



**SUPERCONDUCTOR
TECHNOLOGIES**

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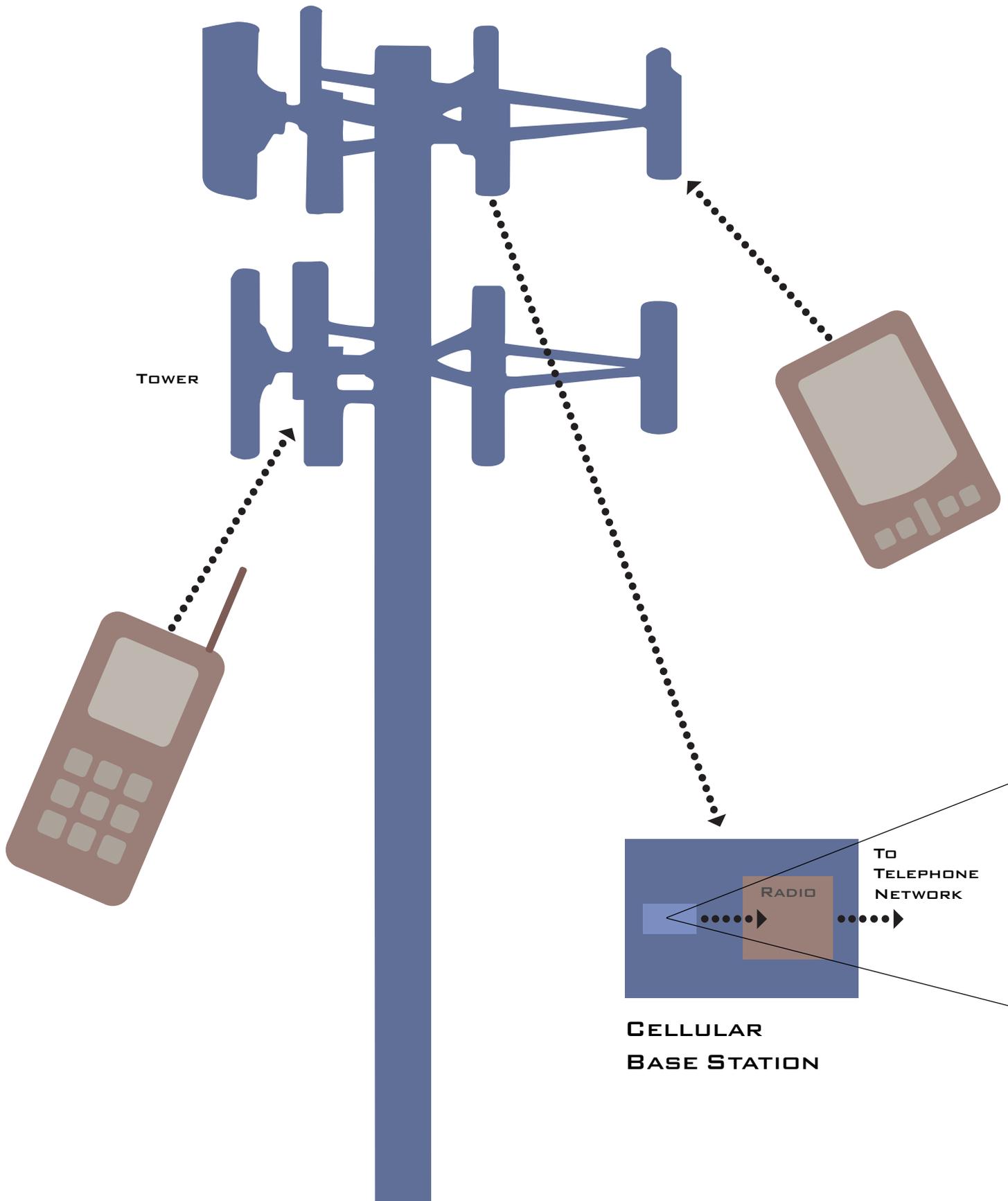
Superconductor Technologies

A N N U A L R E P O R T

2000



IMPROVING THE QUALITY OF WIRELESS



Superconductor Technologies

Superconductor Technologies Inc.

Superconductor Technologies Inc. designs, manufactures, and sells high performance systems and other products for the base stations of wireless telecommunications providers.

Our SuperFilter® Systems use proprietary superconducting technology and are designed to eliminate the tradeoff between selectivity and sensitivity. This enables wireless service providers to enhance customer satisfaction and increase their subscriber base by improving the quality of voice and data transmissions over their networks.

SUPERFILTER®



Customer Benefits

- Supercharge Your Network Capacity
Deliver on the Promise of CDMA
- Coverage Enhancements
It's like X-ray Vision for Wireless
- Superimpose New Networks Over Existing Ones
Range Extension to Fill in Coverage Gaps
- Super Speeds for Data Applications
Delivered Consistently to More Customers
- Future Proof Evolving Networks
STI is With You Each Step of the Way

I M P R O V I N G T H E Q U

To

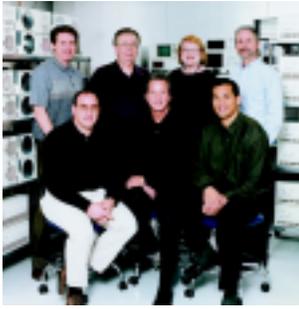


Our Shareholders



uperconductor Technologies Inc. (STI) is on a journey and the year 2000 marked the completion of the second phase of that journey—on a resoundingly positive note. • **Phase I** • Our first phase was ten years of highly successful technology development as an R & D company, developing the new technology of high temperature superconducting (HTS). This phase culminated in 1996 with STI laying claim to the best thin film superconducting technology, as well as the most compact, efficient, long-lived cryo cooler in the world. • **Phase II** • Thus, we had the springboard to embark on phase two of our journey, the transition to an operating company pursuing the application of HTS thin film technology to develop, manufacture, and market a line of products, SuperFilter® Systems, to wireless telecom carriers in North America for use in their network infrastructures. Our first sale was in the fourth quarter of 1997 and in the year 2000 we sold 393 systems for gross commercial revenues of \$7.6 million, an increase of 245 percent above sales in the year 1999. This is still a budding market, albeit one with enormous potential—Allied Business Intelligence estimates that there are more than 700,000 base stations in the world. The year 2000 market could be characterized as one of “early adopters”, companies such as U.S. Cellular Corporation and ALLTEL Communications Corporation, both of whom have signed supply agreements with STI. The “resoundingly positive note” to which I referred earlier was not only the excellent growth we enjoyed in the year

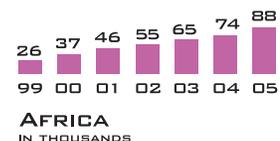
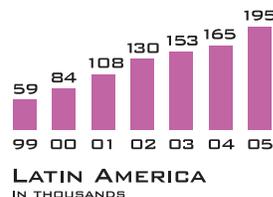


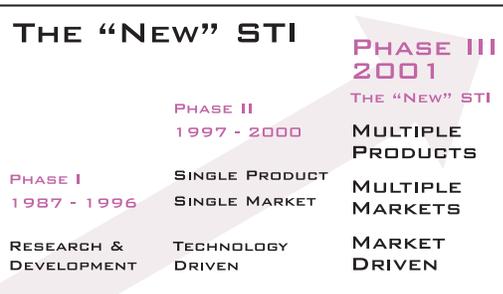


STI Wireless Systems, North America
Division Staff

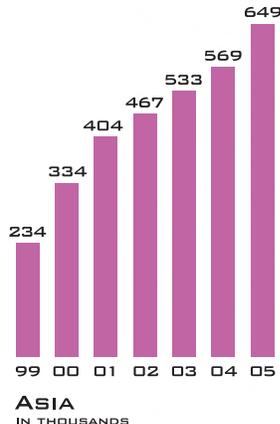
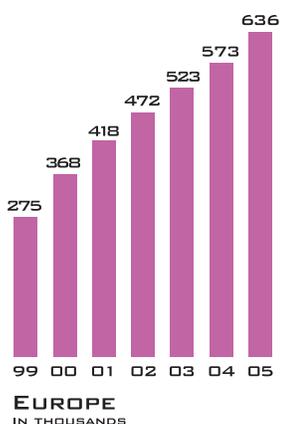
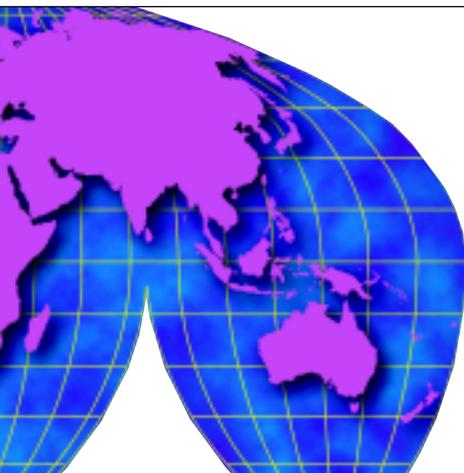
2000, but also our clear emergence as the leader in this early market, with a market share of more than 80 percent. • So, as we leave the year 2000, the leader in our endeavors with more than 600 SuperFilter® Systems installed and operating in wireless networks, primarily in North America, we are ready for the next phase on our journey. • **Phase III** • In Phase I, we were an R & D company pursuing HTS technology development. In Phase II, we were an operating company driven by HTS technology, selling a single product line, SuperFilter® Systems, to wireless telecom operators in a single market, North America. In Phase III, we are transitioning to a company driven by the needs of the wireless infrastructure market, pursuing multiple product lines in multiple geographic markets. On March 20, 2001 at the Cellular Telecommunications & Internet Association (CTIA) trade show in Las Vegas, we announced the “New STI”. To position this new STI, we announced a new product line, SuperLink Solutions™, and a strategic alliance agreement with Paradigm Wireless Systems, the source of our new SuperAmp™ power amplifiers. A week earlier, we had

WIRELESS BASE STATIONS – GLOBAL





announced another new product line, HTS Ready™ Duplexers. SuperLink Solutions™ incorporate SuperFilters®, SuperAmps™, and HTS Ready™ Duplexers, installed and optimized for improved network link quality. • We believe the new STI is a win-win situation. We sell solutions to wireless carriers focused on improving the quality of the wireless link. Our SuperFilter® System deals with the “uplink”, the transmission path from the subscriber to the network. The SuperAmp™ is used to improve the “down-link” path from the network to the subscriber. The duplexer combines both signals on a single antenna. Many

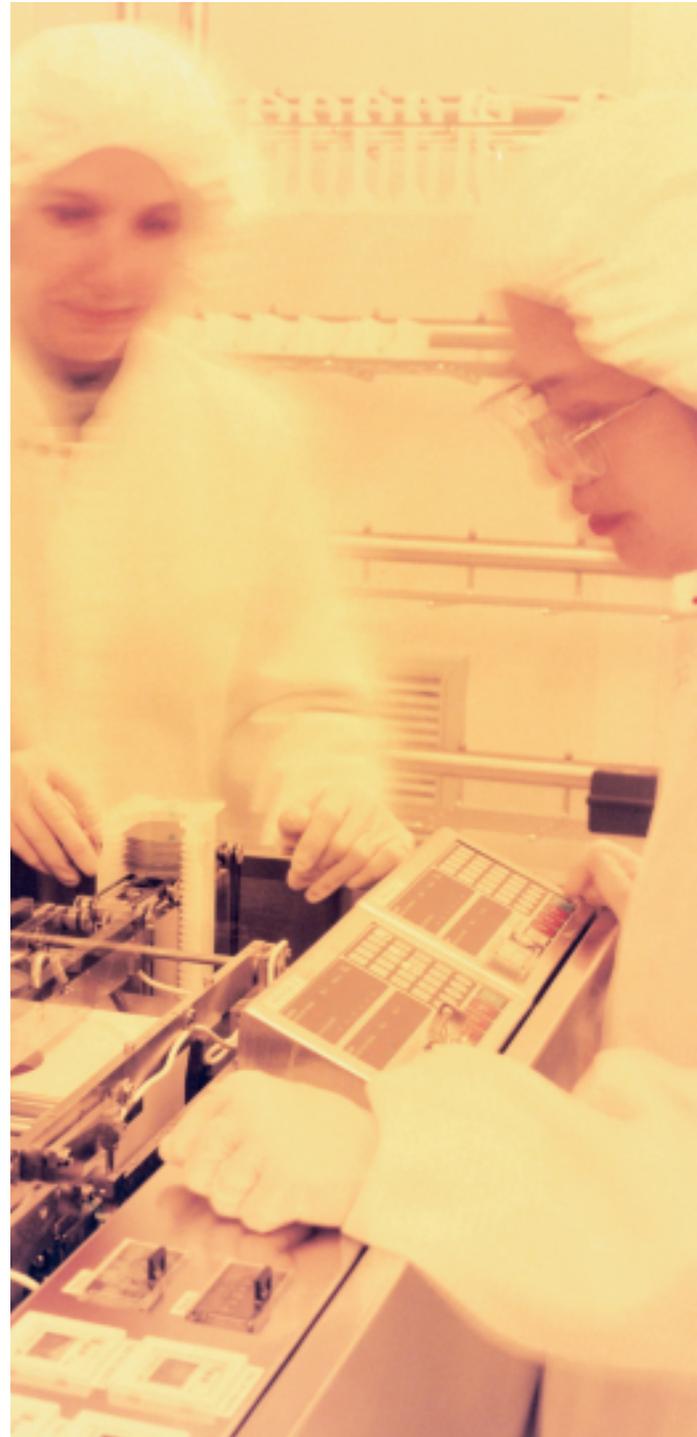


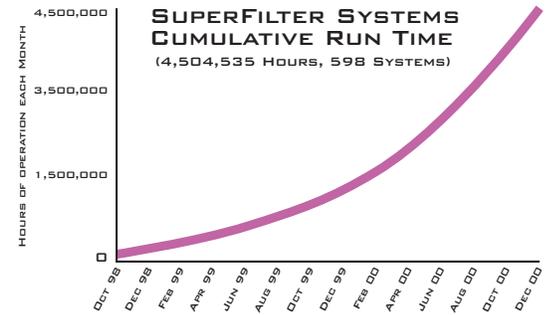


*Superconductor Technologies Inc.
Corporate Management*

networks are “uplink limited”, so the SuperFilter[®] solves a problem. But others are “downlink limited” and in addition, true optimization frequently requires addressing both links. Our bag of tools has just increased.

• **Strengthening Our Balance Sheet, Our Manufacturing, Our Organization** • As STI continued its expansion in 2000, we took important steps to solidify our financial position to support future growth. In 2000 we completed \$45.5 million in new equity financing. This capital enables the infrastructure investments needed to support our anticipated growth in domestic and worldwide markets. Our world class manufacturing facility was expanded to a capacity of more than 1,200 SuperFilter[®] Systems per annum, with further expansion planned. • STI also focused and strengthened its organization by creating two new divisions: STI Wireless Systems, North America and STI Wireless Systems, International to target key geographic market opportunities. We added depth to our





management team to help these units perform. Robert Johnson joined us as the new president of STI Wireless Systems, North America. Bob is supported by excellent executives heading the operating functions of sales and marketing, engineering, and manufacturing. • As STI navigates its new course, penetration of the international wireless markets is important to our continued success. With Ray Cotten, Senior Vice President of Business Development as chief architect, STI Wireless Systems, International is making its presence known worldwide. Ray is supported by a seasoned international executive in sales and marketing. • **In Conclusion** • STI has successfully navigated Phase I and Phase II of its journey. We have every confidence that Phase III will enable continued growth leading to financial success for you, our shareholders. • On behalf of the Board of Directors and all of our employees, I thank you for your confidence and your support of STI. I want to recognize the unwavering support of many long-term investors as well as welcome those of you who are new shareholders.

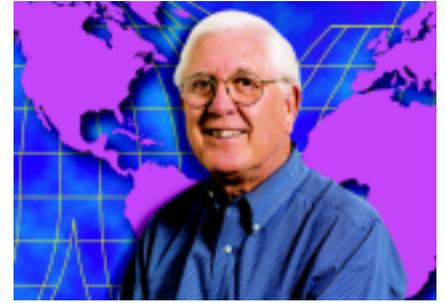
Respectfully,

M. Peter Thomas

President & Chief Executive Officer



International Business



As STI's domestic customer base grows and its product lines expand, it is natural for us to turn our attention to global markets where the much heralded 3G technologies are being developed and deployed. We at STI are carefully but aggressively expanding our marketing reach into the rapidly growing regions of Latin America, Asia, and Europe. • **Latin America** • We chose Brazil as our first significant entry into international markets because of its adoption of network and spectrum standards already in place in the U.S. SuperFilter® System trials with two major carriers validated our expectations for performance in TDMA and CDMA networks and demonstrated the financial viability of our products. Our success in Brazil will provide the model for our expansion into other Latin American countries.

• **Asia-Pacific** • The Asia-Pacific market rapidly embraced the business models for deployment of the futuristic wireless services, Third Generation Wireless or 3G. STI trials in Korea demonstrated that STI's technology can be highly effective in these new high-speed networks, which will permit us to expand our reach throughout Asia. Burgeoning significant partnerships throughout Asia provide STI a roadmap to this complex but rewarding Asian marketplace. • **Europe** • The European market is unsettled at this time due to the record-breaking spectrum prices. European carriers, however, are pursuing technologies necessary to deploy cost-effective network solutions in the 3G arena. STI's line of link enhancement products, we believe, adheres to the cost models required by these carriers. • We subscribe to a long-term vision for serving the wireless industry, evidenced by our link enhancement product lines in the 2G, 2.5G, and 3G environments. We believe wireless telecommunications services are the most efficient, cost-effective method of delivering voice and data telecommunications services to an ever-expanding global marketplace, especially in areas of high demand for wireless internet access, and in areas of limited wireline services. We look to the future with great anticipation and are committed to faithfully serving our customers and our shareholders.

Sincerely,

A handwritten signature in black ink that reads "E. Ray Cotten". The signature is written in a cursive, flowing style.

E. Ray Cotten

Senior Vice President, Business Development

Superconductor Technologies Inc.

Board of Directors

CHAIRMAN

John D. Lockton
Chairman of the Board of the Company
Director of IP Wireless, Inc.

M. Peter Thomas
President, Chief Executive Officer and
Director

Robert P. Caren, Ph.D.
Retired Corporate Vice President,
Science and Engineering
Lockheed Corporation

E. Ray Cotten
Senior Vice President, Business
Development and Chief Marketing
Officer

Dennis J. Horowitz
Chairman, President, Chief Executive
Officer and Director
Wolverine Tube, Inc.

Joseph C. Manzinger
Vice President and Director
The Hillman Company

Glenn E. Penisten
Founder

J. Robert Schrieffer, Ph.D.
Nobel Laureate
Chairman of the Technical Advisory
Board of the Company
Professor, Florida State University
Chief Scientist of the National High
Magnetic Field Laboratory

H. Vaughan Blaxter, III
Vice President, General Counsel and
Director
The Hillman Company

*SuperFilter® is a registered trademark of
Superconductor Technologies Inc. Any
other marks are properties of their
respective owners.*

Management Team

M. Peter Thomas
President, Chief Executive Officer

E. Ray Cotten
Senior Vice President, Business
Development and Chief Marketing
Officer

Robert B. Hammond, Ph.D.
Senior Vice President, Chief Technical
Officer and Secretary

Robert L. Johnson
President, STI Wireless Systems, North
America

William J. Buchanan
Controller and Chief Accounting Officer

David R. Chase
Vice President, Marketing

Grant B. Davis
Vice President, Sales and Marketing, STI
Wireless Systems, North America

Michael M. Eddy, Ph.D.
Vice President, Technology Business
Development

Neal O. Fenzi
Vice President, Engineering, STI
Wireless Systems, North America

James J. Havlovick
Vice President, Manufacturing, STI
Wireless Systems, North America

Martin S. McDermut
Vice President, Finance and Administra-
tion and Chief Financial Officer

Edward W. Triebell
Vice President, Sales and Marketing, STI
Wireless Systems, International

Annual Meeting

The annual meeting of shareholders
will be held on May 17, 2001 at
11:00 am at the Holiday Inn, 5650
Calle Real, Santa Barbara, CA 93111

Corporate Information

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Facsimile 805 683 9496

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c/o Equiserve
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Canton, MA 02021

STOCK EXCHANGE LISTING
Common Stock Trading
NASDAQ
National Market System
Symbol: SCON

Outside Counsel

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10866 Wilshire Boulevard
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Los Angeles, CA 90024

INDEPENDENT AUDITORS
PricewaterhouseCoopers LLP
350 South Grand Avenue
Los Angeles, CA 90071

INVESTOR RELATIONS
Lippert/Heilshorn & Associates, Inc.
44 Montgomery Street
San Francisco, CA 94104

COMMON STOCK PRICES

As of March 26, 2001, there were approximately 160 shareholders of record of the Company's common stock. The Company intends to employ all available funds in the development of business and does not expect to pay any cash dividends for the foreseeable future. Furthermore, the Company may not pay any cash dividends on its common stock until all dividends due and payable on its preferred stock have been declared and paid and without the written consent of its equipment leasing line provider and its lender.

	<i>High</i>	<i>Low</i>		<i>High</i>	<i>Low</i>
Quarter ended April 3, 1999	\$ 4.63	\$ 3.25	Quarter ended April 1, 2000	\$ 115.00	\$ 4.38
Quarter ended July 3, 1999	\$ 3.88	\$ 2.19	Quarter ended July 1, 2000	\$ 42.25	\$ 11.06
Quarter ended October 2, 1999	\$ 5.50	\$ 2.63	Quarter ended September 30, 2000	\$ 40.00	\$ 16.88
Quarter ended December 31, 1999	\$ 5.22	\$ 2.69	Quarter ended December 31, 2000	\$ 19.50	\$ 2.66

SUPERCONDUCTOR TECHNOLOGIES INC.

SELECTED FINANCIAL DATA.

The information set forth below is not necessarily indicative of results of future operations and should be read in conjunction with the Company's Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing in this Annual Report.

	Year Ended December 31,				
	1996	1997	1998	1999	2000
	(In thousands, except per share data)				
Statement of Operations Data:					
Net Revenues:					
Net commercial product revenues	\$250	\$175	\$1,954	\$2,053	\$5,303
Government contract revenues	7,104	8,104	6,029	5,059	4,643
Sub license royalties	38	38	—	10	10
Total net revenues	<u>7,392</u>	<u>8,317</u>	<u>7,983</u>	<u>7,122</u>	<u>9,956</u>
Costs and expenses:					
Cost of commercial product revenues	—	—	5,873	6,848	15,710
Contract research and development	5,721	6,218	4,693	3,427	4,235
Other research and development	2,260	1,809	1,161	1,747	2,633
Selling, general and administrative	2,967	4,076	5,435	5,664	8,225
Non-recurring charge	—	—	—	—	132
Total costs and expenses	<u>10,948</u>	<u>12,103</u>	<u>17,162</u>	<u>17,686</u>	<u>30,935</u>
Loss from operations	(3,556)	(3,786)	(9,179)	(10,564)	(20,979)
Other income (expense), net	85	245	17	(311)	323
Net loss	<u>(3,471)</u>	<u>(3,541)</u>	<u>(9,162)</u>	<u>(10,875)</u>	<u>(20,656)</u>
Less deemed and cumulative preferred stock dividends	—	—	(271)	(1,364)	(2,203)
Net loss available to common stockholders before cumulative effect of accounting change	(3,471)	(3,541)	(9,433)	(12,239)	(22,859)
Cumulative effect of accounting change on preferred stock beneficial conversion feature	—	—	—	—	(10,612)
Net loss available to common stockholders	<u><u>(\$3,471)</u></u>	<u><u>(\$3,541)</u></u>	<u><u>(\$9,433)</u></u>	<u><u>(\$12,239)</u></u>	<u><u>(\$33,471)</u></u>
Basic and diluted net loss per share:					
Net loss per common share before cumulative effect of accounting change					
	(\$0.57)	(\$0.46)	(\$1.22)	(\$1.58)	(\$1.42)
Cumulative effect of accounting change	—	—	—	—	(0.67)
Net loss per common share	<u><u>(\$0.57)</u></u>	<u><u>(\$0.46)</u></u>	<u><u>(\$1.22)</u></u>	<u><u>(\$1.58)</u></u>	<u><u>(\$2.09)</u></u>
Weighted average number of shares outstanding	6,117	7,701	7,725	7,744	16,050

	Year Ended December 31,				
	1996	1997	1998	1999	2000
Balance Sheet Data:					
Cash and cash equivalents	\$ 6,871	\$3,537	\$310	\$66	\$31,824
Working capital	7,178	3,500	1,349	(13)	36,186
Total assets	13,344	10,087	12,509	11,085	46,761
Long-term debt, including current portion	77	13	1,112	961	751
Redeemable preferred stock	—	—	8,982	17,125	—
Total stockholders' equity (deficit)	11,290	8,166	(1,197)	(11,656)	38,409

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

We develop, manufacture and market high performance products to service providers, systems integrators and original equipment manufacturers in the wireless telecommunications industry. Our primary product line is the SuperFilter System. The SuperFilter System is used in wireless base stations to filter and amplify the signals received at the antenna from subscribers' handsets. It is designed to meet the growing demands of the wireless communication market for improved coverage, greater capacity, and reduced interference. It accomplishes these needs through the combination of specialized filters utilizing high temperature superconducting technology with a proprietary cryogenic cooler and a cooled low noise amplifier in a highly compact system. The SuperFilter System offers significant advantages over conventional filter systems. As a result, service providers benefit from lower capital and operating costs and higher minutes of use, the latter a result of subscribers experiencing better call quality, fewer dropped calls and higher speed data transmissions.

From 1987 to 1997, the Company was engaged primarily in research and development and generated revenues primarily from government research contracts. The Company began full-scale commercial production of the SuperFilter in 1997 and shipped more than 390 units in 2000. As the Company continues to focus on its commercial products, commercial revenues are expected to increase as a percentage of revenues. The Company has incurred cumulative losses of \$68 million from inception to December 31, 2000.

Our backlog consists of accepted product purchase orders scheduled for delivery within six months. We had a backlog of \$746,000 at December 31, 2000, as compared to no backlog at December 31, 1999. We also had an additional \$5.8 million of bookings at December 31, 2000 under a \$7.8 million purchase order from U.S. Cellular with unscheduled delivery dates. See subsection below entitled "Non-Cash Charges For Warrants Issued to U.S. Cellular" for a discussion of the accounting for the surcharge order.

Results of Operations

2000 as Compared with 1999

Net revenues increased by \$2.9 million, or 40%, from \$7.1 million in 1999 to \$10.0 million in 2000. The increase is due to higher commercial product revenues, partially offset by lower government contract revenues.

Net commercial product revenues consist of gross commercial product sales proceeds less discounts and an allocation of proceeds to a warrant issued to one customer in 1999 under a long-term supply agreement. For a discussion of the allocation to warrants, please read the discussion under the subsection below entitled "Non-Cash Charges for Warrants Issued To U.S. Cellular." The following table summarizes the calculation of net commercial product revenues for 1999 and 2000:

<i>Dollars in thousands</i>	Year Ended December 31,	
	1999	2000
Gross commercial product sales proceeds	\$2,177	\$7,647
Less allocation of proceeds to warrants issued to U.S. Cellular	(124)	(2,295)
Less sales discounts	—	(49)
Net commercial product revenues	<u>\$2,053</u>	<u>\$5,303</u>

Net commercial product revenues increased by \$3.2 million, or 159%, from \$2.1 million in 1999 to \$5.3 million in 2000. This increase is the result of increased sales of our SuperFilter products and a shift in the product mix toward higher-priced SIX-Pak units. The increase in gross commercial product sales proceeds was partially offset by \$2.3 million in 2000 and \$124,000 in 1999 to reflect an allocation of proceeds to warrants issued to U.S. Cellular in connection with those sales. The warrant charges increased because of growing product shipments to U.S. Cellular and a dramatic increase in our stock price during 2000.

Government contract revenues decreased by \$416,000, or 8%, from \$5.1 million in 1999 to \$4.6 million in 2000. We expect government contract revenues to decline as we focus more of our research and development resources on our commercial business. We plan to focus our future government contract work on projects that have applications to our commercial product business.

Cost of commercial product revenues includes all direct costs, manufacturing overhead and related start-up costs. The cost of commercial product revenues was \$15.7 million for 2000, including an accrued non-cash loss of \$4.2 million relating to the purchase order received from U.S. Cellular and other non-cash warrant charges relating to U.S. Cellular of \$482,000. Please read the subsection below entitled "Non-Cash Charges for Warrants Issued To U.S. Cellular." Excluding the non-cash charges relating to the supply agreement with U.S. Cellular, cost of commercial revenues increased \$4.1 million, or over 60%, from \$6.9 million for 1999. This increase results from increased units shipments and higher costs associated with ramping up the Company's manufacturing abilities, partially offset by lower material costs and the effect of increased manufacturing efficiencies.

We generate negative gross margins on our SuperFilter products at current sales levels primarily due to fixed manufacturing overhead costs. Based on current prices, expected product mix and costs, we estimate that we will achieve positive gross margins when product sales reach approximately 200 systems per quarter. We expect to reach this level sometime in the second half of 2001.

Contract research and development expenses increased by \$808,000, or 24%, from \$3.4 million in 1999 to \$4.2 million in 2000. Contract research and development expenses as a percentage of related revenues totaled 91% for 2000, as compared with 68% last year. The percentage increase is due to higher expenses associated with a completed contract, the effect of spreading fixed expenses over a lower revenue base and the increased use of subcontractors.

Other research and development expenses increased by \$886,000, or 51%, from \$1.7 million in 1999 to \$2.6 million in 2000. This increase is due to increased spending on product line expansion, further development of the SuperFilter product line and product cost reduction efforts.

Selling, general and administrative expenses increased by \$2.6 million, or 45%, from \$5.7 million in fiscal 1999 to \$8.2 million in fiscal 2000. This increase results primarily from increased corporate development, domestic and international marketing and sales efforts, management recruitment activities, occupancy expenses, the implementation of a management incentive program, liability insurance premiums and expenses associated with distributing annual meeting information to a larger shareholder base.

Non-recurring charges of \$132,000 consist of the write off of deferred offering expenses in the second quarter of 2000.

Interest income increase to \$806,000 in 2000, as compared to \$21,000 in the prior year, due to higher levels of cash available for investment.

Interest expense increased by \$151,000, or 45%, from \$332,000 in 1999 to \$483,000 in 2000 and resulted from new financing agreements in 1999 and 2000.

The Company had a net loss of \$20.7 million for the year ended December 31, 2000, as compared to \$10.9 million for the prior year. Excluding the effect of the allocation of sales proceeds to warrants and loss accrual relating to the long-term sales contract with U.S. Cellular, the Company would have had a net loss of \$13.6 million in 2000 as compared to \$10.8 million in the prior year.

The net loss available to common shareholders of \$33.5 million, or \$2.09 per share, for fiscal 2000 included \$10.6 million for the non-cash cumulative effect of an accounting change and \$2.2 million of non-cash deemed dividends on preferred stock. The net loss available to common shareholders of \$12.2 million, or \$1.58 per share, for fiscal 1999 included \$1.4 million for non-cash dividends and other deemed distributions to preferred stockholders. Excluding the effect of these non-cash items and those in the preceding paragraph, the loss per share for 2000 totaled \$0.85 per share as compared to \$1.39 per share last year.

1999 as Compared with 1998

Total net revenues decreased by \$861,000, or 11%, from \$8.0 million in 1998 to \$7.1 million in 1999. Lower government contract revenues were only partially offset by increased net commercial product revenues.

The following table summarizes the calculation of net commercial product revenues for fiscal 1998 and 1999:

<i>Dollars in thousands</i>	<u>Year Ended December 31,</u>	
	<u>1998</u>	<u>1999</u>
Gross commercial product sales proceeds	\$1,954	\$2,177
Less allocation of proceeds to warrants issued to U.S. Cellular	—	(124)
Net commercial product revenues	<u>\$1,954</u>	<u>\$2,053</u>

Net commercial product revenues increased by \$99,000, or 5%, from \$2.0 million in 1998 to \$2.1 million in 1999. This increase is the result of higher sales of our SuperFilter products and a shift to higher priced units, partially offset by decreasing average selling prices due to competitive pricing pressures. Gross commercial product sales proceeds were reduced by \$124,000 in 1999 to reflect an allocation of the proceeds from sales to U.S. Cellular to the warrants vesting in connection with those sales. For a discussion of the allocation of proceeds to the warrant, please read the discussion under the subsection below entitled "Non-Cash Charges for Warrants Issued To U.S. Cellular."

Government contract revenues decreased by \$970,000, or 16%, from \$6.0 million in 1998 to \$5.1 million in 1999. This decrease is attributable to the completion of certain government programs.

The cost of commercial product revenues increased by \$975,000, or 17%, from \$5.9 million for 1998 to \$6.8 million in 1999. The increase reflects the larger number of commercial product shipments partially offset by lower manufacturing costs.

Contract research and development expenses decreased by \$1.3 million, or 27%, from \$4.7 million in 1998 to \$3.4 million in 1999 and is attributable to the decrease in government contract activity.

Other research and development expenses increased by \$586,000, or 50%, from \$1.2 million in 1998 to \$1.7 million in 1999. This increase is due to increased spending on product line expansion, further development of the SuperFilter product line and product cost reduction efforts.

Selling, general and administrative expenses increased by \$229,000, or 4%, from \$5.4 million in 1998 to \$5.7 million in 1999, due to increased promotional and sales efforts relating to the Company's SuperFilter products.

Interest income decreased by \$58,000 or 73%, from \$79,000 in 1998 to \$21,000 in 1999 due to less cash available for investment purposes.

Interest expense increased by \$270,000, or over 100%, from \$62,000 in 1998 to \$332,000 in 1999. This increase occurred as the Company entered into new working capital financing agreements and increased borrowings for working capital needs in 1999.

The Company had a net loss of \$10.9 million for the year ended December 31, 1999, as compared to \$9.2 million for the prior year. The net loss available to common shareholders of \$12.2 million, or \$1.58 per share, for 1999 included \$1.4 million for non-cash deemed dividends on preferred stock. The net loss available to common shareholders totaled \$9.4 million, or \$1.22 per share, for 1998 and included \$271,000 for non-cash dividends.

Liquidity and Capital Resources

Cash and cash equivalents increased by approximately \$31.8 million from \$66,000 on December 31, 1999 to \$31.8 million on December 31, 2000. The increase results from the cash received from private placements of convertible preferred stock and related warrants and common stock to institutional investors and the proceeds from the exercise of outstanding warrants and stock options. These amounts were partially offset by cash used in operations and investing activities and the pay down of the line of credit.

Cash used in operations totaled \$14.5 million in 2000. We used \$11.8 million to fund the cash portion of our net losses. We also used cash to fund a \$2.1 million increase in accounts receivable and a \$1.0 million increase in inventory. Cash used in operations in 1999 totaled \$9.7 million and was used primarily to fund operating losses of \$9.2 million net of non-cash adjustments.

Net cash used in investing activities totaled \$2.2 million in fiscal 2000 and related to the purchase of manufacturing equipment. Net cash provided by investing activities totaled \$285,000 in fiscal 1999 and resulted from the purchase of equipment offset by the proceeds of \$900,000 from the sale and leaseback of certain production equipment.

Net cash provided by financing activities totaled \$48.4 million in fiscal 2000. Cash received from private sales of common stock and preferred stock, as well as from the exercise of outstanding warrants and stock options, totaled \$50.1 million and was partially offset by the net reduction in borrowings of \$1.7 million. In the same period of 1999, cash provided by financing operations totaled \$9.2 million and primarily resulted from private sales of preferred stock and short term borrowings, partially offset by payments due on long-term obligations.

On September 29, 2000, we raised net proceeds of \$35.1 million from the private sale of 37,500 shares of a newly created Series E Convertible Preferred Stock and warrants to purchase up to an additional 1,044,568 shares of common stock.

The preferred stock is non-voting, has a stated value and liquidation preference of \$1,000 per share, and is convertible into common stock at an initial conversion price of \$17.95 per common share until June 29, 2001. After that date, the preferred stock is convertible at the lower of \$17.95 per common share or the market price of the common stock at the time of conversion, subject to a floor. The preferred stock automatically converts into common stock on the second anniversary of the closing. Based on the current conversion price of \$17.95 per common share, the preferred stock is convertible into 2,089,136 shares of common stock. The optional and automatic conversions of preferred stock are limited to an aggregate maximum of 3,554,656 shares of common stock. The preferred stock carries a 7% conversion premium, payable upon conversion in cash or common stock subject to certain limitations, at our option.

In connection with the sale of the preferred stock, we also issued two five-year warrants to purchase shares of common stock at an exercise price of \$21.54 per share. The first warrant is for the purchase of 313,370 shares and is exercisable immediately. The second warrant is for the purchase of up to 731,198 additional shares of common stock if the preferred stock is held for at least one year. The warrant is not exercisable until the first anniversary date and size of the warrant will be reduced proportionately to reflect any conversions of the preferred stock prior to the first anniversary date. Both warrants contain "weighted average" antidilution provisions which adjust the warrant exercise price and the number of shares issuable under the warrant in the event we sell equity securities at a discount to then prevailing market prices. The amount of the adjustment depends on the size of the below-market transaction and the amount of the discount to the market price. The warrant exercise price cannot be reduced below a minimum of \$18.91 as the result of adjustments under this provision.

During fiscal 2000, the holders of the Series A-2, A-3, B-1, C and D Redeemable Convertible Preferred Stock converted their holdings into 5,633,901 shares of common stock. As an inducement to convert their preferred shares into common stock, we issued the Series A-2, A-3 and C preferred stockholders warrants to purchase 250,000 shares of common stock. The issuance of these warrants is considered a deemed distribution to the preferred stockholders and, therefore, the fair market value of the warrants of \$1.5 million is considered in the computation of the net loss per share.

We also have a revolving line of credit available that matures on December 20, 2001. The line of credit cannot exceed the lesser of (i) \$2.5 million or (ii) 80% of eligible accounts receivable. The line of credit bears interest at prime rate (9.5% at December 31, 2000) plus 1%, requires that certain financial and business covenants be maintained and is collateralized by substantially all of the Company's assets.

We are prohibited from paying any dividends on, or repurchasing any shares of, common stock under the terms of our Series E Preferred Stock.

At December 31, 2000, we had cash commitments for the purchase of fixed assets totaling \$933,000. To meet the anticipated continued increase in demand for our products, we expect to invest \$3.6 to \$4.6 million for equipment in 2001. In addition, increased sales will require

that higher inventory and accounts receivable balances be maintained. We expect our existing cash resources, together with our line of credit, will be sufficient to meet our cash needs into 2002.

Non-Cash Charges For Warrants Issued To U.S. Cellular

In August 1999, the Company entered into a warrant agreement with United States Cellular Corporation ("U.S. Cellular") where the exercise of a warrant to purchase up to 1,000,000 shares of common stock was conditioned upon future product purchases by U.S. Cellular. Under the terms of the warrant, U.S. Cellular vests in the right to purchase one share of common stock at \$4 per share for every \$25 of SuperFilter systems purchased from the Company. The warrant is immediately exercisable with respect to any vested shares and expires August 27, 2004. For accounting purposes, we are allocating proceeds from sales under this agreement between commercial product revenues and the estimated value of the warrants vesting in connection with those sales. The estimated fair value of the warrants in excess of the related sales, when applicable, is recorded in cost of commercial product revenues. U.S. Cellular vested in the right to purchase 48,980 shares of common stock for product purchases in 1999 and 53,460 shares of common stock for product purchases in 2000. As a result, we allocated \$124,000 of sales proceeds to vesting warrants in 1999 and \$1,660,000 of sales proceeds to vesting warrants in 2000. We also allocated \$482,000 to cost of commercial product revenues in the second quarter of 2000 for the estimated value of vesting warrants in excess of related sales to U.S. Cellular.

In September 2000, the Company received a \$7.8 million noncancelable purchase order from U.S. Cellular for SuperFilter systems to be shipped over the next nine quarters. In consideration for the purchase order, the Company amended the August 1999 warrant agreement and vested 312,000 warrants to U.S. Cellular. The vested warrants are immediately exercisable, not subject to forfeiture, and U.S. Cellular has no other obligations to the Company.

We estimated the fair value of the warrants vesting upon receipt of this order at \$5,635,000 using the Black-Scholes option-pricing model and recorded this amount as a deferred warrant charge in the statement of stockholders' equity. As SuperFilter systems are shipped under this purchase order, the related sales proceeds will be allocated between stockholders equity and commercial product revenue using the percentage relationship which existed between the fair value of the warrants as recorded in September 2000 and the amount of the non-cancelable purchase order. In 2000, we allocated sales proceeds of \$1,118,000 for shipments under this purchase to the deferred warrant charge and recorded sales proceeds of \$1,765,000 as commercial product revenues.

After the allocation of sales proceeds to the related warrants, the estimated cost of providing products under the purchase order exceeds related revenue by \$5.3 million. We included the resulting loss in the results of operations for the year ended December 31, 2000. In addition, through December 31, 2000, we amortized \$1,059,000 of this reserve against the cost of product delivered under this purchase order.

The following table summarizes the allocation of sales proceeds to warrants issued under the U.S. Cellular agreement and the contract loss reserve for the years indicated:

Dollars in thousands

	Year Ended December 31,		
	1998	1999	2000
Warrants issued to U. S. Cellular allocated from gross commercial product sales proceeds through September 14, 2000	\$ —	\$124	\$1,177
Warrants issued to U.S. Cellular allocated from gross commercial product sales proceeds subsequent to September 14, 2000	—	—	<u>1,118</u>
Total	<u>\$ —</u>	<u>\$124</u>	<u>\$2,295</u>
Warrants issued to U.S. Cellular included in cost of commercial product revenue	<u>\$ —</u>	<u>\$ —</u>	<u>\$482</u>
Non-cash loss included in cost of commercial product revenues in September 2000	\$ —	\$ —	\$5,300
Amortization of non-cash loss against cost of commercial product revenues delivered to U.S. Cellular	—	—	<u>(\$1,059)</u>
Non-cash loss remaining at December 31, 2000 to be amortized against cost of commercial product revenues based on future products deliverable to U.S Cellular	<u>\$ —</u>	<u>\$ —</u>	<u>\$4,241</u>

As of December 31, 2000, U.S. Cellular had 585,560 unvested warrants that can be earned from future product orders through August 27, 2004.

Net Operating Loss Carryforward

At December 31, 2000, the Company had a federal net operating loss carryforward of approximately \$78.4 million. Section 382 of the Internal Revenue Code imposes an annual limitation on the utilization of net operating loss carryforwards based on a statutory rate of return (usually the “applicable federal funds rate”, as defined in the Internal revenue Code) and the value of the corporation at the time of a “change of ownership” as defined by Section 382. We have not evaluated the circumstances under which the exercise of our outstanding warrants and options, combined with our private stock sales over the last few years, may trigger a “change in ownership” under Section 382. If this were to occur, it could significantly diminish the value of our net operating loss carryforwards by limiting the rate at which we would be permitted to offset them against any future taxable income.

Future Accounting Requirements

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, “Accounting for Derivatives Instruments and Hedging Activities”; SFAS No. 133 requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. It also requires that gains or losses resulting from changes in the values of those derivatives be accounted for depending on the use of the derivative and whether it qualifies for hedge accounting. Adoption of SFAS No. 133 is required for the fiscal year beginning January 1, 2001. Management believes the adoption of SFAS No. 133 will not have a material impact on the Company’s financial position or results of operations.

Market Risk

The Company is exposed to various market risks, including changes in interest rates. Market risk is the potential loss arising from adverse changes in market rates and prices. The Company does not enter into derivatives of other financial instruments for trading or speculation purposes.

The Company relies on short-term variable rate debt obligations. As of December 31, 2000, the Company had no amounts outstanding under a variable rate revolving line of credit. The variable rate obligations are based on the lenders’ prime rate plus 1%. Assuming \$2.5 million borrowings against the revolving line of credit, an increase of one-half of a percentage point in the lenders’ prime rate on January 1, 2001, and no principal payments for the remainder of the year, the Company’s total interest expenses would increase by less than \$13,000 for 2001 as compared to 2000.

At December 31, 2000, the Company had \$31.5 million invested in a money market account yielding approximately 6%. Assuming a 1% decrease in the yield on this money market account and no liquidation of principal for the year, the Company’s total interest income would decrease \$315,000 per annum.

Forward-Looking Statements

This report contains forward-looking statements that involve risks and uncertainties. We have made these statements in reliance on the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Our forward-looking statements relate to future events or our future performance and include, but are not limited to, statements concerning our business strategy, future commercial revenues, market growth, capital requirements, new product introductions, expansion plans and the adequacy of our funding. Other statements contained in this report that are not historical facts are also forward-looking statements. We have tried, wherever possible, to identify forward-looking statements by terminology such as “may,” “will,” “could,” “should,” “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates” and other comparable terminology.

Forward-looking statements are not guarantees of future performance and are subject to various risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially from those expressed in forward-looking statements. They can be affected by many factors, including, but not limited to the following:

- fluctuations in product demand,
- the impact of competitive filter products, technologies and pricing,
- manufacturing capacity constraints and difficulties,
- market acceptance risks, and
- general economic conditions.

Please read Exhibit 99 to the Company’s Annual Report on Form 10-K for the year ended December 31, 2000 entitled “Disclosure Regarding Forward-Looking Statements” for a description of additional uncertainties and factors that may affect our forward-looking statements. Forward-looking statements are based on information presently available to senior management, and we do not assume any duty to update our forward-looking statements.

Inflation

The Company does not foresee any material impact on its operations from inflation.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors
and Stockholders of
Superconductor Technologies Inc.

In our opinion, the accompanying balance sheets and the related statements of operations, stockholders' equity and cash flows present fairly, in all material respects, the financial position of Superconductor Technologies Inc. at December 31, 2000 and 1999, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Los Angeles, California
February 19, 2001


PRICEWATERHOUSECOOPERS LLP

SUPERCONDUCTOR TECHNOLOGIES INC.

BALANCE SHEET

	December 31, 1999	December 31, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	\$66,000	\$31,824,000
Accounts receivable	1,590,000	3,689,000
Inventory	2,745,000	3,775,000
Prepaid expenses and other current assets	452,000	500,000
Total current assets	4,853,000	39,788,000
Property and equipment, net of accumulated depreciation of \$8,054,000 and \$9,353,000 respectively	4,097,000	4,991,000
Patents and licenses, net of accumulated amortization of \$1,521,000 and \$1,761,000 respectively	1,927,000	1,877,000
Other assets	208,000	105,000
Total assets	\$11,085,000	\$46,761,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings	\$1,953,000	\$ -
Accounts payable	1,796,000	1,996,000
Accrued expenses	906,000	1,364,000
Current portion of long-term debt and capitalized lease obligations	211,000	242,000
Total current liabilities	4,866,000	3,602,000
Long-term debt and capitalized lease obligations	750,000	509,000
Accrual for contract loss-Note 8	-	4,241,000
Total liabilities	5,616,000	8,352,000
Redeemable convertible preferred stock	17,125,000	-
Series A-2 shares, 64,584 and none, issued and outstanding		
Series A-3 shares, 12,500 and none, issued and outstanding		
Series B-1 shares, 50,000 and none, issued and outstanding		
Series C shares, 41,667 and none, issued and outstanding		
Series D shares, 106,000 and none, issued and outstanding		
Commitments and contingencies-Note 10		
Stockholders' equity (deficit):		
Preferred stock, \$.001 par value, 2,000,000 shares authorized, Series E convertible preferred stock, none and 37,500 shares authorized, issued and outstanding; liquidation preference of \$38,169,000	-	-
Common stock, \$.001 par value, 30,000,000 and 75,000,000 shares authorized, 7,739,218 and 17,823,164 shares issued and outstanding	8,000	18,000
Capital in excess of par value	35,426,000	110,654,000
Deferred warrant charges	-	(4,517,000)
Accumulated deficit	(47,090,000)	(67,746,000)
Total stockholders' equity (deficit)	(11,656,000)	38,409,000
Total liabilities and stockholders' equity	\$11,085,000	\$46,761,000

See accompanying notes to the financial statements

SUPERCONDUCTOR TECHNOLOGIES INC.

STATEMENT OF OPERATIONS

	For the Year Ended December 31		
	1998	1999	2000
Net revenues:			
Net commercial product revenues-Note 8	\$1,954,000	\$2,053,000	\$5,303,000
Government contract revenues	6,029,000	5,059,000	4,643,000
Sub license royalties	-	10,000	10,000
Total net revenues	<u>7,983,000</u>	<u>7,122,000</u>	<u>9,956,000</u>
Costs and expenses:			
Cost of commercial product revenues-Note 8	5,873,000	6,848,000	15,710,000
Contract research and development	4,693,000	3,427,000	4,235,000
Other research and development	1,161,000	1,747,000	2,633,000
Selling, general and administrative	5,435,000	5,664,000	8,225,000
Non-recurring charge	-	-	132,000
Total costs and expenses	<u>17,162,000</u>	<u>17,686,000</u>	<u>30,935,000</u>
Loss from operations	(9,179,000)	(10,564,000)	(20,979,000)
Interest income	79,000	21,000	806,000
Interest expense	(62,000)	(332,000)	(483,000)
Net loss	<u>(9,162,000)</u>	<u>(10,875,000)</u>	<u>(20,656,000)</u>
Less:			
Redeemable preferred stock dividends	(271,000)	(908,000)	-
Deemed distribution attributable to the inducement to convert preferred stock and beneficial conversion feature	<u>-</u>	<u>(456,000)</u>	<u>(2,203,000)</u>
Net loss available to common stockholders before cumulative effect of accounting change	(9,433,000)	(12,239,000)	(22,859,000)
Cumulative effect of accounting change on preferred stock beneficial conversion feature	<u>-</u>	<u>-</u>	<u>(10,612,000)</u>
Net loss available to common stockholders for computation of loss per common share	<u>(\$9,433,000)</u>	<u>(\$12,239,000)</u>	<u>(\$33,471,000)</u>
Basic and diluted net loss per common share			
Net loss per common share before cumulative effect of accounting change	(\$1.22)	(\$1.58)	(\$1.42)
Cumulative effect of accounting change	<u>-</u>	<u>-</u>	<u>(0.67)</u>
Net loss per common share	<u>(\$1.22)</u>	<u>(\$1.58)</u>	<u>(\$2.09)</u>
Weighted average number of common shares outstanding	<u>7,724,829</u>	<u>7,744,008</u>	<u>16,050,423</u>

See accompanying notes to the financial statements

SUPERCONDUCTOR TECHNOLOGIES INC.

STATEMENT OF STOCKHOLDERS' EQUITY

	Common Stock		Convertible Preferred Stock		Capital in Excess of	Deferred Warrant	Accumulated	Total
	Shares	Amount	Shares	Amount	Par Value	Charge	Deficit	
Balance at December 31, 1997	7,699,581	\$8,000	-	\$ -	\$35,211,000	\$ -	\$(27,053,000)	\$8,166,000
Exercise of stock options	23,010	-	-	-	70,000	-	-	70,000
Cumulative dividends on redeemable preferred stock	-	-	-	-	(271,000)	-	-	(271,000)
Net loss							(9,162,000)	(9,162,000)
Balance at December 31, 1998	7,722,591	8,000	-	-	35,010,000	-	(36,215,000)	(1,197,000)
Cumulative dividends on redeemable preferred stock	-	-	-	-	(95,000)	-	-	(95,000)
Issuance of warrants	-	-	-	-	491,000	-	-	491,000
Exercise of stock options	16,627	-	-	-	20,000	-	-	20,000
Net loss							(10,875,000)	(10,875,000)
Balance at December 31, 1999	7,739,218	8,000	-	-	35,426,000	-	(47,090,000)	(11,656,000)
Conversion of mandatory redeemable convertible preferred stock	5,633,901	6,000	-	-	17,119,000	-	-	17,125,000
Issuance of common stock for conversion of note payable	153,846	-	-	-	500,000	-	-	500,000
Issuance of common stock for cash	2,319,855	2,000	-	-	7,381,000	-	-	7,383,000
Exercise of warrants	1,152,174	1,000	-	-	3,968,000	-	-	3,969,000
Exercise of stock options	824,170	1,000	-	-	3,562,000	-	-	3,563,000
Issuance of warrants and stock options	-	-	-	-	7,543,000	(5,635,000)	-	1,908,000
Amortization of deferred warrant charges	-	-	-	-	-	1,118,000	-	1,118,000
Issuance of Series E Convertible Preferred Stock and warrants	-	-	37,500	-	35,155,000	-	-	35,155,000
Net loss							(20,656,000)	(20,656,000)
Balance at December 31, 2000	<u>17,823,164</u>	<u>\$18,000</u>	<u>37,500</u>	<u>\$ -</u>	<u>\$110,654,000</u>	<u>(\$4,517,000)</u>	<u>(\$67,746,000)</u>	<u>\$38,409,000</u>

See accompanying notes to the financial statements.

SUPERCONDUCTOR TECHNOLOGIES INC.

STATEMENT OF CASH FLOW

	For the Year Ended December 31		
	1998	1999	2000
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	(\$9,162,000)	(\$10,875,000)	(\$20,656,000)
Adjustments to reconcile net loss to net cash used for operating activities:			
Depreciation and amortization	941,000	1,306,000	1,794,000
Accrued loss on sales contract	-	-	4,241,000
Warrants and options charges	-	335,000	2,798,000
Changes in assets and liabilities:			
Accounts receivable	(891,000)	349,000	(2,099,000)
Inventory	(2,042,000)	(329,000)	(1,030,000)
Prepaid expenses and other current assets	(27,000)	(155,000)	(159,000)
Patents and licenses	(145,000)	(94,000)	(165,000)
Other assets	(113,000)	3,000	90,000
Accounts payable and accrued expenses	1,135,000	(277,000)	691,000
Net cash used in operating activities	<u>(10,304,000)</u>	<u>(9,737,000)</u>	<u>(14,495,000)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sale of short-term investments	2,099,000	-	-
Purchase of property and equipment	(3,372,000)	(615,000)	(2,193,000)
Proceeds from sale of property and equipment	-	900,000	-
Net cash (used in) provided by investing activities	<u>(1,273,000)</u>	<u>285,000</u>	<u>(2,193,000)</u>
CASH FLOW FROM FINANCING ACTIVITIES:			
Proceeds from borrowings	1,786,000	3,200,000	1,500,000
Payments on short term borrowings	-	-	(2,953,000)
Payments on long-term obligations	(118,000)	(190,000)	(211,000)
Net proceeds from sale of preferred and common stock	8,781,000	6,198,000	50,110,000
Net cash provided by financing activities	<u>10,449,000</u>	<u>9,208,000</u>	<u>48,446,000</u>
Net increase (decrease) in cash and cash equivalents	(1,128,000)	(244,000)	31,758,000
Cash and cash equivalents at beginning of year	1,438,000	310,000	66,000
Cash and each equivalents at end of year	<u>\$310,000</u>	<u>\$66,000</u>	<u>\$31,824,000</u>

See accompanying notes to the financial statements.

SUPERCONDUCTOR TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

Note 1 – The Company

Superconductor Technologies Inc. (the “Company”) was incorporated in Delaware on May 11, 1987 and maintains its headquarters in Santa Barbara, California. The Company, which operates in a single industry segment, manufactures and markets high-performance filters to service providers and original equipment manufacturers in the mobile wireless communications industry. The Company’s principal product, the SuperFilter, combines high-temperature superconductors with cryogenic cooling technology to produce a filter with significant advantages over conventional filters. From 1987 to 1997, the Company was engaged primarily in research and development and generated revenues primarily from government research contracts. The Company began full-scale commercial production of the SuperFilter“ in 1997 and shipped more than 390 units in 2000.

The Company continues to be involved as either contractor or subcontractor on a number of contracts with the United States government. These contracts have been and continue to provide a significant source of revenues for the Company. For the years ended December 31, 1998, 1999, and 2000, government related contract accounts for 76%, 71%, and 47% respectively, of the Company’s net revenues.

Note 2 – Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments with original maturities of three months or less.

Accounts Receivable

The Company sells predominantly to entities in the wireless communications industry and to entities of the United States government. The Company grants uncollateralized credit to its customers. The Company performs ongoing credit evaluations of its customers before granting uncollateralized credit.

Revenue Recognition

Commercial revenues are principally derived from the sale of the Company’s SuperFilter products and are recognized once all of the following conditions have been met: a) an authorized purchase order has been received in writing, b) customer’s credit worthiness has been established, c) shipment of the product has occurred, d) title has transferred, and e) if stipulated by the contract, customer acceptance has occurred and all significant vendor obligations, if any, have been satisfied.

Contract revenues are principally generated under research and development contracts. Contract revenues are recognized utilizing the percentage-of-completion method measured by the relationship of costs incurred to total estimated contract costs. If the current contract estimate were to indicate a loss, utilizing the funded amount of the contract, a provision would be made for the total anticipated loss. Revenues from research related activities are derived primarily from contracts with agencies of the United States Government. Credit risk related to accounts receivable arising from such contracts is considered minimal. These contracts include cost-plus, fixed price and cost sharing arrangements and are generally short-term in nature.

All payments to the Company for work performed on contracts with agencies of the U.S. Government are subject to adjustment upon audit by the Defense Contract Audit Agency. Based on historical experience and review of current projects in process, management believes that the audits will not have a significant effect on the financial position, results of operations or cash flows of the Company.

Warranties

The Company recognizes the estimated cost of warranty expense at the time of revenue recognition. Warranty reserves are reviewed periodically and adjusted based on actual and anticipated experience.

Research and Development Costs

Research and development costs are expensed as incurred. Research and development costs incurred solely in connection with research and development contracts are charged to contract research and development expense. Other research and development costs are charged to research and development expense.

Inventories

Inventories are stated at the lower of cost or market, with costs primarily determined using standard costs, which approximate actual costs utilizing the first-in, first-out method. Provision for potentially obsolete or slow moving inventory is made based on management's analysis of inventory levels and sales forecasts.

Property and Equipment

Property and equipment are recorded at cost. Property and equipment are depreciated using the straight-line method over their estimated useful lives ranging from three to twelve years. Leasehold improvements and assets financed under capital leases are amortized over the shorter of their useful lives or the lease term. Expenditures for additions and major improvements are capitalized. Expenditures for repairs and maintenance and minor improvements are charged to expense as incurred. When property or equipment is retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the accounts. Gains or losses from retirements and disposals are recorded as other income or expense.

Patents and Licenses

Patents and licenses are recorded at cost and are amortized using the straight-line method over the shorter of their estimated useful lives or seventeen years.

Long-Lived Assets

The realizability of long-lived assets is evaluated periodically as events or circumstances indicate a possible inability to recover the carrying amount. Such evaluation is based on various analyses, including cash flow and profitability projections. The analyses necessarily involve significant management judgment. In the event the projected undiscounted cash flows are less than net book value of the assets, the carrying value of the assets will be written down to their fair value.

Income Taxes

The Company accounts for taxes under the provisions of Statement of Financial Accounting Standards No. 109 ("SFAS 109"), "Accounting for Income Taxes." SFAS 109 utilizes an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. In estimating future tax consequences, SFAS 109 generally considers all expected future events other than enactments of changes in the tax law or rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Marketing Costs

All costs related to marketing and advertising the Company's products are expensed as incurred or at the time the advertising takes place.

Net Loss Per Share

Basic and diluted net loss per share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding in each year. Net loss available to common stockholders is computed after deducting accumulated dividends on cumulative preferred stock, deemed dividends and accretion of redemption value on redeemable preferred stock for the period and beneficial conversion features on issuance of preferred stock. Common stock equivalents are not included in the calculation of diluted loss per share because their effect is antidilutive.

Stock-based Compensation

As permitted under Statement of Financial Accounting Standards No. 123 (SFAS 123), "Accounting for Stock-Based Compensation", the Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" in accounting for its stock options and other stock-based employee awards. Pro forma information regarding net loss and loss per share, as calculated under the provisions of SFAS 123, are disclosed in the notes to the financial statements. The Company accounts for equity securities issued to non-employees in accordance with the provision of SFAS 123 and Emerging Issues Task Force 96-18.

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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The significant estimates in the preparation of the financial statements relate to the assessment of the carrying amount of accounts receivable, inventory, intangibles and estimated provisions for warranty costs. Actual results could differ from those estimates and such differences may be material to the financial statements.

Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to the short-term nature of these instruments. The Company estimates that the carrying amount of the debt approximates fair value based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Comprehensive Income

The Company has no items of other comprehensive income in any period and consequently does not report comprehensive income.

Segment Information

The Company operates in a single business segment, the research, development and manufacture of high temperature superconducting products for the wireless communications industry. Net revenues derived principally from government research and development contracts are presented separately on the statement of operations for all periods presented. Management views its government research and development contracts as a supplementary source of revenue to fund its development of high temperature superconducting products.

Reclassifications

Certain reclassifications have been made to the 1998 and 1999 financial statements to conform to the 2000 presentation.

Certain Risks and Uncertainties

During the three year period ended December 31, 2000, the Company sold almost 600 SuperFilter[®] units, but the Company has continued to incur operating losses. The Company's long-term prospects are dependent upon the continued and increased market acceptance for the product.

Our two largest commercial customers accounted for 21%, 69% and 49% of our net commercial revenues for fiscal 1998, 1999 and 2000 respectively and 38% and 63% of accounts receivable as of December 31, 1999 and 2000, respectively.

We currently purchase substrates for growth of high-temperature superconductor films from one supplier because of the quality of its substrates.

Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivatives Instruments and Hedging Activities"; SFAS No. 133 requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. It also

requires that gains or losses resulting from changes in the values of those derivatives be accounted for depending on the use of the derivative and whether it qualifies for hedge accounting. Adoption of SFAS No. 133 is required for the fiscal year beginning January 1, 2001. Management believes the adoption of SFAS No. 133 will not have a material impact on the Company's financial position or results of operations.

Note 3 – Cumulative Accounting Change

On November 6, 2000, the Emerging Issues Task Force ("EITF") issued EITF 00-27, "Application of EITF Issue No.98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios to Certain Convertible Instruments". EITF 0-27 requires that any beneficial conversion feature associated with a convertible instrument be calculated using the intrinsic value of a conversion option after first allocating the proceeds received to the convertible instrument and any other detachable instruments included in the exchange (such as detachable warrants). As a result of adopting EITF 00-27, the Company has included in the computation of basic and diluted loss per share for fiscal 2000 a non-recurring cumulative effect of an accounting change on a preferred stock beneficial conversion feature of \$10,612,000 related to the issuance of its Series E Preferred Stock in September 2000 and to the issuance of its Series D Preferred Stock in June 1999.

Note 4 – Patents and Licenses

The Company has focused its development efforts on thallium barium calcium copper oxide ("TBCCO") materials and, to a lesser extent, on yttrium barium copper oxide ("YBCO") materials. Several U.S. patents have been issued to the University of Arkansas covering TBCCO, and the Company has an exclusive worldwide license (including the right to sublicense) under these patents, subject to the University of Arkansas' right to conduct research related to the patents. The Company is obligated to pay royalties of 4% on sales of TBCCO-based products, subject to a \$100,000 annual minimum and royalties of 35% of sublicense revenues received by the Company. In the event that the Company fails to pay minimum annual royalties, the license automatically becomes non-exclusive. These royalty obligations terminate upon expiration of the right to claim damages for infringement of all the patents covered.

Note 5 – Short Term Borrowings and Notes Payable

The Company has a revolving line of credit maturing on December 20, 2001. The revolving line of credit is not to exceed the lesser of (i) \$2.5 million or (ii) 80% of eligible accounts receivable. The revolving line of credit bears interest at the prime rate (8.5% at December 31, 1999 and 9.5% at December 31, 2000) plus 1%. Outstanding borrowings under this line of credit at December 31, 1999 and 2000 were \$1,453,000 and none, respectively. The Company is required to maintain certain minimum tangible net worth, debt, cash flow and other financial and business covenants. Borrowings under the revolving line of credit are collateralized by substantially all of the Company's assets. The agreement is renewable annually. In connection with the credit agreement in 1999, the Company issued warrants for the purchase of 62,500 shares of common stock at a price of \$3 per share. In December 1999, five year warrants to purchase 33,333 shares of common stock at \$3 per share were issued in connection with an amendment to the credit agreement. In January 2000, the credit facility was amended to include a \$1.5 million term note. The term note bore interest at the prime rate (8.5% at January 12, 2000) plus 4%. Five year warrants to purchase 27,692 shares of common stock at \$3.25 per share were issued in connection with this amendment. This term loan was paid in full on February 11, 2000.

During 1999, the Company borrowed \$2.4 million from the majority-preferred stockholder. These borrowings were due on demand and bore interest at 8%. Notes totaling \$1.9 million were used to purchase shares of Series C and D Convertible Preferred Stock. A demand note for \$500,000 remained outstanding at December 31, 1999 and was subsequently used to purchase 153,846 shares of common stock on February 11, 2000. A five-year warrant to purchase 20,000 shares of common stock at \$3 per share was issued in connection with this borrowing.

The weighted average interest rate on short-term borrowings at December 31, 1999 was 8.4%.

The fair values of the warrants issued in connection with borrowings were estimated using the Black-Scholes option pricing model and were accounted for as debt issuance costs and were amortized over the term of the related debt.

Note 6 – Income Taxes

The Company has incurred a net loss in each year of operation since inception resulting in no current or deferred tax expense for the years ended December 31, 1998, 1999 and 2000.

The benefit for income taxes differs from the amount obtained by applying the federal statutory income tax rate to loss before benefit for income taxes for the years ended December 31, 1998, 1999 and 2000 as follows:

	For the Year Ended December 31,		
	1998	1999	2000
Tax benefit computed at Federal statutory rate	34.0%	34.0%	34.0%
Increase (decrease) in taxes due to:			
Change in valuation allowance	(41.8)	(39.8)	(42.8)
State taxes, net of federal benefit	5.8	5.8	8.5
Nondeductible expenses	(0.1)	-	-
Other	2.1	-	0.3
	<u>-</u>	<u>-</u>	<u>-</u>

The significant components of deferred tax assets (liabilities) at December 31 are as follows:

	1998	1999	2000
Loss carryforwards	\$9,709,000	\$13,603,000	\$28,432,000
Capitalized research and development	2,175,000	2,155,000	3,220,000
Depreciation	1,726,000	1,487,000	1,087,000
Tax credits	1,402,000	985,000	1,187,000
Inventory	56,000	80,000	160,000
Other	-	-	374,000
Less: valuation allowance	<u>(15,068,000)</u>	<u>(18,310,000)</u>	<u>(34,460,000)</u>
Net deferred tax asset	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>

The valuation allowance increased by \$3,832,000, \$3,242,000, and \$16,150,000 in 1998, 1999 and 2000, respectively.

As of December 31, 2000, the Company has net operating loss carryforwards for federal and state income tax purposes of approximately \$78.4 million and \$30.5 million, respectively, which expire in the years 2000 through 2020. In addition, the Company has research and development and other tax credits for federal and state income tax purposes of approximately \$761,000 and \$351,000 respectively, which expire in the years 2002 through 2020.

Due to the uncertainty surrounding the realization of the favorable tax attributes of such net operating loss carryforwards in future tax returns, the Company has recorded a valuation allowance against its otherwise recognizable deferred tax assets. Accordingly, no deferred tax asset has been recorded in the accompanying balance sheet.

Section 382 of the Internal Revenue Code imposes an annual limitation on the utilization of net operating loss carryforwards based on a statutory rate of return (usually the "applicable federal funds rate", as defined in the Internal Revenue Code) and the value of the corporation at the time of a "change of ownership" as defined by Section 382. We have not completed our evaluation of the circumstances under which the exercise of our outstanding warrants and options, combined with our private stock sales over the last few years, may trigger a "change in ownership" under Section 382. If this were to occur, it could significantly diminish the value of our net operating loss carryforwards by limiting the rate at which they could be permitted to offset them against any future taxable income.

Note 7 – Stockholders' Equity

Preferred Stock

Pursuant to the Company's Certificate of Incorporation, the Board of Directors is authorized to issue up to 2,000,000 shares of preferred stock (par value \$.001 per share) in one or more series and to fix the rights, preferences, privileges, and restrictions, including the dividend rights, conversion rights, voting rights, redemption price or prices, liquidation preferences, and the number of shares constituting any series or the designation of such series.

Convertible Preferred Stock

On September 29, 2000, the Company issued in a private placement of 37,500 shares of a newly created Series E Convertible Preferred Stock and warrants to purchase up to an additional 1,044,568 shares of common stock. Proceeds, net of issuance costs, totaled approximately \$35,155,000.

The preferred stock is non-voting, has a stated value and a liquidation preference of \$1,000 per share, and is convertible into common stock at an initial conversion price of \$17.95 per common share until June 29, 2001. After that date, the preferred stock is convertible at the lower of \$17.95 per common share or the market price of the common stock at the time of conversion, subject to a floor. The preferred stock automatically converts into common stock on the second anniversary of the closing. Based on the current conversion price of \$17.95 per common share, the preferred stock is convertible into 2,089,136 shares of common stock. The optional and automatic conversions of preferred stock are limited to an aggregate maximum of 3,554,656 shares of common stock. The preferred stock carries a 7% conversion premium, payable upon conversion in cash or common stock subject to certain limitations, at the Company's option. The beneficial conversion feature related to this conversion premium is being included in the calculation of net loss available to common shareholders over the period it is earned by the preferred stockholder.

In connection with the sale of the preferred stock, the Company also issued two five-year warrants to purchase shares of common stock at an exercise price of \$21.54 per share. The first warrant is for the purchase of 313,370 shares and is exercisable immediately. The second warrant is for the purchase of up to 731,198 additional shares of common stock if the preferred stock is held for at least one year. The warrant is not exercisable until the first anniversary date and size of the warrant will be reduced proportionately to reflect any conversions of the preferred stock prior to the first anniversary date. Both warrants contain "weighted average" antidilution provisions which adjust the warrant exercise price and number of shares in the event the Company sells equity securities at a discount to then prevailing market prices. The amount of the adjustment depends on the size of the below-market transaction and the amount of the discount to the market price. The warrant exercise price cannot be reduced below a minimum of \$18.91 as the result of adjustments under this provision.

The Company is prohibited from paying any dividends on, or repurchasing any shares of, common stock as long as any of the shares of the preferred stock remain outstanding. The Company has filed with the Securities and Exchange Commission a registration statement for resale of the shares of common stock issuable upon conversion of the preferred stock and exercise of the warrants.

Redeemable Convertible Preferred Stock

During 1998, the Company completed private placements of Series A and Series A-1 Cumulative Convertible Preferred Stock, to a certain investor. Each share of Series A and A-1 preferred stock was convertible into two shares of common stock, carried a cumulative dividend of 6% per annum, had voting rights, liquidation preferences and was not redeemable by the Company prior to March 26, 2001. In March 1998, the Company raised approximately \$3,000,000 from the sale of 500,000 shares of Series A preferred stock at \$6.00 per share, and issued warrants to purchase up to 100,000 shares of common stock at an exercise price of \$4.00 per share. In August 1998, the Company raised approximately \$1,000,000 from the sale of 125,000 shares of Series A-1 preferred stock at \$8.00 per share with warrants to purchase up to 66,667 shares of common stock at an exercise price of \$4.00 per share. In September 1998 the Company raised approximately \$875,000 from the sale of 145,833 shares of Series A preferred stock at \$6.00 per share with no warrants.

Also in September 1998, the Company completed a private placement of 500,000 shares of Series B Cumulative Convertible Preferred Stock to certain investors at \$8.00 per share. Each share of Series B preferred stock carried a cumulative dividend rate of 7% per annum, was convertible into two shares of common stock, had voting rights and liquidation preferences. The proceeds of the offering, net of offering expenses, totaled approximately \$4 million. The Series B preferred stock was not redeemable prior to September 2, 2001. The Company also issued warrants to purchase up to 120,000 shares of Common Stock at \$5.70 per share.

In February 1999, the Company entered into an agreement to exchange all of the then outstanding redeemable preferred shares and related warrants for shares in a new series of preferred stock and modified warrants. The impact of the exchange was to eliminate the redemption provision of the then outstanding redeemable preferred stock. The Series A preferred stock and related warrants were exchanged for 64,584 shares of Series A-2 preferred stock and warrants to purchase 100,000 shares of common stock. The Series A-1 preferred stock and related warrants were exchanged for 12,500 shares of Series A-3 preferred stock and warrants to purchase 66,669 shares of common stock. The Series B preferred stock and related warrants were exchanged for 50,000 shares of Series B-1 preferred stock and warrants to purchase 120,000 shares of common stock. The warrants received in the exchange generally have the same terms as the warrants surrendered. In connection with the exchange, the Company issued to the preferred stockholders warrants to purchase up to 75,000 shares of common stock at \$7.00.

Each share of the Series A-2, Series A-3 and Series B-1 Convertible Preferred Stock was convertible into twenty shares of common stock and had voting rights. The Series A-2 Convertible Preferred Stock carried a cumulative annual dividend of 6% per share and a liquidation preference of \$72 per share until March 26, 2001, and \$60 per share plus accrued dividends, thereafter. Each share of the Series A-3 Convertible Preferred Stock carried a cumulative annual dividend of 6% per share and a liquidation preference of \$96 per share until March 26, 2000, and \$80 per share plus accrued dividends, thereafter. Each share of the Series B-1 Convertible Preferred Stock carried a cumulative annual dividend of 7% per share and had a liquidation preference of \$80 per share plus unpaid dividends.

In March 1999, the Company completed a private placement of 41,667 shares of Series C Convertible Preferred Stock to certain investors at \$72 per share. The gross proceeds of the offering totaled \$3 million. Each share of preferred stock carried a cumulative dividend of 7% per annum, had voting rights and a liquidation preference of the greater of \$86.40 or \$72 per share plus accrued dividends. A five-year warrant to purchase 120,000 shares of common stock at \$4.50 per share was also issued in connection with this financing.

In June 1999, the Company entered into a private equity financing agreement providing for the sale of securities in two tranches with gross proceeds of up to \$5.3 million. Under the first transaction, the Company sold 77,296 shares of Series D Convertible Preferred Stock at \$50 per share, which resulted in gross proceeds of approximately \$3.9 million. Under the second transaction, the Company sold 28,704 shares of Series D Convertible Preferred Stock at \$50 per share, resulting in gross proceeds of approximately \$1.4 million. Each share was convertible into twenty shares of common stock, and carried a cumulative dividend of 6% per annum, had voting rights and a liquidation preference of \$65 per share until December 17, 2003 and \$50 per share plus accrued dividends per share thereafter. In connection with this financing, the Company also issued five year warrants for the purchase of up to 212,000 shares of common stock at \$3 per share. The Company granted the Series D investors registration rights with respect to the common stock underlying the Series D preferred stock and related warrants.

The Company recorded a deemed distribution for accounting purposes in 1999 totaling \$456,000 relating to the issuance of the Series C and D Convertible Preferred Stock, which, at issuance, was convertible at a discount from the market price of the Company's common stock. The deemed dividend was a non-cash, non-recurring accounting entry for determining net loss available to common stockholders and the related net loss per share.

The issuance of the Series D Convertible Preferred Stock resulted in an anti-dilution adjustment to the Series A-2, A-3, B-1 and C Convertible Preferred Stock. Following the completion of the Series D financing, the total number of common shares issuable upon conversion of the Company's outstanding preferred stock was as follows:

	Shares of Preferred	Common Stock Issuable Upon Conversion
Series A-2	64,584	1,322,539
Series A-3	12,500	263,852
Series B-1	50,000	1,055,410
Series C	41,667	872,100
Series D	106,000	<u>2,120,000</u>
		<u>5,633,901</u>

As described below, all redeemable convertible preferred shares were converted into common shares in 2000.

On February 11, 2000, the Company completed the registration and sale of 2,473,701 shares of common stock, priced at \$3.25 per share, of which 2,319,855 shares of common stock were sold for a cash payment totaling \$7,540,000 and 153,846 shares of common stock were exchanged for short-term indebtedness of \$500,000. Net proceeds to the Company totaled \$7.4 million. Concurrent with the offering, the holders of the Series A-2, A-3 and C Redeemable Convertible Preferred Stock converted their holdings into 2,458,391 shares of common stock. As an inducement to convert the preferred shares, the Company issued the preferred stockholders warrants to purchase 250,000 shares of common stock at \$3.58 per share. The fair value of the warrants was estimated using the Black-Scholes option-pricing model and was accounted for as a deemed distribution of \$1,548,000 to the preferred stockholders for determining the loss per common share in the first quarter and full year of 2000. Also during the year ended December 31, 2000, the holders of the outstanding Series B-1 and D preferred shares elected to convert their holdings into 3,175,409 shares of common stock.

Stock Options

The Company has four stock option plans, the 1992 Stock Option Plan, the nonstatutory 1992 Directors Stock Option Plan, and the 1998 and 1999 Stock Option Plans (collectively, the "Stock Option Plans"). The 1988 Stock Option Plan expired in October 1998. Stock awards may be made to directors, key employees, consultants, and non-employee directors of the Company under the Stock Option Plans at prices no less than 100% of the market value on the date of grant. Generally, stock options become exercisable in installments over a minimum of four years, beginning one year after the date of grant, and expire not more than ten years from the date of grant, with the exception of 10% or greater stockholders which may have options granted at prices no less than the market value on the date of grant, and expire not more than five years from the date of grant. At December 31, 2000, options for 677,345 shares of Common Stock were exercisable.

At December 31, 2000, 672,454 shares of common stock were available for future grants and 1,889,101 options had been granted but not yet exercised. Option activity during the three years ended December 31, 2000 was as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding at December 31, 1997	1,453,672	\$ 4.333
Granted	450,950	\$ 4.733
Canceled	(124,315)	\$ 5.038
Exercised	<u>(15,010)</u>	\$ 1.991
Outstanding at December 31, 1998	1,765,297	\$ 4.406
Granted	391,873	\$ 3.423
Cancelled	(257,991)	\$ 1.193
Exercised	<u>(16,627)</u>	\$ 4.668
Outstanding at December 31, 1999	1,882,552	\$ 4.194
Granted	984,030	\$ 20.60
Canceled	(153,311)	\$ 7.72
Exercised	<u>(824,170)</u>	\$ 4.32
Outstanding at December 31, 2000	<u>1,889,101</u>	\$ 12.40

The following table summarizes information concerning currently outstanding and exercisable stock options at December 31, 2000:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$2.3130 - \$3.6250	421,089	7.22	\$3.1049	237,033	\$3.0889
\$3.7500 - \$5.0000	407,006	7.07	\$4.2200	257,094	\$4.1609
\$5.0630 - \$11.3750	426,186	7.86	\$7.8753	183,218	\$6.1704
\$14.0000 - \$30.6880	590,020	9.37	\$25.7312	-	-
\$35.625 - \$49.3750	<u>44,800</u>	9.34	<u>\$41.4969</u>	-	-
	<u>1,889,101</u>	8.05	\$12.3987	<u>677,345</u>	\$4.3293

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, ("SFAS 123"), "Accounting for Stock-Based Compensation." Accordingly, no compensation cost has been recognized for the stock-based compensation other than for non-employees. If the Company had elected to recognize compensation expense for employee awards based upon the fair value at the grant date consistent with the methodology prescribed by SFAS 123, the Company's net loss and net loss per share would have been increased to the pro forma amounts indicated below:

	1998	1999	2000
Net Loss:			
As reported	(\$ 9,162,000)	(\$10,875,000)	(\$20,656,000)
Pro forma	(\$ 9,963,000)	(\$11,689,000)	(\$23,440,000)
Loss per Share:			
As reported	(\$1.22)	(\$1.58)	(\$2.09)
Pro forma	(\$1.33)	(\$1.69)	(\$2.26)

These pro forma amounts may not be representative of future disclosures since the estimated fair value of stock options is amortized to expense over the vesting period, and additional options may be granted in future years. The fair value of these options was estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for the years ended December 31, 1998, 1999 and 2000, respectively: dividend yields of zero percent each year; expected volatilities of 50, 75, and 85 percent; risk-free interest rates of 5.31, 5.62, and 6.19%; and expected life of 3.9, 4.0, and 4.0 years. The weighted average fair value of options granted in 1998, 1999 and 2000 for which the exercise price equals the market price on the grant date was \$2.08, \$1.80, and \$13.86 respectively.

Warrants

The following is a summary of outstanding warrants at December 31, 2000:

	Number of Shares Exercisable		Price per Share	Expiration Date
	Total	Currently		
Warrants related to issuance of Series E Preferred	1,044,568	313,370	\$21.54	September 29, 2005
Warrants related to borrowings and sales agreements	62,500	62,500	\$3.00	June 18, 2004
	1,000,000	414,440	\$4.00	August 27, 2004
	33,333	33,333	\$3.00	December 1, 2004
	27,692	27,692	\$3.25	January 12, 2005

Note 8 – Warrants Issued to U.S. Cellular

In August 1999, the Company entered into a warrant agreement with United States Cellular Corporation (“U.S. Cellular”) where the exercise of a warrant to purchase up to 1,000,000 shares of common stock was conditioned upon future product purchases by U.S. Cellular. Under the terms of the warrant, U.S. Cellular vests in the right to purchase one share of common stock at \$4 per share for every \$25 of SuperFilter systems purchased from the Company. The warrant is immediately exercisable with respect to any vested shares and expires August 27, 2004. For accounting purposes proceeds from sales to U.S. Cellular under this agreement are allocated between commercial product revenue and the estimated value of the warrants vesting using the Black-Scholes option-pricing model. The estimated fair value of the warrants in excess of the related sales, when applicable is recorded in cost of commercial product revenues. For product sales in 1999 and 2000, respectively, U.S. Cellular has vested in the right to exercise the warrant and purchase a total of 48,980 and 53,460 shares of common stock, respectively. As a result, sales proceeds allocated to warrants vesting in 1999 and 2000 were \$124,000 and \$1,660,000, respectively. In addition, the estimated value of warrants vesting in excess of certain sales to U.S. Cellular in the second quarter of 2000 of \$482,000 was recorded in cost of commercial product revenues.

In September 2000, the Company received a \$7.8 million non-cancelable purchase order from U.S. Cellular for SuperFilter systems to be shipped over the next nine quarters. In consideration for the purchase order, the Company amended the August 1999 warrant agreement and vested 312,000 warrants to U.S. Cellular. The vested warrants are immediately exercisable, not subject to forfeiture, and U.S. Cellular has no other obligations to the Company.

The estimated fair value of the warrants vesting upon receipt of this order was calculated to be \$5,635,000 using the Black-Scholes option-pricing model and has been recorded as a deferred warrant charge in the statement of stockholders' equity. As SuperFilter systems are shipped under this purchase order, the related sales proceeds will be allocated between stockholder's equity and commercial product revenue using the percentage relationship which existed between the fair value of the warrants as recorded in September 2000 and the amount of the non-cancelable purchase order. The fair value of the warrants was calculated utilizing a volatility factor of 85%, risk-free interest rate of 6.01%, and an expected life of 3.92 years. During fiscal 2000 sales proceeds of \$1,118,000 for shipments pursuant to this purchase order were allocated to the deferred warrant charge and proceeds of \$1,765,000 were recorded as commercial product revenues.

After the allocation of sales proceeds to the related warrants, the estimated cost of providing products under the purchase order exceeds related revenue by \$5.3 million. The resulting loss has been reflected in the results of operations for the year ended December 31, 2000. In addition through December 31, 2000, \$1,059,000 of this reserve was amortized against the cost of product delivered under this purchase order.

As of December 31, 2000 U.S. Cellular has 585,560 unvested warrants that can be earned from future product orders through August 27, 2004.

Note 9 – Employee Savings Plan

In December 1989, the Board of Directors approved a 401(k) savings plan (the “401(k) Plan”) for the employees of the Company that became effective in 1990. Eligible employees may elect to make contributions under the terms of the 401(k) Plan; however, contributions by the Company are made at the discretion of management. The Company has made no contributions to the Plan.

Note 10 – Commitments and Contingencies

Operating Leases

The Company leases its offices and production facilities under non-cancelable operating leases that expire at various times over the next ten years. Generally leases contain escalation clauses for increases in annual renewal options and require the Company to pay utilities, insurance, taxes and other operating expenses.

In March 1999, the Company entered into a master lease agreement for \$1.5 million in lease financing. Under this agreement, the Company entered into agreements for the sale and leaseback of certain production equipment with a net book value of \$944,000 for \$900,000 cash. The loss of \$44,000 realized on the sale transactions has been deferred and is being charged against income over the lease term. The Company has purchase and lease renewal options at fair market value. To help insure the Company's performance under the terms of the lease agreement, the lessor has a collateral interest in its assets subject to previously granted liens. In connection with entering into this lease, the Company issued four year warrants for the purchase of 25,180 shares of common stock at \$4.17 per share. The estimated fair value of the warrants was calculated using the Black-Scholes option-pricing model and is being amortized over the term of the lease.

For the years ended December 31, 1998, 1999, and 2000, rent expense was \$499,000, \$749,000, and \$851,000 respectively.

Capital Leases

The Company leases certain property and equipment under capital lease arrangements that expire at various dates through 2003. The leases bear interest at various rates ranging from 13.01% to 18.84%.

The minimum lease payments under operating and capital lease obligations are as follows:

<u>Year ending December 31,</u>	<u>Operating Leases</u>	<u>Capital Leases</u>
2001	\$ 767,000	\$ 337,000
2002	733,000	337,000
2003	518,000	241,000
2004	452,000	-
2005	452,000	-
Thereafter	1,983,000	-
Total payments	<u>\$4,905,000</u>	<u>915,000</u>
Less: amount representing interest		<u>(164,000)</u>
Present value of minimum lease		751,000
Less current portion		<u>242,000</u>
Long term portion		<u>\$509,000</u>

Other Matters

In the normal course of business, the Company, from time to time, is a defendant on certain litigation, claims and inquiries. In addition, the Company makes various commitments and can incur contingent liabilities. While it is not feasible to predict the outcomes of these matters, the Company is not presently aware of nor expects that any sum it may be required to pay in connection with these matters would have a material effect on its financial position or results of operation.

Note 11 – Earnings Per Share

The computation of per share amounts for 1998, 1999, and 2000 is based on the average number of common shares outstanding for the period. Options and warrants to purchase 2,241,964, 3,920,964, and 4,062,194 shares of common stock during 1998, 1999, and 2000 respectively, were not considered in the computation of diluted earnings per share because their inclusion would have been antidilutive. Also, the preferred stock convertible into 2,541,666, 5,633,900, and 2,089,136 shares of common stock at December 31, 1998, 1999, and 2000 was not considered in the computation of diluted earnings per share because its inclusion would also have been antidilutive.

Note 12 – Details of Certain Financial Statement Components and Supplemental Disclosures of Cash Flow Information and Non-Cash Activities

Balance sheet data:

	December 31	
	1999	2000
<u>Accounts receivable:</u>		
Accounts receivable-trade	\$ 793,000	\$ 2,662,000
U.S. government accounts receivable-billed	317,000	718,000
U.S. government accounts receivable-unbilled	480,000	321,000
Less: allowance for doubtful accounts	-	(12,000)
	<u>\$1,590,000</u>	<u>\$ 3,689,000</u>
<u>Inventories:</u>		
Raw materials	\$428,000	\$ 1,094,000
Work-in-process	1,688,000	1,960,000
Finished goods	629,000	721,000
	<u>\$2,745,000</u>	<u>\$ 3,775,000</u>
<u>Property and Equipment:</u>		
Equipment	\$ 9,985,000	\$12,165,000
Leasehold improvements	2,064,000	2,072,000
Furniture and fixtures	102,000	107,000
	12,151,000	14,344,000
Less: accumulated depreciation and amortization	(8,054,000)	(9,353,000)
	<u>\$ 4,097,000</u>	<u>\$ 4,991,000</u>
<u>Accrued Expenses</u>		
Compensation related	\$ 669,000	\$900,000
Warranty reserve	100,000	250,000
other	137,000	214,000
	<u>\$ 906,000</u>	<u>\$1,364,000</u>

Unbilled accounts receivable represent costs and profits in excess of billed amounts on contracts-in-progress at year-end. Such amounts are billed based upon the terms of the contractual agreements. Such amounts are substantially collected within one year.

At December 31, 1999 and 2000, equipment includes \$1,211,000 of assets financed under capital lease arrangements, net of \$281,000 and \$600,000 of accumulated amortization, respectively. Depreciation expense amounted to \$713,000, \$1,126,000, and \$1,299,000 for the years ended December 31, 1998, 1999 and 2000, respectively.

Supplemental Cash Flow Information:

	For The Years Ended December 31,		
	1998	1999	2000
Cash paid for interest	\$ 62,000	\$ 232,000	\$ 230,000
Non-cash investing and financing activities:			
Equipment acquired through issuance of capital lease	-	34,000	-
Redeemable preferred stock exchanged for common stock	-	-	17,125,000
Common stock options issued for past services in lieu of accounts payable	-	14,000	72,000
Issuance of warrants in connection with debt and lease agreements	-	491,000	131,000
Dividends accrued not paid	271,000	95,000	-
Conversion of notes payable to purchase preferred and common stock	-	1,875,000	500,000
Disposal of fully depreciated property and equipment	277,000	-	-
Equity issuance costs not yet paid	-	-	40,000
Assets acquired through issuance of stock options	-	-	26,000

Quarterly Financial Data (Unaudited)

2000	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net revenues	\$1,669,000	\$2,249,000	\$2,372,000	\$3,666,000
Loss from operations	(3,616,000)	(4,014,000)	(9,292,000)	(4,046,000)
Net loss	(3,760,000)	(4,081,000)	(9,318,000)	(3,497,000)
Basic and diluted loss per common share				
Net loss per common share before cumulative effect of accounting change	(\$0.47)	(\$0.23)	(\$0.53)	(\$0.23)
Cumulative effect of accounting change	-	-	-	(0.60)
Net loss per common share	(\$0.47)	(\$0.23)	(\$0.53)	(0.83)
1999				
Net revenues	\$1,491,000	\$1,478,000	\$1,970,000	\$2,183,000
Loss from operations	(2,565,000)	(2,310,000)	(2,813,000)	(2,877,000)
Net loss	(2,616,000)	(2,412,000)	(2,860,000)	(2,987,000)
Basic and diluted loss per common share	(\$0.36)	(\$0.35)	(\$0.43)	(\$0.42)