SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with our Consolidated Financial Statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this 1999 Annual Report. The consolidated statement of operations data for each of the years in the three-year period ended December 31, 1999, and the consolidated balance sheet data as of December 31, 1998 and 1999, are derived from consolidated financial statements that have been audited by KPMG LLP, independent auditors, and are included elsewhere in this 1999 Annual Report. The consolidated balance sheet data as of December 31, 1995, 1996 and 1997, and the consolidated statement of operations data for the years ended December 31, 1995 and 1996, are derived from consolidated financial statements that have been audited by KPMG LLP that are not included in this Annual Report. Historical results are not necessarily indicative of the results to be expected in the future.

In the following tables and in this document, "EBITDA" represents earnings (loss) before net interest expense, income taxes, depreciation, amortization (including amortization of deferred stock compensation) and other noncash charges. EBITDA should not be used as an alternative to operating loss or net cash provided by (used for) operating activities, investing activities or financing activities, each as measured under generally accepted accounting principles. In addition, EBITDA may not be comparable to other similarly titled information from other companies. However, our management believes that EBITDA is an additional meaningful measure of performance and liquidity. With respect to the captions entitled "Deficiency of earnings available to cover fixed charges," earnings consist of income (loss) before provision for income taxes plus fixed charges. Fixed charges consist of interest charges and amortization of debt expense and discount or premium related to indebtedness, whether expensed or capitalized, and that portion of rental expense we believe to be representative of interest.

SELECTED CONSOLIDATED FINANCIAL DATA

(In thousands, except per share data) Years Ended December 31,	1995	1996	1997	1998	1999
CONSOLIDATED STATEMENT OF OPERATIONS DATA:					
Revenues	$ 1,408	$ 3,130	$ 12,408	$ 52,745	$ 242,140
Costs and expenses:					
Cost of revenues	1,128	2,990	16,868	61,578	197,231
Marketing and sales	1,056	2,734	12,702	29,034	75,809
General and administrative	427	1,056	5,983	16,058	42,951
Product development	70	444	1,647	3,507	8,869
Amortization of goodwill and intangible assets	–	–	–	141	9,438
Merger costs	–	–	–	–	5,058
Total costs and expenses	2,681	7,224	37,200	110,318	339,356
Operating loss	(1,273)	(4,094)	(24,792)	(57,573)	(97,216)
Interest income	–	68	193	7,157	15,928
Interest expense	(38)	(107)	(699)	(16,900)	(49,035)
Net loss	(1,311)	(4,133)	(25,298)	(67,316)	(130,323)
Cumulative dividends and accretion on redeemable convertible preferred stock	–	–	(1,413)	(2,014)	–
Net loss attributable to common stockholders	$ (1,311)	$ (4,133)	$ (26,711)	$ (69,330)	$ (130,323)
Basic and diluted net loss per share [1]	$ (0.12)	$ (0.27)	$ (1.73)	$ (0.55)	$ (0.78)
Shares used in computing basic and diluted net loss per share [1]	10,524	15,312	15,428	125,808	167,924
CONSOLIDATED STATEMENT OF CASH FLOWS DATA:					
Net cash used for operating activities	$ (461)	$ (3,116)	$ (15,518)	$ (47,312)	$ (46,726)
Net cash used for investing activities	(69)	(3,877)	(23,864)	(92,757)	(390,614)
Net cash provided by financing activities	692	10,545	45,937	285,814	1,296,745
OTHER DATA:					
EBITDA [2]	$ (1,208)	$ (3,633)	$ (20,274)	$ (41,945)	$ (44,738)
Depreciation and amortization	65	461	3,429	13,024	50,881
Capital expenditures	69	3,499	22,489	44,564	283,468
Deficiency of earnings available to cover fixed charges [3]	(1,311)	(4,133)	(25,298)	(67,316)	(130,323)
CONSOLIDATED BALANCE SHEET DATA:					
Cash and cash equivalents	$ 163	$ 3,715	$ 10,270	$ 156,015	$ 1,015,960
Restricted cash equivalents and investments	–	378	1,753	45,614	35,390
Working capital (deficiency)	(1,170)	1,892	(3,707)	124,636	942,659
Total assets	840	8,289	40,973	298,798	1,742,890
Equipment loans, line of credit facilities and capital lease obligations, less current portion	141	1,449	15,135	27,284	48,696
Convertible subordinated notes	–	–	–	–	749,800
Senior notes	–	–	–	200,000	776,231
Total stockholders' equity (deficit)	(1,140)	(5,234)	(30,600)	24,277	17,615

[1] See Note 1 of Notes to Consolidated Financial Statements for an explanation of the determination of the number of shares used in computing per share data.

[2] Represents loss before net interest expense, income taxes, depreciation, amortization (including amortization of deferred stock compensation) and other noncash charges ("EBITDA"). Although EBITDA should not be used as an alternative to operating loss or net cash provided by (used for) operating activities, investing activities or financing activities, each as measured under generally accepted accounting principles, and, although EBITDA may not be comparable to other similarly titled information from other companies, our management believes that EBITDA is an additional meaningful measure of performance and liquidity.

[3] Earnings consist of income (loss) before provision for income taxes plus fixed charges. Fixed charges consist of interest charges and amortization of debt expense and discount or premium related to indebtedness, whether expensed or capitalized, and that portion of rental expense we believe to be representative of interest.

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

The following discussion of our financial condition and results of operations contains forward-looking statements that involved risks and uncertainties that may cause actual results to differ materially from those discussed in such forward-looking statements. The forward-looking statements are identified by words such as "believes," "anticipates," "expects," "intends," "may," "will" and other similar expressions. However, these words are not the exclusive means of identifying such statements. In addition, any statements which refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Factors that may cause such differences include, but are not limited to, those set forth under "Factors Affecting Future Results." We undertake no obligation to publicly release the results of any revisions to these forward-looking statements which may be made to reflect events or circumstances occurring in the future. Readers are urged to carefully review and consider the various disclosures made by Exodus in this 1999 Annual Report and in our reports filed with the Securities and Exchange Commission, that attempt to advise interested parties of the risks and factors that may affect our business.

OVERVIEW

We are a leading provider of complex Internet hosting for enterprises with mission-critical Internet operations. We offer sophisticated system and network management solutions, along with technology professional services to provide optimal performance for customers' Web sites. We deliver our services from our geographically distributed, state-of-the-art Internet Data Centers that are connected through a high-performance Internet backbone network.

We are the successor to a Maryland corporation that was formed in August 1992 to provide computer-consulting services. We began offering server hosting and Internet connectivity services in late 1995, opened our first dedicated Internet Data Center in August 1996 and introduced Managed Services in 1997 and Professional Services in 1998. We have derived most of our revenues from customers for whom we provide these services. Many of our Internet Data Center customers initially purchase a subset of our service offerings to address specific departmental or enterprise Internet computing needs, and many of these customers purchase additional services as the scale and complexity of their Internet operations increase. We sell our services under contracts that typically have minimum terms of one year. Customers pay monthly fees for the services utilized, as well as one-time fees for installation, for certain professional services and for equipment they purchase from us.

We opened our first Internet Data Center in the Silicon Valley metropolitan area in August 1996. Since that time, we have opened 16 additional domestic Internet Data Centers in the metropolitan areas of New York (March 1997 and September 1999), Silicon Valley (August 1997, June 1998 and June 1999), Seattle (September 1997 and June 1999), Los Angeles (October 1997 and September 1999), Washington, D.C. (December 1997 and May 1999), Boston (July 1998 and December 1999), Chicago (April 1999), Austin, Texas (November 1999) and Atlanta (December 1999). In addition, we opened our first Internet Data Center outside of the United States in London in June 1999. In December 1999, we acquired Global OnLine Japan Co., Ltd. of Tokyo, Japan, which has an Internet Data Center located in Tokyo. The building of Internet Data Centers has required us to obtain substantial equity and debt financing. See "Factors Affecting Future Results—Our substantial leverage and debt service obligations adversely affect our cash flow" and "—Liquidity and Capital Resources" below.

On October 2, 1998, we purchased substantially all of the assets, including customer agreements, and assumed certain liabilities of Arca Systems, Inc. ("Arca"), a wholly owned subsidiary of Cyberguard Corporation. Arca, which has been in business for more than 10 years, is a provider of advanced network and system security consulting services and designs and develops security technology solutions for complex and sensitive information systems. Arca operates as a wholly owned subsidiary of ours. Total consideration paid, including direct acquisition costs, aggregated approximately $5,800,000. The acquisition was accounted for as a purchase and the results of Arca's operations have been included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $5,000,000 and was attributed primarily to workforce in place ($2,500,000) and goodwill ($2,400,000). These amounts are being amortized on a straight-line basis over periods ranging from 2 to 10 years.

On February 1, 1999, we purchased all of the capital stock of American Information Systems, Inc ("AIS"). AIS provides co-location services as well as professional services. Total consideration paid, including direct acquisition costs, aggregated approximately $20,500,000. The acquisition was accounted for as a purchase with the results of AIS' operations included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $18,700,000 and was attributed primarily to goodwill ($15,000,000), customer lists ($3,200,000) and assembled workforce ($500,000). These amounts are being amortized on a straight-line basis over periods ranging from 5 to 7 years.

On July 27, 1999, we completed our acquisition of Cohesive Technology Solutions, Inc. ("Cohesive"). Cohesive offers a variety of services including network design and development, Internet-based and application development and information technology strategy and project management. Pursuant to the exchange ratios applied in the acquisition, we issued 1,600,796 shares of our common stock and paid approximately $50,000,000 in cash and assumed options to purchase a total of 408,712 shares of our common stock for a total purchase price of approximately $112,000,000. Of the cash consideration, $10,000,000 was deposited in an escrow account to secure and collateralize the indemnification obligations of Cohesive stockholders to Exodus and certain affiliates of Exodus. The acquisition was accounted for as a purchase with the results of Cohesive's operations included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $107,900,000 and was attributed primarily to goodwill ($69,300,000), customer lists ($32,300,000) and workforce in place ($6,300,000). These amounts are being amortized on a straight-line basis over periods ranging from 5 to 8 years.

In connection with the Cohesive purchase, we announced plans to consolidate seven professional services practice offices of Cohesive in August 1999. We determined that the consolidation of these offices would maximize efficiencies of the combined entity. As such, we recorded a restructuring charge of $923,000 in 1999, which is included in merger costs in the consolidated statement of operations for the year ended December 31, 1999. This charge includes approximately $689,000 for lease termination and other related office closure costs and $234,000 in severance and other employee benefits. As of December 31, 1999, the remaining restructuring reserve balance was approximately $550,000. We expect to complete the restructuring activities in the third quarter of fiscal year 2000.

We completed our merger with Service Metrics, Inc. ("SMI") on November 23, 1999. The merger was accounted for as a pooling of interests. Accordingly, the consolidated financial statements have been restated for all periods presented as if we and SMI had always been combined. In connection with the merger, we incurred one-time expenses of approximately $4,100,000, which are included in merger costs in the consolidated statement of operations for the year ended December 31, 1999. SMI is a leading provider of Internet monitoring applications and services that measure the consistency, availability and performance of Web sites. Under the terms of the agreement, the former shareholders and option holders of SMI common stock received shares and options of Exodus common stock at the rate of approximately 0.252 shares of Exodus common stock for each share of SMI common stock. We issued a total of approximately 6,300,000 shares of Exodus common stock in exchange for all outstanding shares of SMI common stock and reserved approximately 750,000 shares of common stock for issuance upon the exercise of SMI options we assumed pursuant to the agreement.

On December 17, 1999, we acquired 85% of the common stock of Global OnLine Japan Co., Ltd. ("GOL") of Tokyo, Japan. GOL operates its own nationwide backbone network and provides such services as Web design, e-commerce solutions, co-location, and system integration. We issued 415,296 shares of Exodus common stock and paid approximately $12,000,000 in cash for a total purchase price of approximately $36,000,000. As we have a majority share of 85% in GOL, we have consolidated GOL's results of operations with its results of operations for the year ended December 31, 1999. The acquisition was accounted for using the purchase method of accounting with the results of GOL's operations included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $33,800,000 and was attributed primarily to goodwill ($31,300,000), customer lists ($1,300,000) and workforce in place ($1,200,000). These amounts are being amortized on a straight-line basis over periods ranging from 3 to 5 years.

On July 1, 1998, we issued $200,000,000 of 11¼% Senior Notes due 2008 for aggregate net proceeds of approximately $193.4 million (net of discounts to the initial purchasers and offering expenses). Interest is payable semiannually on January 1 and July 1 each year. On June 22, 1999, we issued an additional $75,000,000 of Senior Notes due 2008 at 100.50% plus accrued interest, if any, from June 22, 1999, for aggregate net proceeds of approximately $73.2 million (net of offering expenses). Interest is payable semiannually on January 1 and July 1 of each year. On December 8, 1999, we issued $375,000,000 and Euro 125,000,000 of 10¾% Senior Notes due 2009 for aggregate net proceeds of approximately $486 million (net of offering expenses). Interest is payable semiannually on June 15 and December 15 of each year.

On March 3, 1999, we issued $250,000,000 of 5% Convertible Subordinated Notes due March 15, 2006 for aggregate net proceeds of approximately $242.1 million (net of offering expenses). The convertible notes are convertible into our common stock at a conversion rate of 87.5704 shares per $1,000 principal amount of convertible notes, subject to adjustment in certain events and at each holder's option. Interest on the convertible notes is payable on March 15 and September 15 of each year. On December 8, 1999, we issued $500,000,000 of 4¾% Convertible Subordinated Notes due July 15, 2008 for aggregate net proceeds of approximately $485 million (net of offering expenses). These convertible notes are convertible into our common stock at a conversion rate of 14.2034 shares per $1,000 principal amount of the notes, subject to adjustment in certain circumstances. Interest is payable on January 15 and July 15 of each year.

We intend to expand domestically and internationally. Prior to building an Internet Data Center in a new geographic region, we employ various means to evaluate the market opportunity in a given location, including market research on Internet usage statistics, the preselling of services into the proposed market and analysis of specific financial criteria. We typically require at least six months to select the appropriate location for an Internet Data Center, construct the necessary facilities, install equipment and telecommunications infrastructure, and hire the operations and sales personnel needed to conduct business at that site. Expenditures related to an Internet Data Center commence well before the Internet Data Center opens, and it takes an extended period to approach break-even capacity utilization at each site. As a result, we expect that individual Internet Data Centers will experience losses for in excess of one year from the time they are opened. We experience further losses from sales personnel hired to test market our services in markets where there is no, and may never be an, Internet Data Center. As a result, we expect to make investments in expanding our business rapidly into new geographic regions which, while potentially increasing our revenues in the long term, will lead to significant losses for the foreseeable future. See "Factors Affecting Future Results—Our rapid expansion produces a significant strain on our business and requires us to expend substantial resources."

Since we began to offer server hosting and Internet connectivity services in 1995, we have experienced operating losses and negative cash flows from operations in each fiscal quarter and year. As of December 31, 1999, we had an accumulated deficit of approximately $228.2 million. The revenue and income potential of our business and market is unproven, and our limited operating history makes an evaluation of our prospects and us difficult. We intend to invest in new Internet Data Centers and other sites, product development, and sales and marketing programs. We therefore believe that we will continue to experience net losses on a quarterly and annual basis for the foreseeable future. As a company in the new and rapidly evolving market for Internet system and network management solutions, we encounter risks, expenses and difficulties that affect our business and prospects. There can be no assurance that we will achieve profitability on a quarterly or an annual basis or that we will sustain profitability. See "Factors Affecting Future Results—Our short operating history and heavy losses make our business difficult to evaluate."

In March 2000, we entered into a definitive agreement to make a $637.5 million investment in the common stock of Mirror Image Internet, Inc. ("Mirror Image"), a provider of content distribution services. $75.0 million of the investment will be paid in cash, with the balance of the consideration consisting of 3,758,268 shares of our common stock. We agreed to register the resale of those shares. This agreement is expected to close by May 2000. We also entered into a commercial agreement to offer Mirror Image's content distribution services and to deploy Mirror Image Content Access Point architecture throughout our Internet Data Center network.

RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999

The following table sets forth certain statement of operations data as a percentage of total revenues for the years ended December 31, 1997, 1998 and 1999. The information for the years ended December 31, 1997, 1998 and 1999 has been derived from our audited consolidated financial statements included in this 1999 Annual Report. This information should be read in conjunction with the consolidated financial statements and related notes included in this 1999 Annual Report. The operating results in any periods are not necessarily indicative of the results to be expected for any future period.

Years Ended December 31,	1997	1998	1999
Revenues	100.0%	100.0%	100.0%
Costs and expenses:			
Costs of revenues	135.9%	116.8%	81.4%
Marketing and sales	102.4%	55.0%	31.3%
General and administrative	48.2%	30.4%	17.7%
Product development	13.3%	6.6%	3.7%
Amortization of goodwill and intangible assets	–	0.3%	3.9%
Merger costs	–	–	2.1%
Total costs and expenses	299.8%	209.1%	140.1%
Operating loss	(199.8%)	(109.1%)	(40.1%)
Interest income	1.6%	13.6%	6.6%
Interest expense	(5.7%)	(32.0%)	(20.3%)
Net loss	(203.9%)	(127.5%)	(53.8%)

REVENUES Our revenues consist of (1) monthly fees from customer use of Internet Data Center sites, network services and managed services, including professional services and use of equipment and software provided by us, (2) revenues from sales or rentals of third-party equipment to customers and (3) fees for installation and certain professional services. Currently, substantially all of our revenue is derived from services. Revenues, other than installation fees, equipment sales to customers and certain professional services, are generally billed and recognized ratably over the term of the contract, which is generally one year. Installation fees are typically recognized at the time the installation occurs, and equipment revenues are typically recognized when the equipment is delivered to the customer or placed into service at an Internet Data Center. We sell third-party equipment to our customers as an accommodation to facilitate their purchase of services. One-time professional service fees are typically recognized when the services are rendered.

Our revenues increased 325% from $12.4 million in 1997 to $52.7 million in 1998 and increased an additional 359% to $242.1 million in 1999. This growth in service revenues was primarily the result of opening our Internet Data Centers, increases in the number of new customers, increases in revenues from existing customers, and increases in revenues arising from our managed service and professional service offerings.

COST OF REVENUES Our cost of revenues is comprised of the costs for salaries and benefits for our customer service and operations personnel (customer service personnel, network engineers and professional services personnel), depreciation and amortization, rent, consultants' fees, our network and local telecommunications circuits, interconnections to other networks, repairs and utilities related to our Internet Data Centers and other sites and costs of third-party equipment sold or rented to customers.

Cost of service revenues increased 265% from $16.9 million in 1997 to $61.6 million in 1998 and increased an additional 220% to $197.2 million in 1999. Our cost of service revenues as a percentage of revenues decreased from 136% in 1997 to 117% in 1998 and declined to 81% in 1999. The year-to-year increases in cost of service revenues in absolute dollars were primarily the result of increased costs associated with hiring additional employees and consultants, including professional services employees hired in connection with our business combinations, traffic on our network and to other networks, increased depreciation due to capital expenditures related to the buildout and expansion of Internet Data Centers, increased rent, and increased utilities and other costs related to the opening and expanding of Internet Data Centers. The year-to-year decrease in cost of service revenues as a percentage of revenues primarily resulted from revenues from new and existing Internet Data Centers increasing faster than related costs of revenues. We expect that cost of revenues will continue to increase in absolute dollars.

MARKETING AND SALES Our marketing and sales expenses are comprised of salaries, commissions and benefits for our marketing and sales personnel, printing and advertising costs, public relations costs, consultants' fees and travel and entertainment expenses.

Our marketing and sales expenses increased 129% from $12.7 million in 1997 to $29.0 million in 1998 and increased an additional 161% to $75.8 million in 1999. Our marketing and sales expenses as a percentage of revenues decreased from 102% in 1997 to 55% in 1998 and to 31% in 1999. The year-to-year increases in marketing and sales expenses in absolute dollars were primarily the result of increased compensation and related expenses associated with hiring additional marketing and sales personnel, including employees hired in connection with our business combinations, and increased expenses related to branding campaigns for expanding marketing programs in connection with our expansion of our operations. These expanded operations include the number and scope of our Internet system and network management solutions. The year-to-year decrease in marketing and sales expenses as a percentage of revenues was primarily due to revenues growing faster than marketing and sales expenses over that time period. We expect that marketing and sales expenses will continue to increase in absolute dollars.

GENERAL AND ADMINISTRATIVE Our general and administrative expenses are primarily comprised of salaries and benefits for our administrative and management information systems personnel, consulting fees, recruiting fees and travel expenses.

Our general and administrative expenses increased 168% from $6.0 million in 1997 to $16.1 million in 1998 and increased an additional 167% to $43.0 million in 1999. Our general and administrative expenses as a percentage of revenues decreased from 48% in 1997 to 30% in 1998 and to 18% in 1999. The year-to-year increases in general and administrative expenses in absolute dollars were primarily the result of increased compensation expenses associated with additional hiring of general and administrative personnel, including employees hired in connection with our business combinations, costs for consultants and professional services providers, increased recruiting expenses, higher depreciation and increased rent and related expenses due to entering into additional operating leases. The decrease in general and administrative expenses as a percentage of revenues was primarily due to revenues growing faster than general and administrative expenses. We expect that general and administrative expense will continue to increase in absolute dollars.

PRODUCT DEVELOPMENT Our product development expenses consist primarily of salaries and benefits for our product development personnel and fees paid to consultants.

Our product development expenses increased 113% from $1.6 million in 1997 to $3.5 million in 1998 and increased an additional 153% to $8.9 million in 1999. Our product development expenses as a percentage of revenues decreased from 13% in 1997 to 7% in 1998 and to 4% in 1999. The year-to-year increases in product development expenses in absolute dollars were primarily the result of the hiring of additional product development personnel to support our expanded service offerings. The year-to-year decrease in product development expenses as a percentage of revenues resulted from revenues growing faster than product development expenses. We expect that product development expenses will continue to increase in absolute dollars.

AMORTIZATION OF GOODWILL AND INTANGIBLE ASSETS As part of our strategy to grow through acquisitions of complementary businesses, we acquired the assets of Arca in October 1998, AIS in February 1999, Cohesive in July 1999, and GOL in December 1999. In connection with those acquisitions, we have recorded intangible assets related to goodwill, customer lists and workforce in place. Amortization related to those intangibles was $141,000 in 1998 and $9.4 million in 1999. These intangibles are being amortized on a straight-line basis over periods ranging from 2 to 10 years. We expect amortization related to goodwill and other intangible assets will continue to increase in absolute dollars.

MERGER COSTS Merger costs generally comprise one-time charges related to our acquisitions of complementary businesses. In 1999, we incurred approximately $5.1 million in merger costs related to the acquisitions of Service Metrics in November 1999 and Cohesive in July 1999.

NET INTEREST EXPENSE Our net interest expense increased from $506,000 in 1997 to $9.7 million in 1998 and to $33.1 million in 1999. The increase in net interest expense from 1997 to 1998 was primarily the result of interest expenses associated with the $200 million of 11¼% senior notes which were issued July 1, 1998, substantially increased borrowings as we entered into equipment loans and lease agreements to finance the construction of our Internet Data Centers, and working capital lines of credit to finance working capital for our operations offset in part by increased interest income related to the additional cash raised in the $200 million senior notes financing. The increase in net interest expenses from 1998 to 1999 was primarily due to the $250 million of 5% convertible subordinated notes issued March 3, 1999, the $200 million and $75 million of 11¼% senior notes issued July 1, 1998 and June 22, 1999, respectively, the $375 million and Euro 125 million 10¾% senior notes financing and the $500 million 4¾% convertible notes financing which occurred on December 8, 1999 and increased borrowings as we entered into equipment loans and lease agreements to finance the construction of our Internet Data Centers. Interest expense for 1999 was partially offset by increased interest income in 1999 as a result of cash raised in our $200 million and $75 million senior notes financings and our $250 million convertible notes financing, along with our $375 million and Euro 125 million 10¾% senior notes financing and our $500 million 4¾% convertible notes financing which occurred on

December 8, 1999. We expect that net interest expense will continue to increase as we incur interest expenses associated with our $375 million and Euro 125 million 10¾% senior notes financing and our $500 million 4¾% convertible notes financing for the full year, enter into additional equipment leases and loans, obtain additional borrowings and long term debt and experience reduced interest income as a result of the decline in our cash reserves to fund working capital and other uses.

EBITDA Our loss before net interest expense, income taxes, depreciation, amortization (including amortization of deferred stock compensation) and other noncash charges ("EBITDA") was $20.3 million in 1997, $41.9 million in 1998 and $44.7 million in 1999. The year-to-year increases in the level of EBITDA losses were primarily due to increased expenditures needed to support our growth in operations, including salaries and benefits for additional employees, network costs, rent, utilities and other costs related to the increase in the number of our Internet Data Centers as well as increased marketing and sales expenses, general and administrative expenses, consulting fees and professional services.

Although EBITDA should not be used as an alternative to operating loss or net cash provided by (used for) operating activities, investing activities or financing activities, each as measured under generally accepted accounting principles, our management believes that EBITDA is an additional meaningful measure of performance.

LIQUIDITY AND CAPITAL RESOURCES

From inception through December 31, 1999, we have financed our operations primarily through private sales of preferred stock, our initial public offering of common stock in March 1998, our senior notes offerings in July 1998, June 1999 and December 1999, our convertible subordinated notes offerings in March 1999 and December 1999, and through various types of equipment loans and lease lines and working capital lines of credit. At December 31, 1999, our principal source of liquidity was approximately $1.0 billion in cash and cash equivalents. In addition, due to our senior notes offering in December 1999, we also have the right to issue up to $100.0 million of additional senior notes on or prior to December 15, 2000. As of December 31, 1999, our outstanding bank borrowings, equipment loans and lines of credit facilities, capital lease obligations and senior and convertible notes were approximately $1.6 billion. See Notes 4 and 6 of Notes to Consolidated Financial Statements.

Since we began to offer server-hosting services in 1995, we have had significant negative cash flows from operating activities. Net cash used for operating activities for the year ended December 31, 1999 was $46.7 million, primarily due to net losses and increases in accounts receivable and prepaid expenses and other assets, offset in part by depreciation and amortization and increases in accounts payable, accrued expenses and accrued interest payable. This compares to net cash used for operating activities for the year ended December 31, 1998 of $47.3 million which was primarily due to net losses and an increase in accounts receivable, offset in part by depreciation and amortization and an increase in accrued interest payable. Net cash used for operating activities for the year ended December 31, 1997 was $15.5 million, primarily due to net losses.

Net cash used for investing activities for the year ended December 31, 1999 was $390.6 million primarily due to capital expenditures for the continued construction of Internet Data Centers, the acquisitions of AIS, Cohesive, and Global OnLine, and telecommunication and software licensing agreements. This compares to net cash used for investing activities for the year ended December 31, 1998 of $92.8 million which was due to capital expenditures for the construction of Internet Data Centers and the acquisition of Arca and an increase in restricted cash equivalents and investments. Net cash used for investing activities for the year ended December 31, 1997 was $23.9 million primarily due to capital expenditures for the construction of Internet Data Centers.

Net cash provided by financing activities for the year ended December 31, 1999 was approximately $1.3 billion, primarily due to the proceeds from our issuance of $250 million and $500 million convertible subordinated notes offerings in March and December 1999, respectively, and our $75 million senior notes offering in June 1999 and $375 million and Euro 125 million senior notes offerings in December 1999. This compares to net cash provided by financing activities for the year ended December 31, 1998 of $285.8 million which was primarily due to our $200 million senior notes offering in July 1998, the proceeds from equipment loans and line of credit facilities and our initial public offering of common stock in March 1998. Net cash provided by financing activities for the year ended December 31, 1997 was $45.9 million, primarily due to the proceeds from our issuance of redeemable convertible preferred stock and warrants and the proceeds from equipment loans and line of credit facilities.

As of December 31, 1999, we had commitments under capital leases and under noncancellable operating leases of $57.5 million and $389.2 million, respectively, through 2012. In addition, in August 1999 we entered into capacity purchase agreements with Global Crossing USA, Inc. The agreements provide for a total potential outlay of approximately $105.0 million for fiber capacity and related maintenance covering approximately 25 years. As of December 31, 1999 we had expended $19.0 million.

We intend to make significant expenditures during the next 12 months primarily for property and equipment, in particular equipment and construction needed for existing and future Internet Data Centers, as well as office equipment, computers and telephones. We have a $10 million line of credit with a financial institution that is primarily used for letters of credits required to obtain facilities for operating activities. We expect to finance capital expenditures primarily through the remaining net proceeds from the 11¼% senior notes issued in June 1999 and our 10¾% senior notes and 4¾% convertible subordinated notes issued in December 1999, existing and future equipment loans and lease lines of credit, and issuances of additional debt and other financing activities. We believe our currently estimated working capital and capital expenditure requirements over the next 12 months can be met with existing cash and cash equivalents and short-term investments, cash from sales of services and proceeds from debt financings and existing and future equipment financing lines of credit. We may enter into additional equipment loans and capital leases. We may also seek to raise additional funds through public or private financing, strategic relationships or other arrangements. There can be no assurance that we will be successful in generating sufficient cash flows from operations or raising capital in sufficient amounts on terms acceptable to us. See "Factors Affecting Future Results—Our rapid expansion produces a significant strain on our business."

In December 1999, $200,000 principal amount of our 5% convertible subordinated notes due March 15, 2006 were converted into 17,514 shares of our common stock. In March 2000, holders of an aggregate of approximately $160.0 million principal amount of our 5% convertible subordinated notes due March 15, 2006 converted the notes into approximately 14,000,000 shares of our common stock. We made aggregate payments of approximately $3,200,000 to the holders in connection with these conversions. Also, holders of an additional approximate $18.0 million principal amount of our 5% convertible subordinated notes due March 15, 2006 converted the notes into approximately 1,600,000 shares of our common stock. We did not make any payments in connection with these conversions.

RECENT ACCOUNTING PRONOUNCEMENTS In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities.* SFAS No. 133 establishes methods for accounting for derivative financial instruments and hedging activities related to those instruments, as well as other hedging activities. Because we do not currently hold any derivative instruments and do not engage in hedging activities, we expect that the adoption of SFAS No. 133 will not have a material impact on our financial position, results of operations or cash flows. We will be required to implement SFAS No. 133 for the year ending December 31, 2001.

FACTORS AFFECTING FUTURE RESULTS

OUR SHORT OPERATING HISTORY AND HEAVY LOSSES MAKE OUR BUSINESS DIFFICULT TO EVALUATE Our limited operating history makes evaluating our business operations and our prospects difficult. We began offering server hosting and Internet connectivity services in 1995, opened our first dedicated Internet Data Center in August 1996 and introduced managed services in 1997 and professional services in 1998. Due to our short operating history, our business model is still evolving. We have incurred operating losses and negative cash flows each fiscal quarter and year since 1995. Our accumulated deficit was approximately $228.2 million at December 31, 1999. We anticipate continuing to make significant investments in new Internet Data Centers and network infrastructure, product development, sales and marketing programs and personnel. We believe that we will continue to experience net losses on a quarterly and an annual basis for the foreseeable future. We may also use significant amounts of cash and/or equity to acquire complementary businesses, products, services or technologies. Although we have experienced significant growth in revenues in recent periods, this growth rate is not necessarily indicative of future operating results. It is possible that we may never achieve profitability on a quarterly or an annual basis.

OUR OPERATING RESULTS HAVE FLUCTUATED WIDELY AND WE EXPECT THIS TO CONTINUE We have experienced significant fluctuations in our results of operations on a quarterly and an annual basis. We expect to continue to experience significant fluctuations due to a variety of factors, many of which are outside of our control, including:

- demand for and market acceptance of our services;
- reliable continuity of service and network availability;
- the ability to increase bandwidth as necessary, both on our network and at our interconnection points with other networks;
- costs related to the acquisition of network capacity and arrangements for interconnections with third-party networks;
- customer retention and satisfaction;
- capacity utilization of our Internet Data Centers;
- the timing, magnitude and integration of acquisitions of complementary businesses and assets;
- the timing of customer installations;
- the provision of customer discounts and credits;
- the mix of services sold by us;
- the timing and success of marketing efforts and service introductions by us and our competitors;
- the timing and magnitude of capital expenditures, including construction costs relating to the expansion of operations;
- the timing of expansion of existing Internet Data Centers and completion of new Internet Data Centers, including obtaining necessary permits and adequate public utility power;
- the introduction by third parties of new Internet and networking technologies;
- changes in our pricing policies and those of our competitors;
- fluctuations in bandwidth used by customers; and
- licenses and permits required to construct facilities, deploy networking infrastructure or operate in the United States and foreign countries.

In addition, a relatively large portion of our expenses are fixed in the short term, particularly with respect to telecommunications, depreciation, substantial interest expenses, real estate and personnel. Therefore, our results of operations are particularly sensitive to fluctuations in revenues. Furthermore, if we were to become unable to continue leveraging third-party products in our services offerings, our product development costs could increase significantly. Finally, many of our customers are emerging growth companies which may have negative cash flows, and there is the possibility that we will not be able to collect receivables on a timely basis.

OUR RAPID EXPANSION PRODUCES A SIGNIFICANT STRAIN ON OUR BUSINESS AND REQUIRES US TO EXPEND SUBSTANTIAL RESOURCES The expansion of our network through the opening of additional Internet Data Centers in geographically diverse locations is one of our key strategies. We currently have 17 Internet Data Centers located in nine metropolitan areas of the United States: Atlanta, Austin, Boston, Chicago, Los Angeles, New York, Seattle, Silicon Valley and Washington, D.C. In June 1999, we opened our first Internet Data Center outside of the United States in the London metropolitan area. In December 1999, we acquired GOL, which has an Internet Data Center located in Tokyo. To expand successfully, we must be able to assess markets, locate and secure new Internet Data Center sites, install telecommunications circuits and equipment and Internet Data Center facilities, and establish additional interconnections with Internet service providers. To manage this expansion effectively, we must continue to improve our operational and financial systems and expand, train and manage our employee base. Our inability to establish additional Internet Data Centers or effectively manage our expansion would have a material adverse effect upon our business.

We expect to expend substantial resources for leases and/or the purchase of real estate, significant improvements of facilities, purchase of complementary businesses, assets and equipment, implementation of multiple telecommunications connections and hiring of network, administrative, customer support and sales and marketing personnel with the establishment of each new Internet Data Center. Moreover, we expect to make additional significant investments in sales and marketing and the development of new services as part of our expansion strategy. The failure to generate sufficient cash flows or to raise sufficient funds may require us to delay or abandon some or all of our development and expansion plans or otherwise forego market opportunities, making it difficult for us to generate additional revenue and to respond to competitive pressures.

In general, it takes us at least six months to select the appropriate location for a new Internet Data Center, construct the necessary facilities, install equipment and telecommunications infrastructure and hire operations and sales personnel. Expenditures commence well before the Internet Data Center opens, and it takes an extended period for us to approach break-even capacity utilization. As a result, we expect that individual Internet Data Centers will experience losses for in excess of one year from the time they are opened. We incur further expenses from sales personnel hired to test market our services in markets where there is no Internet Data Center. Growth in the number of our Internet Data Centers is likely to increase the amount and duration of losses. In addition, if we do not attract customers to new Internet Data Centers in a timely manner, or at all, our business would be materially adversely affected.

WE COMPETE WITH MUCH LARGER COMPANIES AND THERE ARE FEW BARRIERS TO ENTRY, AND IF WE CANNOT COMPETE EFFECTIVELY, WE WILL LOSE BUSINESS Our market is intensely competitive. There are few substantial barriers to entry, and we expect to face additional competition from existing competitors and new market entrants in the future. Many companies have announced that they intend to begin providing and/or greatly expand their service offerings that are competitive with our services. The principal competitive factors in this market include:

- the ability to deliver services when requested by the customer;
- Internet system engineering and other expertise;
- customer service;
- network capability, reliability, quality of service and scalability;
- the variety of services offered;
- access to network resources, including circuits, equipment and interconnection capacity to other networks;
- broad geographic presence;
- price;
- the ability to maintain and expand distribution channels;
- brand name;
- the timing of introductions of new services;
- network security; and
- financial resources.

There can be no assurance that we will have the resources or expertise to compete successfully in the future. Our current and potential competitors in the market include:

- providers of server hosting services;
- national, foreign and regional ISPs;
- global, regional and local telecommunications companies and Regional Bell Operating Companies;
- IT outsourcing firms; and
- other technology services and products companies.

Many of our competitors have substantially greater resources, more customers, longer operating histories, greater name recognition and more established relationships in the industry. As a result, these competitors may be able to develop and expand their network infrastructures and service offerings more quickly, devote greater resources to the marketing and sale of their products and adopt more aggressive pricing policies. In addition, these competitors have entered and will likely continue to enter into business relationships to provide additional services competitive with those we provide.

Some of our competitors may be able to provide customers with additional benefits in connection with their Internet system and network management solutions, including reduced communications costs, which could reduce the overall costs of their services relative to ours. We may not be able to offset the effects of any price reductions. In addition, we believe our market is likely to encounter consolidation in the near future, which could result in increased prices and other competition.

OUR MARKET IS NEW AND OUR SERVICES MAY NOT BE GENERALLY ACCEPTED BY ENTERPRISES LOOKING TO OUTSOURCE THEIR MISSION-CRITICAL INTERNET OPERATIONS, WHICH COULD HARM OUR OPERATING RESULTS The market for Internet system and network management solutions has only recently begun to develop, is evolving rapidly and is characterized by an increasing number of market entrants. This market may not prove to be viable or, if it becomes viable, may not continue to grow. We currently incur costs greater than our revenues. If we cannot retain or grow our customer base, we will not be able to increase our sales and revenues or create economics of scale to offset our fixed and operating costs.

Our future growth depends on the willingness of enterprises to outsource the system and network management of their mission-critical Internet operations and our ability to market our services in a cost-effective manner to a sufficiently large number of customers. If this market fails to develop, or develops more slowly than expected, or if our services do not achieve market acceptance, our business would be adversely affected. In addition, in order to be successful we must be able to differentiate ourselves from our competition through our service offerings and delivery.

OUR SUBSTANTIAL LEVERAGE AND DEBT SERVICE OBLIGATIONS ADVERSELY AFFECT OUR CASH FLOW

We have substantial amounts of outstanding indebtedness, primarily from our 10¾% senior notes, 4¾% convertible subordinated notes, 11¼% senior notes, and our 5% convertible subordinated notes. There is the possibility that we may be unable to generate cash sufficient to pay the principal of, interest on and other amounts due in respect of, our debt when due. As of December 31, 1999, we had debt of approximately $1.6 billion. We also have the right to issue additional 10¾% senior notes on or prior to December 15, 2000 in an aggregate principal amount not to exceed $100.0 million. In addition, we expect to add additional equipment loans and lease lines to finance capital expenditures for our Internet Data Centers and to obtain additional long term debt, working capital lines of credit and lease lines. We cannot be certain that any financing arrangements will be available.

Our substantial leverage could have significant negative consequences, including:

- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing;
- requiring the dedication of a substantial portion of our expected cash flow from operations to service our indebtedness, thereby reducing the amount of our expected cash flow available for other purposes, including capital expenditures;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete; and
- placing us at a possible competitive disadvantage compared to less leveraged competitors and competitors that have better access to capital resources.

WE ARE SUBJECT TO RESTRICTIVE COVENANTS IN OUR NOTE INDENTURES THAT LIMIT OUR FLEXIBILITY IN MANAGING OUR BUSINESS Our senior notes and convertible subordinated notes contain various restrictions on our ability to incur debt, pay dividends or make other restricted payments, sell assets, enter into affiliate transactions and take other actions. Furthermore, our existing financing arrangements are, and future financing arrangements are likely to be, secured by substantially all of our assets. The existing financing arrangements require, and future financing arrangements are likely to require, that we maintain specific financial ratios and comply with covenants restricting our ability to incur debt, pay dividends or make other restricted payments, sell assets, enter into affiliate transactions or take other actions.

In addition, a number of instruments evidencing our debt restrict the manner in which the funds raised in our debt financings and debt incurred in the future may be used.

WE MUST MANAGE GROWTH EFFECTIVELY BY EXPANDING OPERATING AND FINANCIAL PROCEDURES, CONTROLS AND SYSTEMS OR OUR BUSINESS WILL BE HARMED We are experiencing, and expect to continue experiencing, rapid growth with respect to the building of our Internet Data Centers and network infrastructure, acquisitions of assets and companies, expansion of our service offerings, geographic expansion, expansion of our customer base and increases in the number of employees. This growth has placed, and we expect it to continue to place, a significant strain on our financial, management, operational and other resources, including our ability to ensure customer satisfaction. This expansion also requires significant time commitment from our senior management and places a significant strain on their ability to manage the existing business. In addition, we are required to manage multiple relationships with a growing number of third parties as we seek to complement our service offerings. Our ability to manage our growth effectively will require us to continue to expand operating and financial procedures and controls, to replace or upgrade our operational, financial and management information systems and to attract, train, motivate and retain key employees. We have recently hired many key employees and officers, and as a result, our entire management team has worked together for only a brief time. In addition, we intend to hire additional senior management personnel to support our growth and expansion of our business. If our executives are unable to manage growth effectively, our business could be materially adversely affected.

WE MAY EXPERIENCE DIFFICULTY IN INTEGRATING OUR RECENT ACQUISITIONS WHICH COULD HARM OUR OPERATING RESULTS In October 1998 we acquired the assets of Arca, in February 1999 we acquired AIS, in July 1999 we acquired Cohesive, in November 1999 we merged with SMI, and in December 1999 we acquired GOL. Furthermore, in February 2000, we completed our acquisition of KeyLabs. We continue to expend resources integrating Cohesive, SMI, and KeyLabs and the personnel hired in connection with acquisitions. As we acquire additional companies, we will incur additional expenses.

We believe that our future growth depends, in part, upon the acquisition of complementary businesses, products, services or technologies. After purchasing a company, we could have difficulty in assimilating that company's technology, personnel and operations. In addition, the key personnel of the acquired company may decide not to work for us. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses. In addition, future acquisitions by us may require us to issue stock that could dilute the ownership of our then existing stockholders, incur additional debt or assume liabilities, result in large one-time write-offs or create goodwill or other intangible assets that could result in amortization expenses.

SYSTEM FAILURES COULD LEAD TO SIGNIFICANT COSTS
We must protect our network infrastructure, our equipment, and customers' equipment against damage from human error, physical or electronic security breaches, power loss and other facility failures, fire, earthquake, flood, telecommunications failure, sabotage, vandalism and similar events. Despite precautions we have taken, a natural disaster or other unanticipated problems at one or more of our Internet Data Centers could result in interruptions in our services or significant damage to customer equipment. In addition, failure of any of our telecommunications providers, such as MCI WorldCom, Qwest Communications Corporation and Global Crossing, to provide consistent data communications capacity, and local exchange carriers to provide interconnection agreements, could result in interruptions in our services. Any damage to or failure of our systems or service providers could result in reductions in, or terminations of, services supplied to our customers, which could have a material adverse effect on our business. In the past, we have experienced interruptions in specific circuits within our network resulting from events outside our control, temporary loss of power, and failure of networking equipment, all of which led to short-term degradation in the level of performance of our network or temporary unavailability of our services. We attempt to limit exposure to system downtime by contract by giving customers a credit of free service for a short period of time for disruptions. However, customers may demand additional remedies. If we incur significant service level commitment obligations in connection with system downtime, our liability insurance may not be adequate to cover those expenses.

CUSTOMER SATISFACTION WITH OUR SERVICES IS CRITICAL TO OUR SUCCESS Our customers demand a very high level of service. Our customer contracts generally provide a limited service-level commitment related to the continuous availability of service on a 24-hour-per-day, seven-day-per-week basis. This commitment is generally limited to a credit consisting of free service for a short period of time for disruptions in Internet transmission services. If we incur significant service-level commitment obligations in connection with system downtime, our liability insurance may not be adequate to cover these expenses. As customers outsource more mission-critical operations to us, we are subject to increased liability claims and customer dissatisfaction if our systems fail or our customers otherwise become unsatisfied.

OUR ABILITY TO EXPAND OUR NETWORK IS UNPROVEN AND WILL REQUIRE SUBSTANTIAL FINANCIAL, OPERATIONAL AND MANAGEMENT RESOURCES To satisfy customer requirements, we must continue to expand and adapt our network infrastructure. We are dependent on MCI WorldCom, Qwest, Global Crossing and other telecommunications providers for our network capacity. The expansion and adaptation of our telecommunications infrastructure will require substantial financial, operational and management resources as we negotiate telecommunications capacity with network infrastructure suppliers. Due to the limited deployment of our services to date, our ability to connect and manage a substantially larger number of customers at high transmission speeds is unknown. We have yet to prove our network's ability to be scaled up to higher customer levels while maintaining superior performance. Furthermore, it may be difficult for us to increase quickly our network capacity in light of current necessary lead times within the industry to purchase circuits and other critical items. If we fail to achieve or maintain high capacity data transmission circuits, customer demand could diminish because of possible degradation of service. In addition, as we upgrade our telecommunications infrastructure to increase bandwidth available to our customers, we expect to encounter equipment or software incompatibility which may cause delays in implementation.

WE DEPEND ON NETWORK INTERCONNECTIONS PROVIDED BY THIRD PARTIES WHO MAY RAISE THEIR FEES OR DENY ACCESS We rely on a number of public and private network interconnections to allow our customers to connect to other networks. If the networks with which we interconnect were to discontinue their interconnections, our ability to exchange traffic would be significantly constrained. Furthermore, our business will be harmed if these networks do not add more bandwidth to accommodate increased traffic. Many of the companies with which we maintain interconnections are our competitors. Some of these networks require that we pay them fees for the right to maintain interconnections. There is nothing to prevent any networks, many of which are significantly larger than we are, from increasing fees or denying access. In the future, networks could refuse to continue to interconnect directly with us, might impose significant costs on us or limit our customers' access to their networks. In this event, we may not be able on a cost-effective basis to access alternative networks to exchange our customers' traffic. In addition, we may not be able to pass through to our customers any additional costs of utilizing these networks. In these cases, our business could be harmed.

DIFFICULTIES PRESENTED BY INTERNATIONAL ECONOMIC, POLITICAL, LEGAL, ACCOUNTING AND BUSINESS FACTORS COULD HARM OUR BUSINESS IN INTERNATIONAL MARKETS A component of our strategy is to expand into international markets. We opened our first Internet Data Center outside of the United States in the London metropolitan area in June 1999 and acquired an Internet Data Center in Tokyo through our acquisition of GOL in December 1999. Furthermore, we plan to open additional international Internet Data Centers by the end of 2000. In order to expand our international operations, we may enter into joint ventures or outsourcing agreements with third parties, acquire rights to high-bandwidth transmission capability, acquire complementary businesses or operations, or establish and maintain new operations outside of the United States. Thus, we may depend on third parties to be successful in our international operations. In addition, the rate of development and adoption of the Internet has been slower outside of the United States, and the cost of bandwidth has been higher, which may adversely affect our ability to expand operations and may increase our cost of operations internationally. The risks inherent in conducting business internationally include:

- unexpected changes in regulatory requirements, export restrictions, tariffs and other trade barriers;
- challenges in staffing and managing foreign operations;
- differences in technology standards;
- employment laws and practices in foreign countries;
- longer payment cycles and problems in collecting accounts receivable;
- political instability;
- fluctuations in currency exchange rates and imposition of currency exchange controls; and
- potentially adverse tax consequences.

WE MIGHT NOT BE SUCCESSFUL IN OUR ATTEMPTS TO KEEP UP WITH RAPID TECHNOLOGICAL CHANGE AND EVOLVING INDUSTRY STANDARDS Our future success will depend on our ability to offer services that incorporate leading technology and address the increasingly sophisticated and varied needs of our current and prospective customers. Our market is characterized by rapidly changing and unproven technology, evolving industry standards, changes in customer needs, emerging competition and frequent new service introductions. Future advances in technology may not be beneficial to, or compatible with, our business. In addition, we may not be able to incorporate advances on a cost-effective and timely basis. Moreover, technological advances may have the effect of encouraging our current or future customers to rely on in-house personnel and equipment to furnish the services we currently provide. In addition, keeping pace with technological advances may require substantial expenditures and lead time.

We believe that our ability to compete successfully is also dependent upon the continued compatibility and interoperability of our services with products, services and architectures offered by various vendors. Although we work with various vendors in testing newly developed products, these products may not be compatible with our infrastructure or adequate to address changing customer needs. Any incompatibility would require us to make significant investments to achieve compatibility. Although we intend to support emerging standards, industry standards may not be established or we may not be able to conform timely to new standards. Our failure to conform to a prevailing standard, or the failure of a common standard to emerge, could have a material adverse effect on our business.

SYSTEM SECURITY RISKS COULD DISRUPT OUR SERVICES

The ability to provide secure transmissions of confidential information over networks accessible to the public is a significant barrier to electronic commerce and communications. A portion of our services relies on encryption and authentication technology licensed from third parties. Despite a variety of network security measures taken by us, we cannot assure that unauthorized access, computer viruses, accidental or intentional actions and other disruptions will not occur. Our Internet Data Centers have experienced and may in the future experience delays or interruptions in service as a result of the accidental or intentional actions of Internet users, current and former employees of Exodus or others. Furthermore, inappropriate use of the network by third parties could also jeopardize the security of confidential information, such as customer and Exodus passwords as well as credit card and bank account numbers, stored in our computer systems or those of our customers. As a result, we could become liable to others and lose existing or potential customers.

The costs required to eliminate computer viruses and alleviate other security problems could be prohibitively expensive. In addition, the efforts to address these problems could result in interruptions, delays or cessation of service to our customers.

WE DEPEND ON THIRD-PARTY EQUIPMENT AND SOFTWARE SUPPLIERS We depend on vendors to supply key components of our telecommunications infrastructure and system and network management solutions. Some of the telecommunications services and networking equipment is available only from sole or limited sources. For instance, the routers, switches and modems we use are currently supplied primarily by Cisco Systems, Inc. We typically purchase or lease all of our components under purchase orders placed from time to time. We do not carry significant inventories of components and have no guaranteed supply arrangements with vendors. If we are unable to obtain required products or services on a timely basis and at an acceptable cost, our business would be harmed. In addition, if our sole or limited source suppliers do not provide products or components that comply with evolving Internet and telecommunications standards or that interoperate with other products or components we use, our business would be harmed. For example, we have experienced performance problems, including previously unknown software and firmware bugs, with routers and switches that have caused temporary disruptions in and impairment of network performance.

GOVERNMENT REGULATION AND LEGAL UNCERTAINTIES MAY HARM OUR BUSINESS Laws and regulations directly applicable to communications and commerce over the Internet are becoming more prevalent. The United States Congress has recently considered enacting Internet laws regarding children's privacy, copyrights, taxation and the transmission of sexually explicit material. The European Union also recently enacted its own privacy regulations. The law of the Internet, however, remains largely unsettled, even in areas where there has been some legislative action. It may take years to determine whether and how existing laws such as those governing intellectual property, privacy, libel and taxation apply to the Internet. In addition, the growth and development of the market for online commerce may prompt calls for more stringent consumer protection laws, both in the United States and abroad, that may impose additional burdens on companies conducting business online. The adoption or modification of laws or regulations relating to the Internet could adversely affect our business. We provide services over the Internet in many states in the United States and in many foreign countries, and we facilitate the activities of our customers in these jurisdictions. As a result we may be required to qualify to do business, or be subject to taxation, or be subject to other laws and regulations, in these jurisdictions even if we do not have a physical presence or employees or property in these jurisdictions. The application of these multiple sets of laws and regulations is uncertain, but we could find that Exodus is subject to regulation, taxation, enforcement or other liability in unexpected ways, which could materially adversely affect our business.

WE COULD BE HELD LIABLE FOR THE INFORMATION DISSEMINATED THROUGH OUR NETWORK The law relating to the liability of online services companies and Internet access providers for information and commerce carried on or disseminated through their networks is currently unsettled. The Child Online Protection Act of 1998 imposes criminal penalties and civil liability on anyone engaged in the business of selling or transferring material that is harmful to minors, by means of the World Wide Web, without restricting access to this type of material by underage persons. Numerous states have adopted or are currently considering similar types of legislation. The imposition upon us and other Internet network providers of potential liability for information carried on or disseminated through systems could require us to implement measures to reduce exposure to liability, which may require the expenditure of substantial resources, or to discontinue various service or product offerings. Further, the costs of defending against any claims and potential adverse outcomes of these claims could have a material adverse effect on our business. While we carry professional liability insurance, it may not be adequate to compensate or may not cover us in the event we become liable for information carried on or disseminated through our networks.

Some businesses, organizations and individuals have in the past sent unsolicited commercial e-mail messages through our network or advertising sites hosted at our facilities to a massive number of people. This practice, known as "spamming," has led to some complaints against us. In addition, some ISPs and other online services companies could deny network access to us if we allow undesired content or spamming to be transmitted through our networks. Although we prohibit customers by contract from spamming, we cannot be sure that customers will not engage in this practice, which could have a material adverse effect on our business.

OUR FUTURE SUCCESS DEPENDS ON OUR KEY PERSONNEL Our success depends in significant part upon the continued services of our key technical, sales and senior management personnel. Any officer or employee can terminate his or her relationship at any time. If we lose the services of one or more of our key employees or are unable to attract additional qualified personnel, our business would be adversely affected. We do not carry key-person life insurance for any of our employees.

IF THE INTERNET AND INTERNET INFRASTRUCTURE DEVELOPMENT DO NOT CONTINUE TO GROW, OUR BUSINESS WILL BE HARMED Our success depends in large part on continued growth in the use of the Internet. Critical issues concerning the commercial use of the Internet, including security, reliability, cost, ease of access, quality of service and necessary increases in bandwidth availability, remain unresolved and are likely to affect the development of the market for our services. In addition, the rate of development and adoption of the Internet has been slower outside of the United States and the cost of bandwidth has been higher. The recent growth in the use of the Internet has caused frequent periods of performance degradation, requiring the upgrade of routers and switches, telecommunications links and other components forming the infrastructure of the Internet by ISPs and other organizations with links to the Internet. Any perceived degradation in the performance of the Internet as a whole could undermine the benefits of our services. Consequently, the emergence and growth of the market for our services is dependent on improvements being made to the entire Internet infrastructure to alleviate overloading and congestion.

WE FACE RISKS ASSOCIATED WITH PROTECTION AND ENFORCEMENT OF INTELLECTUAL PROPERTY RIGHTS We rely on a combination of copyright, patent trademark, service mark and trade secret laws and contractual restrictions to establish and protect proprietary rights in our products and services. We have very little patented technology that would preclude or inhibit competitors from entering our market. Although we have entered into confidentiality agreements with our employees, contractors, suppliers, distributors and appropriate customers to limit access to and disclosure of our proprietary information, these may prove insufficient to prevent misappropriation of our technology or to deter independent third-party development of similar technologies. In addition, the laws of various foreign countries may not protect our products, services or intellectual property rights to the same extent as do the laws of the United States.

In addition to licensing technologies from third parties, we are developing and acquiring additional proprietary intellectual property. Third parties may try to claim that our products or services infringe on their intellectual property. We expect that participants in our markets will be increasingly subject to infringement claims. Any claim, whether meritorious or not, could be time consuming, result in costly litigation, cause product installation delays or require us to enter into royalty or licensing agreements. These royalty or licensing agreements might not be available on terms acceptable to us or at all.

POTENTIAL RISKS RELATED TO THE YEAR 2000 PROBLEM MIGHT HARM OUR BUSINESS In many of our recent filings with the Commission, we discussed the nature and progress of our plans to become year 2000 compliant. In late 1999, we completed our remediation and testing of systems. As a result of those planning and implementation efforts, we experienced no significant disruptions in mission critical information technology systems and other internal operating systems. Costs directly associated with our year 2000 compliance efforts were not material, amounting to less than $1.0 million. We are not aware of any material problems with our products or services or internal operating systems resulting from year 2000 issues, and we have not received notice of any material year 2000 compliance issues from our external vendors. However, it remains possible that year 2000 problems associated with our systems or our vendors' products may still arise or that we could receive notice of year 2000 problems that have arisen with our vendors' products.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. We place our investments with high quality issuers and, by policy, limit the amount of risk by investing primarily in money market funds, United States Treasury Notes and certificates of deposit. An increase or decrease in interest rates would not significantly increase or decrease interest expense on debt obligations due to the fixed nature of our debt obligations. We do not currently have any significant foreign operations and thus are not currently materially exposed to foreign currency fluctuations.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data) December 31,	1998	1999
ASSETS		
Current assets:		
Cash and cash equivalents	$ 156,015	$ 1,015,960
Accounts receivable, net of allowance for doubtful accounts of $1,821 and $7,577 as of December 31, 1998 and 1999, respectively	9,653	61,916
Prepaid expenses and other current assets	6,205	15,331
Total current assets	171,873	1,093,207
Property and equipment, net	68,572	368,239
Restricted cash equivalents and investments	45,614	35,390
Goodwill and other intangible assets	4,898	156,002
Other assets	7,841	90,052
	$ 298,798	$ 1,742,890
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of equipment loans and line of credit facilities	$ 14,367	$ 6,897
Current portion of capital lease obligations	5,223	17,162
Accounts payable	9,208	60,203
Accrued expenses	6,876	42,457
Accrued interest payable	11,563	23,829
Total current liabilities	47,237	150,548
Equipment loans and line of credit facilities, less current portion	15,695	8,353
Capital lease obligations, less current portion	11,589	40,343
Convertible subordinated notes	–	749,800
Senior notes	200,000	776,231
Total liabilities	274,521	1,725,275
Commitments and contingencies		
Stockholders' (deficit) equity:		
Preferred stock, $0.001 par value: 5,000,000 shares authorized as of December 31, 1998 and 1999, respectively, and no shares issued or outstanding as of December 31, 1998 and 1999	–	–
Convertible preferred stock of Service Metrics, Inc.; 1,553,158 shares and no shares issued and outstanding as of December 31, 1998 and 1999, respectively; aggregate liquidation preference of $6,000 and $0 as of December 31, 1998 and 1999, respectively	5,961	–
Common stock, $0.001 par value: 50,000,000 and 300,000,000 shares authorized as of December 31, 1998 and 1999, respectively; 161,670,962 and 177,914,376 shares issued and outstanding as of December 31, 1998 and 1999, respectively	162	178
Additional paid-in capital	117,127	247,983
Deferred stock compensation	(1,080)	(2,894)
Accumulated deficit	(97,893)	(228,216)
Accumulated other comprehensive income	–	564
Total stockholders' equity	24,277	17,615
	$ 298,798	$ 1,742,890

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data) Years Ended December 31,	1997	1998	1999
Revenues	$ 12,408	$ 52,745	$ 242,140
Costs and expenses:			
Costs of revenues	16,868	61,578	197,231
Marketing and sales	12,702	29,034	75,809
General and administrative	5,983	16,058	42,951
Product development	1,647	3,507	8,869
Amortization of goodwill and intangible assets	–	141	9,438
Merger costs	–	–	5,058
Total costs and expenses	37,200	110,318	339,356
Operating loss	(24,792)	(57,573)	(97,216)
Interest income	193	7,157	15,928
Interest expense	(699)	(16,900)	(49,035)
Net loss	(25,298)	(67,316)	(130,323)
Cumulative dividends and accretion on redeemable convertible preferred stock	(1,413)	(2,014)	–
Net loss attributable to common stockholders	$(26,711)	$ (69,330)	$(130,323)
Basic and diluted net loss per share	$ (1.73)	$ (0.55)	$ (0.78)
Shares used in computing basic and diluted net loss per share	15,428	125,808	167,924

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' (DEFICIT) EQUITY AND COMPREHENSIVE LOSS

(In thousands)	Convertible Preferred Stock of Service Metrics, Inc Shares	Amount	Common Stock Shares	Amount
Balances as of December 31, 1996	–	$ –	15,568	$ 16
Comprehensive loss:				
Net loss and comprehensive loss	–	–	–	–
Issuance of common stock in connection with exercise of stock options and warrants	–	–	1,378	1
Repurchase of common stock	–	–	(408)	–
Repayment of notes receivable from stockholders	–	–	–	–
Deferred stock compensation related to stock option grants	–	–	–	–
Amortization of deferred stock compensation	–	–	–	–
Accrual of cumulative dividends on Series C and D redeemable convertible preferred stock	–	–	–	–
Accretion on Series C and D redeemable convertible preferred stock	–	–	–	–
Balances as of December 31, 1997	–	–	16,538	17
Comprehensive loss:				
Net loss and comprehensive loss	–	–	–	–
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options and warrants	–	–	6,703	7
Issuance of common stock in conjunction with initial public offering, net of offering costs of $7,062	–	–	41,000	41
Issuance of common stock to an officer for cash	–	–	400	–
Issuance of common stock and common stock warrants	–	–	–	–
Issuance of Service Metrics, Inc. convertible preferred stock	3,106	5,961	–	–
Issuance of Service Metrics, Inc. common stock to founders	–	–	1,132	1
Repayment of notes receivable from stockholders	–	–	–	–
Conversion of redeemable convertible preferred stock into common stock	–	–	95,898	96
Amortization of deferred stock compensation	–	–	–	–
Accrual of cumulative dividends on Series C and D redeemable convertible preferred stock	–	–	–	–
Accretion on Series C and D redeemable convertible preferred stock	–	–	–	–
Balances as of December 31, 1998	3,106	5,961	161,671	162
Comprehensive loss:				
Net loss	–	–	–	–
Foreign currency translation adjustment	–	–	–	–
Comprehensive loss				
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options and warrants	–	–	9,040	9
Issuance of common stock and assumption of stock options in connection with acquisitions	–	–	2,015	2
Issuance of Service Metrics, Inc. convertible preferred stock	2,065	9,476	–	–
Conversion of Service Metrics, Inc. convertible preferred stock into common stock	(5,171)	(15,437)	5,171	5
Deferred stock compensation related to stock option grants	–	–	–	–
Conversion of convertible subordinated notes into common stock	–	–	17	–
Amortization of deferred stock compensation	–	–	–	–
Balances as of December 31, 1999	–	$ –	177,914	$ 178

See accompanying notes to consolidated financial statements.

Additional Paid-In Capital	Notes Receivable from Stockholders	Deferred Stock Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' (Deficit) Equity	Comprehensive Loss
$ 215	$ (186)	$ –	$ (5,279)	$ –	$ (5,234)	
–	–	–	(25,298)	–	(25,298)	$ (25,298)
221	–	–	–	–	222	
(12)	12	–	–	–	–	
–	34	–	–	–	34	
3,482	–	(3,482)	–	–	–	
–	–	1,089	–	–	1,089	
(750)	–	–	–	–	(750)	
(663)	–	–	–	–	(663)	
2,493	(140)	(2,393)	(30,577)	–	(30,600)	
–	–	–	(67,316)	–	(67,316)	$ (67,316)
2,286	–	–	–	–	2,293	
69,777	–	–	–	–	69,818	
450	–	–	–	–	450	
786	–	–	–	–	786	
–	–	–	–	–	5,961	
8	–	–	–	–	9	
–	140	–	–	–	140	
43,341	–	–	–	–	43,437	
–	–	1,313	–	–	1,313	
(462)	–	–	–	–	(462)	
(1,552)	–	–	–	–	(1,552)	
117,127	–	(1,080)	(97,893)	–	24,277	
–	–	–	(130,323)	–	(130,323)	$ (130,323)
–	–	–	–	564	564	564
						$ (129,759)
25,884	–	–	–	–	25,893	
85,929	–	–	–	–	85,931	
–	–	–	–	–	9,476	
15,432	–	–	–	–	–	
3,411	–	(3,411)	–	–	–	
200	–	–	–	–	200	
–	–	1,597	–	–	1,597	
$ 247,983	$ –	$ (2,894)	$ (228,216)	$ 564	$ 17,615	

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands) Years Ended December 31,	1997	1998	1999
Cash flows from operating activities:			
Net loss	$ (25,298)	$ (67,316)	$ (130,323)
Adjustments to reconcile net loss to net cash used for operating activities:			
Depreciation and amortization	3,429	13,024	50,881
Loss on disposal of property and equipment	–	464	–
Noncash common stock and warrant expense	–	786	–
Amortization of deferred stock compensation	1,089	1,354	1,597
Amortization of debt issuance costs	–	846	1,668
Interest accretion on restricted cash equivalents and investments	–	(1,088)	(1,365)
Changes in operating assets and liabilities:			
Accounts receivable	(1,316)	(8,306)	(41,072)
Prepaid expenses and other assets	(748)	(4,193)	(13,656)
Accounts payable	5,089	2,791	48,436
Accrued expenses	2,237	2,763	24,842
Accrued interest payable	–	11,563	12,266
Net cash used for operating activities	(15,518)	(47,312)	(46,726)
Cash flows from investing activities:			
Capital expenditures	(22,489)	(44,564)	(283,468)
Proceeds from sale of property and equipment	–	245	–
Business acquired, net of cash received	–	(5,654)	(77,676)
Release of restricted cash equivalents and investments	–	–	25,045
Increase in restricted cash equivalents and investments	(1,375)	(42,773)	(13,413)
Other assets	–	(11)	(41,102)
Net cash used for investing activities	(23,864)	(92,757)	(390,614)
Cash flows from financing activities:			
Proceeds from issuance of redeemable convertible preferred stock and warrants	23,320	2,176	–
Proceeds from issuance of Service Metrics, Inc. convertible preferred stock	–	5,961	9,477
Proceeds from issuance of common stock, net	222	72,530	25,916
Proceeds from issuance of bridge financing convertible notes	3,975	–	–
Repayment of notes receivable from stockholders	34	140	–
Bank borrowings, net	3,000	(3,000)	–
Proceeds from sale-leaseback transactions	932	4,035	1,523
Payments on capital leases obligations	(720)	(3,020)	(11,256)
Proceeds from equipment loans and line of credit facilities	16,480	18,611	–
Repayment of equipment loans and line of credit facilities	(1,306)	(5,019)	(15,601)
Proceeds from convertible subordinated notes, net of offering costs	–	–	727,354
Proceeds from senior notes, net of discounts and offering costs	–	193,400	559,332
Net cash provided by financing activities	45,937	285,814	1,296,745
Net increase in cash and cash equivalents	6,555	145,745	859,405
Effects of exchange rates on cash and cash equivalents	–	–	540
Cash and cash equivalents at beginning of year	3,715	10,270	156,015
Cash and cash equivalents at end of year	$ 10,270	$ 156,015	$ 1,015,960
Supplemental disclosures of cash flow information:			
Cash paid—interest	$ 699	$ 4,923	$ 36,955
Noncash investing and financing activities:			
Assets recorded under capital leases	$ 2,700	$ 12,001	$ 50,425
Cumulative dividends and accretion on Series C and D redeemable convertible preferred stock	$ 1,413	$ 2,014	$ –
Deferred compensation on grants of stock options	$ 3,482	$ –	$ 3,411
Warrants issued for financing commitments	$ 730	$ –	$ –
Conversion of bridge financing convertible notes to redeemable convertible preferred stock	$ 3,975	$ –	$ –
Conversion of convertible subordinated notes into common stock	$ –	$ –	$ 200
Conversion of redeemable convertible preferred stock to common stock	$ –	$ 43,437	$ –
Conversion of Service Metrics, Inc. convertible preferred stock to common stock	$ –	$ –	$ 15,437
Issuance of common stock and assumption of stock options in connection with acquisitions	$ –	$ –	$ 85,931

See accompanying notes to consolidated financial statements.

NOTE 1: SUMMARY OF THE COMPANY AND SIGNIFICANT ACCOUNTING POLICIES

THE COMPANY Exodus Communications, Inc. is a leading provider of complex Internet hosting for enterprises with mission-critical Internet operations. The Company offers sophisticated system and network management solutions, along with technology professional services to provide optimal performance for customers' Web sites.

BASIS OF PRESENTATION The consolidated financial statements include the accounts of Exodus and its majority-owned subsidiaries ("Exodus" or the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation. The equity and net loss attributable to minority shareholder interests that related to the Company's subsidiaries are included in the consolidated balance sheets and consolidated statements of operations, respectively, and were not material as of December 31, 1999.

In November 1999, the Company acquired all outstanding shares of Service Metrics, Inc. ("SMI") common stock (see Note 2). The merger was accounted for as a pooling of interests. Accordingly, the consolidated financial statements have been restated for all periods presented as if SMI and the Company had always been combined. In recording the pooling-of-interests combination, the Company's consolidated statement of operations for the year ended December 31, 1998, has been combined with SMI's statement of operations for the period from May 19, 1998 ("inception") through December 31, 1998. The Company's consolidated statements of operations for the year ended December 31, 1999, have been combined with SMI's statements of operations for that same period. The consolidated balance sheets of the Company as of December 31, 1998 and 1999, have been combined with the balance sheets of Service Metrics as of the same dates.

USE OF ESTIMATES The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

REVENUE RECOGNITION The Company's revenues consist of (i) monthly fees from customer use of Internet Data Center sites, network services, managed services, and professional services and use of equipment and software provided by the Company, (ii) revenues from sales or rentals of third-party equipment to customers and (iii) fees for installation and certain professional services. Currently, substantially all of the Company's revenue is derived from services. Revenues (other than installation fees, equipment sales to customers and certain professional services) are generally billed and recognized ratably over the term of the contract, which is generally one year. Installation fees are typically recognized at the time the installation occurs, and equipment revenues are typically recognized when the equipment is delivered to the customer or placed into service at an Internet Data Center. The Company sells third-party equipment to its customers as an accommodation to facilitate their purchase of services. One-time professional service fees are typically recognized when services are rendered. Revenues from sales or rentals of third-party equipment were less than 10% of total revenues for the years ended December 31, 1997, 1998 and 1999.

CASH EQUIVALENTS AND INVESTMENTS Cash equivalents consist of highly liquid investments with original maturities of 90 days or less. As of December 31, 1999, cash equivalents consisted principally of money market funds at several financial institutions.

The Company classifies its investments as "held-to-maturity." As of December 31, 1999, such investments consisted of U.S. Treasury Notes and are recorded at amortized cost, which approximates fair value.

The components of restricted cash equivalents and investments are as follows (in thousands):

December 31,	1998	1999
United States Treasury Notes:		
Due within one year	$ 10,733	$ 13,674
Due after one year through two years	20,594	–
Money market funds	11,049	15,745
Cash collateral related to leases	3,238	5,971
Total restricted cash equivalents and investments	$ 45,614	$ 35,390

See Notes 4 and 6 for additional information regarding restricted cash equivalents and investments.

FINANCIAL INSTRUMENTS AND CONCENTRATION OF CREDIT RISK The carrying value of the Company's cash and cash equivalents, investments, accounts receivable, equipment loans and line of credit facilities, and capital lease obligations approximate fair value. The carrying value of the Company's convertible subordinated notes and senior notes approximated fair value as of December 31, 1998. The fair values of the Company's convertible subordinated notes and senior notes based on quoted market prices as of December 31, 1999 were $2,630,794,000 and $795,638,000, respectively.

Financial instruments that potentially expose the Company to a concentration of credit risk principally consist of cash and cash equivalents, investments and accounts receivable. The Company's customer base is composed of businesses primarily throughout the United States and also in Europe and Asia Pacific. The Company performs ongoing credit evaluations of its customers and maintains reserves for potential losses.

PROPERTY AND EQUIPMENT Property and equipment are stated at cost and depreciated on a straight-line basis over their respective estimated useful lives, which are generally three to five years. Equipment recorded under capital leases and leasehold improvements are amortized using the straight-line method over the shorter of the respective lease term or estimated useful life of the asset.

SOFTWARE DEVELOPMENT COSTS The Company capitalizes software development costs incurred to develop certain of the Company's collaborative system management services that are included in the Company's co-location services in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.* Costs are capitalized after technological feasibility is achieved, generally upon the development of a working model. To date, software development costs capitalizable under SFAS No. 86 have not been material.

INCOME TAXES The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be recovered.

STOCK-BASED COMPENSATION The Company uses the intrinsic value-based method to account for all of its employee stock-based compensation plans. Expense associated with stock-based compensation is being amortized consistent with the method described in Financial Accounting Standards Board (FASB) Interpretation No. 28 over the vesting period of the individual options.

IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF The Company evaluates its long-lived assets, including goodwill and certain identifiable intangibles, for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets or intangibles may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

GOODWILL AND OTHER INTANGIBLE ASSETS Goodwill and other intangible assets are comprised primarily of amounts recorded in business acquisitions and are included in goodwill and other intangible assets on the accompanying consolidated balance sheets. The goodwill and other intangible amounts related to the acquisitions are being amortized on a straight-line basis over periods ranging from 2 to 10 years (see Note 2).

DEBT FINANCE COSTS In connection with its financing arrangements (see Note 4), the Company incurs certain direct, incremental costs from third parties who perform services that assist in the closing of the related transactions. These costs are included in other assets on the balance sheet (see Note 3) and amortized using the effective interest method over the term of the financing.

NET LOSS PER SHARE Basic and diluted net loss per share has been computed by dividing the net loss attributable to holders of common stock by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share does not include the effect of the following common equivalent shares as the effect of their inclusion is antidilutive during each period (in thousands):

Years Ended December 31,	1997	1998	1999
Shares issuable under stock options	13,672	38,594	62,197
Shares issuable pursuant to warrants to purchase common and redeemable convertible preferred stock	22,504	1,448	507
Shares of redeemable convertible preferred stock and convertible preferred stock on an “as if converted” basis	272,936	3,106	–
Shares of convertible subordinated notes on an “as if converted” basis	–	–	28,977

COMPREHENSIVE LOSS Accumulated other comprehensive income, as presented in the accompanying balance sheets, consists solely of cumulative translation adjustments.

RECENT ACCOUNTING PRONOUNCEMENTS In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities.* SFAS No. 133 establishes methods for accounting for derivative financial instruments and hedging activities related to those instruments, as well as other hedging activities. Because the Company does not currently hold any derivative instruments and does not currently engage in hedging activities, the Company expects that the adoption of SFAS No. 133 will not have a material impact on our financial position, results of operations or cash flows. The Company will be required to implement SFAS No. 133 for the year ending December 31, 2001.

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." This statement of position requires companies to capitalize qualifying computer software costs which are incurred in the application development stage and amortize them over the software's estimated useful life. SOP 98-1 is effective for fiscal years beginning after December 15, 1998. As such, the Company adopted SOP 98-1 effective January 1, 1999. To date, SOP 98-1 has not had a material impact on the Company's financial position, results of operations or cash flows.

RECLASSIFICATIONS Certain prior period amounts have been reclassified to conform to the current period presentation.

NOTE 2: BUSINESS COMBINATIONS

PURCHASE TRANSACTIONS On October 2, 1998, the Company purchased substantially all of the assets, including customer agreements, and assumed certain liabilities of Arca Systems, Inc. ("Arca"), a wholly owned subsidiary of Cyberguard Corporation. Arca, which has been in business for more than 10 years, is a provider of advanced network and system security consulting services and designs and develops security technology solutions for complex and sensitive information systems. Arca operates as a wholly owned subsidiary of the Company. Total consideration paid, including direct acquisition costs, aggregated approximately $5,800,000. The acquisition was accounted for as a purchase and the results of Arca's operations have been included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $5,000,000 and was attributed primarily to workforce in place ($2,500,000) and goodwill ($2,400,000). These amounts are being amortized on a straight-line basis over periods ranging from 2 to 10 years.

On February 1, 1999, the Company purchased all of the capital stock of American Information Systems, Inc ("AIS"). AIS provides co-location services as well as professional services. Total consideration paid, including direct acquisition costs, aggregated approximately $20,500,000. The acquisition was accounted for as a purchase with the results of AIS' operations included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $18,700,000 and was attributed primarily to goodwill ($15,000,000), customer lists ($3,200,000) and assembled workforce ($500,000). These amounts are being amortized on a straight-line basis over periods ranging from 5 to 7 years.

On July 27, 1999, the Company completed its acquisition of Cohesive Technology Solutions, Inc. ("Cohesive"). Cohesive offers a variety of services including network design and development, Internet-based and application development and information technology strategy and project management. Pursuant to the exchange ratios applied in the acquisition, the Company issued 1,600,796 shares of Exodus common stock and paid approximately $50,000,000 in cash and assumed options to purchase a total of 408,712 shares of Exodus common stock for a total purchase price of approximately $112,000,000. Of the cash consideration, $10,000,000 was deposited in an escrow account to secure and collateralize the indemnification obligations of Cohesive stockholders to Exodus and certain affiliates of Exodus. The acquisition was accounted for as a purchase with the results of Cohesive's operations included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $107,900,000 and was attributed primarily to goodwill ($69,300,000), customer lists ($32,300,000) and workforce in place ($6,300,000). These amounts are being amortized on a straight-line basis over periods ranging from 5 to 8 years.

In connection with the Cohesive purchase, the Company, in August 1999, announced plans to consolidate seven professional services practice offices of Cohesive. The Company determined that the consolidation of these offices would maximize efficiencies of the combined entity. As such, the Company recorded a restructuring charge of $923,000 in 1999, which is included in merger costs in the consolidated statement of operations for the year ended December 31, 1999. This charge includes approximately $689,000 for lease termination and other related office closure costs and $234,000 in severance and other employee benefits. As of December 31, 1999, the remaining restructuring reserve balance was approximately $550,000. The Company expects to complete the restructuring activities in the third quarter of fiscal year 2000.

On December 17, 1999, the Company acquired 85% of the common stock of Global OnLine Japan Co., Ltd. ("GOL") of Tokyo, Japan. GOL operates its own nationwide backbone network and provides such services as Web design, e-commerce solutions, co-location, and system integration. The Company issued 415,296 shares of Exodus common stock and paid approximately $12,000,000 in cash for a total purchase price of approximately $36,000,000. As the Company has a majority share of 85% in GOL, the Company has consolidated GOL's results of operation with its results of operations for the year ended December 31, 1999. The acquisition was accounted for using the purchase method of accounting with the results of GOL's operations included from the acquisition date. The excess of the purchase price over the fair value of tangible net assets acquired amounted to approximately $33,800,000 and was attributed primarily to goodwill ($31,300,000), customer lists ($1,300,000) and workforce in place ($1,200,000). These amounts are being amortized on a straight-line basis over periods ranging from 3 to 5 years.

The summary table below, prepared on an unaudited pro forma basis, combines the Company's consolidated results of operations with Arca's, AIS's, and Cohesive's results of operations as if each company had been acquired as of January 1, 1997 (in thousands, except per share data). GOL's March 31 fiscal year end differs from the Company's December 31 fiscal year end. As such, fiscal years 1997 and 1998 presented in the table below include GOL's results of operations for the period from April 1, 1997 through March 31, 1998 and from April 1, 1998 though March 31, 1999, respectively. For fiscal year 1999, information presented in the table below includes GOL's results of operations from April 1, 1999 through December 17, 1999, the date of acquisition.

Years ended December 31,	1997	1998	1999
Revenues	$ 45,347	$109,500	$ 278,369
Net loss attributable to common stockholders	$(30,705)	$(94,824)	$(147,578)
Basic and diluted net loss per share	$ (1.76)	$ (0.74)	$ (0.87)
Shares used in pro forma per share computation	17,443	127,823	169,553

The pro forma results are not necessarily indicative of what would have occurred if the acquisitions had been in effect for the periods presented. In addition, they are not intended to be a projection of future results and do not reflect any synergies that might be achieved from combined operations.

POOLING TRANSACTION As discussed in Note 1, the Company completed its merger with SMI on November 23, 1999. The merger was accounted for as a pooling of interests. In connection with the merger, the Company incurred one-time expenses of approximately $4,100,000, which are included in merger costs in the consolidated statement of operations for the year ended December 31, 1999. SMI is a leading provider of Internet monitoring applications and services that measure the consistency, availability and performance of Web sites. Under the terms of the agreement, the former shareholders and option holders of SMI common stock received shares and options of Exodus common stock at the rate of approximately 0.252 shares of Exodus common stock for each share of SMI common stock. The

Company issued a total of approximately 6,300,000 shares of Exodus common stock in exchange for all outstanding shares of SMI common stock and reserved approximately 750,000 shares of common stock for issuance upon the exercise of SMI options the Company assumed pursuant to the agreement. The table below summarizes the components of the combined results of operations for the years ended December 31, 1998 and 1999. SMI's results of operations for the year ended December 31, 1999, included its results for the period from January 1, 1999 through November 23, 1999, the date the merger was consummated. As SMI was incorporated in May 1998, consolidated results of operations for the year ended December 31, 1997, consists solely of Exodus' historical results of operations.

Years Ended December 31,	**1998**	**1999**
Net revenues:		
Exodus	$ 52,738	$ 241,172
Service Metrics	7	968
	$ 52,745	$ 242,140
Net loss:		
Exodus	$(66,442)	$(122,582)
Service Metrics	(874)	(7,741)
	$(67,316)	$(130,323)

NOTE 3: FINANCIAL STATEMENT COMPONENTS

PROPERTY AND EQUIPMENT Property and equipment consisted of the following (in thousands):

December 31,	**1998**	**1999**
Data centers and related equipment	$43,959	$ 332,092
Furniture, fixtures, computer equipment and other	33,179	55,790
Construction in progress	8,497	35,663
	85,635	423,545
Less accumulated depreciation and amortization	17,063	55,306
	$68,572	$ 368,239

Computer and other equipment and certain data center infrastructure are recorded under capital leases that aggregated $20,528,000 and $70,953,000 as of December 31, 1998 and 1999, respectively. Accumulated amortization on the assets recorded under capital leases aggregated $4,452,000 and $23,853,000 as of December 31, 1998 and 1999, respectively.

GOODWILL AND OTHER INTANGIBLE ASSETS Goodwill and other intangible assets consisted of the following (in thousands):

December 31,	**1998**	**1999**
Goodwill	$ 2,389	$ 117,950
Customer lists	150	37,007
Workforce in place	2,500	10,624
	5,039	165,581
Less accumulated amortization	141	9,579
	$ 4,898	$ 156,002

OTHER ASSETS Other assets consisted of the following (in thousands):

December 31,	**1998**	**1999**
Debt issuance costs (see Note 4)	$5,504	$ 44,726
Telecommunication agreements	–	25,633
Other	2,337	19,693
	$7,841	$ 90,052

ACCRUED EXPENSES Accrued expenses consisted of the following (in thousands):

December 31,	**1998**	**1999**
Accrued payroll and related expenses	$ 3,549	$11,725
Other	3,327	30,732
	$ 6,876	$42,457

NOTE 4: BANK BORROWINGS AND DEBT

SENIOR NOTES On July 1, 1998, the Company issued $200,000,000 of 11¼% Senior Notes ("Original Senior Notes") due 2008 for aggregate net proceeds of approximately $193,400,000 (net of discounts to the initial purchasers and offering expenses). Interest is payable semiannually on January 1 and July 1 of each year commencing January 1, 1999. The Company was required to initially deposit approximately $42,400,000 with an escrow agent to be used to pay the first four semiannual interest payments when due. Interest payments of $11,250,000 were made in January and July 1999 and January 2000. As of December 31, 1999, restricted cash and equivalents included approximately $21,100,000 for the remaining two interest payments. Subject to significant exceptions, the Original Senior Notes indenture restricts, among other things, the Company's ability to incur additional indebtedness and the use of proceeds therefrom, pay dividends, make certain other restricted payments, incur certain liens to secure indebtedness or engage in merger transactions.

On June 22, 1999, the Company issued an additional $75,000,000 of Senior Notes due 2008 ("Additional Senior Notes") at 100.50% plus accrued interest, if any, from June 22, 1999, for aggregate net proceeds of approximately $73,200,000 (net of offering expenses). The Company issued the Additional Senior Notes under the indenture dated July 1, 1998 under which it previously issued the Original Senior Notes discussed above. The Additional Senior Notes will be subject to substantially the same terms and conditions as the Original Senior Notes. Interest is payable semiannually on January 1 and July 1 of each year commencing July 1, 1999. Concurrent with the closing of the offering, the Company deposited approximately $8,400,000 with an escrow agent that would be sufficient to pay when due the first three interest payments. An interest payment of approximately $211,000 was made in July 1999 representing interest from June 22, 1999 to July 1, 1999 and one for approximately $4,200,000 was made in January 2000. As of December 31, 1999, restricted cash and equivalents included approximately $8,200,000 for the remaining two interest payments.

On December 8, 1999, the Company issued $375,000,000 and Euro 125,000,000 of 10¾% Senior Notes due 2009 (collectively, the "10¾% Senior Notes"), for aggregate net proceeds of approximately $486,000,000 (net of offering expenses). Interest is payable semiannually on June 15 and December 15 of each year commencing June 15, 2000. Subject to significant exceptions, the 10¾% Senior Notes indenture restricts, among other things, the Company's ability to incur additional indebtedness, pay dividends, make certain investments, create liens or sell assets, enter into certain transactions with affiliates, and enter into certain business combinations.

CONVERTIBLE SUBORDINATED NOTES On March 3, 1999, the Company issued $250,000,000 of 5% Convertible Subordinated Notes due March 15, 2006 (the "Convertible Notes") for aggregate net proceeds of approximately $242,100,000 (net of offering expenses). Proceeds from the sale of the Convertible Notes may be used only for limited purposes. Proceeds in the amount of $48,500,000 may be used for general corporate purposes. The remaining $193,600,000 may be used only to finance the purchase of assets or other businesses to be used in the Company's business. The Convertible Notes are convertible into the Company's common stock at a conversion rate of 87.5704 shares per $1,000 principal amount of Convertible Notes, subject to adjustment in certain events and at each holder's option. The Convertible Notes will not be subject to redemption prior to March 20, 2001, and generally will be redeemable on or after that date at the option of the Company, at the redemption prices set forth in the indenture to the Convertible Notes ("Convertible Notes Indenture"), subject to certain provisions. In the event of a Change in Control (as defined in the Convertible Notes Indenture), each holder of the Convertible Notes has the right, subject to certain conditions and restrictions, to require the Company to repurchase all or any part of the holder's Convertible Notes at a repurchase price of 100% of the principal amount, plus accrued interest of the Convertible Notes being repurchased. Interest on the Convertible Notes is payable on March 15 and September 15 of each year, commencing on September 15, 1999. Accordingly, the Company made its first interest payment in the amount of approximately $6,700,000 on September 15, 1999. The Convertible Notes are unsecured obligations of the Company and are subordinated to all existing and future Senior Indebtedness (as defined in the Convertible Notes Indenture) and effectively subordinated to all indebtedness and other liabilities of the Company's subsidiaries.

On December 8, 1999, the Company issued $500,000,000 of 4¾% Convertible Subordinated Notes due July 15, 2008 (the "4¾% Notes") for aggregate net proceeds of approximately $485,000,000 (net of offering expenses). Proceeds from the sale of the 4¾% Notes may be used only for limited purposes. Proceeds in the amount of $291,750,000 may be used for general corporate purposes. The remaining $193,250,000 may be used only to finance the purchase of assets or other businesses to be used in the Company's business. The 4¾% Notes are convertible into the Company's common stock at a conversion rate of 14.2034 shares per $1,000 principal amount of the 4¾% Notes, subject to adjustment in certain circumstances. The 4¾% Notes will not be subject to redemption at the option of the Company prior to January 20, 2002, and generally will be redeemable on or after that date at the option of the Company, at the redemption prices set forth in the indenture to the 4¾% Notes ("the 4¾% Notes Indenture"). However, the 4¾% Notes will not be redeemable at the Company's option following January 20, 2002 and before January 15, 2004 unless the closing price of the common stock is at least 140% of the conversion price for at least 20 trading days within a period of 30 consecutive days ending within five trading days of the call for redemption. In the event of a Change in Control (as defined in the 4¾% Notes Indenture), each holder of the 4¾% Notes has the right, subject to certain conditions and restrictions, to require the Company to repurchase the 4¾% Notes, in whole or in part, at a repurchase price of 100% of the principal amount, plus accrued interest to the repurchase date. Interest on the 4¾% Notes is payable on January 15 and July 15 of each year, commencing on July 15, 2000. The 4¾% Notes are unsecured obligations of the Company and are subordinated to all existing and future Senior Indebtedness (as defined in the 4¾% Notes Indenture) and effectively subordinated to all indebtedness and other liabilities of the Company's subsidiaries.

EQUIPMENT LOANS AND LINE OF CREDIT FACILITIES

The Company has various equipment loans and line of credit facilities with payments due currently through August 2002 and effective interest rates ranging from 12.8% to 16.4%. As of December 31, 1999, aggregate maturities for outstanding equipment loans and line of credit facilities for fiscal 2000, 2001 and 2002 were $7,342,000, $5,943,000 and $2,410,000, respectively.

On July 22, 1999, the Company amended its revolving line of credit agreement with a financial institution, increasing the total commitment amount from $7,000,000 to $10,000,000. Pursuant to the terms of the new amendment, the line of credit can be used for working capital requirements, foreign exchange forward contracts, and letters of credit. The amount available for working capital borrowings is limited to $4,000,000. In addition, total foreign exchange contracts at any one time cannot exceed 10 times the amount of the foreign exchange sublimit, which is a maximum of $1,000,000. The line of credit will expire in July 2000 and is subject to certain covenants.

NOTE 5: CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' (DEFICIT) EQUITY

CONVERTIBLE PREFERRED STOCK OF SERVICE METRICS, INC. In May 1998, SMI issued 540,936 shares of Series A convertible preferred stock for approximately $1,000,000 in cash. In December 1998, SMI issued 1,012,222 shares of Series B convertible preferred stock for approximately $5,000,000 in cash. In January 1999, SMI issued an additional 303,667 shares of Series B convertible preferred stock for approximately $1,500,000 in cash. In July 1999, SMI issued 728,953 shares of Series C convertible preferred stock for approximately $8,000,000 in cash.

The Series A, B, and C convertible preferred stock ("SMI Preferred Stock") was convertible, at the option of the holder, into common stock of SMI based on formulas specified in the preferred stock agreements. The SMI Preferred Stock would automatically convert into common stock upon the closing of an initial public offering of SMI, where the net cash proceeds were at least $15,000,000 and the public offering price would be at least $2.50 per share. The holders of the SMI Preferred Stock were entitled to receive dividends at the rate of $0.16 for Series A, $0.48 for Series B, and $1.10 for Series C, when and if declared by the Board of Directors. These dividends were noncumulative. Holders of the SMI preferred stock were entitled to vote upon any matter submitted to the stockholders for a vote and have one vote for each full share of common stock into which their SMI Preferred Stock would be converted at the date of the vote. The SMI Preferred Stock had liquidation privileges generally equal to the SMI Preferred Stock purchase price per share plus any declared but unpaid dividends and was in preference to shares of common stock.

In connection with the merger between Exodus and SMI on November 23, 1999, all of the SMI preferred shareholders converted their SMI Preferred Stock into SMI common stock which was converted into Exodus common stock based on a specified exchange ratio (see Note 2).

INITIAL PUBLIC OFFERING On March 24, 1998, the Company completed its initial public offering ("IPO") of 41,000,000 shares of its common stock. Net proceeds to the Company, after deducting underwriting discounts and commissions and offering expenses, aggregated approximately $69,800,000. At the closing of the IPO, all redeemable convertible preferred stock was converted to common stock and all warrants to purchase redeemable convertible preferred stock were converted to warrants to purchase common stock on a one-for-three basis. In connection with the IPO, certain warrant holders exercised their warrants to purchase redeemable convertible preferred stock (which converted into common stock), which resulted in additional proceeds of $1,842,000.

STOCK PURCHASE AND STOCK OPTION PLANS During 1995, the Company adopted a Stock Purchase Plan under which 2,933,336 shares of common stock were authorized. Awards totaling 858,944 shares of common stock were granted to individuals through 1996, at a price of $0.03 per share, the estimated fair value of the shares on the date of the award. No awards were granted during the years ended December 31, 1997, 1998 and 1999. Generally, the shares are subject to a 50-month vesting period. As of December 31, 1999, 1,334 shares remained unvested. Unvested shares are subject to repurchase, at the Company's option, at the original purchase price upon a participant's termination. Of the shares granted, 370,408 had been repurchased by the Company through December 31, 1999.

In January 1998, the Company adopted the 1998 Employee Stock Purchase Plan (the "Purchase Plan") and reserved a total of 4,800,000 shares of the Company's common stock for issuance thereunder. The Purchase Plan permits eligible employees to purchase common stock through payroll deductions at a purchase price of 85% of the lower of the fair market value of the common stock on the first day of the offering period or on the last day of the purchase period. During 1998 and 1999, 436,528 and 999,200 shares were issued under the Purchase Plan, respectively, at a weighted-average purchase price of $1.67 and $2.66 per share, respectively.

In January 1997, the Company adopted the 1997 Equity Incentive Plan (the "1997 Plan"), which served as the successor to the Company's 1995 Stock Option Plan (the "1995 Plan"). Options granted under the 1995 Plan before its termination continue to remain outstanding in accordance with their terms, but no further options may be granted under the 1995 Plan. Options granted under the 1995 Plan were granted with exercise prices not less than fair market value at the date of grant as determined by the Board of Directors, generally vested 12% after 6 months from the date of grant and 2% per month thereafter, and generally are exercisable for a term of 10 years after the date of grant. Under the 1997 Plan, the Company reserved 17,600,000 shares of its common stock for issuance to employees and consultants to be granted as either incentive or nonqualified stock options. Options granted under the 1997 Plan generally vest 12% after 6 months from the date of grant and 2% per month thereafter and are generally exercisable for a term of 10 years after the date of grant.

In January 1998, the Company adopted the 1998 Equity Incentive Plan (the "1998 Plan"). On the effective date of the Company's IPO, the 1998 Plan became effective as the successor to the 1997 Plan. The Company has reserved 12,000,000 shares of common stock for issuance under the 1998 Plan in addition to the shares that remain from the 1997 Plan. The 1998 Plan permits the grant of either incentive or nonqualified stock options. Options granted under the 1998 Plan will have a maximum term of 10 years and generally will vest over 50 months. The 1998 Plan will terminate in January 2008.

On June 2, 1999, the Company's stockholders approved an amendment to the Company's 1998 Equity Incentive Plan to increase the number of shares of common stock reserved for issuance thereunder by 8,000,000 shares, from 12,000,000 shares to 20,000,000 shares.

In January 1998, the Company adopted the 1998 Directors Stock Option Plan (the "Directors Plan") and reserved a total of 1,600,000 shares of the Company's common stock for issuance thereunder. Each nonemployee director who is or becomes a member of the Board of Directors on or after the effective date of the Company's IPO, with certain limited exceptions, will initially be granted an option for 40,000 shares of the Company's common stock and, thereafter, an option to purchase an additional 10,000 shares of the Company's common stock annually. Initial options granted under the Directors Plan will vest as to 33⅓% of the shares on each annual anniversary of the date of grant. Annual grants will vest 25% on each annual anniversary of the date of grant. The exercise price of the options granted under the Directors Plan will be at the fair market value of the Company's common stock on the date of grant.

In January 1998, the Company granted stock options to purchase 2,666,672 shares of common stock to an officer of the Company, of which half have an exercise price of $1.13 per share and vest 100% after 3 years and half have an exercise price of $2.25 per share and vest 100% after 5 years. The stock options accelerate and become fully vested if the Company is acquired or sells all or substantially all of its assets or upon other certain events. In November 1999, an event occurred which lead to the acceleration of the vesting for all of these options and they became fully vested.

In March 1998, the Company granted a stock option to an officer of the Company to purchase 5,775,848 shares of common stock with an exercise price of $1.13 per share (fair market value on the date of grant) that vests as to 12% of such shares in September 1998 and vests as to an additional 2% per month thereafter.

In January 1999, the Company adopted the 1999 Stock Option Plan (the "1999 Plan"). Under the 1999 Plan, the Company has reserved 24,000,000 shares of common stock to be granted as nonqualified stock options. Such grant will be made to employees and consultants, and will be used for acquisitions. Options granted under the 1999 Plan generally will vest over 50 months and are generally exercisable for a term of 10 years from the date of grant.

SERVICE METRICS, INC. STOCK OPTION PLAN In July 1998, the SMI Board of Directors adopted the 1998 Stock Option Plan. Under the Plan, officers, employees and certain other individuals could be granted options and rights to purchase shares of common stock. Options granted could be either incentive stock options or nonstatutory stock options. SMI had reserved 512,624 shares of common stock for issuance of stock options. However, in connection with the merger between Exodus and SMI on November 23, 1999, all of the SMI stock options were assumed by Exodus and converted into Exodus stock options based on a specified exchange ratio.

WARRANTS Prior to its IPO, the Company issued approximately 3,000,000 warrants to purchase common stock and redeemable convertible preferred stock, with exercise prices ranging from $0.30 to $2.85 per share, in conjunction with various financing arrangements. The fair value of the warrants was calculated using the Black-Scholes option pricing model. The fair value, when material, is being charged to expense over the term of the respective financing arrangement.

In March 1998, in connection with a strategic alliance, the Company issued warrants to purchase an aggregate of 480,000 shares of the Company's common stock at a price of $1.88 per share. The fair value of these warrants was determined to be $525,000. This amount was recorded as marketing and sales expense in the accompanying consolidated statement of operations for the year ended December 31, 1998.

As of December 31, 1998 and 1999, the Company had 1,448,680 and 506,664 warrants to purchase common stock outstanding, respectively, with weighted-average exercise prices of $1.24 and $1.83, respectively.

FAIR VALUE DISCLOSURES The Company uses the intrinsic value method in accounting for its employee stock-based compensation plans. Accordingly, no compensation cost has been recognized for any of its stock options because the exercise price of each option equaled or exceeded the fair value of the underlying common stock as of the grant date for each stock option, except for stock options granted by the Company from March 1997 through December 1997 and stock options granted by SMI from January 1999 to September 1999. With respect to the stock options granted by the Company from March to December 1997, the Company recorded deferred stock compensation of $3,482,000 for the difference at the grant date between the exercise price and the fair value of the common stock underlying the options. With respect to the stock options granted by SMI from January 1999 to September 1999, the Company has recorded total deferred stock compensation of $3,411,000. These amounts are being amortized consistent with the method described in FASB Interpretation No. 28 over the vesting period of the individual options, generally 48 to 50 months. Had compensation cost been determined in accordance with SFAS No. 123 for all of the Company's and SMI's stock-based compensation plans, net loss attributable to holders of common stock and net loss per share would have been changed to the amounts indicated below (in thousands, except per share data):

Years Ended December 31,	1997	1998	1999
Net loss applicable to common stockholders:			
As reported	($26,711)	($69,330)	($130,323)
Pro forma	($26,711)	($77,009)	($222,660)
Basic and diluted net loss per share:			
As reported	($1.73)	($0.55)	($0.78)
Pro forma	($1.73)	($0.61)	($1.33)

The fair value of each stock option is estimated on the date of grant using the minimum value method prior to the IPO and the Black-Scholes option pricing model after the IPO, with no expected dividends and the following weighted-average assumptions:

Years Ended December 31,	1997	1998	1999
Expected life (years)	2.59	3.09	2.95
Risk-free interest rate	5.81%	4.98%	5.83%
Volatility	–	80%	80%

The fair value of purchase rights granted under the Purchase Plan is estimated on the date of grant using the Black-Scholes option pricing model with no expected dividends and the following weighted-average assumptions:

Years Ended December 31,	1998	1999
Expected life (years)	1.33	1.34
Risk-free interest rate	5.26%	5.55%
Volatility	80%	80%

The weighted-average fair value of purchase rights granted under the Purchase Plan during 1998 and 1999 was $1.25 per share and $13.46 per share, respectively.

A summary of the company's stock option plans is as follows:

Years Ended December 31,	1997		1998		1999	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	2,336,264	$0.03	13,674,288	$0.10	38,589,878	$ 2.26
Granted	12,894,400	0.11	31,594,374	2.84	26,481,567	31.13
Forfeited	(846,880)	0.08	(2,311,752)	1.03	(2,691,670)	15.71
Exercised	(709,496)	0.04	(4,367,032)	0.33	(7,226,510)	3.22
Outstanding at end of year	13,674,288	0.10	38,589,878	2.26	55,153,265	15.41
Exercisable at end of year	1,791,600	0.06	3,076,720	0.61	10,383,564	3.14
Weighted average fair value of options granted during the year at market	2,666,136	0.01	28,560,800	1.57	25,822,005	31.68
Weighted average fair value of options granted during the year at less than market	10,228,264	0.29	366,914	0.78	88,104	30.48
Weighted average fair value of options granted during the year at greater than market	–	–	2,666,672	0.53	571,458	6.28

The following table summarizes information about stock options outstanding as of December 31, 1999:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$ 0.03 to 1.13	14,805,469	7.93	$ 0.61	5,727,968	$ 0.60
$ 1.88 to 5.00	16,597,470	8.74	3.77	3,566,287	3.39
$ 6.85 to 28.42	8,880,285	9.22	14.44	986,086	13.79
$30.13 to 72.25	14,870,041	9.71	43.73	103,223	33.92
	55,153,265	8.86	15.41	10,383,564	3.14

STOCKHOLDER RIGHTS PLAN In January 1999, the Company adopted a Stockholder Rights Plan ("the Rights Plan"). The Rights Plan is designed to protect the long-term value of the Company for its stockholders during any future unsolicited acquisition attempt. In connection with the Rights Plan, the Company declared a dividend of one preferred share purchase right for each share of the Company's common stock outstanding on February 11, 1999 ("Record Date") and further directed the issuance of one such right with respect to each share of the Company's common stock that is issued after the Record Date, except in certain circumstances.

On June 2, 1999, stockholders approved an amendment to the Company's Restated Certificate of Incorporation to increase the authorized number of shares of common stock issuable by the Company from 100,000,000 to 300,000,000.

STOCK SPLITS On April 12, 1999, August 12, 1999, and December 14, 1999, the Company completed two-for-one stock splits accomplished in the form of stock dividends. Share and per share amounts in the accompanying consolidated financial statements reflect these two-for-one stock splits retroactively.

NOTE 6: COMMITMENTS AND CONTINGENCIES

LEASES The Company has entered into a number of operating leases for its facilities. The leases expire from 1999 through 2010. As of December 31, 1999, the Company had collateralized letters of credit aggregating $5,971,000 for these leases. The related funds are included in restricted cash equivalents and investments on the accompanying consolidated balance sheet. The Company also leases certain data center infrastructure and equipment under capital leases. Certain of these capital leases were entered into as sales-leaseback transactions. No gain or loss was recorded in any such transaction due to the short holding period from the time the assets were purchased until the time of the sale-leaseback. Future minimum lease payments as of December 31, 1999 are as follows (in thousands):

Years Ending December 31,	Capital Leases	Operating Leases
2000	25,083	22,879
2001	23,938	32,467
2002	18,215	37,120
2003	161	37,567
2004	–	38,542
Thereafter	–	220,662
Total minimum lease payments	67,397	389,237
Less amount representing imputed interest	9,892	
Present value of minimum lease payments	57,505	
Less current portion	17,162	
Capital lease obligations, less current portion	40,343	

The Company's rent expense was $1,764,000, $5,583,000, $18,981,000 for the years ended December 31, 1997, 1998, and 1999, respectively.

TELECOMMUNICATIONS AGREEMENTS In September 1997, the Company entered into an agreement to obtain telecommunications services for a period of 60 months with a minimum commitment of $230,000 per month. In January 1999, this original agreement was replaced with a new agreement for a period of 60 months with a minimum commitment of $1,000,000 per month.

In July 1998, the Company entered into an agreement to obtain telecommunications services for a period of 36 months with a minimum commitment of approximately $500,000 per month.

In August 1999, the Company entered into capacity purchase agreements. The agreements provide for a total potential outlay of up to $105,000,000 for fiber capacity and related maintenance covering approximately 25 years. To date, the Company has paid approximately $19,000,000 related to these agreements, which is included in other assets in the accompanying consolidated balance sheet as of December 31, 1999.

ROYALTY AGREEMENT In April 1997, the Company entered into an agreement with a software company under which the Company licensed certain software for a royalty based on 1% of the Company's gross revenues. Royalty expenses related to this agreement have not been significant to date. In March 1999, this agreement was replaced with a new agreement that obligates the Company to make certain future payments for the use of the software license. These payments are not expected to have a material effect on the consolidated financial statements.

CONTINGENCIES The Company is engaged in certain legal actions arising in the ordinary course of business. The Company believes that it has adequate legal defenses and that the ultimate outcome of these actions will not have a material effect on the Company's consolidated financial position and results of operations.

NOTE 7: INCOME TAXES

The following reconciles the expected corporate federal income tax expense (benefit) (computed by multiplying the Company's income before taxes by 34%) to the Company's income tax expense for the years ended December 31, 1997, 1998 and 1999 (in thousands):

Years Ended December 31,	1997	1998	1999
Expected income tax benefit	$(8,602)	$(22,895)	$(44,310)
Permanent differences	15	81	6,493
Foreign tax rate difference	–	–	305
Net operating loss, temporary differences and tax credits not benefited	8,587	22,814	37,512
Actual income tax expense (benefit)	$ –	$ –	$ –

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities as of December 31, 1998 and 1999 are as follows (in thousands):

December 31,	1998	1999
Deferred tax assets:		
Net operating loss carryforwards	$ 32,280	$ 65,802
Disqualifying disposition	2,857	63,761
Difference between book and tax depreciation	2,284	7,858
Reserves and accruals	1,234	3,352
Research and experimentation credit carryforwards	548	1,565
Deferred compensation	957	964
Difference between book and tax amortization	–	152
Other	6	1,097
Total gross deferred tax assets	40,166	144,551
Less valuation allowance	(40,166)	(144,551)
Net deferred tax assets	$ –	$ –

The Company has a net operating loss carryforward for federal and California purposes at December 31, 1999, of $168,225,000 and $80,453,000, respectively. The difference between the federal and California net operating loss carryforward is due to the 50% limitation of net operating loss carryforwards for California purposes. The federal net operating loss carryforwards will expire from 2010 through 2019. The California net operating loss carryforwards will expire from 2000 through 2004.

The net change in the total valuation allowance was an increase of $28,458,000 and $104,385,000 for the years ended December 31, 1998 and 1999, respectively.

The Company also has research credit carryforwards for federal and California income tax return purposes of approximately $1,057,416 and $586,636, respectively, available to reduce future income taxes. The federal research credit carryforwards expire in years 2010 through 2019. The California research credit carryforward carries forward indefinitely until utilized.

Gross deferred tax assets as of December 31, 1999, include approximately $63,761,000 relating to the exercise of stock options, which will be credited to equity if and when realized.

Federal and California tax laws impose significant restrictions on the utilization of net operating loss carryforwards in the event of a shift in the ownership of the Company, which constitutes an "ownership change" as defined by Internal Revenue Code Section 382. The Company has not determined if an ownership change, as defined, has occurred. The Company plans to compute exact limitations upon realization of taxable earnings and associated potential utilization of the net operating loss carryforwards.

NOTE 8: SEGMENT INFORMATION

The Company operates a number of Internet Data Centers throughout the United States and two internationally. The Company establishes these Internet Data Centers using a consistent investment and operating model. As a result, the expected long-term economic characteristics and financial performance are similar. In particular, each data center provides the same Internet-related services to a similar type of customer who may locate its servers in multiple Internet Data Centers. As a result, the Company believes these Internet Data Centers represent one reportable segment under the aggregation criteria of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information.* Internet Data Center operations primarily include services such as server infrastructure support, Internet connectivity, and managed services.

With the acquisition of Cohesive on July 27, 1999, management began reviewing financial information and business performance and allocating resources based on both Internet Data Center operations and by professional services, given Cohesive's expertise in networking, Internet-based applications and technology solutions. As a result, the Company identified professional services as an additional reportable segment. Professional services primarily include services such as network design and development, Internet-based and application development, and information technology strategy. For the year ended December 31, 1999, the professional services segment's results of operations presented below include amortization of intangible assets and restructuring charges incurred as a result of the Cohesive acquisition.

Financial information for the Company's reportable segments is presented below:

Years Ended December 31,	1997	1998	1999
Revenues:			
Internet Data Centers	$ 12,408	$ 52,263	$ 199,563
Professional services	–	482	42,577
Total revenues	$ 12,408	$ 52,745	$ 242,140
Operating profit (loss):			
Internet Data Centers	$ (1,243)	$ (1,492)	$ 39,407
Professional services	–	(351)	3,242
Corporate areas	(23,549)	(55,730)	(139,865)
Total operating loss	$(24,792)	$(57,573)	$ (97,216)

December 31,	1998	1999
Total assets:		
Internet Data Centers	$ 52,725	$ 314,452
Professional services	212	3,068
Corporate assets	245,861	1,425,370
Total assets	$298,798	$1,742,890

Revenues generated and assets located outside of the United States are not significant for the years ended December 31, 1997, 1998 and 1999.

NOTE 9: SUBSEQUENT EVENTS (UNAUDITED)

On February 10, 2000, the Company completed its acquisition of KeyLabs, Inc. ("KeyLabs"), a provider of e-business testing services based in Utah. The Company issued approximately 393,000 shares of Exodus common stock in exchange for all outstanding shares of KeyLabs common stock and reserved approximately 101,000 shares of common stock for issuance upon the exercise of KeyLabs options the Company assumed pursuant to the agreement, for total consideration valued at approximately $50,000,000. The transaction will be accounted for as a purchase.

On March 3, 2000, the Company announced that its Board of Directors approved a two-for-one stock split, which is to be effected in the form of a stock dividend. The split is subject to stockholder approval of an increase in the Company's authorized shares of common stock. Subject to this approval, the record date for the stock split will be June 7, 2000, and thereafter, on or about June 20, 2000, each stockholder of record will receive one additional share for each share held. Share and per share information in these financial statements does not reflect this stock split.

In March 2000, the Company entered into an agreement to increase its existing $10,000,000 line of credit to $20,000,000. This line of credit will expire in December 2000 and is to be used solely as a letter of credit facility.

SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

(In thousands, except per share data) Three months ended	**3/31/98**	**6/30/98**	**9/30/98**	**12/31/98**	**3/31/99**	**6/30/99**	**9/30/99**	**12/31/99**
Revenues	7,105	10,071	14,462	21,107	30,110	42,616	68,028	101,386
Total costs and expenses	19,600	23,910	28,410	38,398	47,848	58,821	91,417	141,270
Operating loss	(12,495)	(13,839)	(13,948)	(17,291)	(17,738)	(16,205)	(23,389)	(39,884)
Net loss attributable to								
common stockholders	(15,335)	(14,118)	(17,953)	(21,924)	(23,232)	(22,639)	(31,505)	(52,947)
Basic and diluted								
net loss per share	(0.56)	(0.09)	(0.11)	(0.14)	(0.14)	(0.14)	(0.19)	(0.30)
Range of stock prices								
Low	3.40	3.82	2.13	2.42	7.53	15.35	26.91	31.03
High	3.57	5.99	6.11	8.35	18.75	29.99	43.41	91.81

Shown above are the NASDAQ high and low prices of Exodus Communications, Inc. stock for each quarter of 1988 and 1999.

STATEMENT OF MANAGEMENT RESPONSIBILITY

The Company's management is responsible for the preparation, integrity and objectivity of the consolidated financial statements and other financial information presented in this report. The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles and reflect the effects of certain estimates and judgments made by management. The Company's management maintains an effective system of internal control that is designed to provide reasonable assurance that assets are safeguarded and transactions are properly recorded and executed in accordance with management's authorization.

The Company's consolidated financial statements have been audited by KPMG, independent accountants. Their audits were conducted in accordance with generally accepted auditing standards, and included a review of financial controls and tests of accounting records and procedures as they considered necessary in the circumstances.

The Audit Committee of the Board of Directors, which consists of outside directors, meets regularly with management to review accounting, reporting, auditing and internal control matters. The committee has direct and private access to the external auditors.

ELLEN M. HANCOCK
President and Chief Executive Officer

R. MARSHALL CASE
Executive Vice President, Finance
and Chief Financial Officer

RICHARD S. STOLTZ
Former Executive Vice President,
Chief Financial Officer, Chief Operating Officer,
and Treasurer

REPORT OF KPMG LLP, INDEPENDENT AUDITORS

THE BOARD OF DIRECTORS AND STOCKHOLDERS
EXODUS COMMUNICATIONS, INC.:

We have audited the accompanying consolidated balance sheets of Exodus Communications, Inc. and subsidiaries (the Company) as of December 31, 1998 and 1999, and the related consolidated statements of operations, stockholders' (deficit) equity and comprehensive loss, and cash flows for each of the years in the three-year period ended December 31, 1999. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Exodus Communications, Inc. and subsidiaries as of December 31, 1998 and 1999, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1999, in conformity with generally accepted accounting principles.

Mountain View, California
January 25, 2000

BOARD OF DIRECTORS AND MANAGEMENT

MANAGEMENT

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President and
Chief Executive Officer

BEVERLY A. BROWN (*)
Executive Vice President
and Chief Marketing Officer

R. MARSHALL CASE (*)
Executive Vice President, Finance
and Chief Financial Officer

HERBERT A. DOLLAHITE, PH.D. (*)
Executive Vice President, Quality
and Customer Service & Support

PETER FORTENBAUGH
Vice President, Strategic Planning

MICHAEL E. HEALY
Vice President, Finance

ROBERT HELMS
Vice President, Human Resources

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Executive Vice President,
Engineering

SAM S. MOHAMAD (*)
Executive Vice President,
Worldwide Sales

ROBERT V. SANFORD, III
Senior Vice President, Operations

JOSEPH STOCKWELL
Senior Vice President,
Business Development

RICHARD S. STOLTZ
Senior Advisor,
Strategy and Finance

ADAM W. WEGNER (*)
Senior Vice President, Legal
and Corporate Affairs,
General Counsel and Secretary

WILLIAM R. YEACK (*)
Executive Vice President,
Professional Services

(*) Officers subject to the reporting requirements of section 16 of the Securities Exchange Act of 1934

DIRECTORS

K.B. CHANDRASEKHAR
Chairman of the Board of Directors
Exodus Communications, Inc.
CEO and Co-founder
Jamcracker, Inc.

ELLEN M. HANCOCK
President and Chief Executive Officer
Exodus Communications, Inc.

FREDERICK W. W. BOLANDER (1) (2)
Managing Director
Gabriel Venture Partners

JOHN R. DOUGERY (2)
President
Dougery Ventures

MARK DUBOVOY (3) (4)
Managing Partner
Leapfrog Ventures

MAX D. HOPPER (1) (4)
Chief Executive Officer
Max D. Hopper Associates, Inc.

PETER A. HOWLEY (1)
Chief Executive Officer
and Co-founder
IPWireless, Inc.

DANIEL C. LYNCH (3)
Owner
Lynch Enterprises

THADEUS J. MOCARSKI (3) (4)
Managing Director
Fleet Equity Partners

NAOMI O. SELIGMAN (2)
Senior Partner and Co-founder
Cassius Advisors

(1) Member of the Compensation Committee
(2) Member of the Audit Committee
(3) Member of the Finance Committee
(4) Member of the Governance Committee