

SILICON GRAPHICS INC /CA/
Form 10-Q
May 15, 2001

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended March 31, 2001.

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period from _____ to _____.

Commission File Number 1-10441

SILICON GRAPHICS, INC.

(Exact name of registrant as specified in its charter)

| | |
|--|---|
| DELAWARE | 94-2789662 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 1600 Amphitheatre Pkwy., Mountain View, California 94043-1351 | |
| (Address of principal executive offices) (Zip Code) | |

(650) 960-1980

(Registrant's telephone number, including area code)

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

As of May 4, 2001 there were 195,411,611 shares of Common Stock outstanding.

SILICON GRAPHICS, INC.

QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

| | <u>Page No.</u> |
|---|---------------------|
| PART I FINANCIAL INFORMATION | |
| Item 1. Financial Statements (Unaudited): | |
| Condensed Consolidated Statements of Operations | 3 |
| Condensed Consolidated Balance Sheets | 4 |
| Condensed Consolidated Statements of Cash Flows | 5 |
| Notes to Condensed Consolidated Financial Statements | 6 |
| Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition | 14 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 22 |
| PART II OTHER INFORMATION | |
| Item 1. Legal Proceedings | 23 |
| Item 6. Exhibits and Reports on Form 8-K | 23 |
| Signatures | 24 |

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

SILICON GRAPHICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

(In thousands, except per share amounts)

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---------------------------|---------------------------------|------------|--------------------------------|--------------|
| | 2001 | 2000 | 2001 | 2000 |
| Product and other revenue | \$ 339,763 | \$ 400,330 | \$ 945,904 | \$ 1,303,577 |

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| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|--|---------------------------------|--------------------|--------------------------------|---------------------|
| | _____ | _____ | _____ | _____ |
| Service revenue | 169,955 | 163,357 | 477,057 | 493,506 |
| Total revenue | 509,718 | 563,687 | 1,422,961 | 1,797,083 |
| Costs and expenses: | | | | |
| Cost of product and other revenue | 194,278 | 212,159 | 574,597 | 791,498 |
| Cost of service revenue | 131,129 | 115,165 | 373,798 | 366,760 |
| Research and development | 61,272 | 69,564 | 176,732 | 233,521 |
| Selling, general and administrative | 169,924 | 185,197 | 537,824 | 597,044 |
| Other operating expense(1) | 7,246 | (17,677) | 1,025 | 110,861 |
| Total costs and expenses | 563,849 | 564,408 | 1,663,976 | 2,099,684 |
| Operating loss | (54,131) | (721) | (241,015) | (302,601) |
| Interest and other income (expense), net | (37) | (1,723) | (6,983) | (3,577) |
| Other non-recurring expense | (83,129) | (20,837) | (2,549) | (20,837) |
| Loss before income taxes | (137,297) | (23,281) | (250,547) | (327,015) |
| Income tax provision (benefit) | 3,798 | (5,148) | 10,652 | (105,062) |
| Net loss | (141,095) | (18,133) | (261,199) | (221,953) |
| Preferred stock dividend requirement | (129) | (131) | (392) | (394) |
| Net loss available to common stockholders | \$ (141,224) | \$ (18,264) | \$ (261,591) | \$ (222,347) |
| Net loss per share basic and diluted | \$ (0.74) | \$ (0.10) | \$ (1.38) | \$ (1.22) |
| Common shares outstanding basic and diluted | 190,857 | 183,826 | 189,512 | 182,847 |

- (1) Amount represents consulting fees incurred for the ERP implementation project and charges associated with a business reorganization in the three-month period ended March 31, 2001 and for the nine-month period ended March 31, 2001 represents a change in previously estimated restructuring costs, consulting fees incurred for the ERP implementation project, and charges associated with a business reorganization. Amount represents a change in previously estimated restructuring costs in the three-month period ended March 31, 2000 and a net charge for estimated restructuring costs in the nine-month period ended March 31, 2000.

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

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(In thousands)

| | March 31, 2001 | June 30, 2000(1) |
|---|---------------------|---------------------|
| | (unaudited) | |
| Assets: | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 113,402 | \$ 251,811 |
| Short-term marketable investments | 5,064 | 6,270 |
| Short-term restricted investments | 99,523 | |
| Accounts receivable, net | 378,553 | 347,515 |
| Inventories | 201,510 | 181,594 |
| Prepaid expenses and other current assets | 103,434 | 133,119 |
| | <u>901,486</u> | <u>920,309</u> |
| Total current assets | 901,486 | 920,309 |
| Restricted investments | 105,601 | 126,408 |
| Property and equipment, net | 324,279 | 466,726 |
| Other assets | 173,805 | 325,768 |
| | <u>\$ 1,505,171</u> | <u>\$ 1,839,211</u> |
| | <u>\$ 1,505,171</u> | <u>\$ 1,839,211</u> |
| Liabilities and Stockholders' Equity: | | |
| Current liabilities: | | |
| Accounts payable | \$ 200,393 | \$ 147,366 |
| Accrued compensation | 73,169 | 79,289 |
| Deferred revenue | 238,410 | 292,772 |
| Other current liabilities | 291,658 | 342,101 |
| | <u>803,630</u> | <u>861,528</u> |
| Total current liabilities | 803,630 | 861,528 |
| Long-term debt and other | 395,803 | 385,133 |
| Temporary equity | 103,812 | |
| Stockholders' equity: | | |
| Preferred stock | | 16,998 |
| Common stock and additional paid-in-capital | 1,334,670 | 1,410,663 |
| Accumulated deficit | (1,111,844) | (832,219) |
| Treasury stock | (613) | (21,458) |
| Accumulated other comprehensive (loss) income | (20,287) | 18,566 |
| | <u>201,926</u> | <u>592,550</u> |
| Total stockholders' equity | 201,926 | 592,550 |
| | <u>\$ 1,505,171</u> | <u>\$ 1,839,211</u> |
| | <u>\$ 1,505,171</u> | <u>\$ 1,839,211</u> |

(1)

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The balance sheet at June 30, 2000 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

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

4

SILICON GRAPHICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(In thousands)

| | Nine Months Ended March 31 | |
|---|-----------------------------------|------------------|
| | 2001 | 2000 |
| Cash Flows From Operating Activities: | | |
| Net loss | \$ (261,199) | \$ (221,953) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 97,993 | 132,758 |
| Gain on sale of real estate | (7,513) | |
| Gain on sale of marketable investments | (49,561) | |
| Write down of investment in venture company | 83,129 | |
| (Gain) loss on sale of Cray product line | (23,506) | 20,837 |
| Restructuring | (6,221) | 110,861 |
| Change in deferred tax assets | 1,981 | (142,463) |
| Other | (16,635) | 8,506 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (31,038) | 223,758 |
| Inventories | (20,637) | (22,042) |
| Accounts payable | 53,027 | (46,994) |
| Other assets and liabilities | (50,822) | (98,515) |
| Total adjustments | 30,197 | 186,706 |
| Net cash used in by operating activities | (231,002) | (35,247) |
| Cash Flows From Investing Activities: | | |
| Proceeds from sale of real estate | 184,723 | |
| Short-term investments: | | |
| Purchases | (1,178) | (43,982) |
| Maturities | 2,384 | 154,831 |
| Purchases of restricted investments | (374,485) | (244,406) |
| Proceeds from the maturities of restricted investments | 338,899 | 213,328 |
| Capital expenditures | (95,908) | (231,400) |
| Decrease (increase) in other assets | 33,327 | (16,129) |
| Net cash provided by (used in) investing activities | 87,762 | (167,758) |
| Cash Flows From Financing Activities: | | |
| Issuance of debt | 93 | 1,894 |
| Payments of debt principal | (4,511) | (13,884) |
| Sale of SGI common stock | 9,641 | 49,468 |

| | Nine Months Ended March 31 | |
|--|-----------------------------------|---------------|
| | 2001 | 2000 |
| Repurchase of SGI common stock | 0 | (24,420) |
| Cash dividends-preferred stock | (392) | (394) |
| Net cash provided by financing activities | 4,831 | 12,664 |
| Net decrease in cash and cash equivalents | (138,409) | (190,341) |
| Cash and cash equivalents at beginning of period | 251,811 | 571,117 |
| Cash and cash equivalents at end of period | \$ 113,402 | \$ 380,776 |

The accompanying notes are an integral part of these financial statements

5

SILICON GRAPHICS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Consolidated Financial Statements.

The consolidated financial statements include the accounts of SGI and our wholly-owned subsidiaries. The unaudited results of operations for the interim periods shown herein are not necessarily indicative of operating results for the entire fiscal year. In the opinion of management, all adjustments (consisting only of normal recurring accruals) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. The unaudited condensed consolidated financial statements included in this Form 10-Q should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2000.

2. Inventories.

| | March 31, 2001 | June 30, 2000 |
|------------------------------|-----------------------|----------------------|
| | (In thousands) | |
| Components and subassemblies | \$ 66,009 | \$ 38,855 |
| Work-in-process | 41,470 | 50,051 |
| Finished goods | 36,588 | 45,896 |
| Demonstration systems | 57,443 | 46,792 |
| Total inventories | \$ 201,510 | \$ 181,594 |

3. Restricted Investments.

Restricted investments consist of short- and long-term investments held under a security agreement or pledged as collateral against letters of credit and an equity forward purchase arrangement. Restricted investments pledged as collateral are held in the Company's name by major financial institutions.

In April 2001, SGI entered into a \$75 million asset-based credit facility secured by eligible U.S. trade accounts receivable and inventory. SGI has drawn against this line of credit to secure obligations under our building lease agreement and as a result, released \$43 million from short-term restricted investments.

4. Property and Equipment.

March 31, 2001 June 30, 2000

| | (In thousands) | |
|---|----------------|--------------|
| Property and equipment, at cost | \$ 924,512 | \$ 1,050,991 |
| Accumulated depreciation and amortization | (600,233) | (584,265) |
| Property and equipment, net | \$ 324,279 | \$ 466,726 |

6

5. Other Assets.

| | March 31, 2001 | June 30, 2000 |
|---------------------------------------|----------------|---------------|
| | (In thousands) | |
| Investments | \$ 10,999 | \$ 152,642 |
| Spare parts | 97,648 | 98,601 |
| Software licenses, goodwill and other | 65,158 | 74,525 |
| | \$ 173,805 | \$ 325,768 |

6. Other Operating Expense.***Restructuring and Related Charges***

During the first quarter of fiscal 2000, we announced and began to implement restructuring actions that resulted in aggregate charges of \$145 million. These charges included \$65.8 million for the elimination of approximately 1,100 positions across essentially all of our functions and locations. We also recorded operating asset write downs of \$26.6 million for fixed assets and evaluation units, prepaid license agreements and other intangible assets associated with the end of life of our Silicon Graphics® 320 and Silicon Graphics® 540 visual workstations and certain high-end graphics development projects that were canceled. Third party contract cancellation charges associated with the above actions totaled \$8.5 million. We planned to vacate approximately 1,500,000 square feet of leased sales and administrative facilities throughout the world, with lease terms expiring through fiscal 2004. We estimated this would require ongoing lease payments of \$26 million until subleases could be arranged, abandoning \$11 million of leasehold improvements and other fixed assets and incurring \$7 million in exit costs, including costs to restore facilities to original condition.

During the second through fourth quarters of fiscal 2000, we lowered our estimate of the total costs associated with the fiscal 2000 restructuring activities described above. As a result, a cumulative adjustment of approximately \$35 million was recorded in fiscal 2000. The adjustment primarily reflected far more favorable settlements of lease obligations attributable to extremely high demand for facilities in Mountain View, California. It also reflected our new approach to structuring our field organization. The adjustment further reflected lower than estimated severance and related charges due to higher than expected attrition and lower per person costs. We estimated that there would now be approximately 900 involuntary employee terminations associated with the fiscal 2000 restructuring activity. Estimated costs of contract cancellations were also adjusted due to favorable settlements.

During the first quarter of fiscal 2001, we again lowered our estimate of the total costs associated with the fiscal 2000 restructuring activities and recorded an adjustment of \$6 million. The adjustment primarily reflected lower than estimated facilities closure costs due to negotiating better than anticipated sublease arrangements. The adjustment also reflected lower than estimated severance and related charges attributable to higher than expected attrition and lower per person costs. As of March 31, 2001, all of the estimated positions have been eliminated and all severance-related charges have been paid. The remaining facilities related accrual balance of approximately \$2 million at March 31, 2001 is expected to result in cash expenditures through fiscal 2004.

7

The following table depicts the restructuring activity during the first nine months of fiscal 2001:

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| Category | Severance and Related Charges | Vacated Facilities | Total |
|---------------------------|-------------------------------------|-----------------------|----------|
| Balance at June 30, 2000 | \$ 3,265 | \$ 6,440 | \$ 9,705 |
| Adjustments: | | | |
| Decrease | (2,590) | (3,631) | (6,221) |
| Increase | | 3,619 | 3,619 |
| Expenditures: | | | |
| Cash | (675) | (3,361) | (4,036) |
| Non-cash | | (756) | (756) |
| Balance at March 31, 2001 | \$ | \$ 2,311 | \$ 2,311 |

ERP Implementation

During the third quarter of fiscal 2001, we began to design a global system for Enterprise Resource Planning ("ERP") which we believe will improve the efficiency of related business processes. We expect to implement our new ERP system in the first quarter of fiscal 2002. To date, we have incurred approximately \$4.5 million in consulting fees related to the current ERP implementation project. These expenses are incremental to our normal operating expenses.

Business Reorganization

During the third quarter of fiscal 2001, we recorded a charge of approximately \$2.7 million related to a realignment of resources consistent with our ongoing business plan.

7. Earnings Per Share.

The following table sets forth the computation of basic and diluted loss per share:

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---------------------------------|-------------|--------------------------------|--------------|
| | 2001 | 2000 | 2001 | 2000 |
| (In thousands, except per share amounts) | | | | |
| Net loss | \$ (141,095) | \$ (18,133) | \$ (261,199) | \$ (221,953) |
| Less preferred stock dividends | (129) | (131) | (392) | (394) |
| Net loss available to common stockholders | \$ (141,224) | \$ (18,264) | \$ (261,591) | \$ (222,347) |
| Weighted average shares outstanding basic and diluted | 190,857 | 183,826 | 189,512 | 182,847 |
| Net loss per share basic and diluted | \$ (0.74) | \$ (0.10) | \$ (1.38) | \$ (1.22) |
| Potentially dilutive securities excluded from computations because they are anti-dilutive | 9,335 | 9,232 | 8,760 | 10,364 |

8. Preferred Stock Transactions

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On March 1, 2001, NKK Corporation ("NKK") elected to convert the remaining 17,500 shares of Series A convertible preferred stock. As a result of this conversion, NKK received 3,829,321 shares of common stock at a price of \$4.57 per share.

9. Comprehensive Loss.

The components of comprehensive loss, net of tax, are as follows:

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|---|---------------------------------|--------------|--------------------------------|--------------|
| | 2001 | 2000 | 2001 | 2000 |
| | (In thousands) | | | |
| Net loss | \$ (141,095) | \$ (18,133) | \$ (261,199) | \$ (221,953) |
| Change in unrealized gain (loss) on available-for-sale Investments | 217 | (215,621) | (2,406) | 47,097 |
| Reclassification adjustment of accumulated unrealized gain related to the sale of investments | | | (31,226) | |
| Change in unrealized gain on derivative instruments designated and qualifying as cash flow hedges | 5,110 | 1,943 | 4,824 | 1,455 |
| Foreign currency translation adjustments | (4,923) | (13,030) | (10,045) | (9,394) |
| | \$ (140,691) | \$ (244,841) | \$ (300,052) | \$ (182,795) |

The components of accumulated other comprehensive (loss) income, net of tax, are as follows:

| | March 31, 2001 | June 30, 2000 |
|--|-------------------|------------------|
| | (In thousands) | |
| Unrealized (loss) gain on available-for-sale investments | \$ (2,933) | \$ 30,699 |
| Unrealized gain (loss) on derivative instruments designated and qualifying as cash flow hedges | 2,163 | (2,661) |
| Foreign currency translation adjustments | (19,517) | (9,472) |
| | \$ (20,287) | \$ 18,566 |

10. Segment Information.

SGI is a leader in high-performance computing and advanced graphics solutions, offering powerful servers and visual workstations. We have three reportable segments: Servers, Visual Workstations and Global Services. Reportable segments are determined based on several factors including customer base, homogeneity of products, technology, delivery channels and other factors. The Server segment's current products include Silicon Graphics® Onyx2® and the next generation Onyx® 3000 family of graphics systems, the SGI Origin 200 family of servers, the SGI 1000 family of servers and the Origin 2000 and Origin 3000 family of high-performance servers. Fiscal 2000 results include the Cray® product line which was sold to Tera Computer Company ("Tera") in the third quarter of fiscal 2000. The Visual Workstation segment's current products include the Silicon Graphics® O2®, the Silicon Graphics® Octane®, and the Silicon Graphics® Octane2 visual workstations based upon the MIPS® microprocessor and the IRIX® operating system and the Silicon Graphics® 230, Silicon Graphics®330,

Silicon Graphics®550, and the Silicon Graphics Zx10 visual workstations based upon the Intel® microprocessor and the Windows NT® and Red Hat® Linux® operating systems. Fiscal 2000 results include the Silicon Graphics 320 and 540 visual workstations based upon the Intel microprocessor and the Windows NT operating system which were discontinued in favor of more industry standard architectures. The Global Services segment supports our computer hardware and software products and provides professional services to help customers realize the full

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value of their information technology investments. Our professional services organization provides technology consulting, education, communication and entertainment services. We evaluate performance for each of these segments based on profit or loss from operations before interest and taxes.

In addition to the aforementioned reportable segments, expenses of the sales and marketing, manufacturing, finance and administration groups are allocated to the operating units and are included in the results reported. The revenue and related expenses of our wholly-owned software subsidiary Alias/Wavefront, as well as certain corporate-level operating expenses are not allocated to operating units and are included in "Other" in the reconciliation of reported revenue and operating profit. In addition, the revenue and related expenses of MIPS Technologies, Inc. ("MIPS"), a designer of high-performance processors and related intellectual property that was a majority-owned subsidiary until SGI distributed its interest in MIPS to its shareholders through a spin-off effective June 20, 2000, are also included in "Other" in the reconciliation of reported revenue and operating profit in fiscal 2000.

We do not identify or allocate assets or depreciation by operating segment, nor do we evaluate segments on these criteria. Operating units do not sell product to each other, and accordingly, there is no inter-segment revenue to be reported.

Information on reportable segments is as follows (in thousands):

| | Three Months Ended March 31, | | | Nine Months Ended March 31, | | |
|---|------------------------------|---------------------|-----------------|-----------------------------|---------------------|-----------------|
| | Servers | Visual Workstations | Global Services | Servers | Visual Workstations | Global Services |
| 2001: | | | | | | |
| Revenue from external customers | \$ 204,690 | \$ 94,734 | \$ 181,847 | \$ 535,182 | \$ 289,192 | \$ 518,939 |
| Segment (loss) profit | \$ (39,361) | \$ (21,580) | \$ 9,838 | \$ (181,883) | \$ (87,355) | \$ 20,119 |
| 2000: | | | | | | |
| Revenue from external customers | \$ 229,305 | \$ 108,343 | \$ 172,920 | \$ 717,682 | \$ 409,698 | \$ 519,560 |
| Segment (loss) profit | \$ (45,078) | \$ (10,663) | \$ 19,342 | \$ (134,152) | \$ (112,294) | \$ 13,230 |
| Significant items: | | | | | | |
| Non-recurring charges for contract cancellations and inventory and future support costs related to the Silicon Graphics 320 and 540 visual workstations | \$ | \$ 2,537 | \$ 2,100 | \$ | \$ (45,253) | \$ (20,950) |
| Vector supercomputer warranty-related Charges | \$ | \$ | \$ | \$ | \$ | \$ (15,300) |

10

Reconciliation to SGI as reported (in thousands):

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|----------------------------------|------------------------------|-------------|-----------------------------|--------------|
| | 2001 | 2000 | 2001 | 2000 |
| Revenue: | | | | |
| Total reportable segments | \$ 481,271 | \$ 510,568 | \$ 1,343,313 | \$ 1,646,940 |
| Other | 28,447 | 53,119 | 79,648 | 150,143 |
| Total SGI consolidated | \$ 509,718 | \$ 563,687 | \$ 1,422,961 | \$ 1,797,083 |
| Operating (loss) profit: | | | | |
| Total reportable segments | \$ (51,103) | \$ (36,399) | \$ (249,119) | \$ (233,216) |
| Other | 4,218 | 18,001 | 9,129 | 41,476 |
| Other operating (expense) income | (7,246) | 17,677 | (1,025) | (110,861) |

| | Three Months Ended March 31, | | Nine Months Ended March 31, | |
|------------------------|---------------------------------|----------|--------------------------------|--------------|
| | | | | |
| Total SGI consolidated | \$ (54,131) | \$ (721) | \$ (241,015) | \$ (302,601) |

11. Sale Leaseback Transaction

In December 2000, we completed the sale of a portion of our corporate real estate in Mountain View, California for approximately \$260 million, as amended. The transaction resulted in initial net proceeds of \$185 million with the balance of the transaction to be completed and the proceeds received prior to December 31, 2001. As part of the transaction, we leased back specific buildings on our current campus over periods ranging from 2 to 12 years. All of the leases involved in this transaction are classified as operating leases.

As a result of the transaction, we will recognize an overall gain of approximately \$64 million, of which \$10 million has been recognized during the second and third quarters of fiscal 2001. The remaining gain will be recognized over the terms of the respective leases and will be recorded as an offset to rent expense.

12. Recent Accounting Pronouncements

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB 101"), and amended it in March and June 2000. SAB 101 provides guidance on the recognition, presentation and disclosure of revenue in financial statements for all public registrants. Changes in our revenue recognition policy, if any, resulting from the interpretation of SAB 101 will be reported as a change in accounting principle. We are currently reviewing the impact of SAB 101 on our previously reported results of operations and will adopt SAB 101 during the fourth quarter of fiscal 2001.

In November 2000, the FASB Emerging Issues Task Force ("EITF") reached final consensus on EITF Issue No. 00-19, "Determination of Whether Share Settlement is Within the Control of the Issuer" for purposes of applying EITF Issue No. 96-13, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". EITF 00-19 addresses and clarifies whether specific contract provisions or other circumstances cause a net-share or physical settlement alternative to be within or outside the control of the issuer. EITF 96-13 addresses

accounting for equity derivative contracts indexed to, and potentially settled in, a company's own stock by providing guidance for distinguishing between permanent equity, temporary equity and assets and liabilities. Under EITF 00-19, equity derivatives that were issued prior to September 20, 2000, and classified as permanent equity must meet certain criteria or be re-classified as temporary equity. To qualify as permanent equity all the following criteria must be met: the equity derivative contract must permit the company to settle in unregistered shares, the company must have sufficient authorized but unissued shares available to settle the contract, the contract must contain an explicit limit on the number of shares to be delivered in a share settlement, there can be no requirement in the contract to post collateral, there can be no "make whole" provisions in the contract and there can be no provisions in the contract that indicate the counterparty has rights that rank higher than those of a common shareholder.

Compliance with EITF 00-19 did not have a significant impact on our consolidated financial position or results of operation but resulted in a \$104 million reclassification from equity to temporary equity on the balance sheet. This reclassification is necessary because the put option contracts require that collateral be posted and require delivery of registered shares. Subsequent to March 31, 2001, we have settled these equity derivative contracts.

13. Contingencies

We are defending the lawsuits described below. We believe we have good defenses to the claims in each of these lawsuits and we are defending each of them vigorously.

We are defending putative securities class action lawsuits filed in the U.S. District Court for the Northern District of California and in California Superior Court for the County of Santa Clara in December 1997 and January 1998 alleging that SGI and certain of its officers made material misrepresentations and omissions during the period from July to October 1997. The U.S. District Court is considering plaintiffs' motion for a voluntary dismissal of the case without prejudice and defendants' motion for partial summary judgment. Discovery is proceeding in the California Superior Court case.

We also have been defending a securities class action lawsuit involving Alias Research Inc., which was pending when we acquired Alias in June 1995. The Alias case, which was filed in 1991 in the U.S. District Court for the District of Connecticut, alleges that Alias and a former officer and director made material misrepresentations and omissions during the period from May 1991 to April 1992. The case was remanded to the U.S. District Court. In December 2000, the District Court granted Plaintiffs' motion to amend their Complaint and the case is in the discovery phase. In April 2001, Plaintiffs and Defendant reached an understanding that resolves this litigation. The actual settlement document has not been completed; Court approval of the settlement is required. The terms of the settlement will not have a material adverse impact on SGI's financial condition or results of operation.

The U.S. Departments of Commerce and Justice are currently conducting civil and criminal investigations into SGI's compliance with export regulations in connection with several export sales to Tier 3 countries. See "Risks That Affect Our Business Export Regulation."

We routinely receive communications from third parties asserting patent or other rights covering our products and technologies. Based upon our evaluation, we may take no action or we may seek to obtain a license. There can be no assurance in any given case that a license will be available on terms we consider reasonable, or that litigation will not ensue.

12

We are not aware of any pending disputes, including those described above, that would be likely to have a material adverse effect on SGI's financial condition, results of operations or liquidity. However, our evaluation of the likely impact of these pending disputes could change in the future.

14. Subsequent Events

In April 2001, we announced plans to eliminate approximately 1,000 regular, temporary and contractor positions, or about 15% our global workforce, in the fourth quarter of fiscal 2001 with the objective of reducing our operating expenses by about 20% from the fourth quarter of fiscal 2001 to the first quarter of fiscal 2002. These actions will result in a restructuring charge in the fourth quarter of fiscal 2001 of approximately \$60-\$80 million.

13

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Quarterly Report on Form 10-Q includes forward-looking statements regarding our business, objectives, financial condition and future performance. These forward-looking statements include, among others, statements relating to expected levels of revenue, gross margin, operating expense, cash and future profitability, our business transition objectives, headcount reductions and the expected impact on our business of legal proceedings and government regulatory actions. We have based these forward-looking statements on our current expectations about future events. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of such terms or other comparable terminology. These statements are only predictions.

These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied in such forward-looking statements. Such risks and uncertainties include, among other things: adverse changes in general economic or business conditions; adverse changes in the specific markets for our products, including expected rates of growth and decline in our current markets; lower than anticipated demand for our products; changes in customer order patterns; the impact of the Company's restructuring activity on revenue and working capital; inadequate levels of working capital; heightened competition, resulting from rapid technological advances and constantly improving price/performance, which may result in significant discounting and lower gross profit margins; continued success in technological advancements and new product introduction, including timely development and successful introduction of strategic products for specific markets; risks related to dependence on our partners and suppliers; risks related to foreign operations (including the downturn of economic trends, unfavorable currency movements, and export compliance issues); risks associated with implementation of our new business practices, processes and information systems; litigation involving export compliance, intellectual property, securities laws or other issues; and other factors including those listed under the heading "Risks That Affect Our Business."

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We undertake no obligation to publicly update or revise any forward-looking statements, whether changes occur as a result of new information, future events or otherwise. The matters addressed in this discussion, with the exception of the historical information presented, are forward-looking statements involving risks and uncertainties, including business transition and other risks discussed under the heading "Risks That Affect Our Business" and elsewhere in this report. Our actual results may differ significantly from the results discussed in the forward-looking statements.

The following tables and discussion present certain financial information on a comparative basis. During the third and fourth quarters of fiscal 2000, respectively, we sold our Cray product line and distributed our remaining interest in MIPS through a spin-off. We believe it more relevant if certain current fiscal year results (revenue, gross margin and operating expenses other than restructuring activity) are compared with pro forma fiscal 2000 results. The pro forma results for the three and nine-month periods of fiscal 2000 used throughout this discussion are adjusted to exclude the results of operations of the Cray product line and MIPS.

14

Results of Operations

| | Three Months Ended March 31, | | Nine Months Ended March 31, | | Pro Forma Three Months Ended March 31, 2000 | Pro Forma Nine Months Ended March 31 2000 |
|---|---|-------------|--|-------------|--|--|
| | 2001 | 2000 | 2001 | 2000 | | |
| (Numbers may not add due to rounding) | | | | | | |
| (In millions, except per share amounts) | | | | | | |
| Total revenue | \$ 510 | \$ 564 | \$ 1,423 | \$ 1,797 | \$ 471 | \$ 1,548 |
| Cost of revenue | 325 | 327 | 948 | 1,158 | 296 | 1,054 |
| Gross profit | 184 | 236 | 475 | 639 | 175 | 494 |
| Gross profit margin | 36.2% | 41.9% | 33.4% | 35.5% | 37.2% | 31.9% |
| Total operating expenses | 238 | 237 | 716 | 941 | 216 | 879 |
| Operating loss | (54) | (1) | (241) | (303) | (41) | (385) |
| Interest and other income expense, net | | (2) | (7) | (4) | (19) | (17) |
| Other non-recurring expense, net | (83) | (21) | (3) | (21) | | |
| Loss before income taxes | (137) | (23) | (251) | (327) | (60) | (402) |
| Net loss | \$ (141) | \$ (18) | \$ (261) | \$ (222) | \$ (46) | \$ (279) |
| Net loss per share basic and diluted | \$ (0.74) | \$ (0.10) | \$ (1.38) | \$ (1.22) | \$ (0.25) | \$ (1.53) |

Revenue

The following discussion of revenue is based on the results of our reportable segments as described in Note 9 to the Condensed Consolidated Financial Statements. Total revenue is principally derived from three reportable segments: Servers, Visual Workstations and Global Services. These segments were determined based on factors such as customer base, homogeneity of products, technology, delivery channels and other factors.

Revenue for the third quarter and the first nine months of fiscal 2001 increased \$39 million or 8% and decreased \$125 million or 8%, respectively, compared with the corresponding periods of fiscal 2000 on a pro forma basis.

The following table presents total revenue by reportable segment:

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(Numbers may not add due to rounding)

| | Three Months Ended March 31, | | Nine Months Ended March 31, | | Pro Forma Three Months Ended March 31, 2000 | Pro Forma Nine Months Ended March 31, 2000 |
|---------------------|---------------------------------|--------|--------------------------------|--------|--|---|
| | 2001 | 2000 | 2001 | 2000 | | |
| | \$ in millions | | | | | |
| Servers | \$ 205 | \$ 229 | \$ 535 | \$ 718 | \$ 188 | \$ 614 |
| % of total revenue | 40% | 41% | 38% | 40% | 40% | 40% |
| Visual Workstations | \$ 95 | \$ 108 | \$ 289 | \$ 410 | \$ 108 | \$ 410 |
| % of total revenue | 19% | 19% | 20% | 23% | 23% | 26% |
| Global Services | \$ 182 | \$ 173 | \$ 519 | \$ 519 | \$ 148 | \$ 441 |
| % of total revenue | 36% | 31% | 36% | 29% | 31% | 29% |
| Other | \$ 28 | \$ 53 | \$ 80 | \$ 150 | \$ 26 | \$ 83 |
| % of total revenue | 5% | 9% | 6% | 8% | 6% | 5% |

Server revenue for the third quarter and the first nine months of fiscal 2001 increased \$16 million, or 9%, and decreased \$79 million, or 13%, respectively, compared with the corresponding periods of fiscal 2000 on a pro forma basis. The increase in revenue for the third quarter fiscal 2001 is primarily attributable to the sale of products within the Origin and Onyx® product families that were introduced at the beginning of fiscal 2001.

15

Visual Workstation revenue for the third quarter and the first nine months of fiscal 2001 decreased \$14 million, or 13%, and \$121 million, or 30%, respectively, compared with the corresponding periods of fiscal 2000 on a pro forma basis. The decrease in revenue for the third quarter fiscal 2001 is primarily attributable to the continuing decline in our UNIX® workstation market, especially within the O2 product family.

Revenue for the first nine months of fiscal 2001 compared with the corresponding period of fiscal 2000 on a pro forma basis was affected, by limited availability of the industry-standard ceramic packaging used by our supplier of custom ASICs for our Origin 3000 family of high-performance servers, Onyx 3000 family of graphics systems and Octane2 graphics workstations in the first and second quarters of fiscal 2001. We currently do not anticipate that the material constraints noted above will be a factor going forward.

Global Services revenue is comprised of hardware and software support and maintenance, professional services and remanufactured systems sales. Global Services revenue for the third quarter and the first nine months of fiscal 2001 increased \$34 million, or 23%, and \$77 million, or 17%, respectively, compared with the corresponding periods of fiscal 2000 on a pro forma basis. These increases primarily reflect an increase in professional services revenue and remanufactured systems sales, offset in part by a decline in our traditional customer support revenue.

Other revenue is principally comprised of our operating units that are not reportable segments, including the product and service revenue of our software subsidiary, Alias/Wavefront.

Total revenue by geographic area was as follows (in millions):

| Area | Three Months Ended March 31, | | Nine Months Ended March 31, | | Pro Forma Three Months Ended March 31, 2000 | Pro Forma Nine Months Ended March 31 2000 |
|---------------|---------------------------------|--------|-----------------------------------|----------|--|--|
| | 2001 | 2000 | 2001 | 2000 | | |
| Americas | \$ 256 | \$ 306 | \$ 770 | \$ 1,002 | \$ 245 | \$ 872 |
| Europe | 124 | 115 | 340 | 436 | 105 | 375 |
| Rest of World | 130 | 143 | 313 | 359 | 121 | 301 |
| Total revenue | \$ 510 | \$ 564 | \$ 1,423 | \$ 1,797 | \$ 471 | \$ 1,548 |

Geographic revenue as a percentage of total revenue was as follows:

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| Area | Three Months Ended March 31, | | Nine Months Ended March 31, | | Pro Forma Three Months Ended March 31, 2001 | Pro Forma Nine Months Ended March 31, 2000 |
|---------------|---------------------------------|------|--------------------------------|------|--|---|
| | 2001 | 2000 | 2001 | 2000 | | |
| Americas | 50% | 54% | 54% | 56% | 52% | 56% |
| Europe | 24% | 21% | 24% | 24% | 22% | 24% |
| Rest of World | 26% | 25% | 22% | 20% | 26% | 19% |

The geographic revenue mix in the third quarter of fiscal 2001 did not shift significantly when compared with the corresponding period in fiscal 2000 on a pro forma basis. In terms of absolute dollars, increases in revenue were experienced across all regions. The increase in Rest of World business as a percentage of total revenue in the first nine months of fiscal 2001 compared with the corresponding period of fiscal 2000 on a pro forma basis is principally due to an increase in professional services revenue in Japan.

Our consolidated backlog at March 31, 2001 was \$276 million compared with \$386 million at December 31, 2000.

16

Gross Profit Margin

Cost of product and other revenue includes costs related to product shipments, including materials, labor, overhead and other direct or allocated costs involved in their manufacture or delivery. Costs associated with non-recurring engineering revenue are included in research and development expense. Cost of service revenue includes all costs incurred in the support and maintenance of our products, as well as costs to deliver professional services.

Gross margin for the third quarter of fiscal 2001 decreased to 36.2% compared with the pro forma gross margin of 37.2% in the corresponding period of fiscal 2000. After excluding adjustments of approximately \$5 million related to our decision to discontinue the Silicon Graphics 320 and 540 visual workstations, third quarter fiscal 2001 gross margin was relatively consistent with pro forma fiscal 2000 gross margin.

Gross margin for the first nine months of fiscal 2001 was 33.4% compared with pro forma gross margin of 31.9% in the first nine months of fiscal 2000. The fiscal 2000 proforma gross margin reflects certain adjustments related to our decision to discontinue the Silicon Graphics 320 and 540 visual workstations and for estimated warranty related costs associated with the Cray T90 supercomputer product line. Without these adjustments, our gross profit margin for the nine months of fiscal 2000 would have been 37.1%. The adjustments that affected the pro forma gross margin for the first nine months of fiscal 2000 includes charges of approximately \$45 million for third party manufacturing contract cancellations and purchase commitments and for excess product demonstration inventory related to our Silicon Graphics 320 and 540 visual workstations, charges of \$21 million to cost of service revenue for future unrecoverable visual workstation support costs, and charges of \$15 million to cost of service revenue for estimated warranty related costs associated with the Cray T90 supercomputer product line. Gross margin for the first nine months of fiscal 2001 was affected by the residual impact of component issues in the first and second quarters of fiscal 2001 which affected shipping patterns and was a factor in causing a higher percentage of our revenue to come from lower margin products.

Operating Expenses

| | Three Months Ended March 31, | | Nine Months Ended March 31, | | Pro Forma Three Months Ended March 31, 2000 | Pro Forma Nine Months Ended March 31, 2000 |
|-------------------------------------|---------------------------------|---------|--------------------------------|--------|--|---|
| | 2001 | 2000 | 2001 | 2000 | | |
| | \$ in millions | | | | | |
| Research and development | \$ 61 | \$ 70 | \$ 177 | \$ 234 | \$ 56 | \$ 193 |
| % of total revenue | 12.0% | 12.3% | 12.4% | 13.0% | 12.0% | 12.5% |
| Selling, general and administrative | \$ 170 | \$ 185 | \$ 538 | \$ 597 | \$ 178 | \$ 576 |
| % of total revenue | 33.3% | 32.9% | 37.8% | 33.2% | 37.8% | 37.2% |
| Other | \$ 7 | \$ (18) | \$ 1 | \$ 111 | \$ (18) | \$ 111 |
| % of total revenue | 1.4% | (3.1)% | (0.1)% | 6.2% | (3.8)% | 7.2% |

Operating Expenses (excluding Other Operating Expense). Operating expenses for the third quarter and for the first nine months of fiscal 2001 declined 1% and 7%, respectively, in absolute dollars, and decreased as a percentage of total revenue, from 50% to 45% and remained relatively flat at 50%, respectively, compared with the corresponding periods of fiscal 2000 on a pro forma basis. Operating expenses in the third quarter of fiscal 2001 were flat compared with the corresponding period in fiscal 2000, and as a percentage of total revenue decreased due to higher revenue levels. The decrease in operating expenses, in absolute dollars, for the first nine months of fiscal 2001 compared with the corresponding period of fiscal 2000 on a pro forma basis, resulted primarily from lower headcount as a result of restructuring activities and attrition. In addition, concentrated research and development

spending and management focus on expense contributed to the decline in operating expenses year over year. As a result of the reduction in workforce as discussed in Note 14 "Subsequent Events", we expect operating expenses to decline, with the impact of these reductions not to be realized until fiscal 2002.

Other Operating Expense. Other operating expense for the first nine months of fiscal 2001 represents third quarter charges of \$3 million in reorganization costs and \$4 million for consulting fees related to the current ERP implementation project, partially offset by a \$6 million reduction to the restructuring costs we recorded in the first quarter of fiscal 2001. Other operating expense for the first nine months of fiscal 2000 includes a charge for estimated restructuring costs of \$145 million, offset in part by a \$34 million reduction to these estimated restructuring costs. See Note 6 to the Condensed Consolidated Financial Statements, "Other Operating Expense," for further information regarding these activities.

Interest and Other

Interest Income and Other, Net Interest income and other, net includes interest on our cash investments, interest expense, gains and losses on other investments, and other non-operating items. Interest income and other, net for the third quarter and the first nine months of fiscal 2001 declined in comparison to the corresponding periods of fiscal 2000 on a pro forma basis mainly due to lower interest income as a result of lower cash balances.

Other Non-recurring expense Other non-recurring expense for the first nine months of fiscal 2001 includes an \$83 million write-down of a venture investment taken in the third quarter, partially offset by a \$50 million gain on the sale of marketable investments, a \$24 million gain related to the sale of the Cray product line, and a \$8 million gain on the sale of corporate real estate. Other non-recurring expense for the first nine months of fiscal 2000 includes a \$21 million loss on the sale of the Cray product line.

Taxes Our provision for income taxes for the first nine months of fiscal 2001 arose principally from taxes currently payable in foreign jurisdictions. The effective tax benefit rate for the first nine months for fiscal 2000 was 23%, excluding the impact of the \$66 million year-to-date charge related to the Silicon Graphics 320 and 540 visual workstation product line, the impact of the \$15 million charge related to the Cray T90 product line, the \$111 million year-to-date charge for estimated restructuring costs and the \$21 million loss on the sale of the Cray product line, which were tax effected at 37%. The fiscal 2000 benefit rate, excluding the charges related to the Silicon Graphics 320 and 540 products, the Cray T90 product line and estimated restructuring charges, differed from the Federal statutory rate primarily due to foreign losses for which no benefit was recognized.

Financial Condition

At March 31, 2001, cash and cash equivalents and marketable and restricted investments totaled \$324 million compared with \$384 million at June 30, 2000. Included in the March 30, 2001 and June 30, 2000 balances are approximately \$205 million and \$126 million, respectively, of restricted investments as described in Note 3 "Restricted Investments."

Primarily as a result of net losses, operating activities used \$231 million during the first nine months of fiscal 2001 compared with using \$35 million during the first nine months of fiscal 2000. To present cash flow from operating activities, net loss for the first nine months of fiscal 2001 was adjusted for certain significant items. The first nine months of fiscal 2001 net loss is adjusted to remove the impact of the \$83 million write down of a venture investment. The net loss is also adjusted to remove the impact of the \$50 million gain on the sale of marketable investments that is reflected as a cash flow from investing activities.

Investing activities, other than changes in available-for-sale and restricted investments, provided \$122 million in cash during the first nine months of fiscal 2001 compared with consuming \$248 million during the first nine months of fiscal 2000. The principal source of cash during

the first nine months of fiscal 2001 was the \$185 million net cash proceeds received as a result of the sale-leaseback transaction involving a portion of our corporate real estate. The significant investing activity during the first nine months of fiscal 2000 was our election to exercise an option to purchase five buildings on our Mountain View campus for approximately \$125 million that had been held under an off-balance sheet financing arrangement.

Financing activities provided \$5 million during the first nine months of fiscal 2001 compared with \$13 million during the first nine months of fiscal 2000. The principal financing activities during the first nine months of fiscal 2001 included \$10 million in proceeds from the issuance of stock, offset in part by \$5 million in debt payments. The principal financing activities during the first nine months of fiscal 2000 included proceeds from employee stock purchase plan issuances and employee stock option exercises, offset in part by the use of \$24 million to repurchase shares of our common stock and \$14 million to either retire or repay debt.

At March 31, 2001, our principal sources of liquidity included cash and cash equivalents and unrestricted marketable investments of \$118 million. While we believe that this level of liquidity should be adequate to fund our business, this belief is based upon our expectations for operating results over the next several quarters. If our actual results differ materially from these or other relevant assumptions, we could consume more cash than we anticipate, in which case we would need to obtain alternative sources of liquidity, such as sales of assets, sales of securities or borrowings.

In April 2001, we obtained an asset based credit facility, secured by U.S. accounts receivable and inventory. Available credit is determined monthly based on 85% of eligible accounts receivable, up to a maximum of \$75 million. To date, we have used \$43 million of this line to secure a letter of credit.

Risks That Affect our Business

SGI operates in a rapidly changing environment that involves a number of risks, some of which are beyond our control. This discussion highlights some of these risks.

Working Capital Requirements. Primarily as a result of net losses, our operating activities consumed \$231 million in cash during the first nine months of fiscal 2001. Unrestricted cash has declined during the first nine months of fiscal 2001 from \$258 million at June 30, 2000 in unrestricted cash and marketable investments to \$118 million at March 31, 2001, despite the receipt of \$314 million from the sale of non-operating assets during that period. While we believe that this level of liquidity should be adequate to fund our business, this belief is based on assumptions about our operating results over the next several quarters. These assumptions include expected revenue and expense levels, assumptions about the cash levels required for restructuring, and an assumption that suppliers continue to work with us on current or more favorable terms. If our actual results differ materially from these or other relevant assumptions, we could consume more cash than we anticipate, in which case we would need to obtain alternative sources of liquidity, such as sales of assets, sales of securities or borrowings. We have no assurance that these alternatives would be available.

During the first nine months of fiscal 2001, SGI has supplemented its working capital through the sale of certain assets, including real estate and investment securities. We anticipate further sales of real estate and other non core assets during the next few quarters to further supplement working capital. However, given the current general economic environment and the commercial real estate market conditions in Silicon Valley, it is not possible to predict the timing or value of any potential sale.

Given the recent lowering of our credit rating, if we should need to obtain short-term borrowings, there can be no assurance such borrowings could be obtained at favorable rates. The inability to obtain

such borrowings could have a material adverse impact on our operations, financial condition and liquidity.

Expense Reduction Program. SGI has had declining revenue and has been unprofitable on an operating basis for each of the past three fiscal years. While our operating expenses, excluding other operating expenses, have declined from \$1.5 billion in fiscal 1998 to \$1.3 billion in fiscal 1999 and to \$1.1 billion in fiscal 2000, our expenses remain out of line with our revenues.

During the fourth quarter of fiscal 2001, we plan to implement a further reduction in our operating expenses of approximately 20% from the fourth quarter levels, through a series of actions including a 15% targeted reduction in our workforce. While our objective is to reduce our costs in a manner that will not have a material impact on revenue levels, there is no assurance that this will be achieved or that we will successfully reduce our operating expenses in a timely manner and to a level sufficient to become breakeven or cash positive in fiscal 2002.

Implementation of Global IT System. SGI currently intends to implement a global system for Enterprise Resource Planning ("ERP") based on the Oracle software application in the first quarter of fiscal 2002. Our operations could be disrupted if the transition to the new system is not effected smoothly or if the system does not perform as expected.

New Products. Our ability to meet our objectives for fiscal 2001 and beyond is highly dependent on the success of new products. We operate in a highly competitive, quickly changing environment, and our future depends on our ability to develop and introduce new products in a timely fashion. If we are unable to develop new products that our customers will buy, our business and operating results will be adversely affected. Any extended failure to meet these objectives could affect not only our ability to ship our backlog but to continue to attract new orders.

Dependence On Partners And Suppliers. Our business has always involved close collaboration with partners and suppliers. However, many elements of our current business strategy, including the longer-term addition of the Intel 64-bit architecture and additional outsourcing of manufacturing, will increase our dependence on Intel and other partners, and on our manufacturing partners and other component suppliers. Our business could be adversely affected, for example, if Intel fails to meet product release schedules, if we experience supply constraints such as those that have existed during this fiscal year, or if we experience any other interruption or delay in the supply chain. The competitiveness of our system products, particularly our servers, is significantly affected by the availability on our platform of third-party software applications that are important to customers in our target markets. Our ability to work with our software partners to ensure porting of these applications to our IRIX operating system and, in the future, to Linux, is a key factor to our business success.

Employees. Our success depends on our ability to continue to attract, retain and motivate highly qualified technical, marketing and management personnel, who are in great demand. The uncertainties surrounding SGI's business prospects have increased the challenges of retaining world-class talent. We recently announced our plans to implement restructuring actions that are scheduled to occur during the fourth quarter of fiscal 2001. As we work through this process, there is no guarantee that we will not lose highly qualified employees.

Product Development and Introduction. Our continued success depends on our ability to develop and rapidly bring to market technologically complex and innovative products. Product transitions are a recurring part of our business. A number of risks are inherent in this process.

The development of new technology and products is increasingly complex and uncertain, which increases the risk of delays. The introduction of new computer systems requires close collaboration and continued technological advancement involving multiple hardware and software design teams, internal and external manufacturing teams, outside suppliers of key components such as semiconductor and

storage products and outsourced manufacturing partners. The failure of any one of these elements could cause our new products to fail to meet specifications or to miss the aggressive timetables that we establish. There is no assurance that acceptance of our new systems will not be affected by delays in this process. As noted above, our ability to successfully attract and retain key technical, marketing and management personnel in a competitive hiring environment has a direct impact on our ability to maintain our product development timetables.

Short product life cycles place a premium on our ability to manage the transition to new products. We often announce new products in the early part of a quarter while the product is in the final stages of development and testing, and seek to manufacture and ship the product in volume during the same quarter. Our results could be adversely affected by such factors as development delays, the release of products to manufacturing late in any quarter, quality or yield problems experienced by suppliers, variations in product costs and excess inventories of older products and components. In addition, some customers may delay purchasing existing products in anticipation of new product introductions.

Most products are upgraded during their product life cycle. The ability to upgrade products in a timely fashion is necessary to compete in the computer industry. Delay in introducing updates and upgrades can adversely affect acceptance and demand for product.

Dual Platform Strategy. We have announced product roadmaps for both the server and workstation businesses that will, over the next five years, supplement our products based on the MIPS processor architecture with products based on the Intel processor architecture, and from the IRIX operating system to Linux and Windows NT. This process will involve our supporting both architectures indefinitely in order to provide flexibility and support to our customers. Risks associated with this strategy include uncertainty among employees, customers and partners, potential customer defection and higher operating expenses. There can be no assurance that we will introduce the new products required for these transitions as planned, successfully support our customer and partner base as they adopt these new products or otherwise manage this process in a way that will allow us to recover from this uncertainty.

Period To Period Fluctuations. Our operating results may fluctuate for a number of reasons. Delivery cycles are typically short, other than for large-scale server products. A little over half of each quarter's product revenue results from orders booked and shipped during the third month, and disproportionately in the latter half of that month. These factors make the forecasting of revenue inherently uncertain. Because we

plan our operating expenses, many of which are relatively fixed in the short term, on expected revenue, even a relatively small revenue shortfall may cause a period's results to be substantially below expectations. Such a revenue shortfall could arise from any number of factors, including lower than expected demand, supply constraints, delays in the availability of new products, transit interruptions, overall economic conditions, the California energy situation or natural disasters. Demand can also be adversely affected by product and technology transition announcements by SGI or our competitors. The timing of customer acceptance of certain large-scale server products may also have a significant effect on periodic operating results. Margins are heavily influenced by mix considerations, including geographic concentrations, the mix of product and service revenue, and the mix of server and desktop product revenue including the mix of configurations within these product categories.

Our results have typically followed a seasonal pattern, with stronger sequential growth in the second and fourth fiscal quarters, reflecting the buying patterns of our customers.

The present uncertainty in the economy has impacted the timing of buying decisions of our customers. Unless and until the economic environment becomes more positive it will be difficult for us to experience growth in revenue.

21

Our stock price, like that of other technology companies, is subject to significant volatility. If revenue or earnings in any quarter fail to meet the investment community's expectations, there could be an immediate impact on our stock price. The stock price may also be affected by broader market trends unrelated to our performance.

Competition. The computer industry is highly competitive, with rapid technological advances and constantly improving price/performance. Most of our competitors have substantially greater technical, marketing and financial resources and, in some segments, a larger installed base of customers and a wider range of available applications software. Competition may result in significant discounting and lower gross margins.

Impact Of Government Customers. A significant portion of our revenue is derived from sales to the U.S. government, either directly by us or through system integrators and other resellers. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruptions due to appropriation and spending patterns and the government's reservation of the right to cancel contracts for its convenience. The change in administration has apparently delayed some spending decisions by the U.S. government. We expect an upturn in our government business as the new administration is finalized; however, the length of time this will take and any major change in government programs may have a material impact on our operations and ability to generate revenue.

A portion of our business requires security clearances from the United States government. We have implemented measures to maintain our clearances in light of the fact that our CEO, Mr. Robert Bishop, is not a United States citizen. However, these arrangements are subject to customer review and approval and periodic review by the Defense Security Service of the Department of Defense. Any disruption or limitation in our ability to do business with the United States government could have an adverse impact on SGI.

Export Regulation. Our sales to foreign customers are subject to export regulations. Sales of many of our high-end products require clearance and export licenses from the U.S. Department of Commerce under these regulations. The Departments of Commerce and Justice are currently conducting civil and criminal investigations into SGI's compliance with the export regulations in connection with several export sales to Tier 3 countries. We believe that these matters will be resolved without a significant adverse effect on our business. However, there is no assurance that these matters will not have an unforeseen outcome that could impair the conduct of our business with the U.S. government or our sales outside the United States.

Our international sales would also be adversely affected if such regulations were tightened, or if they are not modified over time to reflect the increasing performance of our products.

Intellectual Property. We routinely receive communications from third parties asserting patent or other rights covering our products and technologies. Based upon our evaluation, we may take no action or may seek to obtain a license. In any given case there is a risk that a license will not be available on terms that we consider reasonable, or that litigation will ensue. We expect that, as the number of hardware and software patents issued continues to increase, and as competition in the markets we address intensifies, the volume of these intellectual property claims will also increase.

Market Risk. In the normal course of business, our financial position is routinely subjected to a variety of risks, including market risk associated with interest rate movements and currency rate movements on non-U.S. dollar denominated assets and liabilities, as well as collectibility of accounts receivable. We regularly assess these risks and have established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, we do not anticipate material losses in these areas.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The information required under this Item 3 is included in the section above entitled Market Risk.

22

PART II OTHER INFORMATION

Item 1. Legal Proceedings

We are defending putative securities class action lawsuits filed in the U.S. District Court for the Northern District of California and in California Superior Court for the County of Santa Clara in December 1997 and January 1998 alleging that SGI and certain of its officers made material misrepresentations and omissions during the period from July to October 1997. The U.S. District Court is considering plaintiffs' motion for a voluntary dismissal of the case without prejudice and defendants' motion for partial summary judgment. Discovery is proceeding in the California Superior Court case.

We also have been defending a securities class action lawsuit involving Alias Research Inc., which we acquired in June 1995. The Alias case, which was filed in 1991 in the U.S. District Court for the District of Connecticut, alleges that Alias and a former officer and director made material misrepresentations and omissions during the period from May 1991 to April 1992. The case was remanded to the U.S. District Court. In December, the District Court granted Plaintiffs' motion to amend their Complaint and the case remains in the discovery phase. In April 2001, Plaintiffs and Defendant reached an understanding that resolves this litigation. The actual settlement document has not been completed; Court approval of the settlement is required. The terms of the settlement will not have a material adverse impact on SGI's financial condition or operating results.

The U.S. Departments of Commerce and Justice are currently conducting civil and criminal investigations into SGI's compliance with export regulations in connection with several export sales to Tier 3 countries. See "Risks That Affect Our Business Export Regulation."

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 10.29 Amendment to Stock Purchase Agreement dated December 20, 2000 among the Company, NKK Corporation and NKK U.S.A. Corporation.
- 10.30 Loan and Security Agreement between the Company and Foothill Capital Corporation and Bank of America, N.A. dated April 10, 2001.

(b) Reports on Form 8-K.

None

23

SIGNATURES

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

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Dated: May 14, 2001

SILICON GRAPHICS, INC.
a Delaware corporation

By: /s/ HAROLD L. COVERT

Harold L. Covert
President (Principal Financial Officer)

/s/ JEFFREY ZELLMER

Jeffrey Zellmer
*Vice President, Corporate Controller (Principal
Accounting Officer)*

24

QuickLinks

[SILICON GRAPHICS, INC. QUARTERLY REPORT ON FORM 10-Q TABLE OF CONTENTS](#)

[PART I FINANCIAL INFORMATION](#)

[Item 1. Financial Statements](#)

[SILICON GRAPHICS, INC. CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS \(unaudited\) \(In thousands, except per share amounts\)](#)

[SILICON GRAPHICS, INC. CONDENSED CONSOLIDATED BALANCE SHEETS \(In thousands\)](#)

[SILICON GRAPHICS, INC. CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS \(unaudited\) \(In thousands\)](#)

[SILICON GRAPHICS, INC. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS](#)

[Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition.](#)

[Item 3. Quantitative and Qualitative Disclosures About Market Risk.](#)

[PART II OTHER INFORMATION](#)

[Item 1. Legal Proceedings](#)

[Item 6. Exhibits and Reports on Form 8-K](#)

[SIGNATURES](#)