

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934**

For the quarterly period ended
March 31, 2003

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934**

For the transition period from to

Commission file number 0-26820

CRAY INC.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of
incorporation or organization)

93-0962605
(I.R.S. Employer
Identification No.)

411 First Avenue South, Suite 600
Seattle, WA 98104-2860
(206) 701- 2000

(Address of principal executive offices)
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐

As of May 12, 2003, 65,346,265 shares of the Company's Common Stock, par value \$0.01 per share, were outstanding.

CRAY INC. AND SUBSIDIARIES

TABLE OF CONTENTS

	Page No.
PART I	
FINANCIAL INFORMATION	
Item 1. Unaudited Condensed Consolidated Financial Statements:	
Balance Sheets as of December 31, 2002 and March 31, 2003	3
Statements of Operations for the Three Months Ended March 31, 2002 and 2003	4
Statement of Shareholders' Equity for the Three Months Ended March 31, 2003	5
Statements of Cash Flows for the Three Months Ended March 31, 2002 and 2003	6
Notes to Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures about Market Risk	22
Item 4. Controls and Procedures	23
PART II	
OTHER INFORMATION	
Item 1. Legal Proceedings	23
Item 5. Other Information	23
Item 6. Exhibits and Reports on Form 8-K	24

Available Information

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act are available free of charge at our web site at www.cray.com as soon as reasonably practicable after we file electronically such reports with the SEC.

Cray is a federally registered trademark of Cray Inc., and Cray SV1ex, Cray X1, Cray SX-6, Cray T90, Cray MTA-2, Cray SV1 and Cray T3E are trademarks of Cray Inc.

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2002	March 31, 2003
		(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 23,916	\$ 38,369
Short-term investments, available for sale		22,948
Accounts receivable, net of allowance of \$1,098 in 2002 and 2003	31,017	39,153
Inventory, net	24,033	37,989
Prepaid expenses and other assets	5,805	8,829
Total current assets	84,771	147,288
Property and equipment, net	24,799	23,929
Service spares, net	9,279	8,232
Goodwill	22,680	22,680
Deferred tax asset	263	263
Other assets	3,453	2,924
TOTAL	\$ 145,245	\$ 205,316
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 13,173	\$ 19,675
Accrued payroll and related expenses	15,573	12,200
Other accrued liabilities	4,396	3,241
Deferred revenue	18,406	26,169
Notes payable	215	153
Current portion of warranty reserves	3,273	2,654
Current portion of obligations under capital leases	241	243
Current portion of term loan	2,143	2,143
Total current liabilities	57,420	66,478
Warranty reserves	2,326	927
Obligations under capital leases	152	101
Term loan payable	1,786	1,250
Shareholders' equity:		
Series A Convertible Preferred Stock, par \$.01 - Authorized, issued and outstanding, 3,125,000 shares	24,946	24,946
Common Stock, par \$.01 - Authorized, 100,000,000 shares; issued and outstanding, 56,039,016 and 65,168,653 shares, respectively	211,255	263,092
Accumulated other comprehensive loss	(291)	(326)
Accumulated deficit	(152,349)	(151,152)
	83,561	136,560
TOTAL	\$ 145,245	\$ 205,316

See accompanying notes

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended March 31,	
	2002	2003
REVENUE:		
Product	\$15,071	\$27,284
Service	20,129	16,845
Total revenue	35,200	44,129
OPERATING EXPENSES:		
Cost of product revenue	4,628	17,675
Cost of service revenue	10,925	10,281
Research and development	10,551	7,475
Marketing and sales	4,857	5,521
General and administrative	2,040	1,874
Restructuring charge	1,878	
Total operating expenses	34,879	42,826
Income from operations	321	1,303
OTHER INCOME (EXPENSE), NET	1,384	(53)
INTEREST INCOME (EXPENSE), NET	(571)	6
Income before income taxes	1,134	1,256
PROVISION FOR INCOME TAXES	385	59
Net income	\$ 749	\$ 1,197
Net income per common share:		
Basic	\$ 0.02	\$ 0.02
Diluted	\$ 0.02	\$ 0.02
Weighted average shares outstanding:		
Basic	43,615	59,780
Diluted	47,812	72,764

See accompanying notes

CRAY INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(in thousands)
(unaudited)

	Series A Preferred Stock		Common Stock		Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
	Number of Shares	Amount	Number of Shares	Amount			
BALANCE, January 1, 2003	3,125	\$24,946	56,039	\$211,255	\$(152,349)	\$(291)	\$ 83,561
Public sale of common stock, less issuance costs of \$3,517,000			8,480	49,059			49,059
Issuance of shares under Employee Stock Purchase Plan			70	437			437
Exercise of stock options			352	1,362			1,362
Exercise of warrants			228	979			979
Other comprehensive income:							
Unrealized gain on available for sale investments						8	8
Cumulative currency translation adjustment						(43)	(43)
Net income					1,197		1,197
BALANCE, March 31, 2003	3,125	\$24,946	65,169	\$263,092	\$(151,152)	\$(326)	\$136,560

See accompanying notes

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	For the Three Months Ended March 31,	
	2002	2003
Operating activities		
Net income	\$ 749	\$ 1,197
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization	3,751	4,042
Gain on sale of assets	(38)	
Beneficial conversion feature of notes payable	99	
Cash provided (used) by changes in operating assets and liabilities:		
Accounts receivable	(8,248)	(5,136)
Inventory	(3,093)	(14,498)
Other assets	(187)	(2,495)
Spares		(33)
Accounts payable	(856)	6,502
Other accrued liabilities	(4,375)	(1,155)
Accrued payroll and related expenses	3,667	(3,373)
Warranty reserve	(2,687)	(2,018)
Deferred revenue	12	4,763
Net cash used by operating activities	(11,206)	(12,204)
Investing activities		
Purchases of short-term investments		(22,940)
Purchases of spares	(700)	
Proceeds from sale of assets	46	
Purchases of property and equipment	(2,459)	(1,550)
Net cash used by investing activities	(3,113)	(24,490)
Financing activities		
Restricted cash	108	
Principal payments on term loan	(536)	(536)
Proceeds from line of credit	3,486	
Sale of common stock	3,627	49,059
Proceeds from exercise of options and warrants	1,823	2,341
Proceeds from issuance of common stock through employee purchase plan		437
Principal payments on bank note	(139)	(62)
Principal payments on capital leases	(61)	(49)
Net cash provided by financing activities	8,308	51,190
Effect of foreign exchange rate changes on cash and cash equivalents	(502)	(43)
Net increase (decrease) in cash and cash equivalents	(6,513)	14,453
Cash and cash equivalents		
Beginning of period	12,377	23,916
End of period	\$ 5,864	\$ 38,369
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 192	\$ 119
Non-cash investing and financing activities		
Inventory reclassified to spares	347	507
Inventory reclassified to fixed assets		68
Unrealized gain on short term investments		8

See accompanying notes

CRAY INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Basis of Presentation

In the opinion of management, the accompanying condensed consolidated balance sheets and related condensed consolidated statements of operations, shareholders' equity and cash flows have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. All adjustments considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q 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 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of Cray Inc. and its wholly-owned subsidiaries (the Company). All material intercompany accounts and transactions have been eliminated.

Short-term investments

The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments generally mature between three months and two years from the purchase date. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All cash and short-term investments are classified as available for sale and are recorded at market value using the specific identification method; unrealized gains and losses are reflected in other comprehensive income.

Inventory, net

Inventory consisted of the following (in thousands):

	December 31, 2002	March 31, 2003
Components and subassemblies	\$15,653	\$17,510
Work in process	8,324	19,587
Finished goods	2,414	2,839
	<u>26,391</u>	<u>39,936</u>
Allowance for excess and obsolete	(2,358)	(1,947)
Inventory, net	<u>\$24,033</u>	<u>\$37,989</u>

Revenue in the first quarter of 2002 includes \$5.9 million from the sale of obsolete inventory recorded at a zero cost basis.

Goodwill

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 142 ("SFAS 142") "Goodwill and Other Intangible Assets." As of January 1, 2002, the Company adopted SFAS 142 and no longer amortizes goodwill. Upon adoption of SFAS 142, the Company determined that there was no impairment of Goodwill as of January 1, 2002. Additionally, SFAS 142 requires an annual impairment test or more frequently if impairment indicators arise. In the first quarter of fiscal 2003, the Company completed its annual impairment test in accordance with SFAS 142. Results of the impairment tests did not indicate any impairment loss.

Comprehensive Income

The components of comprehensive income are as follows (in thousands):

	Three months ended March 31,	
	2002	2003
Net income	\$ 749	\$1,197
Unrealized gain on short-term investments		8
Foreign currency translation adjustment	(502)	(43)
Comprehensive income	\$ 247	\$1,162

Segment Information

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately \$38.9 million for the three months ended March 31, 2003, compared to \$29.2 million for the three months ended March 31, 2002.

The Company's significant operations outside North America include sales and service offices in Europe, the Middle East and Africa (EMEA) and Asia Pacific (Japan, Australia, Korea, China and Taiwan). Intercompany transfers between operating segments and geographic areas are primarily accounted for at prices that approximate arm's length transactions.

Geographic revenue and long-lived assets related to operations were as follows (in thousands):

	North America	EMEA	Asia Pacific	Total
Three months ended March 31, 2003:				
Product revenue	\$25,964	\$1,060	\$ 260	\$27,284
Service revenue	\$10,947	\$4,253	\$1,645	\$16,845
Net income (loss)	\$ 2,147	\$ (152)	\$ (798)	\$ 1,197
As of March 31, 2003:				
Long-lived assets	\$54,808	\$1,697	\$1,523	\$58,028
Three months ended March 31, 2002:				
Product revenue	\$ 9,504	\$3,787	\$1,780	\$15,071
Service revenue	\$12,961	\$5,317	\$1,851	\$20,129
Net income (loss)	\$ (136)	\$ 470	\$ 415	\$ 749
As of March 31, 2002:				
Long-lived assets	\$61,295	\$2,358	\$2,168	\$65,821

Earnings Per Share

Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common and common equivalent shares outstanding during the period, which includes the additional dilution related to conversion of stock options as computed under the treasury stock method and the conversion of the preferred stock and convertible debt under the if-converted method.

The following data show the amounts used in computing the weighted average number of shares of dilutive potential common stock (in thousands):

	Three months ended March 31,	
	2002	2003
Weighted average number of shares used in basic EPS	43,615	59,780
Effect of dilutive securities:		
Stock options and warrants	1,072	9,847
Convertible preferred stock	3,125	3,137
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	47,812	72,764

For the three months ended March 31, 2002, 29.0 million common stock equivalents were antidilutive and not included in computing diluted EPS. For the three months ended March 31, 2003, common stock equivalents of 12.0 million shares were not included in computing diluted EPS because their effects were antidilutive.

Restructuring Charges

As of March 31, 2003, a remaining accrued liability of \$709,000 was due to a March 2002 restructuring charge of \$1.9 million. Substantially all of the restructuring charge represents severance expenses for terminated employees. The restructuring liability is included within accrued payroll and related expenses on the balance sheets. The reserve activity for the three months ended March 31, 2002 and 2003 is as follows (in thousands):

	2002	2003
Liability balance, January 1	\$1,700	\$ 866
Additional restructuring charge	1,900	
Payments	(883)	(157)
Liability balance, March 31	\$2,717	\$ 709

Warranty Reserve

Certain components in the Cray T90 vector computers have an unusually high failure rate. The cost of servicing the Cray T90 computers exceeds the related service revenues. The Company recorded a warranty reserve to reflect its estimate of the amount by which the cost of servicing the T90 vector computers would exceed the revenue generated from servicing them. The Company continually monitors the reasonableness of the estimate of the warranty reserve. In determining the appropriate reserve, the Company reduced the T90 reserve and recorded a corresponding reduction to the cost of maintenance revenue of \$1.1 million for the three months ended March 31, 2003, resulting in a remaining T90 warranty reserve of \$3.5 million at March 31, 2003.

Public Offering

In the first quarter of 2003, the Company completed a public offering of 8,480,000 shares of newly issued common stock, and an additional 145,000 shares of common stock from certain selling shareholders, at a public offering price of \$6.20 per share. The Company received from the offering, after underwriting discount and selling expenses, net proceeds of approximately \$49,059,000. The Company intends to use the net proceeds for general corporate purposes.

Taxes

The Company recorded a provision of \$59,000 for income taxes in foreign countries, certain states and the alternative minimum tax for the three months ended March 31, 2003, compared to \$385,000 for the respective 2002 period. Due to utilization of tax losses from operations in prior years, there has been no provision for U.S. federal income (other than for alternative minimum taxes) taxes for any period.

Stock-Based Compensation

The Company applies Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, in accounting for its stock option and purchase plans. Had compensation cost for the Company's stock option plans and its stock purchase plan been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company's net income and net income per common share for the three months ended March 31, 2002, and 2003 would have been the pro forma amounts indicated below (in thousands):

	Three Months Ended March 31, 2002	2003
Net income, as reported	\$ 749	\$ 1,197
Total stock based compensation expense determined under fair value based method for all awards	(1,511)	(2,013)
Pro forma net income (loss)	\$ (762)	\$ (816)
Basic and diluted net income (loss) per common share:		
Basic:		
As reported	\$ 0.02	\$ 0.02
Pro forma	\$ (0.01)	\$ (0.01)
Diluted:		
As reported	\$ 0.02	\$ 0.02
Pro forma	\$ (0.02)	\$ (0.01)

The weighted average Black-Scholes value of options granted under the stock option plans during the three months ended March 31, 2002 and 2003 was \$1.95 and \$2.90, respectively. Fair values were estimated as of the dates of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividend yield, expected volatility of 97% and 95% for the three months ended March 31, 2002 and 2003, respectively, risk-free interest rate of 5.0% and 3.8% for the three months ended March 31, 2002 and 2003, respectively, and an expected term of 8.2 years for the three months ended March 31, 2002 and 2003.

Reclassifications

Certain prior-year amounts have been reclassified to conform with the current-year presentation.

Subsequent Event

In April 2003, the Company completed a financing arrangement with Wells Fargo Bank, National Association to provide for a \$25 million one year revolving credit facility. The new credit facility replaces the Company's previous financing arrangement with Foothill Capital Corporation. The Company paid down the remaining balance of the term loan with Foothill Capital of approximately \$3.2 million. The new credit facility is secured by substantially all of the Company's domestic assets, bears interest annually at the bank's prime rate on any amounts borrowed and carries a 3/8 of one percent annual commitment fee on amounts not borrowed.

Recent Accounting Pronouncements

In December 2002, the FASB issued Statement No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," which is effective for fiscal years ending after December 15, 2002. This statement provides alternative methods for a transition to the fair value method of accounting for stock-based compensation. The statement also amends the disclosure provision of Statement 123, "Accounting for Stock-Based Compensation" by requiring disclosure in the summary of significant accounting policies of the entity's accounting policy, and additional disclosure of the impact on net income of the Company's existing method and fair value method of accounting for stock-based compensation. While the Company has not elected to adopt fair value accounting for its stock-based compensation, it has complied with the new disclosure requirements under Statement 148. The table under the caption "stock-based compensation" above illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions of this

Interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements in this Interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002. This Interpretation did not have a material impact on the Company's consolidated financial statements for the three months ended March 31, 2003.

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

Preliminary Note Regarding Forward-Looking Statements

The information set forth in this Item 2 includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act, as amended, and is subject to the safe harbor created by those sections. Factors that realistically could cause results to differ materially from those projected in the forward-looking statements are set forth in the following discussion and under "Factors That Could Affect Future Results" beginning on page 16. The following discussion should also be read in conjunction with the Financial Statements and Notes thereto.

Overview

We design, develop, market and service high performance computer systems, commonly known as supercomputers. These systems provide capability and capacity far beyond typical mainframe computer systems and address the world's most challenging computing problems for government, industry and academia. We expect that most of our 2003 product revenue will come from sales of our Cray X1 system, the production version of which first shipped in December 2002. In mid-2002, we began a development project with Sandia National Laboratories to design and deliver a new, high bandwidth, massively parallel processing supercomputer system called Red Storm in 2004. We provide maintenance services to the worldwide installed base of Cray computers. We also offer professional services that leverage our industry technical knowledge.

We experienced net losses in each full year of our operations prior to 2002. We incurred net losses of approximately \$35.2 million in 2001, \$25.4 million in 2000, and \$34.5 million in 1999. For the year ended December 31, 2002, we had net income of \$5.4 million and for the three months ended March 31, 2003, we had net income of \$1.2 million.

We recognize product revenue from sales of our computer systems upon acceptance by the customer, although in limited circumstances, depending on sales contract terms, revenue may be recognized when title passes upon shipment or may be delayed until funding is certain or other contractual requirements are satisfied. We recognize product revenue from the Red Storm project using the percentage-of-completion method. We recognize service revenue for the maintenance of our computer systems ratably over the term of each maintenance agreement. Funds from maintenance and product sales contracts that are paid in advance are recorded as deferred revenue. We recognize service revenue from our professional services activities as services are rendered.

Factors that should be considered in evaluating our business, operations and prospects and that could affect our future results and financial condition are set forth below under "Factors That Could Affect Future Results."

Critical Accounting Policies and Estimates

This discussion as well as disclosures included elsewhere in this Form 10-Q are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingencies. On an ongoing basis, we evaluate the estimates used, including those related to estimates of warranty liabilities, valuation of inventory at the lower of cost or market, the percentage completed and estimated gross profit on the Red Storm contract, and impairment of goodwill. We base our estimates on historical experience, current conditions and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources as well as identifying and assessing our accounting treatment with respect to commitments and contingencies. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies involve the more significant judgments and estimates used in the preparation of the consolidated financial statements.

T90 Reserve

We acquired service contracts in the acquisition of the Cray Research business unit in April 2000 for Cray T90 vector computers. Some of the components in the Cray T90 vector computers have an unusually high failure rate. As of April 1, 2000, the date of our acquisition of the Cray Research business unit from Silicon Graphics, Inc. ("SGI"), we recorded a warranty reserve of \$47.5 million, of which \$46.3 million reflected our estimate of the amount by which the cost of servicing the T90 vector computers would exceed the revenue generated from servicing them until they were no longer in use by our customers. As we incur costs to service these computers in excess of the related service revenue, we reduce the amount of the T90 warranty reserve. As of March 31, 2003, our total warranty reserve balance was \$3.6 million, of which \$3.5 million related to the T90 vector computers. We continually monitor the reasonableness of our estimate of the warranty reserve. This involves analysis of our assumptions with regard to the length of time the T90 vector computers will be in use by our customers, the failure rate of modules in the computers considering actual historical failure rates, and personnel and resources, including service spares, that will be required to correct failures that occur in the future. In determining the appropriate reserve, the Company reduced the T90 reserve and recorded a corresponding reduction to the cost of maintenance revenue of \$1.1 million for the quarter ended March 31, 2003. We believe that the T90 warranty reserve balance at March 31, 2003, is a reasonable estimate of the extent to which our costs to service these computers will exceed the revenue generated from existing service contracts. It is possible, however, that our estimates may prove to be inaccurate and that our actual costs may differ materially from our estimates.

Red Storm Contract

Product revenue from the Red Storm contract is accounted for using the percentage of completion method. Revenue is recognized as costs are incurred, and margin is based on the total estimated cost to complete. The estimate to complete is based on several factors, including estimated labor hours to complete certain tasks and estimated cost of purchased components at future dates. Our estimates may need to be adjusted from quarter to quarter, which would impact our revenue and our margin on a cumulative basis.

Inventories

We record our inventories at the lower of cost or market. We regularly evaluate the technological usefulness of various inventory components. When it is determined that previously inventoried components do not function as intended in a fully operational system, the costs associated with these components are expensed. Due to rapid changes in technology and the increasing demands of our customers, we are continually developing new products. As a result, it is possible that older products we have developed may become obsolete or we may sell these products below cost. When we determine that we will likely not recover the cost of inventory items through future sales, we write down the related inventory to our estimate of its market value. Because the products we sell have high average sales prices and because a high number of our prospective customers receive funding from U.S. or foreign governments, it is difficult to estimate future sales of our products and the timing of such sales. It also is difficult to determine whether the cost of our inventories will ultimately be recovered through future sales. While we believe our inventory is stated at the lower of cost or market and that our estimates and assumptions to determine any adjustments to the cost of our inventories are reasonable, our estimates may prove to be inaccurate. We have sold inventory previously reduced in part or in whole to zero, including in the first quarter of 2002, and we may have future sales of previously written down inventory. We may also have additional expense to write down inventory to its estimated market value. Adjustments to these estimates in the future may materially impact our operating results.

Goodwill

Approximately 11% of our assets as of March 31, 2003, consisted of goodwill resulting from our acquisition of the Cray Research business unit from SGI in 2000. We adopted SFAS No. 142 on January 1, 2002, and we no longer amortize goodwill associated with the acquisition, but we are required to conduct ongoing analyses of the recorded amount of goodwill in comparison to its estimated fair value. We performed an annual impairment test effective January 1, 2003 and determined that our recorded goodwill was not impaired. This analysis and ongoing analyses of whether the fair value of recorded goodwill is impaired involve a substantial amount of judgment. Future charges related to goodwill could be material depending on future developments and changes in technology and our business.

Results of Operations

Product Revenue

We had product revenue of \$27.3 million for the three months ended March 31, 2003, compared to \$15.1 million for the respective 2002 period. Product revenue represented 62% of total revenue for the three months ended March 31, 2003, compared to 43% for the respective 2002 period, and consisted in the 2003 period of \$19.2 million for our Cray X1 product line, \$4.2 million for our Red Storm product line and \$3.9 million for our other products. Product revenue for 2002 consisted of \$8.5 million for our Cray SV1ex product line, \$4.1 million for our Cray T90 product line and \$2.5 million for our other products.

With the delivery of the Cray X1 system to customers and the performance of the Red Storm project, we expect our product revenue in 2003 to increase and be a larger percentage of total revenue. We expect our product revenue to vary quarterly.

Service Revenue

We had service revenue, which includes revenue from maintenance services and professional services, of \$16.8 million for the three months ended March 31, 2003, including \$1.4 million from professional services, compared to \$20.1 million, including \$1.6 million from professional services, for the respective 2002 period. Service revenue represented 38% of total revenue for the three months ended March 31, 2003, and 57% for the corresponding 2002 period.

Maintenance services are provided under separate maintenance contracts with our customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods. Maintenance service revenue has declined on an annual basis as older systems are withdrawn from service. We expect maintenance service revenue to continue to decline slowly over the next year or so as our older systems continue to be withdrawn from service and then to stabilize as our new systems are placed in service.

Professional services are provided under separate contracts for a particular activity such as development, design and study of a new high performance computer system, deinstalling a computer system, porting applications to one of our platforms or use of our computer resources for a particular period, and we expect contracts to vary greatly in size. We recorded our first revenue from professional services in the first quarter of 2002, and we expect our professional services revenue to increase modestly in 2003.

Operating Expenses

Cost of Product Revenue. We had cost of product revenue of \$17.7 million for the three months ended March 31, 2003, compared to \$4.6 million for the respective 2002 period. Our cost of product represented 65% of product revenue for the three months ended March 31, 2003, compared to 31% for the corresponding 2002 period. The low cost of product revenue in 2002 was due in large part to the sale of \$5.9 million of inventory previously written down to zero cost.

We expect that, compared to 2002, our cost of product revenue in 2003 will be adversely affected by start-up costs incurred in the Cray X1 ramp-up during the first half of the year and throughout the year by lower margins on the Red Storm project. In addition, we may grant favorable pricing for large multi-system contracts.

Cost of Service Revenue. We had cost of service revenue of \$10.3 million for the three months ended March 31, 2003, including \$1.4 million of cost of professional services revenue, compared to \$10.9 million for the corresponding 2002 period, including \$1.5 million of cost of professional services revenue. Our cost of service revenue represented 61% of service revenue for the three months ended March 31, 2003, compared to 54% for the corresponding 2002 period.

Several items impacted service costs in the first quarter of 2003. Margins from maintenance revenue were adversely affected due to the withdrawal of legacy Cray systems without a commensurate decrease in maintenance expenses and personnel, and there was no contribution to margin from professional services, both trends that we expect will continue for the near term. As we reduce maintenance service personnel, cost of service will be impacted adversely by associated severance expenses. In addition, the amortization of spare parts valued at the time of acquisition is an increasingly greater negative impact to service margins as the installed base of legacy products decline. This non-cash charge has been fixed at \$1.1 million per quarter since the date of acquisition, and will continue until the spare parts are fully written-off in the first quarter of 2004.

Favorably impacting maintenance costs during the quarter was the \$1.1 million reduction of the Cray T90 warranty reserves reflecting our current estimate of costs associated with Cray T90 maintenance.

Maintenance revenue is expected to decline slowly into 2004 before new shipments into the installed base offset retirements. Also, the legacy spares will be written-off and all of the installed base of Cray T90 computers will likely be retired in 2004. Maintenance costs should then stabilize between 60% to 65% of revenue. Until then, the factors experienced in the first quarter of 2003 may continue to impact service costs.

Research and Development

Research and development expenses for the three months ended March 31, 2002 and 2003 reflect our costs associated with the development of the Cray X1 system, and to a lesser extent, the Cray MTA-2 in both the 2002 and 2003 periods, including related software development. Research and development expenses also include personnel expenses, allocated overhead and operating expenses, software, materials and engineering expenses, including payments to third parties. Gross research and development expenses in the first quarter of 2003 in the table below reflect all research and development expenditures, including expenses related to our research and development activities on the Red Storm project. The government funding reflects reimbursement by the government for development and services, including development of the Cray X1 systems, enhancements and successors to the Cray X1 system and other products, and our research and development personnel dedicated to the Red Storm project. The Red Storm research and development costs are reflected as cost of product revenue and the related reimbursements are recorded as product revenue. Research and development expenses for 2003 and 2002 were as follows (in thousands):

	For the three months ended March 31,	
	2002	2003
Gross research and development	\$13,451	\$15,045
Governmental funding	(2,900)	(7,570)
Net research and development	\$10,551	\$ 7,475

Net research and development expenditures represented 30% and 17% of revenue for the three months ended March 31, 2002 and 2003, respectively.

We expect that gross research and development expenses will increase in 2003 to reach or slightly exceed \$65 million as we ramp-up our work on the Red Storm project. However, we expect that net research and development expenses will remain flat or decline for 2003, primarily due to increased governmental funding, and to decline as a percentage of overall revenue as we increase our overall revenue.

Government funding levels will not be even throughout the year. In the first quarter of 2003 development funding for the Cray X1 concluded. Although we have entered into agreements for additional funding for follow-on products, the transition of our engineers to these projects is not immediate, and will cause a drop in governmental funding for the second quarter of 2003.

Marketing and Sales

Marketing and sales expenses were \$5.5 million for the three months ended March 31, 2003, compared to \$4.9 million for the respective 2002 period. The increase in these expenses from 2002 to 2003 was due to the roll out of the Cray X1 product line. We expect marketing and sales expenses to grow modestly in 2003, but to decline as a percentage of revenue.

General and Administrative

General and administrative expenses were \$1.9 million for the three months ended March 31, 2003, compared to \$2.0 million for the respective 2002 period. We expect general and administrative expenses to grow modestly in 2003, but to decline as a percentage of revenue.

Restructuring Charges

Restructuring charges were zero for the three months ended March 31, 2003, compared to \$1.9 million for the 2002 period representing primarily severance expenses related to the termination of 20 employees in 2002.

Other Income (Expense), net

Other expense was \$53,000 for the three months ended March 31, 2003, compared to other income of \$1.4 million for the 2002 period. The decrease in other income primarily resulted from a negotiated settlement of an accrued cancellation charge on a purchase commitment in the first quarter of 2002.

Interest Income (Expense), net

Interest income was \$125,000 for the three months ended March 31, 2003, compared to \$28,000 for the respective 2002 period. The higher amount in 2003 reflects our increased average cash position due to the completion of our public offering of common stock in the first quarter of 2003.

Interest expense was \$119,000 for the three months ended March 31, 2003, compared to \$599,000 for the respective 2002 period. The interest expense for 2002 was largely due to a non-cash charge of \$145,000 associated with the convertible debenture financing completed in November 2001, and \$454,000 of interest on our term loan, line of credit and capital leases. In April 2003 we paid off the term loan in full.

Taxes

We recorded a provision of \$59,000 for income taxes in foreign countries and certain states for the three months ended March 31, 2003, compared to \$385,000 for the respective 2002 period. There has been no provision for U.S. federal income taxes, other than for alternative minimum taxes, for any period.

Liquidity and Capital Resources

Cash, cash equivalents, short-term investments and accounts receivable totaled \$100.5 million at March 31, 2003, compared to \$54.9 million at December 31, 2002. Over that period, cash, cash equivalents, and short-term investments increased from \$23.9 million to \$61.3 million. At March 31, 2003, we had working capital of \$80.8 million compared to \$27.4 million at December 31, 2002. In the first quarter of 2003, we realized approximately \$49.1 million of net proceeds from the public sale of our common stock.

Net cash used by operating activities for the three months ended March 31, 2003 was \$12.1 million compared to \$11.2 million for respective 2002 period. For the three months ended March 31, 2003, net operating cash was used primarily by increases in accounts receivable and inventory and decreases in other accrued liabilities and warranty reserve.

Net cash used by investing activities was \$24.6 million for the three month ended March 31, 2003, compared to \$3.1 million for the respective 2002 period. Net cash used by investing activities for 2003 consisted primarily of purchases of short-term investments following completion of our public offering of common stock and purchases of computers and electronic test equipment, computer software and furniture and fixtures. In 2002, the net cash used in investing activities was primarily for electronic test equipment and computer hardware purchases.

Net cash provided by financing activities was \$51.2 million for the three months ended March 31, 2003, compared to \$8.3 million for the respective 2002 period. The 2003 net cash provided by financing activities was primarily from our public offering, in which we received net proceeds of \$49.1 million. In the three months ended March 31, 2002, we raised \$3.6 million primarily through the sale of common stock and received another \$1.8 million through the exercise of warrants that otherwise would have expired. We also received \$3.5 million from a draw on our line of credit in March 2002.

Over the next twelve months, our significant cash requirements will relate to operational expenses, consisting primarily of personnel costs, costs of inventory and spare parts as we ramp up production of Cray X1 systems, third-party engineering expenses, and acquisition of property and equipment. Our remaining fiscal year 2003 capital expenditure budget for property

and equipment is estimated currently at \$7.5 million. In addition, we lease certain equipment used in our operations under operating or capital leases in the normal course of business. We expect that operations over the next twelve months will generate positive cash flow. The following table is a summary of our contractual cash obligations as of March 31, 2003 (in thousands):

Contractual Obligations	Payments Due By Periods			
	Total	Less than 1 year	1-3 years	4-5 years
Notes payable	\$ 153	\$ 153	\$	\$
Term loan payable	3,393	3,393		
Capital lease obligations	344	243	101	
Operating leases	20,147	3,134	8,762	5,500
Total contractual cash obligations	\$24,037	\$6,923	\$8,863	\$5,500

At any particular time, given the high average selling price of our products, our cash position is affected by the timing of payment for product sales, receipt of prepaid maintenance revenue and receipt of government funding of research and development activities. We believe our current cash resources will be adequate for the next twelve months.

Factors That Could Affect Future Results

The following factors should be considered in evaluating our business, operations and prospects and may affect our future results and financial condition.

Factors Related To Our Business

If we were unable to produce the Cray X1 system on a sustainable basis, our revenue and profits would be reduced. We expect that our success in the remaining 2003 quarters and beyond will depend largely upon our ability to turn the Cray X1 system into a stable production quality product. We depend on our vendors to manufacture components for our systems. If our vendors were unable to manufacture components to our design specifications on a timely basis and with sufficient yields, increased repair charges would reduce margins and profits and any delayed deliveries of production quality Cray X1 systems to customers would adversely affect our revenue and profits. We have received Cray X1 system components with unacceptable yields and are working with our vendors to achieve higher yields of reliable components. We have redesigned, and in the future we may have to redesign further, hardware components of the Cray X1 system because of previously unforeseen defects. Redesign work is costly and could cause delays in the production and sale of Cray X1 systems. We also need to achieve reliable system software to sell Cray X1 systems to production environment governmental and industrial customers. We continue to fix reported software problems and anticipate additional software problems to be reported in the future.

If application programs were not successfully ported to the Cray X1 system, we would have difficulty selling these systems to some customers. To make sales of the Cray X1 system in the automotive, aerospace, chemistry and other engineering and technical markets, including certain governmental users, we must have application programs ported to the Cray X1 system and tuned so that they will achieve high performance. The Cray X1 system has a new architecture that may make porting and tuning of application programs difficult. These application programs are owned in some instances by independent software vendors and in others by potential customers. We must induce these vendors and customers to undertake this activity. The relatively low volume of supercomputer sales makes it difficult for us to attract independent software vendors. We also modify and rewrite thirty-party and customer specific application programs to run on the Cray X1 system. There can be no assurance that we will be able to induce the third-party vendors and customers to rewrite their applications or that we will rewrite successfully third-party and customer specific applications for use on the Cray X1 system.

We may not be successful in completing the Red Storm project on time and on budget, which would adversely affect our earnings. Our efforts to complete the development and delivery of the Red Storm project for Sandia National Laboratories in 2004 on time and on budget are subject to significant risks. Our work is pursuant to a fixed-price contract with payment against significant monthly milestones setting out a tight development schedule and technically challenging performance requirements. Our success depends on third-party software development, some of which is to be supplied by Sandia National Laboratories, and the timely availability of the Opteron integrated circuits from Advanced Micro Devices, Inc. The contract is incrementally funded and is subject to future federal government appropriations. This project is lengthy and technically challenging, and requires a significant investment of engineering and other resources. Falling behind schedule or incurring cost overruns would adversely affect our capital resources and earnings.

If the U.S. government purchases fewer supercomputers, our revenue would be reduced and our profitability would be adversely affected. Historically, sales to the U.S. government and customers primarily serving the U.S. government have represented a significant market for supercomputers. From January 1, 2001, through December 31, 2002, approximately 79% of our product revenue was derived from sales to various agencies of the U.S. government. We expect that our initial sales of Cray X1 systems in 2003 will be predominantly to government agencies in the United States and other countries. Sales to government agencies may be affected by factors outside our control, such as changes in procurement policies, budget considerations and international political developments. If the United States or other governments were to stop, reduce or delay their use and purchases of supercomputers, our revenue would be reduced.

If we lose government support for supercomputer systems, our capital requirements would increase and our ability to conduct research and development would decrease. A few government agencies and research laboratories fund a significant portion of our development efforts. Agencies of the U.S. government historically have facilitated the development of, and have constituted a market for, new and enhanced very high performance computer systems, including the current Cray X1 system and our planned Cray X1e, Black Widow, Cascade and Red Storm development projects. U.S. government agencies may delay or decrease funding of these development efforts due to change of priorities, international political developments or for any other reason. Any such decrease or delay may cause an increased need for capital and may adversely affect our research and development expenditures and our ability to implement our product roadmap.

Procurement proposals based on theoretical peak performance reduce our ability to market our systems. Our high performance computer systems are designed to provide high actual sustained performance on difficult computational problems. Some of our competitors offer systems with higher theoretical peak performance at lower comparable prices, although their actual sustained performance on real applications frequently is a small fraction of their theoretical peak performance. Nevertheless, a number of requests for proposals, primarily from governmental agencies in the United States and elsewhere, continue to have criteria based wholly or significantly on theoretical peak performance. Unless these criteria are changed, we are disadvantaged in these instances by being unable to submit competitive bids, which limits our revenue potential.

The change by NEC Corporation of our distribution rights for the Cray SX-6 system may decrease our revenue and increase competition. We market a rebranded product known as the Cray SX-6 system, which was developed and is built in Japan by NEC Corporation. This product first became available for delivery in North America in the first quarter of 2002, and we became the exclusive distributor of NEC vector supercomputer systems in North America and a non-exclusive distributor outside North America. In late April 2003 NEC notified us that, effective August 1, 2003, our North American distribution rights for this product will be non-exclusive. NEC made no changes to our distribution rights in other areas. Supercomputer customers in the United States have been reluctant to purchase supercomputers from non-U.S. sources, and domestic demand for the Cray SX-6 systems has been far less than we anticipated. Loss of our exclusive distribution rights to NEC vector supercomputer systems may result in competition from NEC in North America, which could decrease our revenue. Outside of North America, NEC has competed aggressively based on price.

Lower than anticipated sales of new supercomputers would further reduce our service revenue from maintenance service contracts. High performance computer systems are typically sold with maintenance service contracts. These contracts generally are for annual periods, although some are for multi-year periods, and provide a predictable revenue base. Revenue from maintenance service contracts has declined from approximately \$125 million in 1999 to approximately \$68 million in 2002 and is expected to decline to approximately \$58 million in 2003 as our older systems are withdrawn from service. This revenue is expected to decline further until a sufficient number of our new computer systems are placed in service to balance the withdrawal of our older systems.

Our reliance on third-party suppliers poses significant risks to our business and prospects. We subcontract the manufacture of substantially all of our hardware components for all of our products, including integrated circuits, printed circuit boards, flex circuits and power supplies, on a sole or limited source basis to third-party suppliers. We use a contract manufacturer to assemble our components for the Cray X1 and other systems. We are subject to substantial risks because of our reliance on these and other limited or sole source suppliers. For example:

- if a supplier did not provide components that meet our specifications in sufficient quantities, then production and sale of our systems would be delayed;
- if a reduction or an interruption of supply of our components occurred, it could take us a considerable period of time to identify and qualify alternative suppliers to redesign our products as necessary and to begin manufacture of the redesigned components;
- if we were ever unable to locate a supplier for a key component, we would be unable to deliver our products;
- one or more suppliers could make strategic changes in their product lines, which might delay or suspend manufacture of our components or systems; and
- some of our key suppliers are small companies with limited financial and other resources, and consequently may be more likely to experience financial and operational difficulties than larger, well-established companies.

From time to time we have experienced delays in obtaining manufactured components and completed assemblies on a timely basis and in sufficient quantities from our suppliers, which have resulted in delays in the development and production of our products.

Development of a new operating system for our Black Widow and other future products is a difficult process, and may delay the availability of our Black Widow System. The technology agreement through which we acquired and licensed patent, know-how and other intellectual property rights from SGI restricts our use of certain SGI technology. Most significantly, the technology agreement limits our use of SGI's IRIX operating system to the Cray X1 product family. We plan to develop or acquire elsewhere our own UNIX-based operating system for successor systems to the Cray X1 product family, starting with the Black Widow system, based on Linux. Developing a new operating system is lengthy and difficult process, and might delay the availability of the Black Widow system.

The high failure rate in the Cray T90 installed base may reduce our earnings. Some of the components in the Cray T90 vector computers, a product we acquired through the Cray Research acquisition, have an unusually high failure rate. The cost of servicing the Cray T90 computers exceeds the related service revenue. In connection with our acquisition of the Cray Research business unit from SGI, we recorded a warranty reserve to provide for anticipated future losses on the Cray T90 maintenance service contracts. The balance of this reserve was \$3.5 million as of March 31, 2003. We anticipate that almost all of our Cray T90 systems will be deinstalled by the end of 2003. We believe that the warranty reserve balance at March 31, 2003, is a reasonable estimate of the extent to which our costs to service these computers will exceed the revenue generated from existing service contracts. Our estimates may prove to be inaccurate, and our actual costs may differ materially from our estimates. In addition, the Cray T90 failures have adversely affected our reputation for quality products with some customers and may adversely affect sales of our new systems.

We may infringe or be subject to claims that we infringe the intellectual property rights of others, and we are defending a lawsuit asserting infringement claims. Third parties may assert intellectual property infringement claims against us, and such claims, if proved, could require us to pay substantial damages or to redesign our existing products. Regardless of the merits, any claim of infringement requires management attention and causes us to incur significant expense to defend. For example, we currently are defending a lawsuit alleging that the evaporative spray cooling system in our Cray X1 system infringes patents and trade secrets held by a third party. The complaint seeks injunctive relief and damages. While we intend to defend this lawsuit vigorously, pre-trial discovery is in its initial stages and at this time we cannot predict the outcome of this lawsuit.

If we cannot attract, retain and motivate key personnel, we may be unable to implement effectively our business plan. Our success also depends in large part upon our ability to attract, retain and motivate highly skilled management, technical and marketing and sales personnel. Competition for highly skilled management, technical, marketing and sales personnel is intense, and we may not be successful in attracting and retaining such personnel.

We may not be able to protect our proprietary information and rights adequately. We rely on a combination of patent, copyright and trade secret protection, nondisclosure agreements and licensing arrangements to establish, protect and enforce our proprietary information and rights. We have a number of patents and have additional applications pending. There can be no assurance, however, that patents will be issued from the pending applications or that any issued patents will protect adequately those aspects of our technology to which such patents will relate. Despite our efforts to safeguard and maintain our proprietary rights, we cannot be certain that we will succeed in doing so or that our competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technologies. The laws of some countries do not protect intellectual property rights to the same extent or in the same manner as do the laws of the United States. Although we continue to implement protective measures and intend to defend our proprietary rights vigorously, these efforts may not be successful.

U.S. export controls could hinder our ability to make sales to foreign customers and our future prospects. The U.S. government regulates the export of high performance computer systems such as our products. Occasionally we have experienced delays in receiving appropriate approvals necessary for certain sales, which have delayed the shipment of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to foreign customers, eliminating an important source of potential revenue.

Factors Related To Our Industry

If we are unable to compete successfully against larger, more established companies in the high performance computer market, our revenue will decline. The performance of our products may not be competitive with the computer systems offered by our competitors. Many of our competitors are established companies that are well known in the high performance computer market, including IBM, SGI, Hewlett-Packard, NEC and Sun Microsystems. Each of these competitors has broader product lines and substantially greater research, engineering, manufacturing, marketing and financial resources than we do. Periodic announcements by our competitors of new high performance computer systems (or plans for future systems) and price adjustments may reduce customer demand for our products. Most of our potential customers already own or lease very high performance computer systems. Some of our competitors offer trade-in allowances or substantial discounts to potential customers, and engage in other aggressive pricing tactics, and we have not always been able to match these sales incentives. We may be required to provide discounts to make sales or to provide lease financing for our products, which would result in a deferral of our receipt of cash for these systems. These developments would limit our revenue and resources and would reduce our ability to be profitable.

We may not compete successfully against innovative competitors or new entrants. Our market is characterized by rapidly changing technology, accelerated product obsolescence and continuously evolving industry standards. Our success will depend upon our ability to sell our current products, and to develop successor systems. We will need to introduce new products and features in a timely manner to meet evolving customer requirements. We may not succeed in these efforts. Even if we succeed, products or technologies developed by others may render our products or technologies noncompetitive or obsolete. New companies have capitalized on developments in parallel processing and increased computer performance through networking and cluster systems. Currently, these products are limited in applicability and scalability and can be difficult to program. A breakthrough in architecture or software technology could make cluster systems more attractive to our potential customers. Such a breakthrough would impair our ability to sell our products and reduce our revenue.

General economic and market conditions could decrease our revenue, increase our need for cash and adversely affect our profitability. While much of our business is related to the government sector, which is less affected by short-term economic cycles, a slow-down in the overall U.S. and global economy and resultant decreases in capital expenditures have affected sales to our industrial customers and may continue to do so. Cancellations or delays in purchases would decrease our revenue, increase our need for working capital and adversely affect our profitability.

Factors Related To An Investment In Our Company

Our quarterly operating results may fluctuate significantly. Our operating results are subject to significant fluctuations due to many factors. One or a few system sales may account for a substantial percentage of our quarterly and annual revenue, and thus revenue, net income or loss and cash flow are likely to fluctuate significantly from quarter to quarter. This is due to the high average sales price of our products, the timing of purchase orders and product delivery, and our general policy of not recognizing product revenue until our customers accept our products. The acceptances of several important installations of Cray X1 systems are scheduled at the end of June 2003. If customer acceptances are delayed for any reason, revenue could move into the third quarter and would negatively affect operating results in the second quarter of 2003. This problem is particularly acute for the second quarter of 2003, and we do not expect this issue to occur to this extent at the end of following quarters. Red Storm revenue and margin may fluctuate from quarter to quarter due to the level of contract activity, including purchases of materials and changes in the estimates of the cost to complete. Because a number of our prospective customers receive funding from the U.S. or foreign governments, the timing of orders from our customers may be subject to the appropriation and funding schedules of the relevant government agencies. The timing of orders and shipments also could be affected by other events outside our control, such as:

- the timely availability of acceptable components in sufficient quantities to meet customer delivery schedules;
- changes in levels of customer capital spending;
- the introduction or announcement of competitive products;
- timing of the receipt of necessary export licenses; or
- currency fluctuations and international conflicts or economic crises.

We have experienced annual losses from operations prior to 2002, and we may not achieve net income on a consistent basis. We experienced net losses in each full year of our operations prior to 2002. We incurred net losses of approximately \$35.2 million in 2001, \$25.4 million in 2000, and \$34.5 million in 1999. For the year ended December 31, 2002, we had net income of \$5.4 million. Whether we will achieve net income on a consistent basis will depend on a number of factors, including:

- our ability to market and sell the Cray X1 system and other products and maintain the Red Storm project on schedule;
- the level of revenue in any given period;
- our expense levels, particularly for research and development and manufacturing and service costs;
- the cost of servicing the Cray T90 installed base; and
- the terms and conditions of sale or lease for our products.

Because of the numerous factors affecting our results of operations, there can be no assurance that we will have consistent net income in the future.

Our stock price may be volatile. The stock market has been and is subject to price and volume fluctuations that particularly affect the market prices for small capitalization, high technology companies like us. The trading price of our common stock is subject to significant fluctuations in response to many factors, including our quarterly operating results, changes in analysts' estimates, our future capital raising activities, announcements of technological innovations by us or our competitors and general conditions in our industry.

A substantial number of our shares are eligible for future sale and may depress the market price of our common stock and may hinder our ability to obtain additional financing. As of March 31, 2003, we had outstanding:

- 65,168,653 shares of common stock;
- 3,125,000 shares of Series A preferred stock convertible into 3,136,763 shares of common stock, plus any dividends on the Series A preferred stock that are paid in shares of common stock;
- warrants to purchase 8,736,701 shares of common stock; and
- stock options to purchase an aggregate of 13,067,118 shares of common stock, of which 6,912,177 options were then exercisable.

Almost all of our outstanding shares of common stock may be sold without substantial restrictions. All of the shares purchased under the warrants and exercisable options are available for sale in the public market, subject in some cases to volume and other limitations. All outstanding shares of Series A preferred stock are owned by NEC Corporation. The Series A preferred stock is not convertible into common stock unless the Series A preferred stock is sold or we sell substantially all our assets or we are acquired and the holders of our voting stock own less than a majority of the voting stock of the entity surviving the acquisition. If we sell substantially all our assets or are acquired in such an acquisition, the holder of Series A preferred stock, in lieu of conversion of that stock into common stock, may elect to receive the liquidation preference of \$8.00 per share of Series A preferred stock, plus any accrued and unpaid dividends, before any payment is made to the holders of common stock. Any shares of Series A preferred stock that are sold automatically convert into common stock. NEC can sell the Series A preferred stock without restriction, except that NEC cannot sell privately to any person who is, or by such sale would become, a beneficial owner of 5% or more of our common stock. In addition, if requested to do so by NEC, we are obligated to register for public resale the common stock issuable upon conversion of the Series A preferred stock. At March 31, 2003, warrants to purchase 3,296,851 shares of common stock, with exercise prices ranging from \$3.00 to \$6.00 per share, expire between January 20, 2004, and November 2, 2004; warrants to purchase 300,442 shares of common stock, with exercise prices ranging from \$4.50 to \$6.00 per share, expire between November 7, 2005, and September 3, 2006; and the remaining warrants to purchase 5,139,408 shares of common stock, with an exercise price of \$2.53 per share, expire on June 21, 2009. Sales in the public market of substantial amounts of our common stock, including sales of common stock issuable upon the exercise or conversion of the warrants, options and Series A preferred stock, may depress prevailing market prices for the common stock. Even the perception that sales could occur may impact market prices adversely. The existence of outstanding warrants, options and Series A preferred stock may prove to be a hindrance to our future equity financings. Further, the holders of the warrants and options may exercise them for shares of common stock, and NEC may sell its Series A preferred stock, at a time when we would otherwise be able to obtain additional equity capital on terms more favorable to us. Such factors could impair our ability to meet our capital needs.

Provisions of our Articles of Incorporation and Bylaws could make a proposed acquisition that is not approved by our Board of Directors more difficult. Provisions of our restated articles of incorporation and restated bylaws could make it more difficult for a third party to acquire us. These provisions could limit the price that investors might be willing to pay in the future for our common stock. For example, our Articles of Incorporation and Bylaws provide for:

- a staggered Board of Directors, so that only two or three of our eight directors are elected each year;
- removal of a director only in limited circumstances and only upon the affirmative vote of not less than two-thirds of the shares entitled to vote to elect directors;
- the ability of our board of directors to issue preferred stock, without shareholder approval, with rights senior to those of the common stock;
- no cumulative voting of shares;
- calling a special meeting of the shareholders only upon demand by the holders of not less than 30% of the shares entitled

to vote at such a meeting;

- amendments to our restated articles of incorporation require the affirmative vote of not less than two-thirds of the outstanding shares entitled to vote on the amendment, unless the amendment was approved by a majority of our continuing directors, who are defined as directors who have either served as a director since August 31, 1995, or were nominated to be a director by the continuing directors;
- special voting requirements for mergers and other business combinations, unless the proposed transaction was approved by a majority of continuing directors;
- special procedures must be followed to bring matters before our shareholders at our annual shareholders' meeting; and
- special procedures must be followed to nominate members for election to our board of directors.

These provisions could delay, defer or prevent a merger, consolidation, takeover or other business transaction between us and a third party.

Additional financings may be dilutive to our shareholders. We may need to raise additional equity or debt capital if we experience lower than anticipated product sales due to delays in availability of Cray X1 systems for delivery to customers or general economic conditions, or if we fail to receive sufficient governmental support for our products and research activities. Financings may not be available to us when needed or, if available, may not be available on satisfactory terms and may be dilutive to our shareholders.

We do not anticipate declaring any cash dividends on our common stock. We have never paid any dividends on our common stock, and we do not anticipate paying any cash dividends on our common stock in the foreseeable future. Our outstanding Series A preferred stock accrues a cumulative dividend, which is payable in cash if declared by our board of directors or otherwise in common stock upon conversion of the Series A preferred stock into common stock. As of May 10, 2003, the aggregate accrued and unpaid dividends on the Series A preferred stock were \$1,000,000. In addition, our credit facilities prohibit us from paying cash dividends without the consent of our lenders.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to financial market risks, including changes in interest rates and equity price fluctuations.

Interest Rate Risk: We invest our available cash in investment-grade debt instruments of corporate issuers and in debt instruments of the U.S. government and its agencies. We do not have any derivative instruments in our investment portfolio. We protect and preserve invested funds by limiting default, market and reinvestment risk. Investments in both fixed-rate and floating-rate interest earning instruments carry a degree of interest rate risk. Fixed-rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have declined in market value due to changes in interest rates. At March 31, 2003, our short-term investment balance was \$22.9 million.

Foreign Currency Risk: We sell our products primarily in North America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our products are generally priced in U.S. dollars, and a strengthening of the dollar could make our products less competitive in foreign markets. While we commonly sell products with payments in U.S. dollars, our product sales contracts occasionally call for payment in foreign currencies and to the extent we do so, we are subject to foreign currency exchange risks. We may use forward currency contracts to minimize these risks. Our foreign maintenance contracts are paid in local currencies and provide a natural hedge against local expenses. To the extent that we wish to repatriate any of these funds to the United States, however, we are subject to foreign exchange risks.

Item 4. Controls and Procedures

Within 90 days prior to the date of this report, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rules 13a-14(c) and 15d-14(c) of the Securities and Exchange Act of 1934, as amended. Our principal executive and financial officers supervised and participated in this evaluation. Based upon this evaluation our principal executive and financial officers each concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

In addition, there have been no significant changes in our internal controls or in other factors that could significantly affect our internal controls subsequent to our most recent evaluation, including any corrective actions with regard to significant deficiencies or material weaknesses.

Part II. Other Information

Item 1. Legal Proceedings

On June 26, 2002, the Company accepted service of a complaint filed by Isothermal Systems Research, Inc. ("ISR") of Clarkston, Washington, in the U.S. District Court for the Eastern District of Washington. The Company is the only defendant. The complaint alleges that SGI approached ISR to assist it in developing an evaporative spray cooling system for a supercomputer product (now the Cray X1), that in 1998 ISR and SGI entered into nondisclosure and product development agreements, that ISR disclosed ISR confidential information to the Cray Research division of SGI, and that SGI improperly breached and terminated the product development agreement. The complaint further alleges that, when the Company acquired the Cray Research business unit from SGI in 2000, the Company received assets and other information, including the ISR confidential information, and that the Company currently is utilizing the ISR confidential information and that such use is both improper and infringes three ISR patents relating to spray cooling technology. The complaint further alleges that the Company and SGI have improperly disclosed ISR confidential information. The complaint seeks judgment that the Company be enjoined from infringing the ISR patents, that ISR be awarded treble damages for the Company's alleged willful infringement of the ISR patents, and that the Company has been unjustly enriched by the receipt, use and disclosure of the ISR confidential information. On November 12, 2002, the Company answered the ISR complaint, denying the substantive allegations. The court has set March 1, 2004, as the trial date. While we intend to defend this lawsuit vigorously, pre-trial discovery is in its initial stages and the Company's management cannot predict the outcome of this proceeding with certainty.

Item 5. Other Information

In the first quarter of 2003, the Company completed a public offering of 8,480,000 shares of newly issued common stock, and an additional 145,000 shares of common stock from certain selling shareholders, at a public offering price of \$6.20 per share. The Company received from the offering, after underwriting discount and selling expenses, net proceeds of approximately \$49,059,000. The Company intends to use the net proceeds for general corporate purposes. Needham & Company, Inc., SG Cowen Securities Corporation and C.E. Unterberg, Towbin acted as managing underwriters for the offering.

On April 14, 2003, the Board of Directors elected Daniel C. Regis to the Board of Directors and as Chairman of the Audit Committee. Mr. Regis, 63, is Managing Director of Digital Partners, a venture capital fund specializing in emerging technology companies, which he co-founded in 2000. From 1996 to 1999, he was with Kirlan Venture Capital, Inc., where he was managing partner of a similarly focused technology fund. For the previous 32 years, he was with Price Waterhouse LLP, where he served as managing partner of the Seattle, Washington, office and earlier as managing partner of the Portland, Oregon, office. Mr. Regis is a director of Primus Knowledge Solutions, Inc., and serves on the board of The Seattle Foundation.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- | | |
|------|---|
| 10.1 | Credit Agreement between Wells Fargo Bank, National Association, and the Company, dated April 10, 2003, and related Note. |
| 99.1 | Certification pursuant to 18 U.S.C. Section 1350 by the President and Chief Executive Officer |
| 99.2 | Certification pursuant to 18 U.S.C. Section 1350 by the Chief Financial and Accounting Officer |

(b) Reports on Form 8-K

A report on Form 8-K for an event of December 31, 2002, was filed on January 3, 2003, reporting the redemption and conversion of the Company's 5% convertible subordinated debentures under Item 5, "Other Events."

A report on Form 8-K for an event of January 30, 2003, was filed on January 31, 2003, reporting the issuance of a press release for the Company's fourth quarter 2002 results under Item 5, "Other Events."

A report on Form 8-K for an event of February 5, 2003, was filed on February 7, 2003, reporting the amendment of the Company's bylaws under Item 5, "Other Events."

A report on Form 8-K for an event of February 19, 2003, was filed on February 21, 2003, reporting the completion of the Company's public offering of common stock under Item 5, "Other Events."

Items 2, 3 and 4 of Part II are not applicable and have been omitted.

SIGNATURES

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

May 15, 2003

CRAY INC.

By: /s/ JAMES E. ROTTSOLK

James E. Rottsolk
President and Chief Executive Officer

/s/ SCOTT J. POTERACKI

Scott J. Poteracki
Chief Financial and Accounting Officer

CERTIFICATIONS

I, James E. Rottsolk, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cray Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's boards of directors (or persons performing the equivalent function):
 - a all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

/s/ James E. Rottsolk

James E. Rottsolk
President and Chief Executive Officer

I, Scott J. Poteracki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cray Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's boards of directors (or persons performing the equivalent function):
 - a all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

/s/ Scott J. Poteracki

Scott J. Poteracki
Chief Financial and Accounting Officer

CREDIT AGREEMENT

THIS AGREEMENT is entered into as of April 10, 2003, by and between CRAY INC., a Washington corporation ("Borrower"), and WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank").

RECITALS

Borrower has requested that Bank extend or continue credit to Borrower as described below, and Bank has agreed to provide such credit to Borrower on the terms and conditions contained herein.

NOW, THEREFORE, for valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Bank and Borrower hereby agree as follows:

ARTICLE I
CREDIT TERMS

SECTION 1.1. LINE OF CREDIT.

(a) Line of Credit. Subject to the terms and conditions of this Agreement, Bank hereby agrees to make advances to Borrower from time to time up to and including May 1, 2004, not to exceed at any time the aggregate principal amount of Twenty-five Million Dollars (\$25,000,000.00) ("Line of Credit"), the proceeds of which shall be used for working capital. Borrower's obligation to repay advances under the Line of Credit shall be evidenced by a promissory note substantially in the form of Exhibit A attached hereto ("Line of Credit Note"), all terms of which are incorporated herein by this reference.

(b) Borrowing and Repayment. Borrower may from time to time during the term of the Line of Credit borrow, partially or wholly repay its outstanding borrowings, and reborrow, subject to all of the limitations, terms and conditions contained herein or in the Line of Credit Note; provided however, that the total outstanding borrowings under the Line of Credit shall not at any time exceed the maximum principal amount available thereunder, as set forth above.

SECTION 1.2. INTEREST/FEES.

(a) Interest. The outstanding principal balance of the each credit subject hereto shall bear interest at the rate of interest set forth in each promissory note or other instrument or document executed in connection therewith.

(b) Computation and Payment. Interest shall be computed on the basis of a 360-day year, actual days elapsed. Interest shall be payable at the times and place set forth in each promissory note or other instrument or document required hereby.

(c) Unused Commitment Fee. Borrower shall pay to Bank a fee equal to three hundred and seventy-five one thousandths of one percent (.375%) per annum (computed on the basis of a 360-day year, actual days elapsed) on the average daily unused amount of the Line of Credit, which fee shall be calculated on a quarterly basis by Bank and shall be due and payable by Borrower in arrears within ten (10) days after each billing is sent by Bank.

SECTION 1.3. COLLECTION OF PAYMENTS. Borrower authorizes Bank to collect all principal, interest and fees due under the Line of Credit by charging Borrower's deposit account number with Bank, or any other deposit account maintained by Borrower with Bank, for the full amount thereof. Should there be insufficient funds in any such deposit account to pay all such sums when due, the full amount of such deficiency shall be immediately due and payable by Borrower.

SECTION 1.4. COLLATERAL.

As security for all indebtedness of Borrower to Bank subject hereto, Borrower hereby grants to Bank security interests of first priority in all Borrower's accounts receivable and other rights to payment, general intangibles, inventory, equipment, including all rights to payments under all contracts between Borrower and the U.S. Government or any political subdivision thereof, and a lien of not less than first priority on that certain real property located at 1050 Lowater Road, Chippewa Falls, Wisconsin 54729.

As security for all indebtedness of Borrower to Bank subject hereto, Borrower shall cause Cray Federal Inc. to grant to Bank security interests of first priority in all its accounts receivable and other rights to payment and general intangibles.

All of the foregoing shall be evidenced by and subject to the terms of such security agreements, financing statements, deeds of trust and other documents, as Bank shall reasonably require, all in form and substance satisfactory to Bank. Borrower shall reimburse Bank immediately upon demand for all costs and expenses incurred by Bank in connection with any of the foregoing security, including without limitation, filing and recording fees and costs of appraisals, audits and title insurance.

SECTION 1.5. GUARANTIES. All indebtedness of Borrower to Bank shall be guaranteed jointly and severally by Cray Federal Inc. in the principal amount of Twenty-five Million Dollars (\$25,000,000.00) each, as evidenced by and subject to the terms of guaranties in form and substance satisfactory to Bank.

ARTICLE II
REPRESENTATIONS AND WARRANTIES

Borrower makes the following representations and warranties to Bank, which representations and warranties shall survive the execution of this Agreement and shall continue in full force and effect until the full and final payment, and satisfaction and discharge, of all obligations of Borrower to Bank subject to this Agreement.

SECTION 2.1. LEGAL STATUS. Borrower is a corporation, duly organized and existing and in good standing under the laws of the State of Washington, and is qualified or licensed to do business (and is in good standing as a foreign corporation, if applicable) in all jurisdictions in which such qualification or licensing is required or in which the failure to so qualify or to be so licensed could have a material adverse effect on Borrower.

SECTION 2.2. AUTHORIZATION AND VALIDITY. This Agreement and each promissory note, contract, instrument and other document required hereby or at any time hereafter delivered to Bank in connection herewith (collectively, the "Loan Documents") have been duly authorized, and upon their execution and delivery in accordance with the provisions hereof will constitute legal, valid and binding agreements and obligations of Borrower or the party which executes the same, enforceable in accordance with their respective terms.

SECTION 2.3. NO VIOLATION. The execution, delivery and performance by Borrower of each of the Loan Documents do not violate any provision of any law or regulation, or contravene any provision of the Articles of Incorporation or By-Laws of Borrower, or result in any breach of or default under any contract, obligation, indenture or other instrument to which Borrower is a party or by which Borrower may be bound.

SECTION 2.4. LITIGATION. There are no pending, or to the best of Borrower's knowledge threatened, actions, claims, investigations, suits or proceedings by or before any governmental authority, arbitrator, court or administrative agency which could have a material adverse effect on the financial condition or operation of Borrower other than those disclosed by Borrower to Bank in writing prior to the date hereof.

SECTION 2.5. CORRECTNESS OF FINANCIAL STATEMENT. The financial statement of Borrower dated December 31, 2002, a true copy of which has been delivered by Borrower to Bank prior to the date hereof, (a) is complete and correct and presents fairly the financial condition of Borrower, (b) discloses all liabilities of Borrower that are required to be reflected or reserved against under generally accepted accounting principles, whether liquidated or unliquidated, fixed or contingent, and (c) has been prepared in accordance with generally accepted accounting principles consistently applied. Since the date of such financial statement there has been no material adverse change in the financial condition of Borrower, nor has Borrower mortgaged, pledged, granted a security interest in or otherwise encumbered any of its assets or properties except in favor of Bank or as otherwise permitted by Bank in writing.

SECTION 2.6. INCOME TAX RETURNS. Borrower has no knowledge of any pending assessments or adjustments of its income tax payable with respect to any year in excess of \$100,000.00, except as disclosed by Borrower to Bank in writing.

SECTION 2.7. NO SUBORDINATION. There is no agreement, indenture, contract or instrument to which Borrower is a party or by which Borrower may be bound that requires the subordination in right of payment of any of Borrower's obligations subject to this Agreement to any other obligation of Borrower.

SECTION 2.8. PERMITS, FRANCHISES. Borrower possesses, and will hereafter possess, all material permits, consents, approvals, franchises and licenses required and rights to all trademarks, trade names, patents, and fictitious names, if any, necessary to enable it to conduct the business in which it is now engaged in compliance with applicable law.

SECTION 2.9. ERISA. Borrower is in compliance in all material respects with all applicable provisions of the Employee Retirement Income Security Act of 1974, as amended or recodified from time to time ("ERISA"); Borrower has not violated any provision of any defined employee pension benefit plan (as defined in ERISA) maintained or contributed to by Borrower (each, a "Plan"); no Reportable Event as defined in ERISA has occurred and is continuing with respect to any Plan initiated by Borrower; Borrower has met its minimum funding requirements under ERISA with respect to each Plan; and each Plan will be able to fulfill its benefit obligations as they come due in accordance with the Plan documents and under generally accepted accounting principles.

SECTION 2.10. OTHER OBLIGATIONS. Borrower is not in default on any obligation for borrowed money, any purchase money obligation or any other material lease, commitment, contract, instrument or obligation, in excess of \$250,000.00.

SECTION 2.11. ENVIRONMENTAL MATTERS. Except as disclosed by Borrower to Bank in writing prior to the date hereof, Borrower is in compliance in all material respects with all applicable

federal or state environmental, hazardous waste, health and safety statutes, and any rules or regulations adopted pursuant thereto, which govern or affect any of Borrower's operations and/or properties, including without limitation, the Comprehensive Environmental Response, Compensation and Liability Act of 1980, the Superfund Amendments and Reauthorization Act of 1986, the Federal Resource Conservation and Recovery Act of 1976, and the Federal Toxic Substances Control Act, as any of the same may be amended, modified or supplemented from time to time. None of the operations of Borrower is the subject of any federal or state investigation evaluating whether any remedial action involving a material expenditure is needed to respond to a release of any toxic or hazardous waste or substance into the environment. Borrower has no material contingent liability in connection with any release of any toxic or hazardous waste or substance into the environment.

SECTION 2.12. REAL PROPERTY COLLATERAL. Except as disclosed by Borrower to Bank in writing prior to the date hereof, with respect to any real property collateral required hereby:

(a) All taxes, governmental assessments, insurance premiums, and water, sewer and municipal charges, and rents (if any) which previously became due and owing in respect thereof have been paid as of the date hereof.

(b) There are no mechanics' or similar liens or claims which have been filed for work, labor or material (and no rights are outstanding that under law could give rise to any such lien) which affect all or any interest in any such real property and which are or may be prior to or equal to the lien thereon in favor of Bank, except to the extent not delinquent or being contested in good faith by appropriate proceedings.

(c) None of the improvements which were included for purpose of determining the appraised value of any such real property lies outside of the boundaries and/or building restriction lines thereof, and no improvements on adjoining properties materially encroach upon any such real property.

(d) There is no pending, or to the best of Borrower's knowledge threatened, proceeding for the total or partial condemnation of all or any portion of any such real property, and all such real property is in good repair and free and clear of any damage that would materially and adversely affect the value thereof as security and/or the intended use thereof.

ARTICLE III CONDITIONS

SECTION 3.1. CONDITIONS OF INITIAL EXTENSION OF CREDIT. The obligation of Bank to extend any credit contemplated by this Agreement is subject to the fulfillment to Bank's satisfaction of all of the following conditions:

(a) Approval of Bank Counsel. All legal matters incidental to the extension of credit by Bank shall be satisfactory to Bank's counsel.

(b) Documentation. Bank shall have received, in form and substance satisfactory to Bank, each of the following, duly executed:

- (i) This Agreement and each promissory note or other instrument or document required hereby.
- (ii) Billing invoice.
- (iii) Certificate of Incumbency (2).
- (iv) Corporate Resolution: Borrowing.

- (v) Corporate Resolution: Continuing Guaranty.
- (vi) Corporate Resolution: Third Party Collateral.
- (vii) S/A; Borrower: Continuing - Rights to Payments & Inventory.
- (viii) S/A; Borrower: Equipment.
- (ix) S/A; Third Party: Rights to Payments.
- (x) Exhibit A to UCC Financing Statement. (2)
- (xi) Mortgage and Exhibit A to Mortgage.
- (xii) Insurance Information Request.
- (xiii) Escrow/Title Instructions.
- (xiv) Such other documents as Bank may require under any other Section of this Agreement.

(c) Financial Condition. There shall have been no material adverse change, as determined by Bank, in the financial condition or business of Borrower or any guarantor hereunder, nor any material decline, as determined by Bank, in the market value of any collateral required hereunder or a substantial or material portion of the assets of Borrower or any guarantor hereunder.

(d) Insurance. Borrower shall have delivered to Bank evidence of insurance coverage on all Borrower's property, in form, substance, amounts, covering risks and issued by companies satisfactory to Bank, and where required by Bank, with loss payable endorsements in favor of Bank, including without limitation, policies of fire and extended coverage insurance covering all real property collateral required hereby, with replacement cost and mortgagee loss payable endorsements, and such policies of insurance against specific hazards affecting any such real property as may be required by governmental regulation or Bank.

(e) Title Insurance. Bank shall have received an ALTA Policy of Title Insurance, with such endorsements as Bank may require, issued by a company and in form and substance satisfactory to Bank, in the amount of \$8,000,000.00, insuring Bank's lien on the real property collateral required hereby to be of first priority, subject only to such exceptions as Bank shall approve in its discretion, with all costs thereof to be paid by Borrower.

(f) Tax Service Contract. Borrower shall have procured and delivered to Bank, at Borrower's cost, such tax service contract as Bank shall require for any real property collateral required hereby, to remain in effect as long as such real property secures any obligations of Borrower to Bank as required hereby.

SECTION 3.2. CONDITIONS OF EACH EXTENSION OF CREDIT. The obligation of Bank to make each extension of credit requested by Borrower hereunder shall be subject to the fulfillment to Bank's satisfaction of each of the following conditions:

(a) Compliance. The representations and warranties contained herein and in each of the other Loan Documents shall be true on and as of the date of the signing of this Agreement and on the date of each extension of credit by Bank pursuant hereto, with the same effect as though such representations and warranties had been made on and as of each such date, and on each such date, no Event of Default as defined herein, and no condition, event or act which with the giving of notice or the passage of time or both would constitute such an Event of Default, shall have occurred and be continuing or shall exist.

(b) Documentation. Bank shall have received all additional documents, which may be required in connection with such extension of credit.

ARTICLE IV
AFFIRMATIVE COVENANTS

Borrower covenants that so long as Bank remains committed to extend credit to Borrower pursuant hereto, or any liabilities (whether direct or contingent, liquidated or unliquidated) of Borrower to Bank under any of the Loan Documents remain outstanding, and until payment in full of all obligations of Borrower subject hereto, Borrower shall, unless Bank otherwise consents in writing:

SECTION 4.1. PUNCTUAL PAYMENTS. Punctually pay all principal, interest, fees or other liabilities due under any of the Loan Documents at the times and place and in the manner specified therein.

SECTION 4.2. ACCOUNTING RECORDS. Maintain adequate books and records in accordance with generally accepted accounting principles consistently applied, and permit any representative of Bank, at any reasonable time with at least one (1) business day's notice so long as no Event of Default shall not have occurred and be continuing, to inspect, audit and examine such books and records, to make copies of the same, and to inspect the properties of Borrower.

SECTION 4.3. FINANCIAL STATEMENTS. Provide to Bank all of the following, in form and detail satisfactory to Bank:

(a) not later than 90 days after and as of the end of each fiscal year, an audited financial statement of Borrower, prepared by a certified public accountant acceptable to Bank, to include an Auditor's Report;

(b) except for the last quarter of each fiscal year, not later than 40 days after and as of the end of each quarter, a financial statement of Borrower, prepared by Borrower, to include Statement of Cash Flows;

(c) contemporaneously with each annual and quarterly financial statement of Borrower required hereby, a certificate of the president or chief financial officer of Borrower that said financial statements are accurate and that there exists no Event of Default nor any condition, act or event which with the giving of notice or the passage of time or both would constitute an Event of Default;

(d) from time to time such other information as Bank may reasonably request, including without limitation, copies of rent rolls and other information with respect to any real property collateral required hereby.

SECTION 4.4. COMPLIANCE. Preserve and maintain all material licenses, permits, governmental approvals, rights, privileges and franchises necessary for the conduct of its business; and comply with the provisions of all documents pursuant to which Borrower is organized and/or which govern Borrower's continued existence and with the requirements of all material laws, rules, regulations and orders of any governmental authority applicable to Borrower and/or its business.

SECTION 4.5. INSURANCE. Maintain and keep in force insurance of the types and in amounts customarily carried in lines of business similar to that of Borrower, including but not limited to fire, extended coverage, public liability, flood, property damage and workers' compensation, with all such insurance carried with companies and in amounts satisfactory to Bank, and deliver to Bank from time to time at Bank's request schedules setting forth all insurance then in effect.

SECTION 4.6. FACILITIES. Use all reasonable efforts to keep all properties useful or necessary to Borrower's business in good repair and condition, and from time to time make necessary repairs, renewals and replacements thereto so that such properties shall be fully and efficiently preserved and maintained to the extent necessary for the conduct of Borrower's business.

SECTION 4.7. TAXES AND OTHER LIABILITIES. Pay and discharge when due any and all indebtedness, obligations, assessments and taxes, both real or personal, including without limitation federal and state income taxes and state and local property taxes and assessments, except such (a) as Borrower may in good faith contest or as to which a bona fide dispute may arise, and (b) for which Borrower has made provision, to Bank's satisfaction, for eventual payment thereof in the event Borrower is obligated to make such payment.

SECTION 4.8. LITIGATION. Promptly give notice in writing to Bank of any litigation pending or overtly threatened against Borrower in excess of \$250,000.00.

SECTION 4.9. FINANCIAL CONDITION. Maintain Borrower's financial condition as follows using generally accepted accounting principles consistently applied and used consistently with prior practices (except to the extent modified by the definitions herein), with compliance determined commencing with Borrower's financial statements for the period ending March 31, 2003:

(a) Cash not less than \$10,000,000.00, determined at fiscal quarter end, with "Cash" defined as the aggregate of unrestricted cash and marketable securities.

(b) Tangible Net Worth not less than \$95,000,000.00, determined at fiscal quarter end, with "Tangible Net Worth" defined as the aggregate of total stockholders' equity plus subordinated debt less any intangible assets.

(c) Total Liabilities divided by Tangible Net Worth not greater than;

(i) 0.85 to 1.0, determined at fiscal quarter ending March 31, 2003;

(ii) 0.85 to 1.0, determined at fiscal quarter ending June 30, 2003;

(iii) 0.85 to 1.0, determined at fiscal quarter ending September 30, 2003; and

(iv) 0.75 to 1.0, determined at fiscal quarter ending December 31, 2003, and each quarter thereafter,

with "Total Liabilities" defined as the aggregate of current liabilities and non-current liabilities less subordinated debt, and with "Tangible Net Worth" as defined above.

(d) Quick Ratio not less than;

(i) 1.25 to 1.0, determined at fiscal quarter ending March 31, 2003;

(ii) 1.25 to 1.0, determined at fiscal quarter ending June 30, 2003;

(iii) 1.25 to 1.0, determined at fiscal quarter ending September 30, 2003; and

(iv) 1.50 to 1.0, determined at fiscal quarter ending December 31, 2003, and each quarter thereafter,

with "Quick Ratio" defined as the aggregate of unrestricted cash, unrestricted marketable securities and receivables convertible into cash divided by total current liabilities.

(e) Pre-tax profit not less than \$1.00 on a quarterly basis, determined in at least three of each four consecutive fiscal quarters and on a rolling twelve month basis, determined as of each fiscal quarter end.

SECTION 4.10. NOTICE TO BANK. Promptly (but in no event more than five (5) days after the occurrence of each such event or matter) give written notice to Bank in reasonable detail of: (a) the occurrence of any Event of Default, or any condition, event or act which with the giving of notice or the passage of time or both would constitute an Event of Default; (b) any change in the name or the organizational structure of Borrower; (c) the occurrence and nature of any Reportable Event or Prohibited Transaction, each as defined in ERISA, or any funding deficiency with respect to any Plan; or (d) any termination or cancellation of any insurance policy which Borrower is required to maintain, or any uninsured or partially uninsured loss through liability or property damage, or through fire, theft or any other cause affecting Borrower's property in excess of \$100,000.00.

ARTICLE V NEGATIVE COVENANTS

Borrower further covenants that so long as Bank remains committed to extend credit to Borrower pursuant hereto, or any liabilities (whether direct or contingent, liquidated or unliquidated) of Borrower to Bank under any of the Loan Documents remain outstanding, and until payment in full of all obligations of Borrower subject hereto, Borrower will not without Bank's prior written consent:

SECTION 5.1. USE OF FUNDS. Use any of the proceeds of any credit extended hereunder except for the purposes stated in Article I hereof.

SECTION 5.2. OTHER INDEBTEDNESS. Create, incur, assume or permit to exist any indebtedness or liabilities resulting from borrowings, loans or advances, whether secured or unsecured, matured or unmatured, liquidated or unliquidated, joint or several, except (a) the liabilities of Borrower to Bank, (b) any other liabilities of Borrower existing as of, and disclosed to Bank prior to, the date hereof, and (c) liabilities not to exceed the aggregate of \$2,000,000.00 at any time outstanding.

SECTION 5.3. DIVIDENDS, DISTRIBUTIONS. Declare or pay any dividend or distribution either in cash, stock or any other property on Borrower's stock now or hereafter outstanding, nor redeem, retire, repurchase or otherwise acquire any shares of any class of Borrower's stock now or hereafter outstanding; provided, however, this Section 5.3 shall not prohibit Borrower from paying accrued or declared preferred stock dividends in the form of Borrower's common stock.

SECTION 5.4. PLEDGE OF ASSETS. Mortgage, pledge, grant or permit to exist a security interest in, or lien upon, all or any portion of Borrower's assets now owned or hereafter acquired, except any of the foregoing in favor of Bank or which is existing as of, and disclosed to Bank in writing prior to, the date hereof, and liabilities not to exceed the aggregate of \$2,000,000.00 at any time outstanding.

ARTICLE VI EVENTS OF DEFAULT

SECTION 6.1. The occurrence of any of the following shall constitute an "Event of Default" under this Agreement:

(a) Borrower shall fail to pay when due any principal, interest, fees or other amounts payable under any of the Loan Documents (in the case of fees, no later than three (3) days from when such fees are due).

(b) Any financial statement or certificate furnished to Bank in connection with, or any representation or warranty made by Borrower or any other party under this Agreement or any other Loan Document shall prove to be incorrect, false or misleading in any material respect when furnished or made.

(c) Any default in the performance of or compliance with any obligation, agreement or other provision contained herein or in any other Loan Document (other than those referred to in subsections (a) and (b) above), and with respect to any such default which by its nature can be cured, such default shall continue for a period of twenty (20) days from the time the default is known, or reasonably should have been known, by any of the executive officers of Borrower.

(d) Any default in the payment or performance of any obligation, or any defined event of default, under the terms of any contract or instrument pursuant to which Borrower or any guarantor hereunder has incurred any debt or other liability to any person or entity, other than Bank, in excess of \$100,000.00.

(e) Any default in the payment or performance of any obligation, or any defined event of default, under the terms of any contract or instrument (other than any of the Loan Documents) pursuant to which Borrower or any guarantor hereunder has incurred any debt or other liability to Bank.

(f) The filing of a notice of judgment lien against Borrower or any guarantor hereunder; or the recording of any abstract of judgment against Borrower or any guarantor hereunder in any county in which Borrower or such guarantor has an interest in real property, in each case not dismissed or charged within 30 days; or the service of a notice of levy and/or of a writ of attachment or execution, or other like process, against the assets of Borrower or any guarantor hereunder; or the entry of a judgment against Borrower or any guarantor hereunder, in each case not dismissed or discharged within 30 days.

(g) Borrower or any guarantor hereunder shall become insolvent, or shall suffer or consent to or apply for the appointment of a receiver, trustee, custodian or liquidator of itself or any of its property, or shall generally fail to pay its debts as they become due, or shall make a general assignment for the benefit of creditors; Borrower or any guarantor hereunder shall file a voluntary petition in bankruptcy, or seeking reorganization, in order to effect a plan or other arrangement with creditors or any other relief under the Bankruptcy Reform Act, Title 11 of the United States Code, as amended or recodified from time to time ("Bankruptcy Code"), or under any state or federal law granting relief to debtors, whether now or hereafter in effect; or any involuntary petition or proceeding pursuant to the Bankruptcy Code or any other applicable state or federal law relating to bankruptcy, reorganization or other relief for debtors is filed or commenced against Borrower or any guarantor hereunder and not discharged or dismissed within 45 days, or Borrower or any such guarantor shall file an answer admitting the jurisdiction of the court and the material allegations of any involuntary petition; or Borrower or any such guarantor shall be adjudicated a bankrupt, or an order for relief shall be entered against Borrower or any such guarantor by any court of competent jurisdiction under the Bankruptcy Code or any other applicable state or federal law relating to bankruptcy, reorganization or other relief for debtors.

(h) There shall exist or occur any event or condition which Bank in good faith believes impairs, or is substantially likely to impair, the prospect of payment or performance by Borrower of its obligations under any of the Loan Documents.

(i) The dissolution or liquidation of Borrower or any guarantor hereunder; or Borrower or any such guarantor, or any of their directors, stockholders or members, shall take action seeking to effect the dissolution or liquidation of Borrower or such guarantor.

(j) Any change in ownership during the term of this Agreement of Cray Federal Inc.

(k) The sale, transfer, hypothecation, assignment or encumbrance, whether voluntary, involuntary or by operation of law, without Bank's prior written consent, of all or any part of or interest in any real property collateral required hereby.

SECTION 6.2. REMEDIES. Upon the occurrence of any Event of Default: (a) all indebtedness of Borrower under each of the Loan Documents, any term thereof to the contrary notwithstanding, shall at Bank's option and without notice become immediately due and payable without presentment, demand, protest or notice of dishonor, all of which are hereby expressly waived by each Borrower; (b) the obligation, if any, of Bank to extend any further credit under any of the Loan Documents shall immediately cease and terminate; and (c) Bank shall have all rights, powers and remedies available under each of the Loan Documents, or accorded by law, including without limitation the right to resort to any or all security for any credit subject hereto and to exercise any or all of the rights of a beneficiary or secured party pursuant to applicable law. All rights, powers and remedies of Bank may be exercised at any time by Bank and from time to time after the occurrence of an Event of Default, are cumulative and not exclusive, and shall be in addition to any other rights, powers or remedies provided by law or equity.

ARTICLE VII MISCELLANEOUS

SECTION 7.1. NO WAIVER. No delay, failure or discontinuance of Bank in exercising any right, power or remedy under any of the Loan Documents shall affect or operate as a waiver of such right, power or remedy; nor shall any single or partial exercise of any such right, power or remedy preclude, waive or otherwise affect any other or further exercise thereof or the exercise of any other right, power or remedy. Any waiver, permit, consent or approval of any kind by Bank of any breach of or default under any of the Loan Documents must be in writing and shall be effective only to the extent set forth in such writing.

SECTION 7.2. NOTICES. All notices, requests and demands which any party is required or may desire to give to any other party under any provision of this Agreement must be in writing delivered to each party at the following address:

BORROWER: Cray Inc.
Attention: Chief Financial Officer or General Counsel
411 First Avenue South, Suite 600
Seattle, Washington 98104

BANK: WELLS FARGO BANK, NATIONAL ASSOCIATION
Seattle RCBO,
999 Third Avenue (11th Floor)
Seattle, Washington 98104

or to such other address as any party may designate by written notice to all other parties. Each such notice, request and demand shall be deemed given or made as follows: (a) if sent by hand delivery, upon

delivery; (b) if sent by mail, upon the earlier of the date of receipt or three (3) days after deposit in the U.S. mail, first class and postage prepaid; and (c) if sent by telecopy, upon receipt.

SECTION 7.3. COSTS, EXPENSES AND ATTORNEYS' FEES. Borrower shall pay to Bank immediately upon demand the full amount of all payments, advances, charges, costs and expenses, including reasonable attorneys' fees (to include outside counsel fees and all allocated costs of Bank's in-house counsel), expended or incurred by Bank in connection with (a) the negotiation and preparation of this Agreement and the other Loan Documents (subject to a maximum of \$10,000.00), Bank's continued administration hereof and thereof, and the preparation of any amendments and waivers hereto and thereto, (b) the enforcement of Bank's rights and/or the collection of any amounts which become due to Bank under any of the Loan Documents, and (c) the prosecution or defense of any action in any way related to any of the Loan Documents, including without limitation, any action for declaratory relief, whether incurred at the trial or appellate level, in an arbitration proceeding or otherwise, and including any of the foregoing incurred in connection with any bankruptcy proceeding (including without limitation, any adversary proceeding, contested matter or motion brought by Bank or any other person) relating to any Borrower or any other person or entity.

SECTION 7.4. SUCCESSORS, ASSIGNMENT. This Agreement shall be binding upon and inure to the benefit of the heirs, executors, administrators, legal representatives, successors and assigns of the parties; provided however, that Borrower may not assign or transfer its interest hereunder without Bank's prior written consent. Bank reserves the right to sell, assign, transfer, negotiate or grant participations in all or any part of, or any interest in, Bank's rights and benefits under each of the Loan Documents. In connection therewith, Bank may disclose all documents and information which Bank now has or may hereafter acquire relating to any credit subject hereto, Borrower or its business, any guarantor hereunder or the business of such guarantor, or any collateral required hereunder.

SECTION 7.5. ENTIRE AGREEMENT; AMENDMENT. This Agreement and the other Loan Documents constitute the entire agreement between Borrower and Bank with respect to each credit subject hereto and supersede all prior negotiations, communications, discussions and correspondence concerning the subject matter hereof. This Agreement may be amended or modified only in writing signed by each party hereto.

SECTION 7.6. NO THIRD PARTY BENEFICIARIES. This Agreement is made and entered into for the sole protection and benefit of the parties hereto and their respective permitted successors and assigns, and no other person or entity shall be a third party beneficiary of, or have any direct or indirect cause of action or claim in connection with, this Agreement or any other of the Loan Documents to which it is not a party.

SECTION 7.7. TIME. Time is of the essence of each and every provision of this Agreement and each other of the Loan Documents.

SECTION 7.8. SEVERABILITY OF PROVISIONS. If any provision of this Agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective only to the extent of such prohibition or invalidity without invalidating the remainder of such provision or any remaining provisions of this Agreement.

SECTION 7.9. COUNTERPARTS. This Agreement may be executed in any number of counterparts, each of which when executed and delivered shall be deemed to be an original, and all of which when taken together shall constitute one and the same Agreement.

SECTION 7.10. GOVERNING LAW. This Agreement shall be governed by and construed in accordance with the laws of the State of Washington.

SECTION 7.11.ARBITRATION.

(a) Arbitration. The parties hereto agree, upon demand by any party, to submit to binding arbitration all claims, disputes and controversies between or among them (and their respective employees, officers, directors, attorneys, and other agents), whether in tort, contract or otherwise arising out of or relating to in any way (i) the loan and related Loan Documents which are the subject of this Agreement and its negotiation, execution, collateralization, administration, repayment, modification, extension, substitution, formation, inducement, enforcement, default or termination; or (ii) requests for additional credit.

(b) Governing Rules. Any arbitration proceeding will (i) proceed in a location in Washington selected by the American Arbitration Association ("AAA"); (ii) be governed by the Federal Arbitration Act (Title 9 of the United States Code), notwithstanding any conflicting choice of law provision in any of the documents between the parties; and (iii) be conducted by the AAA, or such other administrator as the parties shall mutually agree upon, in accordance with the AAA's commercial dispute resolution procedures, unless the claim or counterclaim is at least \$1,000,000.00 exclusive of claimed interest, arbitration fees and costs in which case the arbitration shall be conducted in accordance with the AAA's optional procedures for large, complex commercial disputes (the commercial dispute resolution procedures or the optional procedures for large, complex commercial disputes to be referred to, as applicable, as the "Rules"). If there is any inconsistency between the terms hereof and the Rules, the terms and procedures set forth herein shall control. Any party who fails or refuses to submit to arbitration following a demand by any other party shall bear all costs and expenses incurred by such other party in compelling arbitration of any dispute. Nothing contained herein shall be deemed to be a waiver by any party that is a bank of the protections afforded to it under 12 U.S.C. Section 91 or any similar applicable state law.

(c) No Waiver of Provisional Remedies, Self-Help and Foreclosure. The arbitration requirement does not limit the right of any party to (i) foreclose against real or personal property collateral; (ii) exercise self-help remedies relating to collateral or proceeds of collateral such as setoff or repossession; or (iii) obtain provisional or ancillary remedies such as replevin, injunctive relief, attachment or the appointment of a receiver, before during or after the pendency of any arbitration proceeding. This exclusion does not constitute a waiver of the right or obligation of any party to submit any dispute to arbitration or reference hereunder, including those arising from the exercise of the actions detailed in sections (i), (ii) and (iii) of this paragraph.

(d) Arbitrator Qualifications and Powers. Any arbitration proceeding in which the amount in controversy is \$5,000,000.00 or less will be decided by a single arbitrator selected according to the Rules, and who shall not render an award of greater than \$5,000,000.00. Any dispute in which the amount in controversy exceeds \$5,000,000.00 shall be decided by majority vote of a panel of three arbitrators; provided however, that all three arbitrators must actively participate in all hearings and deliberations. The arbitrator will be a neutral attorney licensed in the State of Washington or a neutral retired judge of the state or federal judiciary of Washington, in either case with a minimum of ten years experience in the substantive law applicable to the subject matter of the dispute to be arbitrated. The arbitrator will determine whether or not an issue is arbitratable and will give effect to the statutes of limitation in determining any claim. In any arbitration proceeding the arbitrator will decide (by documents only or with a hearing at the arbitrator's discretion) any pre-hearing motions, which are similar to motions to dismiss for failure to state a claim or motions for summary adjudication. The arbitrator shall resolve all disputes in accordance with the substantive law of Washington and may grant any remedy or relief that a

court of such state could order or grant within the scope hereof and such ancillary relief as is necessary to make effective any award. The arbitrator shall also have the power to award recovery of all costs and fees, to impose sanctions and to take such other action as the arbitrator deems necessary to the same extent a judge could pursuant to the Federal Rules of Civil Procedure, the Washington Rules of Civil Procedure or other applicable law. Judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction. The institution and maintenance of an action for judicial relief or pursuit of a provisional or ancillary remedy shall not constitute a waiver of the right of any party, including the plaintiff, to submit the controversy or claim to arbitration if any other party contests such action for judicial relief.

(e) Discovery. In any arbitration proceeding discovery will be permitted in accordance with the Rules. All discovery shall be expressly limited to matters directly relevant to the dispute being arbitrated and must be completed no later than 20 days before the hearing date and within 180 days of the filing of the dispute with the AAA. Any requests for an extension of the discovery periods, or any discovery disputes, will be subject to final determination by the arbitrator upon a showing that the request for discovery is essential for the party's presentation and that no alternative means for obtaining information is available.

(f) Class Proceedings and Consolidations. The resolution of any dispute arising pursuant to the terms of this Agreement shall be determined by a separate arbitration proceeding and such dispute shall not be consolidated with other disputes or included in any class proceeding.

(g) Payment Of Arbitration Costs And Fees. The arbitrator shall award all costs and expenses of the arbitration proceeding.

(h) Miscellaneous. To the maximum extent practicable, the AAA, the arbitrators and the parties shall take all action required to conclude any arbitration proceeding within 180 days of the filing of the dispute with the AAA. No arbitrator or other party to an arbitration proceeding may disclose the existence, content or results thereof, except for disclosures of information by a party required in the ordinary course of its business or by applicable law or regulation. If more than one agreement for arbitration by or between the parties potentially applies to a dispute, the arbitration provision most directly related to the Loan Documents or the subject matter of the dispute shall control. This arbitration provision shall survive termination, amendment or expiration of any of the Loan Documents or any relationship between the parties.

ORAL AGREEMENTS OR ORAL COMMITMENTS TO LOAN MONEY, EXTEND CREDIT OR TO FORBEAR ENFORCING REPAYMENT OF A DEBT ARE NOT ENFORCEABLE UNDER WASHINGTON LAW.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the day and year first written above.

BORROWER:

BANK:

CRAY INC.

WELLS FARGO BANK,
NATIONAL ASSOCIATION

By: /s/ James E. Rottsolk
Printed Name: James E. Rottsolk
Title: President

By: /s/ David A. Dehlendorf
David A. Dehlendorf, Relationship Manager

REVOLVING LINE OF CREDIT NOTE

\$25,000,000.00

Seattle, Washington
April 10, 2003

FOR VALUE RECEIVED, the undersigned CRAY INC. ("Borrower") promises to pay to the order of WELLS FARGO BANK, NATIONAL ASSOCIATION ("Bank") at its office at Seattle RCBO, 999 Third Avenue (11th Floor), Seattle, WA 98104, or at such other place as the holder hereof may designate, in lawful money of the United States of America and in immediately available funds, the principal sum of Twenty-Five Million Dollars (\$25,000,000.00), or so much thereof as may be advanced and be outstanding, with interest thereon, to be computed on each advance from the date of its disbursement as set forth herein.

DEFINITIONS:

As used herein, the following terms shall have the meanings set forth after each, and any other term defined in this Note shall have the meaning set forth at the place defined:

(a) "Business Day" means any day except a Saturday, Sunday or any other day on which commercial banks in Washington are authorized or required by law to close.

(b) "Fixed Rate Term" means a period commencing on a Business Day and continuing for 1, 2, 3 or 6 months, as designated by Borrower, during which all or a portion of the outstanding principal balance of this Note bears interest determined in relation to LIBOR; provided however, that no Fixed Rate Term may be selected for a principal amount less than One Hundred Thousand Dollars (\$100,000.00); and provided further, that no Fixed Rate Term shall extend beyond the scheduled maturity date hereof. If any Fixed Rate Term would end on a day which is not a Business Day, then such Fixed Rate Term shall be extended to the next succeeding Business Day.

(c) "LIBOR" means the rate per annum (rounded upward, if necessary, to the nearest whole 1/8 of 1%) and determined pursuant to the following formula:

$$\text{LIBOR} = \frac{\text{Base LIBOR}}{100\% - \text{LIBOR Reserve Percentage}}$$

(i) "Base LIBOR" means the rate per annum for United States dollar deposits quoted by Bank as the Inter-Bank Market Offered Rate, with the understanding that such rate is quoted by Bank for the purpose of calculating effective rates of interest for loans making reference thereto, on the first day of a Fixed Rate Term for delivery of funds on said date for a period of time approximately equal to the number of days in such Fixed Rate Term and in an amount approximately equal to the principal amount to which such Fixed Rate Term applies. Borrower understands and agrees that Bank may base its quotation of the Inter-Bank Market Offered Rate upon such offers or other market indicators of the Inter-Bank Market as Bank in its discretion deems appropriate including, but not limited to, the rate offered for U.S. dollar deposits on the London Inter-Bank Market.

(ii) "LIBOR Reserve Percentage" means the reserve percentage prescribed by the Board of Governors of the Federal Reserve System (or any successor) for "Eurocurrency Liabilities" (as defined in Regulation D of the Federal Reserve Board, as amended), adjusted by Bank for expected changes in such reserve percentage during the applicable Fixed Rate Term.

(d) "Prime Rate" means at any time the rate of interest most recently announced within Bank at its principal office as its Prime Rate, with the understanding that the Prime Rate is one of Bank's base rates and serves as the basis upon which effective rates of interest are calculated for those loans making reference thereto, and is evidenced by the recording thereof after its announcement in such internal publication or publications as Bank may designate.

INTEREST:

(a) Interest. The outstanding principal balance of this Note shall bear interest (computed on the basis of a 360-day year, actual days elapsed) either (i) at a fluctuating rate per annum equal to the Prime Rate in effect from time to time, or (ii) at a fixed rate per annum determined by Bank to be one and one half a percent (1.5%) above LIBOR in effect on the first day of the applicable Fixed Rate Term. When interest is determined in relation to the Prime Rate, each change in the rate of interest hereunder shall become effective on the date each Prime Rate change is announced within Bank. With respect to each LIBOR selection hereunder, Bank is hereby authorized to note the date, principal amount, interest rate and Fixed Rate Term applicable thereto and any payments made thereon on Bank's books and records (either manually or by electronic entry) and/or on any schedule attached to this Note, which notations shall be prima facie evidence of the accuracy of the information noted.

(b) Selection of Interest Rate Options. At any time any portion of this Note bears interest determined in relation to LIBOR, it may be continued by Borrower at the end of the Fixed Rate Term applicable thereto so that all or a portion thereof bears interest determined in relation to the Prime Rate or to LIBOR for a new Fixed Rate Term designated by Borrower. At any time any portion of this Note bears interest determined in relation to the Prime Rate, Borrower may convert all or a portion thereof so that it bears interest determined in relation to LIBOR for a Fixed Rate Term designated by Borrower. At such time as Borrower requests an advance hereunder or wishes to select a LIBOR option for all or a portion of the outstanding principal balance hereof, and at the end of each Fixed Rate Term, Borrower shall give Bank notice specifying: (i) the interest rate option selected by Borrower; (ii) the principal amount subject thereto; and (iii) for each LIBOR selection, the length of the applicable Fixed Rate Term. Any such notice may be given by telephone (or such other electronic method as Bank may permit) so long as, with respect to each LIBOR selection, (A) if requested by Bank, Borrower provides to Bank written confirmation thereof not later than three (3) Business Days after such notice is given, and (B) such notice is given to Bank prior to 10:00 a.m. on the first day of the Fixed Rate Term, or at a later time during any Business Day if Bank, at its sole option but without obligation to do so, accepts Borrower's notice and quotes a fixed rate to Borrower. If Borrower does not immediately accept a fixed rate when quoted by Bank, the quoted rate shall expire and any subsequent LIBOR request from Borrower shall be subject to a redetermination by Bank of the applicable fixed rate. If no specific designation of interest is made at the time any advance is requested hereunder or at the end of any Fixed Rate Term, Borrower shall be deemed to have made a Prime Rate interest selection for such advance or the principal amount to which such Fixed Rate Term applied.

(c) Taxes and Regulatory Costs. Borrower shall pay to Bank immediately upon demand, in addition to any other amounts due or to become due hereunder, any and all (i) withholdings, interest equalization taxes, stamp taxes or other taxes (except income and franchise taxes) imposed by any domestic or foreign governmental authority and related in any manner to LIBOR, and (ii) future, supplemental, emergency or other changes in the LIBOR Reserve Percentage, assessment rates imposed by the Federal Deposit Insurance Corporation, or similar requirements or costs imposed by any domestic or foreign governmental authority or resulting from compliance by Bank with any request or directive (whether or not having the force of law) from any central bank or other governmental authority and related in any manner to LIBOR to the extent they are not included in the calculation of LIBOR. In determining which of the foregoing are attributable to any LIBOR option available to Borrower

hereunder, any reasonable allocation made by Bank among its operations shall be conclusive and binding upon Borrower.

(d) Payment of Interest. Interest accrued on this Note shall be payable on the first day of each month, commencing May 1, 2003.

(e) Default Interest. From and after the maturity date of this Note, or such earlier date as all principal owing hereunder becomes due and payable by acceleration or otherwise, the outstanding principal balance of this Note shall bear interest until paid in full at an increased rate per annum (computed on the basis of a 360-day year, actual days elapsed) equal to four percent (4%) above the rate of interest from time to time applicable to this Note.

BORROWING AND REPAYMENT:

(a) Borrowing and Repayment. Borrower may from time to time during the term of this Note borrow, partially or wholly repay its outstanding borrowings, and reborrow, subject to all of the limitations, terms and conditions of this Note and of any document executed in connection with or governing this Note; provided however, that the total outstanding borrowings under this Note shall not at any time exceed the principal amount stated above. The unpaid principal balance of this obligation at any time shall be the total amounts advanced hereunder by the holder hereof less the amount of principal payments made hereon by or for any Borrower, which balance may be endorsed hereon from time to time by the holder. The outstanding principal balance of this Note shall be due and payable in full on May 1, 2004.

(b) Advances. Advances hereunder, to the total amount of the principal sum stated above, may be made by the holder at the oral or written request of (i) James E. Rottsolk, Scott J. Poteracki or Kenneth W. Johnson, any one acting alone, who are authorized to request advances and direct the disposition of any advances until written notice of the revocation of such authority is received by the holder at the office designated above, or (ii) any person, with respect to advances deposited to the credit of any deposit account of any Borrower, which advances, when so deposited, shall be conclusively presumed to have been made to or for the benefit of each Borrower regardless of the fact that persons other than those authorized to request advances may have authority to draw against such account. The holder shall have no obligation to determine whether any person requesting an advance is or has been authorized by any Borrower.

(c) Application of Payments. Each payment made on this Note shall be credited first, to any interest then due and second, to the outstanding principal balance hereof. All payments credited to principal shall be applied first, to the outstanding principal balance of this Note which bears interest determined in relation to the Prime Rate, if any, and second, to the outstanding principal balance of this Note which bears interest determined in relation to LIBOR, with such payments applied to the oldest Fixed Rate Term first.

PREPAYMENT:

(a) Prime Rate. Borrower may prepay principal on any portion of this Note which bears interest determined in relation to the Prime Rate at any time, in any amount and without penalty.

(b) LIBOR. Borrower may prepay principal on any portion of this Note which bears interest determined in relation to LIBOR at any time and in the minimum amount of One Hundred Thousand Dollars (\$100,000.00); provided however, that if the outstanding principal balance of such portion of this Note is less than said amount, the minimum prepayment amount shall be the entire outstanding principal

balance thereof. In consideration of Bank providing this prepayment option to Borrower, or if any such portion of this Note shall become due and payable at any time prior to the last day of the Fixed Rate Term applicable thereto by acceleration or otherwise, Borrower shall pay to Bank immediately upon demand a fee which is the sum of the discounted monthly differences for each month from the month of prepayment through the month in which such Fixed Rate Term matures, calculated as follows for each such month:

- (i) Determine the amount of interest which would have accrued each month on the amount prepaid at the interest rate applicable to such amount had it remained outstanding until the last day of the Fixed Rate Term applicable thereto.
- (ii) Subtract from the amount determined in (i) above the amount of interest which would have accrued for the same month on the amount prepaid for the remaining term of such Fixed Rate Term at LIBOR in effect on the date of prepayment for new loans made for such term and in a principal amount equal to the amount prepaid.
- (iii) If the result obtained in (ii) for any month is greater than zero, discount that difference by LIBOR used in (ii) above.

Each Borrower acknowledges that prepayment of such amount may result in Bank incurring additional costs, expenses and/or liabilities, and that it is difficult to ascertain the full extent of such costs, expenses and/or liabilities. Each Borrower, therefore, agrees to pay the above-described prepayment fee and agrees that said amount represents a reasonable estimate of the prepayment costs, expenses and/or liabilities of Bank. If Borrower fails to pay any prepayment fee when due, the amount of such prepayment fee shall thereafter bear interest until paid at a rate per annum two percent (2.00%) above the Prime Rate in effect from time to time (computed on the basis of a 360-day year, actual days elapsed). Each change in the rate of interest on any such past due prepayment fee shall become effective on the date each Prime Rate change is announced within Bank.

EVENTS OF DEFAULT:

This Note is made pursuant to and is subject to the terms and conditions of that certain Credit Agreement between Borrower and Bank dated as of April 10, 2003, as amended from time to time (the "Credit Agreement"). Any default in the payment or performance of any obligation under this Note, or any defined event of default under the Credit Agreement, shall constitute an "Event of Default" under this Note.

MISCELLANEOUS:

(a) Remedies. Upon the occurrence of any Event of Default, the holder of this Note, at the holder's option, may declare all sums of principal and interest outstanding hereunder to be immediately due and payable without presentment, demand, notice of nonperformance, notice of protest, protest or notice of dishonor, all of which are expressly waived by each Borrower, and the obligation, if any, of the holder to extend any further credit hereunder shall immediately cease and terminate. Each Borrower shall pay to the holder immediately upon demand the full amount of all payments, advances, charges, costs and expenses, including reasonable attorneys' fees (to include outside counsel fees and all allocated costs of the holder's in-house counsel), expended or incurred by the holder in connection with the enforcement of the holder's rights and/or the collection of any amounts which become due to the holder under this Note, and the prosecution or defense of any action in any way related to this Note, including without limitation, any action for declaratory relief, whether incurred at the trial or appellate level, in an arbitration proceeding or otherwise, and including any of the foregoing incurred in connection with any bankruptcy

proceeding (including without limitation, any adversary proceeding, contested matter or motion brought by Bank or any other person) relating to any Borrower or any other person or entity.

(b) Obligations Joint and Several. Should more than one person or entity sign this Note as a Borrower, the obligations of each such Borrower shall be joint and several.

(c) Governing Law. This Note shall be governed by and construed in accordance with the laws of the State of Washington.

ORAL AGREEMENTS OR ORAL COMMITMENTS TO LOAN MONEY, EXTEND CREDIT OR TO FORBEAR ENFORCING REPAYMENT OF A DEBT ARE NOT ENFORCEABLE UNDER WASHINGTON LAW.

This Note is secured by, among other collateral, a Mortgage dated April 10, 2003.

IN WITNESS WHEREOF, the undersigned has executed this Note as of the date first written above.

CRAY INC.

By: /s/ James E. Rottsolk

Printed Name: James E. Rottsolk

Title: President

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Cray Inc. (the "Company") on Form 10-Q for the quarterly period ended March 31, 2003, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James E. Rottsolk, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ JAMES E. ROTTSOLK

James E. Rottsolk
President and Chief Executive Officer

May 15, 2003

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Cray Inc. (the "Company") on Form 10-Q for the quarterly period ended March 31, 2003, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Scott J. Poteracki, Chief Financial and Accounting Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ SCOTT J. POTERACKI

Scott J. Poteracki
Chief Financial and Accounting Officer

May 15, 2003