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August 14, 1998

RATIONAL SOFTWARE CORP (RATL) Quarterly Report (SEC form 10-Q)

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

OVERVIEW

The statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations include "forward looking" information within the meaning of Sections 27A of the Securities Act of 1993 and 21E of the Securities and Exchange Act of 1934, as amended, and are subject to the safe harbor created by those sections. The actual future results of the Company could differ materially from those projected in the forward looking information. For a discussion of certain factors that could cause actual results to differ materially from those projected by the forward looking information see "Factors That May Affect Future Results", at the end of this Item 2.

The Company's revenue is derived from product license fees and charges for services, including technical consulting, training, and customer support. In accordance with generally accepted accounting principles, the Company recognizes software license revenue upon shipment and recognizes customer-support revenue over the term of the maintenance agreement. Revenue from consulting and training is recognized when earned. The Company's license agreements generally do not provide a right of return, and reserves are maintained for potential credit losses, of which historically there have been only immaterial amounts.

On July 30, 1997 the Company merged with Pure Atria Corporation ("Pure Atria"). The merger was accounted for as pooling-of-interests and the historical consolidated financial statements of the Company for prior periods have been restated to include the financial position, results of operations and cash flows of Pure Atria. See Note 3 to Notes to Consolidated Financial Statements in the Company's Annual Report to Stockholders (Form 10-K) for the year ended March 31, 1998.

COMPARATIVE ANALYSIS OF OPERATING RESULTS FOR THE THREE MONTHS ENDED JUNE 30,

Total revenue increased 25% for the three month period ended June 30, 1998 from the comparable prior year period. Net product revenue and consulting and support revenue increased 30% and 19%, respectively, for the three month period ended June 30, 1998 from the comparable prior year period.

This increase reflects continued strong customer acceptance across the Company's products and services.

International revenues from product sales and consulting and customer support accounted for 34% of total revenues for three month period ended June 30, 1998, and 36% for the comparable prior year period. The Company's international sales are principally priced in local currencies. The Company enters into short-term forward currency contracts to hedge against the impact of foreign currency exchange rate fluctuations on balance sheet exposures denominated in currencies other than the functional currency of the Company or its subsidiaries. The total amount of these contracts is approximately offset by the underlying assets and liabilities denominated in non-functional currencies and such contracts are carried at fair market value. The associated gains and losses were not material to the Company's results of operations in any period presented. See Risks Associated with International Operations.

Cost of product revenue consists principally of materials, packaging and freight, amortization of developed technology and royalties. These costs represented 13% of total product revenue for the three month period ended June 30, 1998, as compared to 10% for the comparable prior year period. The increase in product cost as a percentage of certain product revenue was due mainly to costs associated with the introduction of new versions of company products during the quarter.

Cost of consulting and support revenue consists principally of personnel costs for training, consulting and customer support. Cost of consulting and support increased 18% for the three month period ended June 30, 1998 from the comparable prior year period. These costs represented 28% of total consulting and support revenue for the three month period ended June 30, 1998 as compared to 41% for the comparable prior year period. The decrease in cost as a percentage of related revenue is primarily due to changes to the Company's customer support business model as a result of combining the Pure Atria and Rational service

organizations, combined with the impact of a relatively fixed support cost base servicing increased revenues.

Total expenditures for research and development increased 16% for the three month period ended June 30, 1998 from the comparable prior year period. These costs represented 19% of total revenue for the three month period ended June 30, 1998 versus 20% for the comparable prior year period. The increase in expenditures for research and development is due primarily to the cost of additional personnel and related costs incurred to maintain and enhance existing products as well as develop new products.

Sales and marketing expenses increased 28% for the three month period ended June 30, 1998 from the comparable prior year period. These costs represented 44% of total revenue for the three month period ended June 30, 1998 compared to 43% for the same period last year. The increase in sales and marketing expenses reflect the additional personnel and related costs required to expand Rational's sales channels, to penetrate new markets, and to increase its market share in core markets.

General and administrative expense decreased 2% for the three month period ended June 30, 1998 from the comparable prior year period. These costs represented 8% of total revenue for the three month period ended June 30, 1998 as compared to 10% for the comparable prior year period.

Other income, net consists primarily of interest income, interest expense and gains and losses due to fluctuations in foreign currency exchange rates. Other income has fluctuated as a result of the amount of cash available for investment in interest-bearing instruments and from fluctuations in foreign currency exchange rates. Other income, net decreased $1,470,000 for the three month period ended June 30, 1998 from the comparable prior year period. The current year decrease is due primarily to a lower average amount of invested cash resulting from repurchase of company stock during the quarter.

The provision for income taxes for the three month period ended June 30, 1998 is based on the estimated annual effective tax rate applied to the profit before income taxes and includes federal, state and foreign income taxes. The effective tax rates for fiscal 1999 and 1998 differ from the federal statutory rate, primarily, as a result of the recognition of previously unrecognized deferred tax assets, the non-deductibility of certain merger related costs, losses in certain foreign jurisdictions for which no US benefit was derived, differing tax rates in certain foreign jurisdictions and by state taxes.

LIQUIDITY AND CAPITAL RESOURCES AT JUNE 30, 1998

As of June 30, 1998, the Company had cash, cash equivalents and short-term investments of $243,103,000 and working capital of $191,381,000. Net cash provided by operating activities for the period ended June 30, 1998 was composed primarily of operating income and a decrease in accounts receivable, offset by a decrease in accrued employee benefits and other accrued expenses, accrued merger costs, and accounts payable. Net cash provided by investing activities resulted primarily from a decrease in short-term cash investments offset by an increase in capital expenditures. Net cash used in financing activities resulted primarily from the repurchase of common stock, offset by issuance of common stock under the Employee Stock Purchase Plan and the exercise of employee stock options.

The Company is authorized to repurchase up to six million shares of its common stock in the open market to be used for general corporate purposes. Any repurchase should also help offset dilution from stock issued under the company's stock option and stock purchase plans. Through June 30, 1998 the Company had repurchased 3,141,500 shares of its common stock for a total cash outlay of approximately $50.2 million.

The Company believes that expected cash flow from operations combined with existing cash and cash equivalents and short-term investments will be sufficient to meet its cash requirements for the foreseeable future.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Risks Associated with Recent and Future Acquisitions

Rational acquired Pure Atria Corporation (Pure Atria) on July 30, 1997, with the expectation that the acquisition would result in long-term strategic benefits. The realization of these anticipated benefits will continue to depend in part on integration ~~of~~ the companies' respective product offerings and research and development efforts. There can be no assurance that this will occur. Successful integration of the companies' respective sales forces will continue to require sales personnel to become familiar with the sales cycles and sales approaches required for products recently added to their portfolios, and any failure to do so may result in sales delays and decreased revenues for the Company. It is possible that the continued integration of the companies' respective products and the creation of integrated bundles and suites may not be accomplished in a timely manner or may prove to be technologically infeasible. The difficulties of integrating the two companies' respective operations is compounded by the fact that each company had significant operations on both the East Coast and the West Coast of the United States and in a number of other countries. The acquisition of Pure Atria has been accounted for as a pooling of interests. Accordingly, if such accounting treatment were to be nullified for any reason, it would materially and adversely affect Rational's reported earnings and, potentially, its stock price.

In addition to the acquisition of Pure Atria, during approximately the past three years, Rational has made a number of strategic acquisitions, including SQA, Inc., Performance Awareness Corporation, Requisite, Inc., Softlab AB, and Software 9000 in the quarter ended March 31, 1997, the Visual Test product from Microsoft in October 1996, and other acquisitions in earlier periods. Rational has recently acquired 19.9% of the outstanding capital stock of ObjecTime, Ltd. Acquisitions result in the diversion of management's attention from day-to-day operations and include numerous other risks, including difficulties in the integration of operations, products, and personnel. To the extent that acquisitions have in the past resulted, or may in the future result, in a diversion of resources or that efforts to integrate recent and future acquisitions fail, there could be a material adverse effect on Rational's business, results of operations, and financial condition. Acquisitions have the potential to result in dilutive issuances of equity securities, the incurrence of debt, and amortization expenses related to goodwill and other intangible assets. Rational's management has historically evaluated on an ongoing basis the strategic opportunities available to the Company. Rational may in the near-term or long-term future pursue acquisitions of complementary products, technologies, or businesses.

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Fluctuations in Operating Results

Revenue in any quarter is substantially dependent on orders booked and shipped in that quarter. Because staffing and operating expenses are based on anticipated revenue levels and a high percentage of the costs are fixed, small variations in the timing of the recognition of specific revenues could cause significant variations in operating results from quarter to quarter. Historically, the Company has earned a substantial portion of its revenues in the last weeks of the quarter. To the extent these trends continue, the failure to achieve such revenues in the last weeks of any given quarter will have a material adverse effect on the Company's financial results for that quarter. The Company's revenue is difficult to forecast because Rational's sales cycles, from initial evaluation to purchase, vary substantially from customer to customer and from product to product and because the markets for Rational's products are rapidly evolving. In addition, the Company's results will be affected by the number, timing, and significance of new product announcements by it and its competitors, its ability to develop, introduce, and market new, enhanced, and integrated versions of its products on a timely basis, the level of product and price competition, changes in operating expenses, changes in average selling prices and product mix, any changes in its sales incentive strategy, the experience level of and any changes in sales personnel, any changes in sales cycles, the mix of direct and indirect sales, product returns, and general economic factors, among others. The Company's

sales will also be sensitive to existing and prospective customers' budgeting practices, global economic conditions, and potential cutbacks in U.S. defense spending, which has historically been a significant factor for Rational.

Unanticipated expenses associated with the integration of Rational and Pure Atria may arise, or the Company may incur additional material charges in subsequent quarters to reflect additional costs associated with the integration of the two companies. Total costs associated with such transactions resulted in an operating loss and a net loss for the Company's fiscal year ended March 31, 1998, and could negatively impact financial results in future periods for the reasons discussed above.

Although Rational has experienced growth in revenues in recent years, there can be no assurance that, in the future, Rational will sustain revenue growth or be profitable on a quarterly or annual basis. Further, the revenues and operating income (exclusive of nonrecurring operating, restructuring, and merger-related expenses) experienced by Rational in recent quarters are not necessarily indicative of future results, and period-to-period comparisons of Rational's financial results should not be relied on as an indication of future performance. Fluctuations in operating results have previously and may continue to result in volatility in the price of Rational's common stock.

Due to all of the foregoing factors, it is possible that in some future quarter, Rational's operating results will be below the expectations of public market analysts and investors. In such event, the price of Rational's common stock would likely be materially adversely affected, and significant declines in stock prices frequently result in costly and lengthy securities litigation, with its attendant costs, distraction, and liability exposure.

Volatility of Stock Price

The market price of the Company's common stock has been, and is likely to continue to be, volatile. Factors such as new product announcements or changes in product pricing policies by the Company or its competitors, quarterly fluctuations in the Company's operating results, announcements of technical innovations, announcements relating to strategic relationships or acquisitions, changes in earnings estimates by analysts, and general conditions in the software-development market, among other factors, may have a significant impact on the market price of the Company's common stock. Should the Company fail to introduce products on the schedule expected, the Company's stock price could be adversely affected.

Any shortfall in anticipated operating results could have an immediate and significant adverse effect on the market price of the Company's common stock. Further, the Company incurred substantial merger-related charges in the quarter ended September 30, 1997. Although Rational entered into the merger with the expectation that it would be accretive in the long term, the merger has been dilutive in the initial periods following its effective time, and there can be no assurance as to when the merger will become accretive, if ever. Any failure of the Pure Atria merger to meet expectations as to potential business synergies or any failure of the Pure Atria merger to be accretive in any quarter could have an immediate and significant adverse effect on the market price of the Company's common stock.

Statements or changes in opinions, ratings, or earnings estimates made by brokerage firms or industry analysts relating to the market for software and high-technology company stocks or relating to Rational specifically have resulted, and could in the future result, in an immediate and adverse effect on the market price of Rational's common stock. Statements by financial or industry analysts regarding the extent of the dilution in Rational's net income per share resulting from operating results, the Pure Atria merger, or other developments and the extent to which such analysts expect potential business synergies to offset such dilution can be expected to contribute to volatility in the market price of Rational's common stock. In addition, in recent years the stock market in general, and the shares of technology companies in particular, have experienced extreme price fluctuations. This volatility has had a substantial effect on the market prices of securities issued by many companies, including Rational, in certain cases for reasons unrelated to the operating performance of the specific companies. These broad market fluctuations may adversely affect the market price of Rational's common stock.

Dependence on Market Growth and Development of Industry Standards

Rational's future growth and financial performance will depend in part on broad acceptance of modeling for developing mission-critical applications, and continued growth in the need for and sales of tools for automating software development and management. Sales of these products may not continue to grow, or the Company may be unable to respond effectively to evolving customer requirements. The number of software developers using Rational's products is relatively small compared to the number of developers using more traditional technology and products. The adoption of the Company's products by software programmers who have traditionally used other technology requires reorientation to significantly different programming methods. The acceptance of the Company's products, therefore, may not expand beyond sophisticated programmers who are early adopters of the technology. Furthermore, potential customers may be unwilling to make the investment required to retrain programmers to build software using the Company's products rather than traditional programming techniques. Many of Rational's customers have purchased only small quantities of the Company's products, and these or new customers may decide not to broadly implement or purchase additional units of such products.

Rational's future growth and financial performance may depend on the development of industry standards that facilitate the adoption of component- based development, as well as Rational's ability to play a leading role in the establishment of those standards. The Company has developed the Unified Modeling Language (UML) for visual modeling, which has been adopted by the Object Management Group (OMG), an industry consortium, for inclusion in their object analysis and design facility specification. The official sanction in the future of a competing standard by the OMG could have a material adverse effect on Rational's marketing and sales efforts and, in turn, on Rational's business, operating results, and financial condition.

Expansion of Product Lines; Dependence on New Product Introductions

The Company believes that its continued success will depend in part on its ability to provide a tightly integrated line of software application-development tools, as well as integrated product suites and bundles, that support software development for a number of implementation languages. This will require the Company to modify and enhance its current products and to continue to develop, introduce, and integrate new products. The Company believes its continued success will become increasingly dependent on its ability to support the Microsoft platform, including the Windows 95, Windows 98, and Windows NT operating systems. The Company also believes its continued success will become increasingly dependent on its ability to support Web-based development of business-critical applications using latest technologies. The Company believes that it will be particularly important to successfully develop and market a broader line of products for C++, Visual Basic, Java, and other implementation languages in order to be successful in its efforts to broaden its customer base and to further increase its share in its existing market segments. The Company also believes that, over time, its products must be extended to fully support off-the-shelf products from companies such as SAP, The Baan Company, and PeopleSoft. The Company may be unable to successfully develop and market such a broad line of products or may encounter unexpected difficulties and delays in integrating new products with existing product lines.

Rational has plans to introduce new products and enhanced versions of current products during the next few fiscal quarters. Delay in the start of shipment of new, enhanced, or integrated products, suites, and bundles would have an adverse effect on the Company's revenues, gross profit, and operating income. As a result of Rational's business alliance with Microsoft, certain of Rational's new product releases are expected to be tightly integrated with new releases of certain Microsoft products. To the extent that scheduled Microsoft product releases are delayed, there could be a material adverse effect on Rational's revenues from new products.

Rational attempts to make adequate allowances in its product release schedules for both internal and beta-site testing of product performance. Because of the complexity of the Company's products, however, the release of new products may be postponed should test results indicate the need for redesign

and retesting or should the Company elect to add product enhancements in response to beta customer feedback.

COMPETITION

The industry for tools for automating software application development and management is extremely competitive and rapidly changing. Rational expects to continue to experience significant and increasing levels of competition in the future. Bases of competition include corporate and product reputation, innovation with frequent product enhancement, breadth of integrated product line, the availability of integrated suites and bundles, product architecture, functionality and features, product quality, performance, ease of use, support, availability of technical consulting services, and price. Rational faces intense competition for each product within its product lines, generally from both Windows, Windows NT, and UNIX vendors. Because individual product sales are often the first step in a broader customer relationship, Rational's success will depend in part on its ability to successfully compete with numerous competitors at each point in its product line.

Rational faces competition from software-development tools and processes developed internally by customers, including ad hoc integrations of numerous standalone development tools. Customers may be reluctant to purchase products offered by independent vendors such as the Company. As a result, the Company must educate prospective customers about the advantages of the Company's products versus internally developed software-quality systems.

Rational faces competition from, among others, Intersolv, Inc., Platinum Technology, Inc., Select Software Tools plc, Cayenne, Oracle, IBM Corporation (IBM), Sun Microsystems, and Sybase Inc., as well as numerous privately held tool suppliers offering traditional CASE tools that compete with the Rational Rose approach to visual modeling and component-based development. Rational's RequisitePro requirements-management product faces competition from companies such as GEC-Marconi. Rational's software-testing toolsPurify, Quantify, PureCoverage, SQA Suite, Rational Visual Test, and preVueface competition from Compuware, Mercury Interactive Corporation, Segue Software, Inc., Intersolv, Inc., Computer Associates, Platinum Technologies, Terodyne, Cyrano, SQL Bench International, Inc., and several private companies offering testing-automation tools. Microsoft, Compuware, Oracle, Sybase, and several of the major UNIX platform vendors, including Sun Microsystems, Hewlett Packard, Digital Equipment Corporation, Silicon Graphics, Inc., and IBM, also compete with Rational with respect to software-quality products and testing tools, with testing products customized to certain of their other software products. Rational Apex for C/C++ faces competition from, among others, major UNIX platform vendors such as Sun Microsystems, Hewlett-Packard, and Digital Equipment Corporation, which have C/C++ compilers and debuggers and, in some cases, programming environments for their platforms. In addition, numerous privately held companies offer compilers, debuggers, and programming environments that compete with Rational Apex. Rational's ClearCase, ClearDDTS, and ClearQuest product line faces competition from various suppliers offering products with configuration and change management functions, including Continuus Software Corporation, StarBase Corporation, Hewlett Packard, True Software, SQL Software, LTD., Intersolv, Inc., Sun Microsystems, and IBM. The Rational Apex Ada product line faces competition from Aonix, Green Hills Software, Inc., and a large number of other suppliers offering Ada products for native and embedded systems.

The Company also experiences competition with respect to a number of its products, both from utilities commonly bundled with versions of operating systems and from standalone product offerings. For example, versions of UNIX are commonly bundled with utilities (such as SCCS and RCS) that provide version control, which is part of the functionality provided by ClearCase. Some system vendors, such as Sun, already have products, such as Workshop, that provide features similar to those in Purify or others of the Company's products and would compete directly with such products if offered on a standalone basis. The Company's recently announced ClearQuest defect-tracking product is expected to compete with products from LBMS, Inc., which was recently acquired by Platinum Technology, Inc. There can be no assurance that Sun, which has a license to some of the Company's patents, will not introduce standalone products that compete with the Company's products. Companies offering products competitive with

Rational Summit and ClearCase in the UNIX marketplace include Sun, which offers TeamWare, IBM, which offers Configuration Management/Version Control (CMVC), Computer Associates (CA) through its acquisition of LEGENT Corporation, which offers the Endeavor WSX product, and Platinum through its acquisition of Softool Corp., which markets CCC Harvest. In addition, there are several smaller, privately held companies that market competitive products, including Continuus Software Corporation, which markets Continuus/CM. Other companies have offered version control or configuration management products outside the UNIX market. Companies in this category include CA, Intersolv, and Microsoft. CA has a large installed base of its configuration management product on IBM mainframes. Intersolv has a large installed base of DOS and Windows software developers. In 1994, Microsoft acquired OneTree Software, which offers a version control product. The Company expects additional competition from other established and emerging companies.

Rational believes that the major competitive factors in its markets are corporate and product reputation, breadth of coverage by an integrated product line, product architecture, functionality and features, product quality, performance, ease of use, quality of support, availability of technical consulting services, and price.

Rational believes that the increased level of competition it observed in fiscal 1998 will continue to increase. Certain of Rational's competitors are more experienced than Rational in the development of software-engineering tools, databases, or software-development products. Some of Rational's competitors have, and new competitors may have, larger technical staffs, more established distribution channels, and greater financial resources than Rational. There can be no assurance that either existing or new competitors will not develop products that are superior to Rational's products or that achieve greater market acceptance. Rational's future success will depend in large part on its ability to increase its share of its target markets and to license additional products and product enhancements to existing customers. Future competition may result in price reductions, reduced margins, or loss of sales, which in turn would have a material adverse effect on the Company's business, results of operations, and financial condition.

Dependence on Sales Force and Other Channels of Distribution

Rational currently distributes its products primarily through field sales personnel teamed with highly trained technical-support personnel. Rational believes that a high level of technical consulting, training, and customer support is essential to maintaining its competitive position and has found that the ability to deliver a high level of technical consulting, training, and customer support is an important selling point with respect to its products. Although complementary to Rational's products, the services provided by these personnel have historically yielded lower margins for Rational than the Company's product business. If these services constitute a higher proportion of total revenues in the future, the Company's margins will be adversely affected. Rational markets and sells its products and services directly through its major- accounts field operations, its telesales organizations, and its World Wide Web site, and indirectly through channels such as VARs and distributors. There can be no assurance that such channels will be successful in increasing sales of the Company's products or in reducing its sales costs on a percentage basis.

Dependence on Key Personnel

Rational believes that the hiring and retaining of qualified individuals at all levels in the Company will be essential to the Company's ability to manage growth successfully, and there can be no assurance that the Company will be successful in attracting and retaining the necessary personnel. The Company will be particularly dependent on the efforts and abilities of its senior management personnel. The departure of any of the senior management members or other key personnel of the Company could have a material adverse effect on the Company's business, financial condition, or results of operations, depending on the timing of the departure, changes in the Company's business prior to such time, the availability of qualified personnel to replace them, and whether such personnel depart singly, contemporaneously, or as a group, among other factors. Merger activities, such as the acquisition of Pure Atria, can be accompanied or

followed by the departure of key personnel, which can compound the difficulty of integrating the operations of the parties to the business combination.

The ability of the Company to attract and retain the highly trained technical personnel that are integral to its direct sales and product development teams may limit the rate at which the Company can develop products and generate sales. Competition for qualified personnel in the software industry is intense, and there can be no assurance that the Company will be successful in attracting and retaining such personnel. Merger activities, such as the acquisition of Pure Atria, may have a destabilizing effect on employee retention at all levels within the Company. Departures of existing personnel, particularly in key technical, sales, marketing, or management positions, can be disruptive and can result in departures of other existing personnel, which in turn could have a material adverse effect on the Company's business, operating results, and financial condition.

A traditional means of retaining employees following declines in a corporation's stock price, such as those experienced recently by Rational, is to reprice "underwater" stock options, both to offer an equity incentive to existing employees and to avoid inequities relative to new employees offered lower-priced options. On November 4, 1997, the Company's board of directors approved a program enabling the Company to reprice stock options for most employees. The repriced options are subject to additional lock-up and repurchase restrictions. Members of the Company's senior management team at that time were not eligible to participate in that repricing program. In April 1998, the compensation committee of the board, after consulting with all of the outside directors, approved repricing agreements with the members of the senior management team who were not eligible to participate in the November 1997 repricing program. The senior officer repricing was completed on substantially the same terms, including the disposition limitations and repurchase provisions, offered to the rest of the employees in November 1997, although at the higher fair market price existing at the time of the April 1998 repricing. There can be no assurance that such repricing will be sufficient to retain employees or senior management or that at some future date the outstanding stock options will not again be underwater. To the extent that options held by employees, including members of senior management, again become underwater, those options may not serve as an incentive to retain these individuals. The departure of one or more members of the senior management team could have a material adverse effect on the Company's business, results of operations, and financial condition.

Rapid Technological Change

The industry for tools for automating software application development and management is characterized by rapid technological advances, changes in customer requirements, and frequent new product introductions and enhancements. The introduction of products embodying new technologies and the emergence of new industry standards and practices can render existing products obsolete and unmarketable. The Company must respond rapidly to developments related to Internet and intranet applications, hardware platforms, operating systems, and applicable programming languages. Such developments will require the Company to make substantial product-development investments. Any failure by the Company to anticipate or respond adequately to technology developments and customer requirements, or any significant delays in product development, introduction, or integration, could result in a loss of competitiveness or revenue. To the extent the Company does not respond to technological change or evolving customer requirements with new products or product enhancements, such new products or product enhancements may fail to achieve market acceptance.

In addition, rapid growth of, interest in, and use of Internet and intranet environments is a recent and emerging phenomenon. The Company's success may depend, in part, on the compatibility of its products with Internet and intranet applications. The Company may fail to effectively adapt its products for use in Internet or intranet environments or to produce competitive Internet and intranet applications.

Rational believes that factors affecting the ability of its products to achieve broad consumer acceptance include product performance, price, ease of adoption, displacement of existing approaches, and adaptation to rapid technological change and competitive product offerings. The Company may be unable

to respond promptly and effectively to the challenges of technological change and its competitors' innovations, and it is possible that the Company will be unable to achieve the necessary market acceptance or compete effectively in new markets.

Dependence on Strategic Relationships

Rational's development, marketing, and distribution strategies rely increasingly on its ability to form long-term strategic relationships with major software and hardware vendors, many of whom are substantially larger than Rational. These business relationships often consist of cooperative marketing programs, joint customer seminars, lead referrals, or joint development projects. Although certain aspects of some of these relationships are contractual in nature, many important aspects of these relationships depend on the continued cooperation of each party with Rational. Merger activity, such as the acquisition of Pure Atria, may disrupt these relationships or activities, and certain partners may reassess the value of their relationship with Rational as a result of such merger activity. Divergence in strategy between Rational and any given partner, a change in focus by any given partner, or competitive product offerings introduced by any given partner may interfere with Rational's ability to develop, market, sell, or support its products, which in turn would have a material adverse effect on Rational's business, results of operations, and financial condition. See "Business Alliance with Microsoft."

Business Alliance with Microsoft

On October 2, 1996, Rational and Microsoft announced the formation of a business alliance that consisted of Rational's acquisition of Microsoft's Visual Test product, technology cross-licensing, joint development projects, and joint marketing programs. Although Rational believes that Microsoft's current strategy in relation to the enterprise information systems market is based on component- based development, there can be no assurance that this strategy will continue or that, if it does continue, Microsoft's emphasis or priorities will not change in the future, resulting in less attention and fewer resources being devoted to Microsoft's relationship with Rational. Although certain aspects of the business alliance are contractual in nature, many important aspects of the relationship depend on the continued cooperation of the two companies, and there can be no assurance that Rational and Microsoft will be able to work together successfully over an extended period of time. In addition, there can be no assurance that Microsoft will not use the information it gains in its relationship with Rational to develop or market competing products.

Acquisition of the Visual Test Product

The Company acquired the Visual Test product from Microsoft on October 2, 1996. There can be no assurance that Rational will be able to successfully incorporate the Visual Test product into its integrated family of products or that it will be able to achieve significant sales of the Visual Test product. Many potential customers for Visual Test differ from the Company's historical customer base in terms of component-based software-development expertise, purchasing processes, financial resources, and expectations regarding software- engineering tools. There can be no assurance that the Company will not encounter unanticipated concerns of Visual Test customers that are different from the concerns of the Company's traditional customers or that the Company will have the infrastructure and experience necessary to adequately respond to the volume and type of such concerns.

Rational has granted Microsoft a nonexclusive, perpetual license to the Visual Test product source code for the purpose of creating derivative works and for the purpose of distributing portions of the Visual Test product and derivative works as part of Microsoft products that do not directly compete with the Visual Test product in the software-testing tools area. There can be no assurance that Microsoft will not use such rights to create and distribute products that compete with other Rational products. Rational has also granted Microsoft a five-year option to obtain a license to incorporate certain elements of Visual Test technology into Microsoft development tool products, including Visual Basic, Visual C++, and Visual J++.

Should Microsoft exercise such right, sales of the Visual Test product by Rational could be materially and adversely impacted. See "Fluctuations in Operating Results."

Licensing of Rational Rose Technology to Microsoft

In October 1996, Microsoft and Rational entered into a two-year agreement providing for the inclusion of a subset of the Rational Rose visual modeling technology in future versions of Microsoft's enterprise-oriented visual tools. The Company's objective in entering into this arrangement is to expose the Company's technology to a broader customer base and not to generate direct product revenue from Microsoft. The Company expects that continued changes in the Company's pricing models and combinations of features within product lines will be required to appeal to this customer base, and there can be no assurance that such changes will achieve customer acceptance. Rational does not expect the licensing of its Rational Rose technology to Microsoft to directly result in a material increase in product revenue. In addition, there can be no assurance that developers introduced to the Rational Rose technology incorporated into Microsoft products will become purchasers of Rational products in the future. Rational has granted Microsoft the option to obtain a perpetual, nonexclusive right to source code for certain aspects of the Rational Rose technology after the expiration of the agreement. While Rational believes that Microsoft's and Rational's strategies currently are complementary, there can be no assurance that Microsoft will not use this right to develop and market competing products in the future.

Dependence on Major Operating Systems

Many of Rational's major products have historically been licensed for use principally on certain versions of the UNIX platform. These products constitute a substantial portion of Rational's product and service revenues. Any factors adversely affecting the demand for, or use of, the UNIX operating system that would require changes to Rational's products would have a material adverse effect on the business, operating results, and financial condition of Rational. Likewise, others of Rational's major products have historically been licensed for use purely on the Windows or Windows NT operating systems. These products also constitute a substantial portion of Rational's product and service revenues. Any factors adversely affecting the demand for, or use of, the Windows or Windows NT operating systems that would require changes to Rational's products would have a material adverse effect on the business, operating results, and financial condition of Rational. In addition, any changes to the underlying components of or interfaces to the UNIX, Windows or Windows NT operating systems that would require changes to Rational's products for those platforms would materially adversely affect Rational if it were not able to successfully develop or implement such changes in a timely fashion.

Adverse Impact of Promotional Product Versions on Actual Product Sales

The Company's marketing strategy relies in part on making elements of its technology available for no charge or at a very low price, either directly or by incorporating such elements into products offered by the Company's partners, such as Microsoft. This strategy is designed to expose the Company's products to a broader customer base than its historical customer base and to encourage potential customers to purchase an upgrade or other higher-priced product from the Company. There can be no assurance that the Company will be able to introduce enhancements to its full-price products or versions of its products with intermediate functionality at a rate necessary to adequately differentiate them from the promotional versions, particularly in cases where the Company's partners are distributing versions of the Company's products with other desirable features.

Management of Growth

Rational has experienced rapid growth, particularly as a result of its acquisitions, and the Company is experiencing a period of aggressive product introductions that have placed, and may continue to place, a significant strain on its financial, operational, management, marketing, and sales systems and

resources, including its personnel. Projects such as the expansion of or enhancements to product lines, efforts to address broader markets and to expand distribution channels, numerous acquisitions as described in "Risks Associated with Recent and Future Acquisitions" and business alliances such as the arrangement between Rational and Microsoft, when added to the day-to-day activities of Rational, have placed and will continue to place further strain on management resources and personnel. If Rational's management is unable to effectively manage growth, its business, competitive position, results of operations, and financial condition will be materially and adversely affected.

To achieve and manage continued growth, the Company must continue to expand and upgrade its information-technology infrastructure and its scalability, including improvements to various operations, financial, and management information systems. In addition, the Company believes that to remain competitive it must significantly expand its capabilities for electronic commerce. Improving management systems and infrastructure and building electronic commerce capabilities will require that the Company recruit and retain highly qualified technical personnel, and such personnel resources are extremely scarce in the areas where the Company operates. Failure to improve management infrastructure and build electronic commerce capabilities for future growth would materially and adversely affect the Company's business, competitive position, results of operations, and financial condition. See "Dependence on Key Personnel."

Risk of Software Defects

Software products as complex as those sold by the Company often contain undetected errors, or "bugs," or performance problems. Such defects are most frequently found during the period immediately following the introduction of new products or enhancements to existing products. Despite extensive product testing prior to introduction, the Company's products have in the past contained software errors that were discovered after commercial introduction. Errors or performance problems may also be discovered in the future. Any future software defects discovered after shipment of the Company's products could result in loss of revenues or delays in market acceptance, which could have a material adverse effect on the Company's business, operating results, or financial condition. Further, because the Company relies on its own products in connection with the development of its software, any such errors could make it more difficult to sell such products in the future. Rational attempts to make adequate allowance in its new- product release schedule for both internal and beta-site testing of product performance. Because of the complexity of the Company's products, however, the release of new products by the Company may be postponed should test results indicate the need for redesign and retesting or should the Company elect to add product enhancements in response to beta customer feedback.

Risks Associated with International Operations

International sales accounted for approximately 34%, 34%, and 27% of Rational's revenues in fiscal 1999, 1998, and 1997, respectively. Rational expects that international sales will continue to account for a significant portion of the Company's revenues in future periods. International sales are subject to inherent risks, including unexpected changes in regulatory requirements and tariffs, unexpected changes in global economic conditions, difficulties in staffing and managing foreign operations, longer payment cycles, greater difficulty in accounts receivable collection, potentially adverse tax consequences, price controls or other restrictions on foreign currency, difficulties in obtaining export and import licenses, costs of localizing products for foreign markets, lack of acceptance of localized products in international markets, and the effects of high local wage scales and other expenses. Any material adverse effect on the Company's international business would be likely to materially and adversely affect the Company's business, operating results, and financial condition as a whole.

Rational's international sales are generally transacted through its international sales subsidiaries. The revenue generated by these foreign subsidiaries, as well as their local expenses, are generally denominated in local currencies. Accordingly, the functional currency of each international sales subsidiary is the local currency. Rational has engaged in limited hedging activities to protect it against losses arising from remeasuring assets and liabilities denominated in currencies other than the functional currency of the

related subsidiary. The Company is also exposed to foreign exchange rate fluctuations as the financial results of international subsidiaries are translated into U.S. Dollars in consolidation. As exchange rates vary, these results, when translated, may vary from expectations and adversely impact overall expected profitability. The Company currently does not hedge against this exposure. The Company has currently experienced no significant adverse impact on revenues or operating results as a result of changes in exchange rates or current economic conditions in many Asian countries. There can be no assurance that the Company will not experience a material adverse impact on its financial condition and results of operations from fluctuations in foreign currencies or from further economic problems in Asia in the future.

Risks Associated with Asian Economic Crises

In addition to general risks associated with international operations listed above, there are additional risks associated with the continuing economic crisis in Asia. Many of Rational's customers, who are either based in Europe or the Americas, do a substantial amount of business in Asia. As economic conditions have affected buying behavior in Asia, Rational's customers may also be affected, resulting in changes to their own buying behavior in Europe or the Americas. There can be no assurance that the Company will not experience a material adverse impact on its financial condition and results of operations from the impact of the Asian economic crisis both in Asia and in other geographies.

Limited Protection of Intellectual Property and Proprietary Rights

Rational relies on a combination of copyright, trademark, and trade-secret laws, employee and third-party nondisclosure agreements, and other methods to protect its proprietary rights. Despite these precautions, it may be possible for unauthorized third parties to copy certain portions of the Company's products or reverse engineer or obtain and use information that Rational regards as proprietary. Rational generally licenses its software products to end-users on a right-to-use basis pursuant to a perpetual license. Rational licenses its products primarily under "shrink-wrap" licenses (that is, licenses included as part of the product packaging). Shrink-wrap licenses are not negotiated with or signed by individual licensees and purport to take effect upon the opening of the product package. Certain license provisions protecting against unauthorized use, copying, transfer, and disclosure of the licensed program may be unenforceable under the laws of certain jurisdictions and foreign countries. In addition, the laws of some countries do not protect proprietary rights to the same extent as the laws of the United States. There can be no assurance that these protections will be adequate. To the extent that the Company increases its international activities, its exposure to unauthorized copying and use of its products and proprietary information will increase.

The scope of United States patent protection in the software industry is not well defined and will evolve as the United States Patent and Trademark Office grants additional patents. Because patent applications in the United States are not publicly disclosed until the patent is issued, applications may have been filed that would relate to Rational's products.

Rational also relies on certain software that it licenses from third parties, including software that is integrated with internally developed software and used in its products to perform key functions. There can be no assurance that these third-party software licenses will continue to be available to the Company on commercially reasonable terms or that the software will be appropriately supported, maintained, or enhanced by the licensors. The loss of licenses to or inability to support, maintain, and enhance any of such software could result in increased costs or in delays or deductions in product shipments until equivalent software could be developed, identified, licensed, and integrated, which would materially adversely affect the Company's business, operating results, and financial condition. In addition, Rational licenses certain of its technology to its development partners. There can be no assurance that such partners' use of the technology will be complementary to Rational's strategies or that such partners will not use such technology to develop and market competing products in the future.

Risks of Litigation

Competitors and potential competitors may resort to litigation as a means of competition. Such litigation or other legal disputes may be costly and may expose the Company to new claims that it may not have anticipated. In the past, Rational has instituted litigation against several companies. Although patent and intellectual property disputes in the software area have often been settled through licensing, cross-licensing, or similar arrangements, costs associated with such arrangements may be substantial. The Company is also currently a party to securities litigation. Any litigation involving the Company, whether as plaintiff or defendant, regardless of the outcome, may result in substantial costs and expenses to the Company and significant diversion of effort by the Company's technical and management personnel. In addition, there can be no assurance that litigation, instituted either by or against the Company, will not be

necessary to resolve issues that may arise from time to time in the future. Any such litigation could have a material adverse effect on the Company's business, operating results, and financial condition.

Rational expects that software product developers will be increasingly subject to infringement claims as the number of products and competitors grows and the functionality of products in different industry segments overlaps. There can be no assurance that third parties will not assert infringement claims against the Company in the future or that such claims will not be successful. The Company could incur substantial costs in defending itself and its customers against any such claims. Parties making such claims may be able to obtain injunctive or other equitable relief that could effectively block the Company's ability to sell its products in the United States and abroad and could result in an award of substantial damages. In the event of a claim of infringement, the Company and its customers may be required to obtain one or more licenses from third parties. There can be no assurance that the Company or its customers could obtain necessary licenses from third parties at a reasonable cost or at all. Defense of any lawsuit or failure to obtain any such required license would have a material adverse effect on the Company's business, results of operations, and financial condition. See also "Item 3Legal Proceedings" of Part I in the Company's latest annual report filed with the Securities and Exchange Commission on Form 10-K.

Year 2000 Compliance

Rational is aware of the problems associated with computer systems as the year 2000 approaches. Year 2000 problems are the result of common computer programming techniques that result in systems that do not function properly when manipulating dates later than December 31, 1999. The problem may affect transaction processing computer applications used by the Company for accounting, distribution, and planning. The problem may also affect embedded systems such as building security systems, machine controllers, and other equipment.

Rational is in the process of assessing and upgrading systems which fail to be year 2000 compliant and will continue to review internal system requirements and correct further issues as they are identified. Based on recent assessment, the Company does not anticipate incurring material costs to be year 2000 compliant. However, there can be no assurance that actual costs will not substantially exceed the Company's assessment due to internal year 2000 problems or year 2000 problems associated with the

Company's products. Further, there can be no guarantee that the systems of other companies on which the Company's systems rely will be converted on a timely manner, or that a failure to convert by another company, including without limitation any of the Company's vendors, customers, or partners, or a conversion that is incompatible with the Company's systems would not have a material adverse effect on the Company.

Deferred Tax Assets

Based on the weight of available evidence, which includes the Company's historical operating performance and the reported cumulative net loss for the prior three years, the Company has provided a valuation against certain deferred tax assets for which the "more likely than not" criteria for recognition has not been met.

Recent Filings: Nov 1997 (Qtrly Rpt) | Feb 1998 (Qtrly Rpt) | Jun 1998 (Annual Rpt) | **Aug 1998 (Qtrly Rpt)**
More filings for RATL available from EDGAR Online