or superior to our technology. We may not have the proprietary information controls and procedures in place that we need to protect our proprietary information adequately. In addition, because we license the source code for some of our products to third parties, there is a higher likelihood of misappropriation or other misuse of our intellectual property. We also license some of our products under shrink wrap license agreements that are not signed by licensees and therefore may be unenforceable under the laws of some jurisdictions. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy our products or obtain or use information that we regard as proprietary.

Third parties claiming that we infringe their proprietary rights could cause us to incur significant legal expenses and prevent us from selling products.

From time to time, we receive claims that we have infringed the intellectual property rights of others. As the number of products in the software industry increases and the functionality of these products further overlap, we believe that we may become increasingly subject to infringement claims, including patent and copyright infringement claims. We have received several trademark claims in the past and may receive more claims in the future based on the name VERITAS, which is a word commonly used in trade names throughout Europe and the western hemisphere. We have also received patent infringement claims in the past and may receive more claims in the future based on allegations that our products infringe upon patents held by third parties. In addition, former employers of our former, current or future employees may assert claims that such employees have improperly disclosed to us the confidential or proprietary information of these former employers. Any such claim, with or without merit, could:

be time consuming to defend;

result in costly litigation;

divert management's attention from our core business;

require us to stop selling, to delay shipping or to redesign our product; and

require us to pay monetary amounts as damages, for royalty or licensing arrangements, or to satisfy indemnification obligations that we have with some of our customers.

In addition, we license and use software from third parties in our business. These third party software licenses may not continue to be available to us on acceptable terms. Also, these third parties may from time to time receive claims that they have infringed the intellectual property rights of others, including patent and copyright infringement claims, which may affect our ability to continue licensing this software. Our inability to use any of this third party software could result in shipment delays or other disruptions in our business, which could materially and adversely affect our operating results.

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If we discontinue reporting financial results using non-GAAP financial measures, investors may be confused about our operating results and our stock price could decline.

We have announced our intention to discontinue reporting non-GAAP financial measures (sometimes called pro forma reporting) beginning with our earnings announcement for the quarter ending September 30, 2003. Historically, we reported our financial results using both GAAP financial measures and non-GAAP financial measures, which typically excluded the impact of purchase accounting adjustments and the impact of other special items on our operating results. It is possible that, as we transition away from pro forma reporting, investors may be confused about our operating results, particularly with regard to comparisons to our operating results for prior periods. If this occurs, the market price of our common stock could decline.

Natural disasters could disrupt our business and result in loss of revenue or in higher expenses.

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events. Many of our operations are subject to these risks, particularly our operations located in California. A natural disaster or other unanticipated problem could adversely affect our business, including both our primary data center and other internal operations and our ability to communicate with our customers or sell our products over the Internet.

Some provisions in our charter documents and our stockholder rights plan may prevent or deter an acquisition of VERITAS.

Some of the provisions in our charter documents may deter or prevent certain corporate actions, such as a merger, tender offer or proxy contest, which could affect the market value of our securities. These provisions include:

our board of directors is authorized to issue preferred stock with any rights it may determine;

our board of directors is classified into three groups, with each group of directors to hold office for three years;

our stockholders are not entitled to cumulate votes for directors and may not take any action by written consent without a meeting; and

special meetings of our stockholders may be called only by our board of directors, by the chairman of the board or by our chief executive officer, and may not be called by our stockholders.

We also have in place a stockholder rights plan that is designed to discourage coercive takeover offers. In general, our stockholder rights plan provides our existing stockholders (other than an existing stockholder that becomes an acquiring person) with rights to acquire shares of our common stock at 50% of its trading price if a person or entity acquires, or announces its intention to acquire, 15% or more of the outstanding shares of our common stock, unless our board of directors elects to redeem these rights.

Our board of directors could utilize the provisions of our charter documents and stockholder rights plan to resist an offer from a third party to acquire VERITAS, including an offer to acquire our common stock at a premium to its trading price or an offer that is otherwise considered favorable by our stockholders.

Our stock price may be volatile in the future, and you could lose the value of your investment.

The market price of our common stock has experienced significant fluctuations and may continue to fluctuate significantly, and you could lose the value of your investment. The market price of our common stock may be adversely affected by a number of factors, including:

announcements of our quarterly operating results or those of our competitors or our original equipment manufacturer customers;

rumors, announcements or press articles regarding changes in our management, organization, operations or prior financial statements;

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inquiries by the SEC, NASDAQ or regulatory bodies;

changes in earnings estimates by securities analysts;

announcements of planned acquisitions by us or by our competitors;

gain or loss of a significant customer;

announcements of new products by us, our competitors or our original equipment manufacturer customers;

the potential impact of the SARS illness upon our ability to generate revenues, particularly in the Asia-Pacific region; and

acts of terrorism, the threat of war and economic slowdowns in general.

The stock market in general, and the market prices of stocks of other technology companies in particular, have experienced extreme price volatility, which has adversely affected and may continue to adversely affect the market price of our common stock for reasons unrelated to our business or operating results.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

Foreign Currency Risk

We transact business in various foreign currencies and have established a foreign currency hedging program, utilizing foreign currency forward exchange contracts, or forward contracts, to hedge certain foreign currency transaction exposures. Under this program, increases or decreases in our foreign currency transactions are offset by gains and losses on the forward contracts, so as to mitigate the possibility of foreign currency transaction gains and losses. We do not use forward contracts for speculative or trading purposes. All foreign currency transactions and all outstanding forward contracts are marked-to-market at the end of the period with unrealized gains and losses included in other income (expense). The unrealized gain (loss) on the outstanding forward contracts at June 30, 2003 was immaterial to our consolidated financial statements.

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Our outstanding forward contracts as of June 30, 2003 are presented in the table below. All forward contract amounts are representative of the expected payments to be made under these instruments. As of June 30, 2003, all forward contracts mature in 35 days or less (in thousands):

| | Local Currency Contract Amount | Contract Amount | Fair Market Value at June 30, 2003 (US\$) |
|--------------------------------|-----------------------------------|-----------------|----------------------------------------------------|
| Contracts to Buy US \$ | | | |
| British pound | 2,602.0 GBP | 4,320.3 USD | 7.1 |
| Euro | 26,200.0 EUR | 29,919.0 USD | (196.0) |
| Indian rupee | 352,730.0 INR | 7,593.8 USD | 16.4 |
| Mexican peso | 4,900.0 MXN | 467.3 USD | 1.8 |
| Contracts to Sell US \$ | | | |
| Brazilian real | 6,645.0 BRL | 2,229.9 USD | (94.1) |
| Canadian dollar | 9,000.0 CAD | 6,662.1 USD | 21.5 |
| Contracts to Buy Euro | | | |
| Australian dollar | 4,586.0 AUD | 2,661.8 EUR | 17.3 |
| Malaysian ringgit | 2,112.0 MYR | 507.1 EUR | (28.0) |
| South African rand | 1,915.0 ZAR | 218.2 EUR | 4.2 |
| South Korean won | 365,515.0 KRW | 270.4 EUR | (5.1) |
| Swedish krona | 5,915.0 SEK | 643.9 EUR | (1.0) |
| Contracts to Sell Euro | | | |
| British pound | 43,200.0 GBP | 62,807.2 EUR | 858.3 |
| Hong Kong dollar | 3,320.0 HKD | 372.9 EUR | 3.2 |
| Indian rupee | 145,100.0 INR | 2,688.5 EUR | (38.7) |
| Japanese yen | 2,162,000.0 JPY | 15,874.5 EUR | 227.9 |
| UAE dirham | 13,774.0 AED | 3,278.2 EUR | 42.7 |

In September 2000, we entered into a three-year cross currency interest rate swap transaction, or swap, for the purpose of hedging fixed interest rate, foreign currency denominated cash flows under an inter-company loan receivable. Under the terms of this derivative financial instrument, Euro denominated fixed principal and interest payments to be received under the inter-company loan will be swapped for U.S. dollar-fixed principal and interest payments. As of June 30, 2003, three monthly payments of 4.3 million remained to be swapped at a forward exchange rate of 0.89070 U.S. dollar per Euro. The fair market value of the swap at June 30, 2003 was \$(10.0) million. As a result of entering into the swap, we have mitigated our exposure to foreign currency exchange rate fluctuations. The gains or losses on the foreign currency loan receivable will be offset by the gains or losses on the swap. Because we are receiving fixed interest payments under the swap, we are still subject to fluctuations in value due to changes in U.S. dollar interest rates. As of June 30, 2003, the impact of these fluctuations was not significant. This hedge was deemed to be highly effective as of June 30, 2003.

In January 2002, we entered into two three-year pay fixed, receive floating, interest rate swaps for the purpose of hedging cash flows on variable interest rate debt of our build-to-suit lease agreements. Under the terms of these interest rate swaps, we make payments based on the fixed rate and will receive interest payments based on the 3-month London Inter Bank Offered Rate, or LIBOR. The payments on our build-to-suit lease agreements are based upon a 3-month LIBOR plus a credit spread. If our credit spread remains consistent and other critical terms of the interest rate swap or the hedged item do not change, the interest rate swap will be considered to be highly effective with all changes in the fair value included in other comprehensive income. If our credit spread changes or other critical terms of the interest rate swap or the hedged item change, the hedge may become partially or fully ineffective, which could result in all or a portion of the changes in fair value of the derivative recorded in the statement of operations. The interest rate swaps settle the first day of January, April, July and October until expiration. As of June 30, 2003, the fair value of the interest rate swaps was \$(10.8) million. As a result of entering into the interest rate swaps, we have mitigated our exposure to variable cash flows associated with interest rate fluctuations. Because the rental

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payments on the leases are based on the 3-month LIBOR and we receive 3-month LIBOR from the interest rate swap counter-party, we have eliminated any impact to raising interest rates related to our rent payments under the build-to-suit lease agreements. This hedge was deemed to be highly effective as of June 30, 2003.

Interest Rate Risk

We are exposed to interest rate risk primarily on our investment portfolio and long-term debt obligations. Our primary investment objective is to preserve principal while at the same time maximizing yields without significantly increasing risk. Our portfolio primarily includes money market funds, commercial paper, corporate notes, government securities (taxable and non-taxable), asset-backed securities and market auction preferred. The diversity of our portfolio helps us to achieve our investment objective.

Long-term debt of \$468.7 million consists of \$64.0 million from our 5.25% convertible subordinated notes due 2004 and \$404.7 million from our 1.856% convertible subordinated notes due 2006. The interest rate of 1.856% on the 1.856% notes together with the accrual of original issue discount represent a yield to maturity of 6.5%. The nominal interest rate on these notes is fixed and the notes provide for semi-annual interest payments of approximately \$1.7 million each May 1 and November 1 for the 5.25% notes and approximately \$4.3 million each February 13 and August 13 for the 1.856% notes. The notes are convertible into our common stock at any time prior to the close of business on the maturity date, unless previously redeemed or repurchased, and subject to adjustment under the terms of the notes. In July 2003, we announced that we will be redeeming on August 18, 2003 all of our outstanding 5.25% notes and 1.856% notes.

On August 1, 2003, we issued \$500.0 million of 0.25% convertible subordinated notes due 2013 for which we received net proceeds of approximately \$488.0 million. The nominal interest rate on these notes is fixed and the notes provide for semi-annual interest payments of \$0.6 million each February 1 and August 1, beginning February 1, 2004. The notes are convertible, under specified conditions, into shares of our common stock unless previously redeemed or repurchased and are subject to adjustment under the terms of the notes.

The following table presents the amounts of our cash equivalents, investments and long-term debt, according to maturity date, that may be subject to interest rate risk and the average interest rates as of June 30, 2003 by year of maturity (in thousands, except percentages):

| | Amortized Cost | | | 2003 Fair Value | 2002 Amortized Cost |
|---------------------------------------------------|----------------|----------------------------|-------------|-----------------|---------------------|
| | Due in 2003 | Due in 2004 and Thereafter | Total | | |
| Cash equivalents and short-term investments: | | | | | |
| Fixed rate | \$573,378 | \$636,035 | \$1,209,413 | \$1,215,282 | \$1,778,702 |
| Average fixed rate | 1.35% | 2.38% | 1.90% | 1.89% | 2.26% |
| Variable rate | \$413,673 | \$75,258 | \$488,931 | \$488,668 | \$288,575 |
| Average variable rate | 1.27% | 3.51% | 1.61% | 1.61% | 1.73% |
| Total cash equivalents and short-term investments | \$987,051 | \$711,293 | \$1,698,344 | \$1,703,950 | \$2,067,277 |
| Average rate | 1.32% | 2.50% | 1.81% | 1.81% | 2.18% |
| Long-term debt: | | | | | |
| Fixed rate | \$ | \$468,740 | \$468,740 | \$601,575 | \$460,252 |
| Average fixed rate | | 6.33% | 6.33% | 6.10% | 6.33% |

Equity Price Risk

We have made investments in development-stage companies that we believe provide strategic opportunities for us. We intend that these investments will provide access to new technologies and emerging markets, and create opportunities for additional sales of our products and services. We recognize impairment losses on our strategic investments when we determine that there has been a decline in the fair value of the investment

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that was other than temporary. During the first half of 2003, we recognized impairment losses of \$3.5 million on our strategic investments when we determined that there had been a decline in the fair value of the investments that were other than temporary. The losses represented write-downs of the carrying amount of our investments and were determined by using, among other factors, an investee's significant decline in stock value, its inability to obtain additional private financing and the uncertainty of its financial conditions. As of June 30, 2003, we determined that there was no further impairment in these investments. We cannot assure you that our investments will have the above mentioned results, or even that we will not lose all or any part of these investments.

Item 4. *Controls and Procedures*

Disclosure Controls and Procedures

Regulations under the Securities Exchange Act of 1934 require public companies, including our company, to maintain disclosure controls and procedures, which are defined to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Our chief executive officer and chief financial officer evaluated our disclosure controls and procedures as of June 30, 2003 and concluded that our disclosure controls and procedures were effective for the purposes for which they were designed.

Internal Control over Financial Reporting

Regulations under the Securities Exchange Act of 1934 require public companies, including our company, to evaluate any change in our internal control over financial reporting, which is defined as a process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States. In connection with their evaluation of our disclosure controls and procedures as of June 30, 2003, our chief executive officer and chief financial officer did not identify any change in our internal control over financial reporting during the three month period ended June 30, 2003 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

Item 1. *Legal Proceedings*

In response to subpoenas issued by the Securities and Exchange Commission in the investigation entitled *In the Matter of AOL/Time Warner*, we continue to furnish information requested by the SEC, including information relating to the transactions we entered into with AOL in September 2000 and other transactions. We cannot predict the outcome of this investigation at this time. We will continue our efforts to cooperate with the SEC's investigation.

After we announced in January 2003 that we would restate financial results as a result of transactions entered into with AOL in September 2000, numerous separate complaints purporting to be class actions were filed in the United States District Court for the Northern District of California alleging that VERITAS and some of our officers and directors violated provisions of the Securities Exchange Act of 1934. The complaints contain varying allegations, including that we made materially false and misleading statements with respect to our 2000, 2001 and 2002 financial results included in our filings with the SEC, press releases and other public disclosures. On May 2, 2003, a lead plaintiff and lead counsel were appointed. A consolidated complaint was filed by the lead plaintiff on July 18, 2003. In addition, several complaints purporting to be derivative actions have been filed in California state court against some of our directors and officers. These complaints are based on the same facts and circumstances as the class actions and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. The state court complaints have also been consolidated. All of the complaints generally seek an unspecified amount of

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damages. The cases are still in the preliminary stages, and it is not possible for us to quantify the extent of our potential liability, if any. An unfavorable outcome in any of these cases could have a material adverse effect on our business, financial condition, results of operations and cash flow. In addition, defending any litigation may be costly and divert management's attention from the day-to-day operations of our business.

On January 10, 2003, Raytheon Company sued VERITAS along with Brocade Communications Systems, Oracle Corporation, Overland Storage Inc., Qualstar Corp., QLogic Corporation, Ricoh Corporation and Spectra Logic Corporation in the United States District Court for the Eastern District of Texas. Raytheon is alleging infringement of US Patent No. 5,412,791, or 791 patent, entitled Mass Data Storage Library, and is seeking damages and an injunction against all defendants. We believe that we have numerous defenses and counterclaims to the claims of infringement asserted against us and we intend to vigorously defend ourselves. We filed an answer to Raytheon's complaint on March 7, 2003, denying all material allegations in the complaint and asserting counterclaims seeking to have Raytheon's 791 patent declared invalid and not infringed by us. A trial date is currently scheduled for June 2004.

On October 23, 2001, Storage Computer Corporation initiated litigation against VERITAS Software Corporation in the United States District Court for the Northern District of Texas alleging infringement of one of Storage Computer Corporation's patents. Currently, Storage Computer Corporation is alleging we infringe two of their US patents. We have denied all material allegations in the complaints, have filed counterclaims for declaratory judgment of invalidity and non-infringement of the patents-in-suit and have alleged their infringement of one of our patents. Storage Computer Corporation is seeking damages of approximately \$50.0 million, treble damages, costs of suit and attorneys' fees and a permanent injunction from further alleged infringement. We believe that we have numerous defenses and counterclaims relative to the claims of infringement and the damages claim asserted against us and intend to vigorously defend this action. A trial date is currently scheduled for November 2003.

We are also party to various other legal proceedings that have arisen in the ordinary course of our business. While we currently believe that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on our financial position or overall trends in results of operations, litigation is subject to inherent uncertainties. Were an unfavorable ruling to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the ruling occurs. The estimate of the potential impact on our financial position or overall results of operations for the above legal proceedings could change in the future.

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

The results of our annual meeting of stockholders held on May 13, 2003 are disclosed in Item 4 of Part II of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2003, which was filed with the Securities and Exchange Commission on May 15, 2003. Such information is incorporated by reference in this quarterly report on Form 10-Q.

Item 5. *Other Information*

On August 11, 2003, Gary Bloom, our Chairman, President and Chief Executive Officer, established a stock-trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934, pursuant to which Goldman, Sachs & Co. will undertake to sell up to 250,000 shares of our common stock subject to options currently owned by Mr. Bloom at specified intervals from November 2003 through August 2004.

On August 11, 2003, Edwin Gillis, our Executive Vice President, Finance and Chief Financial Officer, established a stock-trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934, pursuant to which G.W. & Wade Asset Management Company will undertake to sell up to 200,000 shares of our common stock subject to options currently owned by Mr. Gillis at specified intervals from November 2003 through August 2004.

Table of Contents**Item 6. Exhibits and Reports on Form 8-K***(a) Exhibits*

| Exhibit Number | Exhibit Description | Incorporated by Reference | | | Filed Herewith |
|----------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|------|--------|----------------|
| | | Form | Date | Number | |
| 4.01 | Indenture dated as of August 1, 2003 by and between VERITAS and U.S. Bank National Association | | | | X |
| 4.02 | Registration Rights Agreement dated as of August 1, 2003 by and among VERITAS, Goldman Sachs & Co., ABN AMRO Rothschild LLC and McDonald Investments Inc. | | | | X |
| 10.01 | Consent and Sixth Amendment Agreement dated as of June 6, 2003 by and among VERITAS Software Global Corporation, the various parties designated as Guarantors, Wells Fargo Bank Northwest, National Association as Owner Trustee, the various banks and other lending institutions designated as Holders, the various banks and other lending institutions designated as Lenders and Bank of America, N.A. as Agent and relating to the Participation Agreement dated as of March 9, 2000 | | | | X |
| 10.02 | Consent and Seventh Amendment Agreement dated as of June 6, 2003 by and among VERITAS Software Global Corporation, the various parties designated as Guarantors, Wells Fargo Bank Northwest, National Association as Owner Trustee, the various banks and other lending institutions designated as Holders, the various banks and other lending institutions designated as Lenders and Bank of America, N.A. as Agent and relating to the Participation Agreement dated as of April 23, 1999 | | | | X |
| 10.03 | Consent and Sixth Amendment Agreement to Participation Agreement dated as of June 6, 2003 by and among VERITAS Software Global Corporation, the various parties designated as Guarantors, Wells Fargo Bank Northwest, National Association as Owner Trustee, the various banks and other lending institutions designated as Holders, the various banks and other lending institutions designated as Lenders and ABN Amro Bank N.V. as Agent and relating to the Participation Agreement dated as of July 28, 2000 | | | | X |
| 31.01 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | X |
| 31.02 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | X |
| 32.01 | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | | X |
| 99.01 | Consent of Standard & Poor's Corporate Value Consulting | | | | X |

(b) Reports on Form 8-K

| Date of Report | Item(s) | Description |
|----------------|----------|--------------------------------------------------------------------------------|
| 4/23/03 | 7, 9, 12 | VERITAS announced financial results for the three months ended March 31, 2003. |

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SIGNATURE

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 on August 13, 2003.

VERITAS SOFTWARE CORPORATION

/s/ EDWIN J. GILLIS

Edwin J. Gillis
*Executive Vice President, Finance
and Chief Financial Officer*
(Principal Financial and Accounting Officer)

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Table of Contents**EXHIBIT INDEX**

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