

SanDisk 1999 Annual Report

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SanDisk 

annual report 1999



In **Step**
with the **Future**



Flash Memory
mainstreet
Compatibility
alliances
Digital
breakthrough

Reinforcing our purpose.

Embracing our potential.

SanDisk products were in strong demand during 1999. This fact is clearly reflected in our business and financial performance for the year, which is detailed in the following pages. Our mission, "to be the global leader in flash data storage," continued to be a major focus for the company, and we retained our position as the world's top supplier of flash data storage.

SanDisk's alliances with leading manufacturers expanded in scope in 1999. We gained a solid foothold in many emerging consumer markets as SanDisk products became widely used in digital cameras, portable digital music players, cell phones, and a host of other wireless devices which are quickly growing in popularity with consumers around the world.

As the digital information age continues to open up new markets, we are committed to embracing our potential as technology innovators ready to shape the future.



Reaping the rewards of relentless focus.

A LETTER FROM THE PRESIDENT

Fiscal 1999 was a year of remarkable growth and progress for SanDisk. During the year, the vision that we have nurtured for the past decade finally began to fall into place as a beautiful quilt of emerging mega-markets. For several years we have talked about the post-PC era which will see the accelerating conversion of consumer electronics from analog to digital, the explosive growth in wireless/portable communications, and the swift transformations wrought by the advent of the internet and e-commerce. These mega-market forces will shape our lives in the new century. Each will require the power to compute, transmit and store vast amounts of digital information, be it e-mail, voice mail, music, video, images, digital books, maps or video games, and the infrastructure for switching, routing and storing this expanding bandwidth. This is SanDisk's opportunity, and our challenge: to provide the most reliable, most competitive flash storage to these new markets, and to be able to rapidly scale the volume of our business to allow us to maintain our leading market share position globally. I am happy to report that in 1999 we made great strides toward meeting our long-term strategic objectives. At the same time, we continued to demonstrate our attention to the daily details, and our relentless pursuit of lower costs through accelerated introductions of advanced technology.

The numbers speak for themselves. Revenues for 1999 totaled \$247 million, an increase of 82 percent over the previous year. Product revenues grew 99 percent over 1998 due to increased sales of CompactFlash™ and MultiMediaCard products. Royalty revenues increased 27 percent to \$41 million. Net income grew 124% to \$27 million, or \$0.43 a share on a fully diluted basis. We greeted the new millennium with our balance sheet stronger than ever, with cash and investments of \$457 million following a successful secondary

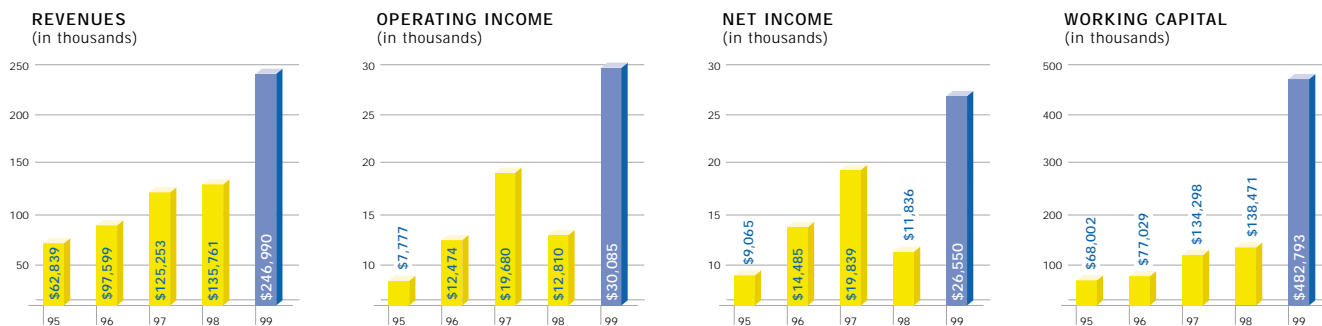
financing in November. The company continues to operate conservatively with essentially no debt.



Driving these impressive numbers is a growing demand from consumer retail sales of our products, particularly into the digital camera market, which began to grow rapidly in the second half of the year. After a decade of working closely with key manufacturers such as Kodak, Canon, Nikon, and Hewlett-Packard to develop the digital camera market, we are beginning to realize considerable returns on our investment. By the end of 1999, SanDisk had shipped over three million CompactFlash memory cards to major OEMs and to more than 13,000 retail outlets worldwide. Today, more than 130 digital camera models sold in retail outlets throughout the world have slots for CompactFlash.

Also during the year, the MultiMediaCard product family gained strong support from the emerging Internet music player market, as well as the digital camcorder and smart cell phone markets. Because of the strong increase in demand, we were supply constrained for flash memory, and as a result were unable to meet our customer demand for MultiMediaCards during 1999. We are focusing significant efforts on adding new flash memory capacity to meet this burgeoning demand.

One of the most significant events of 1999 was the agreement between SanDisk, Matsushita Electric Industrial, and Toshiba to jointly develop and promote the new Secure Digital Memory Card. This high-speed, read/write memory card heralds the next generation of flash memory storage by providing cryptographic security



through its intelligent flash memory controller for protection of copyrighted data, including music, movies, and other digitally available commercial content. We believe that the security features of the Secure Digital Memory Card will be a key enabler for the secure electronic distribution of copyrighted works. First shipments of our new Secure Digital Memory Card are slated for the second quarter of 2000, however, we do not expect to generate substantial Secure Digital Memory Card revenues until 2001, when numerous new designs are expected to arrive on the market.

In the fourth quarter, we announced the signing of a memorandum of understanding with Toshiba for the long-term strategic cooperation in the development and manufacturing of advanced flash memory technology. We expect this partnership to become an important element in SanDisk's market leadership in the years ahead.

During 1999, we relied exclusively on our foundry partnership with UMC for our flash memory production. Despite the severe earthquake in Taiwan in September, UMC was able to recover quickly, minimizing the interruption in our fourth quarter wafer supply. All in all, we shipped almost four times more megabytes of flash memory in 1999 than we shipped in all of 1998.

I am pleased to report the excellent progress we made in 1999 in our operations and technology groups. We began the year focused on the production of our 64Mbit flash chip. By the middle of 1999, we successfully transitioned to 128Mbit production. By the fourth quarter of 1999, we completed the production transition to our first 256Mbit double density flash chip. We believe that now, with the 256Mbit flash chip and its high performance, low cost controller in full production, SanDisk is very well positioned as a world class high volume, low cost producer of flash storage cards.

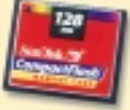
On the production side, we strengthened our manufacturing infrastructure through the increased emphasis on leveraging outside subcontractors for much of our manufacturing, assembly, and test operations. In fiscal 2000, we expect the majority of our production to be completed by subcontractors in China and Taiwan. As a result, our U.S. operations are now focused primarily on new and custom product development and production. With our world class manufacturing partners, we believe that we are well positioned to capitalize on the significant future growth in the market for flash memory.

It is an exciting time at SanDisk. We are breaking new ground in many areas. We believe we are just at the beginning of a long period of sustainable growth. The key to SanDisk's ability to sustain our success lies in the execution of our plan by our employees, our greatest asset. Our employees are enthusiastic, highly dedicated and passionate. Their hard work has brought us to where we are today, a world class, highly respected, market leader. As we look ahead, we are confident that we will continue to reap the rewards of our passion for quality and our relentless focus on lowering the cost and improving the value to our customers of our flash memory products.

We are most grateful for your continued support.

Eli Harari
President and Chief Executive Officer

CompactFlash Memory Cards



SanDisk's CompactFlash memory cards currently range in capacity from 8 to 192MB, and are widely used in digital cameras, handheld PCs, voice recorders and any other CompactFlash compatible device.

FlashDisk Type II PC Cards



SanDisk Type II PC Cards are as convenient as floppy disks, but require far less power and provide considerably more storage. SanDisk PC Cards are currently available in capacities ranging from 8MB to 1.2GB.

SanDisk MultiMediaCards



The SanDisk MultiMediaCard lets you carry more music, images, data, and voice recordings. This small but rugged memory card is great for Internet music players, voice recorders, smart phones, and digital camcorders. It is currently available in capacities ranging from 8 to 64MB.

ImageMate™ Drives and FlashPath™ Adapters



SanDisk's ImageMate external drive is the fastest, most convenient way to transfer data between your memory cards and your computer. The SanDisk FlashPath is a convenient floppy disk-shaped adapter that lets you read and write data to memory cards using your computer's floppy disk drive.

FlashDrives



SanDisk IDE FlashDrives are solid-state mass storage systems for use in mobile computers, communications platforms, and embedded systems. They maintain full compatibility with a hard disk drive but consume less power.

Converging markets. Compelling opportunities.

SanDisk has focused its research and development efforts on flash memory storage products since we were founded in 1988. We introduced CompactFlash in 1994, and today have a team of engineers dedicated to increasing memory capacity, developing advanced features, and reducing manufacturing costs. During 1999, SanDisk shipped more than three million CompactFlash memory cards — more than any previous year — and there are currently more than 220 products on the market that use CompactFlash as their primary storage medium. Last year, sales of CompactFlash accounted for 60 percent of our product revenues.

The rapid emergence of the digital camera market is one of the chief factors driving demand for CompactFlash. Today there are more than 130 digital cameras available with slots for CompactFlash. Using CompactFlash as their "digital film", consumers can capture and store high resolution photographs, and then transport the images directly to a computer, photo printer, or other digital device. A whole new generation is discovering the time- and cost-efficiency of CompactFlash: instead of buying roll after roll of photographic film, they can reuse a single CompactFlash card over a lifetime.

During 1999, we also began to witness the convergence of the markets for consumer electronics, wireless communications, and the Internet. The marketplace is being transformed as consumers opt for smaller, more user-friendly devices that offer mobility, flexibility, and access to a full range of content. SanDisk's MultiMediaCard, originally targeted at cellular phone and pager markets, is finding new applications in emerging markets such as portable digital music players, digital video cameras, and smart phones.

SanDisk Flash Memory Cards are used in a variety of handheld PCs.



SanDisk MultiMediaCards store music files for today's popular Internet music players.



More than 130 digital cameras now take SanDisk's CompactFlash cards.



The Secure Digital Memory Card provides security for copyright protection of digital data.



SanDisk's Personal Tag (P-Tag) makes critical health information accessible to authorized medical personnel.



Over 75 Internet music players now take SanDisk's MultiMediaCard.

Inventive solutions. Breakthrough applications.

Just as our passion for innovation drove the creation of flash memory in 1988, SanDisk's ongoing quest for inventive solutions continued in 1999 with the introduction of two revolutionary new products.

The Secure Digital Memory Card, introduced in August 1999, takes the technology introduced in our MultiMediaCard to new levels. This universal flash memory storage device, about the size of a postage stamp, offers cryptographic security along with high storage capacity. We believe the Secure Digital Memory Card will unleash entirely new business models built around the delivery of high-value, copyright-protected content that can be transferred from the Internet to a computer and a full range of portable wireless devices without compromising the ownership and licensing rights of its creator.

In August 1999, SanDisk joined forces with Matsushita Electric (best known for its Panasonic brand name products) and Toshiba to jointly develop, specify, and promote the Secure Digital Memory Card. As part of this collaboration, all three companies will foster the development of application products using the Secure Digital Memory Card. In January 2000, Matsushita, Toshiba, and SanDisk announced the formation of the SD Association, a new industry-wide organization created to promote the Secure Digital Memory Card standard and to encourage its acceptance in digital applications. Membership in the SD Association is expected to include more than 100 leading technology companies from around the world.

In September 1999, SanDisk broke new ground with the introduction of the Personal Tag (P-Tag), the world's first solid-state, wearable personal storage device. Originally developed for the U.S. Army, P-Tag weighs just two grams and is designed to be comfortably worn 24 hours a day, 7 days a week. The initial application for P-Tag is for storing medical information for military personnel, but it also holds great promise as a storage solution for health care organizations.



SanDisk Secure Digital Memory Card

The next generation of security for protection of valued content. The Secure Digital Memory Card meets the growing demand for flash memory based storage cards while addressing the increasingly complex issue of copyright protection for artists and other content owners. Jointly developed by Matsushita, SanDisk, and Toshiba, the Secure Digital Memory Card provides a high level of security for protection of content, which can be distributed over the Internet. The Secure Digital Memory Card balances the needs of content owners for copyright protection with the needs of the consumer for ease of use and flexibility. Consumers will soon be able to move protected content from the Internet, CDs, or DVDs for their own personal enjoyment without compromising the copyrights of the content owners. The Secure Digital Memory Card is expected to gain endorsement from content providers worldwide, as it will enable them to take full advantage of the Internet-based content distribution model and engage in secure e-commerce transactions involving copyrighted and protected information.

Personal Tag (P-Tag)



This wearable electronic card, less than an inch in diameter, holds from 8MB to 32MB of the carrier's medical history. Designed to be worn at all times, it makes critical health information instantly accessible to authorized medical personnel any time, any place.

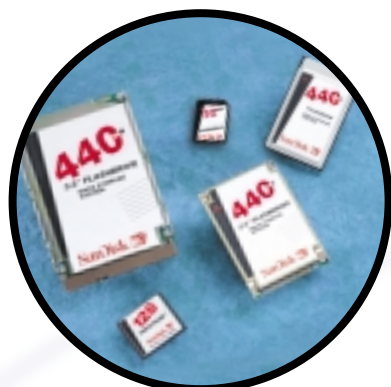
Positioned for success.



As we look to the future, we are determined and optimistic. We are continuing our relentless focus on increasing the capacity and lowering the cost of our flash data storage products. At the same time, we are anticipating the market demands of a new generation by pursuing research and development of innovative solutions that align with the digital age.

We are confident in our capabilities to execute our strategic plans, and we remain firmly committed to creating and enabling new consumer mega-markets by providing world-leading technology, enabling scalable, high-volume production, and developing and promoting industry standards.

As a company, in our many alliances, and as a force for innovation, SanDisk is positioned for success.



SanDisk 1999

Financial Review

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SANDISK CORPORATION SELECTED FINANCIAL DATA

(In thousands, except per share data)

Year Ended December 31,	1999	1998	1997	1996	1995
Revenues					
Product	\$ 205,770	\$ 103,190	\$ 105,675	\$ 89,599	\$ 61,589
License and royalty	41,220	32,571	19,578	8,000	1,250
Total revenues	246,990	135,761	125,253	97,599	62,839
Cost of revenues	152,143	80,311	72,280	58,707	36,613
Gross profits	94,847	55,450	52,973	38,892	26,226
Operating income	30,085	12,810	19,680	12,474	7,777
Net income	\$ 26,550	\$ 11,836	\$ 19,839	\$ 14,485	\$ 9,065
Net income per share					
Basic	\$ 0.48	\$ 0.23	\$ 0.43	\$ 0.33	\$ 0.24
Diluted	\$ 0.43	\$ 0.21	\$ 0.40	\$ 0.30	\$ 0.22
Shares used in per share calculations					
Basic	55,834	52,596	45,760	44,324	37,494
Diluted	61,433	55,344	49,940	48,412	40,656
At December 31,	1999	1998	1997	1996	1995
Working capital	\$ 482,793	\$ 138,471	\$ 134,298	\$ 77,029	\$ 68,002
Total assets	657,724	255,741	245,467	108,268	92,147
Total stockholders' equity	572,127	207,838	191,374	87,810	72,381

See Notes to the Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations.

(Unaudited. In thousands, except per share data)

Quarterly/1999	1st	2nd	3rd	4th
Revenues				
Product	\$ 35,926	\$ 42,300	\$ 57,624	\$ 69,920
License and royalty	8,210	10,249	9,910	12,851
Total revenues	44,136	52,549	67,534	82,771
Gross profits	17,627	21,691	23,637	31,892
Operating income	4,848	7,033	6,956	11,248
Net income	4,323	5,694	6,505	10,028
Net income per share				
Basic	\$ 0.08	\$ 0.11	\$ 0.12	\$ 0.17
Diluted	\$ 0.07	\$ 0.10	\$ 0.11	\$ 0.15
Quarterly/1998	1st	2nd	3rd	4th
Revenues				
Product	\$ 25,426	\$ 23,480	\$ 24,143	\$ 30,141
License and royalty	8,676	7,881	7,935	8,079
Total revenues	34,102	31,361	32,078	38,220
Gross profits	16,330	10,801	13,238	15,081
Operating income	6,004	370	2,633	3,803
Net income	4,703	1,053	2,506	3,574
Net income per share				
Basic	\$ 0.09	\$ 0.02	\$ 0.05	\$ 0.07
Diluted	\$ 0.08	\$ 0.02	\$ 0.05	\$ 0.07

Certain statements in this discussion and analysis are forward looking statements based on current expectations, and entail various risks and uncertainties that could cause actual results to differ materially from those expressed in such forward looking statements. Such risks and uncertainties are set forth in "Factors That May Affect Future Results." The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto.

Overview

SanDisk was founded in 1988 to develop and market flash data storage systems. We sell our products to the consumer electronics and industrial/communications markets. In 1999, the percentage of our product sales attributable to the consumer electronics market, particularly sales of CompactFlash for use in digital camera applications, continued to grow. This increase in sales to the consumer market resulted in a further shift in sales mix to products with average capacities between 8 and 64 megabytes, which typically have lower average selling prices and gross margins than our higher capacity FlashDisk and FlashDrive products. In addition, a substantial portion of our CompactFlash products are sold into the retail channel, which usually has shorter customer order lead-times than our other channels. A majority of our sales to the retail channel are turns business, with orders received and fulfilled in the same quarter, thereby decreasing our ability to accurately forecast future production needs. We believe sales to the consumer market will continue to represent a majority of our sales as the popularity of consumer applications, including digital cameras, increases.

Our operating results are affected by a number of factors including the volume of product sales, availability of foundry capacity, variations in manufacturing cycle times, fluctuations in manufacturing yields and manufacturing utilization, the timing of significant orders, competitive pricing pressures, our ability to match supply with demand, changes in product and customer mix, market acceptance of new or enhanced versions of our products, changes in the channels through which our products are distributed, timing of new product announcements and introductions by us and our competitors, the timing of license and royalty revenues, fluctuations in product costs, increased research and development expenses, and exchange rate fluctuations. In addition, as the proportion of our products sold for use in consumer electronics applications increases, our revenues may become subject to seasonal declines in the first quarter of each year. See "Factors That May Affect Future Results — Our operating results may fluctuate significantly" and " — There is seasonality in our business."

Beginning in late 1995, we adopted a strategy of licensing our flash technology, including our patent portfolio, to selected third party manufacturers of flash products. To date, we have entered into patent cross-license agreements with several companies, and intend to pursue opportunities to enter into additional licenses. Our current license agreements provide for the payment of license fees, royalties, or a combination thereof. The timing and amount of these payments can vary substantially from quarter to quarter, depending on the terms of each agreement and, in some cases, the timing of sales of products by the other parties. As a result, license and royalty revenues have fluctuated significantly in the past and are likely to continue to fluctuate in the future. Given the relatively high gross margins associated with license and royalty revenues, gross margins and net income are likely to fluctuate more with changes in license and royalty revenues than with changes in product revenues.

We market our products using a direct sales organization, distributors, manufacturers' representatives, private label partners, OEMs and retailers. We expect that sales through the retail channel will comprise an increasing share of total revenues in the future, and that a substantial portion of our sales into the retail channel will be made to participants that will have the right to return unsold products. We do not recognize revenues from these sales until the products are sold to the end customers.

Historically, a majority of our sales have been to a limited number of customers. Product sales to our top 10 customers accounted for approximately 57%, 59% and 67%, respectively, of our product revenues for 1999, 1998 and 1997. In addition, in 1999 and 1998 revenues from one customer exceeded 10% of total revenues. No single customer accounted for greater than 10% of total revenues in 1997. We expect that sales of our products to a limited number of customers will continue to account for a substantial portion of our product revenues for the foreseeable future. We have also experienced significant changes in the composition of our customer base from year to year and expect this pattern to continue as market demand for such customers' products fluctuates. The loss of, or

significant reduction in purchases by major customers, could have a material adverse effect on our business, financial condition and results of operations. See "Factors That May Affect Future Results — Sales to a small number of customers represent a significant portion of our revenues."

All of our products require silicon wafers, which are currently manufactured by UMC in Taiwan. Industry wide demand for semi-conductors increased significantly in 1999, due to increased demand in the consumer electronics and cellular phone markets. This increased demand is expected to continue in 2000 causing supply to become constrained and prices to increase. Under our wafer supply agreements, there are limits on the number of wafers we can order and our ability to change that quantity is restricted. Accordingly, our ability to react to significant fluctuations in demand for our products is limited. If customer demand exceeds our forecasts, we may be unable to obtain an adequate supply of wafers to fill customer orders, which could result in lost sales and lower revenues. If we are unable to obtain adequate quantities of flash memory wafers with acceptable prices and yields from our current and future wafer foundries, our business, financial condition and results of operations could be harmed. If customer demand falls below our forecast and we are unable to reschedule or cancel our wafer orders, we may end up with excess wafer inventories, which could result in higher operating expenses and reduced gross margins. We have from time to time taken write downs for excess inventories. For example, in the second quarter of 1998, our product gross margins were negatively impacted by such an inventory write down. These adjustments decrease gross margins in the quarter reported and have resulted, and could in the future result, in fluctuations in gross margins on a quarter to quarter basis. See "Factors That May Affect Future Results — Our operating results may fluctuate significantly."

Export sales are an important part of our business, representing 53%, 56% and 57% of our total revenues in 1999, 1998, and 1997, respectively. Our sales may be impacted by changes in economic conditions in our international markets. For example, in 1998, product sales to Japan declined 19% from the prior year, due in part to the Asian economic crisis. While a majority of our revenues from sales to Japan and other Asian countries are derived from OEM customers who plan to export a portion of their products to countries outside of Asia, economic conditions in Asia may continue to adversely effect our revenues to the extent that demand for our products in Asia declines. Given the recent economic conditions in Asia and the weakness of many Asian currencies relative to the

United States dollar, our products may be relatively more expensive in Asia, which could result in a decrease our sales in that region. We may also experience pressure on our gross margins as a result of increased price competition from Asian competitors. While most of our sales are denominated in U.S. Dollars, we invoice certain Japanese customers in Japanese Yen and are subject to exchange rate fluctuations on these transactions which could affect our business, financial condition and results of operations. See "Factors That May Affect Future Results — Our international operations make us vulnerable to changing conditions and currency fluctuations."

For the foreseeable future, we expect to realize a significant portion of our revenues from recently introduced and new products. Typically new products initially have lower gross margins than more mature products because the manufacturing yields are lower at the start of manufacturing each successive product generation. In addition, manufacturing yields are generally lower at the start of manufacturing any product at a new foundry. To remain competitive, we are focusing on a number of programs to lower manufacturing costs, including development of future generations of D2 flash and advanced technology wafers. There can be no assurance that we will successfully develop such products or processes or that development of such processes will lower manufacturing costs. In addition, if the industry wide supply of flash memory products grows faster than customer demand, we could experience increased price competition in the future, which could result in decreased average selling prices and lower gross margins. See "Factors That May Affect Future Results — We must achieve acceptable manufacturing yields."

Results of Operations

PRODUCT REVENUES.

In 1999, our product revenues increased 99% to \$205.8 million from \$103.2 million in 1998. The increase consisted of an increase of 157% in unit sales, which was partially offset by a 22% decline in average selling prices. In 1999, the largest increase in unit volume came from sales of CompactFlash which represented 61% of product revenues and MultiMediaCard products which represented 7% of product revenues. A shift in product mix to higher capacity cards in 1999 partially offset a decline in the average selling price per megabyte of capacity shipped. In 1999, the average megabyte capacity per unit shipped increased 65% while the average selling price per megabyte of flash memory shipped declined 52% compared to the prior year. The mix of products sold varies from quarter to quarter and may vary in the future, affecting our overall average selling prices and gross margins.

In 1998, our product revenues were \$103.2 million, a decline of 2% from \$105.7 million in 1997. The 1998 decrease consisted of an increase in unit shipments of 34% which was offset by a decline in average selling prices of 28%. In 1998, the largest increase in unit volume came from sales of CompactFlash products, primarily for use in digital cameras and other consumer electronics applications. CompactFlash products represented approximately 50% of product revenues in 1998.

SanDisk's backlog at the end of 1999 was \$157.2 million compared to \$13.4 million in 1998 and \$18.6 million in 1997. See "Factors That May Affect Future Results — Our operating results may fluctuate significantly" and " — There is seasonality in our business."

LICENSE AND ROYALTY REVENUES.

We currently earn patent license fees and royalties under seven cross-license agreements with Hitachi, Intel, Sharp, Samsung, SmartDisk, SST and Toshiba. License and royalty revenue from patent cross-license agreements was \$41.2 million in 1999, up from \$32.6 million in 1998 and \$19.6 million in 1997. The increase in license and royalty revenues in 1999 was primarily due to an increase in patent royalty revenues. The increase in license and royalty revenues in 1998 was partially due to the recognition of a full year of revenues under the Hitachi, Toshiba and Samsung agreements, which were entered into in the third quarter of 1997. Revenues from licenses and royalties were 17% of total revenues in 1999, 24% in 1998 and 16% in 1997.

GROSS PROFITS.

In fiscal 1999, gross profits increased to \$94.8 million, or 38.4% of total revenues from \$55.5 million, or 40.8% of total revenues in 1998 and \$53.0 million, or 42.3% of total revenues in 1997. In 1999, product gross margins increased to 26.1% of product revenues from 22.2% in 1998, primarily due to the lower cost per megabyte of our 256 megabit and 128 megabit flash memory products, which began shipping in volume in the second half of 1999. We expect product gross margins to improve from the 1999 level in the first quarter of 2000 as we transition to our 256 megabit technology for the majority of our product sales.

In 1998, the growth in overall gross profits resulted from an increase in license and royalty revenues, which was partially offset by a decline in gross profit from product sales. Product gross profits declined as a percentage of product revenues to 22.2% in 1998 compared to 31.6% in 1997, primarily due to competitive pricing pressures.

RESEARCH AND DEVELOPMENT.

Research and development expenses consist principally of salaries and payroll related expenses for design and development engineers, prototype supplies and contract services. Research and development expenses increased to \$26.9 million in 1999 from \$18.2 million in 1998 and \$13.6 million in 1997. As a percentage of revenues, research and development expenses represented 10.9% in 1999, 13.4% in 1998 and 10.8% in 1997. In 1999 and 1998, the increase in research and development expenses was primarily due to an increase in salaries and payroll-related expenses associated with additional personnel and higher project related expenses. Increased depreciation due to capital equipment additions also contributed to the growth in research and development expenses in both years. We expect research and development expenses to continue to increase, in absolute dollars and perhaps as a percentage of revenue, to support the development of new generations of flash data storage products, including the proposed 512 megabit and 1 gigabit flash memory co-development and manufacturing joint venture with Toshiba. If we successfully enter into a definitive agreement with Toshiba, we expect the incremental research and development expenses related to the Toshiba joint development project to be in the range of \$6.0 million to \$8.0 million in fiscal 2000.

SALES AND MARKETING.

Sales and marketing expenses include salaries, sales commissions, benefits and travel expenses for our sales, marketing, customer service and applications engineering personnel. These expenses also include other selling and marketing expenses, such as independent manufacturer's representative commissions, advertising and tradeshow expenses. Sales and marketing expenses increased to \$25.3 million in 1999 from \$16.9 million in 1998 and \$12.6 million in 1997. The increase in 1999 was primarily due to increased salaries and payroll related expenses and increased commission expenses due to higher product revenues and increased marketing expenses. The increase in 1998 was primarily due to increased marketing and sales expenses related to the development of the retail channel. Increased salaries and payroll related expenses associated with additional personnel also contributed significantly to the increase in 1998. Sales and marketing expenses represented 10.2% of total revenues in 1999 compared to 12.5% in 1998 and 10.0% in 1997. We expect sales and marketing expenses to increase as sales of our products grow and as we further develop the retail channel for our products.

GENERAL AND ADMINISTRATIVE.

General and administrative expenses include the cost of our finance, information systems, human resources, shareholder relations, legal and administrative functions. General and administrative expenses were \$12.6 million in 1999 compared to \$7.5 million in 1998 and \$7.1 million in 1997. The increase in 1999 was primarily due to higher salaries and payroll related expenses, increased legal fees and an increase in the allowance for doubtful accounts. The increase in 1998 was primarily due to increased consulting expenses related to the implementation of our new management information system and an increase in the allowance for doubtful accounts. General and administrative expenses represented 5.1% of total revenues in 1999 compared to 5.5% in 1998 and 5.7% in 1997. We expect general and administrative expenses to increase as our general and administrative functions grow to support our overall growth. General and administrative expenses could also increase substantially in the future if we pursue additional litigation to defend our patent portfolio. See "Factors That May Affect Future Results — Risks associated with patents, proprietary rights and related litigation."

INTEREST INCOME.

Interest income was \$8.3 million in 1999 compared to \$5.3 million in 1998 and \$3.7 million in 1997. The increase in 1999 is primarily due to higher interest income in the fourth quarter due to the investment of the proceeds from the sale of common stock in our November 1999 follow-on public offering. The increase in 1998 is primarily due to higher investment balances as a result of the investment of the proceeds from the sale of common stock in our November 1997 follow-on public offering.

OTHER INCOME (LOSS), NET.

Other income (loss), net was \$1.3 million in 1999 compared to \$374,000 in 1998 and (\$1,000) in 1997. The increases in 1999 and 1998 were primarily due to increased foreign currency transaction gains of \$1.1 million and \$412,000 respectively.

PROVISION FOR INCOME TAXES.

Our 1999, 1998 and 1997 effective tax rates were approximately 33.0%, 36.0% and 15.0%, respectively. Our 1999 effective tax rate was lower than our 1998 rate due to benefits from federal and state tax credits. Our 1998 tax rate is substantially higher than our 1997 rate due to the utilization of all remaining federal and state tax credit carry forwards in 1997.

Liquidity and Capital Resources

As of December 31, 1999, we had working capital of \$482.8 million, which included \$146.2 million in cash and cash equivalents and \$311.0 million in short-term investments. Operating activities provided \$17.0 million of cash in 1999 primarily from net income, an increase in accounts payable of \$23.8 million, and an increase in accrued liabilities of \$23.7 million, which were partially offset by an increase in accounts receivable of \$33.6 million, as a direct result of increased sales in the fourth quarter, and an increase in inventory of \$26.8 million to support anticipated levels of growth. Cash provided by operations was \$15.1 million in 1998 and \$29.3 million in 1997.

Net cash used in investing activities of \$214.4 million in 1999 included \$21.4 million of capital equipment purchases and net purchases of investments of \$193.0 million. In 1998, net cash used in investing activities of \$23.0 million consisted of a second investment in the USIC foundry of \$10.9 million, \$7.5 million of capital equipment purchases and net purchases of investments of \$4.6 million. In 1997, net cash used in investing activities of \$108.9 million consisted of net purchases of investments of \$59.0 million, an investment of \$40.3 in the USIC foundry and \$9.6 million of capital equipment purchases.

In 1999, financing activities provided \$328.2 million of cash including \$320.3 million from the net proceeds of the sale of common stock in our November 1999 follow-on stock offering and \$7.9 million from the sale of common stock through the SanDisk stock option and employee stock purchase plans. During 1998, cash provided by financing activities of \$2.4 million was primarily from the sale of common stock through the SanDisk stock option and employee stock purchase plans. Financing activities provided \$81.2 million of cash in 1997, primarily from the sale of common stock in our November 1997 follow-on stock offering.

In October 1999, we entered into a nonbinding memorandum of understanding with Toshiba providing for the joint development and manufacturing of 512 megabit and 1 gigabit flash memory chips and Secure Digital Memory Card controllers. Further, we and Toshiba intend to form and fund a joint venture to equip and operate a silicon wafer manufacturing line in Virginia. The cost of equipping the Virginia wafer manufacturing line is estimated at between \$700 million and \$800 million. We, as part of our 50% ownership of the joint venture, expect to invest up to \$150 million in cash, and, if necessary, guarantee equipment lease lines for an additional \$250 million.

Depending on the demand for our products, we may decide to make additional investments, which could be substantial, in assembly and test manufacturing equipment or foundry capacity to support our business in the future. We expect operating expenses to continue to increase as a result of the need to hire additional personnel to support expected growth in sales unit volumes, sales and marketing efforts and research and development activities, including our proposed collaboration with Toshiba providing for the joint development of 512 megabit and 1 gigabit flash memory chips. We believe the existing cash and cash equivalents and short-term investments will be sufficient to meet our currently anticipated working capital and capital expenditure requirements for the next twelve months.

On January 3, 2000, the USIC foundry was merged into UMC. We previously invested \$51.2 million in USIC. In exchange for our USIC shares, we received 111 million UMC shares. These shares were valued at approximately \$396 million at the time of the merger, resulting in a pretax gain of \$344 million (\$204 million after-tax). All the UMC shares we received as a result of the merger are subject to trading restrictions imposed by UMC and the Taiwan Stock Exchange. The trading restrictions will expire on one-half of the shares six months after the date of the merger. The remaining shares will become available for sale over a two year period beginning in January 2002. When the shares are ultimately sold, it is likely that we will report additional gains or losses. To the extent we can liquidate the UMC shares, we will plan to use such funds to support our operations and capital expenditures.

Impact of Currency Exchange Rates

A portion of our revenues are denominated in Japanese Yen. We enter into foreign exchange forward contracts to hedge against changes in foreign currency exchange rates. At December 31, 1999, two forward contracts with notional amounts of \$8.2 million were outstanding. Future exchange rate fluctuations could have a material adverse effect on our business, financial condition and results of operations.

Impact of Recently Issued Accounting Standards

In June 1998, the Financial Accounting Standards Board issued Statement 133, Accounting for Derivative Instruments and Hedging Activities, which is required to be adopted in years beginning after June 15, 2000. Because of our minimal use of derivatives, we do not anticipate that the adoption of the new Statement will have a significant effect on our earnings or financial position, however, we are in the process of studying the actual impact.

Year 2000 Readiness Disclosure

Year 2000 problems are the result of common computer programming techniques that result in systems that do not function properly when manipulating dates later than December 31, 1999. The issue is complex and wide-ranging. The problem may affect transaction processing computer applications we use for accounting, distribution, manufacturing planning, and communications. The problem may also affect embedded systems such as building security systems, machine controllers and production testing equipment. Year 2000 problems with these systems may affect the ability or efficiency with which we can perform many significant functions, including but not limited to order processing and fulfillment, material planning, product assembly, product testing, invoicing and financial reporting. We have not to date experienced any material impact in any of these areas. The Year 2000 problem may also affect the computer systems of our suppliers and customers, potentially disrupting their operations. Year 2000 problems with our business partners may impact our sources of supply and demand.

YEAR 2000 READINESS.

We conducted a Year 2000 risk management program to assess the impact of the Year 2000 issue on us, and to coordinate remediation activities. We completed the evaluation of our products for Year 2000 compliance in the third quarter of 1998. Our storage and connectivity products are used as components in a variety of host systems. The firmware, operating system and application software of these host systems are designed and manufactured by others. We make no claim with regard to the Year 2000 readiness of host systems designed by others in which products are used. In addition, independent system designers make derivative works from our Host Developer's Toolkit source code product. We make no claims with regard to the Year 2000 readiness of host firmware and operating systems designed by others that contain derivative works of the Toolkit.

The Year 2000 remediation of our transaction processing systems was completed with the installation and testing of our new management information system in the fourth quarter of 1998. In the second quarter of 1999, we completed all of the primary elements of our Year 2000 assessment and remediation program for our principal hardware and software. Tests of software applications, which have been identified by their vendors as Year 2000 compliant, and several minor software upgrades were successfully completed in the third quarter of 1999.

Our assessment and remediation of Year 2000 problems in computer systems used for facilities control, machine control and manufacturing testing is complete. We are phasing in new Year 2000 compliant wafer testing equipment in conjunction with the introduction of new generations of flash memory.

Our assessment of Year 2000 risks related to material suppliers, customers and other third parties is complete. Inquiries were made of all critical suppliers and an assessment of their Year 2000 readiness was the basis for strategic decisions regarding alternate material sourcing and/or increasing inventory safety stocks. We also attempted to contact our significant customers regarding their Year 2000 readiness in order to understand the potential for any disruptions in their ordering patterns.

YEAR 2000 RISK MANAGEMENT PROGRAM COSTS.

The cost of Year 2000 project related to upgrading our core management information system was approximately \$1.0 million, \$400,000 of which was related to the purchase of software and hardware which was capitalized. Upgrading application software and replacing non-compliant personal computer systems cost an additional \$175,000. The majority of these costs would have been incurred, in spite of Year 2000 issues, due to the need to upgrade our management information system, application software and personal computers to support our growth. Our Year 2000 remediation projects were funded from operating cash flows. No material projects were deferred in order to complete our Year 2000 assessment and remediation projects.

RISKS RELATED TO YEAR 2000 READINESS.

Success of our Year 2000 compliance effort depends, in part, on the success of our key suppliers and customers in dealing with their Year 2000 issues. We do not have any control over the remediation efforts of our key suppliers and customers and cannot fully determine the extent to which they have resolved their Year 2000 compliance issues. We currently purchase several critical components from single or sole source vendors. While this issue is being carefully managed, disruptions in the supply of components from any of these sole source suppliers due to Year 2000 issues, could cause delays in our fulfillment of customer orders which could result in reduced or lost revenues. Furthermore, our sales have historically been to a limited number of customers. Any disruptions in the purchasing patterns of these customers or potential customers due to Year 2000 issues could cause a decline in our revenues. If our key suppliers and customers have year 2000 problems, our business could be harmed.

Factors That May Affect Future Results

Our operating results may fluctuate significantly which may adversely affect our stock price.

Our quarterly and annual operating results have fluctuated significantly in the past and we expect that they will continue to fluctuate in the future. This fluctuation is a result of a variety of factors, including the following:

- unpredictable demand for our products;
- decline in the average selling prices of our products due to competitive pricing pressures;
- seasonality in sales of our products;
- adverse changes in product and customer mix;
- slower than anticipated market acceptance of new or enhanced versions of our products;
- competing flash memory card standards which displace the standards used in our products;
- changes in our distribution channels;
- timing of license and royalty revenue;
- fluctuations in product costs, particularly due to fluctuations in manufacturing yields and utilization;
- availability of sufficient silicon wafer foundry capacity to meet customer demand;
- excess capacity of flash memory from our competitors and our own new flash wafer capacity;
- significant yield losses which could affect our ability to fulfill customer orders and could increase our costs;
- lengthening in manufacturing cycle times due to our suppliers operating at peak capacity;
- increased research and development expenses;
- exchange rate fluctuations, particularly the U.S. dollar to Japanese yen exchange rate;
- changes in general economic conditions, in particular the economic recession in Japan;
- natural disasters affecting the countries in which we conduct our business, particularly Taiwan, Japan and the United States;
- difficulty of forecasting and management of inventory levels; and
- expenses related to obsolescence of unsold inventory.

DIFFICULTY OF ESTIMATING SILICON WAFER NEEDS

When we order silicon wafers from our foundries, we have to estimate the number of silicon wafers needed to fill product orders several months into the future. If we overestimate this number, we will build excess inventories which could harm our gross margins and operating results. For example, in the second quarter of 1998, our product gross margins declined to 12% from 30% in the previous quarter due in part to a write down of inventory to reflect net realizable value. If we underestimate the number of silicon wafers needed to fill product orders, we may be unable to obtain an adequate supply of wafers which could harm our product revenues. Because our largest volume product, CompactFlash, is sold into an emerging consumer market, it has been difficult to accurately forecast future sales. A substantial majority of our quarterly sales have historically been from orders received and fulfilled in the same quarter. In addition, our product order backlog may fluctuate substantially from quarter to quarter.

ANTICIPATED GROWTH IN EXPENSE LEVELS

We increased our expense levels in 1999 to support our growth. We expect operating expenses to continue to increase in fiscal 2000 as a result of the need to hire additional personnel to support expected growth in sales unit volumes, sales and marketing efforts and research and development activities, including our proposed collaboration with Toshiba providing for the joint development of 512 megabit and 1 gigabit flash memory chips. For example in fiscal 2000, the incremental research and development expenses related to the proposed Toshiba joint development project are projected to be in the range of \$6 million to \$8 million. In addition, we have significant fixed costs and we cannot readily reduce these expenses over the short term. If revenues do not increase proportionately to operating expenses, or if revenues decrease or do not meet expectations for a particular period, our business, financial condition and results of operations will be harmed.

VARIABILITY OF AVERAGE SELLING PRICES AND GROSS MARGIN

Our product mix varies quarterly, which affects our overall average selling prices and gross margins. Our CompactFlash products, which currently represent the majority of our product revenues, have lower average selling prices and gross margins than our higher capacity FlashDisk and FlashDrive products. We believe that sales of CompactFlash products will continue to represent a significant percentage of our product revenues as consumer applications, such as digital cameras, become more popular. Dependence on CompactFlash sales, together with lower pricing caused by

increased competition, caused average unit selling prices to decline 22% during fiscal 1999 compared to a decline of 28% during fiscal 1998. We expect this trend to continue.

VARIABILITY OF LICENSE FEES AND ROYALTIES

Our intellectual property strategy is to cross-license our patents to other manufacturers of flash products. Under these arrangements, we earn license fees and royalties on individually negotiated terms. The timing of revenue recognition from these payments is dependent on the terms of each contract and on the timing of product shipments by the third parties. This may cause license and royalty revenues to fluctuate significantly from quarter to quarter. Because these revenues have higher gross margins than product revenues, gross margins and net income fluctuate significantly with changes in license and royalty revenues.

In transitioning to new processes and products we face production and market acceptance risks.**GENERAL**

Successive generations of our products have incorporated semiconductor devices with greater memory capacity per chip. Two important factors that enable us to decrease the costs per megabyte of our flash data storage products are the development of higher capacity semiconductor devices and the implementation of smaller geometry manufacturing processes. A number of challenges exist in achieving a lower cost per megabyte, including:

- overcoming lower yields often experienced in the early production of new semiconductor devices;
- problems with design and manufacturing of products that will incorporate these devices; and
- production delays.

Because our products are complex, we periodically experience significant delays in the development and volume production ramp up of our products. Similar delays could occur in the future and could harm our business, financial condition and results of operations.

128 MEGABIT TECHNOLOGY

We began shipments of 128 megabit products in the second quarter of 1999. In the third quarter of 1999, we accelerated the production ramp up of our 128 megabit flash memory technology to meet increased demand. In the third quarter of 1999, during the production ramp up of our 128 megabit technology, lower than anticipated yields contributed to a decline in gross margins. If we experience unplanned yield problems on our 128Mbit technology in

the future, we may be unable to meet our customers' demand for high capacity MultiMediaCard and CompactFlash products which could result in lost sales and reduced revenues. In addition, our gross margins may be harmed by any problems we encounter in the production of our 128 megabit flash memory. We plan to decrease production of our 128 megabit products in the second quarter of 2000 as we ramp up production of our 256 megabit products.

D2 FLASH TECHNOLOGY

We have developed new products based on D2 flash technology, a new flash architecture designed to store two bits in each flash memory cell. High density flash memory, such as D2 flash, is a complex technology that requires strict manufacturing controls and effective test screens. Problems encountered in the shift to volume production for new flash products could impact both reliability and yields, and result in increased manufacturing costs and reduced product availability. We may not be able to manufacture future generations of our D2 products with yields sufficient to result in lower costs per megabyte. In fiscal 2000, we expect to increase production of our 256 megabit flash memory technology, which has a lower cost per megabyte than the 128 megabit technology. If we are unable to bring future generations of our 256 megabit flash memory into full production as quickly as planned or if we experience unplanned yield problems, we will not be able to meet our customers' forecasted demand, which would result in lost sales, reduced revenues and reduced margins.

MULTIMEDIACARD PRODUCTS

We expect to increase the MultiMediaCard product family production volumes in the first quarter of 2000. This product presents new challenges in assembly and testing. In the third quarter of 1999, during the MultiMediaCard production startup phase, we experienced fluctuations in yields which reduced MultiMediaCard product availability, increased manufacturing costs and reduced product margins for this product family. We are currently unable to meet customer demand for MultiMediaCard products. This is primarily due to demand exceeding previous forecasts from our customers and the lead time required to adjust our levels of manufacturing to support changes in demand. We have not yet achieved the production assembly yields necessary for high volume production.

SECURE DIGITAL MEMORY CARD PRODUCTS

In the third quarter of 1999, we announced a memorandum of understanding under which we, along with Matsushita and Toshiba, will jointly develop and promote the Secure Digital Memory Card. The Secure Digital Memory Card is an enhanced version of our

MultiMediaCard that will incorporate advanced security and copyright protection features required by the emerging markets for the electronic distribution of music, video and other copyrighted works. We expect to begin shipping our Secure Digital Memory Card products in the second quarter of 2000. Negotiations for a definitive agreement concerning this collaboration are underway, but we cannot assure you that these negotiations will be successful or that we, Matsushita and Toshiba will enter into a definitive agreement.

The Secure Digital Memory Card will incorporate a number of new features, including SDMI compliant security and copy protection, a mechanical write protect switch and a high data transfer rate. We have never built products incorporating these features. Any problems or delays in establishing production capabilities or ramping up production volumes of our Secure Digital Memory Card products could result in lost sales or increased manufacturing costs in 2000. In addition, we cannot be sure that manufacturers of consumer electronic products will develop new products that use the Secure Digital Memory Card. Conversely, broad acceptance of our Secure Digital Memory Card by consumers may reduce demand for our MultiMediaCard and CompactFlash card products. See " — The success of our business depends on emerging markets and new products."

We depend on third party foundries for silicon wafers.

All of our products require silicon wafers. We rely on UMC in Taiwan to supply all of our silicon wafers. We depend on UMC to allocate a portion of its capacity to our needs, produce acceptable quality wafers with acceptable manufacturing yields and deliver our wafers on a timely basis at a competitive price. If UMC is unable to satisfy these requirements, our business, financial condition and operating results may suffer. For example, in September 1999, both UMC foundries producing our flash memory wafers were damaged and temporarily shut down by an earthquake in Taiwan. As a result, approximately 10% of our silicon wafers in production at the time of the earthquake had to be discarded and no new wafers could be manufactured for 11 days, resulting in the loss or destruction of a portion of our fourth quarter 1999 wafer supply. Future earthquakes, aftershocks or other natural disasters in Taiwan could preclude us from obtaining an adequate supply of wafers to fill customer orders, and could significantly harm our business, financial condition and results of operations.

Industry-wide demand for semiconductor wafers has increased significantly due to increased demand in the consumer electronics and cellular phone markets. Increased demand for advanced technology silicon wafers is increasing the price of these wafers as supply becomes constrained. We expect this trend to continue throughout 2000 which could adversely impact the rate of growth of our business, either through reduced supply, higher wafer prices or a combination of the two.

In January 2000, the USIC foundry was merged into UMC. Before the merger, we owned 10% of USIC, had the right to appoint one of its directors and were entitled to 12.5% of its total wafer production. As a result of the merger, we received UMC shares in exchange for our USIC shares. However, we will not have a right to a seat on the board of directors of the combined company. We have received assurances from the senior management of UMC that it intends to continue to supply us the same wafer capacity at the prices we currently enjoy under our agreement with USIC. However, there can be no assurance that we will be able to maintain our current wafer capacity and competitive pricing arrangement in our future supply negotiations with UMC.

Under the terms of our wafer supply agreements with UMC, we are obligated to provide a rolling forecast of anticipated purchase orders for the next six calendar months. Generally, the estimates for the first three months of each forecast are binding commitments. The estimates for the remaining months may only be changed by a certain percentage from the previous month's forecast. This limits our ability to react to fluctuations in demand for our products. For example, if customer demand falls below our forecast and we are unable to reschedule or cancel our wafer orders, we may end up with excess wafer inventories, which could result in higher operating expenses and reduced gross margins. Conversely, if customer demand exceeds our forecasts, we may be unable to obtain an adequate supply of wafers to fill customer orders, which could result in dissatisfied customers, lost sales and lower revenues. In addition, in February 2000, we entered into a capacity and reservation deposit agreement with UMC. To reserve additional foundry capacity under this agreement, we paid UMC a reservation deposit. This deposit will be refunded to us on a quarterly basis over the agreement term, if we purchase the full wafer capacity reserved for us. We may forfeit part of our deposit if we are unable to utilize our reserved capacity within four quarters of the end of the agreement term. If we are unable to obtain scheduled quantities of wafers with acceptable price and yields from any foundry, our business, financial condition and results of operations could be harmed.

The success of our business depends on emerging markets and new products.

In order for demand for our products to grow, the markets for new products that use CompactFlash and the MultiMediaCard, such as portable digital music players and smart phones, must develop and grow. If sales of these products do not grow, our revenues and profit margins could level off or decline.

Because we sell our products for use in many new applications, it is difficult to forecast demand. For example, in 1999, demand for our 32 megabyte capacity MultiMediaCard for use in portable digital music players grew faster than anticipated and we were unable to fill all customer orders during the quarter. Although we are increasing production of the MultiMediaCard, if we are unable to fulfill customer demand for these products in the future, we may lose sales to our competitors.

SECURE DIGITAL MEMORY CARD PRODUCTS

In the third quarter of 1999, we announced a collaboration under which we will jointly develop our Secure Digital Memory Card, an enhanced version of our MultiMediaCard, which will incorporate advanced security and copyright protection features required by the emerging markets for the electronic distribution of music, video and other copyrighted works. We expect to begin shipping our Secure Digital Memory Cards in 32 and 64 megabyte capacities in the second quarter of 2000. The Secure Digital Memory Card is slightly thicker and uses a different interface than our MultiMediaCard. Because of these differences, the Secure Digital Memory Card will not work in current products that include a MultiMediaCard slot. In order for the market for our Secure Digital Memory Card to develop, manufacturers of digital audio/video and portable computing products must include a Secure Digital Memory Card compatible slot in their products and acquire a license to the security algorithms. If OEMs do not incorporate Secure Digital Memory Card slots in their products or do not buy our Secure Digital Memory Cards, our business, financial condition and results of operations may be harmed. In addition, consumers may postpone or altogether forego buying products that utilize our MultiMediaCard and CompactFlash cards in anticipation of new products that will incorporate the Secure Digital Memory Card. If this occurs, sales of our MultiMediaCard and CompactFlash products may be harmed. The main competition for the Secure Digital Memory Card is expected to come from the Sony Memory Stick. Sony has substantially greater financial and other resources than we do and extensive marketing and sales channels and brand recognition. We cannot assure you that our Secure Digital Memory Card will be successful in the face of such competition.

In addition, the market for portable digital music players is very new and it is uncertain how quickly consumer demand for these players will grow. If this market does not grow as quickly as anticipated or our customers are not successful in selling their portable digital music players to consumers, our revenues could be adversely affected. In addition, it is often the case with new consumer markets that after an initial period of new market formation and initial acceptance by early adopters, the market enters a period of slow growth as standards emerge and infrastructure develops. In the event that this occurs in the portable digital music player market or other emerging markets, sales of our products would be harmed.

The success of our new product strategy will depend upon, among other things, the following:

- our ability to successfully develop new products with higher memory capacities and enhanced features at a lower cost per megabyte;
- the development of new applications or markets for our flash data storage products;
- the extent to which prospective customers design our products into their products and successfully introduce their products; and
- the extent to which our products or technologies become obsolete or noncompetitive due to products or technologies developed by others.

512 MEGABIT AND 1 GIGABIT SCALE FLASH MEMORY CARD PRODUCTS

In October 1999, we entered into a nonbinding memorandum of understanding with Toshiba providing for the joint development and manufacture of 512 megabit and 1 gigabit flash memory chips and Secure Digital Memory Card controllers. As part of this proposed collaboration, we and Toshiba plan to employ Toshiba's future 0.16 micron and 0.13 micron NAND flash integrated circuit manufacturing technology and SanDisk's multilevel cell flash and controller system technology. The development of 512 megabit and 1 gigabit flash memory chips and Secure Digital Memory Card controllers is expected to be complex and may incorporate SanDisk and Toshiba technology that is still under development. We cannot assure you that we and Toshiba will successfully develop these new products or the underlying technology, or that any development will be completed in a timely or cost-effective manner. If we are not successful in any of the above, our business, financial condition and results of operations could suffer.

We may be unable to maintain market share.

We may be unable to increase our production volumes at a sufficiently rapid rate so as to maintain our market share. Ultimately, our growth rate depends on our ability to obtain sufficient flash memory wafers and other components to meet demand. If we are unable to do so in a timely manner, we may lose market share to our competitors. Currently, our supply constraints are forcing some of our largest customers to seek alternate sources of supply to meet their growing flash memory product needs.

Our selling prices may be affected by future excess capacity in the market for flash memory products.

Currently industry wide demand for flash memory products far exceeds the available supply. This is primarily driven by an explosion in the growth of cellular phones and internet appliances and the accelerating shift in consumer electronics from analog to digital devices. This strong demand had manifested itself in improved bookings visibility and a more stable pricing environment. All major flash memory suppliers, including SanDisk, are responding to this strong demand by significantly increasing investments in new advanced flash memory production capacity due to the broadly held assumption that our industry is entering a prolonged growth phase which will be able to absorb the new flash production output. If this assumption should prove to be erroneous, or if one or several of our target markets experience delays in anticipated growth, there may be excess supply in market for our products. This excess capacity, even if temporary in nature, could cause average selling prices to drop significantly, thereby adversely impacting our product gross margins and operating results in future quarters.

Our international operations make us vulnerable to changing conditions and currency fluctuations.

POLITICAL RISKS

Currently, all of our flash memory wafers are produced by two UMC foundries in Taiwan. We also use a third-party subcontractor in Taiwan for the assembly and testing of our MultiMediaCard products. We may therefore be affected by the political, economic and military conditions in Taiwan. Taiwan is currently engaged in various political disputes with China and both countries have recently conducted military exercises in or near the other's territorial waters and airspace. The Taiwanese and Chinese governments may continue to escalate these disputes, resulting in an economic embargo, a disruption in shipping routes or even military hostilities. This could harm our business by interrupting or delaying the production or shipment of flash memory wafers or MultiMediaCard products by our Taiwanese foundries and subcontractor. See " — We depend on our suppliers and third party subcontractors."

In addition, in the second quarter of 1999, we began using a third-party subcontractor in China for the assembly and testing of our CompactFlash products. As a result, our business could be harmed by the effect of political, economic, legal and other uncertainties in China. Under its current leadership, the Chinese government has been pursuing economic reform policies, including the encouragement of foreign trade and investment and greater economic decentralization. The Chinese government may not continue to pursue these policies and, even if it does continue, these policies may not be successful. The Chinese government may also significantly alter these policies from time to time. In addition, China does not currently have a comprehensive and highly developed legal system, particularly with respect to the protection of intellectual property rights. As a result, enforcement of existing and future laws and contracts is uncertain, and the implementation and interpretation of such laws may be inconsistent. Such inconsistency could lead to piracy and degradation of our intellectual property protection.

ECONOMIC RISKS

We price our products primarily in U.S. dollars. As a result, if the value of the U.S. dollar increases relative to foreign currencies, our products could become less competitive in international markets. For example, our products are relatively more expensive in Asia because of the weakness of many Asian currencies relative to the US dollar. In addition, we currently invoice some of our customers in Japanese yen. Therefore, fluctuations in the Japanese yen against the U.S. dollar could harm our business, financial condition and results of operations. Similarly, the weakness of the Euro may make our products less competitive in Europe relative to Japanese flash memory suppliers.

Our sales are also highly dependent upon global economic conditions. In fiscal 1998, sales to Japan declined to 31.6% of total product sales from 38.1% in 1997. In 1999, sales to Japan represented 22.4% of product revenue. We believe these declines were primarily due to the Japanese recession.

GENERAL RISKS

Our international business activities could also be limited or disrupted by any of the following factors:

- the need to comply with foreign government regulation;
- general geopolitical risks such as political and economic instability, potential hostilities and changes in diplomatic and trade relationships;
- natural disasters affecting the countries in which we conduct our business, particularly Taiwan and Japan;
- imposition of regulatory requirements, tariffs, import and export restrictions and other barriers and restrictions, particularly in China;
- longer payment cycles and greater difficulty in accounts receivable collection, particularly as we increase our sales through the retail distribution channel;
- potentially adverse tax consequences;
- less protection of our intellectual property rights; and
- delays in product shipments due to local customs restrictions.

We depend on our suppliers and third party subcontractors.

We rely on our vendors, some of which are sole source suppliers, for several of our critical components. We do not have long-term supply agreements with some of these vendors. Our business, financial condition and operating results could be harmed by delays or reductions in shipments if we are unable to develop alternative sources or obtain sufficient quantities of these components. For example, we rely on UMC for all of our flash memory wafers, and NEC to supply certain designs of microcontrollers. In September 1999, both UMC foundries producing our flash memory wafers were damaged and temporarily shut down by an earthquake in Taiwan. In addition, due to industry-wide increasing demand for semiconductors, we have recently experienced resistance to price reductions from some of our important suppliers. See “—We depend on third party foundries for silicon wafers.” In addition, we have begun to experience long order lead times on standard components due to high industry demand. Shortages of any of these standard components could result in higher manufacturing costs or lower revenues due to production delays or reduced product shipments. Additionally, where possible, we are building buffer inventories of critical components. If we accumulate excess inventories or these buffer inventories become obsolete, we will have to write down inventories which will adversely affect our gross margins and results of operations.

We also rely on third-party subcontractors to assemble and test the memory components for our products. We have no long-term contracts with these subcontractors and cannot directly control product delivery schedules. This could lead to product shortages or quality assurance problems which could increase the manufacturing costs of our products and have adverse effects on our operating results.

During the second half of 1999, we transferred a substantial portion of wafer testing, packaged memory final testing, card assembly and card testing to Silicon Precision Industries Co., Ltd. in Taiwan and Celestica, Inc. in China. In fiscal 2000, we expect that they will be assembling and testing a majority of our mature, high-volume products. This increased reliance on subcontractors is expected to reduce manufacturing costs and give us access to increased production capacity. During the transition period, we will continue full operations at our Sunnyvale production facility while simultaneously transferring test equipment and training personnel of our subcontractors. However, we do not have sufficient duplicative production testing equipment at Sunnyvale and at our subcontractors. Therefore, any significant problems in this complex transfer of operations may result in a disruption of production and a shortage of product to meet customer demand in the first half of 2000 and beyond.

Continuing declines in our average sales prices may result in declines in our gross margins.

In 1999, the average unit selling prices of our products declined 22% compared to 1998. In 1999, the average price per megabyte shipped declined 52% compared to 1998. Because flash data storage markets are characterized by intense competition and price reductions for our products are necessary to meet consumer price points, we expect that market-driven pricing pressures will continue. This will likely result in a further decline in average sales prices for our products. We believe that we can offset declining average sales prices by achieving manufacturing cost reductions and developing new products that incorporate more advanced technology, include more advanced features and can be sold at stable average gross margins despite continued declines in average selling price per megabyte. However, if we are unable to achieve such cost reductions and technological advances, this could result in lost sales and declining gross margins, and as a result, our business, financial condition and results of operations could suffer.

The semiconductor industry is cyclical and we believe it is currently in a recovery from one of its most severe down cycles. During most of 1997 and 1998, the semiconductor industry experienced significant production over capacity, which reduced margins for substantially all flash memory suppliers. Currently, the markets for our products are supply constrained and our selling prices have stayed relatively stable. There can be no assurance that this trend will continue throughout 2000.

Our markets are highly competitive.

FLASH MEMORY MANUFACTURERS AND MEMORY CARD ASSEMBLERS

We compete in an industry characterized by intense competition, rapid technological changes, evolving industry standards, declining average selling prices and rapid product obsolescence. Our competitors include many large domestic and international companies that have greater access to advanced wafer foundry capacity, substantially greater financial, technical, marketing and other resources, broader product lines and longer standing relationships with customers. Our primary competitors include:

- storage flash chip producers, such as Hitachi Ltd., Samsung Electronics Company Ltd. and Toshiba Corporation;
- socket flash, linear flash and component manufacturers, such as Advanced Micro Devices, Inc., Atmel Corporation, Intel Corporation, Macronix International Co., Ltd., Micron Technology, Inc., Mitsubishi Electronic Corporation, Sharp Electronics Corporation and STMicroelectronics NV; and
- module or card assemblers, such as Lexar Media, Inc., M-Systems, Inc., Pretec Electronics Corp., Simple Technology Inc., Sony Corporation, Kingston Technology Company, Panasonic Consumer Electronic Company, Silicon Storage Technology, Inc., TDK Corporation, Matsushita Battery, Inc. Delkin Devices, Inc., Silicon Tek and Viking Components, Inc., who combine controllers and flash memory chips developed by others into flash storage cards.

In addition, over 25 companies have been certified by the CompactFlash Association to manufacture and sell their own brand of CompactFlash. We believe additional manufacturers will enter the CompactFlash market in the future.

We have announced a memorandum of understanding under which we, Matsushita and Toshiba will jointly develop and promote a next generation flash memory card called the Secure Digital Memory Card. Under this agreement, Secure Digital Memory Card licenses will be granted to other flash memory card manufacturers, which will increase the competition for our Secure Digital Memory Card, CompactFlash and MultiMediaCard products. In addition, Matsushita and Toshiba will sell Secure Digital Memory Cards that will compete directly with our products. Other flash card manufacturers will be required to pay the SD Association license fees and royalties which will be shared between Matsushita, Toshiba and SanDisk. There will be no royalties or license fees payable among the three companies for their respective sales of the Secure Digital Memory Card. Thus, we will forfeit potential royalty income from Secure Digital Memory Card sales by Matsushita and Toshiba.

In October 1999, we entered into a nonbinding memorandum of understanding with Toshiba providing for the joint development and manufacture of 512 megabit and 1 gigabit flash memory chips and Secure Digital Memory Card controllers. We and Toshiba will each separately market and sell any products developed and manufactured under this relationship. Accordingly, we will compete directly with Toshiba for sales of these advanced chips and controllers.

We have entered into patent cross-license agreements with several of our leading competitors including, Hitachi, Samsung, Toshiba, Intel and Sharp. Under these agreements, each party may manufacture and sell products that incorporate technology covered by the other party's patents related to flash memory devices. As we continue to license our patents to certain of our competitors, competition will increase and may harm our business, financial condition and results of operations. Currently, we are engaged in licensing discussions with several of our competitors. There can be no assurance that we will be successful in concluding licensing agreements under terms which are favorable to us.

ALTERNATIVE STORAGE MEDIA

Competing products have been introduced that promote industry standards that are different from our CompactFlash and MultiMediaCard products, including Toshiba's SmartMedia, Sony Corporation's Memory Stick, Sony's standard floppy disk used for digital storage in its Mavica digital cameras, Panasonic's Mega Storage cards, Iomega's Clik drive, a miniaturized, mechanical, removable disk drive, M-Systems' Diskonchip for embedded storage applications and the Secure MultiMediaCard from Hitachi and Infineon. Each competing standard is mechanically and electronically incompatible with CompactFlash and MultiMediaCard. If a manufacturer of digital cameras or other consumer electronic devices designs in one of these alternative competing standards, CompactFlash or MultiMediaCard will be eliminated from use in that product.

In September 1998, IBM introduced the microdrive, a rotating disk drive in a Type II CompactFlash format. This product competes directly with our Type II CompactFlash memory cards for use in high-end professional digital cameras. In October 1998, M-Systems introduced their Diskonchip 2000 Millennium product which competes against our Flash ChipSet products in embedded storage applications such as set top boxes and networking appliances.

According to independent industry analysts, Sony's Mavica digital camera captured a considerable portion of the United States market

for digital cameras in 1998 and 1999. The Mavica uses a standard floppy disk to store digital images and therefore uses no CompactFlash, or any other flash cards. Our sales prospects for CompactFlash cards have been adversely impacted by the success of the Mavica. Recently, Sony has shifted its focus to the use of its flash Memory Stick in its latest digital camera models.

Our MultiMediaCard products also have faced significant competition from Toshiba's SmartMedia flash cards and we expect to face similarly significant competition from Sony's Memory Stick. Sony has licensed its proprietary Memory Stick to other companies. If it is adopted and achieves widespread use in future products, sales of our MultiMediaCard and CompactFlash products may decline. Recently, Hitachi, Infineon, Sanyo and Fujitsu have proposed their Secure MultiMediaCard which provides the copy protection function that is included in our Secure Digital Memory Card. Should this initiative gain industry wide acceptance, it may reduce the widespread adoption of the Secure Digital Memory Card.

ALTERNATIVE FLASH TECHNOLOGIES

We also face competition from products based on multilevel cell flash technology such as Intel's 64 megabit and 128 megabit StrataFlash chips and Hitachi's 256 megabit multilevel cell flash chip. These products compete with our D2 multilevel cell flash technology. Multilevel cell flash is a technological innovation that allows each flash memory cell to store two bits of information instead of the traditional single bit stored by the industry standard flash technology. In the second quarter of 1999, Intel announced their new 128 megabit multilevel cell chip and Hitachi began shipping customer samples of CompactFlash cards employing their new multilevel cell flash chip. In addition, Toshiba has begun customer shipments of 32 megabyte SmartMedia cards employing their new 256 megabit flash chip. Although Toshiba has not incorporated multilevel cell flash technology in their 256 megabit flash chip, their use of more advanced lithographic design rules may allow them to achieve a more competitive cost structure than that of our 256 megabit D2 flash chip.

Furthermore, we expect to face competition from existing competitors and from other companies that may enter our existing or future markets that have similar or alternative data storage solutions which may be less costly or provide additional features. Price is an important competitive factor in the market for consumer products. Increased price competition could lower gross margins if our average selling prices decrease faster than our costs and could also result in lost sales.

Our business depends upon consumer products.

In 1999, we received more product revenue and shipped more units of products destined for consumer electronics applications, principally digital cameras, than for any other application. We believe that these products will encounter intense competition and be more price sensitive than products sold into our other target markets. In addition, we must spend more on marketing and promotion in consumer markets to establish brand name recognition and preference.

A significant portion of sales to the consumer electronics market is made through distributors and to retailers. Sales through these channels typically include rights to return unsold inventory. As a result, we do not recognize revenue until after the product has been sold to the end user. If our distributors and retailers are not successful in this market, there could be substantial product returns, which would harm our business, financial condition and results of operations.

Sales to a small number of customers represent a significant portion of our revenues.

More than half of our revenues come from a small number of customers. For example, sales to our top 10 customers accounted for approximately 57%, 59%, and 67%, respectively, of our product revenues for 1999, 1998, and 1997. In fiscal 1999, one customer accounted for more than 10% of product sales. In fiscal year 1998, two customers each accounted for 10% or more of our product sales. If we were to lose any of these customers or experience any material reduction in orders from these customers, our revenues and operating results would suffer. Our sales are generally made by standard purchase orders rather than long-term contracts. In addition, the composition of our major customer base changes from year to year as the market demand for our customers' products change.

Our multiple sales channels may compete for a limited number of customer sales.

Web based sales of our products today represent a small but growing portion of our overall sales. Sales on the Internet tend to undercut the traditional distribution channels and may dramatically change the way our consumer products are purchased in future years. We cannot assure you that we will successfully manage the inherent channel conflicts between our retail channel customers and customers that wish to purchase directly on the Internet.

There is seasonality in our business.

Sales of our products, in particular the sale of CompactFlash products, in the consumer electronics applications market may be subject to seasonality. As a result, product sales may be impacted by seasonal purchasing patterns with higher sales generally occurring in

the second half of each year. In addition, in the past we have experienced a decrease in orders in the first quarter from our Japanese OEM customers primarily because most customers in Japan operate on a fiscal year ending in March and prefer to delay purchases until the beginning of their next fiscal year. For example, our product revenues were 24% lower in the first quarter of 1998 than in the fourth quarter of 1997, mostly due to these seasonal factors. Although we did not experience this seasonality in the first quarter of 1999 and are not able to fulfill all demand from our Japanese customers in the first quarter of 2000, we cannot assure you that we will not experience seasonality in the future.

We must achieve acceptable wafer manufacturing yields.

The fabrication of our products requires wafers to be produced in a highly controlled and ultra clean environment. Semiconductor companies that supply our wafers sometimes have experienced problems achieving acceptable wafer manufacturing yields. Semiconductor manufacturing yields are a function of both our design technology and the foundry's manufacturing process technology. Low yields may result from design errors or manufacturing failures. Yield problems may not be determined or improved until an actual product is made and can be tested. As a result, yield problems may not be identified until the wafers are well into the production process. The risks associated with yields are even greater because we rely on independent offshore foundries for our wafers which increases the effort and time required to identify, communicate and resolve manufacturing yield problems. If the foundries cannot achieve the planned yields, this will result in higher costs and reduced product availability, and could harm our business, financial condition and results of operations.

Under the terms of our nonbinding memorandum of understanding with Toshiba, we and Toshiba will jointly form and fund a joint venture which will equip and operate a silicon wafer manufacturing line in Virginia to manufacture 512 megabit and 1 gigabit flash memory chips and Secure Digital Memory Card controllers. However, we cannot assure you that this manufacturing line will produce satisfactory quantities of wafers with acceptable prices and yields. Any failure in this regard could materially harm our business, financial condition and results of operations. In addition, the construction and operation of this line will cause us to incur significant expense and may result in the diversion of resources from other important areas of business. We cannot assure you that we or Toshiba will be able to secure sufficient funding to support this manufacturing line. In addition, we have no experience in operating a wafer manufacturing

line and we cannot assure you that we will be successful in operating it on a cost-effective basis or at all.

Risks associated with patents, proprietary rights and related litigation.

GENERAL

We rely on a combination of patents, trademarks, copyright and trade secret laws, confidentiality procedures and licensing arrangements to protect our intellectual property rights. In the past, we have been involved in significant disputes regarding our intellectual property rights and claims that we may be infringing third parties' intellectual property rights. We expect that we may be involved in similar disputes in the future. We cannot assure you that:

- any of our existing patents will not be invalidated;
- patents will be issued for any of our pending applications;
- any claims allowed from existing or pending patents will have sufficient scope or strength;
- our patents will be issued in the primary countries where our products are sold in order to protect our rights and potential commercial advantage; or
- any of our products may infringe on the patents of other companies.

In addition, our competitors may be able to design their products around our patents.

We intend to vigorously enforce our patents but we cannot be sure that our efforts will be successful. If we were to have an adverse result in any litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of infringing products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to the infringing technology. Any litigation is likely to result in significant expense to us, as well as divert the efforts of our technical and management personnel. For example the Lexar litigation described below has resulted in cumulative litigation expenses of approximately \$1.3 million.

CROSS-LICENSES AND INDEMNIFICATION OBLIGATIONS

If we decide to incorporate third party technology into our products or if we are found to infringe on others' intellectual property, we could be required to license intellectual property from a third party. We may also need to license some of our intellectual property to others in order to enable us to obtain cross-licenses to third party patents. Currently, we have patent cross-license agreements with several companies, including Hitachi, Intel, Samsung, Sharp and Toshiba and we are in discussions with other companies regarding potential cross-license agreements. We cannot be certain that licenses will be offered when we need them, or that the terms offered will be acceptable. If we do obtain licenses from third parties, we may be required to pay license fees or royalty payments. In addition, if we are unable to obtain a license that is necessary to the manufacture of our products, we could be required to suspend the manufacture of products or stop our wafer suppliers from using processes that may infringe the rights of third parties. We cannot assure you that we would be successful in redesigning our products or that the necessary licenses will be available under reasonable terms.

We have historically agreed to indemnify various suppliers and customers for alleged patent infringement. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorney's fees. We may periodically engage in litigation as a result of these indemnification obligations. We are not currently engaged in any such indemnification proceedings. Our insurance policies exclude coverage for third party claims for patent infringement. Any future obligation to indemnify our customers or suppliers could harm our business, financial condition or results of operations.

LITIGATION RISKS ASSOCIATED WITH OUR INTELLECTUAL PROPERTY

From time to time, it may be necessary to initiate litigation against third parties to preserve our intellectual property rights. These parties could in turn bring suit against us. For example, in March 1998 we filed a complaint in federal court against Lexar Media, Inc. for infringement of one of our flash card patents. Lexar disputed this claim and asserted that our patent was invalid or unenforceable, as well as asserting various counterclaims including unfair competition, violation of the Lanham Act, patent misuse, interference with prospective economic advantage, trade defamation and fraud. We have denied all of these counterclaims. In July 1998, the court denied Lexar's request to have the case dismissed. Discovery in this suit began in August 1998. On February 22, 1999, the court considered arguments and papers submitted by the parties regarding

the scope and proper interpretation of the asserted claims in our patent at issue in the Lexar suit. On March 4, 1999, the court issued its ruling on the proper construction of the claim terms in our patent. On July 30, 1999, we filed a motion for partial summary judgment that Lexar CompactFlash and PC Cards contributorily infringe our patent. Lexar filed a motion for summary judgment that our patent is invalid in view of prior art. A hearing on both of these motions was held on March 17, 2000. Both matters were taken under submission by the court and we are waiting for the court's order on both motions. In August 1999, we had a mandatory settlement meeting with Lexar. No settlement was reached through this meeting. A trial date has not yet been set.

Our rapid growth may strain our operations.

We are currently experiencing rapid growth, which has placed, and continues to place, a significant strain on our personnel and other resources. To accommodate this growth, we must continue to hire, train, motivate and manage our employees. We are having difficulty hiring the necessary engineering, sales and marketing personnel to support our growth. In addition, we must make a significant investment in our existing internal information management systems to support increased manufacturing, as well as accounting and other management related functions. Our systems, procedures and controls may not be adequate to support our rapid growth, which could in turn harm our business, financial condition and results of operations.

Our success depends on key personnel, including our executive officers, the loss of whom could disrupt our business.

Our success greatly depends on the continued contributions of our senior management and other key research and development, sales, marketing and operations personnel, including Dr. Eli Harari, our founder, President and Chief Executive Officer. Our success will also depend on our ability to recruit additional highly skilled personnel. We cannot assure you that we will be successful in hiring or retaining such key personnel, or that any of our key personnel will remain employed with us.

Anti-takeover provisions in our charter documents, stockholder rights plan and in Delaware law could prevent or delay a change in control and, as a result, negatively impact our stockholders.

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, we have adopted a stockholder rights plan that would cause substantial dilution to a stockholder who attempts to acquire us on terms not approved by our board of directors. In addition, our certificate of incorporation

grants the board of directors the authority to fix the rights, preferences and privileges of and issue up to 4,000,000 shares of preferred stock without stockholder action. Although we have no present intention to issue shares of preferred stock, such an issuance could have the effect of making it more difficult and less attractive for a third party to acquire a majority of our outstanding voting stock. Preferred stock may also have other rights, including economic rights senior to the common stock that could have a material adverse effect on the market value of the common stock. In addition, we are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law. This section provides that a corporation shall not engage in any business combination with any interested stockholder during the three-year period following the time that such stockholder becomes an interested stockholder. This provision could have the effect of delaying or preventing a change of control of SanDisk.

Our stock price has been, and may continue to be, volatile.

The market price of our stock has fluctuated significantly in the past and is likely to continue to fluctuate in the future. For example in the twelve month period ending December 31, 1999 our stock price has fluctuated from a low of \$6.25 to a high of \$50.31. We believe that such fluctuations will continue as a result of future announcements concerning us, our competitors or principal customers regarding technological innovations, new product introductions, governmental regulations, litigation or changes in earnings estimates by analysts. In addition, in recent years the stock market has experienced significant price and volume fluctuations and the market prices of the securities of high technology companies have been especially volatile, often for reasons outside the control of the particular companies. These fluctuations, as well as general economic, political and market conditions may have an adverse affect on the market price of our common stock.

Market Risk Disclosure Information

INTEREST RATE RISK

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing in widely diversified short-term investments, consisting primarily of investment grade securities, substantially all of which either mature within the next twelve months or have characteristics of short-term investments. A hypothetical 50 basis point increase in interest rates would result in an approximate \$950,000 decline (less than 0.32%) in the fair value of our available-for-sale securities.

FOREIGN CURRENCY RISK

A substantial majority of our revenue, expense and capital purchasing activities are transacted in U.S. dollars. However, we do enter into transactions in other currencies, primarily the Japanese Yen. To protect against reductions in value and the volatility of future cash flows caused by changes in foreign exchange rates, we have established a hedging program. Currency forward contracts are utilized in these hedging programs. Our hedging programs reduce, but do not always entirely eliminate, the impact of foreign currency exchange rate movements. An adverse change of 10% in exchange rates would result in a decline in income before taxes of approximately \$575,000.

All of the potential changes noted above are based on sensitivity analysis performed on our financial positions at December 31, 1999.

(In thousands, except share and per share amounts)

December 31,	1999	1998
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 146,170	\$ 15,384
Short-term investments	311,049	119,074
Accounts receivable, net of allowance for doubtful accounts of \$1,871 in 1999 and \$1,069 in 1998	52,434	18,818
Inventories	35,679	8,922
Deferred tax assets	17,000	15,900
Prepaid expenses and other current assets	6,058	8,276
Total current assets	568,390	186,374
Property and equipment, net	31,788	17,542
Investment in foundry	51,208	51,208
Deposits and other assets	6,338	617
Total assets	\$ 657,724	\$ 255,741
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 30,734	\$ 6,938
Accrued payroll and related expenses	8,259	3,768
Income taxes payable	5,843	4,668
Other accrued liabilities	11,378	5,077
Deferred revenue	29,383	27,452
Total current liabilities	85,597	47,903
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value		
Authorized shares: 4,000,000		
Issued: none	—	—
Common stock, \$0.001 par value		
Authorized shares: 125,000,000		
Issued and outstanding: 65,248,308 in 1999 and 53,256,220 in 1998	65	54
Capital in excess of par value	524,066	186,066
Retained earnings	47,797	21,247
Accumulated other comprehensive income	199	471
Total stockholders' equity	572,127	207,838
Total liabilities and stockholders' equity	\$ 657,724	\$ 255,741

The accompanying notes are an integral part of these consolidated financial statements

SANDISK CORPORATION CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

Years Ended December 31,	1999	1998	1997
Revenues			
Product	\$ 205,770	\$ 103,190	\$ 105,675
License and royalty	41,220	32,571	19,578
Total revenues	246,990	135,761	125,253
Cost of revenues	152,143	80,311	72,280
Gross profits	94,847	55,450	52,973
Operating expenses			
Research and development	26,883	18,174	13,577
Sales and marketing	25,294	16,933	12,568
General and administrative	12,585	7,533	7,148
Total operating expenses	64,762	42,640	33,293
Operating income	30,085	12,810	19,680
Interest income	8,280	5,307	3,661
Other income (loss), net	1,261	374	(1)
Income before taxes	39,626	18,491	23,340
Provision for income taxes	13,076	6,655	3,501
Net income	\$ 26,550	\$ 11,836	\$ 19,839
Net income per share			
Basic	\$ 0.48	\$ 0.23	\$ 0.43
Diluted	\$ 0.43	\$ 0.21	\$ 0.40
Shares used in computing net income per share			
Basic	55,834	52,596	45,760
Diluted	61,433	55,344	49,940

The accompanying notes are an integral part of these consolidated financial statements

(In thousands)

	Common Stock		Capital In Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders Equity
	Shares	Amount				
Balance at December 31, 1996	44,654	\$ 45	\$98,188	\$ (10,428)	\$ 5	\$ 87,810
Net income	—	—	—	19,839	—	19,839
Unrealized gain on available for sale securities	—	—	—	—	37	37
Comprehensive Income						19,876
Exercise of stock options for cash	714	1	583	—	—	584
Issuance of stock pursuant to employee stock purchase plan	252	—	1,189	—	—	1,189
Net exercise of common stock warrants	110	—	—	—	—	—
Sale of common stock, net of issuance costs	6,000	6	79,411	—	—	79,417
Income tax benefit from stock options exercised	—	—	2,498	—	—	2,498
Balance at December 31, 1997	51,730	52	181,869	9,411	42	191,374
Net income	—	—	—	11,836	—	11,836
Unrealized gain on available for sale securities	—	—	—	—	429	429
Comprehensive income						12,265
Exercise of stock options for cash	1,260	1	929	—	—	930
Issuance of stock pursuant to employee stock purchase plan	260	1	1,474	—	—	1,475
Net exercise of common stock warrants	6	—	—	—	—	—
Income tax benefit from stock options exercised	—	—	1,761	—	—	1,761
Compensation expense related to modification of stock options	—	—	33	—	—	33
Balance at December 31, 1998	53,256	54	186,066	21,247	471	207,838
Net income	—	—	—	26,550	—	26,550
Unrealized loss on available for sale securities	—	—	—	—	(272)	(272)
Comprehensive income						26,278
Exercise of stock options for cash	1,766	2	6,107	—	—	6,109
Issuance of stock pursuant to employee stock purchase plan	268	—	1,807	—	—	1,807
Net exercise of common stock warrants	58	—	—	—	—	—
Sale of common stock, net of issuance costs	9,900	9	320,277	—	—	320,286
Income tax benefit from stock options exercised	—	—	9,809	—	—	9,809
Balance at December 31, 1999	65,248	\$ 65	\$ 524,066	\$ 47,797	\$ 199	\$ 572,127

The accompanying notes are an integral part of these consolidated financial statements

SANDISK CORPORATION CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Years Ended December 31,	1999	1998	1997
Cash flows from operating activities:			
Net income	\$ 26,550	\$ 11,836	\$ 19,839
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	7,145	5,839	3,985
Deferred tax asset	(1,100)	1,160	(16,055)
Compensation related to modification of stock option terms	—	33	—
Changes in assets and liabilities:			
Accounts receivable	(33,616)	(247)	(7,643)
Inventories	(26,757)	6,726	(6,018)
Prepaid expenses and other current assets	2,959	(6,089)	(946)
Deposits and other assets	(5,721)	283	(9)
Accounts payable	23,796	(7,174)	6,516
Accrued payroll and related expenses	4,491	(906)	1,817
Income taxes payable	10,984	2,617	4,495
Other accrued liabilities	6,301	1,548	990
Deferred revenue	1,931	(515)	22,315
Total adjustments	(9,587)	3,275	9,447
Net cash provided by operating activities	16,963	15,111	29,286
Cash flows from investing activities:			
Purchases of short-term investments	(332,379)	(137,822)	(148,954)
Proceeds from short-term investments	139,391	133,214	89,919
Acquisition of property and equipment	(21,391)	(7,489)	(9,592)
Investment in foundry	—	(10,923)	(40,284)
Net cash used in investing activities	(214,379)	(23,020)	(108,911)
Cash flows from financing activities:			
Sale of common stock and warrants	328,202	2,405	81,190
Net cash provided by financing activities	328,202	2,405	81,190
Net increase (decrease) in cash and cash equivalents	130,786	(5,504)	1,565
Cash and cash equivalents at beginning of year	15,384	20,888	19,323
Cash and cash equivalents at end of year	\$ 146,170	\$ 15,384	\$ 20,888
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	\$ 4,306	\$ 8,277	\$ 15,172

The accompanying notes are an integral part of these consolidated financial statements

NOTE 1:
Organization and Summary of Significant Accounting Policies

ORGANIZATION AND NATURE OF OPERATIONS

SanDisk Corporation (the Company) was incorporated in Delaware on June 1, 1988, to design, manufacture, and market industry-standard, solid-state mass storage products using proprietary, high-density flash memory technology. The Company operates in one segment and serves customers in the consumer electronics, industrial, communications and highly portable computing markets. Principal geographic markets for the Company's products include the United States, Japan, Europe and the Far East.

SUPPLIER AND CUSTOMER CONCENTRATIONS

A limited number of customers historically have accounted for a substantial portion of the Company's revenues. In each of 1999 and 1998, one customer accounted for more than 10% of total revenues. In 1997, no single customer accounted for greater than 10% of total revenues. Sales of the Company's products will vary as a result of fluctuations in market demand. Further, the flash data storage markets in which the Company competes are characterized by rapid technological change, evolving industry standards, declining average selling prices and rapid technological obsolescence.

Certain of the raw materials used by the Company in the manufacture of its products are available from a limited number of suppliers. For example, all of the Company's products require silicon wafers which are currently supplied by United Microelectronics Corporation ("UMC") in Taiwan. The Company is dependent on its foundries to allocate to the Company a portion of their foundry capacity sufficient to meet the Company's needs, to produce wafers of acceptable quality and with acceptable manufacturing yields and to deliver those wafers to the Company on a timely basis. On occasion, the Company has experienced difficulties in each of these areas.

Under each of the Company's wafer supply agreements, the Company is obligated to provide a monthly rolling forecast of anticipated purchase orders. Except in limited circumstances and subject to acceptance by the foundries, the estimates for the first three months of each forecast constitute a binding commitment and the estimates for the remaining months may not increase or decrease by more than a certain percentage from the previous month's forecast. These restrictions limit the Company's ability to react to significant fluctuations in demand for its products. As a result, the Company has not been able to match its purchases of

wafers to specific customer orders, and therefore the Company has taken write downs for potential excess inventory purchased prior to the receipt of customer orders and may be required to do so in the future. These adjustments decrease gross margins in the quarter reported and have resulted, and could in the future result in fluctuations in gross margins on a quarter to quarter basis. To the extent the Company inaccurately forecasts the number of wafers required, it may have either a shortage or an excess supply of wafers, either of which could have a material adverse effect on the Company's business, financial condition and results of operations. Additionally, if the Company is unable to obtain scheduled quantities of wafers from any foundry with acceptable yields, the Company's business, financial condition and results of operations could be negatively impacted.

In addition, certain key components are purchased from single source vendors for which alternative sources are currently not available. Shortages could occur in these essential materials due to an interruption of supply or increased demand in the industry. If the Company were unable to procure certain of such materials, it would be required to reduce its manufacturing operations which could have a material adverse effect upon its results of operations. We also rely on third-party subcontractors to assemble and test the memory components for our products. We have no long-term contracts with these subcontractors and cannot directly control product delivery schedules. This could lead to product shortages or quality assurance problems which could increase the manufacturing costs of our products and have adverse effects on our operating results.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

BASIS OF PRESENTATION

The Company's fiscal year ends on the Sunday closest to December, 31. Fiscal year 1999 ended on January 2, 2000 and was 53 weeks in length. Fiscal years 1998 and 1997 ended on December 27, 1998 and December 28, 1997, respectively, and were each 52 weeks in length. For ease of presentation, the accompanying financial statements have been shown as ending on the last day of the calendar month.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company balances and transactions have been eliminated.

FOREIGN CURRENCY TRANSACTIONS

Foreign operations are measured using the U.S. dollar as the functional currency. Accordingly, monetary accounts (principally cash, accounts receivable and liabilities) are remeasured using the foreign exchange rate at the balance sheet date. Operations accounts and nonmonetary balance sheet accounts are remeasured at the rate in effect at the date of transaction. The effects of foreign currency remeasurement are reported in current operations. See Note 2.

RECLASSIFICATIONS

Certain reclassifications have been made to prior year's amounts to conform to the current year's presentation.

CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

Cash equivalents consist of short-term, highly liquid financial instruments with insignificant interest rate risk that are readily convertible to cash and have maturities of three months or less from the date of purchase. Cash equivalents and short-term investments consist of money market funds, taxable commercial paper, U.S. government agency obligations, corporate / municipal notes and bonds with high-credit quality, money market preferred stock and auction rate preferred stock. The fair market value, based on quoted market prices, of cash equivalents and short-term investments is substantially equal to their carrying value at December 31, 1999 and 1998.

Under FAS 115, management classifies investments as available-for-sale at the time of purchase and periodically reevaluates such designation. Debt securities classified as available-for-sale are reported at fair value. Unrecognized gains or losses on available-for-sale securities are included, in equity until their disposition. Realized gains and losses and declines in value judged to be other than temporary on available-for-sale securities are included in interest income. The cost of securities sold is based on the specific identification method.

All cash equivalents and short-term investments as of December 31, 1999 and 1998 are classified as available-for-sale securities and consist of the following:

December 31,	1999	1998
(In thousands)		
Cash equivalents:		
Money market fund	\$ 21,853	\$ 1,389
Commercial paper	117,769	9,178
Corporate notes / bonds	—	2,251
Total	\$ 139,622	\$ 12,818
Short term investments:		
U.S. government		
agency obligations	\$ 2,969	\$ —
Municipal notes / bonds	133,462	91,073
Corporate notes / bonds	58,969	12,550
Commercial paper	4,009	—
Auction rate preferred stock	111,640	15,451
Total	\$ 311,049	\$ 119,074

Unrealized holding losses and gains on available-for-sale securities at December 31, 1999 and 1998 were (\$536,000) and \$471,000, respectively. Gross realized gains and losses on sales of available-for-sale securities during the years ended December 31, 1999 and 1998 were immaterial.

Debt securities at December 31, 1999 and 1998, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers of the securities may have the right to prepay obligations.

December 31,	1999	1998
(In thousands)		
Short-term investments:		
Due in one year or less	\$ 170,097	\$ 93,983
Due after one year		
through two years	140,952	25,091
Total	\$ 311,049	\$ 119,074

INVENTORIES

Inventories are stated at the lower of cost or market. Cost is computed on a currently adjusted standard basis (which approximates actual costs on a first-in, first-out basis). Market value is based upon an estimated average selling price reduced by normal gross margins. Inventories are as follows:

December 31,	1999	1998
Raw materials	\$ 10,387	\$ 2,710
Work-in-process	20,708	3,818
Finished goods	4,584	2,394
Total	\$ 35,679	\$8,922

Given the volatility of the market, the Company writes down inventories to net realizable value based on backlog and forecasted demand. However, backlog is subject to revisions, cancellations and rescheduling. Actual demand may differ from forecasted demand and such differences may have a material effect on the Company's financial position and results of operations.

PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

December 31,	1999	1998
Machinery and equipment	\$ 47,004	\$ 30,008
Software	5,994	3,413
Furniture and fixtures	1,335	1,173
Leasehold improvements	3,772	2,120
Property and equipment, at cost	58,105	36,714
Accumulated depreciation and amortization	(26,317)	(19,172)
Property and equipment, net	\$ 31,788	\$ 17,542

DEPRECIATION AND AMORTIZATION

Depreciation is computed using the straight-line method over the estimated useful lives of the assets or the remaining lease term, whichever is shorter, generally two to seven years.

INVESTMENT IN FOUNDRY

In 1997, the Company invested \$40.3 million in United Silicon, Inc., ("USIC") a semiconductor manufacturing subsidiary of United Microelectronics Corporation in Taiwan ("UMC"). The transaction gave the Company an equity stake of approximately 10% in the facility (which is accounted for on the cost basis) and guaranteed access to approximately 12.5% of the wafer output from the facility.

In 1998, the Company increased its investment by \$10.9 million to retain its 10% ownership interest. No changes were made to the production agreement. In January 2000, the USIC foundry was merged into UMC. SanDisk received 111 million shares of UMC stock in exchange for its USIC shares. (See Note 11).

REVENUE RECOGNITION

Product revenue, less a provision for estimated sales returns, is recognized when title passes which is generally at the time of shipment. However, revenue on shipments to distributors and retailers, subject to certain rights of return and price protection, is deferred until the merchandise is sold by the distributors or retailers, or the rights expire.

The Company earns patent license and royalty revenue under patent cross-license agreements with Hitachi Ltd., Intel Corporation, Samsung Electronics Company Ltd., Sharp Electronics Corporation, Silicon Storage Technology, Inc., SmartDisk Corporation and Toshiba Corporation. The Company's current license agreements provide for the payment of license fees, royalties, or a combination thereof, to the Company. The timing and amount of these payments can vary substantially from quarter to quarter, depending on the terms of each agreement and, in some cases, the timing of sales of products by the other parties.

Patent license and royalty revenue is recognized when earned. In 1999, 1998 and 1997, the Company received payments under these cross license agreements, portions of which were recognized as revenue and portions of which are deferred revenue. Recognition of deferred revenue is expected to occur in future periods as the Company meets certain obligations as provided in the various agreements.

NET INCOME PER SHARE

The Company determines net income per share in accordance with Financial Accounting Standards Statement 128, "Earnings Per Share".

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

December 31,	1999	1998	1997
Numerator:			
Numerator for basic and diluted net income per share			
— net income	\$ 26,550	\$ 11,836	\$ 19,839
Denominator for basic net income per share:			
Weighted average common shares	55,834	52,596	45,760
Shares used in computing basic net income per share			
	55,834	52,596	45,760
Basic net income per share			
	\$ 0.48	\$ 0.23	\$ 0.43
Denominator for diluted net income per share:			
Weighted average common shares	55,834	52,596	45,760
Employee stock options and warrants to purchase common stock	5,599	2,748	4,180
Shares used in computing diluted net income per share			
	61,433	55,344	49,940
Diluted net income per share			
	\$ 0.43	\$ 0.21	\$ 0.40

Options and warrants to purchase 190,807; 1,802,886 and 514,016 shares of common stock in 1999, 1998 and 1997, respectively, have been omitted from the earnings per share calculation, as their effect is antidilutive.

STOCK BASED COMPENSATION

The Company accounts for employee stock based compensation under APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Pro forma net income and net income per share disclosures are required by Statement of Financial Accounting Standards No. 123, "Accounting for Stock Based Compensation," and are included in Note 4.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In June 1998, the Financial Accounting Standards Board issued Statement 133, Accounting for Derivative Instruments and Hedging Activities, which is required to be adopted in fiscal years beginning after June 15, 2000. Because of the Company's minimal use of derivatives, management does not anticipate that the adoption of the new Statement will have a significant effect on earnings or the financial position of the Company, however, the Company is in the process of studying the impact.

**NOTE 2:
Financial Instruments****CONCENTRATION OF CREDIT RISK**

The Company's concentration of credit risk consists principally of cash, cash equivalents, short-term investments and trade receivables. The Company's investment policy restricts investments to high-credit quality investments and limits the amounts invested with any one issuer. The Company sells to original equipment manufacturers, retailers and distributors in the United States, Japan, Europe and the Far East, performs ongoing credit evaluations of its customers' financial condition, and generally requires no collateral. Reserves are maintained for potential credit losses.

OFF BALANCE SHEET RISK

Certain of the Company's balance sheet accounts are denominated in Japanese Yen. The Company enters into foreign exchange contracts to hedge against changes in foreign currency exchange rates. The effects of movements in currency exchange rates on these instruments are recognized when the related operating revenues and expenses are recognized. The Company has a foreign exchange contract line in the amount of \$15.0 million at December 31, 1999. Under this line, the Company may enter into forward exchange contracts which require the Company to sell or purchase foreign currencies. Two forward exchange contracts in the notional amount of \$8.2 million were outstanding at December 31, 1999. Foreign currency translation gains of \$122,000 were deferred at December 31, 1999 in connection with these contracts as the contracts have been identified as hedging contracts. One forward exchange contract in the amount of \$4.3 million was outstanding at December 31, 1998. Foreign currency translation losses of \$34,000 were deferred at December 31, 1998 in connection with this forward contract.

The impact of movements in currency exchange rates on foreign exchange contracts substantially mitigates the related impact on the underlying items hedged. The Company had net transaction gains (losses) of approximately \$1,467,000, \$412,000 and (\$7,000) for

the years ended December 31, 1999, 1998 and 1997, respectively. These amounts are included in other income (loss), net, in the statement of income.

NOTE 3: Commitments and Contingencies

COMMITMENTS

The Company leases its headquarters and sales offices under operating leases that expire at various dates through 2001. Future minimum lease payments under operating leases at December 31, 1999 are as follows:

Year Ending December 31,	
(In thousands)	
2000	\$ 1,868
2001	1,035
Total	\$ 2,903

Rental expense under all operating leases was \$2.1 million, \$1.7 million and \$1.3 million for the years ended December 31, 1999, 1998 and 1997, respectively.

CONTINGENCIES

The Company relies on a combination of patents, trademarks, copyright and trade secret laws, confidentiality procedures and licensing arrangements to protect its intellectual property rights. There can be no assurance that there will not be any disputes regarding the Company's intellectual property rights. Specifically, there can be no assurance that any patents held by the Company will not be invalidated, that patents will be issued for any of the Company's pending applications or that any claims allowed from existing or pending patents will be of sufficient scope or strength or be issued in the primary countries where the Company's products can be sold to provide meaningful protection or any commercial advantage to the Company. Additionally, competitors of the Company may be able to design around the Company's patents.

To preserve its intellectual property rights, the Company believes it may be necessary to initiate litigation with one or more third parties, including but not limited to those the Company has notified of possible patent infringement. In addition, one or more of these parties may bring suit against the Company. Any litigation, whether as a plaintiff or as a defendant, would likely result in significant expense to the Company and divert the efforts of the Company's technical and management personnel, whether or not such litigation is ultimately determined in favor of the Company.

In March 1998, the Company filed a complaint in federal court against Lexar Media, Inc. ("Lexar") for infringement of a fundamental flashdisk patent. Lexar has disputed the Company's claim of patent infringement, claimed SanDisk's patent is invalid or unenforceable and asserted various counterclaims including unfair competition, violation of the Lanham Act, patent misuse, interference with prospective economic advantage, trade defamation and fraud. SanDisk has denied each of Lexar's counterclaims.

In July 1998, the federal district court denied Lexar's request to have the case dismissed on the grounds the Company failed to perform an adequate prefiling investigation. Discovery in the Lexar suit commenced in August 1998. The claims construction phase commenced in February 1999. The Company intends to vigorously enforce its patents, but there can be no assurance that these efforts will be successful.

On February 22, 1999, the court considered arguments and papers submitted by the parties regarding the scope and proper interpretation of the asserted claims in our patent at issue in the Lexar suit. On March 4, 1999, the court issued its ruling on the proper construction of the claim terms in our patent. On July 30, 1999, we filed a motion for partial summary judgement that Lexar CompactFlash and PC Cards contributorily infringe our patent. In December 1999, Lexar filed a counter motion for partial summary judgement for invalidity of our patent. Both motions were heard by the court on March 17, 2000 and the matters were taken under submission by the court. We are waiting for the court's ruling on both matters. In August 1999, we had a mandatory settlement meeting with Lexar. No Settlement was reached through this meeting. A trial date has not yet been set.

In May 1999, Lexar filed a complaint against us in federal court for claims of unfair competition, false advertising, trade libel and intentional and negligent interference with prospective business advantage. In Lexar's complaint, Lexar alleged that statements by us regarding the comparative performance of our products and Lexar's in digital cameras were false, and further alleged that we had interfered with the certification of certain Lexar products by the CompactFlash Association. On July 1, 1999, we filed a motion to dismiss the Lexar complaint. Also, in July 1999, Lexar filed a motion for preliminary injunction seeking to stop certain advertising practices that Lexar alleges were misleading. On August 26, 1999, the parties executed and filed with the court a joint stipulation withdrawing our motion to dismiss and granting Lexar permission to amend its complaint. Lexar has amended its complaint to remove

any allegations and causes of action based on our alleged interference in certification by the CompactFlash Association. On September 17, 1999, the court conducted a hearing on Lexar's motion for preliminary injunction. On September 24, 1999, the court issued an order granting a limited preliminary injunction, which enjoins us from using or implying certain terminology in advertising regarding the comparative performance of our memory products in digital cameras. On October 1, 1999, we filed counterclaims against Lexar asserting causes of action including unfair competition and false advertising under both federal and California law. Although we cannot predict the ultimate outcome of the case, we believe that Lexar's claims are without merit and that we have meritorious counterclaims against Lexar.

In the event of an adverse result in any such litigation, the Company could be required to pay substantial damages, cease the manufacture, use and sale of infringing products, expend significant resources to develop non-infringing technology or obtain licenses to the infringing technology, or discontinue the use of certain processes.

From time to time the Company agrees to indemnify certain of its suppliers and customers for alleged patent infringement. The scope of such indemnity varies but may in some instances include indemnification for damages and expenses, including attorneys fees. The Company may from time to time be engaged in litigation as a result of such indemnification obligations. Third party claims for patent infringement are excluded from coverage under the Company's insurance policies. There can be no assurance that any future obligation to indemnify the Company's customers or suppliers, will not have a material adverse effect on the Company's business, financial condition and results of operations.

Litigation frequently involves substantial expenditures and can require significant management attention, even if the Company ultimately prevails. In addition, the results of any litigation matters are inherently uncertain. Accordingly, there can be no assurance that any of the foregoing matters, or any future litigation, will not have a material adverse effect on the Company's business, financial condition and results of operations.

NOTE 4: Stockholders' Equity

STOCK BENEFIT PLAN

The 1989 Stock Benefit Plan, in effect through August 1995, comprised two separate programs, the Stock Issuance Program and

the Option Grant Program. The Stock Issuance Program allowed eligible individuals to immediately purchase the Company's common stock at a fair value as determined by the Board of Directors. Under the Option Grant Program, eligible individuals were granted options to purchase shares of the Company's common stock at a fair value, as determined by the Board of Directors, of such shares on the date of grant. The options generally vest over a four-year period, expiring no later than ten years from the date of grant. Unexercised options are canceled upon the termination of employment or services. Options that are canceled under this plan will be available for future grants under the 1995 Stock Option Plan. There were no shares available for option grants under the 1989 Stock Benefit Plan at December 31, 1999.

1995 STOCK BENEFIT PLAN

The 1995 Stock Option Plan provides for the issuance of incentive stock options and nonqualified stock options. Under this plan, the vesting and exercise provisions of option grants are determined by the Board of Directors. The options generally vest over a four-year period, expiring no later than ten years from the date of grant.

On July 17, 1998, the Board of Directors approved an option cancellation/regrant program. Under the cancellation/regrant program, employees could elect to exchange their stock options with exercise prices in excess of \$6.00 per share for new options priced at \$5.00 per share, the market price of the Company's common stock on the date of implementation, August 21, 1998. Under the new options, shares become exercisable six to twelve months later than under the old higher-priced options. The new options have a maximum term of ten years from the August 21, 1998, grant date. Officers and directors of the Company were not eligible for participation in the option cancellation/regrant program. Options covering a total of approximately 1,806,846 shares were canceled and regranted in connection with the program. The number of options shown as granted and canceled in the table below reflect this exchange of options. Such options had a weighted average exercise price before repricing of \$10.3305, and the new options were granted at an exercise price of \$5.00.

In May 1999, the stockholders increased the shares available for future issuance under the 1995 Stock Benefit Plan by 7,000,000 Shares and approved an automatic share increase feature pursuant to which the number of shares available for issuance under the plan will automatically increase on the first trading day in January each calendar year, beginning with calendar Year 2002 and continuing over the remaining term of the plan, by an amount equal to four and

thirty-six hundredths percent (4.36%) of the total number of shares outstanding on the last trading day in December in the immediately preceding calendar year, but in no event will any such annual increase exceed 4,000,000 shares.

1995 NON-EMPLOYEE DIRECTORS STOCK OPTION PLAN

In August 1995, the Company adopted the 1995 Non-employee Directors Stock Option Plan (the Directors' Plan). Under this plan, automatic option grants are made at periodic intervals to eligible non-employee members of the Board of Directors. Initial option grants vest over a four-year period. Subsequent annual grants vest one year after date of grant. All options granted under the Non-employee Directors Stock Option Plan expire ten years after the date of grant. In May 1999, the stockholders increased the shares available for future

issuance under the 1995 Non-Employee Directors Stock Option Plan by 400,000 and approved an automatic share increase feature pursuant to which the number of shares available for issuance under the plan will automatically increase on the first trading day in January each calendar year, beginning with calendar year 2002 and continuing over the remaining term of the plan, by an amount equal to two tenths of one percent (0.2%) of the total number of shares outstanding on the last trading day in December in the immediately preceding calendar year, but in no event will any such annual increase exceed 200,000 shares. At December 31, 1999, the Company reserved 800,000 shares of common stock for issuance under the Directors' Plan and a total of 368,000 options had been granted at exercise prices ranging from \$4.75 to \$15.2188 per share.

A summary of activity under all stock option plans follows:

	Total Available for Future Grant/Issuance	Total Outstanding	Weighted Average Exercise Price
(Shares in thousands)			
Balance at December 31, 1996	644	6,288	\$ 2.745
Increase in authorized shares	5,100	—	—
Granted	(1,824)	1,824	\$ 10.295
Exercised	—	(716)	\$ 0.815
Canceled	290	(290)	\$ 4.915
Balance at December 31, 1997	4,210	7,106	\$ 4.79
Granted	(4,444)	4,444	\$ 5.97
Exercised	—	(1,260)	\$ 0.74
Canceled	2,038	(2,038)	\$ 10.04
Balance at December 31, 1998	1,804	8,252	\$ 4.75
Increase in authorized shares	7,400	—	—
Granted	(3,000)	3,000	\$ 31.00
Exercised	—	(1,766)	\$ 3.47
Canceled	308	(308)	\$ 9.69
Balance at December 31, 1999	6,512	9,178	\$ 9.50

At December 31, 1999, options outstanding were as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding as of December 31, 1999	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable as of December 31, 1999	Weighted Average Exercise Price	
\$ 0.075 - \$ 5.000	3,158,873	7.06	\$ 3.6738	2,000,893	\$ 3.0218	
\$ 5.094 - \$ 6.375	2,568,148	8.21	\$ 6.1155	1,020,628	\$ 6.0525	
\$ 6.438 - \$ 17.563	848,266	8.59	\$ 11.1795	308,936	\$ 10.4085	
\$ 22.500 - \$ 30.000	684,000	9.67	\$ 25.4940	0	\$ 0.0000	
\$ 31.188 - \$ 41.031	1,918,932	9.91	\$ 35.8804	0	\$ 0.0000	
\$ 0.075 - \$ 41.031	9,178,219	8.32	\$ 13.4104	3,330,457	\$ 4.6358	

EMPLOYEE STOCK PURCHASE PLAN

In August 1995, the Company adopted the Employee Stock Purchase Plan (the Purchase Plan). In May 1999, the stockholders increased the shares available for future issuance under the Employee Stock Purchase Plan by 600,000 and approved an automatic share increase feature pursuant to which the number of shares available for issuance under the plan will automatically increase on the first trading day in January each calendar year, beginning with calendar year 2002 and continuing over the remaining term of the plan, by an amount equal to forty-three hundredths of one percent (0.43%) of the total number of shares outstanding on the last trading day in December in the immediately preceding calendar year, but in no event will any such annual increase exceed 400,000 shares. Under the Purchase Plan, qualified employees are entitled to purchase shares through payroll deductions at 85% of the fair market value at the beginning or end of the offering period, whichever is lower. As of December 31, 1999, the Company had reserved 2,366,666 shares of common stock for issuance under the Directors' Plan and a total of 964,870 shares had been issued.

ACCOUNTING FOR STOCK BASED COMPENSATION

The Company has elected to follow APB 25 and related interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under SFAS 123 "Accounting for Stock-Based Compensation," requires use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, because the exercise price of the Company's stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Pro forma information regarding net income and earnings per share is required by SFAS 123, which also requires that the information be determined as if the Company has accounted for its employee stock options granted subsequent to December 31, 1994 under the fair value method of this Statement. For all grants subsequent to December 31, 1994 that were granted prior to the Company's initial public offering in November 1995, the fair value of these options was determined using the minimum value method with a weighted average risk free interest rate of 6.32% and an expected life of 5 years. The fair value for the options granted subsequent to the Company's initial public offering in November 1995 was estimated at the date of grant using a Black-Scholes single option pricing model with the following weighted average assumptions: risk-free interest rates of 5.52%, 4.84% and 6.24% for 1999, 1998 and 1997, respectively; a dividend yield of 0.0%, a volatility factor of the expected market price of the Company's common stock

of 0.888, 0.60 and 0.655 for 1999, 1998 and 1997 respectively; and a weighted-average expected life of the option of 5 years. The weighted average fair value of those options granted were \$22.38, \$3.325 and \$6.225 for 1999, 1998 and 1997, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Under the 1995 Employee Stock Purchase Plan participating employees can choose to have up to 10% of their annual base earnings withheld to purchase the Company's common stock. The purchase price of the stock is 85% of the lower of the subscription date fair market value and the purchase date fair market value. Approximately 79% of eligible employees have participated in the plan in 1999 and 65% and 75% in 1998 and 1997, respectively. Under the Plan, the Company sold 269,092, 259,484 and 251,591 shares to employees in 1999, 1998 and 1997, respectively. Pursuant to APB 25 and related interpretations, the Company does not recognize compensation cost related to employee purchase rights under the Plan. To comply with the pro forma reporting requirements of SFAS 123, compensation cost is estimated for the fair value of the employees' purchase rights using the Black-Scholes model with the following assumptions for those rights granted in 1999, 1998 and 1997: dividend yield of 0.0%; and expected life of 6 months; expected volatility factor of .98 and 1.16 in 1999, .65 and 1.02 in 1998 and 0.63 and 0.89 in 1997; and a risk free interest rate ranging from 5.35% to 6.08%. The weighted average fair value of those purchase rights granted in February 1997, August 1997, February 1998, August 1998, February 1999 and August 1999 were \$1.71, \$2.345, \$3.5, \$2.25, \$6.01 and \$17.72, respectively.

Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

Years ended December 31,	1999	1998	1997
(in thousands, except per share amounts)			
Pro forma net income	\$ 16,213	\$ 5,178	\$ 17,156
Pro forma net income per share			
Basic	\$ 0.29	\$ 0.10	\$ 0.37
Diluted	\$ 0.26	\$ 0.09	\$ 0.34

Because SFAS 123 is applicable only to options granted subsequent to December 31, 1994, its pro forma effect was not fully reflected until 1999.

SHAREHOLDER RIGHTS PLAN

On April 21, 1997, the Company adopted a shareholder rights plan (the Rights Agreement). Under the Rights Agreement, rights were distributed as a dividend at the rate of one right for each share of common stock of the Company held by stockholders of record as of the close of business on April 28, 1997. The rights will expire on April 28, 2007 unless redeemed or exchanged. Under the Rights Agreement, each right will initially entitle the registered holder to buy one one-fiftieth of a share of Series A Junior Participating Preferred Stock for \$250.00. The rights will become exercisable only if a person or group (other than Seagate Technology, Inc., which is permitted to own up to 25 percent of outstanding common stock of the Company) acquires beneficial ownership of 15 percent or more of the Company's common stock or commences a tender offer or exchange offer upon consummation of which such person or group would beneficially own 15 percent or more of the Company's common stock.

WARRANTS

The Company has periodically granted warrants in connection with the sale of its stock and certain lease and bank agreements. The Company had no warrants outstanding at December 31, 1999. During 1999, the Company issued 59,340 shares of common stock for no proceeds in the net issuance of shares upon the exercise of 64,246 warrants with an exercise price of \$1.65 per share.

STOCK SPLIT

On January 26, 2000, the Company's board of directors approved a 2-for-1 stock split, in the form of a 100% stock dividend, payable to stockholders of record as of February 8, 2000. The dividend was paid and the split was effected on February 22, 2000. Shares, per share amounts, common stock at par value and additional paid in capital have been restated to reflect the stock split for all periods presented.

NOTE 5: Retirement Plan

Effective January 1, 1992, the Company adopted a tax-deferred savings plan, the SanDisk 401(k) Plan, for the benefit of qualified employees. The plan is designed to provide employees with an accumulation of funds at retirement. Qualified employees may elect to make contributions to the plan on a monthly basis. The Company may make annual contributions to the plan at the discretion of the Board of Directors. The Company contributed \$105,000 for the plan year ended December 31, 1999. No contributions were made by the Company for the years ended December 31, 1998 and 1997

NOTE 6: Income Taxes

The provision for income taxes consists of the following:

December 31,	1999	1998	1997
(In thousands)			
Current:			
Federal	\$ 10,354	\$ 1,413	\$ 12,131
State	2,117	651	2,662
Foreign	4,105	2,936	5,263
	16,576	5,000	20,056
Deferred:			
Federal	(2,600)	1,305	(13,205)
State	(400)	350	(3,350)
Foreign	(500)	—	—
	(3,500)	1,655	(16,555)
Provision for income taxes	\$ 13,076	\$ 6,655	\$ 3,501

The tax benefits associated with stock options reduces taxes currently payable as shown above by \$9,809,000, \$1,761,000 and \$2,498,000 in 1999, 1998 and 1997, respectively. Such benefits are credited to capital in excess of par when realized.

The Company's provision for income taxes differs from the amount computed by applying the federal statutory rates to income before taxes as follows:

December 31,	1999	1998	1997
Federal statutory rate	35.0 %	35.0 %	35.0 %
State taxes, net of federal benefit	2.8	3.5	(1.9)
Research credit	(1.7)	(1.9)	(3.8)
Valuation allowance	—	—	(14.9)
Foreign tax in excess of U.S. rate	—	—	0.4
Other individually immaterial items	0.8	5.5	0.2
Tax exempt interest income	(3.9)	(6.1)	—
	33.0 %	36.0 %	15.0 %

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Significant components of the Company's deferred tax assets as of December 31, 1999 and 1998 are as follows:

December 31,	1999	1998
(In thousands)		
Deferred tax assets:		
Inventory reserves	\$ 3,400	\$ 2,700
Deferred revenue	10,600	10,300
Accruals and reserves	3,500	2,900
Other	1,300	—
	\$ 18,800	\$ 15,900

**NOTE 7:
Related Party Transactions**

The Company invested \$51.2 million in United Silicon, Inc., a semiconductor manufacturing subsidiary of United Microelectronics Corporation in Taiwan. The transaction gave the Company an equity stake of approximately 10% in the facility (which was accounted for on the cost basis) and guarantees access to approximately 12.5% of the wafer output from the facility. In 1999 and 1998, the Company purchased wafers from USIC totaling approximately \$22.8 million and \$11.6 million, respectively. The amount payable to USIC for wafer purchases was \$9.3 million and \$0.2 million at December 31, 1999 and 1998, respectively. In January 2000, the USIC

foundry was merged into UMC. SanDisk received 111 million shares of UMC stock in exchange for its USIC shares (See Note 11).

**NOTE 8:
Toshiba Joint Venture**

In October 1999, the Company entered into a nonbinding memorandum of understanding with Toshiba providing for the joint development and manufacturing of 512 megabit and 1 gigabit flash memory chips and Secure Digital Memory Card controllers. Further, the Company and Toshiba intend to form and fund a joint venture to equip and operate a silicon wafer manufacturing line in Virginia. The cost of equipping the Virginia wafer manufacturing line is estimated at between \$700 million and \$800 million. The Company, as part of its 50% ownership of the joint venture, expects to invest up to \$150 million in cash and, if necessary, guarantee equipment lease lines for an additional \$250 million. The Company does not expect any material revenues from the 512 megabit technology for at least one year and from the 1 gigabit technology for at least two years. A definitive agreement based upon this memorandum of understanding is being negotiated and is expected to be concluded by the second quarter of fiscal 2000, subject to final approval by the Company's board of directors and that of Toshiba.

**NOTE 9:
Segment Information**

The Company adopted SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, in fiscal 1998. SFAS No. 131 supersedes SFAS No. 14, Financial Reporting for Segments of a Business Enterprise and establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or group, in deciding how to allocate resources and in assessing performance.

The Company operates in one segment, flash memory products. The Company markets its products in the United States and in foreign countries through its sales personnel, dealers, distributors, retailers and its subsidiaries. The Chief Executive Officer has been identified as the Chief Operating Decision Maker ("CODM") because he has final authority over resource allocation decisions and performance assessment. The CODM does not receive discrete financial information about individual components of the market.

GEOGRAPHIC INFORMATION:

Information regarding geographic areas for the years ended December 31, 1999, 1998, and 1997 are as follows:

Years Ended December 31,	1999	1998	1997
(In thousands)			
Revenues:			
United States	\$ 116,922	\$ 60,113	\$ 53,820
Japan	62,176	46,276	51,677
Europe	22,674	9,810	10,774
Other foreign countries	45,218	19,562	8,982
Total	\$ 246,990	\$ 135,761	\$ 125,253
Long Lived Assets:			
United States	\$ 25,442	\$ 16,779	\$ 15,422
Japan	261	445	246
Europe	20	9	3
Other foreign countries	57,273	51,517	40,505
Total	82,996	68,750	56,176

Revenues are attributed to countries based on the location of the customers. Long lived assets in other foreign countries includes the investment in USIC of \$51.2 million in 1999 and 1998, and \$40.3 million in 1997.

MAJOR CUSTOMERS

In 1999 and 1998, revenues from one customer represented approximately \$28.0 million and \$14.0 million, respectively, of consolidated revenues. In 1997, there were no customers who accounted for more than 10% of total revenue.

NOTE 10:**Accumulated Other Comprehensive Income**

As of January 1, 1998, the Company adopted Statement No. 130, Reporting Comprehensive Income. Statement 130 establishes new rules for the reporting and displaying of comprehensive income and its components; however, the adoption of this Statement had no impact on the Company's net income or shareholders' equity. Statement 130 requires unrealized gains or losses on the Company's available-for-sale securities, which prior to adoption were reported separately in shareholders' equity, to be included in other comprehensive income. Comprehensive income consists of net income and other comprehensive income.

Accumulated other comprehensive income presented in the accompanying balance sheet consists of the accumulated unrealized gains and losses on available-for-sale marketable securities for all periods presented. The tax effects for other comprehensive income were immaterial for all periods presented.

	1999	1998	1997
(In thousands)			
Accumulated other comprehensive income at beginning of year	\$ 471	\$ 42	\$ 5
Change of accumulated other comprehensive income during the year			
Unrealized gain (loss) on available-for-sale securities	\$ (272)	\$ 429	\$ 37
Accumulated other comprehensive income at year end	\$ 199	\$ 471	\$ 42

NOTE 11:**Subsequent Events**

On January 3, 2000, the USIC foundry was merged into UMC. The Company had invested \$51.2 million in USIC. In exchange for its USIC shares, the Company received 111 million UMC shares. These shares were valued at approximately \$396 million at the time of the merger, resulting in a pretax gain of \$344 million (\$204 million after-tax). All of the UMC shares received by the Company are subject to trading restrictions imposed by UMC and the Taiwan Stock Exchange. The trading restrictions will expire on one-half of the shares six months after the date of the merger. The remaining shares will become available for sale, over a two year period beginning in January 2002. When the shares are ultimately sold, it is likely that the Company will report additional gains or losses.

THE BOARD OF DIRECTORS AND STOCKHOLDERS

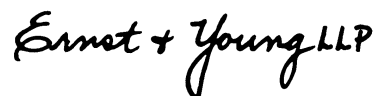
SANDISK CORPORATION

We have audited the accompanying consolidated balance sheets of SanDisk Corporation as of December 31, 1999 and 1998, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1999. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SanDisk Corporation at December 31, 1999 and 1998 and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with generally accepted accounting principles in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

San Jose, California
January 25, 2000

The signature of Ernst & Young LLP is written in a black, cursive script. The words "Ernst & Young" are written in a larger, more prominent font, with "LLP" in a smaller font to the right. The signature is positioned on the right side of the page, below the main body of text.

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Georgia Institute of Technology

Alan F. Shugart ⁽²⁾

AI Shugart International
President and CEO,

⁽¹⁾ Audit Committee

⁽²⁾ Compensation Committee

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Business Development and
Intellectual Property

Frank Calderoni

CFO, Senior Vice President,
Finance and Administration

Nelson Chan

Senior Vice President, Marketing

Dr. Eli Harari

President and CEO

Ralph Hudson

Senior Vice President, Operations

Jocelyn Scarborough

Vice President, Human Resources

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