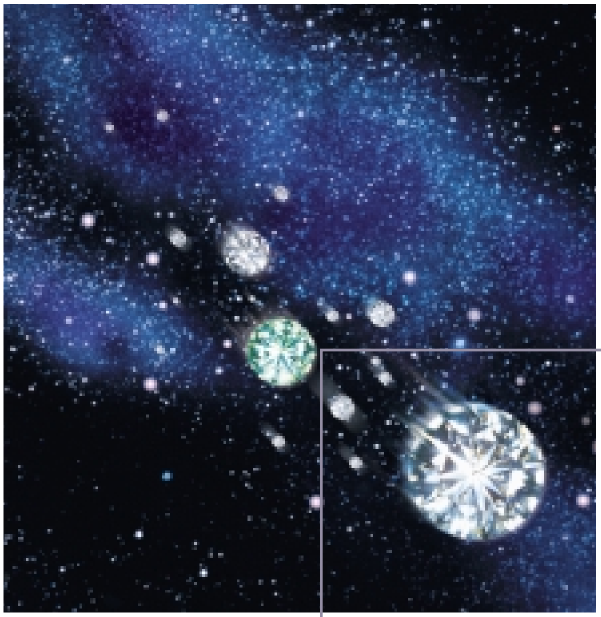
Annual Report
C3, Inc.

1999



CHARLES & COLVARD™
Created
MOISSANITE

NOW AVAILABLE ON EARTH

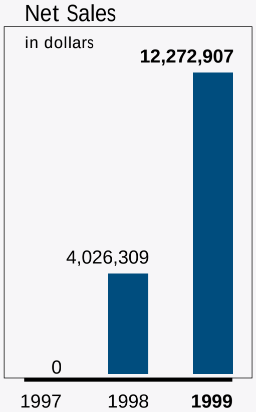
A century ago, Nobel prize winner Dr. Henri Moissan discovered minute quantities of a new mineral in an ancient meteorite from the remote Canyon Diablo in Arizona. At its essence was the potential for a shimmering brilliance, fire, luster and incredible hardness. However, the available quantity of this natural moissanite mineral, even if Dr. Moissan had thought of it at the time, was too limited to make even a pair of earrings.

Inspired by Dr. Moissan's discovery, Charles & Colvard, formerly C3, was founded in 1995 to create moissanite jewels for use in fine jewelry. Charles & Colvard is the sole manufacturer and marketer of moissanite – an uncommon blend of art and science. With brilliance, fire and luster unlike any jewel you've ever seen, Charles & Colvard created moissanite is the essence of truly stunning jewelry.

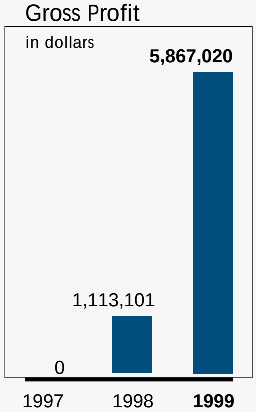
FINANCIAL HIGHLIGHTS

Year Ended December 31	**1999**	1998	1997
Net sales	**$ 12,272,907**	$ 4,026,309	$ –
Gross profit	**5,867,020**	1,113,101	–
Operating expenses	**12,160,329**	9,662,922	5,391,289
Operating loss	**6,293,309**	8,549,821	5,391,289
Net loss	**5,151,683**	6,733,488	4,920,159
Net loss per common share	**.73**	0.97	1.73
Working capital	**26,709,142**	33,887,496	43,687,405
Shareholders' equity	**33,494,143**	37,996,332	44,046,281

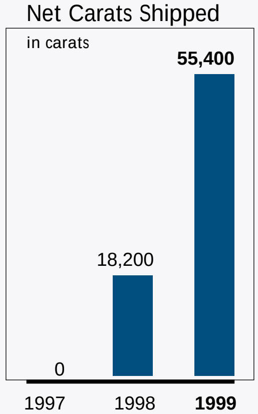
Net Sales



Gross Profit



Net Carats Shipped



LETTER TO SHAREHOLDERS

Jeff N. Hunter
Chairman and Chief Executive Officer

Dear Shareholders,

From my point of view, I would characterize 1999 as "the worst of times and the beginning of the best of times." It was the worst of times because we missed our sales and profit goals. It was the beginning of the best of times because we used our mistakes as evidence for the kind of changes we should make. We cut operating cost, which reduced our net loss from $6.7 million a year ago to $5.2 million in 1999. Although we missed our sales and profit goals, we learned, and in the process we tripled sales in 1999 over 1998; we sold over $12.2 million of product.

1999 Results

- Achieved unprecedented gains in the net usable yield of two-inch diameter moissanite crystals resulting in nearly a three-fold increase in salable moissanite jewels.
- Tripled sales in 1999 over 1998; unfortunately, we did not reach our profit objectives.
- Launched a global branding strategy for Charles & Colvard created moissanite.

" I chose to wear Charles & Colvard created moissanite jewelry because of the beauty of the jewels and what they represent - unique jewelry which women like me can buy for themselves."

Mia Hamm

That achievement was made more meaningful by the new category-defining introduction of a global brand-building program. Late in the fourth quarter we recalibrated our "strategic intent." As defined by the *Harvard Business Review*, "strategic intent" means stepping outside the calculated comfort of what is conventionally doable. That's what President John F. Kennedy did when he articulated his vision of an American on the moon, and then set what was deemed an impossible deadline. Yet an American reached the moon on time.

Charles & Colvard has initiated something similar, but on a more earthly scale. We are stepping out of the comfort zone to introduce a new brand, unlike any before it. We are creating a brand based on an uncommon blend of science and art. We are creating a brand fueled by a powerful trend in today's world: the skyrocketing surge of self-confident, successful women making their mark in their chosen professions. We are creating a brand which will enable Charles & Colvard to pilot its strategic course and maintain the kind of profit margins which will increase shareholder value well beyond our patent-protected years.

PERSPECTIVE

Early in our history, a high-end diamond retailer in New York asked to see several prototypes of colorless moissanite jewels. His immediate response was, "If I took these moissanite stones to 47th Street (the diamond district), I could walk away with $30,000." It was then that we realized we had an ethical dilemma. Should we continue with immediate plans to sell moissanite or wait and solve the problem of misidentification before going public? We made the right decision. We stopped plans to sell moissanite until we developed a test instrument that could accurately and reliably distinguish moissanite from diamond, and began a comprehensive education and awareness program. We want the jewelry industry and consumers to be confident that they are buying authentic Charles & Colvard created moissanite jewels.

Before I continue, I am delighted to recognize two employees whose performance was truly outstanding in contributing to our success in manufacturing and product development. On behalf of the Company and its shareholders, our heartfelt congratulations go to Mr. Earl Hines, Director of Manufacturing, and Dr. Mark Kellam, Director of Technology. I am proud to have them as team-mates and personally thank them for their commitment to excellence in crystal yield and manufacturing improvements.

MANUFACTURING

Process Overview. The manufacturing process begins when we receive large single crystals of moissanite from Cree, Inc. (Cree). The crystals are precision cut into small pieces called "preforms" that approximate the shape and size of the finished jewel. We ship the preforms to our faceting vendors, where they are cut and polished by hand to our exacting standards. The finished loose jewels are returned to us, where we inspect, sort and grade them by clarity, color and cut.

Crystal Yields. Crystal yields at the beginning of the year were hovering at a low point. Since demand was outstripping supply, we were concerned about increasing the customer base until the supply issues were resolved. In the second half of the year, yields and overall quality of two-inch diameter moissanite crystals improved at a dramatic and unprecedented rate. In less than 12 months,

” I selected moissanite jewels for the Costume Designers Guild Awards because they are an uncommon blend of art and science. My custom-designed pieces are unique and make a statement about what I have achieved.“

Brooke Shields

we nearly tripled the number of salable carats we can produce per crystal. To support this increase in crystal yield and supply, manufacturing capabilities, including implementation of a cost-effective preform process, were increased substantially over the year.

In addition, two critical milestones were reached for three-inch diameter crystals. The next goal for this program is a fully repeatable process which can again double the number of carats produced per crystal and advance gross margins.

Intellectual Property. We are the sole supplier of moissanite jewels with product patents that give us broad rights to manufacture, market and distribute moissanite jewels exclusively in any shape or color until 2015 in the United States. These patents, combined with our exclusive supply agreement with Cree, afford Charles & Colvard the opportunity to create a powerful new brand, which results in greater confidence in the long-term value of Charles & Colvard created moissanite at all levels of the jewelry trade.

BRANDING

As the sole manufacturer of scientifically-made moissanite jewels, we are creating a unique brand image which positions moissanite as a jewel in its own right, distinct from all other jewels based on its fire, brilliance, luster, durability and rarity. Webster's 3rd International Dictionary defines "jewel" as an article with intrinsic value used for adornment; an ornament of precious metal often set with stones; and, worn as an accessory of dress, or a badge of order. The underlying implication is that a jewel has been crafted – that some or all of it is handmade. We firmly believe that Charles & Colvard created moissanite jewels are an uncommon blend of science and art which have unique intrinsic value.

The strategic global marketing program, launched in November 1999, targets "early adopter," working women ages 25-54 with an annual household income in excess of $50,000. The aim of our global marketing strategy is to inspire this group of women to seek out moissanite jewels for themselves, instead of waiting for a gift of jewelry. Additionally, as part of our transition from a technology-focused manufacturing company to a consumer-focused marketing company, we began doing business as Charles & Colvard in October. This name reflects the heritage of our Company and is consistent with our long-term branding and marketing strategy.

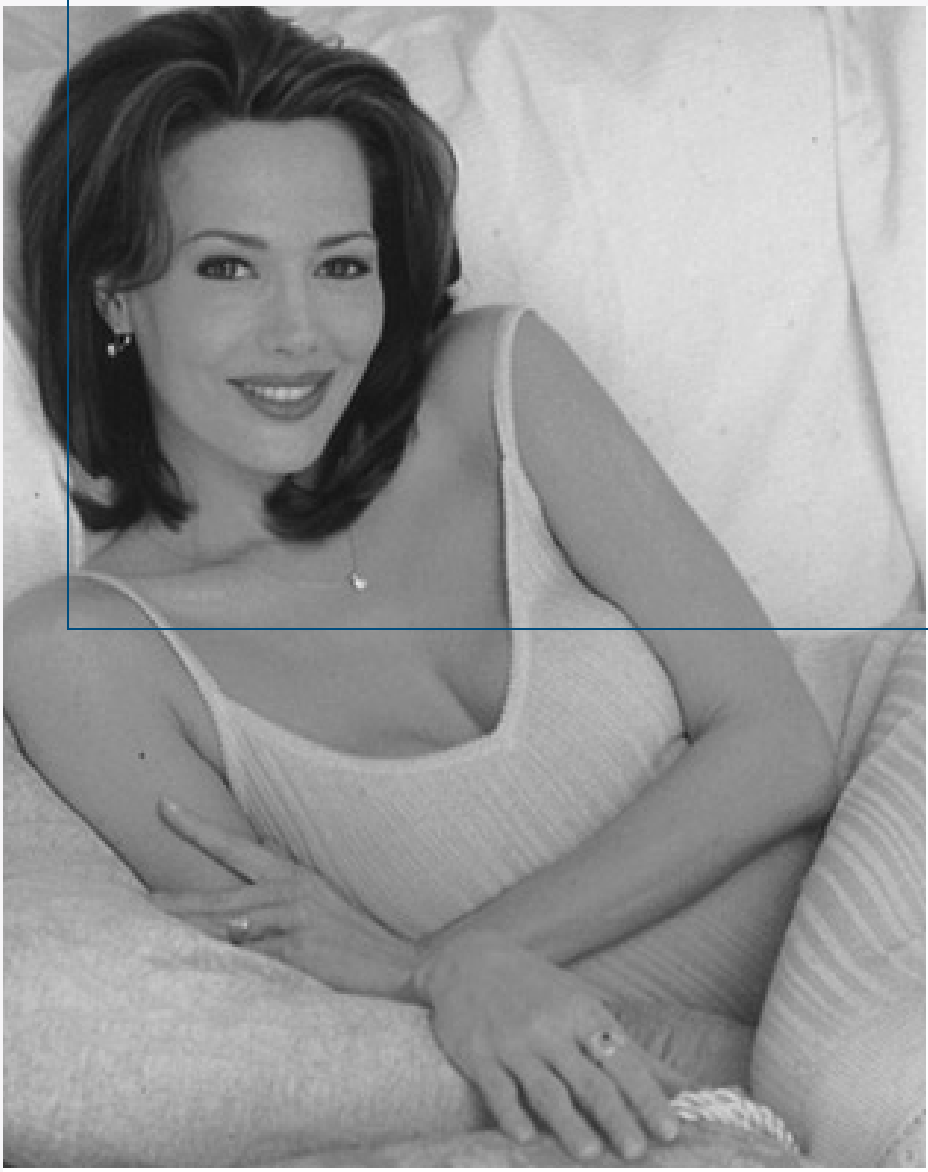
Public Relations. We announced the introduction of our global marketing strategy to stylists, trade press, fashion press and other influencers of lifestyle products at events in Los Angeles and New York in late 1999. As a result, here are some of the new faces who have chosen to wear Charles & Colvard created moissanite:

- Brooke Shields, host for the February 12, 2000 Costume Designers Guild Awards.
- Mia Hamm, for the February 14, 2000 ESPY awards, where she won the female athlete of the year award.
- Hunter Tylo, in *People Magazine* (January 31, 2000) and *Star Magazine* (February 1, 2000). Additionally, Ms. Tylo will be featured on behalf of the Company at public appearances and media interviews.

These women are high profile "achievers" who have made their mark in their respective professions.

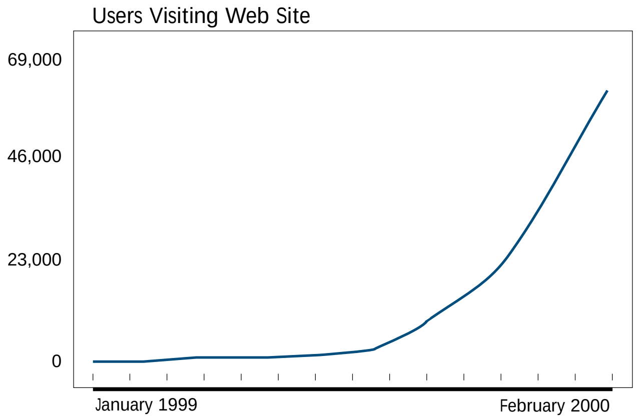
" Balancing the demands of a career and family can be difficult, but that doesn't mean I have to compromise the way I look and feel. I'm proud to wear unique pieces of Charles & Colvard created moissanite jewelry."

Hunter Tylo



Marketing and Advertising. Through our partnership with The Kaplan Thaler Group, an advertising and entertainment company based in New York, we created our strategic global marketing program. The first 120 days of the domestic launch of the global marketing campaign was a consumer communications blitz greater than any in our history. It targeted our profile of working women on national network and national cable television, in *Harper's Bazaar*, in the cinema in ten leading media markets and in local market special events and promotions.

The advertising campaign for Charles & Colvard created moissanite invited consumers to seek out our Web site (www.moissanite.com). The results were staggering. During the national advertising campaign, the number of visitors grew thirty fold – from a previous monthly average of 2,700 to over 65,000 for February as shown in the following graph.



Our exclusive international distributors have embraced the Charles & Colvard created moissanite brand. We work closely with these customers to apply the advertising and marketing materials, developed in the U.S., to their local markets. To drive brand recognition further in Europe, we have entered into an agreement with Emisphere, a marketing and communications company in Milan, Italy, for public relations services in certain European countries.

Sales. We believe moissanite is best sold through independent retail jewelers, where their staff can most effectively educate consumers on Charles & Colvard created moissanite's unique qualities. However, we have been unable to increase the number of these jewelers at a rate necessary to achieve our business objectives. Effective as of Spring 2000, we are accelerating our distribution program in North America. We are going to sell loose jewels through the two leading suppliers whose customer base includes the nation's most successful independent retail jewelers: Rio Grande (Rio) and Stuller Settings, Inc. (Stuller). We shall also sell through high-end jewelry manufacturers and designers whose skills will enhance the brand reputation of Charles & Colvard created moissanite jewels. This expanded distribution model, coupled with our brand-building program, will bring added value to our new partners, their customers and to our shareholders.

Established in 1944 and 1970, respectively, Rio and Stuller are two of the largest suppliers of jewelry-related products in North America, with thousands of customers each, a large percentage of which are independent retail jewelers. With reputations for service and quality unparalleled in the

Goals for 2000

- Broaden consumer and trade awareness of the Charles & Colvard created moissanite brand and accelerate distribution, especially in North America.
- Take the next significant step in building a bond with the self-confident woman achiever who will buy Charles & Colvard created moissanite for herself because she believes she's earned it.
- Achieve a repeatable process for three-inch diameter crystals to drive the cost per carat lower and double the number of salable jewels per crystal.

jewelry industry, Rio and Stuller will offer retail jewelers greater access to Charles & Colvard created moissanite jewels and jewelry. Our current customers will be able to purchase directly from Rio and Stuller, as well as selected jewelry manufacturers and designers with which we may forge agreements.

We shipped more than 55,000 carats of Charles & Colvard created moissanite jewels, ranging in size from 0.05 to approximately five carats, and more than 3,000 test instruments in 1999. Nearly two-thirds of sales were to international customers. ArsAurea Gems, our Italian distributor and single largest customer last year, is implementing an expanded sales model for Italy this year targeting the top 2,000 retail stores. Recomira-Ray, our partner in the Philippines, opened nine moissanite-only retail jewelry stores last year with plans to add more stores in 2000. Pricing was firm; in fact, demand for larger size round brilliant and fancy cut Charles & Colvard created moissanite jewels resulted in price increases.

THE FUTURE

To bring us to where we are today has required vision, courage and resources from you, our shareholders. In the past four years, we have invested nearly $40 million to make high quality moissanite crystals, to develop the corporate infrastructure and, most importantly, to introduce the Charles & Colvard created moissanite brand.

The future is clear as shown in our corporate mission:

> Charles & Colvard's mission is to manufacture and brand moissanite jewels on a worldwide basis. Charles & Colvard will turn the jewel into a brand with a competitive advantage beyond patent protection; it will be both the author and authenticator of the brand's promise and values. That brand imprint must be made indelible so it can enable Charles & Colvard to:
>
> - Offer a unique benefit;
> - Establish a new category, one exclusive to Charles & Colvard created moissanite and sustain our leadership and dominance in the category;
> - Control our profit margins;
> - Preserve the core business and stimulate further innovation; and,
> - Increase shareholder value year after year.

On behalf of the employees of Charles & Colvard, the members of our Board of Directors and my family, I thank you for your belief and confidence in Charles & Colvard created moissanite jewels.

Jeff N. Hunter

Jeff N. Hunter

SELECTED FINANCIAL DATA

The following selected statement of operations data for the years ended December 31, 1999, 1998 and 1997, and the selected balance sheet data at December 31, 1999 and 1998 have been derived from, and are qualified by reference to, the Company's financial statements included elsewhere in this report which have been audited by Deloitte & Touche LLP, independent auditors. The selected statement of operations data for the years ended December 31, 1997 and 1996 and for the period from inception through December 31, 1995 and the selected balance sheet data at December 31, 1997, 1996 and 1995 have been derived from audited financial statements not included herein. The selected financial data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Financial Statements and Notes thereto included elsewhere in this report.

	Year Ended December 31				Period from Inception (June 28, 1995) to December 31,
	1999	1998	1997	1996	1995
Statements of Operations Data					
Net sales	**$ 12,272,907**	$ 4,026,309	$ —	$ —	$ —
Cost of goods sold	**6,405,887**	2,913,208	—	—	—
Gross profit	**5,867,020**	1,113,101	—	—	—
Operating expenses:					
Marketing and sales	**6,410,042**	2,989,737	535,329	47,019	10,313
General and administrative (1)	**3,039,595**	2,671,445	2,744,898	134,715	10,822
Research and development	**2,710,692**	4,001,740	2,111,062	236,047	6,052
Total operating expenses	**12,160,329**	9,662,922	5,391,289	417,781	27,187
Operating loss	**6,293,309**	8,549,821	5,391,289	417,781	27,187
Interest income, net	**(1,141,626)**	(1,816,333)	(471,130)	(35,173)	—
Net loss	**$ 5,151,683**	$ 6,733,488	$ 4,920,159	$ 382,608	$ 27,187
Basic and diluted net loss per share	**$ 0.73**	$ 0.97	$ 1.73	$ 0.19	$ 0.02
Shares used in computing basic and diluted net loss per share (2)	**7,040,891**	6,954,600	2,845,773	2,036,813	1,704,000

December 31	**1999**	1998	1997	1996	1995
Balance Sheet Data					
Cash and equivalents	**$ 13,161,665**	$ 32,004,045	$ 43,980,385	$ 1,167,458	$ 9,109
Working capital	**26,709,142**	33,887,496	43,687,405	1,161,603	8,355
Total assets	**36,780,902**	40,168,323	44,873,089	1,226,134	32,913
Shareholders' equity	**33,494,143**	37,996,332	44,046,281	1,213,279	22,813

1. Compensation expense related to the issuance of stock options for 1999, 1998 and 1997 was $282,572, $527,811 and $1,632,804, respectively. In addition, for the year ended December 31, 1997, general and administrative expense includes $66,000 of compensation expense related to the January 2, 1997 issuance of common stock to Cree pursuant to a stock option. See Note 6 of Notes to Financial Statements.

2. The calculation of shares for all periods reflects a 2.13-for-1 common stock split effected in September 1997. The calculation also gives effect to the automatic conversion of the Series A Preferred Stock and Series B Preferred Stock into 2.13 shares of common stock for each share of Preferred Stock effective upon completion of the Company's initial public offering. See Notes 2, 4 and 5 of Notes to Financial Statements.

Overview The Company manufactures, markets and distributes Charles & Colvard created moissanite jewels (hereinafter referred to as moissanite or moissanite jewels) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name, silicon carbide (SiC), is a rare, naturally occurring mineral found primarily in meteorites. As the sole manufacturer of scientifically-made moissanite jewels, the Company is creating a unique brand image which positions moissanite as a jewel in its own right, distinct from all other jewels based on its fire, brilliance, luster, durability and rarity.

From its inception in June 1995 through June 30, 1998, the Company was a development stage enterprise that devoted its resources to fund research and development of colorless, scientifically-made moissanite jewels. At the same time, the Company assembled a management team, conducted market research and developed its strategic business plans. The Company began shipping moissanite to authorized retail jewelers in Atlanta and Miami / Fort Lauderdale during the second quarter of 1998. At that time, it launched limited consumer-focused advertising and promotion activities in those areas. In addition, the Company entered into exclusive distribution agreements with a number of international distributors.

Through the first half of 1999, the Company limited its efforts to expand the distribution of moissanite jewels as a result of limited product availability and the lack of confidence the Company had regarding the quality of the SiC crystals it was receiving. Late in the second quarter, the Company began to receive indications that the quality of the SiC crystals it was receiving was improving rapidly. The rate of improvement in the quality of the SiC crystals continued to accelerate through the end of 1999, far exceeding the Company's expectations. At the same time, the Company experienced a decline in shipments of moissanite jewels during the third quarter as a result of a slower than expected rate of adding retailers domestically, lack of targeted retailer-driven marketing programs abroad and poor overall jewelry market performance in certain international markets. The improved supply of SiC crystals along with the decrease in sales led to a significant increase in inventories of moissanite jewels. In December 1999, the Company and Cree agreed to reschedule approximately 50% of the expected shipments of SiC crystals from Cree to the second half of 2000 from the first half of 2000.

With the improvements in the supply of salable moissanite jewels, the Company launched its strategic global marketing program in the fourth quarter of 1999 to spur consumer awareness of this new category of jewel. In addition, in March 2000, the Company entered into distribution agreements with Stuller Settings, Inc. ("Stuller") and Rio Grande, two of the largest suppliers of jewelry-related products to the jewelry industry, for the North American distribution of moissanite. The Company has also sought and has entered into several agreements with domestic jewelry manufacturers. The Company's decision to enter into agreements with Stuller, Rio Grande and jewelry manufacturers is intended to rapidly increase the introduction of moissanite into the domestic jewelry market.

As discussed below, the shift in the Company's domestic distribution strategy may affect the Company's historical relationships between revenues and expenses as well as the Company's liquidity and capital requirements.

Results Of Operations

Year ended December 31, 1999 compared with Year ended December 31, 1998.

Net sales were $12,272,907 for the year ended December 31, 1999 compared to $4,026,309 for the year ended December 31, 1998, an increase of $8,246,598 or 204.8%. The Company's net sales of moissanite jewels and jewelry increased to approximately $11,680,000 in 1999 from approximately $3,285,000 in 1998. Additionally, during the first half of 1998, the company operated as a development stage enterprise and sales of moissanite jewels during that period of $324,000 were netted against research and development expenses on the operating statement because many of the jewels were associated with the Company's research and development program. The increase resulted primarily from expanded distribution of moissanite jewels. The Company will seek to add more distribution outlets both domestically and internationally in 2000 and beyond.

The Company’s gross profit margin was 47.8% for the year ended December 31, 1999 compared to 27.6% for the year ended December 31, 1998. The increase resulted from higher yields of moissanite jewels from SiC crystals purchased from Cree, thereby lowering the cost per carat. During 2000, particularly as the Company works with Cree to develop the manufacturing process for the new 3-inch diameter crystal growth systems, yields may vary. Any significant yield changes would have a material impact on gross profit. In addition, although the Company’s new domestic distribution strategy is designed to increase sales, it also is expected to decrease gross profit margin as a result of the discounts that will be made available for volume purchases.

Marketing and sales expenses were $6,410,042 for the year ended December 31, 1999 compared to $2,989,737 for the year ended December 31, 1998, an increase of $3,420,305 or 114.4%. The increase was due primarily to the development and introduction of the strategic global marketing program, including the creative and production efforts supporting the specific advertising messages that were launched in the fourth quarter of 1999, as well as compensation and other expenses related to additional staff. The Company has currently budgeted approximately $6 million for increased advertising and other marketing in 2000 as compared to approximately $3 million spent in 1999.

General and administrative expenses were $3,039,595 for the year ended December 31, 1999 compared to $2,671,445 for the year ended December 31, 1998, an increase of $368,150 or 13.8%. The increase resulted primarily from increased use of professional services and increased insurance and taxes on the Company’s increasing fixed assets.

Research and development expenses were $2,710,692 for the year ended December 31, 1999 compared to $4,001,740 for the year ended December 31, 1998, a decrease of $1,291,048 or 32.3%. The decrease resulted primarily from cost savings related to a more focused development effort late in 1998 and from the reduction of development efforts effective September 1, 1999, from a funding level of $240,000 per month to $120,000 per month.

Net interest income was $1,141,626 for the year ended December 31, 1999 compared to $1,816,333 for the year ended December 31, 1998, a decrease of $674,707 or 37.1%. This decrease resulted from lower interest income earned on lower cash balances due primarily to the use of the invested proceeds from the Company's initial public offering in November 1997.

Year ended December 31, 1998 compared with Year ended December 31, 1997.

Net sales for the year ended December 31, 1998, were $4,026,309. The Company generated net sales of approximately $3,285,000 from moissanite jewels and jewelry, and approximately $741,000 from the Company’s proprietary test instrument. In addition, during the first six months of 1998 prior to emerging from the development stage, the Company generated net sales of approximately $324,000 from moissanite jewels, which were netted against research and development expenses on the operating statement because many of the jewels were associated with the Company’s research and development program. There were no sales for the year ended December 31, 1997.

Gross profit was $1,113,101 or 27.6% of net sales for the year ended December 31, 1998. There were no sales for the year ended December 31, 1997.

Marketing and sales expenses were $2,989,737 for the year ended December 31, 1998 compared to $535,329 for the year ended December 31, 1997, an increase of $2,454,408 or 458.5%. The increase was primarily due to development and execution of consumer-focused advertising and marketing expenses associated with the initial launch of moissanite, increased market research and compensation and travel expenses associated with the expansion of the Company’s sales staff.

General and administrative expenses were $2,671,445 for the year ended December 31, 1998 compared to $2,744,898 for the year ended December 31, 1997, a decrease of $73,453 or 2.7%. The decrease resulted primarily from an approximate $1,200,000 decrease in compensation expense related to the issuance of stock options. Stock option compensation expense aggregated approximately $530,000 in 1998 compared to approximately $1,700,000 in 1997. This decrease was partially offset by an increase of approximately $1,100,000 resulting from compensation and other expenses related to additional staff, occupancy expenses, investor relations and legal expenses associated with business expansion and additional SEC compliance obligations incurred as a public company.

Research and development expenses were $4,001,740 for the year ended December 31, 1998 compared to $2,111,062 for the year ended December 31, 1997, an increase of $1,890,678 or 89.6%. The majority of the increase was attributable to development expenses incurred under the Company's June 1997 Development Agreement, January 1998 Supplemental Development Agreement and July 1998 Amended and Restated Development Agreement with Cree, Inc. In addition, production costs of moissanite jewels during the first half of 1998 while the Company was in the development stage, increased expenditures for the Company's internal development of prototype jewel pre-forming and faceting operations and compensation expense for Company research and development staff contributed to the increased expense.

Net interest income was $1,816,333 for the year ended December 31, 1998 compared to $471,130 for the year ended December 31, 1997, an increase of $1,345,203 or 285.5%. This increase resulted from higher interest income earned on higher cash balances due primarily to the investment of proceeds from the Company's initial public offering in November 1997.

Liquidity and Capital Resources The Company has financed its operations since inception primarily through the net proceeds of its initial public offering of common stock in November 1997 and, prior to such offering, through private equity sales. Net proceeds from the Company's initial public offering were $41,072,982. In 1999, the Company used $15,721,801 to fund operations and $3,487,501 to fund capital expenditures and patent expenses. At December 31, 1999, the Company had $13,161,665 of cash and cash equivalents and $26,709,142 of working capital.

In addition to the use of all of the crystal growth systems that Cree is required to provide at its expense under the Exclusive Supply Agreement, during 1999 the Company ordered a quantity of crystals that required additional crystal growth systems to be added. As permitted under the Exclusive Supply Agreement, Cree elected to have C3 purchase those systems. During 1999 the Company paid approximately $2.6 million to Cree for these systems which were placed in operation at various dates from August through December. The Company routinely evaluates Cree's progress under the Development Agreement and the size and quality of SiC crystals being produced by Cree in assessing its plans for larger orders which will require the acquisition of additional crystal growth systems. Under the terms of the Exclusive Supply Agreement, when the Company's orders for SiC crystals exceeds the capacity of the existing crystal growth systems, Cree may, at its sole discretion, elect to have the Company purchase the additional growth systems that will be needed or to fund the cost of the systems on its own and recoup its costs by incorporating the costs of the additional systems into the cost of the SiC crystals purchased by the Company. Under a letter agreement dated December 22, 1999, the Company and Cree agreed to shift approximately 50% of the SiC crystal purchases scheduled for the first half of 2000 to the second half of 2000. The Company has committed to purchase $10.6 million of SiC crystals during 2000. The Company's agreement with Cree concerning the pricing of moissanite under the Exclusive Supply Agreement will expire as of December 31, 2000 and will need to be renegotiated prior to that time. The Company plans to engage in increasingly substantial marketing activities to support the expanding distribution of moissanite jewels. Such activities may include advertising campaigns, cooperative advertising with retail jewelers and distributors, point-of-purchase displays, educational materials and individualized jeweler training. The Company has currently budgeted approximately $6 million for increased advertising and other marketing in 2000 as compared to approximately $3 million spent in 1999.

The four-year Development Agreement, as amended, between the Company and Cree requires the Company to fund a development program at Cree for $1.44 million annually through June 30, 2002. Either party may terminate the agreement if Cree does not meet the annual performance milestone or if the Company and Cree do not mutually agree on the performance milestones for the ensuing year.

The Company has no committed external sources of additional capital and has experienced negative cash flow from operating activities since inception. As indicated above, the Company used approximately $15.7 million in cash to fund operating activities in 1999, which primarily resulted from an increase in inventories of approximately $11.6 million and a net loss of approximately $5.2 million. Inventories increased due to dramatic improvements in the production of useable SiC crystals from the Company's sole supplier, Cree, as well as the slower than expected rate of growth in sales explained above.

The Company's new domestic distribution strategy, together with a continuation of its advertising strategy which commenced in the fourth quarter of 1999, is designed to substantially increase the sales volume of Charles & Colvard created moissanite and to allow the Company to slow the growth of inventories. The Company does not currently have committed capital resources to fund its desired level of expenditures. To continue pursuing this strategy, the Company believes that it will be required to seek additional capital resources during 2000. Therefore, the Company has engaged Scott & Stringfellow, Inc., a Virginia-based investment banking firm, to assist the Company in its capital raising activities. If the Company is not able to secure capital, it will be necessary for the Company to conserve cash by decreasing advertising expenditures, deferring or decreasing other operating expenditures and attempting to renegotiate its agreements with Cree. There can be no assurance that the Company will be able to secure the required financing to execute its new domestic distribution strategy, or, if available, that it will be available on terms acceptable to the Company. Additionally, there can be no assurance that if the Company does secure the desired capital resources that its new domestic distribution strategy will be successful.

Net Operating Loss Carryforward As of December 31, 1999 the Company had a net operating loss ("NOL") carryforward of approximately $15.3 million, which expires between 2010 and 2014. In accordance with Section 382 of the Internal Revenue Code of 1986, as amended, a change in equity ownership of greater than 50% of the Company within a three-year period results in an annual limitation on the Company's ability to utilize its NOL carryforwards that were created during tax periods prior to the change in ownership. As a result of various equity offerings and certain shareholder transactions, the utilization of the Company's NOL carryforwards has become limited, however, the Company does not believe this limitation will have a material effect on the Company's ability to utilize the NOL carryforward.

Year 2000 Compliance The year 2000 issue was a result of computer systems and software products not being coded to accept four digit entries in the date code field. As a result, these date code fields would not distinguish between dates in the 20th or 21st century. As part of its evolution to an operating company, the Company selected and implemented an enterprise-wide information technology system to support the long-term information needs of the Company. The Company selected a system that was year 2000 compliant. The procedures the Company undertook to prepare for the year 2000 for its other systems appear to be successful. The Company has experienced no significant disruptions due to this issue. The total costs associated with the Company's preparation for this issue were not significant.

Newly Issued Accounting Pronouncements In June 1998, Statement of Financial Accounting Standards No. 133 ("FAS 133"), Accounting for Derivative Instruments and Hedging Activities, was issued. This statement establishes standards for valuing and reporting at fair value all derivative instruments as either assets or liabilities. FAS 133 is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. The Company has not evaluated the impact of the adoption of this Statement on the financial statements.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of
C3, Inc. d/b/a Charles & Colvard
Research Triangle Park, North Carolina

We have audited the accompanying balance sheets of C3, Inc., d/b/a Charles & Colvard (the "Company") as of December 31, 1999 and 1998, and the related statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 1999. 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 in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company at December 31, 1999 and 1998, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP

Raleigh, North Carolina
February 21, 2000

STATEMENTS OF OPERATIONS

Year Ended December 31	1999	1998	1997
Net sales	**$ 12,272,907**	$ 4,026,309	$ —
Cost of goods sold	**6,405,887**	2,913,208	—
Gross profit	**5,867,020**	1,113,101	—
Operating expenses:			
Marketing and sales	**6,410,042**	2,989,737	535,329
General and administrative (Note 6)	**3,039,595**	2,671,445	2,744,898
Research and development	**2,710,692**	4,001,740	2,111,062
Total operating expenses	**12,160,329**	9,662,922	5,391,289
Operating loss	**6,293,309**	8,549,821	5,391,289
Interest income, net	**(1,141,626)**	(1,816,333)	(471,130)
Net loss	**$ 5,151,683**	$ 6,733,488	$ 4,920,159
Basic and diluted net loss per share (Note 2)	**$ 0.73**	$ 0.97	$ 1.73
Weighted-average common shares, basic and diluted (Note 2)	**7,040,891**	6,954,600	2,845,773

See notes to financial statements.

BALANCE SHEETS

December 31	1999	1998
Assets		
Current Assets:		
Cash and equivalents	**$ 13,161,665**	$ 32,004,045
Accounts receivable, net of allowance for doubtful accounts of $70,000 and $77,000 respectively	**1,331,528**	546,921
Interest receivable	**74,999**	121,276
Inventory, net (Note 2)	**14,767,888**	3,092,448
Prepaid expenses and other assets	**659,821**	294,797
Total current assets	**29,995,901**	36,059,487
Equipment, net (Note 3)	**6,292,221**	3,832,019
Patent and license rights, net (Note 3)	**492,780**	276,817
	$ 36,780,902	$ 40,168,323
Liabilities and Shareholders' Equity		
Current Liabilities:		
Accounts payable:		
Cree, Inc. (Note 8)	**$ 2,305,218**	$ 1,679,600
Other	**627,704**	250,157
Accrued expenses and other liabilities	**235,107**	223,248
Deferred revenue	**118,730**	18,986
Total current liabilities	**3,286,759**	2,171,991
Commitments (Note 8)		
Shareholders' Equity (Notes 4, 5, and 6):		
Common stock, no par value; 50 million shares authorized; 7,098,911 and 6,993,309 shares issued and outstanding at December 31, 1999 and 1998, respectively	**48,757,702**	48,149,406
Additional paid-in capital—stock options	**1,951,566**	1,910,368
Accumulated deficit	**(17,215,125)**	(12,063,442)
Total shareholders' equity	**33,494,143**	37,996,332
	$ 36,780,902	40,168,323

See notes to financial statements.

STATEMENTS OF SHAREHOLDERS' EQUITY

	1996 Series A Preferred Stock		1997 Series B Preferred Stock		Common Stock		Additional Paid-in		
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount	Capital Stock Options	Accumulated Deficit	Total Shareholders' Equity
Balance at December 31, 1996	105,000	$ 593,271	—	$ —	2,236,500	$ 1,029,803	$ —	$ (409,795)	$ 1,213,279
Exercise of stock option	—	—	—	—	24,601	66,000	—	—	66,000
Issuance of 1997 Series B preferred stock, net of offering costs of $34,999	—	—	682,500	4,981,375	—	—	—	—	4,981,375
Compensation expense related to stock options	—	—	—	—	—	—	1,632,804	—	1,632,804
Proceeds from IPO, net of offering costs of $3,927,018	—	—	—	—	3,000,000	41,072,982	—	—	41,072,982
Conversion of preferred stock to common stock	(105,000)	(593,271)	(682,500)	(4,981,375)	1,677,375	5,574,646	—	—	—
Net loss	—	—	—	—	—	—	—	(4,920,159)	(4,920,159)
Balance at December 31, 1997	—	—	—	—	6,938,476	47,743,431	1,632,804	(5,329,954)	44,046,281
Exercise of stock options	—	—	—	—	54,833	405,975	(250,247)	—	155,728
Compensation expense related to stock options	—	—	—	—	—	—	527,811	—	527,811
Net loss	—	—	—	—	—	—	—	(6,733,488)	(6,733,488)
Balance at December 31, 1998	—	—	—	—	6,993,309	48,149,406	1,910,368	(12,063,442)	37,996,332
Exercise of stock options	**—**	**—**	**—**	**—**	**105,602**	**608,296**	**(241,374)**	**—**	**366,922**
Compensation expense related to stock options	**—**	**—**	**—**	**—**	**—**	**—**	**282,572**	**—**	**282,572**
Net loss	**—**	**—**	**—**	**—**	**—**	**—**	**—**	**(5,151,683)**	**(5,151,683)**
Balance at December 31, 1999	**—**	**$ —**	**—**	**$ —**	**7,098,911**	**$48,757,702**	**$ 1,951,566**	**$ (17,215,125)**	**$ 33,494,143**

See notes to financial statements.

STATEMENTS OF CASH FLOWS

Year Ended December 31	**1999**	1998	1997
Operating Activities			
Net loss	**$ (5,151,683)**	$ (6,733,488)	$ (4,920,159)
Adjustments:			
Depreciation and amortization	**741,402**	223,708	26,154
Stock option compensation	**282,572**	527,811	1,698,804
Loss on disposal of long term assets	**69,934**	—	—
Changes in assets and liabilities:			
Accounts receivable	**(784,607)**	(542,623)	(4,298)
Interest receivable	**46,277**	56,378	(177,654)
Inventory	**(11,675,440)**	(2,813,846)	(278,602)
Prepaid expenses and other assets	**(365,024)**	(221,523)	(66,274)
Accounts payable	**1,003,165**	1,125,461	791,441
Accrued expenses and other liabilities	**11,859**	223,248	—
Deferred revenue	**99,744**	(3,526)	22,512
Net cash used in operating activities	**(15,721,801)**	(8,158,400)	(2,908,076)
Investing Activities			
Purchases of equipment	**(3,159,625)**	(3,827,322)	(221,177)
Patent and license rights costs	**(327,876)**	(146,346)	(112,177)
Net cash used in investing activities	**(3,487,501)**	(3,973,668)	(333,354)
Financing Activities			
Stock options exercised	**366,922**	155,728	—
Proceeds from common stock offerings, net of costs	**—**	—	41,072,982
Proceeds from preferred stock offerings, net of costs	**—**	—	4,981,375
Net cash provided by financing activities	**366,922**	155,728	46,054,357
Net change in cash and equivalents	**(18,842,380)**	(11,976,340)	42,812,927
Cash and equivalents at beginning of year	**32,004,045**	43,980,385	1,167,458
Cash and equivalents at end of year	**$ 13,161,665**	$ 32,004,045	$ 43,980,385

See notes to financial statements.

1. Organization and Basis of Presentation

C3, Inc. ("C3" or the "Company"), was incorporated in North Carolina on June 28, 1995, and manufactures, markets and distributes scientifically-created moissanite jewels (hereinafter referred to as moissanite or moissanite jewels) for sale in the jewelry market. Moissanite, also known by its chemical name, silicon carbide (SiC), is a rare, naturally occurring mineral found primarily in meteorites. Moissanite is being positioned as a jewel in its own right, distinct from all other jewels based on its fire, brilliance, luster, durability and rarity and it is being marketed to working women ages 25-54 with an annual household income in excess of $50,000. As part of its transition from a technology-focused manufacturing company to a consumer-focused marketing company, C3 began doing business as Charles & Colvard in the fall of 1999. In addition to moissanite jewels, the Company has developed and began selling, in 1998, a test instrument, which distinguishes colorless moissanite jewels from diamond.

From its inception in June 1995 through June 30, 1998, the Company was a development stage enterprise that devoted its resources to fund research and development of colorless, scientifically made moissanite jewels. At the same time, the Company assembled a management team, conducted market research and developed its strategic business plans. The Company began shipping moissanite to authorized retail jewelers in Atlanta and Miami/Ft. Lauderdale during the second quarter of 1998. At that time it launched limited consumer-focused advertising and promotion activities in those areas. In addition, the Company entered into exclusive distribution agreements with a number of international distributors.

Through the first half of 1999, the Company limited its efforts to expand the distribution of moissanite jewels as a result of limited product availability and the lack of confidence the Company had regarding the quality of the SiC crystals it was receiving. Late in the second quarter, the Company began to receive indications that the quality of the SiC crystals it was receiving was improving rapidly. The rate of improvement in the quality of the SiC crystals continued to accelerate through the end of 1999, far exceeding the Company's expectations. At the same time, the Company experienced a decline in shipments of moissanite jewels during the third quarter as a result of a slower than expected rate of adding retailers domestically, lack of targeted retailer-driven marketing programs abroad and poor overall jewelry market performance in certain international markets. The improved supply of SiC crystals along with the decrease in sales led to a significant increase in inventories of moissanite jewels. With the improvements in the supply of salable moissanite jewels, the Company launched its strategic global marketing program in the fourth quarter of 1999 to spur consumer awareness of this new category of jewel. In addition, in 2000, the Company has entered into business relationships with certain domestic jewelry manufacturers and gemstone distributors to accelerate the distribution of moissanite jewels.

The ability of the Company to successfully develop, manufacture and market its proprietary products is dependent upon many factors, and during the period required to develop and market these products, the Company may require additional funds which may not be available to it. Accordingly, there can be no assurance of the Company's future success.

All the Company's activities are within a single business segment.

2. Summary of Significant Accounting Policies

Cash and Equivalents The Company considers all money market accounts, debt instruments purchased with an original maturity of three months or less, and other highly liquid investments to be cash equivalents.

Inventory Inventories are stated at the lower of cost or market determined on a first in, first out basis. Test instruments are shown net of a reserve for excess inventory of $242,000 and $132,000, respectively.

December 31	1999	1998
Moissanite		
Raw materials	**$ 371,843**	$ 140,411
Work-in-process	**5,779,326**	819,953
Finished goods	**8,127,119**	1,113,619
	14,278,288	2,073,983
Test instruments	**489,600**	1,018,465
Total Inventory	**$ 14,767,888**	$ 3,092,448

Equipment Equipment is recorded at cost and depreciated on the straight-line method based on estimated useful lives of three to 12 years. Leasehold improvements are amortized on the straight-line method over the life of the related lease.

Patents and License Rights The Company capitalizes costs associated with obtaining patents issued or pending for inventions and license rights related to the manufacture of moissanite jewels and moissanite jewel test instruments. Such costs are amortized over 17 years.

Accounting for Long-Lived Assets The Company accounts for long-lived assets in accordance with Statement of Financial Accounting Standards No. 121 ("FAS 121"), Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be disposed of. The Company evaluates the recoverability of its long-lived assets for financial impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be fully recoverable. Based on these evaluations, there were no significant adjustments to the carrying value of long-lived assets in 1999 or 1998.

Concentrations of Credit Risk Financial instruments which potentially subject the Company to concentrations of credit risk are primarily cash equivalents and trade receivables. The Company places its cash equivalents with high quality financial institutions and invests in low risk securities including U.S. Treasury bills and money market funds, government agency notes and commercial paper.

Trade receivables are generated from a broad and diverse group of customers, primarily independent retail jewelry stores. The Company extends credit to its customers based upon an evaluation of the customer's financial condition and credit history and generally does not require collateral. During 1999 one customer accounted for approximately 11.7% of the revenue. During 1998, no customer accounted for 10% or more of the Company's revenue. At December 1999 and 1998, no customer accounted for more than 10% of total accounts receivable.

Revenue Recognition Revenue is generally recognized when products are shipped. From time to time, the Company ships certain items on "memo" terms. For goods shipped on memo terms, the customer receives title to the goods and assumes the risk of loss, however they have absolute right of return during the specified memo period. The Company recognizes revenue on these transactions upon the earlier of 1) the customer informing the Company that it will keep the product or 2) the expiration of the memo period.

Advertising Costs Advertising production costs are expensed as incurred. Media placement costs are expensed over the period the advertising appears. Advertising expenses for the years ended December 31, 1999, 1998 and 1997 amounted to approximately $2,920,000, $750,000 and $69,000, respectively. At December 31, 1999, prepaid expenses and other assets included approximately $215,000 of prepaid advertising costs.

Research and Development All research and development costs are expensed as incurred.

Stock Compensation The Company's stock option plans are accounted for in accordance with Accounting Principles Board Opinion No. 25 ("APB 25"), Accounting for Stock Issued to Employees. In January 1996, the Company adopted the disclosure requirements of Statement of Financial Accounting Standards No. 123 ("FAS 123"), Accounting for Stock Based Compensation.

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 period. Actual results could differ from those estimates.

Income Taxes The Company accounts for income taxes under the provisions of Statement of Financial Accounting Standards No. 109 ("FAS 109") Accounting for Income Taxes. Under FAS 109, deferred income taxes are recognized for the tax consequences of "temporary" differences by applying enacted statutory tax rates applicable to future years to difference between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is more likely than not expected to be realized. As of December 31, 1999 and 1998, the net deferred tax assets have been fully reserved.

Net Loss Per Share In 1997, the Company adopted Statement of Financial Accounting Standards No. 128 ("FAS 128"), Earnings Per Share. FAS 128 requires the presentation of both basic and diluted earnings per share, regardless of materiality, unless per share amounts are equal. Basic loss per share computations are based on the weighted-average common shares outstanding. Diluted loss per share computations include the dilutive effect, if any, of stock options and warrants using the treasury stock method.

Warrants to purchase 300,000 shares of common stock at $18 per share, options outstanding at December 31, 1999 to purchase 1,229,118 shares of common stock (exercise prices ranging from $1.88 – $16.44), and retroactive conversion of the Series A and Series B preferred stock into common shares as of the date of issuance were excluded from the computation of diluted loss per share because either the options' exercise price was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to loss per share.

Newly Issued Accounting Pronouncements In June 1998, Statement of Financial Accounting Standards No. 133 ("FAS 133"), Accounting for Derivative Instruments and Hedging Activities, was issued. This statement establishes standards for valuing and reporting at fair value all derivative instruments as either assets or liabilities. FAS 133 is effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. The Company has not evaluated the impact of the adoption of this statement on the financial statements.

Reclassification Certain 1998 and 1997 amounts have been reclassified to conform with the 1999 presentation.

3. Equipment and Patent and License Rights

Equipment balances are summarized as follows:

December 31	**1999**	1998
Machinery and equipment	**$ 6,391,946**	$ 3,614,984
Computer equipment	**435,847**	310,054
Furniture and fixtures	**212,412**	55,209
Leasehold improvements	**101,890**	44,345
Construction in progress	**28,227**	39,440
Total	**7,170,322**	4,064,032
Accumulated depreciation	**(878,101)**	(232,013)
Total equipment, net	**$ 6,292,221**	$ 3,832,019

Depreciation expense for 1999, 1998 and 1997 was $648,565, $210,293 and $20,268, respectively.

Patent and license rights balances are summarized as follows:

December 31	**1999**	1998
Patent and license rights	**$ 605,049**	$ 298,182
Accumulated amortization	**(112,269)**	(21,365)
Patent and license rights, net	**$ 492,780**	$ 276,817

4. Common Stock

On September 25, 1997, the Company effected a 2.13-for-1 stock split of its common stock. The effect of this stock split is reflected as if it had occurred at the beginning of the earliest period presented.

On November 14, 1997, the Company completed an initial public offering of 3,000,000 shares of its common stock with net proceeds of $41,072,982 (net of offering costs of $3,927,018).

5. Preferred Stock

The Company has authorized 10 million shares of preferred stock, no par value. The preferred stock may be issued from time to time in one or more series.

1996 Series A Preferred Stock—The Board designated 105,000 shares of its preferred stock as 1996 Series A preferred stock. In September 1996, the Company issued 105,000 shares of Series A preferred stock with net proceeds of approximately $593,000 (net of offering costs of $10,479). All of the 1996 Series A preferred stock was converted to common stock concurrent with the initial public offering at a ratio of 2.13 common shares for each share of preferred stock.

1997 Series B Preferred Stock—The Company designated 682,500 shares of its preferred stock as 1997 Series B preferred stock. Effective March 7, 1997, the Company completed the offering of 682,500 shares of its 1997 Series B preferred stock with net proceeds of approximately $5 million. All of the 1997 Series B preferred stock was converted to common stock concurrent with the 1997 initial public offering at a ratio of 2.13 common shares for each share of preferred stock.

On February 21, 1999 the Company adopted a Shareholder Rights Plan under which all shareholders of record as of March 8, 1999 received rights to purchase shares of a new series of Preferred Stock. The adoption of this plan is intended as a means to guard against abusive takeover tactics. The rights will be exercisable only if a person or group acquires or announces a tender offer to acquire 20% or more of the Company's common stock. Under the plan all shareholders except the purchaser will be entitled to acquire the Company's common stock at a 50% discount. The rights will trade with the Company's common stock, unless and until they are separated upon the occurrence of certain future events.

6. Stock Option Plans

In 1996, the Company adopted the 1996 Stock Option Plan of C3, Inc. ("1996 Option Plan") under which options to acquire 777,450 common shares, reduced by the number of options granted outside the 1996 Option Plan, may be granted to key employees, directors and independent consultants. Under the 1996 Option Plan, both incentive and non-qualified options may be granted under terms and conditions established by the compensation committee of the board of directors. The exercise price for incentive options will be the fair market value of the related common stock on the date the option is granted. Options granted under the 1996 Option Plan generally vest equally over a three-year period and have terms of 10 years. The Company currently has no plans to award additional options under the 1996 Option Plan.

In September 1997, the Company adopted the 1997 Omnibus Stock Plan of C3, Inc. (the "1997 Omnibus Plan"). The 1997 Omnibus Plan authorizes the Company to grant stock options, stock appreciation rights and restricted awards (collectively, "awards") to selected employees, independent contractors and directors of the Company and related corporations in order to promote a closer identification of their interests with those of the Company and its shareholders. The maximum number of shares of common stock for which awards may be granted under the 1997 Omnibus Plan may be increased from time to time to a number of shares equal to (i) 20% of the shares of common stock outstanding as of that time less (ii) the number of shares of common stock subject to outstanding options under the 1996 Option Plan. The number of shares reserved for issuance under the 1997 Omnibus Plan may also be adjusted upon certain events affecting the Company's capitalization. Options granted under the 1997 Omnibus Plan generally vest over three to five-year periods and have terms of 10 years. The Board of Directors has reserved 930,912 shares for the 1997 Omnibus Plan.

The following is a summary of activity for the Company's two stock option plans:

	1996 Option Plan		1997 Omnibus Plan	
	Number Of Shares	Weighted-Average Exercise Price	Number Of Shares	Weighted-Average Exercise Price
1997				
Outstanding at beginning of year	200,220	$ 2.37	—	$ —
Granted	461,571	4.64	477,000	14.61
Outstanding at end of year	661,791	3.95	477,000	14.61
1998				
Granted	—	—	195,000	8.94
Exercised	93,379	4.97	—	—
Canceled	13,547	3.66	48,366	14.67
Outstanding at end of year	554,865	3.78	623,634	12.83
1999				
Granted	**—**	**—**	**175,800**	**11.19**
Exercised	**92,620**	**3.49**	**2,333**	**10.10**
Canceled	**—**	**—**	**56,853**	**13.09**
Outstanding at end of year	**462,245**	**$ 3.83**	**740,248**	**$ 12.43**

During 1996, the Company granted options to acquire 37,275 shares of common stock to certain consultants. These options, which were granted prior to the establishment of formal plans, are immediately exercisable, have a term of five years and an exercise price of $1.88 per share. During 1999, 10,650 of these options were exercised.

During 1995, the Company issued Cree, Inc. ("Cree"), a related company, an option to acquire (1%) of the outstanding shares of common stock on the date of exercise at an exercise price of $500 at any time through July 1, 1997. However, the Company retained the right to waive the $500 option fee and issue the stock at any time during the option period. The Company issued 24,601 shares of common stock to Cree pursuant to this right on January 2, 1997. The Company recorded compensation expense of approximately $66,000 in 1997 related to this transaction.

The following summarizes information about stock options outstanding at December 31, 1999:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Outstanding as of 12/31/1999	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Exercisable as of 12/31/1999	Weighted-Average Exercise Price
$1.64- $3.28	170,755	6.6	$ 2.2404	170,755	$ 2.2404
$3.29- $4.93	318,115	7.0	$ 4.5247	306,755	$ 4.5519
$6.58- $8.22	65,300	7.2	$ 7.8331	30,431	$ 8.0120
$8.23- $9.86	199,200	8.1	$ 9.1482	73,499	$ 8.8977
$9.87-$11.51	17,498	7.2	$ 10.8100	16,664	$ 10.8100
$13.15-$14.79	176,000	8.0	$ 13.8659	111,431	$ 13.8696
$14.80-$16.44	282,250	7.5	$ 15.0076	47,600	$ 15.0000
	1,229,118	7.4	$ 8.9668	757,135	$ 6.7575

In accordance with APB 25, and the provision of FAS 123 as applicable to consultants, the Company recorded compensation expense of approximately $280,000, $530,000 and $1,633,000 during 1999, 1998 and 1997, respectively, relating to stock options granted with exercise prices less than market value or granted to consultants. Had compensation expense for all stock options been determined consistent with FAS 123, rather than APB 25, the Company's net loss and loss per share for the years ended December 31, 1999, 1998 and 1997 would have been increased to the pro forma amounts indicated below:

	1999	1998	1997
Net loss, as reported	**$ 5,151,683**	$ 6,733,488	$ 4,920,159
Pro forma net loss	**$ 6,029,709**	$ 7,525,000	$ 5,561,000
Basic and diluted net			
Loss per share:			
As reported	**$ 0.73**	$ 0.97	$ 1.73
Pro forma	**$ 0.86**	$ 1.08	$ 1.95

The fair value of each option grant is estimated on the grant date. Options granted during 1997 were valued using the minimum value method and 1998 and 1999 grants were valued using a Black-Scholes option pricing model. The valuations for the years ended December 31, 1999, 1998 and 1997 were based on the following assumptions:

	1999	1998	1997
Weighted-average grant date fair value	**$ 8.46**	$ 7.46	$ 10.28
Weighted-average expected lives (in years)	**7.00**	9.98	3.04
Risk-free interest rate	**6.65%**	5.13%	5.50%
Dividend yield	**0%**	0%	0%
Volatility factor	**.766**	.782	0%

In connection with the Company's initial public offering on November 14, 1997, the Company granted the underwriters options to purchase 450,000 shares of common stock at $15 per share solely to cover over-allotments in the sale of common stock in the offering. The options had an exercise term of 45 days and expired as of December 31, 1997. Also in connection with the offering, the Company issued warrants to the underwriter to purchase 300,000 shares of common stock at a price of $18 per share. The warrants are exercisable for a period of four years beginning November 14, 1998.

7. Income Taxes

The Company accounts for income taxes under the liability method in accordance with FAS 109. Under the liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities.

Significant components of the Company's deferred tax assets and liabilities are as follows:

December 31	**1999**	1998
Federal and state loss carryforwards	**$ 5,993,000**	$ 3,716,000
Benefit of research tax credits	**360,000**	234,000
Reserves and accruals	**189,000**	131,000
Depreciation	**(366,000)**	(168,000)
Total deferred tax assets	**6,176,000**	3,913,000
Less valuation allowance	**(6,176,000)**	(3,913,000)
Net deferred tax assets	**$ —**	$ —

A reconciliation between expected income taxes, computed at the statutory federal income tax rate applied to pretax accounting income, and the income taxes included in the statements of operations for the years ended December 31, 1999, 1998 and 1997 follows:

	1999	1998	1997
Anticipated income tax			
benefit at the statutory federal rate	**$ (1,752,000)**	$ (2,290,000)	$ (1,673,400)
State income tax benefit,			
net of federal tax effect	**(264,000)**	(344,000)	(252,000)
Research tax credits	**(126,000)**	(142,000)	—
Compensation expense—stock options	**111,000**	164,000	640,000
Other	**71,000**	9,000	33,000
Increase in valuation allowance	**1,960,000**	2,603,000	1,252,400
Income tax (benefit) expense	**$ —**	$ —	$ —

At December 31, 1999, the Company has operating and economic loss carryforwards of approximately $15,300,000 expiring through 2014, which can be offset against future federal and state taxable income. In accordance with Section 382 of the Internal Revenue Code of 1986, as amended, a change in equity ownership of greater than 50% of the Company within a three-year period results in an annual limitation on the Company's ability to utilize its NOL carryforwards that were created during tax periods prior to the change in ownership. As a result of various equity offerings and certain shareholder transactions, the utilization of the Company's NOL carryforwards has become limited, however, the Company does not believe this limitation will have a material effect on the Company's ability to utilize the NOL carryforward.

Based on the Company's assessment of the future net realizable value of deferred tax assets, a valuation allowance has been provided as it is more likely than not that sufficient taxable income will not be generated to realize certain temporary differences and tax credit carryforwards. Additionally, at December 31, 1999, approximately $345,000 of the valuation allowance was attributable to the potential tax benefit of stock option transactions, which will be credited directly to common stock if realized.

8. Commitments

Operating Lease The Company leases approximately 12,700 square feet of mixed use space from an unaffiliated third party at a base cost of approximately $10,400 per month, plus contingent rentals based on the Company's proportionate share of the lessor's operating costs, as defined in the lease agreement. The lease expires August 31, 2004, however, the Company may cancel the lease effective August 31, 2002 by delivering to the lessor written notice nine months prior to the cancellation date and by paying a cancellation fee of $36,000. The lease provides for escalations of the base rent throughout the lease term, up to $11,700 at September 1, 2003.

In September 1999, the Company entered into an agreement to sublease approximately 13,807 square feet of office space, contiguous to its existing space, from an unaffiliated third party at a base cost of approximately $12,100 per month, plus contingent rentals based on the Company's proportionate share of the lessor's operating costs, as defined in the lease agreement. The lease expires on October 30, 2002.

The future minimum lease payments, including the $36,000 cancellation fee, are as follows: $271,000 in 2000, $275,000 in 2001, $245,000 in 2002, totaling $791,000. Rental expense incurred for operating leases and leases whose terms are less than one year in duration for 1999, 1998 and 1997 was approximately $215,000, $153,000 and $69,000, respectively.

Purchase Commitment On June 6, 1997, the Company entered into an Amended and Restated Exclusive Supply Agreement ("Exclusive Supply Agreement") and a Development Agreement with Cree, a related company. The Exclusive Supply Agreement has an initial term of ten years which may be extended for an additional ten years by either party if the Company orders in any 36-month period SiC crystals with an aggregate purchase price in excess of $1 million. The Company has met this order threshold and expects to extend the term of the Exclusive Supply Agreement. In connection with the Exclusive Supply Agreement, the Company has committed to purchase a minimum of 50% (by dollar volume) of its requirements for SiC crystals from Cree. If the Company's orders require Cree to expand beyond specified production levels, the Company must commit to purchase certain minimum quantities. Through December 31, 2000 the Company has agreed to purchase approximately $10.56 million of crystals produced by existing crystal growers and the Company and Cree have agreed that the price paid to Cree for each SiC crystal will be based on a sliding scale depending on the quality of each crystal received. The Company is totally dependent on Cree to supply SiC crystals for its production process. If the Company is unable to obtain SiC crystals from Cree, its operations would be materially adversely affected.

The July 1, 1998 Development Agreement, which replaces the June 1997 Development Agreement and the 1998 Supplemental Development Agreement, provides for a four-year development effort by Cree to increase the yield of usable material in each SiC crystal manufactured by Cree for use by C3 in the production of moissanite jewels. The Company was initially obligated to pay Cree approximately $2.88 million annually through June 30, 2002 under this agreement which was reduced to $1.44 million annually effective October 1, 1999. However, either party may terminate the agreement if Cree does not meet the annual performance milestones or if the Company and Cree do not mutually agree on the performance milestones for the ensuing year.

During 1999, 1998, and 1997, the Company made purchases from Cree of approximately $16,219,900 $7,568,500 and $2,022,700, respectively, for SiC materials and research and development costs.

CORPORATE INFORMATION

DIRECTORS

Richard G. Hartigan, Jr.
President, Hartigan Consulting Group

Jeff N. Hunter
Chairman of the Board

Barbara Kotlikoff
President, Monet Group, Inc.

Kurt Nassau, Ph.D.
President, Nassau Consultants

Cecil D. Raynor
Vice President, Manufacturing,
Nortel Networks Corporation

Howard Rubin
President, GemDialogue Systems, Inc.

Frederick A. Russ, Ph.D.
Dean, College of Business
Administration, University of Cincinnati

Ollin B. Sykes
President,
Sykes & Company, P.A.

OFFICERS

Jeff N. Hunter
Chief Executive Officer

Robert S. Thomas
President and Chief Operating Officer

Mark W. Hahn
Chief Financial Officer,
Treasurer and Secretary

Earl R. Hines
Director of Manufacturing

Mark D. Kellam, Ph.D.
Director of Technology

David Fudge
Vice President of Sales

CORPORATE HEADQUARTERS

Charles & Colvard
3800 Gateway Boulevard
Suite 311
Morrisville, NC 27560

INDEPENDENT AUDITORS

Deloitte & Touche LLP
Suite 1800
First Union Capital Center
150 Fayetteville Street Mall
Raleigh, NC 27601

TRANSFER AGENT AND REGISTRAR

First Union National Bank
1525 West W.T. Harris Boulevard, 3C3
Charlotte, NC 28288-1153

STOCK LISTING

Nasdaq Stock Market
Symbol: CTHR

SHAREHOLDER INQUIRIES

The Company's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, may be obtained without charge upon written request to:

Charles & Colvard
3800 Gateway Boulevard
Suite 311
Morrisville, NC 27560

ANNUAL MEETING OF SHAREHOLDERS

Monday, May 15, 2000, 10:00 a.m.
Sheraton Imperial Hotel
4700 Emperor Boulevard
Durham, NC 27703

MARKET INFORMATION

The Company's Common Stock trades on the Nasdaq Stock Market under the symbol "CTHR." The following table presents, for the periods indicated, the high and low sales prices of the Company's Common Stock, as reported by the Nasdaq Stock Market. As of March 1, 2000, there were 242 shareholders of record of the Common Stock.

Sales Price Per Share

1999	High	Low
First Quarter	$17.88	$8.13
Second Quarter	18.00	10.00
Third Quarter	17.25	10.00
Fourth Quarter	11.00	5.88

1998	High	Low
First Quarter	$12.38	$8.50
Second Quarter	10.00	7.25
Third Quarter	9.75	4.75
Fourth Quarter	14.50	9.88

The Company has never paid dividends on its capital stock. The Company intends to retain earnings, if any, for use in its business and does not anticipate paying any cash dividends in the foreseeable future.

Cautionary Note:
Certain statements contained in this Annual Report are forward-looking statements. Such forward-looking statements are subject to a number of material risks, uncertainties and contingencies that could cause actual results to differ materially from those set forth in the forward-looking statements. Those risks and uncertainties include, but are not limited to: the Company's ability to successfully implement its business strategies; the effects of general economic conditions; the need for further product development; the Company's reliance on third parties, including Cree, Inc.; the small size of the current market for the Company's products and uncertainty of market acceptance and demand for such products in the future; the Company's dependence on its patents and other intellectual property; intense competition for gemstones; possible governmental regulation in the United States and abroad, and other risks and uncertainties set forth in the Company's Forms 10-K, 10-Q and other filings with the Securities and Exchange Commission.

De Plano Group New York

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