

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

FOR THE FISCAL YEAR ENDED JANUARY 31, 1998

OR

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

For the transition from _____ to _____

COMMISSION FILE NUMBER 0-22823

QAD INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or Other Jurisdiction of
Organization)

77-0462381
(I.R.S. Employer Incorporation or
Identification No.)

6450 VIA REAL, CARPINTERIA, CALIFORNIA 93013
(Address of Principal Executive Offices)

805-684-6614
(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: None

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: Common Stock, \$.001
par value

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the closing price for the registrant's Common Stock in the Nasdaq National Market on April 20, 1998, was approximately \$441,090,420. This calculation does not reflect a determination that certain persons are affiliates of the registrant for any other purposes. The number of outstanding shares of the registrant's Common Stock as of the close of business on April 20, 1998 was 29,163,003.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10,11,12 and 13 of Part III incorporate information by reference from the definitive proxy statement for the registrant's Annual Meeting of Stockholders to be held on June 30, 1998.

QAD INC.

FISCAL YEAR 1998 FORM 10-K ANNUAL REPORT

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Forward Looking Statement

In addition to historical information, this form 10-K contains forward-looking statements. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in these forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in the sections entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Factors That May Affect Future Results and Market Price of Stock." Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date hereof. The Company undertakes no obligation to revise or publicly release the results of any revision to these forward-looking statements. Readers should carefully review the risk factors described in other documents the Company files from time to time with the Securities and Exchange Commission, including the Quarterly Reports on Form 10-Q to be filed by the Company in fiscal year ended January 31, 1999.

PART I

ITEM 1. BUSINESS

The Company is a provider of supply chain enabled Enterprise Resource Planning ("ERP") software for multinational and other large manufacturing companies. The Company's software solutions are designed to facilitate global management of resources and information to allow manufacturers to reduce order fulfillment cycle times and inventories, improve operating efficiencies and measure critical company performance criteria against defined business plan objectives. The flexibility of the Company's products also helps manufacturers adapt to growth, organizational change, business process reengineering, supply chain management and other challenges.

The Company's principal product, MFG/PRO software, is specifically designed for deployment at the plant or division level of global manufacturers in five targeted industry segments: electronics/industrial, food/beverage, consumer packaged goods, medical and automotive. MFG/PRO software provides multinational organizations with an integrated ERP solution that is based on an open, client/server architecture and includes manufacturing, distribution, financial and service/support management applications. Additionally, the Company is currently focused on extending its presence in multi-site manufacturing by developing a line of object-oriented, supply chain management solutions, named On/Q software. The Company's initial On/Q software product, Outbound Logistics, is designed to allow for consolidation of orders, contract management, shipping

and logistics management. Outbound Logistics is currently in development and its initial release is expected to be commercially available in the second half of calendar year 1998. As of January 31, 1998, the Company had licensed MFG/PRO software at approximately 3,600 sites to approximately 1,900 customers in more than 80 countries. The Company's customers include Cargill, Inc., Colgate-Palmolive Company, Johnson Controls, Inc., Johnson & Johnson, Lucent Technologies, Inc., Philips Electronics N.V., St. Jude Medical, Inc., Unilever N.V., United Technologies Automotive, Genzyme Corp. and AT&T.

The Company was founded in 1979 and was incorporated in California as qad.inc in 1986. In February 1997, the Company's name was changed to QAD Inc. The Company was reincorporated in Delaware in July 1997. The Company's executive offices are located at 6450 Via Real, Carpinteria, California 93013, and its telephone number is (805) 684-6614. "QAD," "Qwizard" and "On/Q" are trademarks and "MFG/PRO" is a registered trademark of the Company. This form 10-K also contains trademarks and registered trademarks of persons and companies other than QAD.

Industry Background

In recent years, businesses have been subject to increasing global competition, resulting in pressure to lower production costs, improve product performance and quality, increase responsiveness to customers and shorten product development and delivery cycles. In addition, globalization has greatly increased the scope and complexity of multinational manufacturing organizations. Through business process reengineering, many organizations have begun to reengineer their critical business processes and restructure their organizations to accommodate and exploit rapid changes in the business environment. As part of this process, businesses are seeking ERP software solutions which will enable them to better manage resources across the enterprise and facilitate the integration of sales management, component procurement, inventory management, manufacturing control, project management, distribution, transportation, finance and other functions on a global basis. While historically many companies have developed their ERP software internally, companies are increasingly deploying open, client/server-based ERP applications developed by third parties which reduce internal software development costs and enable increased flexibility and inter-operability across a broad range of hardware and software platforms. The Gartner Group has estimated that the global ERP software market totaled more than \$6.2 billion in 1997 and will grow to an estimated \$10.0 billion by the year 2000.

While current ERP software enables the integration and management of critical data within enterprises, organizations increasingly are recognizing the need to deploy new software systems that manage the global supply chain by enhancing the flow of information to and from customers, suppliers and other business partners outside the enterprise. More recently, the availability and use of the Internet has created a demand for software, which will operate across the Internet to enhance business-to-business electronic commerce.

The Company believes that the increasing complexity and diversity of customer requirements limits the ability of any single-vendor solution to fully meet the enterprise-wide needs of its customers and has led to the emergence of three distinct segments within the ERP software market: (i) corporate; (ii) plant; and (iii) supply chain management.

Corporate ERP solutions are primarily focused on the consolidated data management, financial and human resource needs of large Fortune 1000 companies. Leading vendors of corporate level solutions include Oracle Corporation ("Oracle"), PeopleSoft, Inc. ("PeopleSoft") and SAP AG ("SAP"). While corporate ERP systems offer robust functionality, the Company believes that the very broad scope, significant cost and limited flexibility of many of these systems limit their effectiveness in addressing the needs of individual plants or divisions. In addition, this limited flexibility makes these systems difficult to deploy throughout the enterprise.

Plant ERP solutions are primarily focused on the specific needs of manufacturing plants and distribution sites of global companies, such as manufacturing planning, production control and distribution. Leading vendors of plant ERP solutions include the Company, Baan Company N.V. ("Baan"), J.D. Edwards & Company ("J.D. Edwards") and Systems Software Associates, Inc. ("SSA"). Given the diverse and constantly changing needs of manufacturing and distribution sites, ERP users demand highly flexible, industry-specific plant

ERP solutions that can be deployed rapidly and cost-effectively across multiple sites on a global basis.

Supply chain management solutions are designed to link a company more closely with customers, suppliers and other business partners in order to optimize manufacturing and distribution processes, reduce costs and enhance customer satisfaction. Supply chain

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management functions include logistics and order management, advanced planning and scheduling, global purchasing, and sales and support management. Leading vendors in the supply chain management market include i2 Technologies, Inc. ("i2"), Industri-Matematik International, Inc. ("IMI") and Manugistics Group, Inc. ("Manugistics"), as well as certain corporate level ERP software vendors. The Company believes that supply chain management represents one of the greatest current opportunities for companies to reduce costs and enhance customer relationships.

Market Opportunity

While ERP solutions have provided significant benefits to companies by centralizing and integrating the management of enterprise-wide data, the Company believes that customer requirements for industry-specific functionality, flexibility and ease of implementation pose significant challenges for many ERP vendors. As a result, the Company believes that there is a large and rapidly growing market demand for industry-specific software solutions that meet customers' needs for plant-level deployments and global supply chain management.

The Company believes that the adoption of open, client/server-based ERP solutions at the plant level will accelerate as potential customers transition from proprietary, legacy systems in coming years. In addition, the Company believes that supply chain management represents a compelling market opportunity. To be successful in meeting customer requirements in these market segments, the Company believes ERP software vendors must:

- Offer localized, multi-language, multi-currency functionality to support global deployments;

- Offer industry-specific product functionality and expertise in key vertical markets;

- Provide global service and support, either directly or through third parties;

- Offer ease of implementation and rapid time to benefit;

- Provide flexibility to meet the diverse needs and business practices of global, multi-site manufacturing implementations;

- Inter-operate and co-exist with corporate-level ERP solutions and industry-leading supply chain management solutions;

- Address supply chain management challenges by offering technology which integrates and optimizes interactions between companies and their customers, suppliers and other business partners; and

- Develop and utilize advanced technologies to deliver superior product functionality.

The QAD Solution

The Company is a leading provider of ERP software for multinational and other large manufacturing companies. The Company's principal product, MFG/PRO software, is a modular software program designed specifically to address the plant-level needs of multinational manufacturers for flexible, inter-operable and rapidly deployable ERP software solutions. Additionally, the Company is currently focused on extending its presence in multi-site manufacturing by developing a line of supply chain management solutions designed to serve the needs of multinational manufacturing companies. The Company meets customer requirements in its vertical markets by delivering the following:

Global Solutions for Multinational Manufacturers. The Company focuses on the plant-level ERP and supply chain management requirements of global manufacturers. The Company's MFG/PRO software incorporates multi-currency capabilities, is available in 26 languages and is tailored to local financial practices and requirements in many of its major markets. The Company's customers have deployed MFG/PRO software in more than 80 countries.

Expertise and Functionality for Key Vertical Markets. The Company targets and has achieved leadership positions in the electronics/industrial, food/beverage, consumer packaged goods, medical and automotive industries. The Company believes that its substantial expertise in these markets, together with its strategy of developing software modules that address specific industry needs, provides the Company with a competitive advantage. For example, the Company's MFG/PRO software includes features which facilitate United States Food and Drug Administration ("FDA") compliance and validation for the medical industry, advanced pricing and promotion management for the consumer packaged goods industry, and customer/supplier scheduling via electronic data interchange for the automotive industry.

Global Service and Support. The Company believes that a high level of global service and support is a critical component of its ERP solution for multinational manufacturers. The Company offers product service and support directly through its sales and support offices in 19 countries and indirectly through its global network of systems integration partners and distributors located in more than 40 countries. The Company's systems integrator and distributor network also offers consultant services for the implementation of its software solutions.

Ease of Implementation. The modular product design of MFG/PRO software, together with the Company's focus and expertise in its key vertical markets, enables rapid product implementation, often within six months at a particular site. Product modules are designed to address the specific needs of customers in the Company's targeted markets, limiting the need for extensive customization upon implementation. In addition, customers are able to implement only those modules with functionality appropriate for their needs, limiting time-consuming implementation and training for unneeded features.

Open, Client/Server-Based Solutions. The Company's products are based on an open, client/server computing architecture. The Company believes that this architecture enables superior flexibility and inter-operability and addresses the desire of customers to migrate critical business software to an open platform. MFG/PRO software operates in Windows NT and major UNIX environments on more than 20 hardware platforms and is compatible with Oracle and Progress databases.

The QAD Strategy

The Company's objectives are to expand its leadership position in plant-level solutions and become a leading provider of supply chain management software solutions to multinational manufacturers. The key elements of the Company's strategy for achieving these objectives include the following:

Maintain and Leverage Leadership in Plant-Level Manufacturing. The Company believes its MFG/PRO software is the leading open systems ERP solution for plant-level deployments worldwide. As of January 31, 1998, the Company had licensed MFG/PRO software at approximately 3,600 sites to approximately 1,900 customers in more than 80 countries. The Company's strategy is to continue to aggressively pursue plant-level opportunities in its targeted markets to enhance its leadership position. The Company believes that the success of its MFG/PRO software provides a strong existing customer base from which to license additional modules and additional users. In addition, the Company intends to leverage its installed base of MFG/PRO software customers in order to accelerate the adoption of On/Q software, the Company's new supply chain management solution.

Focus on Global Supply Chain Management Solutions. The Company believes that supply chain optimization represents one of the greatest current opportunities for companies to reduce costs and enhance customer relationships. The Company is developing a group of new applications, known as On/Q software,

for this market. The initial product, Outbound Logistics, is being developed specifically to meet demand-side requirements of multinational manufacturing companies, including complex high-volume order processing, import/export management, multiple-route segmentation and logistics, distribution point optimization, lead and sales order management, contract management and liquidation. In addition, the Company intends to develop additional applications, including inbound logistics and planning, and to provide seamless inter-operability with other industry leading supply chain management solutions for scheduling. The Company believes that these new products, coupled with its strength in plant-level ERP solutions and the Company's products' demonstrated ability to inter-operate with other corporate applications, positions the Company to succeed in the emerging supply chain management marketplace.

Leverage Alliances. The Company leverages the expertise of distribution, implementation and technology partners to meet the diverse needs of its customers. The Company augments its direct sales organization with a global network of more than 40 distributors and numerous implementation providers. The Company plans to leverage its network of distributors and implementation providers to further penetrate its vertical markets. For implementation of its software, the Company relies almost exclusively on third-party providers, allowing the Company to maintain its focus on developing, marketing and distributing its software. In addition, the Company has entered into a number of joint development agreements with third-party software developers who provide functionality that has been embedded into or integrated with MFG/PRO software to deliver a more complete solution for its targeted vertical markets.

Maintain Technology Leadership. The Company was one of the first providers of open, client/server-based ERP software and is committed to maintaining its technology leadership. The Company's technology strategy is focused on migrating its products to a component object architecture in order to enable customers to improve inter-operability with existing software applications and to deploy and integrate new "best of breed" software applications across the enterprise. The Company believes inter-operability will become an important requirement of software applications as organizations seek fully integrated ERP solutions. In addition, the Company believes this object architecture will enable it to provide enhanced functionality in its new On/Q software, which is currently under development.

Capitalize on Year 2000 Compliance. Many companies are facing significant business problems due to the failure of their existing ERP systems to appropriately recognize years after 1999. The Company believes that this problem will accelerate the migration to open, client/server-based ERP solutions that are configured to handle this transition. The Company's products are year 2000 capable. The Company believes that it is well positioned to leverage its MFG/PRO software and its On/Q software to be a part of customers' year 2000 solutions.

Products

The Company targets its MFG/PRO software to manufacturing companies within the electronics/industrial, food/beverage, consumer packaged goods, medical and automotive industries. In addition, the Company is developing On/Q software, a group of applications targeted to the supply chain management needs in these industry segments. The first of these applications, Outbound Logistics, is currently under development and its initial release is expected to be commercially available in the second half of calendar year 1998.

The Company's principal product, MFG/PRO software, provides multinational organizations with an integrated ERP solution that includes manufacturing, distribution, financial and service/support management applications within an open systems environment. MFG/PRO software is composed of an extensive set of modules designed to address the needs of customers in the Company's vertical markets. The Company's software supports multiple currencies and global tax management and is tailored to financial practices and requirements in many of its major geographic markets. MFG/PRO software supports 26 languages, including most European languages, Japanese, Chinese, Korean and Russian. MFG/PRO software operates in both host and distributed, client/server computing environments and supports single or multiple sites, as well as multiple production and operational processes. These capabilities enable multinational manufacturers to manage multiple hybrid production methods within a single organization or a single production site, and also provide the flexibility to adapt to additional sites and processes as an organization's business evolves. Licensing fees for the Company's MFG/PRO software generally range from \$50,000 to several million

dollars, depending on the configuration of the software, the number of sites and the number of users. Annual maintenance fees for such software generally approximate 15% of the list price of the software.

The modular design of MFG/PRO software enables the Company's customers to select the modules necessary to meet their specific operational needs. Customers generally may choose which of the base package of modules they wish to implement and then choose additional modules to add to the base implementation. For example, in the automotive industry, MFG/PRO software's Repetitive Manufacturing module, coupled with the Customer Schedules and Supplier Schedules modules, provides high-volume businesses with streamlined manufacturing capabilities. The Product Change Control module allows electronics/industrial companies to meet challenges presented by rapidly changing products and short product life-cycles through sophisticated engineering change management. In the industrial and consumer packaged goods industries, MFG/PRO software supports mixed-mode and discrete manufacturing with powerful planning and execution management modules. In the food/beverage industry, the Advanced Pricing Manager module tracks product promotion life cycles from concept through analysis. In the medical industry, MFG/PRO software has the tools to allow for accurate FDA compliance reporting and validation.

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MFG/PRO software currently includes the following modules and distinct functionality:

- Accounts Payable
- Accounts Receivable
- Advanced Pricing Manager
- Capacity Requirements Planning
- Cash Management
- Client/Server
- Compliance (for FDA)
- Configurator
- Configurator Product Modeler
- Configured Products
- Cost Management
- Customer Schedules
- Decision Support
- Distribution Requirements Planning
- Electronic Data Interchange
- Enterprise Operations Planning
- Fixed Assets
- Forecasting
- Formula/Process
- General Ledger
- GL Report Writer
- Intrastat
- Inventory Control
- Master Scheduling
- Materials Requirements Planning
- Multiple Currency
- Payroll
- Physical Inventory
- Product Change Control
- Product Line Planning
- Product Structures
- Purchasing
- Quality Management
- Repetitive Manufacturing
- Resource Planning
- Results Files
- Routings/Work Centers
- Sales Analysis
- Sales Orders/Invoices
- Sales Quotations
- Service/Repair Orders
- Service/Support Management
- Shop Floor Control
- Supplier Schedules
- Validation (for FDA)
- Work Orders

The Company has a number of business alliances to enhance the functionality of MFG/PRO software. The Company has entered into a number of joint development agreements with third-party software developers who provide functionality that has been embedded into or integrated with MFG/PRO software to deliver more complete solutions for its targeted vertical markets.

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To further enhance the rapid deployment and ease of use of MFG/PRO software, the Company introduced Qwizard software in March 1997. Qwizard software provides self-paced interactive training for users of MFG/PRO software. In addition, Qwizard software includes tools to design and customize the visual interface of MFG/PRO software to match the users' workflows and job responsibilities.

Products Under Development

The Company's planned suite of supply chain management solutions, On/Q software, is designed to inter-operate with MFG/PRO software and other ERP and supply chain software solutions. The initial On/Q software product under development, Outbound Logistics, is designed to allow for consolidation of orders, contract management, shipping and logistics management. The Company anticipates that the initial release of Outbound Logistics will be commercially available in the second half of calendar year 1998. Outbound Logistics is specifically designed to meet demand-side requirements of global multinationals, including complex high-volume order processing, import/export management, multiple-route segmentation and logistics, distribution point optimization, lead and sales order management, contract management and liquidation. The Outbound Logistics application is targeted to address supply chain issues associated with global manufacturing operations, and is designed to allow orders to be taken from any customer, placed with any number of plants as capacity and product mix change, and filled from the most cost-efficient available distribution center, while consolidating or distributing invoices to any combination of sold-to-, ship-to- and bill-to-customers. Outbound Logistics is also designed to provide cost-efficient consolidation and to provide multi-lingual and multi-currency capabilities. The Company plans to follow Outbound Logistics with additional On/Q software products. There can be no assurance, however, that any of the Company's supply chain management solutions will be successfully developed in accordance with planned schedules or at all, or that if successfully developed, such software will achieve market acceptance. See "Factors That May Affect Future Results and Market Price of Stock-Supply Chain Solutions Under Development and Underlying Technology."

Technology

MFG/PRO software has been developed with a commercially available, fourth generation language and tool set marketed by Progress that addresses relational databases provided by Oracle and Progress. See "Factors That May Affect Future Results and Market Price of Stock-Dependence on Progress Products." MFG/PRO software is being migrated to component objects and to a Java user interface which the Company believes will enable customers to improve inter-operability with existing software applications and to deploy and integrate new "best of breed" software applications across the enterprise. The Company also believes object-orientation will enable the Company to provide enhanced functionality in its new On/Q software under development. While the Company's MFG/PRO software is dependent upon Progress technology, the Company's new On/Q software under development is not dependent on Progress technology. However, both the Company's MFG/PRO software and new On/Q software are reliant on third-party software for specific functionality. See "Factors That May Affect Future Results and Market Price of Stock-Reliance on and Need to Develop Additional Relationships with Third Parties." The Company is currently in the process of converting its MFG/PRO software modules to object-oriented technology where the Company believes such conversion will add value. The software operates in Windows NT and major UNIX environments on more than 20 hardware platforms. MFG/PRO software supports distributed and mirrored databases, local and wide area networks, character-based and graphical user interfaces.

The Company is also embracing object-oriented technology as a next generation technology to address the complex supply chain management requirements of companies and to improve business processes. The Company believes that new object-based functionality will play a key role in the competitive manufacturing, distribution, financial, planning and service/support management strategies of customers in the Company's targeted industry

segments. Object-oriented technology allows for the creation of systems which are scalable and flexible and which are capable of accommodating changes in business requirements and technology infrastructure.

The Company's deployment of object-oriented technology consists of three main elements: component objects; Convergent Engineering methodology; and an open interface server.

Component objects are simple building blocks of small, discrete pieces of functionality that can be configured to create complete applications and enable developers to rapidly create and modify systems to provide the desired set of functionality for specific vertical markets or individual customers. The Company has defined three types of component objects: business object frameworks, common business objects and application objects.

Convergent Engineering methodology is a new software design methodology employed by the Company to develop future products. Convergent Engineering methodology allows business requirements to be captured as a series of simple facts, actions and rules, enabling software to more flexibly accommodate current business practices and processes.

Q/LinQ (formerly InterLinQ), the open interface server developed by the Company, uses commercially available messaging tools along with the Company's proprietary data mapping applications. This product is used to provide inter-operability with other software applications, even among multiple revision levels of the same or different products.

There can be no assurance that the Company will be successful in converting its MFG/PRO software to component objects and to a Java user interface or developing its new supply chain management software to incorporate component objects and convergent engineering technology on a timely basis, if at all, or that if converted or developed such software will achieve necessary market acceptance. See "Factors That May Affect Future Results and Market Price of Stock-Supply Chain Solutions Under Development and Underlying Technology."

Research and Development

The Company originally introduced its client/server-based MFG/PRO software in 1986 and has subsequently released a number of product enhancements. The Company's research and development staff, augmented by third-party development resources, is focused on continuing updates and enhancements to its MFG/PRO software, as well as the continual migration of MFG/PRO software to component objects and to a Java user interface. The Company also maintains a separate advanced technology development organization to research longer term software solutions. This organization is specifically focused on developing the Company's On/Q software supply chain management solutions, the first of which will be Outbound Logistics. In April 1997, the Company also invested in a private company focused on developing the Convergent Engineering methodology to participate in research and development efforts of that company. The Company had an option to acquire an additional interest in such company, and in September 1997 the Company exercised this option and, as a result, owns a 33% equity interest. See Note 11 to Notes to Consolidated Financial Statements.

The Company believes that Internet capability for its products will be important to the future success of its products. Accordingly, the Company is developing Web-enabled versions of its products through in-house and third-party development. The Company's Outbound Logistics product is also being designed to include Web enablement. There can be no assurance that the Company will be successful in developing any new products or enhancements, that the Company will not experience difficulties that could delay or

prevent successful development, introduction or sales of these products or that its new products will adequately meet the requirements of the marketplace and achieve market acceptance.

Research and development expense increased significantly in recent years as

the Company has continued to focus on development of new and enhanced products. Research and development expense, which does not include costs of product support and customization, increased to \$29.3 million for the fiscal year ended January 31, 1998, from \$25.4 million and \$17.0 million for the fiscal years ended January 31, 1997 and December 31, 1995, respectively. At January 31, 1998 the Company had 289 personnel in its research and development department. See "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Factors That May Affect Future Results and Market Price of Stock-Rapid Technological Change," and "-Supply Chain Solutions Under Development and Underlying Technology."

Sales and Marketing

The Company sells and supports its products through direct and indirect sales organizations throughout the world. The Company's direct sales organization consists of approximately 239 personnel located at its corporate headquarters in Carpinteria, California, its regional headquarters in Mt. Laurel, New Jersey, Hoofddorp, The Netherlands, Hong Kong, China and Sydney, Australia, and more than 20 other direct sales offices worldwide. The Company's sales team is organized around its five targeted vertical markets, enabling the Company to address the specialized needs of its customers.

The Company's indirect sales channel consists of approximately 40 distributors worldwide. The Company does not grant exclusive rights to any of its distributors. The Company's distributors primarily sell independently to companies within their geographic territory but may also work in conjunction with the Company's direct sales organization. In addition, the Company leverages its relationships with implementation providers, hardware vendors and other third parties to identify sales opportunities on a global basis.

Following the conclusion of its initial public offering, the Company has commenced discussions with certain of its distributors regarding possible acquisitions of controlling interests in such distributors. The Company is pursuing this acquisition strategy to enhance the effectiveness and allegiance of existing distributors and provide capital to help such distributors meet the Company's growth targets.

The Company's sales and marketing strategy is to develop demand for its products by creating visibility for the Company and awareness of its principal product, MFG/PRO software. The Company participates in major computer and vertical market industry trade shows and sponsors regional and worldwide user conferences and regional alliance conferences. The Company also advertises in leading business and targeted industry publications.

The Company's future success will depend in part upon the productivity of its sales and marketing force and the ability of the Company to continue to attract, integrate, train, motivate and retain new sales and marketing personnel. Competition for sales and marketing personnel in the Company's industry is intense. There can be no assurance the Company will be successful in hiring such personnel in accordance with its plans. In addition, the failure by the Company to maintain successfully its distributor relationships or to establish new relationships in the future would have a material adverse effect on the Company's business, results of operations and financial condition. See "Factors That May Affect Future Results and Market Price of Stock-Dependence Upon Development and Maintenance of Sales and Marketing Channels."

Third-Party Implementation Providers

The Company has historically followed a strategy of utilizing almost exclusively third parties to provide implementation and customization services to the Company's customers. The Company chose this strategy to allow the Company to maintain its focus on developing, marketing and distributing its software and to enhance the effectiveness, expertise and commitment of third parties who provide services on behalf of the Company. The Company also uses these third parties for sales lead generation. Implementation and system integration services are provided by a network of consultants and system integrators, including Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, Integrated Systems & Services, LLC and Strategic Information Group International, Inc. in the United States, BDM Largotim US, Inc., CSBI S.A., Origin Technology in Business Nederland B.V. and Sligos S.A. in Europe and Iris

Ifec Co., Ltd and STCS Systems Pte Ltd in Asia. In most cases, the Company's distributors also deliver consulting and integration services. All third-party providers are required to be certified in the applications and methodologies of the Company's products. To the extent the Company implements its distributor acquisition strategy, the Company anticipates that it will, directly or indirectly, be providing implementation and system integration services. In addition, in connection with the introduction of its On/Q software, the Company intends to provide implementation services for this new product. The Company believes this service will be an important factor in ensuring the successful implementation of the initial installations of On/Q software and in successfully transferring knowledge to third-party implementation partners to enable them to provide necessary implementation services for future On/Q software installations.

The Company typically enters into separate agreements with each of its installation and implementation partners that provide such partners with the non-exclusive right to promote and market the Company's products, and to provide training, installation, implementation and other services for the Company's products, within a defined territory for a specified period of time (generally two years). Although the Company's installation and implementation partners do not receive fees for the sale of the Company's software products, they generally are permitted to set their own rates for such services and the Company typically does not collect a royalty or percentage fee from such partners on services performed. The Company also enters into similar agreements with its distributor partners that grant such partners the non-exclusive right, within a specified territory, to market, license, deliver and support the Company's products. In exchange for such distributors' services, the Company receives a negotiated royalty fee for the license of its software products. The Company also relies on third parties for the development or inter-operation of key components of its software so that users of the Company's software will obtain the functionality demanded. Such research and product alliances include software developed to be sold in conjunction with the Company's software products, technology developed to be included in or encapsulated within the Company's software products and numerous third-party software programs that generally are not sold with the Company's software but inter-operate directly with the Company's software through application program interfaces. The Company generally enters into joint development agreements with its third-party software development partners that govern ownership of the technology collectively developed. Each of the Company's partner agreements and third-party development agreements contain strict confidentiality and non-disclosure provisions for the service provider, end user and third-party developer and the Company's third-party development agreements contain restrictions on the use of the Company's technology outside of the development process. The failure of the Company to establish or maintain successful relationships with such third-party software providers or such third-party installation, implementation and development partners or to failure of such third-party software providers to develop and support their software could have a material adverse effect on the Company's business, operating results and financial condition. See "Factors That May Affect Future Results and Market Price of Stock-Reliance on and Need to Develop Additional Relationships with Third Parties."

Customers

The Company targets the industrial/electronics, food/beverage, consumer packaged goods, medical and automotive sectors worldwide. As of January 31, 1998, the Company had licensed MFG/PRO software at approximately 3,600 sites to approximately 1,900 customers in more than 80 countries. No one customer accounted for more than 10% of total revenue during any of the Company's last three fiscal years. The following are among companies and/or subsidiaries of such companies in each of the Company's target vertical markets that have each generated more than \$400,000 in software license and maintenance revenue over the last three fiscal years:

Electronics/Industrial

ABB Flakt Oy
Alcatel Services International B.V.
Allen-Bradley Co. Inc.
Aluminum Company of America
AT&T
Courtaulds plc
Ingersoll-Rand Company

Lucent Technologies Inc.
Matsushita Electric-Industrial Co., Ltd
NEC America, Inc.
Newbridge Networks Corporation
Philips International B.V.
RayChem Corporation
Schlumberger Technology Corp.
Silicon Graphics SA
Sun Microsystems, Inc.
Xerox Corporation

Food/Beverage

AEP Borden Nederland B.V.
Cargill, Incorporated
Kraft Jacobs Suchard AG
Pepsi-Cola Company
Presto Foods Products
The Quaker Oats Company
Rich Products Corporation

Consumer Packaged Goods

The Black & Decker Corporation
Colgate-Palmolive Company
Gillette Company
Johnson & Johnson
Unilever N.V.

Automotive

Aeroquip-Vickers, Inc.
Daewoo Information Systems Co. Ltd.
Ford Motor Corporation

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Johnson Controls, Inc.
Lear Seating Corporation
R.J. Tower Corporation
Rockwell Automotive
United Technologies Automotive
Varity Kelsey-Hayes Company

Medical

Alza Corporation
BOC Ohmeda Inc.
Physio-Control Corporation
Rexall Sundown, Inc.
St.Jude Medical, Inc.
Sunrise Medical Inc.
Ventritex, Inc.
Genzyme Corporation

Customer Service and Support

The Company believes that providing a high level of customer service and support is essential to customer satisfaction and the Company's long-term success. The Company's service and support organization is based primarily in centers located in Mt. Laurel, New Jersey, Hoofddorp, The Netherlands, Hong Kong, China, Sydney, Australia and Sao Paulo, Brazil. Global support is also provided through the Company's extensive network of alliance partners. This global presence helps the Company support customers and partners in different regions and time zones worldwide.

The Company also provides its customers with access to information and customer support services via the World Wide Web. The Company's Internet-enabled services facilitate the exchange of information seven days per week, 24 hours a day and provide customers with access to QAD support databases. These databases contain a wide variety of product information, customer support functionality, answers to frequently asked questions, and a search-enabled online knowledge base. In addition, ongoing training of support personnel, internal and external

consultants and the Company's alliance partners helps to ensure that customers are up to date on the latest technologies and product enhancements offered by the Company.

The Company offers, for a fee, a comprehensive education and training program to its customers' information and technology staff and end-users, as well as its implementation providers. Classes are offered through in-house facilities at Company offices in various locations, as well as on-site training services at customer locations. The Company has also assisted implementation providers and customers in developing their own in-house support centers.

Competition

The ERP software market is highly competitive, rapidly changing and affected by new product introductions and other market activities of industry participants including consolidations among industry participants. The Company competes in the ERP software market primarily on the basis of functionality, ease of use and implementation, technology, time to benefit, supplier viability, service and cost. The Company currently competes primarily with (i) other vendors of software focused on the specific needs of manufacturing plants and distribution sites of multinational manufacturing companies, which include Baan, J.D. Edwards and SSA, (ii) smaller independent companies that have developed or are attempting to develop advanced planning and scheduling software which complement or compete with ERP or manufacturing resource planning solutions,

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(iii) internal development efforts by corporate information technology departments and (iv) companies offering standardized or customized products on mainframe and/or mid-range computer systems. The Company expects that competition for its MFG/PRO software will increase as other large companies such as Oracle and SAP, as well as other business application software vendors, enter the market for plant-level ERP solutions. With the Company's strategic entry into the supply chain management software market, the Company can expect to meet substantial additional competition from companies presently serving that market, such as i2, IMI and Manugistics, as well as from broad based solution providers such as Baan, Oracle, PeopleSoft and SAP that the Company believes are increasingly focusing on this segment. In addition, certain competitors, such as Baan, Oracle, PeopleSoft and SAP, have well established relationships with present or potential customers of the Company. The Company may also face market resistance from the large installed base of legacy systems because of the reluctance of these potential customers to commit the time, effort and resources necessary to convert to an open, client/server-based software solution. Further, as the client/server market continues to develop, companies with significantly greater resources than the Company may attempt to increase their presence in these markets by acquiring or forming strategic alliances with competitors, partners or potential partners of the Company. Increased competition is likely to result in price reductions, reduced operating margins and loss of market share, any one of which could materially adversely affect the Company's business, results of operations and financial condition. Many of the Company's present or future competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, greater name recognition and a larger installed base of customers than the Company. As a result, they may be able to respond more quickly to new or emerging technologies and to changes in customer requirements, or to devote greater resources to the development, promotion and sale of their products, than can the Company. There can be no assurance that the Company will be able to compete successfully with existing or new competitors or that competition will not have a material adverse effect on the Company's business, operating results and financial condition.

Proprietary Rights and Licensing

The Company's success is dependent upon its proprietary technology and other intellectual property. The Company relies primarily on a combination of the protections provided by applicable copyright, trademark and trade secret laws, as well as on confidentiality procedures and licensing arrangements, to establish and protect its rights in its software. The Company enters into license agreements with each of its customers. Each of the Company's license agreements provides for the non-exclusive license of the Company's MFG/PRO software. Such licenses generally are perpetual (unless terminated by either party upon 30 days written notice) and contain strict confidentiality and non-disclosure provisions, a limited warranty covering MFG/PRO software and indemnification for the customer from any infringement action related to MFG/PRO

software. The pricing policy under each license is based on a standard price list and may vary based on the number of end-users, number of sites, number of modules, number of languages, the country in which the license is granted and level of ongoing support, training and services to be provided by the Company. Payment terms are generally 30 days from the date of shipment. The Company has no patents or pending patent applications. In order to facilitate the customization required by most of the Company's customers, the Company generally licenses its MFG/PRO software to end users in both object code (machine-readable) and source code (human-readable) format. While this practice facilitates customization, making software available in source code also makes it easier for third parties to copy or modify the Company's software for non-permitted purposes. One of the Company's distributors has developed modifications to the Company's software, which it owns jointly with the Company. The Company has entered into a reciprocal license with this distributor who markets the product enhancements in conjunction with MFG /PRO software. This or other distributors or other persons may continue to independently develop a modified version of the Company's software. The Company seeks to protect its software,

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documentation and other written materials under the legal provisions relating to trade secret, copyright and contract law. The Company's license agreements generally allow the use of MFG/PRO software solely by the customer for internal purposes without the right to sublicense or transfer the MFG/PRO software to third parties. The Company believes that the foregoing measures afford only limited protection. Despite the Company's efforts, it may be possible for third parties to copy certain portions of the Company's products or reverse engineer or obtain and use information that the Company regards as proprietary. In addition, the laws of certain countries do not protect the Company's proprietary rights to the same extent as do the laws of the United States. Accordingly, there can be no assurance that the Company will be able to protect its proprietary software against unauthorized third-party copying or use, which could adversely affect the Company's competitive position. Policing unauthorized use of the Company's products is difficult, and while the Company is unable to determine the extent to which piracy of its software products exist, software piracy can be expected to be a problem. Furthermore, there can be no assurance that the Company's competitors will not independently develop technology similar to that of the Company.

The Company has in the past been subject to claims of intellectual property infringement and may increasingly be subject to such claims as the number of products and competitors in the Company's targeted vertical markets grows and the functionality of products in other industry segments overlaps. Although the Company is not aware that any of its products infringes upon the proprietary rights of third parties, there can be no assurance that third parties will not claim infringement by the Company with respect to current or future products. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company, or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition. The Company may also initiate claims or litigation against third parties for infringement of the Company's proprietary rights or to establish the validity of the Company's proprietary rights. Litigation to determine the validity of any claims could result in significant expense to the Company and divert the efforts of the Company's technical and management personnel from productive tasks, whether or not such litigation were determined in favor of the Company.

The Company has in the past and may in the future resell certain software, which it licenses from third parties. In addition, the Company has in the past and may in the future jointly develop software in which the Company will have co-ownership or cross-licensing rights. There can be no assurance that these third-party software arrangements and licenses will continue to be available to the Company on terms that provide the Company with the third-party software it requires to provide adequate functionality in its products, on terms that adequately protect the Company's proprietary rights or on terms that are commercially favorable to the Company. The loss of or inability to maintain or obtain any of these software licenses, including a loss as a result of a third-party infringement claim, could result in delays or reductions in product shipments until equivalent software, if any, could be identified, licensed and integrated, which could materially and adversely affect the Company's business,

operating results and financial condition. See "-Products" and "-Research and Development."

Year 2000 Compliance

The Company's internal business information systems are primarily composed of the same commercial application software products generally offered for license by the Company to end-user customers. The Company is in the process of implementing the current release of certain modules of its MFG/PRO software and is not aware of any material operational issues or costs associated with preparing such internal systems for the Year 2000. However, the Company utilizes other third-party vendor network equipment,

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telecommunication products, and other third-party software products which may or may not be Year 2000 compliant. The Company recognizes the need to ensure its operations will not be adversely impacted by Year 2000 software failures and has established a project team to assess Year 2000 risks. The project team will coordinate the identification and implementation of changes to computer hardware and software applications that will ensure availability and integrity of the Company's financial systems and the reliability of its operational systems. Although the Company has undertaken these steps to address the impact, if any, of the Year 2000 issue surrounding such third-party products, failure of any critical technology components to operate properly in the Year 2000 may have an adverse impact on business operations or require the Company to incur unanticipated expenses to remedy any problems.

The Company believes that all versions of its software products are "Year 2000 compliant;" that is, they are capable of adequately distinguishing 21st century dates from 20th century dates. However, the Company's products are generally integrated into enterprise systems involving software products developed by other vendors and varying hardware platforms. The Company believes that, due to the necessary interaction with such other software (including older versions of other vendors' software) and platforms or other modifications to older versions of the Company's software products, some of the Company's customers are running earlier versions of the Company's software products that in operation may not be Year 2000 compliant. The Company has produced corrections for known non-compliant or potentially non-compliant situations and is continuing its program of analysis for other potential non-compliant situations involving its software. The Company has been encouraging customers to implement corrections developed by the Company or to migrate to current product versions.

The total cost of these Year 2000 compliance activities has not been, and is not anticipated to be, material to the Company's financial condition or its operating results. These costs and the timing in which the Company plans to complete its Year 2000 modification and testing processes are based on management's best estimates. However, there can be no assurance that the Company will timely identify and remediate all significant Year 2000 problems, that remedial efforts will not involve significant time and expense, or that such problems will not have a material adverse effect on the Company's business, operating results and financial condition. In addition, the Company may in the future be subject to claims based on Year 2000 problems arising upon the use of the Company's products with others' products, custom modifications made by third parties to the Company's products, or issues arising from the integration of multiple products within an overall system. Although the Company has not been a party to any litigation or arbitration proceeding to date involving its products or services and related to Year 2000 compliance issues, there can be no assurance that the Company will not in the future be required to defend its products or services in such proceedings, or to negotiate resolutions of claims based on Year 2000 issues. The costs of defending and resolving Year 2000-related disputes, and any liability of the Company for Year 2000-related damages, including consequential damages, could have a material adverse effect on the Company's business, operating results and financial condition.

Employees

As of January 31, 1998, the Company had 917 full-time employees of which 289 were in research and development, 173 were in customer and product support, 280 were in sales and marketing, and 175 were in general and administration and other. In addition, the Company contracted with approximately 213 temporary employees. None of the Company's workers is represented by collective bargaining

agreements with the exception of certain of the employees of the Company's Netherlands subsidiary who are represented by statutory Works Councils as required under the laws of The Netherlands. The Company believes that its employee relations are good. The Company's success depends to a significant extent upon a

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limited number of key employees and other members of senior management of the Company. There can be no assurance that the Company will be successful in attracting and retaining such personnel, and the failure to attract and retain such personnel could have a material adverse effect on the Company's business. See "Factors That May Affect Future Results And Market Price Of Stock-Dependence Upon Key Personnel; Need to Hire Additional Personnel in All Areas."

Executive Officers of the Registrant

Set forth below is certain information concerning the executive officers of the Company as of January 31, 1998.

Name	Age	Position(s)
Pamela M. Lopker	43	Chairman of the Board and President
Karl F. Lopker	46	Chief Executive Officer, Chief Financial Officer and Secretary
Rita V. Foley.....	45	Executive Vice President, Global Sales and Marketing
Barry R. Anderson.....	46	Vice President, Administration
Vincent P. Niedzielski.....	44	Vice President, Development

Pamela M. Lopker founded the Company in 1979 and has been its Chairman of the Board and President since inception. Prior to founding the Company, Ms. Lopker served as Senior Systems Analyst for Comtek Research from 1977 to 1979. Ms. Lopker is certified in Production and Inventory Management by the American Production and Inventory Control Society. Ms. Lopker earned a Bachelor of Arts degree in Mathematics from the University of California at Santa Barbara.

Karl F. Lopker has served as Director, Chief Executive Officer and Secretary since joining the Company in 1981. Mr. Lopker was founder and President of Deckers Outdoor Corporation from 1973 to 1981, where he currently serves as a Director. Mr. Lopker is certified in Production and Inventory Management at the Fellow level by the American Production and Inventory Control Society. Mr. Lopker studied Electrical Engineering and Computer Science at the University of California at Santa Barbara. Mr. Lopker and Pamela Lopker are married.

Rita V. Foley joined QAD in August 1997 as Executive Vice President, Global Sales and Marketing. Prior to joining QAD, Mrs. Foley was with Digital Corporation where she held progressively more responsible positions within Sales, Marketing, Services, and Engineering. Most recently, she was Vice President of the Partners Group. Before joining Digital, Mrs. Foley held positions with Harris Lanier and Polaroid UK Ltd.

Barry R. Anderson has served as Vice President, Administration since April 1997. Prior to joining QAD, Mr. Anderson was Chief Administrative Officer at the Bank South in Atlanta, Georgia. Previous experience includes ten years with Lanier Worldwide as Vice President, Human Resources plus experience with ARAMCO (Arabian American Oil Company), Lockheed and Pan Am. Mr. Anderson received a Bachelor of Science degree in Business Management from Florida State University and a Juris Doctorate degree from Atlanta Law School.

Vincent P. Niedzielski has served as Vice President, Development since joining the Company in April 1996. Prior to joining the Company, Mr. Niedzielski served as Vice President, Production and Development at Candle Corporation from 1984 to 1996.

Mr. Niedzielski holds a Bachelor of Science degree in Mathematics from the University of Scranton.

On March 31, 1998 A.J. Moyer joined the Company as its Chief Financial Officer.

ITEM 2. PROPERTIES

The Company leases facilities to support its operations in several locations throughout the world. The corporate headquarters are located in Carpinteria, California in approximately 95,000 square feet of leased space in two facilities subject to thirteen leases. The leases expire on dates ranging from May 1998 to January 2003. An additional 14,000 square feet of office space is leased in a neighboring location, with the lease expiring in February 2003. The Company owns approximately 28 acres and 54,000 square feet of office space in a neighboring location, which also supports portions of its operations. The Company also owns a 34-acre parcel located in Carpinteria, California at which it is considering developing additional facilities. Regional headquarters are located in Mount Laurel, New Jersey, Hoofddorp, The Netherlands, Hong Kong, and Sydney, Australia in space covering approximately 62,000, 16,000, 6,500 and 13,000 square feet and subject to leases expiring in 2001, 2000, 1998 and 2000, respectively. Satellite offices are located in the Americas, Europe, Asia and Australia in space covering approximately 52,000, 16,000, 10,000, and 10,000 square feet and subject to leases expiring in 2003, 2000, 1999 and 2002, respectively. All of the Company's leases have been negotiated with independent third parties on an arms length basis, and the Company believes they are on commercially reasonable terms. Total rent expense for the year ended January 31, 1998 was \$6.5 million. The global presence of the Company is supported by offices located in the United States, Canada, Mexico, Brazil, The Netherlands, United Kingdom, France, Germany, Sweden, Poland, Australia, Singapore, Japan, Korea, India and China (Hong Kong and Shanghai). Although the Company has from time to time sought and will in the future seek new or expanded facilities for existing or additional regional offices, the Company expects that its current domestic and international facilities will be sufficient to meet its needs for at least the next 12 months. See Notes 2 and 8 of Notes to Consolidated Financial Statements.

ITEM 3. LEGAL PROCEEDINGS

The Company is subject to various legal proceedings and claims, either asserted or unasserted, which arise in the ordinary course of business. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on the Company's consolidated results of operations or consolidated financial position.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock has been traded in the Nasdaq National Market since the Company's initial public offering in August 1997. According to records of the Company's transfer agent, the Company had approximately 461 stockholders of record as of January 31, 1998. The following table sets forth the low and high sale price as of the close of market of the Company's Common Stock in each of the fiscal quarters since the Company's initial public offering.

Low Sale Price

High Sale Price

Fiscal 1998:

Fourth Quarter.....	\$11.75	\$15.75
Third Quarter.....	\$11.13	\$23.25

The Company's policy has been to reinvest earnings to fund future growth. Accordingly, the Company has not paid dividends and does not anticipate declaring dividends on its Common Stock in the foreseeable future.

On June 2, 1997 the Company announced a two-for-one stock split. The effective date of the stock split was June 19, 1997. Per share data and numbers of common shares contained in these consolidated financial statements and in Management's Discussion and Analysis of Financial Condition and Results of Operations have been adjusted to reflect the stock split for all periods presented.

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ITEM 6. SELECTED FINANCIAL DATA (in thousands, except per share data)

	Year Ended December 31,			Year Ended January 31,	
	1993	1994	1995	1997 (1)	1998 (1)
Statement of Income Data:					
Revenue	\$ 46,543	\$ 66,360	\$ 89,949	\$126,444	\$172,234
Operating income (loss)	6,442	4,084	(2,646)	2,720	14,695
Net income (loss)	3,694	2,878	(686)	1,000	9,856
Basic net income (loss) per share (2)	0.18	0.14	(0.03)	0.05	0.38
Diluted net income (loss) per share (2)	\$ 0.18	\$ 0.12	\$ (0.03)	\$ 0.04	\$ 0.38

	December 31,			January 31,	
	1993	1994	1995	1997	1998
Balance Sheet Data:					
Cash and cash equivalents	\$ 1,413	\$ 1,706	\$ 1,519	\$ 301	\$ 70,082
Working capital (deficiency)	5,015	2,271	(2,814)	(5,976)	79,258
Total assets	26,489	44,361	68,466	77,250	190,506
Notes payable and current installments of long-term debt	2,630	4,767	9,610	8,465	143
Long-term debt, less current installments	1,380	4,677	7,341	5,036	39
Total stockholders' equity	\$ 7,098	\$ 11,993	\$ 11,732	\$ 10,804	\$112,375

<FN>

(1) Effective February 1, 1996, the Company changed its financial reporting year-end from December 31 to January 31. See Note 1 of Notes to Consolidated Financial Statements.

(2) The basis for the determination of stock used in computing basic and diluted net income (loss) per share is described in Note 1 of Notes to Consolidated Financial Statements.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

The following discussion should be read in conjunction with the

Consolidated Financial Statements of the Company and the Notes thereto included elsewhere in this form 10-K. Effective February 1, 1996, the Company changed its financial reporting year end from December 31 to January 31. The Company's fiscal years ending on or prior to December 31, 1995 ended December 31.

Overview

Founded in 1979, the Company is a provider of ERP software for multinational and other large manufacturing companies. In 1986, the Company commercially released its open, client/server based ERP application, MFG/PRO software. Since that time, the Company has introduced several new generations of its MFG/PRO software, and has significantly expanded its operations. As of January 31, 1998, the Company had 917 full time employees, more than 20 direct sales and support offices and approximately 40 distributors worldwide and approximately 1,900 customers in more than 80 countries. Total revenues have grown rapidly in recent years, increasing from \$46.5 million to \$172.2 million in the year ended December 31, 1993 and year ended January 31, 1998, respectively.

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The Company derives its revenue from license fees, maintenance contracts and other products and services. License fees are primarily derived from the licensing of the Company's MFG/PRO software. License fees also include fees received by the Company for licenses of third-party software sold in conjunction with MFG/PRO software. Maintenance and other revenue consist primarily of maintenance contracts and, to a lesser extent, revenue from consulting, training and other services. Maintenance contract revenue typically represents 15% of the software license list price (net of any distributor discounts) and is recognized ratably over the life of the contract, which is typically 12 months. The Company has historically followed a strategy of relying on its network of third-party distribution and implementation alliances to provide hardware, consulting and implementation services. As a result, the Company's revenue related to license fees and maintenance contracts as a percentage of total revenues has increased from 75% to 91% from the year ended December 31, 1993 to the year ended January 31, 1998, respectively. In the event the Company pursues certain acquisitions of distributors, the Company anticipates that revenues from implementation services may increase as a percentage of revenue. Further, if the Company is successful in the launch of its On/Q software and the Company pursues its strategy of directly providing implementation services for such product, the Company anticipates that service revenue will be increased.

License fees for the Company's products generally range from \$50,000 to several million dollars, depending on the configuration of the products, the number of sites and the number of users. No single customer has accounted for greater than 10% of the Company's total revenues in any of the Company's last three fiscal years. However, it is not uncommon for QAD to conclude a multi-million dollar contract with a single customer, and the Company expects revenue from large individual licenses to increase as a percentage of total revenues.

The sales cycle for the Company's products is typically four to 15 months. Like many enterprise software companies, the Company has experienced in the past and expects to continue to experience seasonal fluctuations in its operating results. Prior to the year ended January 31, 1998 the Company generally realized lower total revenues (i) in July and August, due primarily to the timing of the Company's fiscal quarter end and reduced economic activity in Europe during that period and (ii) to a lesser extent, in the first two months of the fiscal year, due to the Company's timing of the Company's fiscal year end and a concentration of customers which purchase products in the fourth fiscal quarter, and their resulting lower purchasing activity during the immediately following months. In addition, like many enterprise software companies, the Company also typically realizes a significant portion of its software license revenue in the last month of each quarter. Unlike a number of the Company's competitors, the Company does not derive material revenue from implementation in connection with its license sales. As a result, the Company's revenue tends to be less predictable. Furthermore, when QAD was a private company, QAD had historically focused its efforts primarily on achieving annual financial results, with a significant percentage of the Company's sales force compensation based on the achievement of annual revenue goals. The Company believes that such practice had also contributed to the weighting of total revenues to the fourth calendar quarter. With the change in the Company's fiscal year end to January 31, the Company experienced some shifting in revenues to the last month of each fiscal quarter.

In the year ended January 31, 1998 QAD implemented various changes designed to mitigate the seasonal and quarterly fluctuations in its operating results. Such changes included the hiring of additional financial personnel experienced in quarterly budgeting, including a new Chief Financial Officer. The Chief Financial Officer retained by the Company in the year ended January 31, 1998 was replaced by a new Chief Financial Officer who started with the Company on March 31, 1998. Other changes included the changing of the Company's fiscal year end from December 31 to January 31 and the changing of the Company's planning systems to incorporate quarterly performance goals and quarterly forecasting procedures. Additionally, the Company is including quarterly financial incentives into its

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sales compensation system. There can be no assurance that such changes will alleviate the seasonal, quarterly or other fluctuations in the Company's financial results or that such changes will have a positive effect at all.

During the year ended December 31, 1995 through the year ended January 31, 1998, the Company significantly increased its sales and marketing, service and support and research and development staffs. These increases resulted in substantial growth in the number of its full-time employees (from 521 at March 31, 1995, to 917 at January 31, 1998), the scope of its financial and operating systems and the geographic distribution of its direct sales and support operations (from 12 to 19 countries). These investments were incurred in connection with the Company's strategy to establish and maintain a leadership position as a global supplier of ERP solutions at the plant level as well as to enter new markets such as supply chain management software. QAD believes that such investments were essential in the development of the Company's products and operations. Such commitment of resources has had, and may continue to have, a significant impact on the Company's financial results, including annual and quarterly profitability.

License fees revenue is recognized upon shipment of the software provided there are no vendor obligations to be fulfilled and collectibility is probable within a 12-month period from date of shipment. Typically, the Company's software licenses do not include significant vendor obligations. Maintenance revenue for ongoing customer support and product updates is recognized ratably over the term of the maintenance period, which is typically 12 months. Other revenue is derived mainly from training, consulting and manual sales. Training and consulting revenue is recognized as the services are performed.

The Company records revenue primarily in United States dollars. However, the Company has historically recorded local expenses in local currency. Foreign currency transaction and translation gains and losses are recorded in accordance with Statement of Financial Accounting Standards (SFAS) No. 52. In the years ended January 31, 1997 and 1998, the Company realized \$879,000 and \$407,000, respectively, in foreign currency transaction gains, compared to a loss of \$477,000 in the year ended December 31, 1995. The Company has not previously undertaken hedging transactions to cover its currency exposure, but may implement programs to mitigate foreign currency exposure risk in the future as management deems appropriate. See "Factors That May Affect Future Results and Market Price of Stock-Risks Associated With International Operations" and "-Exposure To Currency Fluctuations."

Results of Operations

The following table sets forth for the periods indicated the percentage of total revenues represented by certain items reflected on the Company's Consolidated Statements of Income:

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Year Ended December 31,		Year Ended January 31,
----	----	-----
1995	1997	1998
----	----	----

Revenue:			
License fees	71%	68%	66%
Maintenance and other	29	32	34
	----	----	----
Total revenues	100%	100%	100%
	=====	=====	=====
Cost and expenses:			
Cost of revenues	26	23	24
Sales and marketing	43	42	39
Research and development	19	20	17
General and administrative	15	13	11
	----	----	----
Total cost and expenses	103	98	91
	----	----	----
Operating income (loss)	(3)	2	9
Other (income) expense:			
Interest income	(0)	(0)	(1)
Interest expense	1	1	1
Other	(0)	(0)	(1)
	----	----	----
Total other (income) expense	1	1	(1)
	----	----	----
Income (loss) before income taxes	(4)	1	10
Income tax expense (benefit)	(3)	0	4
	----	----	----
Net income (loss)	(1)%	1%	6%
	=====	=====	=====

For the year ended December 31, 1995 and years ended January 31, 1997 and 1998

Total Revenues. Total revenues increased 36% to \$172.2 million in the year ended January 31, 1998 from \$126.4 million in the year ended January 31, 1997, and increased 41% in the year ended January 31, 1997 from \$89.9 million in the year ended December 31, 1995. License fees as a percentage of total revenues decreased to 66% in the year ended January 31, 1998 from 68% in the year ended January 31, 1997 and 71% in the year ended December 31, 1995. The dollar increases in total revenues were primarily due to growing acceptance of the Company's MFG/PRO software, continued market penetration into its targeted vertical markets and the Company's expansion into new geographical markets. The decreases in license fees and increases in maintenance and other revenue as a percentage of total revenues were primarily a result of a larger installed base and increased maintenance renewals.

Cost of Revenues. Cost of revenues increased 43% to \$41.6 million in the year ended January 31, 1998 from \$29.2 million in the year ended January 31, 1997, and increased 24% in the year ended January 31, 1997 from \$23.6 million in the year ended December 31, 1995. Cost of revenues as a percentage of total revenues increased to 24% in the year ended January 31, 1998 from 23% in the year ended January 31, 1997 and decreased from the 26% in the year ended December 31, 1995. The increase in dollar amount was primarily the result of costs associated with the year over year growth in revenues of reselling third-party databases. The decrease in cost of revenues as a percentage of total revenues in the year ended January 31, 1997 from the year ended December 31, 1995 was primarily due to increased sales of MFG/PRO software licenses where the purchase of third-party tools and databases were deferred or where the licensee obtained licenses of third-party tools and databases directly from the third-party vendor. The increase in cost of revenue as a percentage of total revenue in the year ended January 31, 1998 from the year ended January 31, 1997 was due to significantly higher costs associated with reselling third-party databases.

Sales and Marketing. Sales and marketing expense increased 26% to \$67.2 million in the year ended January 31, 1998 from \$53.2 million in the year ended January 31, 1997, and increased 39% in the year ended January 31, 1997 from \$38.3 million in the year ended December 31, 1995. Sales and marketing expense as a percentage of total revenues decreased to 39% in the year ended January 31, 1998 from 42% in the year ended January 31, 1997 and 43% in the year ended December 31, 1995. The increase in dollar amount was primarily due to the expansion of the Company's global sales force, opening and supporting global

sales offices and increasing marketing expense to promote the Company's name and products. The expansion was initiated in the year ended December 31, 1995 and continued into the year ended January 31, 1998. The decrease in sales and marketing expense as a percentage of total revenue was primarily due to the fixed cost portion of the expense base not increasing commensurate with the revenue increases.

Research and Development. Research and development expense increased 15% to \$29.3 million in the year ended January 31, 1998 from \$25.4 million in the year ended January 31, 1997, and increased 49% in the year ended January 31, 1997 from \$17.0 million in the year ended December 31, 1995. Research and development expense as a percentage of total revenues decreased to 17% in the year ended January 31, 1998 from 20% in the year ended January 31, 1997 and 19% in the year ended December 31, 1995. The increase in total research and development was primarily due to ongoing enhancements to MFG/PRO software, including the ongoing migration of MFG/PRO software to object-oriented technology. In addition, the increases were due to increased staffing of, and associated support for, product engineers in connection with efforts to develop On/Q software, the Company's new supply chain management software which the Company expects to be commercially available in the second half of calendar year 1998, and Qwizard, a computer-based interactive training tool which became commercially available in May 1997. The decrease in research and development expense as a percentage of total revenue was primarily the result of the increase in revenue and the reduction in the utilization of third-party software developers in the first half of the year ended January 31, 1998.

General and Administrative. General and administrative expense increased 22% to \$19.4 million in the year ended January 31, 1998 from \$15.9 million in the year ended January 31, 1997, and increased 17% in the year ended January 31, 1997 from \$13.6 million in the year ended December 31, 1995. General and administrative expense as a percentage of total revenues decreased to 11% in the year ended January 31, 1998 from 13% in the year ended January 31, 1997 and 15% in the year ended December 31, 1995. The dollar increases in general and administrative expense were primarily the result of costs associated with the expansion of the Company's administrative infrastructure to support increases in the Company's total revenues. In addition, the Company recognized compensation expense of \$648,000 and \$2.4 million in the year ended January 31, 1997 and the year ended December 31, 1995, respectively, in connection with the repurchase of stock held by employees upon their departure from the Company. The decrease in general and administrative expense as a percentage of total revenues resulted from total revenues growing faster than general and administrative expense. See Note 10 of Notes to Consolidated Financial Statements.

Total Other (Income) Expense. Total other (income) expense increased 333% to \$(2,320,000) in the year ended January 31, 1998 from \$997,000 in the year ended January 31, 1997, and decreased 19% in the year ended January 31, 1997 from \$835,000 in the year ended December 31, 1995. The increase in the year ended January 31, 1998 was primarily the result of significantly reduced interest expense as the IPO proceeds were applied to the repayment and retirement of debt, and to interest income accruing from investment of the remaining proceeds in short-term investment-grade securities and money market instruments. The decrease in the year ended January 31, 1997 was primarily the result of foreign currency transaction gains and miscellaneous rental income offset by increased interest expense.

Income Tax Expense (Benefit). The Company recorded income tax expense (benefit) of \$7.2 million, \$723,000 and \$(2.8) million in the years ended January 31, 1998 and 1997 and the year ended December 31, 1995, respectively. The Company's effective income tax rates were 42% in the years ended January 31, 1998 and 1997, respectively. The Company's effective income tax rate historically has benefited from the United States research and development tax credit and tax benefits generated from export sales made from the United States. The tax benefit recorded in the year ended December 31, 1995 relates primarily to loss carrybacks and carryforwards associated with the Company's entry into new foreign taxing jurisdictions and anticipated future taxable income to be earned in such jurisdictions. The Company has available tax benefits associated with net operating loss carryforwards of foreign subsidiaries aggregating \$1.8 million at January 31, 1998. See Note 6 of the Notes to Consolidated Financial Statements.

Fiscal Year Transition Period

Effective February 1, 1996, the Company changed its financial reporting year-end from December 31 to January 31. As a result of the change, the Company is disclosing interim financial results for the one-month period ended January 31, 1996. Total revenues, total cost and expenses, total other (income) expense and net income (loss) were \$3.5 million, \$7.3 million, \$65,000 and \$(2.9) million, respectively, for the one-month period. During that month, the Company experienced normal monthly operational costs including planned increases in headcount for the coming year. The net loss for this period reflects these planned increases in conjunction with seasonally low revenue in the month of January.

Liquidity and Capital Resources

On August 6, 1997, the Company completed its initial public offering of common stock, selling 5,750,000 shares at \$15.00 per share. Net proceeds to the Company were approximately \$78.5 million. Additionally, on August 12, 1997, the Company sold, through exercise of the underwriters' options, an additional 862,500 shares of the Company's common stock, for which the Company received additional net proceeds of approximately \$12.0 million. Prior to the initial public offering, the Company financed its operations and met its capital expenditure requirements through cash flows from operations as well as short and long term borrowings.

At January 31, 1998, the Company had \$70.1 million of cash and cash equivalents. Net cash provided by operating activities were \$9.5 million, \$7.4 million and \$4.1 million in the years ended January 31, 1998 and 1997 and the year ended December 31, 1995, respectively. Net cash used in investing activities was primarily related to the purchase of computer equipment, office furniture and real estate and aggregated \$16.5 million, \$3.4 million and \$9.5 million in the years ended January 31, 1998 and 1997 and the year ended December 31, 1995, respectively. Net cash provided by (used in) financing activities were primarily related to proceeds from the initial public offering, proceeds from (used in) borrowings and proceeds from the sale of stock to employees and totaled \$76.8 million, \$(4.5) million and \$5.0 million in the years ended January 31, 1998 and 1997 and the year ended December 31, 1995, respectively. At January 31, 1998, the Company did not have any material commitments for capital expenditures.

At January 31, 1998, the Company had a working capital of \$79.3 million. Accounts receivable, net of allowance for doubtful accounts, increased to \$75.7 million at January 31, 1998 from \$46.7 million at January 31, 1997. The Company's accounts receivable days' sales outstanding ("DSO"), calculated on a quarterly basis (for quarters ending on April 30, July 31, October 31, and January 31), has ranged from 125 days to 66 days over the last three years and has demonstrated seasonal fluctuations. During each of those years, DSO peaked in the quarter ended April 30 and (except for the year ended January 31, 1998) improved significantly during the middle two quarters. The quarters ended January

31 are impacted by the significant amount of seasonal maintenance renewals. The Company believes that the days' sales outstanding are higher than desired and the Company is focusing on its sales terms and collection processes to improve cash flows and working capital. Total deferred revenue increased to \$43.0 million at January 31, 1998 from \$29.1 million at January 31, 1997 primarily as a result of increased billings of maintenance agreements.

Subsequent to the initial public offering the Company entered into a revolving credit agreement with Bank of America National Trust and Savings Association, which expires on August 4, 1999. The maximum available amount of borrowings under the revolving credit agreement is equal to \$20 million, unless there is a voluntary termination or reduction of commitment by the Company. The total amount of available borrowings under the revolving credit agreement at January 31, 1998 was approximately \$20 million. Borrowings under the revolving credit agreement bear interest at a rate per annum equal to the Offshore Rate plus the Applicable Margin or the Base Rate plus the Applicable Margin. The Applicable Margin means, with respect to Base Rate Loans, 0%, and with respect to Offshore Rate Loans, 1.25% when 50% or less of the loan commitment is being utilized, and 1.50% when more than 50% of the loan commitment is being utilized. The Company pays a commitment fee on the average unused portion of the loan

commitment to the bank, equal to one-half of one percent (.50%) per annum.

The Company believes that its available working capital, the available borrowings under its revolving credit agreement and cash generated by operations, will satisfy the Company's working capital requirements for at least the next 12 months.

Recent Accounting Pronouncements

In October 1997, the American Institute of Certified Public Accountants issued Statement of Position 97-2: Software Revenue Recognition (SOP 97-2) which is effective for software transactions entered into in fiscal years beginning after December 15, 1997. The Company is currently evaluating the effect of this new statement.

The Financial Accounting Standards Board has issued SFAS No. 130 Reporting Comprehensive Income and SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information. SFAS No. 130 will affect the disclosure requirements for the first quarter of the year ended January 31, 1999 financial statements. SFAS No. 131 will affect the disclosure requirements for the year ended January 31, 1999 annual financial statements. The Company is currently evaluating the effect of these new statements.

Year 2000 Compliance

In 1997, the Company developed a plan to deal with the Year 2000 problem and began converting its computer systems to be Year 2000 compliant. The plan provides for the conversion efforts to be completed by the end of 1999. The Year 2000 problem is the result of computer programs being written using two digits rather than four to define the applicable year. The total cost of the project has not been, and is not anticipated to be, material to the Company's financial position, results of operations or liquidity. The costs of the project has been and will continue to be funded through operating cash flows. The Company is expensing all costs associated with these systems changes as the costs are incurred. See "Business-Year 2000 Compliance."

International Operations

The Company has reassessed, and continues to closely monitor, its international business risks due to the recent economic conditions in the Asian markets. Although the Company does not anticipate that the Asian conditions will materially impact its business,

there can be no assurance that the current economic conditions in Asia will not worsen or that the situation will not negatively impact the Company's financial condition or results of operations.

FACTORS THAT MAY AFFECT FUTURE RESULTS AND MARKET PRICE OF STOCK

Historical Fluctuations in Quarterly Results and Potential Future Significant Fluctuations

The Company's quarterly revenue, expenses and operating results have varied significantly in the past, and the Company anticipates that such fluctuations will continue in the future as a result of a number of factors, many of which are outside the Company's control. The factors affecting these fluctuations include demand for the Company's products and services, the size, timing and structure of significant licenses by customers, market acceptance of new or enhanced versions of the Company's software products and products that operate with the Company's products, the publication of opinions about the Company, its products and technology by industry analysts, the entry of new competitors and technological advances by competitors, delays in localizing the Company's products for new markets, delays in sales as a result of lengthy sales cycles, changes in operating expenses, foreign currency exchange rate fluctuations, changes in pricing policies by the Company or its competitors, customer order deferrals in anticipation of product enhancements or new product offerings by the Company or its competitors, the timing of the release of new or enhanced versions of the Company's software products and products that operate with the Company's products, changes in the method of product distribution (including the mix of direct and indirect channels), product life cycles, changes in the mix of products and services licensed or sold by the Company, customer cancellation of

major planned software development programs and general economic factors.

A significant portion of the Company's revenue in any quarter may be derived from a limited number of large, non-recurring license sales. The Company expects to continue to experience from time to time large, individual license sales, which may cause significant variations in quarterly license fees. The Company also believes that the purchase of its products is relatively discretionary and generally involves a significant commitment of a customer's capital resources. Therefore, a downturn in any potential customer's business could result in order cancellations, which could have a significant adverse impact on the Company's revenue and quarterly results. Moreover, declines in general economic conditions could precipitate significant reductions in corporate spending for information technology, which could result in delays or cancellations of orders for the Company's products.

The Company has also historically recognized a substantial portion of its revenue from sales booked and shipped in the last month of a quarter. As a result, the magnitude of quarterly fluctuations in license fees may not become evident until late in, or at the end of, a particular quarter. If sales forecasted from a specific customer for a particular quarter are not realized in that quarter, the Company is unlikely to be able to generate revenue from alternate sources in time to compensate for the shortfall. As a result, a lost or delayed sale could have a material adverse effect on the Company's quarterly operating results. To the extent that significant sales occur earlier than expected, operating results for subsequent quarters may be adversely affected. The Company has also historically operated with little backlog because its products are generally shipped as orders are received. As a result, revenue from license fees in any quarter is substantially dependent on orders booked and shipped in that quarter and on sales by the Company's distributors and other resellers. Sales derived through indirect channels are harder to predict and may have lower profit margins than direct sales.

The Company has generally realized lower revenue (i) in July and August, due primarily to the timing of the Company's fiscal quarter end and reduced economic activity

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in Europe during that period and (ii) to a lesser extent, in the first two months of the fiscal year, due to the timing of the Company's fiscal year end and the concentration by some customers of purchases in the fourth quarter of the fiscal year, and their consequently lower purchasing activity during the immediately following months. In addition, like many software companies, the Company typically realizes a significant portion of its software license revenue in the last month of the quarter and in the last quarter of the year. With the change in the Company's fiscal year end to January 31, the Company experienced some shifting in revenues to the last month of each new fiscal quarter. Unlike a number of the Company's competitors, the Company does not derive material revenue from the provision of services in connection with its license sales. As a result, a greater proportion of the Company's revenue tends to be less predictable and to occur later in the quarter and in the year than the revenue of competitors who provide such services.

The Company's expense levels are relatively fixed and are based, in significant part, on expectations of future revenue. Consequently, if revenue levels are below expectations, expense levels could be disproportionately high as a percentage of total revenue, and operating results would be immediately and adversely affected and losses could occur.

Based upon the factors described above, the Company believes that its quarterly revenue, expenses and operating results are likely to vary significantly in the future, that period-to-period comparisons of its results of operations are not necessarily meaningful and that, as a result, such comparisons should not be relied upon as indications of future performance. Moreover, although the Company's revenue has generally increased in recent periods, there can be no assurance that the Company's revenue will grow in future periods, at past rates or at all, or that the Company will be profitable on a quarterly or annual basis. The Company has in the past experienced and may in the future experience quarterly losses.

In the year ended January 31, 1998, QAD implemented various changes designed to mitigate the seasonal and quarterly fluctuations in its operating results. Such changes included the hiring of additional financial personnel,

including a new Chief Financial Officer, the changing of the Company's fiscal year end from December 31 to January 31 and the changing of the Company's planning systems to incorporate quarterly performance goals and quarterly forecasting procedures. Additionally, the Company is including quarterly financial incentives into its sales compensation system. There can be no assurance that such changes will alleviate the seasonal, quarterly or other fluctuations in the Company's financial results or that such changes will have a positive effect at all.

In future periods, the Company's operating results may be below the expectations of stock market analysts and investors. In such event, the price of the Common Stock could be materially adversely affected. See "-Seasonality of Operating Results" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Risks Associated with Sales Cycle

Because the license of the Company's products generally involves a significant commitment of capital (which ranges from approximately \$50,000 to several million dollars), the sales cycle associated with a customer's purchase of the Company's products is generally lengthy (with a typical duration of four to 15 months), varies from customer to customer and is subject to a number of significant risks over which the Company has little or no control. These risks include customers' budgetary constraints, timing of budget cycle, concerns about the introduction of new products by the Company or its competitors and general economic downturns which can result in delays or cancellations of information systems investments. Due in part to the strategic nature of the Company's products, potential customers are typically cautious in making product acquisition

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decisions. The decision to license the Company's products generally requires the Company to provide a significant level of education to prospective customers regarding the uses and benefits of the Company's products, and the Company must frequently commit substantial presales support resources. The Company is almost completely reliant on third parties for implementation and systems integration services, which may cause sales cycles to be lengthened or result in the loss of sales. The uncertain outcome of the Company's sales efforts and the length of its sales cycles could result in substantial fluctuations in operating results. If sales forecasted from a specific customer for a particular quarter are not realized in that quarter, then the Company is unlikely to be able to generate revenue from alternative sources in time to compensate for the shortfall. As a result, and due to the relatively large size of some orders, a lost or delayed sale could have a material adverse effect on the Company's quarterly operating results. See "Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations."

Seasonality of Operating Results

The Company has generally realized lower revenue (i) in July and August, due primarily to the timing of the Company's fiscal quarter end and reduced economic activity in Europe during that period and (ii) to a lesser extent, in the first two months of the fiscal year, due to the timing of the Company's fiscal year end and the concentration by some customers of purchases in the fourth quarter of the fiscal year and their consequently lower purchasing activity during the immediately following months. Notwithstanding the change in the Company's fiscal year end from December 31 to January 31 and the recent changes in the Company's planning and compensation systems, the Company anticipates that such seasonality will continue to cause significant quarterly fluctuations in the Company's operating results. See "-Historical Fluctuations in Quarterly Results and Potential Future Significant Fluctuations" and "Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations."

Product Concentration

The Company has historically derived substantially all of its revenue from the licensing and maintenance of the Company's MFG/PRO software and third-party software. In the fiscal year ended January 31, 1997 and 1998, such revenue equaled approximately 94% and 91%, respectively, of the Company's total revenue. The Company expects that such revenue will continue to represent substantially all of the Company's revenue for the foreseeable future. However, in the event

the Company pursues certain acquisitions of distributors, the Company anticipates that revenues from implementation services will increase. In addition, if the Company is successful in the launch of its On/Q software and the Company pursues its strategy of directly providing implementation services for such product, the Company anticipates that service revenue will be increased. The Company's success depends on continued market acceptance of the Company's MFG/PRO software, as well as the Company's ability to introduce new versions of MFG/PRO software and other products to meet the evolving needs of its customers. Although demand for MFG/PRO software has grown in recent years, management believes that the market for ERP software is still developing and there can be no assurance that it will continue to grow or that, even if the market does grow, businesses will continue to adopt MFG/PRO software. The failure of the market for ERP software to continue to grow, any reduction in demand for MFG/PRO software as a result of increased competition in the market for ERP software, technological change, failure by the Company to introduce new versions of products acceptable to the marketplace or other similar factors would have a material adverse effect on the Company's business, operating results and financial condition. The Company has spent, and intends to continue to spend, considerable resources educating potential customers about ERP in general and about the features and functions of MFG/PRO software in particular. However, there can be no assurance that such expenditures will enable MFG/PRO software to achieve any additional degree of market penetration or a higher level of market acceptance, nor can there be any assurance that any new ERP products being

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developed by the Company will achieve the market acceptance necessary to make such products profitable. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business-Products."

Dependence on Progress Products

The Company's MFG/PRO software is written in a programming language that is proprietary to Progress Software Corporation ("Progress"). The Company has entered into a license agreement with Progress (the "Progress Agreement") that provides the Company and each of its subsidiaries, among other things, with the perpetual, worldwide, royalty-free right to use the Progress programming language to develop, market, distribute and license the Company's software products. The Progress Agreement also provides for continued software support from Progress through June 2002 without charge to the Company. Progress may only terminate the Progress Agreement upon the Company's adjudication as bankrupt, its liquidation or other similar event, or if the Company has ceased business operations in full. The Company's success is dependent upon Progress continuing to develop, support and enhance this programming language, its tool set and database, as well as the continued market acceptance of Progress as a standard database program. The Company has in the past and may in the future experience product release delays because of delays in the release of Progress products or product enhancements. Any such delays could have a material adverse effect on the Company's business, operating results and financial condition. MFG/PRO software employs Progress programming interfaces, which allow MFG/PRO software to operate with Oracle database software. However, the Company's software programs do not run within programming environments other than Progress and the Company's customers must acquire rights to Progress Software in order to use MFG/PRO software. The Company's On/Q software products, the initial application of which is currently under development and is expected to be commercially available in the second half of calendar year 1998, are not dependent upon Progress technology. The failure of Progress to continue its relationship with the Company or to develop, support or enhance its programming language in a manner competitive with enhancements of other present or future programming languages, the increased market acceptance of programming languages other than Progress in the Company's market or the Company's inability to adapt its software to such other languages could have a material adverse effect on the Company's business, operating results and financial condition.

Rapid Technological Change

The market for the Company's software products is characterized by rapid technological advances, evolving industry standards in computer hardware and software technology, changes in customer requirements and frequent new product introductions and enhancements. Customer requirements for products can change rapidly as a result of innovations or changes within the computer hardware and software industries, the introduction of new products and technologies

(including new hardware platforms and programming languages) and the emergence, evolution or widespread adoption of industry standards. For example, increasing commercial use of the Internet may give rise to new customer requirements and new industry standards. The Company's future success will depend upon its ability to continue to enhance its current product line and to develop and introduce new products that keep pace with technological developments, satisfy increasingly sophisticated customer requirements and achieve market acceptance. In particular, the Company believes its future success will depend on its ability to convert its products to object-oriented technology as well as its ability to develop products that will operate across the Internet. There can be no assurance that the Company will be successful in developing and marketing, on a timely and cost-effective basis, product enhancements or new products that respond to technological advances by others, or that its products will achieve market acceptance. The Company's failure to successfully develop and market product enhancements or new products could have a material adverse effect on the Company's business, operating results and financial condition.

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While the Company generally takes steps to avoid interruptions of sales due to the pending availability of new products, customers may delay their purchasing decisions in anticipation of the general availability of new or enhanced MFG/PRO software, which could have a material adverse effect on the Company's business, operating results and financial condition. The actual or anticipated introduction of new products, technologies and industry standards can also render existing products obsolete or unmarketable or result in delays in the purchase of such products. As a result, the life cycles of the Company's products are difficult to estimate. The Company must respond to developments rapidly and incur substantial product development expenses. Any failure by the Company to anticipate or respond adequately to technology developments or customer requirements, or any significant delays in introduction of new products, could result in a loss of revenue. Moreover, significant delays in the general availability of such new releases, significant problems in the installation or implementation of such new releases, or customer dissatisfaction with such new releases, could have a material adverse effect on the Company's business, operating results and financial condition. The Company is also dependent upon third parties for necessary services in connection with the installation and implementation of the Company's products and associated post-sales training. Any errors, delays or other deficiencies in such services due to technology changes or other factors could have a material adverse effect on the Company's business, operating results and financial condition. See "Business-Products" and "-Third-Party Implementation Providers."

Supply Chain Solutions Under Development and Underlying Technology

A significant element of the Company's strategy is its development of On/Q software, a series of new products targeted to the supply chain management needs of manufacturing companies. Over the past two years, the Company has devoted substantial resources to developing its On/Q software and working with third parties to develop software components which may be included as part of or encapsulated within On/Q software. The Company's first On/Q software product, Outbound Logistics, is currently under development and is anticipated to be commercially available in the second half of calendar year 1998. Although the Company has performed preliminary tests on its Outbound Logistics software, it has not completed its development or commenced beta testing, nor has the product been implemented in a commercial setting. There can be no assurance that Outbound Logistics or any other of the Company's planned On/Q software products developed by the Company or third parties will achieve the performance standards required for commercialization or that such products will achieve market acceptance or be profitable. If Outbound Logistics or the Company's other planned supply chain management software products do not achieve such performance standards or do not achieve market acceptance, the Company's business, operating results and financial condition would be materially and adversely affected.

On/Q software is being designed based upon object-oriented technology. Object-oriented applications are characterized by technology, development style and programming languages that differ from those used in traditional software applications, including the current version of MFG/PRO software. The Company believes that new object-based functionality will play a key role in the competitive manufacturing, distribution, financial, planning and service/support management information technology strategies of customers in the Company's targeted industry segments. The Company is also currently in the process of converting its MFG/PRO software modules to component objects and to a Java user

interface where the Company believes such conversion will add value. There can be no assurance that the Company will be successful in developing its new supply chain management software or converting its MFG/PRO software to component objects or to a Java user interface on a timely basis, if at all, or that if developed or converted such software will achieve market acceptance. The Company is also reliant on the Java programming language in developing and supporting its Java user interface for MFG/PRO and its On/Q software products. The failure to successfully incorporate component objects in

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new products, to convert MFG/PRO software to component objects, to integrate Java user interfaces or of Java to achieve market acceptance could have a material adverse effect on the Company's business, operating results and financial condition.

Convergent Engineering is a new software design methodology employed by the Company to develop future products. Convergent Engineering methodology allows business requirements to be captured as a series of simple facts, actions and rules, enabling software to more flexibly accommodate business practices and processes. Although Convergent Engineering does not require the user to adopt new business practices or principles for their own work processes, Convergent Engineering models business management processes differently than traditional business models. As a result, use of Company products based upon Convergent Engineering principles will require the Company's implementation partners to be educated in the new methodology. There can be no assurance that the Company will gain acceptance among its implementation providers for this methodology on which the Company's new products are based. The failure to obtain such acceptance would have a material adverse effect on the marketability of the Company's products under development and the Company's business, operating results and financial condition. See "Business-Products."

Risk of Software Defects

As a result of the complexities inherent in client/server computing environments and the broad functionality and performance demanded by customers for ERP products, major new products and product enhancements can require long development and testing periods. In addition, software programs as complex as those offered by the Company may contain undetected errors or "bugs" when first introduced or as new versions are released that, despite testing by the Company, are discovered only after a product has been installed and used by customers. While the Company has on occasion experienced delays in the scheduled introduction of new and enhanced products, to date the Company's business has not been materially adversely affected by delays or the release of products containing errors. However, there can be no assurance that errors will not be found in future releases of the Company's software, or that the Company will not experience material delays in releasing product improvements or new products. The occurrence of such errors could result in significant losses to the Company or to customers. Such occurrences could also result in reduced market acceptance of the Company's products, which would have a material adverse effect on the Company's business, operating results and financial condition.

Market Concentration

The Company has made a strategic decision to concentrate its product development and sales and marketing in five primary vertical industry segments: electronics/industrial, food/beverage, consumer-packaged goods, medical and automotive. An important element of the Company's strategy is to achieve technological and market leadership recognition for its software products in these segments. The failure of the Company's products to achieve or maintain substantial market acceptance for its software products in one or more of these segments could have a material adverse effect on the Company's product and business strategy in that segment and on the business, operating results and financial condition of the Company. If any of the industry segments targeted by the Company experiences a material downturn in expansion or in prospects for future growth, such downturn would materially adversely affect the demand for the Company's products and will materially adversely affect its business, operating results and financial condition. See "Business-Sales and Marketing."

Management of Growth

The Company's business has grown rapidly in the last seven years, with revenue increasing from approximately \$46.5 million in the fiscal year ended

approximately \$172.2 million in the fiscal year ended January 31, 1998. During the fiscal year ended December 31, 1995 and continuing through the fiscal year ended January 31, 1998, the Company significantly increased its sales and marketing, service and support and research and development staffs, resulting in substantial growth in the number of its full-time employees (from 521 at March 31, 1995 to 917 at January 31, 1998), the scope of its operating and financial systems and the geographic distribution of its operations and customers. This recent rapid growth has placed, and will continue to place, a significant strain on the Company's management and operations. The Company expects to continue to increase staffing levels, primarily in the sales and marketing and research and development areas, and incur additional associated costs in future periods. The Company's future operating results will depend on the ability of its officers and other key employees to continue to implement and improve its operational, customer support and financial control systems, and to effectively expand, train and manage its employee base. There can be no assurance that the Company will be able to manage any future expansion successfully, and any inability to do so would have a material adverse effect on the Company's business, operating results and financial condition. The Company has undertaken a project to significantly upgrade its financial planning and control systems, including an upgrade of its current transaction accounting systems through, among other things, the implementation of the most recent release of the Company's own software for financial controls. The Company believes the success of such implementation will improve its budgeting, forecasting and financial statement reporting capabilities. However, implementation of these systems upgrades will require significant management and other employee attention and coordination, and there can be no assurance that the implementation will be successful. The failure to successfully implement the upgrades could materially adversely affect the Company's future budgeting, forecasting and financial statement reporting capabilities.

The Company has made a strategic decision to be a global provider of its products. To accomplish this goal, over the last two years the Company has expanded its direct sales and support operations from 12 countries to 19 countries. In addition, during that time, the Company has significantly expanded its distributor and partner relationships. Currently, the Company has approximately 40 distributors worldwide. The management of these widely dispersed international operations has placed and will continue to place significant strain on the Company's management and operations. The Company believes that its ability to provide products and services on a global basis is critical to the Company's success. However, there can be no assurance that the Company will be able to continue to successfully manage its widespread international operations or successfully manage future expansion of such operations, and the failure by the Company to do so would have a material adverse effect on its business, operating results and financial condition.

The Company days' sales outstanding have generally exceeded industry averages. If the Company experiences rapid growth, this lengthy collection cycle could result in a significant impairment of the Company's cash position. While the Company has undertaken efforts to reduce the length of its collection cycle, the failure of the Company to successfully implement such changes or the failure of such changes to reduce such collection cycle could have a material adverse effect on the Company's business, operating results and financial condition. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Dependence Upon Key Personnel; Need to Hire Additional Personnel in All Areas

The Company's future operating results depend in significant part upon the continued service of a relatively small number of key technical and senior management personnel, including Pamela M. Lopker, its President and founder, and Karl F. Lopker, its Chief Executive Officer, neither of whom is bound by an employment agreement. Pamela and Karl Lopker are married to each other and jointly own approximately 65% of the outstanding Common Stock. Although the Company maintains key-individual insurance in the amount of \$2.5

million with respect to each of Pamela and Karl Lopker and the Company is the beneficiary of such policies, the loss of one or more of these or other key individuals could have a material adverse effect on the Company's business, operating results and financial condition.

The Company's future success also depends on its continuing ability to attract and retain other highly qualified technical and managerial personnel. Competition for such personnel is intense, and the Company has at times in the past experienced difficulty in recruiting qualified personnel. There can be no assurance that the Company will retain its key technical and managerial employees or that it will be successful in attracting, assimilating and retaining other highly qualified technical and managerial personnel in the future. The loss of any member of the Company's key technical and senior management personnel or the inability to attract and retain additional qualified personnel could have a material adverse effect on the Company's business, operating results and financial condition. See "Business-Employees" and "-Executive Officers of the Registrant."

Dependence Upon Development and Maintenance of Sales and Marketing Channels

The Company sells and supports its products through direct and indirect sales organizations throughout the world. The Company has made significant expenditures in recent years in the expansion of its sales and marketing force, primarily outside the United States, and plans to continue to expand its sales and marketing force. The Company's future success will depend in part upon the productivity of its sales and marketing force and the ability of the Company to continue to attract, integrate, train, motivate and retain new sales and marketing personnel. Competition for sales and marketing personnel in the software industry is intense. There can be no assurance the Company will be successful in hiring such personnel in accordance with its plans. There can be no assurance that the Company's recent and other planned expenses in sales and marketing will ultimately prove to be successful or that the incremental revenue generated will exceed the significant incremental costs associated with these efforts. In addition, there can be no assurance that the Company's sales and marketing organization will be able to compete successfully against the significantly more extensive and better funded sales and marketing operations of many of the Company's current and potential competitors. If the Company were unable to develop and manage its sales and marketing force expansion effectively, the Company's business, operating results and financial condition would be materially adversely affected.

The Company's indirect sales channel consists of approximately 40 distributors worldwide. The Company does not grant exclusive rights to any of its distributors. The Company's distributors primarily sell independently to companies within their geographic territory but may also work in conjunction with the Company's direct sales organization. The Company will need to maintain and expand its relationships with its existing distributors and enter into relationships with additional distributors in order to expand the distribution of its products. There can be no assurance that current or future distributors will provide the level and quality of expertise and service required to successfully license the Company's products, that the Company will be able to maintain effective, long-term relationships with distributors, or that selected distributors will continue to meet the Company's sales needs. Further, there can be no assurance that these distributors will not market software products in competition with the Company in the future or will not otherwise reduce or discontinue their relationships with or support of the Company and its products. The failure by the Company to maintain successfully its existing distributor relationships or to establish new relationships in the future would have a material adverse effect on the Company's business, results of operations and financial condition. In addition, if any of the Company's distributors exclusively adopts a product other than the Company's products, or if any such distributor materially reduces its sales efforts relating to the Company's products or materially increases such support

for competitive products, the Company's business, operating results and financial condition could be materially and adversely affected. See "Business-Sales and Marketing."

Competition

The ERP software market is highly competitive, rapidly changing and

affected by new product introductions and other market activities of industry participants, including consolidations among industry participants. The Company currently competes primarily with (i) other vendors of software focused on the specific needs of manufacturing plants and distribution sites of multinational manufacturing companies, which include Baan, J.D. Edwards and SSA, (ii) smaller independent companies that have developed or are attempting to develop advanced planning and scheduling software which complement or compete with ERP or manufacturing resource planning solutions, (iii) internal development efforts by corporate information technology departments and (iv) companies offering standardized or customized products on mainframe and/or mid-range computer systems. The Company expects that competition for its MFG/PRO software will increase as other large companies such as Oracle and SAP, as well as other business application software vendors, enter the market for plant-level ERP solutions. With the Company's strategic entry into the supply chain management software market, the Company can expect to meet substantial additional competition from companies presently serving that market, such as i2, IMI and Manugistics, as well as from broad based solution providers such as Baan, Oracle, PeopleSoft and SAP that the Company believes are increasingly focusing on this segment. In addition, certain competitors, such as Baan, Oracle, PeopleSoft and SAP, have well established relationships with present or potential customers of the Company. The Company may also face market resistance from potential customers with large installed legacy systems because of their reluctance to commit the time, effort and resources necessary to convert to an open, client/server-based software solution. Further, as the client/server market continues to develop, companies with significantly greater resources than the Company may attempt to increase their presence in these markets by acquiring or forming strategic alliances with competitors, partners or potential partners of the Company. Increased competition is likely to result in price reductions, reduced operating margins and loss of market share, any one of which could materially adversely affect the Company's business, operating results and financial condition. Many of the Company's present or future competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, greater name recognition and a larger installed base of customers than the Company. As a result, they may be able to respond more quickly to new or emerging technologies and to changes in customer requirements, or to devote greater resources to the development, promotion and sale of their products, than can the Company. The Company believes that the principal factors on which it competes in the ERP software market are functionality, ease of use and implementation, technology, time to benefit, supplier viability, service and cost. The Company intends to continue to acquire, develop and allocate its resources to focus on these targeted competitive areas, as well as to identify additional or different areas where the Company perceives competitive advantage. There can be no assurance that the Company will be able to compete successfully with existing or new competitors or that competition will not have a material adverse effect on the Company's business, operating results and financial condition. See "Business-Competition."

Reliance on and Need to Develop Additional Relationships with Third Parties

The Company has established strategic relationships with a number of consulting and systems integration organizations that it believes are important to its worldwide sales, marketing, service and support activities and the implementation of its products. The Company is particularly reliant on third parties for installation and implementation of its products because the Company, unlike a number of its competitors, has not historically provided these services. In the event the Company pursues certain acquisitions of distributors and the Company is successful in the launch of its On/Q software and pursues

its strategy of directly providing implementation services for such product, the Company will increase its provision of installation and implementation services. If the Company is unable to train adequately a sufficient number of system integrators or, if for any reason, any such integrators terminate their relationship with the Company or do not have or devote the resources satisfactory to provide necessary consulting and implementation of the Company's products, the Company's business, operating results and financial condition could be materially and adversely affected. The Company is aware that these third-party providers do not provide systems integration services exclusively for the Company's products and in many instances such firms have similar, and often more established, relationships with the Company's principal competitors. The Company expects to continue to rely upon such third parties, particularly installation and implementation service providers, for marketing and sales, lead

generation, product installation and implementation, customer support services, product localization, end-user training assistance in the sales process and after-sale training and support. These relationships also assist the Company in keeping pace with the technological and marketing developments of major software vendors, and, in certain instances, provide it with technical assistance for its product development efforts. Organizations providing such consulting and systems integration and implementation services in connection with the Company's products include Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, Integrated Systems & Services, LLC and Strategic Information Group International, Inc. in the United States, BDM Largotim US, Inc., CSBI S.A., Origin Technology in Business Nederland B.V. and Sligos S.A. in Europe and Iris Ifec Co., Ltd and STCS Systems Pte Ltd in Asia. In most cases distributors will also deliver consulting and systems integration services. The Company will need to expand its relationships with these parties and enter into relationships with additional third parties in order to expand the distribution of its products. There can be no assurance that these and other third parties will provide the level and quality of service required to meet the needs of the Company's customers, that the Company will be able to maintain an effective, long-term relationship with such third parties, or that such third parties will continue to meet the needs of the Company's customers. Further, there can be no assurance that these third-party implementation providers, many of which have significantly greater financial, technical, personnel and marketing resources than the Company, will not market software products in competition with the Company in the future or will not otherwise reduce or discontinue their relationships with or support of the Company and its products. The failure by the Company to maintain its existing relationships or to establish new relationships in the future, or the failure of such third parties to meet the needs of the Company's customers, would have a material adverse effect on the Company's business, results of operations and financial condition. In addition, if such third parties exclusively adopt a product or technology other than the Company's products or technology, or if such third parties materially reduce their support of the Company's products or technology or materially increase such support for competitive products or technology, the Company's business, operating results and financial condition will be materially and adversely affected.

The Company typically enters into separate agreements with each of its installation and implementation partners that provide such partners with the non-exclusive right to promote and market the Company's products, and to provide training, installation, implementation and other services for the Company's products, within a defined territory for a specified period of time (generally two years). The Company's installation and implementation partners generally do not receive fees for the sale of the Company's software products unless they participate actively in a sale as a sales agent. However, they generally are permitted to set their own rates for their installation and implementation services, and the Company typically does not collect a royalty or percentage fee from such partners on services performed. The Company also enters into similar agreements with its distribution partners that grant such partners the non-exclusive right, within a specified territory, to market, license, deliver and support the Company's products. In exchange for such distributors' services, the Company grants a discount to the distributor for the license of its software products. The Company also

relies on third parties for the development or inter-operation of key components of its software so that users of the Company's software will obtain the functionality demanded. Such research and product alliances include software developed to be sold in conjunction with the Company's software products, technology developed to be included in or encapsulated within the Company's software products and numerous third-party software programs that generally are not sold with the Company's software but inter-operate directly with the Company's software through application program interfaces. The Company generally enters into joint development agreements with its third-party software development partners that govern ownership of the technology collectively developed. Each of the Company's partner agreements and third-party development agreements contain strict confidentiality and non-disclosure provisions for the service provider, end user and third-party developer and the Company's third-party development agreements contain restrictions on the use of the Company's technology outside of the development process. The failure of the Company to establish or maintain successful relationships with such third-party software providers or such third-party installation, implementation and development partners or the failure of such third-party software providers to

develop and support their software could have a material adverse effect on the Company's business, operating results and financial condition. See "Business-Sales and Marketing," "-Third-Party Implementation Providers" and "-Proprietary Rights and Licensing."

Intellectual Property Rights; Use of Licensed Technology

The Company's success is dependent upon its proprietary technology and other intellectual property. The Company relies primarily on a combination of the protections provided by applicable copyright, trademark and trade secret laws, as well as on confidentiality procedures and licensing arrangements, to establish and protect its rights in its software. The Company enters into license agreements with each of its customers. Each of the Company's license agreements provides for the non-exclusive license of the Company's MFG/PRO software. Such licenses generally are perpetual (unless terminated by either party upon 30 days written notice) and contain strict confidentiality and non-disclosure provisions, a limited warranty covering MFG/PRO software and indemnification for the customer from any infringement action related to MFG/PRO software. The pricing policy under each license is based on a standard price list and may vary based on the number of end-users, number of sites, number of modules, number of languages, the country in which the license is granted and level of ongoing support, training and services to be provided by the Company. The Company has no patents or pending patent applications. In order to facilitate the customization required by most of the Company's customers, the Company generally licenses its MFG/PRO software to end users in both object code (machine-readable) and source code (human-readable) format. While this practice facilitates customization, making software available in source code also makes it easier for third parties to copy or modify the Company's software for non-permitted purposes. One of the Company's distributors has developed modifications to the Company's software, which it owns jointly with the Company. The Company has entered into a reciprocal license with this distributor who markets the product enhancements in conjunction with MFG/PRO software. This or other distributors or other persons may continue to independently develop a modified version of the Company's software. The Company seeks to protect its software, documentation and other written materials under the legal provisions relating to trade secret, copyright and contract law. The Company's license agreements generally allow the use of MFG/PRO software solely by the customer for internal purposes without the right to sublicense or transfer MFG/PRO software to third parties. The Company believes that the foregoing measures afford only limited protection. Despite the Company's efforts, it may be possible for third parties to copy certain portions of the Company's products or reverse engineer or obtain and use information that the Company regards as proprietary. In addition, the laws of certain countries do not protect the Company's proprietary rights to the same extent as do the laws of the United States. Accordingly, there can be no assurance that the Company will be able to protect its proprietary software against unauthorized third-party copying or use, which could adversely affect the Company's

competitive position. Policing unauthorized use of the Company's products is difficult, and while the Company is unable to determine the extent to which piracy of its software products exist, software piracy can be expected to be a problem. Furthermore, there can be no assurance that the Company's competitors will not independently develop technology similar to that of the Company.

The Company has in the past been subject to claims of intellectual property infringement and may increasingly be subject to such claims as the number of products and competitors in the Company's targeted vertical markets grows and the functionality of products in other industry segments overlaps. Although the Company is not aware that any of its products infringes upon the proprietary rights of third parties, there can be no assurance that third parties will not claim infringement by the Company with respect to current or future products. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company, or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition. The Company may also initiate claims or litigation against third parties for infringement of the Company's proprietary rights or to establish the validity of the Company's proprietary rights. Litigation to determine the validity of any claims could result in significant expense to the Company and divert the efforts of the Company's

technical and management personnel from productive tasks, whether or not such litigation were determined in favor of the Company.

The Company has in the past and may in the future resell certain software, which it licenses from third parties. In addition, the Company has in the past and may in the future jointly develop software in which the Company will have co-ownership or cross-licensing rights. There can be no assurance that these third-party software arrangements and licenses will continue to be available to the Company on terms that provide the Company with the third-party software it requires to provide adequate functionality in its products, on terms that adequately protect the Company's proprietary rights or on terms that are commercially favorable to the Company. The loss of or inability to maintain or obtain any of these software licenses, including as a result of third-party infringement claims, could result in delays or reductions in product shipments until equivalent software, if any, could be identified, licensed and integrated, which could materially and adversely affect the Company's business, operating results and financial condition. See "Business-Products" and "-Research and Development."

Risks Associated With International Operations

The Company derived approximately 44%, 42% and 39% of its total revenue from sales outside the United States in the years ended December 31, 1995, January 31, 1997 and January 31, 1998, respectively. Of the Company's approximately 3,600 licensed sites in more than 80 countries as of January 31, 1998, over 70% are outside the United States. The Company's engineering and research and development operations are located in the United States and Brazil and its sales and support operations are located in the United States and in 16 other countries. The Company also has more than 40 distributors and numerous partnerships and alliances worldwide. The geographic distance between these locations has in the past led, and could in the future lead, to logistical and communications difficulties. There can be no assurance that the geographic, time zone, language and cultural differences between the Company's international personnel and operations will not result in problems that materially adversely affect the Company's business, operating results and financial condition.

The Company expects to commit additional time and resources to expanding its worldwide sales and marketing activities, localizing its products for selected markets and developing local sales and support channels. There can be no assurance that such efforts

will be successful. Failure to sustain or increase international revenue could have a material adverse effect on the Company's business, operating results and financial condition. The Company may also experience an operating loss in one or more regions of the world for one or more periods. The Company's ability to manage such operational fluctuations and to maintain adequate long-term strategies in the face of such developments will be critical to the Company's continued growth and profitability. International operations are subject to a number of risks, including the

Costs of localizing products for different countries, longer accounts receivable collection periods and greater difficulty in accounts receivable collections in certain geographic regions, unexpected changes in regulatory requirements, changes in tax rates or applications, dependence on distributors and technology standards, import and export restrictions and tariffs, difficulties and costs of staffing and managing international operations, potentially adverse tax treatment and consequences, political instability, the burdens of complying with multiple, potentially conflicting laws and the impact of business cycles and economic instability. See "Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations" and "Business-Sales and Marketing."

Exposure to Currency Fluctuations

To date, the Company's revenue from international operations has primarily been denominated in United States dollars. The Company prices its products in United States dollars and over 90% of the Company's sales in the years ended December 31, 1995, January 31, 1997 and 1998, were denominated in United States dollars, with the remainder in ten different currencies. The Company expects that a growing percentage of its business will be conducted in currencies other than the United States dollar. The Company also incurs a significant portion of

its expenses in currencies other than the United States dollar, including a substantial portion of its general and administrative expenses. As a result, fluctuations in the values of the respective currencies relative to the other currencies in which the Company generates revenue could materially adversely affect its business, operating results and financial condition. While the Company may in the future change its pricing practices, an increase in the value of the United States dollar relative to foreign currencies could make the Company's products more expensive and, therefore, less competitive in other markets. Fluctuations in currencies relative to the United States dollar will affect period-to-period comparisons of the Company's reported results of operations. In the fiscal year ended January 31, 1998 and 1997, the Company recognized \$879,000 and \$407,000, respectively in foreign currency transaction gains, compared to losses of \$477,000 the fiscal year ended December 31, 1995. Due to the constantly changing currency exposures and the volatility of currency exchange rates, there can be no assurance that the Company will not experience currency losses in the future, nor can the Company predict the effect of exchange rate fluctuations upon future operating results. Although the Company does not currently undertake hedging transactions the Company may choose to hedge a portion of its currency exposure in the future as it deems appropriate. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Control by Principal Stockholders

As of January 31, 1998, Pamela and Karl Lopker jointly beneficially own approximately 65% of the Company's outstanding Common Stock. Current directors and executive officers as a group will own approximately 70% of the Common Stock. Consequently, the directors and executive officers, and the Lopkers in particular, will be able to control the outcome of all matters submitted for stockholder action, including the election of members to the Company's Board of Directors and the approval of significant change in control transactions, and will effectively control the management and affairs of the Company, which may have the effect of delaying or preventing a change in control of the Company. The Lopkers currently constitute two of the five directors and therefore have significant influence in directing the actions of the Board of Directors.

Product Liability

While the Company's license agreements with its customers typically contain provisions designed to limit the Company's exposure to potential product liability claims, it is possible that such limitation of liability provisions may not be effective under the laws of certain jurisdictions. Although the Company has not experienced any product liability claims to date, there can be no assurance that the Company will not be subject to such claims in the future. The Company has product liability insurance, but the Company currently does not have errors and omissions coverage, and there can be no assurance that such insurance will be available to the Company on commercially reasonable terms or at all. A successful product liability or errors or omissions claim brought against the Company could have a material adverse effect on the Company's business, operating results and financial condition. Moreover, defending such a suit, regardless of its merits, could entail substantial expense and require the time and attention of key management personnel, either of which could have a material adverse effect on the Company's business, operating results and financial condition.

Anti-Takeover Provisions

The Company's Certificate of Incorporation and Bylaws, contain certain provisions that may have the effect of discouraging, delaying or preventing a change in control of the Company or unsolicited acquisition proposals that a stockholder might consider favorable, including provisions which authorize the issuance of "blank check" preferred stock, provide for a Board of Directors with staggered three-year terms, require super-majority voting to effect certain amendments to the Certificate of Incorporation and Bylaws, limit the persons who may call special meetings of stockholders, and establish advance notice requirements for stockholder nominations for election to the Board of Directors or for stockholder proposals of business to be considered at stockholders meetings. Certain provisions of Delaware law may also have the effect of discouraging, delaying or preventing a change in control of the Company or unsolicited acquisition proposals.

Dividend Policy

The Company has never declared or paid any cash dividends on its capital stock and currently intends to retain any future earnings to fund the growth of the Company's business. The payment of any future dividends will be determined by the Board of Directors in light of conditions then existing, including the Company's results of operations, financial condition, cash requirements, restrictions in financing agreements, business conditions and other factors.

The Company is restricted by the terms of its outstanding debt and financing agreements from paying cash dividends on its Common Stock, and may in the future enter into loan or other agreements that restrict the payment of cash dividends on the Common Stock. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Liquidity and Capital Resources" and Note 4 of the Notes to Consolidated Financial Statements.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The response to this item is submitted as a separate section of this Form 10-K. See Item 14.

ITEM 9. CHANGE IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

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PART III.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information regarding the Directors of the Company is incorporated by reference to the section entitled "Election of Directors" appearing in the Registrant's Definitive Proxy Statement for the Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission (the "Commission") within 120 days after the end of the Company's fiscal year ended January 31, 1998. Certain information with respect to persons who are or may be deemed to be executive officers of the Registrant is set forth under the caption "Executive Officers of the Registrant" in Part I of this form 10-K.

ITEM 11. EXECUTIVE COMPENSATION

Information regarding executive compensation is incorporated by reference to the information set forth under the caption "Executive Compensation" in the Company's Definitive Proxy Statement for the Annual Meeting of Stockholders to be filed with Commission within 120 days after the end of the Company's fiscal year ended January 31, 1998.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information regarding security ownership of certain beneficial owners and management is incorporated by reference to the information set forth under the caption "Security Ownership of Certain Beneficial Owners and Management Ownership" in the Company's Definitive Proxy Statement for the Annual Meeting of Stockholders to be filed with the Commission within 120 days after the end of the Company's fiscal year ended January 31, 1998.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions are incorporated by reference to the information set forth under the caption "Certain Transactions" in the Company's Definitive Proxy Statement for the Annual Meeting of Stockholders to be filed with the Commission within 120 days after the end of the Company's fiscal year ended January 31, 1998.

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PART IV.

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(A) 1. FINANCIAL STATEMENTS

The following financial statements are filed as a part of this form 10-K:

QAD Inc.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page -----
Independent Auditors' Report.....	F-1
Consolidated Balance Sheets as of January 31, 1998 and 1997.....	F-2
Consolidated Statements of Income for the years ended January 31 1998 and 1997, the one month ended January 31, 1996 and the year ended December 31 1995.....	F-3
Consolidated Statement of Stockholders' Equity for the years ended January 31, 1998 and 1997, the one month ended January 31, 1996 and the year ended December 31 1995.....	F-4
Consolidated Statements of Cash Flows for the years ended January 31, 1998 and 1997, the one month ended January 31, 1996 and the year ended December 31, 1995.....	F-5
Notes to Consolidated Financial Statements.....	F-6

(A) 2. FINANCIAL STATEMENT SCHEDULES

The following financial statement schedule is filed as a part of this report:

II. Valuation and Qualifying Accounts.....	S-1
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All other schedules are omitted because they are not required or the required information is shown in the financial statements or notes thereto.

(A) 3. EXHIBITS

The following exhibits are filed herewith or are incorporated by reference to exhibits previously filed with the Commission. The Company shall furnish copies of exhibits for a reasonable fee (covering the expense of furnishing copies) upon request.

EXHIBIT NUMBER	EXHIBIT TITLE
3.1	Certificate of Incorporation of the Registrant, filed with the Delaware Secretary of State on May 15, 1997*
3.2	Certificate of Amendment of Certificate of Inspection of the Registrant, filed with the Delaware Secretary of State on June 19, 1997*
3.9	Bylaws of the Registrant*
4.1	Specimen Stock Certificate*
10.1	QAD Inc. 1994 Stock Ownership Program*
10.2	QAD Inc. 1997 Stock Incentive Program*
10.3	Form of Indemnification Agreement with Directors and Executive Officers*
10.4	Loan and Security Agreement between Greyrock Business Credit, a Division of Nations Credit Commercial Corporation ("GBC") and the Registrant dated July 3, 1996*

10.5	Schedule to Loan Agreement between GBC and the Registrant dated July 3, 1996*
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- 10.6 Letter Agreement between the Registrant and GBC dated July 3, 1996*
- 10.7 Letter Agreement between the Registrant and GBC dated July 5, 1996*
- 10.8 Letter Agreement between the Registrant and GBC dated July 5, 1996*
- 10.9 Secured Promissory Note in the original principal amount of \$4,000,000 made by the Registrant to the order of GBC dated July 3, 1996*
- 10.10 Trademark Security Agreement between GBC and the Registrant dated July 3, 1996*
- 10.11 Security Agreement in Copyrighted Works executed by the Registrant in favor of GBC dated July 3, 1996*
- 10.12 Deed of Trust with respect to real property located in Santa Barbara County, California executed by the Registrant in favor of GBC dated July 3, 1996*
- 10.13 Employment Offer Letter between the Registrant and Dennis R. Raney dated January 15, 1997*
- 10.14 Master License Agreement between the Registrant and Progress Software Corporation dated June 30, 1995*+
- 10.15 Lease Agreement between the Registrant and Matco Enterprises, Inc. for Suites I, K and L located at 5464 Carpinteria Ave., Carpinteria, California dated November 30, 1992*
- 10.16 First Amendment to Office Lease between the Registrant and Matco Enterprises, Inc. for Suites C and H located at 5464 Carpinteria Ave., Carpinteria, California dated September 9, 1993*
- 10.17 Second Amendment to Office Lease between the Registrant and Matco Enterprises, Inc. for Suite J located at 5464 Carpinteria Ave., Carpinteria, California dated January 14, 1994*
- 10.18 Third Amendment to Office Lease between the Registrant and Matco Enterprises, Inc. for Suites B and C located at 5464 Carpinteria Ave., Carpinteria, California dated January 14, 1994*
- 10.19 Fourth Amendment to Office Lease between the Registrant and Matco Enterprises, Inc. for Suite H located at 5464 Carpinteria Ave., Carpinteria, California dated February 15, 1994*
- 10.20 Fifth Amendment to Office Lease between the Registrant and Matco Enterprises, Inc. for Suites G and E located at 5464 Carpinteria Ave., Carpinteria, California dated September 12, 1994*
- 10.21 Sixth Amendment to Office Lease between the Registrant and Matco Enterprises, Inc. for Suites A, B, D, F and H, and Room A located at 5464 Carpinteria Ave., Carpinteria, California dated October 30, 1996*
- 10.22 Lease Agreement between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 3 through 8 located at 6430 Via Real, Carpinteria, California dated November 30, 1993*
- 10.23 Addendum to Lease between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 3 through 8 located at 6430 Via Real, Carpinteria, California dated November 30, 1993*
- 10.24 Lease Agreement between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for 6450 Via Real, Carpinteria, California dated November 30, 1993*
- 10.25 Addendum to Lease between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for 6450 Via Real, Carpinteria, California dated November 30, 1993*
- 10.26 Lease Agreement between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 1 through 5 located at 6460 Via Real, Carpinteria, California dated November 30, 1993*
- 10.27 Addendum to Lease between the Registrant and William D. and Edna J.

Wright dba South Coast Business Park for Suites 1 through 5 located at 6460 Via Real, Carpinteria, California dated November 30, 1993*

10.28 Lease Agreement between the Registrant and William D. and Edna J. Wright dba

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South Coast Business Park for Suites 7 and 8 located at 6440 Via Real, Carpinteria, California dated September 8, 1995*

10.29 Addendum to Lease between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 7 and 8 located at 6440 Via Real, Carpinteria, California dated September 8, 1995*

10.30 Lease Agreement between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 9 and 10 located at 6440 Via Real, Carpinteria, California dated September 8, 1995*

10.31 Addendum to Lease between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 9 and 10 located at 6440 Via Real, Carpinteria, California dated September 8, 1995*

10.32 Lease Agreement between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 1 and 2 located at 6430 Via Real, Carpinteria, California dated September 8, 1995*

10.33 Addendum to Lease between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 1 and 2 located at 6430 Via Real, Carpinteria, California dated September 8, 1995*

10.34 Lease Agreement between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 1 through 7 and 10 located at 6420 Via Real, Carpinteria, California dated January 27, 1997*

10.35 Addendum to Lease between the Registrant and William D. and Edna J. Wright dba South Coast Business Park for Suites 1 through 7 and 10 located at 6420 Via Real, Carpinteria, California dated January 27, 1997*

10.36 Multi-Tenant Office Lease Agreement between the Registrant and EDB Property Partners, LP III, successor to Laurel Larchmont Office, Inc. located at 10,000 Midlantic Drive, Mt. Laurel, New Jersey dated December 29, 1993*

10.37 Amendment to Multi-Tenant Office Lease Agreement between the Registrant and EDB Property Partners, LP III, successor to Laurel Larchmont Office, Inc. located at 10,000 Midlantic Drive, Mt. Laurel, New Jersey dated April 26, 1994*

10.38 Second Amendment to Multi-Tenant Lease Agreement between the Registrant and EDB Property Partners, LP III, dated May 30, 1995*

10.39 Third Amendment to Multi-Tenant Lease Agreement between the Registrant and EDB Property Partners L.P. I dated November 30, 1995*

10.40 Agreement and Plan of Merger between QAD California and the Registrant dated July 8, 1997*

10.41 Credit Agreement dated as of August 4, 1997 between the Registrant and Bank of America National Trust and Savings Association

10.42 Standard Industrial Commercial Multi-Tenant Lease--Modified Net dated as of December 29, 1997 between the Registrant and CITO Corp.

21.1 Subsidiaries of the Registrant*

23.1 Consent of KPMG Peat Marwick LLP and opinion on Schedule II

27.1 Financial Data Schedule

- (*) Incorporated by reference to the Registrant's Registration Statement in Form S-1 (Commission File No. 333-28441).
- (+) Certain portions of exhibit have been omitted based upon a request for confidential treatment. The omitted portions have been separately filed with the Securities and Exchange Commission.

(B) REPORTS ON FORM 8-K

No reports on Form 8-K were filed during the fourth quarter of the fiscal year ended January 31, 1998.

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INDEPENDENT AUDITORS' REPORT

The Board of Directors
QAD Inc.:

We have audited the accompanying consolidated balance sheets of QAD Inc. and subsidiaries as of January 31, 1997 and 1998 and the related consolidated statements of income, stockholders' equity and cash flows for the year ended December 31, 1995, the one month ended January 31, 1996 and the years ended January 31, 1997 and 1998. 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 QAD Inc. and subsidiaries as of January 31, 1997 and 1998 and the results of their operations and their cash flows for the year ended December 31, 1995, the one month ended January 31, 1996 and the years ended January 31, 1997 and 1998 in conformity with generally accepted accounting principles.

KPMG PEAT MARWICK LLP

Los Angeles, California
April 24, 1998

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QAD Inc.
Consolidated Balance Sheets
(in thousands, except for number of shares)

	January 31, 1997	January 31, 1998
Assets		
Current assets:		
Cash and cash equivalents	\$ 301	\$ 70,082
Trade accounts receivable, net of allowances of \$3,694 and \$5,510 at January 31, 1997 and 1998, respectively	46,745	75,683
Deferred income taxes	4,816	1,858
Other current assets	2,112	8,584
Total current assets	53,974	156,207
Property and equipment, net	18,071	25,717
Other assets, net	3,051	6,402
Deferred income taxes	2,154	2,180
Total assets	\$ 77,250	\$ 190,506

Liabilities and Stockholders' Equity		
Current liabilities:		
Notes payable and current installments of long-term debt	\$ 8,465	\$ 143
Accounts payable	9,403	12,778
Accrued expenses	12,739	18,110
Income taxes payable	741	2,282
Deferred revenue and deposits	28,602	43,636
Total current liabilities	59,950	76,949
Long-term debt, less current installments	5,036	39
Deferred revenue - non-current	991	424
Other deferred liabilities	379	708
Minority interest	90	11
Stockholders' equity:		
Preferred stock, Authorized 5,000,000 shares; none issued and outstanding	--	--
Common stock, no par value. Authorized 150,000,000 shares; issued and outstanding 22,218,572 shares and 29,096,269 shares at January 31, 1997 and 1998, respectively	5,942	97,238
Retained earnings	7,539	17,395
Receivable from stockholders	(197)	(397)
Unearned compensation-restricted stock	(2,129)	(1,510)
Cumulative foreign currency translation adjustment	(351)	(351)
Total stockholders' equity	10,804	112,375
Total liabilities and stockholders' equity	\$ 77,250	\$ 190,506

See accompanying notes to consolidated financial statements.

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QAD Inc.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except for share data)

	Year Ended December 31, 1995	One Month Ended January 31, 1996	Year Ended January 31, 1997	Year Ended January 31, 1998
Revenue:				
License fees	\$ 63,756	\$ 993	\$ 85,753	\$ 113,447
Maintenance and other	26,193	2,479	40,691	58,787
Total revenues	89,949	3,472	126,444	172,234
Cost and expenses:				
Cost of revenues	23,599	1,649	29,158	41,551
Sales and marketing	38,341	3,294	53,194	67,249
Research and development	17,037	1,547	25,434	29,317
General and administrative	13,618	856	15,938	19,422
Total cost and expenses	92,595	7,346	123,724	157,539
Operating income (loss)	(2,646)	(3,874)	2,720	14,695
Other (income) expense:				
Interest income	(38)	--	(49)	(1,785)
Interest expense	825	126	1,654	1,064
Other	48	(61)	(608)	(1,599)
Total other (income) expense	835	65	997	(2,320)
Income (loss) before income taxes	(3,481)	(3,939)	1,723	17,015
Income tax expense (benefit)	(2,795)	(1,078)	723	7,159
Net income (loss)	\$ (686)	\$ (2,861)	\$ 1,000	\$ 9,856
Basic net income (loss) per share	\$ (0.03)	\$ (0.13)	\$ 0.05	\$ 0.38
Diluted net income (loss) per share	\$ (0.03)	\$ (0.13)	\$ 0.04	\$ 0.38

See accompanying notes to consolidated financial statements.

QAD Inc.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

Year ended December 31, 1995, one month ended January 31, 1996
and years ended January 31, 1997 and 1998
(in thousands, except for number of shares)

	Common Stock		Retained Earnings	Receivable from Stockholders	Restricted Stock	
	Shares	Amount			Shares	Amount
Balance, December 31, 1994	20,804,858	\$ 1,805	\$ 10,086	--	--	--
Common Stock Issued:						
Under stock purchase plan	250,750	601	--	--	--	--
Under stock options	1,024,000	74	--	--	--	--
Pursuant to performance awards	148,514	336	--	--	--	--
Common stock repurchases	(1,262,370)	(624)	--	--	--	--
Receivable from stockholders	--	--	--	(151)	--	--
Translation adjustments	--	--	--	--	--	--
Net loss	--	--	(686)	--	--	--
Balance, December 31, 1995	20,965,752	2,192	9,400	(151)	--	--
Common Stock Issued:						
Pursuant to performance awards	23,722	57	--	--	--	--
Common stock repurchases	(10,720)	(26)	--	--	--	--
Translation adjustments	--	--	--	--	--	--
Net loss	--	--	(2,861)	--	--	--
Balance, January 31, 1996	20,978,754	2,223	6,539	(151)	--	--
Common Stock Issued:						
Under stock purchase plan	793,438	1,411	--	--	--	--
Under stock options	105,000	185	--	--	--	--
Pursuant to performance awards	108,062	256	--	--	--	--
Pursuant to restricted stock awards	559,066	2,584	--	--	(559,066)	(2,584)
Common stock earned under restricted stock awards	--	--	--	--	149,954	455
Common stock repurchases	(325,748)	(717)	--	--	--	--
Receivable from stockholders	--	--	--	(46)	--	--
Translation adjustments	--	--	--	--	--	--
Net income	--	--	1,000	--	--	--
Balance, January 31, 1997	22,218,572	5,942	7,539	(197)	(409,112)	(2,129)

	Cumulative Translation Adjustment	Total Stockholders Equity
Balance, December 31, 1994	\$ 102	\$ 11,993
Common Stock Issued:		
Under stock purchase plan	--	601
Under stock options	--	74
Pursuant to performance awards	--	336
Common stock repurchases	--	(624)
Receivable from stockholders	--	(151)
Translation adjustments	189	189
Net loss	--	(686)
Balance, December 31, 1995	291	11,732
Common Stock Issued:		

Pursuant to performance awards	--	57
Common stock repurchases	--	(26)
Translation adjustments	121	121
Net loss	--	(2,861)
	-----	-----
Balance, January 31, 1996	412	9,023
Common Stock Issued:		
Under stock purchase plan	--	1,411
Under stock options	--	185
Pursuant to performance awards	--	256
Pursuant to restricted stock awards	--	--
Common stock earned under restricted stock awards	--	455
Common stock repurchases	--	(717)
Receivable from stockholders	--	(46)
Translation adjustments	(763)	(763)
Net income	--	1,000
	-----	-----
Balance, January 31, 1997	(351)	10,804

(Continued)

	Common Stock		Retained Earnings	Receivable from Stockholders	Restricted Stock	
	Shares	Amount			Shares	Amount
	-----	-----	-----	-----	-----	-----
Common Stock Issued:						
Under initial public offering (net of offering costs)	6,612,500	90,516	--	--	--	--
Under stock purchase and incentive plan	251,129	2,413	--	--	--	--
Under stock options	299,000	709	--	--	--	--
Pursuant to performance awards	50,060	431	--	--	--	--
Pursuant to restricted stock awards	20,400	194,000	--	--	(20,400)	(194,000)
Common stock earned under restricted stock awards	1,536	--	--	--	208,296	663
Tax benefit associated with stock option exercise	--	523	--	--	--	--
Common stock repurchases	(334,528)	(3,340)	--	--	--	--
Restricted stock awards cancelled	(22,400)	(150,000)	--	--	22,400	150,000
Receivable from stockholders	--	--	--	(200)	--	--
Net income	--	--	9,856	--	--	--
	=====	=====	=====	=====	=====	=====
Balance, January 31, 1998	29,096,269	\$ 97,238	\$ 17,395	\$ (397)	(198,816)	\$ (1,510)

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	Cumulative Translation Adjustment	Total Stockholders Equity
	-----	-----
Common Stock Issued:		
Under initial public offering (net of offering costs)	--	90,516
Under stock purchase and incentive plan	--	2,413

Under stock options	--	709
Pursuant to performance awards	--	431
Pursuant to restricted stock awards	--	--
Common stock earned under restricted stock awards	--	663
Tax benefit associated with stock option exercise	--	523
Common stock repurchases	--	(3,340)
Restricted stock awards cancelled	--	--
Receivable from stockholders	--	(200)
Net income	--	9,856
	=====	=====
Balance, January 31, 1998	\$ (351)	\$ 112,375
	=====	=====

See accompanying notes to consolidated financial statements.

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QAD Inc.

Consolidated Statements of Cash Flows
(in thousands)

	Year Ended December 31, 1995	One Month Ended January 31, 1996	Year Ended January 31, 1997	Year Ended January 31, 1998
	-----	-----	-----	-----
Cash flows from operating activities:				
Net income (loss)	\$ (686)	\$ (2,861)	\$ 1,000	\$ 9,856
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation and amortization	4,346	390	5,345	6,921
Provision for doubtful accounts and sales returns	945	(25)	3,432	4,370
Loss on disposal of equipment	--	--	25	82
Minority interest	--	106	(16)	(79)
Compensation expense pursuant to stock repurchase	2,408	--	--	--
Compensation expense pursuant to stock awards	336	57	1,044	1,361
Changes in assets and liabilities:				
(Increase) decrease in assets:				
Trade accounts receivable	(15,103)	5,444	(14,941)	(33,508)
Income tax receivable	(231)	231	--	--
Deferred income taxes	(3,780)	(1,781)	(1,398)	2,932
Other assets	(1,929)	(15)	(2,408)	(7,962)
Increase (decrease) in liabilities:				
Accounts payable	6,283	(2,816)	2,991	3,375
Accrued expenses	2,236	(607)	4,137	5,577
Income taxes payable	(1,192)	288	453	2,174
Deferred revenue and deposits	10,459	539	7,708	14,467
Other deferred liabilities	--	--	46	62
Net cash provided by (used in) operating activities	4,092	(1,050)	7,418	9,628
Cash flows from investing activities:				
Additions to land and buildings	(2,341)	(206)	(435)	(281)
Purchase of property and equipment	(7,243)	(735)	(3,008)	(13,280)
Investment in equity securities	--	--	--	(3,000)
Proceeds from disposition of property and equipment	117	--	83	51
Net cash used in investing activities	(9,467)	(941)	(3,360)	(16,510)
Cash flows from financing activities:				
Proceeds from notes payable and long-term debt	24,654	4,254	84,841	9,648
Reduction of notes payable and long-term debt	(19,555)	(2,414)	(90,131)	(22,967)
Proceeds from initial public offering	--	--	--	90,516
Issuance of common stock for cash	675	--	1,596	2,474
Repurchase of common stock	(624)	(26)	(717)	(2,692)
Receivable from stockholders	(151)	--	(46)	(200)
Net cash provided by (used in) financing activities	4,999	1,814	(4,457)	76,779
Effect of exchange rate changes on cash and cash equivalents	189	121	(763)	(116)
Net increase (decrease) in cash and cash equivalents	(187)	(56)	(1,162)	69,781
Cash and cash equivalents at beginning of period	1,706	1,519	1,463	301
Cash and cash equivalents at end of period	\$ 1,519	\$ 1,463	\$ 301	\$ 70,082
	=====	=====	=====	=====

Supplemental disclosure of cash flow information:
Cash paid during the period for:

Interest	\$	824	\$	99	\$	1,553	\$	892
Income taxes	\$	1,087	\$	6	\$	707	\$	1,179

Supplemental disclosure of non-cash investing and financing activities:

During the year ended December 31, 1995, one month ended January 31, 1996 and years ended January 31, 1997 and 1998, the Company acquired property and equipment under capital lease obligations aggregating \$1,081,000, \$79,000, \$97,000 and \$0.

During the year ended December 31, 1995, the Company issued a note payable in the amount of \$2,407,788 in connection with the repurchase of common shares.

See accompanying notes to consolidated financial statements.

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QAD Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The Company

The Company is a provider of Enterprise Resource Planning software for multinational and other large manufacturing companies. The Company's software solutions are designed to facilitate global management of resources and information to allow manufacturers to reduce order fulfillment cycle times and inventories, improve operating efficiencies and measure critical company performance criteria against defined business plan objectives. The flexibility of the Company's products also helps manufacturers adapt to growth, organizational change, business process reengineering, supply chain management and other challenges.

Effective February 1, 1996, the Company determined that it would change its reporting period from years ending December 31 to fiscal years ending January 31. Accordingly, the accompanying statements of income, stockholders' equity and cash flows include results for the one-month transition period ending January 31, 1996.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of QAD Inc. and its majority-owned subsidiaries. The Company also has various branch offices worldwide. All significant intercompany accounts and transactions have been eliminated in consolidation.

Concentrations of Credit Risk

Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers comprising the Company's customer base, and their dispersion across many different industries and geographic locations throughout the world. At January 31, 1997, one customer had an outstanding receivable that constituted 12% of the Company's net trade accounts receivable. There were no other concentrations of such credit risk for the periods presented.

Use of Estimates

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents

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Revenue Recognition

The Company's principal source of software license fee revenue is derived from licensing MFG/PRO software. Revenues from maintenance and other activities are generated from maintenance support services, training and consulting and are billed separately from license revenues. Revenues from software license agreements, including licenses sold through distributors, are recognized at the time of shipment, net of any applicable distributor discount, provided there are no remaining significant obligations to be fulfilled by the Company and collectibility is probable. Where distributors have reproduction rights, revenue is recognized upon notification of shipment by the distributor. Typically, the Company's software licenses do not include significant vendor obligations. Where license contracts call for payment terms in excess of 12 months from date of shipment, revenue is recognized as payments become due. Maintenance revenues for ongoing customer support and product updates are recognized ratably over the term of the maintenance period, which is generally 12 months. Training and consulting revenues are recognized as the services are performed. Returns and allowances are estimated and provided for in the period of sale.

Revenue on all sales in which there are outstanding obligations to provide resources over a period of time, as a component of the sale, is deferred and recognized as services are provided on a percentage of completion basis. At December 31, 1995, January 31, 1997 and 1998, \$2,261,000, \$811,000 and \$1,449,000, respectively, of revenue, net of related expenses, had been deferred until future periods for recognition as services are provided. Further, the Company recognizes revenue consistent with customer payment terms on all sales where extended payment terms beyond one year are granted. At January 31, 1997 and 1998, sales contracts totaling \$4,259,000 and \$1,256,000, respectively having payment terms through January 31, 2000 were deferred, to be recognized as payments become due.

Depreciation and Amortization

Depreciation of property and equipment is provided on the straight-line method over the estimated useful lives of the related assets. Asset lives range from three to seven years. Leasehold improvements are amortized on a straight-line basis over the term of the lease or the life of the related improvements, whichever is shorter.

Computer Software Costs

Pursuant to Statement of SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," issued by the Financial Accounting Standards Board, the Company capitalizes software development costs incurred in connection with the localization and translation of its products once technological feasibility has been achieved. Capitalized development costs are amortized on a straight-line basis over three years and charged to cost of revenues. All other development costs are expensed to research and development as incurred.

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Accrued Expenses

Accrued expenses are as follows:

	January 31, 1997	January 31, 1998
	-----	-----
Accrued payroll	\$ 7,538	\$ 9,268
Accrued other	5,201	8,842
	-----	-----
	\$ 12,739	\$ 18,110
	=====	=====

Income Taxes

The Company provides for income taxes under SFAS No. 109, "Accounting for Income Taxes," which employs an asset and liability approach in accounting for income taxes payable or refundable at the date of the financial statements as a result of all events that have been recognized in the financial statements and as measured by the provisions of enacted laws. See Note 6.

Computation of Net Income (Loss) Per Share

In February 1997, the SFAS No. 128, Earnings Per Share. SFAS No. 128 specifies new standards designed to improve the earnings per share ("EPS") information provided in financial statements by simplifying the existing computational guidelines, revising the disclosure requirements and increasing the comparability of EPS data on an international basis. Some of the changes made to simplify the EPS computations include: (a) eliminating the presentation of primary EPS and replacing it with basic EPS, with the principal difference being that common stock equivalents are not considered in computing basic EPS, (b) eliminating the modified treasury stock method and the three percent materiality provision and (c) revising the contingent share provision and the supplemental EPS data requirements. SFAS No. 128 also makes a number of changes to existing disclosure requirements. SFAS No. 128 is effective for financial statements issued for periods ending after December 15, 1997, including interim periods. All prior period information has been restated to conform with the provisions of the SFAS No. 128.

Net income (loss) per share has been computed using the weighted average number of shares of common stock and common stock equivalents outstanding using the treasury-stock method summarized as follows:

	Year Ended	One Month Ended	Year Ended	Year Ended
	December 31, 1995	January 31, 1996	January 31, 1997	January 31, 1998
Weighted average shares of common stock outstanding used in basic income (loss) per share calculation	21,100,000	21,230,000	21,931,000	25,701,000
Weighted average shares of common stock equivalents issued using the treasury stock method	--	--	1,083,000	582,000
Weighted average shares of common stock and common stock equivalents outstanding used in diluted income (loss) per share calculation ..	21,100,000	21,230,000	23,014,000	26,283,000

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Net income (loss) for basic and diluted calculation is the same in each respective period. Shares of common stock equivalents issued using the treasury stock method of 2,177,000 and 1,244,000 for the year ended December 31, 1995 and one month ended January 31, 1996, respectively were not included in the diluted calculation because they were anti-dilutive.

Foreign Currency Translation

Foreign currency translation adjustments are accumulated as a separate component of stockholders' equity. Revenues, costs and expenses are translated at average rates for each month. (Gains) and losses from foreign currency transactions are reflected in net earnings in the year incurred, classified as "other income expense," and totaled approximately \$477,000, \$(34,000), \$(407,000) and \$(879,000) for the year ended December 31, 1995, one month period ended January 31, 1996 and years ended January 31, 1997 and 1998, respectively.

Fair Value of Financial Instruments

The carrying amounts of the following financial instruments approximate fair value because of the short maturity of those instruments: cash and cash equivalents, accounts receivable, accounts payable and accrued expenses.

The carrying value of the Company's obligations under capital leases, notes

payable and long-term debt approximates fair value and was estimated by discounting the future cash flows of the capital leases, notes payable and long-term debt at rates currently offered to the Company for similar capital leases, notes payable and long-term debt of comparable maturities by the Company's bankers.

Long-Lived Assets

The Company has adopted the provisions of SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset 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 undiscounted operating 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 exceeds the fair value of the assets.

Accounting for Stock Options

Prior to January 1, 1996, the Company accounted for its stock option grants in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. On January 1, 1996, the Company adopted SFAS No. 123, "Accounting for Stock-Based Compensation," which permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No. 123 also allows entities to continue to apply the provisions of APB Opinion No. 25 and provide pro forma net income and pro forma earnings per share disclosures for employee stock option grants made in the year ended December 31, 1995 and future years as if the fair value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of

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APB Opinion No. 25 and provide the pro forma disclosure provisions of SFAS No. 123 (see Note 10).

Effect of Recent Accounting Pronouncements

In October 1997, the American Institute of Certified Public Accountants issued Statement of Position 97-2: Software Revenue Recognition (SOP 97-2) which is effective for software transactions entered into in fiscal years beginning after December 15, 1997. The Company is currently evaluating the effect of this new statement.

The Financial Accounting Standards Board has issued SFAS No. 130 Reporting Comprehensive Income and SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information. SFAS No. 130 will affect the disclosure requirements for the first quarter of the year ended January 31, 1999 financial statements. SFAS No. 131 will affect the disclosure requirements for the year ended January 31, 1999 annual financial statements. The Company is currently evaluating the effect of these new statements.

Reclassifications

Certain prior year balances have been reclassified to conform to current year presentation.

2. Property and Equipment

Property and equipment is summarized as follows (in thousands):

January 31, 1997	January 31, 1998
-----	-----

Land and buildings	\$	8,802	\$	9,082
Automobiles		71		123
Computer equipment and software		12,306		23,479
Furniture and office equipment		6,160		7,654
Leasehold improvements		1,032		1,868
Equipment under capital lease		1,921		353
		-----		-----
		30,292		42,559
Less accumulated depreciation and amortization, which includes \$1,217 and \$469 for January 31, 1997 and January 31, 1998 respectively, for equipment under capital leases		(12,221)		(16,842)
		-----		-----
Net property and equipment	\$	18,071	\$	25,717
		=====		=====

Included in land and buildings is capitalized interest aggregating \$329,000 as of January 31, 1997 and 1998.

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3. Other Assets

Other assets at January 31, 1997 and 1998 include capitalized software development costs of \$1,065,000 and \$2,416,000 (net of \$2,341,000 and \$3,034,000 of accumulated amortization), respectively. Amortization of these costs totaled \$694,000, \$61,000, \$671,000 and \$693,000 during the year ended December 31, 1995, one month ended January 31, 1996, and years ended January 31, 1997 and 1998, respectively. Amortization costs are included in cost of revenues. Software development costs incurred prior to achieving technological feasibility are expensed as incurred as research and development. Such costs aggregated \$17,037,000, \$1,547,000, \$25,434,000 and \$29,317,000 for the year ended December 31, 1995, one month ended January 31, 1996, and years ended January 31, 1997 and 1998, respectively.

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4. Notes Payable and Long-Term Debt

Notes payable and long-term debt are summarized as follows (in thousands):

	January 31, 1997	January 31, 1998
	-----	-----
Advances under a \$16,000,000 revolving credit agreement with a bank, secured by substantially all assets and guarantees of certain stockholders, bearing interest at the highest LIBOR for the period (5.49% at January 31, 1997) plus 4.875% per annum, expiring July 1997	\$ 4,349	\$ --
Term notes payable, secured by property and equipment, payable in monthly installments ranging from \$6,276 to \$41,667, at interest rates ranging from 8.29% to 10.365% per annum, expiring from June 1997 to December 1999, repaid in 1998	5,258	--
Note payable under term portion of credit agreement, secured by real estate, principal payable commencing August 1996 in monthly installments of \$66,666 plus interest at the highest LIBOR during the month (5.49% at January 31, 1997) plus 4.875% per annum (to be no less than 8% per annum), through July 2001, repaid in 1998	3,600	--
Note payable, secured by leasehold improvements, payable in monthly installments of \$681 through February 1998	9	1
Capital lease obligations	285	181
	-----	-----
	13,501	182
Less current installments	(8,465)	(143)
	-----	-----
	\$ 5,036	\$ 39
	=====	=====

At January 31, 1998, future minimum principal payments of notes payable and long-term debt are as follows (in thousands):

Year ending January 31:

1999	\$	143
2000		39

	\$	182
	=====	

Subsequent to the initial public offering the Company entered into a revolving credit agreement with Bank of America National Trust and Savings Association ("Bank"), which expires on August 4, 1999. The maximum available amount of borrowings under the revolving credit agreement is equal to \$20 million, unless there is a voluntary termination or reduction of commitment by the Company. The total amount of available borrowings under the revolving credit agreement at January 31, 1998 was approximately \$20 million. Borrowings under the revolving credit agreement bear interest at a rate per annum equal to the Offshore Rate plus the Applicable Margin or the Base Rate plus the Applicable Margin. The Applicable Margin means, with respect to Base Rate Loans, 0%, and with respect to Offshore Rate Loans, 1.25% when 50% or less of the Commitment is being utilized, and 1.50% when more than 50% of the Commitment is being utilized. The Company pays a commitment fee on the average unused portion of the Commitment to the Bank, equal to one-half of one percent (.50%) per annum.

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5. Deferred Revenue

The Company bills for ongoing maintenance and post-sale customer support separately from sales of products and records such amounts as deferred revenue when billed. Deferred revenue aggregated \$29,125,000 and \$43,226,000 at January 31, 1997 and 1998, respectively. Revenue under maintenance contracts is recognized ratably over the term of the contract, which is typically 12 months.

6. Income Taxes

Components of income tax expense (benefit) are as follows (in thousands):

	Year Ended December 31, 1995	One Month Ended January 31, 1996	Year Ended	
			January 31, 1997	January 31, 1998
	-----	-----	-----	-----
Current:				
Federal	\$ 371	\$ (1,402)	\$ 881	\$ 1,675
State	110	(203)	(63)	197
Foreign	503	890	227	2,421
Total	984	(715)	1,045	4,293
Deferred:				
Federal	(1,946)	80	(94)	2,449
State	(290)	9	(10)	(573)
Foreign	(1,543)	(452)	(218)	990
Total	(3,779)	(363)	(322)	2,866
	\$ (2,795)	\$ (1,078)	\$ 723	\$ 7,159
	=====	=====	=====	=====

SFAS No. 109 requires companies to record deferred tax assets for the benefit to be derived from deductible temporary differences, net of appropriate valuation reserves to reflect management estimates of realizability of such deferred tax assets. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands):

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	January 31, 1997	January 31, 1998
	-----	-----
Deferred tax assets:		
Allowance for bad debts	\$ 1,387	\$ 1,999
Accrued vacation	524	751
Accrued commission	--	267

Alternative minimum tax	98	98
Research and development credits	1,217	1,149
Foreign tax credits	778	320
Stock awards/discounts	--	266
Long term contract	328	--
Net operating loss carry forwards	5,054	2,417
Other	34	213
	-----	-----
	9,420	7,480
Less valuation allowance	(2,081)	(1,814)
	-----	-----
Net deferred tax assets	7,339	5,666
Less current portion	(5,288)	(2,719)
	-----	-----
Long-term net deferred tax assets (net of \$2,081 and \$1,814 valuation allowance, respectively)	2,051	2,947
	-----	-----
Deferred tax liabilities:		
Capitalized translation and research and development costs	355	1,056
State income taxes	119	(68)
Other	(2)	195
Mark to market	--	807
Depreciation and amortization	(103)	(362)
	-----	-----
	369	1,628
Less current portion	(472)	(861)
	-----	-----
Long-term net deferred tax liabilities	\$ (103)	\$ 767
	=====	=====

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

For U.S. tax purposes, management has determined that the realization of recorded deferred tax assets arising in the United States is reasonably assured, and accordingly, no valuation allowance has been recorded on such items. With available tax planning strategies and projections of future income over the periods in which the foreign deferred tax assets are deductible, management believes it is more likely than not that the Company will realize a portion of the benefits of these deductible differences on tax returns filed in foreign jurisdictions. The Company's net operating loss carryforward benefits aggregating \$5.1 million and \$2.4 million at January 31, 1997 and 1998, respectively arise principally from losses incurred by foreign subsidiaries and expire commencing in 2001.

The Company's net operating loss carryforward benefits aggregating \$5.1 million and \$2.4 million at January 31, 1997 and 1998, respectively arise principally from losses incurred by foreign subsidiaries and expire commencing in 2001.

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At January 31, 1997 and 1998, the valuation allowance attributable to deferred tax assets was \$2,081,000 and \$1,814,000, respectively, an overall decrease of \$267,000.

Actual income tax expense (benefit) differs from that obtained by applying the statutory Federal income tax rate to earnings (loss) before income taxes as follows (in thousands):

	Year Ended December 31, 1995	One Month Ended January 31, 1996	Year Ended ----- January 31, 1997 January 31, 1998 -----	
Computed expected tax expense (benefit)	\$ (1,183)	\$ (1,339)	\$ 586	\$ 5,968
State income taxes, net of Federal income tax benefit	(209)	(236)	103	815
Incremental tax expense from foreign operations	--	649	117	203
Alternative minimum tax ("AMT")	182	--	--	--

Net change in deferred tax assets and liabilities	(1,856)	(87)	918	(267)
Meals and entertainment	279	9	286	325
Foreign sales corporation	1,341	--	(539)	--
Research, AMT and foreign tax credits	(1,386)	(174)	(1,082)	(1,135)
Foreign dividends	--	--	--	541
Reduction of research and development credits and foreign tax credits previously recorded	--	94	350	600
Other	37	6	(16)	109
	<u>\$ (2,795)</u>	<u>\$ (1,078)</u>	<u>\$ 723</u>	<u>\$ 7,159</u>

7. 401(k) Plan

The Company has a defined contribution 401(k) plan, which is available to U.S. employees after 30 days of employment. Employees may contribute up to the maximum allowable by the Internal Revenue Code. The Company may make additional contributions at the discretion of the Board of Directors. Participants are immediately vested in their employee contributions. Employer contributions vest over a five-year period. The employer contributions for the years ended December 31, 1995, January 31, 1997 and 1998 were \$101,000, \$422,000 and \$371,000, respectively, which are included in general and administrative expenses in the accompanying consolidated statements of income.

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8. Commitments and Contingencies

The Company finances equipment under capital leases and leases office facilities under operating lease agreements expiring through 2004. The present value of future minimum capital lease payments and future minimum lease payments under non-cancelable operating leases are as follows (in thousands):

	Capital	Operating Leases
	-----	-----
Year ending January 31,:		
1999	\$ 152	\$ 4,784
2000	41	3,402
2001	--	2,281
2002	--	1,548
2003	--	639
Thereafter	--	26
	-----	-----
Total minimum lease payments	193	\$ 12,680
Less amount representing interest at rates ranging from 11% to 14.5%	(12)	

Present value of minimum lease payments	<u>\$ 181</u>	
	=====	

Total rent expense for the year ended December 31, 1995, one month ended January 31, 1996 and years ended January 31, 1997 and 1998 aggregated \$4,981,000, \$457,000, \$5,929,000 and \$6,509,000, respectively.

The Company is subject to various legal proceedings and claims, either asserted or unasserted, which arise in the ordinary course of business. While the outcome of these claims cannot be predicted with certainty, management does not believe that the outcome of any of these legal matters will have a material adverse effect on the Company's consolidated results of operations or consolidated financial position.

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9. Geographic Information

The following table shows revenues, operating income (loss) and identifiable assets by geographic segment (in thousands):

Year Ended

	December 31, 1995	January 31, 1997	January 31, 1998
Revenue:			
U.S	\$ 49,955	\$ 73,519	\$ 105,446
Europe	24,619	32,725	43,027
Asia/Pacific	12,354	15,543	18,354
Other	3,021	4,657	5,407
	=====	=====	=====
	\$ 89,949	\$ 126,444	\$ 172,234
Operating income (loss):			
U.S	\$ 1,094	\$ 6,839	\$ 12,054
Europe	1,251	341	9,870
Asia/Pacific	(5,621)	(5,691)	(8,982)
Other	630	1,231	1,753
	=====	=====	=====
	\$ (2,646)	\$ 2,720	\$ 14,695

	January 31, 1997	January 31, 1998
Identifiable assets:		
U.S	\$ 46,959	\$ 150,744
Europe	18,691	24,366
Asia/Pacific	9,226	8,871
Other	2,374	6,525
	=====	=====
	\$ 77,250	\$ 190,506

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10. Employee Stock Option, Purchase Plans and Restricted Stock Awards

Employee Stock Option Agreements

The Company has stock option agreements with certain key employees. As of January 31, 1997 and 1998, options to purchase 1,121,000 and 2,724,000 shares of common stock had been granted and were outstanding. Outstanding options generally vest over a five-year period and have contractual lives of 10 years. Transactions in stock options are summarized as follows:

	Shares	Weighted Average Exercise Price	Options Exercisable
Outstanding options at December 31, 1994	2,350,000	\$ 0.18	2,114,000
Options issued	--		
Options exercised	(1,024,000)	0.02	
Options expired and terminated	--		

Outstanding options at December 31, 1995	1,326,000	0.31	1,240,000
Options issued	--		
Options exercised	--		
Options expired and terminated	--		

Outstanding options at January 31, 1996	1,326,000	0.31	1,240,000
Options issued	--		
Options exercised	(105,000)	0.40	
Options expired and terminated	(100,000)	1.61	

Outstanding options at January 31, 1997	1,121,000	0.18	1,121,000
Options issued	2,040,000	13.61	
Options exercised	(299,000)	0.21	
Options expired and terminated	(138,000)	11.01	

Outstanding options at January 31, 1998	2,724,000	\$ 9.68	822,000
	=====		

The weighted average remaining contractual life of stock options outstanding as of January 31, 1998 was as follows:

Range of Exercise Prices	Number of Options Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Options Exercisable	
				Number Exercisable	Weighted Average Exercise Price
- - - - -	- - - - -	- - - - -	- - - - -	- - - - -	- - - - -
\$ 0.12 - \$ 0.39	822,000	2.3	\$ 0.17	822,000	\$ 0.17
\$11.88 - \$14.88	815,000	9.9	12.06	--	--
\$15.00 - \$18.75	1,087,000	9.5	15.09	--	--
	-----	-----	-----	-----	-----
Total	2,724,000	7.4	\$ 9.68	822,000	\$ 0.17
	=====			=====	

The Company applies APB Opinion No. 25 in accounting for its option plans and, accordingly, no compensation cost was recognized as the exercise price of the stock options equaled the fair value at the grant date. The pro forma impact of applying SFAS No. 123 is not presented for the years ended December 31, 1995 and January 31, 1997 as SFAS 123 is applicable only to options granted during the year ended December 31, 1995 and later, and all options outstanding as of January 31, 1997 were granted prior to 1995. The

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fair value of the options at date of grant was estimated using the Black Scholes model with the following assumptions:

	January 31, 1998

Expected Life (years).....	6.00
Interest Rate.....	5.95%
Volatility.....	0.41
Dividend Yield.....	\$ 0.00

If the Company had recognized compensation cost for stock-based employee compensation in accordance with SFAS No. 123, the Company's net income for the year ended January 31, 1998 would have decreased as follows:

	As Reported	Pro Forma
	-----	-----
Net income	\$ 9,856	\$ 8,201
Basic earnings per share .	\$ 0.38	\$ 0.32
Diluted earnings per share	\$ 0.38	\$ 0.31

During 1995, the Company repurchased 1,000,000 shares issued to an employee immediately upon exercise of stock options. Accordingly, the Company recorded compensation expense of \$2,408,000 in the accompanying consolidated financial statements for the year ended December 31, 1995. Additionally, during the year ended January 31, 1997 certain employees holding vested options with respect to 70,000 shares at an average of \$0.27 per share gave notice as to their intention to terminate employment. The Company determined that it would reacquire the shares, which would be issued to the employees. Accordingly, \$648,000 of compensation expense representing the difference between exercise price and acquisition cost, has been accrued as compensation expense at January 31, 1997.

1994 Stock Ownership Program

The Company has also established the QAD Inc. 1994 Stock Ownership Program (the "Plan") covering 4,800,000 shares of its common stock. Subject to certain limitations, the Plan allows eligible employees to purchase shares of common stock at the fair market value of the common stock by direct cash payment or at 95% of the fair market value through payroll deduction. The Company has the right, but not the obligation, to repurchase shares at fair value upon the termination of employment. During the years ended December 31, 1995, and January 31, 1997 and 1998, 250,750, 793,438 and 215,160 shares, respectively, were issued under the Plan at average prices of \$2.40, \$1.78 and \$9.42, respectively. No shares were issued under the Plan in January 1996.

During the year ended January 31, 1997 and 1998, respectively, 559,066 and 20,400 restricted shares of the Company's common stock were granted to certain employees. The fair market value of shares awarded was \$2,584,000 and \$194,000, respectively. These amounts were recorded as unearned compensation-restricted stock, shown as a separate component of stockholders' equity. Unearned compensation is being amortized to expense over the periods in which the restrictions lapse, generally one to three years from date of award. Such expenses amounted to \$788,000 and \$930,000 in the years ended January 31, 1997 and 1998, respectively, \$333,000 and \$600,000 of which is included in accrued expense, respectively, and \$455,000 and \$663,000 of which has been recorded as a reduction in unearned compensation-restricted stock as the restricted shares are issued to employees.

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During the year ended December 31, 1995, one month ended January 31, 1996 and years ended January 31, 1997 and 1998, the Company granted 148,514, 23,722, 108,062 and 50,060 unrestricted shares, respectively, to certain employees having a fair value of \$336,000, \$57,000, \$256,000 and \$431,000 at date of grant, respectively. Compensation expense has been recognized in each respective period for the fair value of such stock grants.

1997 Stock Incentive Program

The Company has adopted the 1997 Stock Incentive Program (the "Program"). The Program consists of seven parts:

The first part is the Incentive Stock Option Plan under which incentive stock options are granted. The second part is the Non-Qualified Stock Option Plan under which nonqualified stock options are granted. The third part is the Restricted Share Plan under which restricted shares of Common Stock are granted. The fourth part is the Employee Stock Purchase Plan. The Plan allows participating employees to purchase shares of common stock through payroll deductions at 85% of the lower of the beginning or the ending calendar quarter share price. During the three months ended December 31, 1997, 35,969 shares were issued at \$10.73. The fifth part is the Non-Employee Director Stock Option Plan under which grants of options to purchase shares of Common Stock may be made to non-employee directors of the Company. The sixth part is the Stock Appreciation Rights Plan under which SARs (as defined therein) are granted. The seventh part is the Other Stock Rights Plan under which (i) units representing the equivalent shares of Common Stock are granted; (ii) payments of compensation in the form of shares of Common Stock are granted; and (iii) rights to receive cash or shares of Common Stock based on the value of dividends paid with respect to a share of Common Stock are granted. The maximum aggregate number of shares of Common Stock subject to the Program is 4,000,000 shares. The Program will be valid for 10 years from the date of adoption.

Total Compensation Cost Recognized for Stock-Based Compensation Plans

Total compensation cost recognized for stock-based employee compensation awards was as follows:

	December 31, 1995	January 31, 1997	January 31, 1998
	-----	-----	-----
Pursuant to performance awards	\$ 336,000	\$ 256,000	\$ 431,000
Pursuant to restricted stock grants	--	788,000	930,000

Pursuant to optioned shares repurchased immediately upon exercise	2,408,000	648,000	--
TOTAL	\$ 2,744,000	\$ 1,692,000	\$ 1,361,000

During the one-month period ended January 31, 1996 compensation cost aggregating \$57,000 was recognized pursuant to stock performance awards.

Receivable from Stockholders

In connection with the 1994 Stock Ownership Program, the Company has guaranteed indebtedness incurred by certain stockholders to purchase shares with cash deposited with a lending institution. These amounts are classified as "Receivable from Stockholders" in the accompanying balance sheets.

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11. Quarterly information (unaudited)

The following table sets forth selected unaudited quarterly information for the Company's last eight fiscal quarters. The Company believes that all necessary adjustments (which consisted only of normal recurring adjustments) have been included in the amounts stated below to present fairly the results of such periods when read in conjunction with the financial statements and related notes included elsewhere herein (in thousands):

	Quarter Ended			
	April 30	July 31	Oct. 31	Jan. 31
1997				
Statement of Income Data:				
Total revenues	\$ 20,116	\$ 33,555	\$ 23,806	\$ 48,967
Operating income (loss)	(10,158)	5,545	(3,554)	10,887
Net income (loss)	(7,317)	3,513	(2,790)	7,594
Basic net income (loss) per share	(0.33)	0.17	(0.13)	0.35
Diluted net income (loss) per share	\$ (0.33)	\$ 0.16	\$ (0.13)	\$ 0.33
1998				
Statement of Income Data:				
Total revenues	\$ 32,073	\$ 41,661	\$ 44,021	\$ 54,479
Operating income	317	2,706	2,502	9,170
Net income	560	1,665	1,385	6,246
Basic net income (loss) per share	0.03	0.07	0.05	0.21
Diluted net income (loss) per share	\$ 0.02	\$ 0.07	\$ 0.05	\$ 0.21

An allocation of accrued expenses of \$1.5 million has been recorded into the second quarter ended July 31, 1997. This adjustment related primarily to reallocation of accruals between the fourth quarter and the second quarter and resulted in an increase in net income of \$924,000, or 4 cents per share, in the previously reported second quarter.

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Schedule II

SCHEDULE OF VALUATION AND QUALIFYING ACCOUNTS

Description	Balance at Beginning of Period	Charged to Costs and Expenses	(1) Deletions	Adjustments	Balance at End of Period
Allowance for doubtful					

accounts and sales returns							
Year ended:							
December 31, 1995	\$	2,528	\$	945	\$	(1,209)	\$ 34 2,298
One month ended:							
January 31, 1996		2,298		(25)		--	7 2,280
Years ended:							
January 31, 1997		2,280		3,432		(1,983)	(35) 3,694
January 31, 1998	\$	3,694	\$	4,370	\$	(2,554)	\$ -- 5,510

- -----
 <FN>
 (1) Actual write-offs and product returns.
 </FN>

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on April 28, 1998.

QAD Inc.

By: /s/ KARL F. LOPKER
 Karl F. Lopker
 Chief Executive Officer,
 Chief Financial Officer and Secretary

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

Signature	Title	Date
/s/ PAMELA M. LOPKER Pamela M. Lopker	Chairman of the Board and President (Principal Executive Officer)	April 28, 1998
/s/ KARL F. LOPKER Karl F. Lopker	Director, Chief Executive Officer and Chief Financial Officer (Principal Financial and Accounting Officer)	April 28, 1998
/s/ KOH BOON HWEE Koh Boon Hwee	Director	April 28, 1998
/s/ PETER VAN CUYLENBURG Peter Van Cuylenburg	Director	April 28, 1998
/s/ EVAN M. BISHOP Evan M. Bishop	Director, Vice President Technology	April 28, 1998

CREDIT AGREEMENT

Dated as of August 4, 1997

between

QAD INC.

and

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION

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CREDIT AGREEMENT

This CREDIT AGREEMENT is entered into as of August 4, 1997, between QAD Inc., a Delaware corporation (the "Company"), and Bank of America National Trust and Savings Association (the "Bank").

WHEREAS, the Bank has agreed to make available to the Company a revolving credit facility upon the terms and conditions set forth in this Agreement;

NOW, THEREFORE, in consideration of the mutual agreements, provisions and covenants contained herein, the parties agree as follows:

ARTICLE I

DEFINITIONS

1.01 Certain Defined Terms . The following terms have the following meanings:

"Acquisition" means any transaction or series of related transactions for the purpose of or resulting, directly or indirectly, in (a) the acquisition of all or substantially all of the assets of a Person, or of any business or division of a Person, (b) the acquisition of in excess of 50% of the capital stock, partnership interests, membership interests or equity of any Person, or otherwise causing any Person to become a Subsidiary, or (c) a merger or consolidation or any other combination with another Person (other than a Person that is a Subsidiary) provided that the Company or the Subsidiary is the surviving entity.

"Affiliate" means, as to any Person, any other Person which, directly or indirectly, is in control of, is controlled by, or is under common control with, such Person. A Person shall be deemed to control another Person if the controlling Person possesses, directly or indirectly, the power to direct or cause the direction of the management and policies of the other Person, whether through the ownership of voting securities, membership interests, by contract, or otherwise.

"Agreement" means this Credit Agreement.

"Applicable Margin" means: (i) with respect to Base Rate Loans, 0%; and (ii) with respect to Offshore Rate Loans, (a) during the periods when 50% or less of the Commitment is being utilized, the Applicable Margin for all Offshore Rate Loans outstanding during such periods shall be 1.25%, and (b) during the periods when more than 50% of the Commitment is being utilized, the Applicable Margin for all Offshore

Rate Loans outstanding during such periods shall be 1.50%. As a result, the Applicable Margin for all Offshore Rate Loans outstanding at any one time can vary from time to time depending on the amount of the Commitment that is being utilized at any one time.

"Assignee" has the meaning specified in subsection 9.08(a).

"Attorney Costs" means and includes all reasonable fees and disbursements of any law firm or other external counsel, the allocated

cost of internal legal services and all disbursements of internal counsel.

"Base Rate" means, for any day, the higher of: (a) 0.50% per annum above the latest Federal Funds Rate, which means, for any day, the rate set forth in the weekly statistical release designated as H.15(519), or any successor publication, published by the Federal Reserve Bank of New York (including any such successor, "H.15(519)") on the preceding Business Day opposite the caption "Federal Funds (Effective)"; or, if for any relevant day such rate is not so published on any such preceding Business Day, the rate for such day will be the arithmetic mean as determined by the Bank of the rates for the last transaction in overnight Federal funds arranged prior to 9:00 a.m. (New York City time) on that day by each of three leading brokers of Federal funds transactions in New York City selected by the Bank; and (b) the rate of interest in effect for such day as publicly announced from time to time by the Bank in San Francisco, California, as its "reference rate." (The "reference rate" is a rate set by the Bank based upon various factors including the Bank's costs and desired return, general economic conditions and other factors, and is used as a reference point for pricing some loans, which may be priced at, above, or below such announced rate.) Any change in the reference rate announced by the Bank shall take effect at the opening of business on the day specified in the public announcement of such change.

"Base Rate Loan" means a Loan that bears interest based on the Base Rate.

"Borrowing Date" means any date on which a Loan is made to the Company under Section 2.03.

"Business Day" means any day other than a Saturday, Sunday or other day on which commercial banks in San Francisco are authorized or required by law to close and, if the applicable Business Day relates to any Offshore Rate Loan, means such a day on which dealings are carried on in the applicable offshore dollar interbank market.

"Capital Adequacy Regulation" means any guideline, request or directive of any central bank or other Governmental Authority, or any other law, rule or regulation, whether or not having the force of law, in each case, regarding capital adequacy of any bank

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or of any corporation controlling a bank.

"Cash Equivalents" means:

(a) securities issued or fully guaranteed or insured by the United States Government or any agency thereof having maturities of not more than 12 months from the date of acquisition;

(b) certificates of deposit, time deposits, Eurodollar time deposits, repurchase agreements, reverse repurchase agreements, or bankers' acceptances, having in each case a tenor of not more than 12 months, issued by any U.S. commercial bank or any branch or agency of a non-U.S. bank licensed to conduct business in the U.S. having combined capital and surplus of not less than \$100,000,000 and whose short-term securities are rated at least A-1 by Standard & Poor's Corporation ("S&P") or at least P-1 by Moody's Investor Service, Inc. ("Moody's");

(c) taxable and tax-exempt commercial paper of an issuer rated at least A-1 by S&P or at least P-1 by Moody's and in either case having a tenor of not more than 270 days;

(d) medium term notes of an issuer rated at least AA by S&P or at least Aa2 by Moody's and having a remaining term of not more than 12 months after the date of acquisition by

the Company or its Subsidiaries;

(e) municipal notes and bonds which are rated at least SP-1 or AA by S&P or at least MIG-2 or Aa by Moody's with tenors of not more than 12 months;

(f) investments in taxable or tax-exempt money market funds with assets greater than \$500,000,000 and whose assets have average maturities less than or equal to 180 days and are rated at least A-1 by S&P or at least P-1 by Moody's;

(g) money market preferred instruments of an issuer rated at least A-1 by S&P or at least P-1 by Moody's with tenors of not more than 12 months; or

(h) other similar investments, subject to the Bank's prior written approval.

"Closing Date" means the date on which all conditions precedent set forth in Section 4.01 are satisfied or waived by the Bank.

"Code" means the Internal Revenue Code of 1986, and regulations promulgated thereunder.

"Commitment" has the meaning specified in Section 2.01.

"Compliance Certificate" means a certificate substantially in the form of Exhibit C.

"Consolidated Tangible Net Worth" means, at any time of determination, in respect of the Company and its Subsidiaries, determined on a consolidated basis, total assets (exclusive of goodwill, licensing agreements, patents, trademarks, trade names, organization expense, treasury stock, unamortized debt discount and premium, deferred charges and other like intangibles) minus total liabilities (including accrued and deferred income taxes), at such time.

"Contingent Obligation" means, as to any Person, any direct or indirect liability of that Person, whether or not contingent, with or without recourse, (a) with respect to any Indebtedness, lease, dividend, letter of credit or other obligation (the "primary obligations") of another Person (the "primary obligor"), including any obligation of that Person (i) to purchase, repurchase or otherwise acquire such primary obligations or any security therefor, (ii) to advance or provide funds for the payment or discharge of any such primary obligation, or to maintain working capital or equity capital of the primary obligor or otherwise to maintain the net worth or solvency or any balance sheet item, level of income or financial condition of the primary obligor, (iii) to purchase property, securities or services primarily for the purpose of assuring the owner of any such primary obligation of the ability of the primary obligor to make payment of such primary obligation, or (iv) otherwise to assure or hold harmless the holder of any such primary obligation against loss in respect thereof (each, a "Guaranty Obligation"); (b) with respect to any Surety Instrument issued for the account of that Person or as to which that Person is otherwise liable for reimbursement of drawings or payments; (c) to purchase any materials, supplies or other property from, or to obtain the services of, another Person if the relevant contract or other related document or obligation requires that payment for such materials, supplies or other property, or for such services, shall be made regardless of whether delivery of such materials, supplies or other property is ever made or tendered, or such services are ever performed or tendered, or (d) in respect of any Swap Contract.

"Consolidated Current Liabilities" means, at any time of determination, all amounts which would, in accordance with GAAP, be included under current liabilities on a consolidated balance sheet of the Company and its Subsidiaries, but in any event including all outstanding Loans, at such time.

"Contractual Obligation" means, as to any Person, any provision of any security issued by such Person or of any agreement, undertaking, contract, indenture, mortgage, deed of trust or other instrument, document or agreement to which such Person is a party or by

which it or any of its property is bound.

"Conversion/Continuation Date" means any date on which, under Section 2.04, the Company (a) converts a Loan of one Type to a Loan of another Type, or (b) continues as a Loan of the same Type, but with a new Interest Period, a Loan having an Interest Period expiring on such date.

"Default" means any event or circumstance which, with the giving of notice, the lapse of time, or both, would (if not cured or otherwise remedied during such time) constitute an Event of Default.

"Dollars", "dollars" and "\$" each mean lawful money of the United States.

"Environmental Claims" means all claims, however asserted, by any Governmental Authority or other Person alleging potential liability or responsibility for violation of any Environmental Law, or for release or injury to the environment.

"Environmental Laws" means all federal, state or local laws, statutes, common law duties, rules, regulations, ordinances and codes, together with all administrative orders, directed duties, requests, licenses, authorizations and permits of, and agreements with, any Governmental Authorities, in each case relating to environmental, health, safety and land use matters.

"ERISA" means the Employee Retirement Income Security Act of 1974, and regulations promulgated thereunder.

"ERISA Affiliate" means any trade or business (whether or not incorporated) under common control with the Company within the meaning of Section 414(b) or (c) of the Code (and Sections 414(m) and (o) of the Code for purposes of provisions relating to Section 412 of the Code).

"ERISA Event" means (a) with respect to a Pension Plan, any of the events set forth in Section 4043(c) of ERISA or the regulations thereunder, other than any such event for which the 30-day notice requirement under ERISA has been waived in regulations issued by the PBGC; (b) a withdrawal by the Company or any ERISA Affiliate from a Pension Plan subject to Section 4063 of ERISA during a plan year in which it was a substantial employer (as defined in Section 4001(a)(2) of ERISA) or a cessation of operations which is treated as such a withdrawal under Section 4062(e) of ERISA; (c) a complete or partial withdrawal by the Company or any ERISA Affiliate from a Multiemployer Plan or notification that a Multiemployer Plan is in reorganization; (d) the filing of a notice of intent to terminate, the treatment of a Plan amendment as a termination under Section 4041 or 4041A of ERISA, or the commencement of proceedings by the PBGC to terminate a Pension Plan or Multiemployer Plan; (e) an event or condition which might reasonably be expected to constitute grounds under Section 4042 of ERISA for the termination of, or the appointment of a trustee to administer, any Pension Plan or Multiemployer Plan; or (f) the imposition of any liability under Title IV of ERISA, other than PBGC premiums due but not delinquent under Section 4007 of ERISA, upon the Company or any ERISA Affiliate.

"Event of Default" means any of the events or circumstances specified in Section 8.01.

"FDIC" means the Federal Deposit Insurance Corporation, and any Governmental Authority succeeding to any of its principal functions.

"FRB" means the Board of Governors of the Federal Reserve System, and any Governmental Authority succeeding to any of its principal functions.

"GAAP" means generally accepted accounting principles set forth from time to time in the opinions and pronouncements of the Accounting Principles Board and the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board (or agencies with similar functions of comparable stature and authority within the U.S. accounting

profession), which are applicable to the circumstances as of the date of determination.

"Governmental Authority" means any nation or government, any state or other political subdivision thereof, any central bank (or similar monetary or regulatory authority) thereof, any entity exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government, and any corporation or other entity owned or controlled, through stock or capital ownership or otherwise, by any of the foregoing.

"Guaranty Obligation" has the meaning specified in the definition of "Contingent Obligation."

"Indebtedness" of any Person means, without duplication, (a) all indebtedness for borrowed money; (b) all obligations issued, undertaken or assumed as the deferred purchase price of property or services (other than trade payables entered into in the ordinary course of business on ordinary terms); (c) all non-contingent reimbursement or payment obligations with respect to Surety Instruments; (d) all obligations evidenced by notes, bonds, debentures or similar instruments, including obligations so evidenced incurred in connection with the acquisition of property, assets or businesses; (e) all indebtedness created or arising under any conditional sale or other title retention agreement, or incurred as financing, in either case with respect to property acquired by the Person (even though the rights and remedies of the seller or bank under such agreement in the event of default are limited to repossession or sale of such property); (f) all obligations with respect to capital leases; (g) all net indebtedness referred to in clauses (a) through (f) above secured by (or for which the holder of such Indebtedness has an existing right, contingent or otherwise, to be secured by) any Lien upon or in property (including accounts and contracts rights) owned by such Person, even though such Person has not assumed or become liable for the payment of such Indebtedness; and (h) all Guaranty Obligations in respect of indebtedness or obligations of others of the kinds referred to in clauses (a) through (g) above. Notwithstanding the foregoing, the term "Indebtedness" shall not include the Company's deferred maintenance revenue arising in the Company's ordinary course of business and calculated in accordance with GAAP. For all purposes of this Agreement, the Indebtedness of any Person shall include all recourse Indebtedness of any partnership or joint venture or limited liability company in which such Person is a general partner or a joint venturer or a member.

"Indemnified Liabilities" has the meaning specified in Section 9.05.

"Indemnified Person" has the meaning specified in Section 9.05.

"Independent Auditor" has the meaning specified in subsection 6.01(a).

"Insolvency Proceeding" means, with respect to any person, (a) any case, action or proceeding with respect to such Person before any court or other Governmental Authority relating to bankruptcy, reorganization, insolvency, liquidation, receivership, dissolution, winding-up or relief of debtors, or (b) any general assignment for the benefit of creditors, composition, marshalling of assets for creditors, or other, similar arrangement in respect of its creditors generally or any substantial portion of its creditors; undertaken under U.S. Federal, state or foreign law, including the Federal Bankruptcy Reform Act of 1978 (11 U.S.C. ss.101, et seq.).

"Interest Payment Date" means, as to any Loan other than a Base Rate Loan, the last day of each Interest Period applicable to such Loan and, as to any Base Rate Loan, the last Business Day of each calendar quarter and each date such Loan is converted into another Type of Loan, provided, however, that if any Interest Period for an Offshore Rate Loan exceeds three months, the date that falls three months after the beginning of such Interest Period and after each Interest Payment Date thereafter is also an Interest Payment Date.

"Interest Period" means, as to any Offshore Rate Loan, the period commencing on the Borrowing Date of such Loan or on the

Conversion/Continuation Date on which the Loan is converted into or continued as an Offshore Rate Loan, and ending on the date one, two, three or six months thereafter as selected by the Company in its Notice of Borrowing or Notice of Conversion/Continuation; provided that:

(i) if any Interest Period would otherwise end on a day that is not a Business Day, that Interest Period shall be extended to the following Business Day unless, in the case of an Offshore Rate Loan, the result of such extension would be to carry such Interest Period into another calendar month, in which event such Interest Period shall end on the preceding Business Day;

(ii) any Interest Period pertaining to an Offshore Rate Loan that begins on the last Business Day of a calendar month (or on a day for which there is no numerically corresponding day in the calendar month at the end of such Interest Period) shall end on the last Business Day of the calendar month at the end of such Interest Period; and

(iii) no Interest Period for any Loan shall extend beyond the Termination Date as determined by subsection (a) of the definition of that term.

"Joint Venture" means a single-purpose corporation, partnership, limited liability company, joint venture or other similar legal arrangement (whether created by contract or conducted through a separate legal entity) now or hereafter formed by the Company or any of its Subsidiaries with another Person in order to conduct a common venture or enterprise with such Person.

"Leverage Ratio" means, as of any date of determination, the ratio of (a) total consolidated liabilities of the Company and its Subsidiaries on such date less deferred revenue of the Company and its Subsidiaries as of such date, to (b) Consolidated Tangible Net Worth, in each case as determined in accordance with GAAP.

"Lien" means any security interest, mortgage, deed of trust, pledge, hypothecation, assignment, charge or deposit arrangement, encumbrance, lien (statutory or other) or preferential arrangement of any kind or nature whatsoever in respect of any property (including those created by, arising under or evidenced by any conditional sale or other title retention agreement, the interest of a lessor under a capital lease, any financing lease having substantially the same economic effect as any of the foregoing, or the filing of any financing statement naming the owner of the asset to which such lien relates as debtor, under the Uniform Commercial Code or any comparable law), but not including the interest of a lessor under an operating lease.

"Loan" means an extension of credit by the Bank to the Company under Article II, or any portion thereof remaining after or resulting from any conversion of a Loan under Section 2.04, and may be a Base Rate Loan or an Offshore Rate Loan (each, a "Type" of Loan).

"Loan Documents" means this Agreement and all other documents delivered to the Bank in connection herewith.

"Margin Stock" means "margin stock" as such term is defined in Regulation G, T, U or X of the FRB.

"Material Adverse Effect" means (a) a material adverse change in, or a material adverse effect upon, the operations, business, properties, condition (financial or otherwise) or prospects of the Company or the Company and its Subsidiaries taken as a whole; (b) a material impairment of the ability of the Company to perform under any Loan Document and to avoid any Event of Default; or (c) a material adverse effect upon the legality, validity, binding effect or enforceability against the Company of any Loan Document.

"Multiemployer Plan" means a "multiemployer plan", within the meaning of Section 4001(a)(3) of ERISA, to which the Company or any ERISA Affiliate makes, is making, or is obligated to make contributions or, during the preceding three calendar years, has made, or been obligated to make, contributions.

"Net Issuance Proceeds" means, as to any issuance of debt or equity by any Person, cash proceeds and non-cash proceeds received or receivable by such Person in connection therewith, net of reasonable out-of-pocket costs and expenses paid or incurred in connection therewith in favor of any Person not an Affiliate of such Person.

"Notice of Borrowing" means a notice in substantially the form of Exhibit A.

"Notice of Conversion/Continuation" means a notice in substantially the form of Exhibit B.

"Obligations" means all advances, debts, liabilities, obligations, covenants and duties arising under any Loan Document owing by the Company to the Bank or any Indemnified Person, whether direct or indirect (including those acquired by assignment), absolute or contingent, due or to become due, now existing or hereafter arising.

"Offshore Rate" means, for any Interest Period, with respect to an Offshore Rate Loan the rate of interest per annum (rounded upward to the next 1/16th of 1%) determined by the Bank as follows:

$$\text{Offshore Rate} = \frac{\text{IBOR}}{1.00 - \text{Eurodollar Reserve Percentage}}$$

Where,

"Eurodollar Reserve Percentage" means for any day for any Interest Period the maximum reserve percentage (expressed as a decimal, rounded upward to the next 1/100th of 1%) in effect on such day (whether or not applicable to the Bank) under regulations issued from time to time by the FRB for determining the maximum reserve requirement (including any emergency, supplemental or other marginal reserve requirement) with respect to Eurocurrency funding (currently referred to as "Eurocurrency liabilities"); and

"IBOR" means the rate of interest per annum determined by the Bank as the rate at which dollar deposits in the approximate amount of the Bank's Offshore Rate Loan for such Interest Period would be offered by the Bank's Grand Cayman Branch, Grand Cayman B.W.I. (or such other office as may be designated for such purpose by the Bank), to major banks in the offshore dollar interbank market at their request at approximately [11:00 a.m. (New York City time) two Business Days prior to] the commencement of such Interest Period.

The Offshore Rate shall be adjusted automatically as to all Offshore Rate Loans then outstanding as of the effective date of any change in the Eurodollar Reserve Percentage.

"Offshore Rate Loan" means a Loan that bears interest based on the Offshore Rate.

"Organization Documents" means, for any corporation, the certificate or articles of incorporation, the bylaws, any certificate of determination or instrument relating to the rights of preferred shareholders of such corporation, any shareholder rights agreement, and all applicable resolutions of the board of directors (or any committee thereof) of such corporation.

"Participant" has the meaning specified in subsection 9.08(b).

"PBGC" means the Pension Benefit Guaranty Corporation, or any Governmental Authority succeeding to any of its principal functions under ERISA.

"Pension Plan" means a pension plan (as defined in Section 3(2) of ERISA) subject to Title IV of ERISA which the Company sponsors, maintains, or to which it makes, is making, or is obligated to make contributions, or in the case of a multiple employer plan (as described in Section 4064(a) of ERISA) has made contributions at any time during the immediately preceding five (5) plan years.

"Permitted Liens" has the meaning specified in Section 7.01.

"Permitted Swap Obligations" means all obligations (contingent or otherwise) of the Company or any Subsidiary existing or arising under Swap Contracts, provided that each of the following criteria is satisfied: (a) such obligations are (or were) entered into by such Person in the ordinary course of business for the purpose of directly mitigating risks associated with liabilities, commitments or assets held by such Person, or changes in the value of securities issued by such Person in conjunction with a securities repurchase program not otherwise prohibited hereunder, and not for purposes of speculation or taking a "market view;" (b) such Swap Contracts do not contain any provision ("walk-away" provision) exonerating the non-defaulting party from its obligation to make payments on outstanding transactions to the defaulting party or any provision creating or permitting the declaration of an event of default, termination event or similar event upon the occurrence of an Event of Default hereunder (other than an Event of Default under subsection 8.01(a)).

"Person" means an individual, partnership, corporation, limited liability company, business trust, joint stock company, trust, unincorporated association, joint venture or Governmental Authority.

"Plan" means an employee benefit plan (as defined in Section 3(3) of ERISA) which the Company sponsors or maintains or to which the Company makes, is making, or is obligated to make contributions and includes any Pension Plan.

"Requirement of Law" means, as to any Person, any law (statutory or common), treaty, rule or regulation or determination of an arbitrator or of a Governmental Authority, in each case applicable to or binding upon the Person or any of its property or to which the Person or any of its property is subject.

"Responsible Officer" means the chief executive officer or the president of the Company, or any other officer having substantially the same authority and responsibility; or, with respect to compliance with financial covenants, the chief financial officer or the treasurer of the Company, or any other officer having substantially the same authority and responsibility.

"SEC" means the Securities and Exchange Commission, or any Governmental Authority succeeding to any of its principal functions.

"Subsidiary" of a Person means any corporation, association, partnership, limited liability company, joint venture or other business entity of which more than 50% of the voting stock, membership interests or other equity interests (in the case of Persons other than corporations), is owned or controlled directly or indirectly by the Person, or one or more of the Subsidiaries of the Person, or a combination thereof. Unless the context otherwise clearly requires, references herein to a "Subsidiary" refer to a Subsidiary of the Company.

"Surety Instruments" means all letters of credit (including standby and commercial), banker's acceptances, bank guaranties, shipside bonds, surety bonds and similar instruments.

"Swap Contract" means any agreement, whether or not in writing, relating to any transaction that is a rate swap, basis swap, forward rate transaction, commodity swap, commodity option, equity or equity index swap or option, bond, note or bill option, interest rate option, forward foreign exchange transaction, cap, collar or floor transaction, currency swap, cross-currency rate swap, swaption, currency option or any other, similar transaction (including any option to enter into any of the foregoing) or any combination of the foregoing, and, unless the context otherwise clearly requires, any master agreement relating to or governing any or all of the foregoing.

"Swap Termination Value" means, in respect of any one or more Swap Contracts, after taking into account the effect of any legally enforceable netting agreement relating to such Swap Contracts, (a) for any date on or after the date such Swap Contracts have been closed out and termination value(s) determined in accordance therewith, such termination value(s), and (b) for any date prior to the date referenced in clause (a) the amount(s) determined as the mark-to-market value(s)

for such Swap Contracts, as determined by the Company based upon one or more mid-market or other readily available quotations provided by any recognized dealer in such Swap Contracts (which may include any Bank).

"Termination Date" means the earlier to occur of:

(a) the date that is two (2) years after the Closing Date; provided, that if the Termination Date shall fall on a date that is not a Business Day, the Termination Date shall be the immediately preceding Business Day; and

(b) the date on which the Commitment terminates in accordance with the provisions of this Agreement.

"Type" has the meaning specified in the definition of "Loan."

"Unfunded Pension Liability" means the excess of a Plan's benefit liabilities under Section 4001(a)(16) of ERISA, over the current value of that Plan's assets, determined in accordance with the assumptions used for funding the Pension Plan pursuant to Section 412 of the Code for the applicable plan year.

"United States" and "U.S." each means the United States of America.

"Wholly-Owned Subsidiary" means any corporation in which (other than directors' qualifying shares required by law) 100% of the capital stock of each class having ordinary voting power, and 100% of the capital stock of every other class, in each case, at the time as of which any determination is being made, is owned, beneficially and of record, by the Company, or by one or more of the other Wholly-Owned Subsidiaries at the Company, or both.

1.02 Other Interpretive Provisions. (a) The meanings of defined terms are equally applicable to the singular and plural forms of the defined terms.

(b) The words "hereof", "herein", "hereunder" and similar words refer to this Agreement as a whole and not to any particular provision of this Agreement; and subsection, Section, Schedule and Exhibit references are to this Agreement unless otherwise specified. The term "documents" includes any and all instruments, documents, agreements, certificates, indentures, notices and other writings, however evidenced. The term "including" is not limiting and means "including without limitation." In the computation of periods of time from a specified date to a later specified date, the word "from" means "from and including"; the words "to" and "until" each mean "to but excluding", and the word "through" means "to and including."

(c) Unless otherwise expressly provided herein, (i) references to agreements (including this Agreement) and other contractual instruments shall be deemed to include all subsequent amendments and other modifications thereto, but only to the extent such amendments and other modifications are not prohibited by the terms of any Loan Document, and (ii) references to any statute or regulation are to be construed as including all statutory and regulatory provisions consolidating, amending, replacing, supplementing or interpreting the statute or regulation.

(d) The captions and headings of this Agreement are for convenience of reference only and shall not affect the interpretation of this Agreement. This Agreement and other Loan Documents may use several different limitations, tests or measurements to regulate the same or similar matters. All such limitations, tests and measurements are cumulative and shall each be performed in accordance with their terms. Unless otherwise expressly provided, any reference to any action of the Agent or the Banks by way of consent, approval or waiver shall be deemed modified by the phrase "in its/their sole discretion."

(e) This Agreement and the other Loan Documents are the result of negotiations between and have been reviewed by counsel to the Bank and the Company, and are the products of both parties. Accordingly, they shall not be construed against the Bank merely because of the Bank's involvement in their preparation.

1.03 Accounting Principles . Unless the context otherwise clearly requires, all accounting terms not expressly defined herein shall be construed, and all financial computations required under this Agreement shall be made, in

accordance with GAAP, consistently applied. References herein to "fiscal year" and "fiscal quarter" refer to such fiscal periods of the Company.

ARTICLE II

THE CREDIT

2.01 Amount and Terms of Commitment . The Bank agrees, on the terms and conditions set forth herein, to make Loans to the Company from time to time on any Business Day during the period from the Closing Date to the Termination Date, in an aggregate amount not to exceed at any time outstanding \$20,000,000 (such amount, as the same may be reduced under Section 2.05 or as a result of one or more assignments under Section 9.08, the "Commitment"). Within the limits of the Commitment, and subject to the other terms and conditions hereof, the Company may borrow under this Section 2.01, prepay under Section 2.06 and reborrow under this Section 2.01.

2.02 Loan Accounts . The Loans made by the Bank shall be evidenced by one or more loan accounts or records maintained by the Bank in the ordinary course of business. The loan accounts or records maintained by the Bank shall be conclusive absent manifest error of the amount of the Loans made by the Bank to the Company and the interest and payments thereon. Any failure so to record or any error in doing so shall not, however, limit or otherwise affect the obligation of the Company hereunder to pay any amount owing with respect to the Loans.

2.03 Procedure for Borrowing . Each Loan shall be made upon the Company's irrevocable written notice delivered to the Bank in the form of a Notice of Borrowing, (which notice must be received by the Bank prior to 9:00 a.m. (San Francisco time) (a) three Business Days prior to the requested Borrowing Date, in the case of an Offshore Rate Loan; and (b) on the requested Borrowing Date, in the case of a Base Rate Loan, specifying: (i) the amount of the Loan, which shall be in a minimum amount of \$500,000 or any multiple of \$100,000 in excess thereof; (ii) the requested Borrowing Date, which shall be a Business Day; (iii) the Type of Loan requested; and (iv) the duration of the Interest Period applicable to such Loan. If the Notice of Borrowing fails to specify the duration of the Interest Period for an Offshore Rate Loan, such Interest Period shall be three months. The proceeds of each Loan will be made available to the Company by the Bank either (i) by crediting the account of the Company on the books of the Bank, or by wire transfer in accordance with written instructions provided to the Bank by the Company. After giving effect to any borrowing of a Loan, there shall not be more than ten different Interest Periods in effect.

2.04 Conversion and Continuation Elections . (a) The Company may, upon irrevocable written notice to the Bank in accordance with subsection 2.04(b): (i) elect, as of any Business Day, in the case of a Base Rate Loan, or as of the last day of the applicable Interest Period, in the case of an Offshore Rate Loan, to convert any such Loan (or any part thereof in an amount not less than \$500,000, or that is in an integral multiple of \$100,000 in excess thereof) into a Loan of any other Type; or (ii) elect, as of the last day of the applicable Interest Period, to continue a Loan having an Interest Period expiring on such day (or any part thereof in an amount not less than \$500,000, or that is in an integral multiple of \$100,000 in excess thereof); provided, that if at any time the amount of any Offshore Rate Loan is reduced, by payment, prepayment, or conversion of part thereof to be less than \$500,000, such Offshore Rate Loan shall automatically convert into a Base Rate Loan, and on and after such date the right of the Company to continue such Loan as, and convert such Loan into, an Offshore Rate Loan shall terminate.

(b) The Company shall deliver a Notice of Conversion/Continuation to be received by the Bank not later than 9:00 a.m. (San Francisco time) at least (i) three Business Days in advance of the Conversion/Continuation Date, if any Loan is to be converted into or continued as an Offshore Rate Loan; and (ii) on the Conversion/Continuation Date, if any Loan is to be converted into a Base Rate Loan, specifying: (A) the proposed Conversion/Continuation Date; (B) the amount of the Loan to be converted or continued; (C) the Type of Loan resulting from the proposed conversion or continuation; and (D) in the case of conversions into Offshore Rate Loans, the duration of the requested Interest Period.

(c) If upon the expiration of any Interest Period applicable to an Offshore Rate Loan, the Company has failed to select timely a new Interest Period to be applicable to such Loan, or if any Default or Event of Default then

exists, the Company shall be deemed to have elected to convert such Loan into a Base Rate Loan effective as of the expiration date of such Interest Period.

(d) Unless the Bank otherwise consents, during the existence of a Default or Event of Default, the Company may not elect to have a Loan converted into or continued as an Offshore Rate Loan.

(e) After giving effect to any conversion or continuation of any Loan, there shall not be more than ten different Interest Periods in effect.

2.05 Voluntary Termination or Reduction of Commitment. The Company may, upon not less than five Business Days' prior notice to the Bank, terminate the Commitment, or permanently reduce the Commitment by a minimum amount of \$500,000, or any multiple of \$100,000 in excess thereof; unless, after giving effect thereto and to any prepayments of Loans made on the effective date thereof, the then-outstanding principal amount of the Loans would exceed the amount of the Commitment then in effect. Once reduced in accordance with this Section, the Commitment may not be increased. All accrued commitment fees to, but not including the effective date of any reduction or termination of the Commitment, shall be paid on the effective date of such reduction or termination.

2.06 Optional Prepayments. Subject to the terms and provisions of Section 3.04, the Company may, at any time or from time to time, upon not less than one Business Day's irrevocable notice to the Bank received prior to 10:00 a.m. (San Francisco time), prepay without penalty Loans in whole or in part, in minimum amounts of \$500,000, or any multiple of \$100,000 in excess thereof. Such notice of prepayment shall specify the date and amount of such prepayment and the Type(s) of Loans to be prepaid. If such notice is given by the Company, the Company shall make such prepayment and the payment amount specified in such notice shall be due and payable on the date specified therein, together with accrued interest to each such date on the amount prepaid and any amounts required pursuant to Section 3.04.

2.07 Repayment. The Company shall repay to the Bank on the Termination Date the aggregate principal amount of all Loans outstanding on such date.

2.08 Interest. (a) Each Loan shall bear interest on the outstanding principal amount thereof from the applicable Borrowing Date at a rate per annum equal to the Offshore Rate or the Base Rate, as the case may be (and subject to the Company's right to convert to other Types of Loans under Section 2.04), plus the Applicable Margin.

(b) Interest on each Loan shall be paid in arrears on each Interest Payment Date. Interest shall also be paid on the date of any prepayment of Loans under Section 2.06 for the portion of the Loans so prepaid and upon payment (including prepayment) in full thereof and, during the existence of any Event of Default, interest shall be paid on demand of the Bank.

(c) Notwithstanding subsection (a) of this Section, while any Event of Default exists or after acceleration, the Company shall pay interest (after as well as before entry of judgment thereon to the extent permitted by law) on the principal amount of all outstanding Loans, at a rate per annum which is determined by adding 2% per annum to the Applicable Margin then in effect for such Loans; provided, however, that, on and after the expiration of any Interest Period applicable to any Offshore Rate Loan outstanding on the date of occurrence of such Event of Default or acceleration, the principal amount of such Loan shall, during the continuation of such Event of Default or after acceleration, bear interest at a rate per annum equal to the Base Rate plus 2%.

2.09 Commitment Fee. The Company shall pay to the Bank a commitment fee on the average daily unused portion of the Commitment, computed on a quarterly basis in arrears on the last Business Day of each calendar quarter based upon the daily utilization for that quarter as calculated by the Bank, equal to one-half of one percent (.50%) per annum. Such commitment fee shall accrue from the Closing Date to the Termination Date and shall be due and payable quarterly in arrears on the last Business Day of each quarter commencing on the Closing Date through the Termination Date, with the final payment to be made on the Termination Date provided that, in connection with any reduction or termination of Commitment under Section 2.05, the accrued commitment fee calculated for the period ending on such date shall also be paid on the date of such reduction or termination, with the following quarterly payment being calculated on the basis of the period from such reduction or termination date to such quarterly payment date. The commitment fee provided in this subsection shall accrue at all times after the above-mentioned commencement date, including at any time during which

one or more conditions in Article IV are not met.

2.10 Computation of Fees and Interest. All computations of interest for Base Rate Loans when the Base Rate is determined by the Bank's "reference rate" shall be made on the basis of a year of 365 or 366 days, as the case may be, and actual days elapsed. All other computations of fees and interest shall be made on the basis of a 360-day year and actual days elapsed (which results in more interest being paid than if computed on the basis of a 365-day year). Interest and fees shall accrue during each period during which interest or such fees are computed from the first day thereof to the last day thereof. Each determination of an interest rate by the Bank shall be conclusive and binding on the Company in the absence of manifest error.

2.11 Payments by the Company. All payments to be made by the Company shall be made without set-off, recoupment or counterclaim. Except as otherwise expressly provided herein, all payments by the Company shall be made to the Bank at the address from time to time specified by the Bank for such purpose, and shall be made in dollars and in immediately available funds, no later than 3:00 p.m. (San Francisco time) on the date specified herein. Any payment received by the Bank later than 3:00 p.m. (San Francisco time) shall be deemed to have been received on the following Business Day and any applicable interest or fee shall continue to accrue. Subject to the provisions set forth in the definition of "Interest Period" herein, whenever any payment is due on a day other than a Business Day, such payment shall be made on the following Business Day, and such extension of time shall in such case be included in the computation of interest or fees, as the case may be.

ARTICLE III

TAXES, YIELD PROTECTION AND ILLEGALITY

3.01 Taxes. If any payments to the Bank under this Agreement are made from outside the United States, the Company will not deduct any foreign taxes from any payments it makes to the Bank. If any such taxes are imposed on any payments made by the Company (including payments under this Section), the Company will pay the taxes and will also pay to the Bank, at the time interest is paid, any additional amount which the Bank specifies as necessary to preserve the after-tax yield the Bank would have received if such taxes had not been imposed. The Company will confirm that it has paid the taxes by giving the Bank official tax receipts (or notarized copies) within 30 days after the due date.

3.02 Illegality. (a) If the Bank determines that the introduction of any Requirement of Law, or any change in any Requirement of Law, or in the interpretation or administration of any Requirement of Law, has made it unlawful, or that any central bank or other Governmental Authority has asserted that it is unlawful, for the Bank or any applicable lending office of the Bank to make Offshore Rate Loans, then, on notice thereof by the Bank to the Company, any obligation of the Bank to make Offshore Rate Loans shall be suspended until the Bank notifies the Company that the circumstances giving rise to such determination no longer exist.

(b) If the Bank determines that it is unlawful to maintain Offshore Rate Loans, the Company shall, upon its receipt of notice of such fact and demand from the Bank, prepay in full all Offshore Rate Loans then outstanding, together with interest accrued thereon and amounts required under Section 3.04, either on the last day of the Interest Period thereof, if the Bank may lawfully continue to maintain Offshore Rate Loans to such day, or immediately, if the Bank may not lawfully continue to maintain Offshore Rate Loans. If the Company is required to so prepay any Offshore Rate Loan, then concurrently with such prepayment, the Company shall borrow from the Bank, in the amount of such repayment, a Base Rate Loan.

3.03 Increased Costs and Reduction of Return. (a) If the Bank determines that, due to either (i) the introduction of or any change in or in the interpretation of any law or regulation or (ii) the compliance by the Bank with any guideline or request from any central bank or other Governmental Authority (whether or not having the force of law), there shall be any increase in the cost to the Bank of agreeing to make or making, funding or maintaining any Offshore Rate Loan, then the Company shall be liable for, and shall from time to time, upon written demand, pay to the Bank, additional amounts as are sufficient to compensate the Bank for such increased costs.

(b) If the Bank shall have determined that (i) the introduction of any Capital Adequacy Regulation, (ii) any change in any Capital Adequacy

Regulation, (iii) any change in the interpretation or administration of any Capital Adequacy Regulation by any central bank or other Governmental Authority charged with the interpretation or administration thereof, or (iv) compliance by the Bank (or any applicable lending office of the Bank) or any corporation controlling the Bank with any Capital Adequacy Regulation, affects or would affect the amount of capital required or expected to be maintained by the Bank or any corporation controlling the Bank and (taking into consideration the Bank's or such corporation's policies with respect to capital adequacy and the Bank's desired return on capital) determines that the amount of such capital is increased as a consequence of its Commitment, loans, credits or obligations under this Agreement, then, upon written demand of the Bank to the Company, the Company shall pay to the Bank, from time to time as specified by the Bank, additional amounts sufficient to compensate the Bank for such increase.

3.04 Funding Losses. The Company shall reimburse the Bank and hold the Bank harmless from any loss or expense which the Bank may sustain or incur as a consequence of: (a) the failure of the Company to make on a timely basis any payment of principal of any Offshore Rate Loan; (b) the failure of the Company to borrow, continue or convert a Loan after the Company has given (or is deemed to have given) a Notice of Borrowing or a Notice of Conversion/Continuation; (c) the failure of the Company to make any prepayment in accordance with any notice delivered under Section 2.06; (d) the prepayment or other payment (including after acceleration thereof) of an Offshore Rate Loan on a day that is not the last day of the relevant Interest Period; or (e) the automatic conversion under Section 2.04 of any Offshore Rate Loan to a Base Rate Loan on a day that is not the last day of the relevant Interest Period; including any such loss or expense arising from the liquidation or reemployment of funds obtained by it to maintain any Offshore Rate Loans or from fees payable to terminate the deposits from which such funds were obtained.

3.05 Inability to Determine Rates. If the Bank determines that for any reason adequate and reasonable means do not exist for determining the Offshore Rate for any requested Interest Period with respect to a proposed Offshore Rate Loan, or that the Offshore Rate applicable pursuant to subsection 2.08(a) for any requested Interest Period with respect to a proposed Offshore Rate Loan does not adequately and fairly reflect the cost to the Bank of funding such Loan, the Bank will promptly so notify the Company. Thereafter, the obligation of the Bank to make or maintain Offshore Rate Loans, as the case may be, hereunder shall be suspended until the Bank revokes such notice in writing. Upon receipt of such notice, the Company may revoke any Notice of Borrowing or Notice of Conversion/Continuation then submitted by it. If the Company does not revoke such Notice, the Bank shall make, convert or continue the Loan, as proposed by the Company, in the amount specified in the applicable notice submitted by the Company, but such Loans shall be made, converted or continued as a Base Rate Loan instead of an Offshore Rate Loan.

3.06 Survival. The agreements and obligations of the Company in this Article III shall survive the payment of all other Obligations.

ARTICLE IV

CONDITIONS PRECEDENT

4.01 Conditions of Initial Loan. The obligation of the Bank to make the initial Loan hereunder is subject to the condition that the Bank has received on or before the Closing Date all of the following, in form and substance satisfactory to the Bank:

(a) Credit Agreement. This Agreement executed by the Company;

(b) Resolutions; Incumbency. (i) Copies of the resolutions of the board of directors of the Company authorizing the transactions contemplated hereby, certified as of the Closing Date by the Secretary of the Company; and (ii) a certificate of the Secretary of the Company certifying the names and true signatures of the officers of the Company authorized to execute, deliver and perform, as applicable, this Agreement, and all other Loan Documents to be delivered by it hereunder;

(c) Organization Documents; Good Standing. Each of the following documents: (i) the articles or certificate of incorporation and the bylaws of the Company as in effect on the Closing Date, certified by the Secretary of the Company as of the Closing Date; and (ii) a good standing and tax good standing certificate for the Company from the Secretary of State (or similar, applicable Governmental Authority) of its state of incorporation and each state where the Company is qualified to do business as a foreign

corporation as of a recent date, together with a bring-down certificate by facsimile, dated the Closing Date;

(d) Legal Opinion. A favorable opinion of counsel to the Company, addressed to the Bank, with respect to such legal matters relating hereto as the Bank may reasonably request, provided that such opinion shall be limited to United States legal matters;

(e) Payment of Fees. Evidence of payment by the Company of all accrued and unpaid fees, costs and expenses to the extent then due and payable on the Closing Date, together with Attorney Costs of the Bank to the extent invoiced prior to or on the Closing Date, plus such additional amounts of Attorney Costs as shall constitute the Bank's reasonable estimate of Attorney Costs incurred or to be incurred by it through the closing proceedings (provided that such estimate shall not thereafter preclude final settling of accounts between the Company and the Bank); including any such costs, fees and expenses arising under or referenced in Sections 2.10 and 9.04;

(f) Certificate. A certificate signed by a Responsible Officer, dated as of the Closing Date, stating that: (i) the representations and warranties contained in Article V are true and correct on and as of such date, as though made on and as of such date; (ii) no Default or Event of Default exists or would result from the execution and delivery of this Agreement; and (iii) there has occurred since January 31, 1997, no event or circumstance that has resulted or could reasonably be expected to result in a Material Adverse Effect; and

(g) Other Documents. Such other approvals, opinions, documents or materials as the Bank may reasonably request.

4.02 Conditions to All Loans. The obligation of the Bank to make any Loan (including the initial Loan) or to continue or convert any Loan under Section 2.04 is subject to the satisfaction of the following conditions precedent on the relevant Borrowing Date or Conversion/Continuation Date:

(a) Notice of Borrowing or Conversion/Continuation. The Bank shall have received a Notice of Borrowing or a Notice of Conversion/Continuation, as applicable;

(b) Continuation of Representations and Warranties. The representations and warranties in Article V shall be true and correct on and as of such Borrowing Date or Conversion/Continuation Date with the same effect as if made on and as of such Borrowing Date or Conversion/Continuation Date (except to the extent such representations and warranties expressly refer to an earlier date, in which case they shall be true and correct as of such earlier date);

(c) No Existing Default. No Default or Event of Default shall exist or shall result from such Loan or continuation or conversion;

(d) Recapitalization. Completion of the recapitalization transaction described in the Company's Form S-1 filing with the Securities and Exchange Commission dated June 3, 1997 (a true and correct copy of which is attached hereto as Exhibit D), including (i) the sale of common shares to the public, producing net cash proceeds to the Company in the minimum amount of \$60,000,000, and (ii) the repayment of the indebtedness, the termination of the credit facilities and the release of the Liens, in each case, identified in Schedule 4.02(d) hereto, all of which must be demonstrated or otherwise evidenced to the Bank's reasonable satisfaction on or prior to September 1, 1997; and

(e) Schedules. The Bank shall have received by no later than August 11, 1997, the Schedules hereto in form and substance satisfactory to the Bank, in its sole discretion.

Each Notice of Borrowing and Notice of Conversion/Continuation submitted by the Company hereunder shall constitute a representation and warranty by the Company hereunder, as of the date of each such notice and as of each Borrowing Date or Conversion/Continuation Date, as applicable, that the conditions in this Section 4.02 are satisfied.

ARTICLE V

REPRESENTATIONS AND WARRANTIES

The Company represents and warrants to the Bank that:

5.01 Corporate Existence and Power. Each of the Company and its Subsidiaries: (a) is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation; (b) has the power and authority and all governmental licenses, authorizations, consents and approvals to own its assets, carry on its business and to execute, deliver, and perform its obligations under the Loan Documents; (c) is duly qualified as a foreign corporation and is licensed and in good standing under the laws of each jurisdiction where its ownership, lease or operation of property or the conduct of its business requires such qualification or license; and (d) is in compliance with all Requirements of Law; except, in each case referred to in clause (c) or clause (d), to the extent that the failure to do so could not reasonably be expected to have a Material Adverse Effect.

5.02 Corporate Authorization; No Contravention. The execution, delivery and performance by the Company of this Agreement and each other Loan Document to which the Company is party, have been duly authorized by all necessary corporate action, and do not and will not: (a) contravene the terms of any of the Company's Organization Documents; (b) conflict with or result in any breach or contravention of, or the creation of any Lien under, any document evidencing any Contractual Obligation to which the Company is a party or any order, injunction, writ or decree of any Governmental Authority to which the Company or its property is subject (other than the documents described in Schedule 4.01(h) hereto evidencing obligations of the Company to be paid or otherwise satisfied and released in full on or prior to the Closing Date); or (c) violate any Requirement of Law.

5.03 Governmental Authorization. No approval, consent, exemption, authorization, or other action by, or notice to, or filing with, any Governmental Authority is necessary or required in connection with the execution, delivery or performance by, or enforcement against, the Company or any of its Subsidiaries of the Agreement or any other Loan Document.

5.04 Binding Effect. This Agreement and each other Loan Document to which the Company is a party constitute the legal, valid and binding obligations of the Company, enforceable against the Company in accordance with their respective terms, except as enforceability may be limited by applicable bankruptcy, insolvency, or similar laws affecting the enforcement of creditors' rights generally or by equitable principles relating to enforceability.

5.05 Litigation. There are no actions, suits, proceedings, claims or disputes pending, or to the best knowledge of the Company, threatened or contemplated, at law, in equity, in arbitration or before any Governmental Authority, against the Company, or its Subsidiaries or any of their respective properties which: (a) purport to affect or pertain to this Agreement or any other Loan Document, or any of the transactions contemplated hereby or thereby; or (b) if determined adversely to the Company or its Subsidiaries, would reasonably be expected to have a Material Adverse Effect. No injunction, writ, temporary restraining order or any order of any nature has been issued by any court or other Governmental Authority purporting to enjoin or restrain the execution, delivery or performance of this Agreement or any other Loan Document, or directing that the transactions provided for herein or therein not be consummated as herein or therein provided.

5.06 No Default. No Default or Event of Default exists or would result from the incurring of any Obligations by the Company. As of the Closing Date, neither the Company nor any Subsidiary is in default under or with respect to any Contractual Obligation in any respect which, individually or together with all such defaults, could reasonably be expected to have a Material Adverse Effect, or that would, if such default had occurred after the Closing Date, create an Event of Default under subsection 8.01(e).

5.07 ERISA Compliance. (a) Each Plan is in compliance in all material respects with the applicable provisions of ERISA, the Code and other federal or state law. Each Plan which is intended to qualify under Section 401(a) of the Code has received a favorable determination letter from the Internal Revenue Service, and any Governmental Authority succeeding to any of its principal functions under the Code, and to the best knowledge of the Company, nothing has occurred which would cause the loss of such qualification. The Company and each ERISA Affiliate has made all required contributions to any Plan subject to Section 412 of the Code, and no application for a funding waiver or an extension of any amortization period pursuant to Section 412 of the Code has been made with respect to any Plan.

(b) There are no pending or, to the best knowledge of Company,

threatened claims, actions or lawsuits, or action by any Governmental Authority, with respect to any Plan which has resulted or could reasonably be expected to result in a Material Adverse Effect. There has been no prohibited transaction or violation of the fiduciary responsibility rules with respect to any Plan which has resulted or could reasonably be expected to result in a Material Adverse Effect.

(c) (i) No ERISA Event has occurred or is reasonably expected to occur; (ii) no Pension Plan has any Unfunded Pension Liability; (iii) neither the Company nor any ERISA Affiliate has incurred, or reasonably expects to incur, any liability under Title IV of ERISA with respect to any Pension Plan (other than premiums due and not delinquent under Section 4007 of ERISA); (iv) neither the Company nor any ERISA Affiliate has incurred, or reasonably expects to incur, any liability (and no event has occurred which, with the giving of notice under Section 4219 of ERISA, would result in such liability) under Section 4201 or 4243 of ERISA with respect to a Multiemployer Plan; and (v) neither the Company nor any ERISA Affiliate has engaged in a transaction that could be subject to Section 4069 or 4212(c) of ERISA.

5.08 Use of Proceeds; Margin Regulations. The proceeds of the Loans are to be used solely for the purposes set forth in and permitted by Section 6.12 and Section 7.07. Neither the Company nor any Subsidiary is generally engaged in the business of purchasing or selling Margin Stock or extending credit for the purpose of purchasing or carrying Margin Stock.

5.09 Title to Properties. The Company and each Subsidiary have good record and marketable title in fee simple to, or valid leasehold interests in, all real property necessary or used in the ordinary conduct of their respective businesses, except for such defects in title as could not, individually or in the aggregate, have a Material Adverse Effect. As of the Closing Date, the property of the Company and its Subsidiaries is subject to no Liens, other than Permitted Liens.

5.10 Taxes. The Company and its Subsidiaries have filed all Federal and other material tax returns and reports required to be filed, and have paid all Federal and other material taxes, assessments, fees and other governmental charges levied or imposed upon them or their properties, income or assets otherwise due and payable, except those which are being contested in good faith by appropriate proceedings and for which adequate reserves have been provided in accordance with GAAP. There is no proposed tax assessment against the Company or any Subsidiary that would, if made, have a Material Adverse Effect.

5.11 Financial Condition. The audited consolidated financial statements of the Company and its Subsidiaries dated January 31, 1997, and the related consolidated statements of income or operations, shareholders' equity and cash flows for the fiscal year ended on that date: (i) were prepared in accordance with GAAP consistently applied throughout the period covered thereby, except as otherwise expressly noted therein; (ii) fairly present the financial condition of the Company and its Subsidiaries as of the date thereof and results of operations for the period covered thereby; and (iii) show all material indebtedness and other liabilities, direct or contingent, of the Company and its consolidated Subsidiaries as of the date thereof, including liabilities for taxes, material commitments and Contingent Obligations. Since January 31, 1997, there has been no Material Adverse Effect.

5.12 Environmental Matters. The Company conducts in the ordinary course of business a review of the effect of existing Environmental Laws and existing Environmental Claims on its business, operations and properties, and as a result thereof the Company has reasonably concluded that, such Environmental Laws and Environmental Claims could not, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect.

5.13 Regulated Entities. None of the Company, any Person controlling the Company, or any Subsidiary, is an "Investment Company" within the meaning of the Investment Company Act of 1940. The Company is not subject to regulation under the Public Utility Holding Company Act of 1935, the Federal Power Act, the Interstate Commerce Act, any state public utilities code, or any other Federal or state statute or regulation limiting its ability to incur Indebtedness.

5.14 No Burdensome Restrictions. Neither the Company nor any Subsidiary is a party to or bound by any Contractual Obligation, or subject to any restriction in any Organization Document, or any Requirement of Law, which could reasonably be expected to have a Material Adverse Effect (other than under the documents described in Schedule 4.01(h) hereof evidencing obligations of the Company to be paid or otherwise satisfied and released in full on or prior to

the Closing Date).

5.15 Copyrights, Patents, Trademarks and Licenses, etc. The Company or its Subsidiaries own or are licensed or otherwise have the right to use all of the patents, trademarks, service marks, trade names, copyrights, contractual franchises, authorizations and other rights that are reasonably necessary for the operation of their respective businesses, without conflict with the rights of any other Person. To the best knowledge of the Company, no slogan or other advertising device, product, process, method, substance, part or other material now employed, or now contemplated to be employed, by the Company or any Subsidiary infringes upon any rights held by any other Person. No claim or litigation regarding any of the foregoing is pending or threatened, and no patent, invention, device, application, principle or any statute, law, rule, regulation, standard or code is pending or, to the knowledge of the Company, proposed, which, in either case, could reasonably be expected to have a Material Adverse Effect.

5.16 Subsidiaries. As of the Closing Date, the Company has no Subsidiaries other than those specifically disclosed in part (a) of Schedule 5.16 hereto and has no equity investments in any other corporation or entity other than those specifically disclosed in part (b) of Schedule 5.16.

5.17 Insurance. The properties of the Company and its Subsidiaries are insured with financially sound and reputable insurance companies not Affiliates of the Company, in such amounts, with such deductibles and covering such risks as are customarily carried by companies engaged in similar businesses and owning similar properties in localities where the Company or such Subsidiary operates.

5.18 Swap Obligations. Neither the Company nor any of its Subsidiaries has incurred any outstanding obligations under any Swap Contracts, other than Permitted Swap Obligations. The Company has undertaken its own independent assessment of its consolidated assets, liabilities and commitments and has considered appropriate means of mitigating and managing risks associated with such matters and has not relied on any swap counterparty or any Affiliate of any swap counterparty in determining whether to enter into any Swap Contract.

5.19 Full Disclosure. None of the representations or warranties made by the Company in the Loan Documents as of the date such representations and warranties are made or deemed made, and none of the statements contained in any exhibit, report, statement or certificate furnished by or on behalf of the Company in connection with the Loan Documents (including the offering and disclosure materials delivered by or on behalf of the Company to the Bank prior to the Closing Date), contains any untrue statement of a material fact or omits any material fact required to be stated therein or necessary to make the statements made therein, in light of the circumstances under which they are made, not misleading as of the time when made or delivered.

ARTICLE VI

AFFIRMATIVE COVENANTS

So long as the Bank shall have any Commitment hereunder, or any Loan or other Obligation shall remain unpaid or unsatisfied, unless the Bank waives compliance in writing:

6.01 Financial Statements. The Company shall deliver to the Bank, in form and detail satisfactory to the Bank:

(a) as soon as available, but not later than 95 days after the end of each fiscal year (commencing with the fiscal year ended January 31, 1998), a copy of the audited consolidated balance sheet of the Company and its Subsidiaries as at the end of such year and the related consolidated statements of income or operations, shareholders' equity and cash flows for such year, setting forth in each case in comparative form the figures for the previous fiscal year, and accompanied by the opinion of a nationally-recognized independent public accounting firm ("Independent Auditor") which report shall state that such consolidated financial statements present fairly the financial position for the periods indicated in conformity with GAAP applied on a basis consistent with prior years. Such opinion shall not be qualified or limited because of a restricted or limited examination by the Independent Auditor of any material portion of the Company's or any Subsidiary's records; and

(b) as soon as available, but not later than 50 days after the end of each of the first three fiscal quarters of each fiscal year (commencing

with the fiscal quarter ended July 31, 1997, a copy of the unaudited consolidated balance sheet of the Company and its Subsidiaries as of the end of such quarter and the related consolidated statements of income, shareholders' equity and cash flows for the period commencing on the first day and ending on the last day of such quarter, and certified by a Responsible Officer as fairly presenting, in accordance with GAAP (subject to ordinary, good faith year-end audit adjustments), the financial position and the results of operations of the Company and the Subsidiaries;

6.02 Certificates; Other Information. The Company shall furnish to the Bank:

(a) concurrently with the delivery of the financial statements referred to in subsection 6.01(a), a certificate of the Independent Auditor stating that in making the examination necessary therefor no knowledge was obtained of any Default or Event of Default, except as specified in such certificate;

(b) concurrently with the delivery of the financial statements referred to in subsections 6.01(a) and (b), a Compliance Certificate executed by a Responsible Officer;

(c) promptly, copies of all financial statements and reports that the Company sends to its shareholders, and copies of all financial statements and regular, periodical or special reports (including Forms 10K, 10Q and 8K) that the Company or any Subsidiary may make to, or file with, the SEC; and

(d) promptly, such additional information regarding the business, financial or corporate affairs of the Company or any Subsidiary as the Bank may from time to time reasonably request.

6.03 Notices. The Company shall promptly notify the Bank:

(a) of the occurrence of any Default or Event of Default, and of the occurrence or existence of any event or circumstance that foreseeably will become a Default or Event of Default;

(b) of any matter that has resulted or may result in a Material Adverse Effect, including (i) breach or non-performance of, or any default under, a Contractual Obligation of the Company or any Subsidiary; (ii) any dispute, litigation, investigation, proceeding or suspension between the Company or any Subsidiary and any Governmental Authority; or (iii) the commencement of, or any material development in, any litigation or proceeding affecting the Company or any Subsidiary; including pursuant to any applicable Environmental Laws;

(c) of the occurrence of any of the following events affecting the Company or any ERISA Affiliate (but in no event more than 10 days after such event), and deliver to the Bank a copy of any notice with respect to such event that is filed with a Governmental Authority and any notice delivered by a Governmental Authority to the Company or any ERISA Affiliate with respect to such event: (i) an ERISA Event; (ii) a material increase in the Unfunded Pension Liability of any Pension Plan; (iii) the adoption of, or the commencement of contributions to, any Plan subject to Section 412 of the Code by the Company or any ERISA Affiliate; or (iv) the adoption of any amendment to a Plan subject to Section 412 of the Code, if such amendment results in a material increase in contributions or Unfunded Pension Liability; and

(d) of any material change in accounting policies or financial reporting practices by the Company or any of its consolidated Subsidiaries.

Each notice under this Section shall be accompanied by a written statement by a Responsible Officer setting forth details of the occurrence referred to therein, and stating what action the Company or any affected Subsidiary proposes to take with respect thereto and at what time. Each notice under subsection 6.03(a) shall describe with particularity any and all clauses or provisions of this Agreement or other Loan Document that have been (or foreseeably will be) breached or violated.

6.04 Preservation of Corporate Existence, Etc. The Company shall, and shall cause each Subsidiary to: (a) preserve and maintain in full force and effect its corporate existence and good standing under the laws of its state or jurisdiction of incorporation; (b) preserve and maintain in full force and effect all governmental rights, privileges, qualifications, permits, licenses

and franchises necessary or desirable in the normal conduct of its business except in connection with transactions permitted by Section 7.03 and sales of assets permitted by Section 7.02; (c) use reasonable efforts, in the ordinary course of business, to preserve its business organization and goodwill; and (d) preserve or renew all of its registered patents, trademarks, trade names and service marks, the non-preservation of which could reasonably be expected to have a Material Adverse Effect.

6.05 Maintenance of Property. The Company shall maintain, and shall cause each Subsidiary to maintain, and preserve all its property which is used or useful in its business in good working order and condition, ordinary wear and tear excepted and make all necessary repairs thereto and renewals and replacements thereof except where the failure to do so could not reasonably be expected to have a Material Adverse Effect.

6.06 Insurance. The Company shall maintain, and shall cause each Subsidiary to maintain, with financially sound and reputable independent insurers, insurance with respect to its properties and business against loss or damage of the kinds customarily insured against by Persons engaged in the same or similar business, of such types and in such amounts as are customarily carried under similar circumstances by such other Persons.

6.07 Payment of Obligations. The Company shall, and shall cause each Subsidiary to, pay and discharge as the same shall become due and payable, all their respective obligations and liabilities, including: (a) all tax liabilities, assessments and governmental charges or levies upon it or its properties or assets, unless the same are being contested in good faith by appropriate proceedings and adequate reserves in accordance with GAAP are being maintained by the Company or such Subsidiary; (b) all lawful claims which, if unpaid, would by law become a Lien upon its property; and (c) all Indebtedness, as and when due and payable, but subject to any subordination provisions contained in any instrument or agreement evidencing such Indebtedness.

6.08 Compliance with Laws. The Company shall comply, and shall cause each Subsidiary to comply, in all material respects with all Requirements of Law of any Governmental Authority having jurisdiction over it or its business (including the Federal Fair Labor Standards Act), except such as may be contested in good faith or as to which a bona fide dispute may exist.

6.09 Compliance with ERISA. The Company shall, and shall cause each of its ERISA Affiliates to: (a) maintain each Plan in compliance in all material respects with the applicable provisions of ERISA, the Code and other federal or state law; (b) cause each Plan which is qualified under Section 401(a) of the Code to maintain such qualification; and (c) make all required contributions to any Plan subject to Section 412 of the Code.

6.10 Inspection of Property and Books and Records. The Company shall maintain and shall cause each Subsidiary to maintain proper books of record and account, in which full, true and correct entries in conformity with GAAP consistently applied shall be made of all financial transactions and matters involving the assets and business of the Company and such Subsidiary. The Company shall permit, and shall cause each Subsidiary to permit, representatives and independent contractors of the Bank to visit and inspect any of their respective properties, to examine their respective corporate, financial and operating records, and make copies thereof or abstracts therefrom, and to discuss their respective affairs, finances and accounts with their respective directors, officers, and independent public accountants, all at the reasonable expense of the Company and at such reasonable times during normal business hours and as often as may be reasonably desired, upon reasonable advance notice to the Company; provided, however, when an Event of Default exists the Bank may do any of the foregoing at the expense of the Company at any time during normal business hours and without advance notice.

6.11 Environmental Laws. The Company shall, and shall cause each Subsidiary to, conduct its operations and keep and maintain its property in compliance with all Environmental Laws.

6.12 Use of Proceeds. The Company shall use the proceeds of the Loans for working capital and other general corporate purposes not in contravention of any Requirement of Law or of any Loan Document.

ARTICLE VII

NEGATIVE COVENANTS

So long as the Bank shall have any Commitment hereunder, or any Loan or other Obligation shall remain unpaid or unsatisfied, unless the Bank waives compliance in writing:

7.01 Limitation on Liens. The Company shall not, and shall not suffer or permit any Subsidiary to, directly or indirectly, make, create, incur, assume or suffer to exist any Lien upon or with respect to any part of its property, whether now owned or hereafter acquired, other than the following ("Permitted Liens"):

(a) any Lien existing on property of the Company or any Subsidiary on the Closing Date and set forth in Schedule 7.01 securing Indebtedness outstanding on such date;

(b) any Lien created under any Loan Document;

(c) Liens for taxes, fees, assessments or other governmental charges which are not delinquent or remain payable without penalty, or to the extent that non-payment thereof is permitted by Section 6.07, provided that no notice of lien has been filed or recorded under the Code;

(d) carriers', warehousemen's, mechanics', landlords', materialmen's, repairmen's or other similar Liens arising in the ordinary course of business which are not delinquent or remain payable without penalty or which are being contested in good faith and by appropriate proceedings, which proceedings have the effect of preventing the forfeiture or sale of the property subject thereto;

(e) Liens (other than any Lien imposed by ERISA) consisting of pledges or deposits required in the ordinary course of business in connection with workers' compensation, unemployment insurance and other social security legislation;

(f) Liens on the property of the Company or its Subsidiary securing (i) the non-delinquent performance of bids, trade contracts (other than for borrowed money), leases, statutory obligations, (ii) contingent obligations on surety and appeal bonds, and (iii) other non-delinquent obligations of a like nature; in each case, incurred in the ordinary course of business, provided all such Liens in the aggregate would not (even if enforced) cause a Material Adverse Effect;

(g) Liens consisting of judgment or judicial attachment liens, provided that the enforcement of such Liens is effectively stayed and all such Liens in the aggregate at any time outstanding for the Company and its Subsidiaries do not exceed \$1,000,000;

(h) easements, rights-of-way, restrictions and other similar encumbrances incurred in the ordinary course of business which, in the aggregate, are not substantial in amount, and which do not in any case materially detract from the value of the property subject thereto or interfere with the ordinary conduct of the businesses of the Company and its Subsidiaries;

(i) Liens on assets of corporations which become Subsidiaries after the date of this Agreement, provided, however, that such Liens existed at the time the respective corporations became Subsidiaries and were not created in anticipation thereof;

(j) purchase money security interests on any property acquired or held by the Company or its Subsidiaries in the ordinary course of business, securing Indebtedness incurred or assumed for the purpose of financing all or any part of the cost of acquiring such property; provided that (i) any such Lien attaches to such property concurrently with or within 20 days after the acquisition thereof, (ii) such Lien attaches solely to the property so acquired in such transaction, (iii) the principal amount of the debt secured thereby does not exceed 100% of the cost of such property, and (iv) the principal amount of the Indebtedness secured by any and all such purchase money security interests (excluding purchase money security interests otherwise permitted under this subsection (j) securing Indebtedness incurred or assumed for the purpose of financing all or any part of the cost of acquiring new operating facilities for the Company or its Subsidiaries) shall not at any time exceed, together with Indebtedness permitted under subsection 7.05(d), \$5,000,000;

(l) Liens arising solely by virtue of any statutory or common law provision relating to banker's liens, rights of set-off or similar rights

and remedies as to deposit accounts or other funds maintained with a creditor depository institution; provided that (i) such deposit account is not a dedicated cash collateral account and is not subject to restrictions against access by the Company in excess of those set forth by regulations promulgated by the FRB, and (ii) such deposit account is not intended by the Company or any Subsidiary to provide collateral to the depository institution; and

(m) Liens consisting of pledges of cash collateral or government securities to secure on a mark-to-market basis obligations under Swap Contracts entered into in the ordinary course of business as bona fide hedging transactions, provided that (i) the counterparty to such Swap Contract is under a similar requirement to deliver similar collateral from time to time to the Company or the Subsidiary party thereto, and (ii) the aggregate value of such collateral so pledged by the Company and the Subsidiaries together in favor of any counterparty does not at any time exceed \$1,000,000.

7.02 Disposition of Assets. The Company shall not, and shall not suffer or permit any Subsidiary to, directly or indirectly, sell, assign, lease, convey, transfer or otherwise dispose of (whether in one or a series of transactions) any property (including accounts and notes receivable, with or without recourse) or enter into any agreement to do any of the foregoing, except:

(a) dispositions of inventory, or used, worn-out or surplus equipment, all in the ordinary course of business;

(b) the sale of equipment to the extent that such equipment is exchanged for credit against the purchase price of similar replacement equipment, or the proceeds of such sale are reasonably promptly applied to the purchase price of such replacement equipment;

(c) dispositions of inventory, equipment and other property by the Company or any Subsidiary to the Company or any Subsidiary pursuant to reasonable business requirements; and

(d) dispositions of assets (other than accounts receivable of the Company or any Subsidiary) not otherwise permitted hereunder which are made for fair market value; provided, that (i) at the time of any disposition, no Event of Default shall exist or shall result from such disposition, (ii) the aggregate sales price from such disposition shall be paid in cash, and (iii) the aggregate value of all assets so sold by the Company and its Subsidiaries, together, shall not exceed in any fiscal year an amount equal to 10% of Consolidated Tangible Net Worth measured as of the end of the then immediately preceding fiscal year.

7.03 Consolidations and Mergers. The Company shall not, and shall not suffer or permit any Subsidiary to, merge, consolidate with or into, or convey, transfer, lease or otherwise dispose of (whether in one transaction or in a series of transactions) all or substantially all of its assets (whether now owned or hereafter acquired) to or in favor of any Person, except:

(a) any Subsidiary may merge with the Company, provided that the Company shall be the continuing or surviving corporation, or with any one or more Subsidiaries, provided that if any transaction shall be between a Subsidiary and a Wholly-Owned Subsidiary, the Wholly-Owned Subsidiary shall be the continuing or surviving corporation; and

(b) any Subsidiary may sell all or substantially all of its assets (upon voluntary liquidation or otherwise), to the Company or another Wholly-Owned Subsidiary.

7.04 Loans and Investments. The Company shall not purchase or acquire, or suffer or permit any Subsidiary to purchase or acquire, or make any commitment therefor, any capital stock, equity interest, or any obligations or other securities of, or any interest in, any Person, or make or commit to make any Acquisitions, or make or commit to make any advance, loan, extension of credit or capital contribution to or any other investment in, any Person including any Affiliate of the Company, except for:

(a) investments in the form of Cash Equivalents or short term marketable securities;

(b) extensions of credit in the nature of accounts receivable or notes receivable arising from the sale or lease of goods or services in the ordinary course of business;

(c) extensions of credit by the Company to any of its Wholly-Owned Subsidiaries or by any of its Wholly-Owned Subsidiaries to another of its Wholly-Owned Subsidiaries;

(d) investments incurred in order to consummate Acquisitions otherwise permitted herein, provided that (i) the book value (as to the purchaser) of any such Acquisition, together with such value of all prior Acquisitions undertaken by the Company and its Subsidiaries after the Closing Date, shall not exceed at the time of such investment \$10,000,000 in the aggregate, (ii) such Acquisition is undertaken in accordance with all applicable Requirements of Law, and (iii) the prior, effective written consent or approval to such Acquisition of the board of directors or equivalent governing body of the acquiree is obtained; or

(e) investments constituting Permitted Swap Obligations or payments or advances under Swap Contracts relating to Permitted Swap Obligations.

(f) investments in the capital stock of any corporation not otherwise permitted hereunder provided that such investments, together with investments made pursuant to clause (d) above, do not exceed \$10,000,000 in the aggregate.

7.05 Limitation on Indebtedness. The Company shall not, and shall not suffer or permit any Subsidiary to, create, incur, assume, suffer to exist, or otherwise become or remain directly or indirectly liable with respect to, any Indebtedness, except: (a) Indebtedness incurred pursuant to this Agreement; (b) Indebtedness consisting of Contingent Obligations permitted pursuant to Section 7.08; (c) Indebtedness existing on the Closing Date and set forth in Schedule 7.05; (d) Indebtedness secured by Liens permitted by subsection 7.01(i), (j) and (m) in an aggregate amount outstanding not to exceed \$10,000,000; and (e) Indebtedness incurred in connection with leases permitted pursuant to Section 7.10.

7.06 Transactions with Affiliates. The Company shall not, and shall not suffer or permit any Subsidiary to, enter into any transaction with any Affiliate of the Company, except upon fair and reasonable terms no less favorable to the Company or such Subsidiary than would obtain in a comparable arm's-length transaction with a Person not an Affiliate of the Company or such Subsidiary.

7.07 Use of Proceeds. The Company shall not, and shall not suffer or permit any Subsidiary to, use any portion of the Loan proceeds, directly or indirectly, (i) to purchase or carry Margin Stock, (ii) to repay or otherwise refinance indebtedness of the Company or others incurred to purchase or carry Margin Stock, (iii) to extend credit for the purpose of purchasing or carrying any Margin Stock, or (iv) to acquire any security in any transaction that is subject to Section 13 or 14 of the Securities and Exchange Act of 1934, and regulations promulgated thereunder.

7.08 Contingent Obligations. The Company shall not, and shall not suffer or permit any Subsidiary to, create, incur, assume or suffer to exist any Contingent Obligations except: (a) endorsements for collection or deposit in the ordinary course of business; (b) Permitted Swap Obligations; and (c) Contingent Obligations of the Company and its Subsidiaries existing as of the Closing Date and listed in Schedule 7.08.

7.09 Joint Ventures. The Company shall not, and shall not suffer or permit any Subsidiary to enter into any Joint Venture, other than in the ordinary course of business.

7.10 Lease Obligations. The Company shall not, and shall not suffer or permit any Subsidiary to, create or suffer to exist any obligations for the payment of rent for any property under lease or agreement to lease, except for: (a) leases of the Company and of Subsidiaries in existence on the Closing Date and any renewal, extension or refinancing thereof; (b) operating leases entered into by the Company or any Subsidiary after the Closing Date in the ordinary course of business.

7.11 Restricted Payments. The Company shall not, and shall not suffer or permit any Subsidiary to, declare or make any dividend payment or other distribution of assets, properties, cash, rights, obligations or securities on account of any shares of any class of its capital stock, or purchase, redeem or otherwise acquire for value any shares of its capital stock or any warrants,

rights or options to acquire such shares, now or hereafter outstanding; except that the Company and any Wholly-Owned Subsidiary may: (a) declare and make dividend payments or other distributions payable solely in its common stock; and (b) purchase, redeem or otherwise acquire shares of its common stock or warrants or options to acquire any such shares (i) in an aggregate amount not to exceed \$5,000,000 or (ii) with the proceeds received from the substantially concurrent issue of new shares of its common stock.

7.12 ERISA. The Company shall not, and shall not suffer or permit any of its ERISA Affiliates to: (a) engage in a prohibited transaction or violation of the fiduciary responsibility rules with respect to any Plan which has resulted or could reasonably be expected to result in a Material Adverse Effect; or (b) engage in a transaction that could be subject to Section 4069 or 4212(c) of ERISA.

7.13 Change in Business. The Company shall not, and shall not suffer or permit any Subsidiary to, engage in any material line of business substantially different from those lines of business carried on by the Company and its Subsidiaries on the date hereof (including the development of the On/Q product described in the Company's Form S-1).

7.14 Accounting Changes. The Company shall not, and shall not suffer or permit any Subsidiary to, make any significant change in accounting treatment or reporting practices, except as required by GAAP, or change the fiscal year of the Company or of any Subsidiary.

7.15 Financial Covenants.

(a) Adjusted Quick Ratio. The Company shall not as of the end of any fiscal quarter suffer or permit its ratio (determined on a consolidated basis) of (i) cash plus the value (valued in accordance with GAAP) of all Cash Equivalents, other than cash and Cash Equivalents subject to a Lien securing Indebtedness, plus net current accounts receivable (valued in accordance with GAAP) to (ii) Consolidated Current Liabilities, to be less than (A) 1.15 to 1.00 from the Closing Date through the fiscal quarter ending July 31, 1998 and (B) 1.20 to 1.00 thereafter.

(b) Leverage Ratio. The Company shall not as of the end of any fiscal quarter suffer or permit its Leverage Ratio to be greater than 0.65 to 1.00.

(c) Profitability. The Company shall not suffer or permit, on a net or operating basis, (i) a loss in any two fiscal quarters during any period of four consecutive fiscal quarters beginning after the fourth fiscal quarter ended after the Closing Date, (ii) a loss in any single fiscal quarter or for any period of two consecutive fiscal quarters of more than 10% of Consolidated Tangible Net Worth measured as of the end of the immediately preceding fiscal quarter, and (iii) a loss for any period of four consecutive fiscal quarters.

(d) Minimum Tangible Net Worth. The Company shall not suffer or permit Consolidated Tangible Net Worth as of the end of any fiscal quarter to be less than (i) 85% of Consolidated Tangible Net Worth measured as of July 31, 1997, plus (ii) 75% of net income for the Company and its Subsidiaries earned in each fiscal quarter ended after the Closing Date, determined on a consolidated basis and not reduced by any quarterly loss, plus (iii) 100% of the Net Issuance Proceeds of any sale of capital stock of the Company by or for the account of the Company occurring on or after the Closing Date.

ARTICLE VIII

EVENTS OF DEFAULT

8.01 Event of Default. Any of the following shall constitute an "Event of Default":

(a) Non-Payment. The Company fails to pay, (i) when and as required to be paid herein, any amount of principal of any Loan, or (ii) within five (5) days after the same becomes due, any interest, fee or any other amount payable hereunder or under any other Loan Document; or

(b) Representation or Warranty. Any representation or warranty by the Company made or deemed made herein, in any other Loan Document, or which is contained in any certificate, document or financial or other statement by the Company, or any Responsible Officer, furnished at any time under this Agreement,

or in or under any other Loan Document, is incorrect in any material respect on or as of the date made or deemed made; or

(c) Specific Defaults. The Company fails to perform or observe any term, covenant or agreement contained in any of Sections 6.01, 6.02, 6.03 or 6.09 or in Article VII; or

(d) Other Defaults. The Company fails to perform or observe any other term or covenant contained in this Agreement or any other Loan Document, and such default shall continue unremedied for a period of 20 days after the earlier of (i) the date upon which a Responsible Officer knew or reasonably should have known of such failure and (ii) the date upon which written notice thereof is given to the Company by the Bank; or

(e) Cross-Default. (i) The Company or any Subsidiary (A) fails to make any payment in respect of any Indebtedness or Contingent Obligation (other than in respect of Swap Contracts), having an aggregate principal amount (including undrawn committed or available amounts and including amounts owing to all creditors under any combined or syndicated credit arrangement) of more than \$2,500,000 when due (whether by scheduled maturity, required prepayment, acceleration, demand, or otherwise) and such failure continues after the applicable grace or notice period, if any, specified in the relevant document on the date of such failure; or (B) fails to perform or observe any other condition or covenant, or any other event shall occur or condition exist, under any agreement or instrument relating to any such Indebtedness or Contingent Obligation, and such failure continues after the applicable grace or notice period, if any, specified in the relevant document on the date of such failure if the effect of such failure, event or condition is to cause, or to permit the holder or holders of such Indebtedness or beneficiary or beneficiaries of such Indebtedness (or a trustee or agent on behalf of such holder or holders or beneficiary or beneficiaries) to cause such Indebtedness to be declared to be due and payable prior to its stated maturity, or such Contingent Obligation to become payable or cash collateral in respect thereof to be demanded; or (ii) there occurs under any Swap Contract an Early Termination Date (as defined in such Swap Contract) resulting from (1) any event of default under such Swap Contract as to which the Company or any Subsidiary is the Defaulting Party (as defined in such Swap Contract) or (2) any Termination Event (as so defined) as to which the Company or any Subsidiary is an Affected Party (as so defined), and, in either event, the Swap Termination Value owed by the Company or such Subsidiary as a result thereof is greater than \$2,500,000; or

(f) Insolvency; Voluntary Proceedings. The Company or any Subsidiary (i) ceases or fails to be solvent, or generally fails to pay, or admits in writing its inability to pay, its debts as they become due, subject to applicable grace periods, if any, whether at stated maturity or otherwise; (ii) voluntarily ceases to conduct its business in the ordinary course; (iii) commences any Insolvency Proceeding with respect to itself; or (iv) takes any action to effectuate or authorize any of the foregoing; or

(g) Involuntary Proceedings. (i) Any involuntary Insolvency Proceeding is commenced or filed against the Company or any Subsidiary, or any writ, judgment, warrant of attachment, execution or similar process, is issued or levied against a substantial part of the Company's or any Subsidiary's properties, and any such proceeding or petition shall not be dismissed, or such writ, judgment, warrant of attachment, execution or similar process shall not be released, vacated or fully bonded within 60 days after commencement, filing or levy; (ii) the Company or any Subsidiary admits the material allegations of a petition against it in any Insolvency Proceeding, or an order for relief (or similar order under non-U.S. law) is ordered in any Insolvency Proceeding; or (iii) the Company or any Subsidiary acquiesces in the appointment of a receiver, trustee, custodian, conservator, liquidator, mortgagee in possession (or agent therefor), or other similar Person for itself or a substantial portion of its property or business; or

(h) ERISA. (i) An ERISA Event shall occur with respect to a Pension Plan or Multiemployer Plan which has resulted or could reasonably be expected to result in liability of the Company under Title IV of ERISA to the Pension Plan, Multiemployer Plan or the PBGC in an aggregate amount in excess of \$1,000,000; (ii) the aggregate amount of Unfunded Pension Liability among all Pension Plans at any time exceeds \$1,000,000; or (iii) the Company or any ERISA Affiliate shall fail to pay when due, after the expiration of any applicable grace period, any installment payment with respect to its withdrawal liability under Section 4201 of ERISA under a Multiemployer Plan in an aggregate amount in excess of 1,000,000; or

(i) Monetary Judgments. One or more non-interlocutory judgments, non-interlocutory orders, decrees or arbitration awards is entered against the Company or any Subsidiary involving in the aggregate a liability (to the extent not covered by independent third-party insurance as to which the insurer does not dispute coverage) as to any single or related series of transactions, incidents or conditions, of \$2,500,000 or more, and the same shall remain unsatisfied, unvacated and unstayed pending appeal for a period of 10 days after the entry thereof; or

(j) Non-Monetary Judgments. Any non-monetary judgment, order or decree is entered against the Company or any Subsidiary which does or would reasonably be expected to have a Material Adverse Effect, and there shall be any period of 10 consecutive days during which a stay of enforcement of such judgment or order, by reason of a pending appeal or otherwise, shall not be in effect; or

(l) Loss of Licenses. Any Governmental Authority revokes or fails to renew any material license, permit or franchise of the Company or any Subsidiary, or the Company or any Subsidiary for any reason loses any material license, permit or franchise, or the Company or any Subsidiary suffers the imposition of any restraining order, escrow, suspension or impound of funds in connection with any proceeding (judicial or administrative) with respect to any material license, permit or franchise; or

(m) Adverse Change. There occurs a Material Adverse Effect.

8.02 Remedies. If any Event of Default occurs, the Bank may: (a) declare the commitment of the Bank to make Loans to be terminated, whereupon such commitment shall be terminated; (b) declare the unpaid principal amount of all outstanding Loans, all interest accrued and unpaid thereon, and all other amounts owing or payable hereunder or under any other Loan Document to be immediately due and payable, without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived by the Company; and (c) exercise all rights and remedies available to it under the Loan Documents or applicable law; provided, however, that upon the occurrence of any event specified in subsection (f) or (g) of Section 8.01 (in the case of clause (i) of subsection (g) upon the expiration of the 60-day period mentioned therein), the obligation of the Bank to make Loans shall automatically terminate and the unpaid principal amount of all outstanding Loans and all interest and other amounts as aforesaid shall automatically become due and payable without further act of the Bank.

8.03 Rights Not Exclusive. The rights provided for in this Agreement and the other Loan Documents are cumulative and are not exclusive of any other rights, powers, privileges or remedies provided by law or in equity, or under any other instrument, document or agreement now existing or hereafter arising.

ARTICLE IX

MISCELLANEOUS

9.01 Amendments and Waivers. No amendment or waiver of any provision of this Agreement or any other Loan Document, and no consent with respect to any departure by the Company therefrom, shall be effective unless the same shall be in writing and signed by the Bank and the Company, and then any such waiver or consent shall be effective only in the specific instance and for the specific purpose for which given.

9.02 Notices. (a) All notices, requests, consents, approvals, waivers and other communications shall be in writing (including, unless the context expressly otherwise provides, by facsimile transmission, provided that any matter transmitted by the Company by facsimile (i) shall be immediately confirmed by a telephone call to the recipient at the number specified on the signature page hereof with respect to such Person, and (ii) shall be followed promptly by delivery of a hard copy original thereof) and mailed, telecopied or delivered, to the address or facsimile number specified for notices on the signature page hereof with respect to such Person; or, as directed to the Company or the Bank, to such other address as shall be designated by such party in a written notice to the other parties, and as directed to any other party, at such other address as shall be designated by such party in a written notice to the Company and the Bank.

(b) All such notices, requests and communications shall, when transmitted by overnight delivery, or faxed, be effective when delivered for

overnight (next-day) delivery, or transmitted in legible form by facsimile machine, respectively, or if mailed, upon the third Business Day after the date deposited into the U.S. mail, or if delivered, upon delivery; except that notices pursuant to Article II shall not be effective until actually received by the Bank.

(c) Any agreement of the Bank herein to receive certain notices by telephone or facsimile is solely for the convenience and at the request of the Company. The Bank shall be entitled to rely on the authority of any Person purporting to be a Person authorized by the Company to give such notice and the Bank shall not have any liability to the Company or other Person on account of any action taken or not taken by the Bank in reliance upon such telephonic or facsimile notice. The obligation of the Company to repay the Loans shall not be affected in any way or to any extent by any failure by the Bank to receive written confirmation of any telephonic or facsimile notice or the receipt by the Bank of a confirmation which is at variance with the terms understood by the Bank to be contained in the telephonic or facsimile notice.

9.03 No Waiver; Cumulative Remedies. No failure to exercise and no delay in exercising, on the part of the Bank, any right, remedy, power or privilege hereunder, shall operate as a waiver thereof; nor shall any single or partial exercise of any right, remedy, power or privilege hereunder preclude any other or further exercise thereof or the exercise of any other right, remedy, power or privilege.

9.04 Costs and Expenses. The Company shall: (a) whether or not the transactions contemplated hereby are consummated, pay or reimburse the Bank within five Business Days after demand (subject to subsection 4.01(e)) for all reasonable costs and expenses incurred by the Bank in connection with the development, preparation, delivery, administration and execution of, and any amendment, supplement, waiver or modification to (in each case, whether or not consummated), this Agreement, any Loan Document and any other documents prepared in connection herewith or therewith, and the consummation of the transactions contemplated hereby and thereby, including Attorney Costs incurred by the Bank with respect thereto; and (b) pay or reimburse the Bank within five Business Days after demand for all reasonable costs and expenses (including Attorney Costs) incurred by it in connection with the enforcement, attempted enforcement, or preservation of any rights or remedies under this Agreement or any other Loan Document during the existence of an Event of Default or after acceleration of the Loans (including in connection with any "workout" or restructuring regarding the Loans, and including in any Insolvency Proceeding or appellate proceeding).

9.05 Indemnification. Whether or not the transactions contemplated hereby are consummated, the Company shall indemnify, defend and hold the Bank and each of its officers, directors, employees, counsel, agents and attorneys-in-fact (each, an "Indemnified Person") harmless from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, charges, expenses and disbursements (including Attorney Costs) of any kind or nature whatsoever which may at any time (including at any time following repayment of the Loans) be imposed on, incurred by or asserted against any such Person in any way relating to or arising out of this Agreement or any document contemplated by or referred to herein, or the transactions contemplated hereby, or any action taken or omitted by any such Person under or in connection with any of the foregoing, including with respect to any investigation, litigation or proceeding (including any Insolvency Proceeding or appellate proceeding) related to or arising out of this Agreement or the Loans or the use of the proceeds thereof, whether or not any Indemnified Person is a party thereto (all the foregoing, collectively, the "Indemnified Liabilities"); provided, that the Company shall have no obligation hereunder to any Indemnified Person with respect to Indemnified Liabilities resulting solely from the gross negligence or willful misconduct of such Indemnified Person. The agreements in this Section shall survive payment of all other Obligations.

9.06 Payments Set Aside. To the extent that the Company makes a payment to the Bank, or the Bank exercises its right of set-off, and such payment or the proceeds of such set-off or any part thereof are subsequently invalidated, declared to be fraudulent or preferential, set aside or required (including pursuant to any settlement entered into by the Bank in its discretion) to be repaid to a trustee, receiver or any other party, in connection with any Insolvency Proceeding or otherwise, then to the extent of such recovery the obligation or part thereof originally intended to be satisfied shall be revived and continued in full force and effect as if such payment had not been made or such set-off had not occurred.

9.07 Successors and Assigns. The provisions of this Agreement shall be

binding upon and inure to the benefit of the parties hereto and their respective successors and assigns, except that the Company may not assign or transfer any of its rights or obligations under this Agreement without the prior written consent of the Bank.

9.08 Assignments, Participations, etc. (a) The Bank may at any time and from time to time, with the prior consent of the Company, at all times other than during the existence of an Event of Default, which consent shall not be unreasonably withheld (provided, that no consent of the Company shall be required in connection with any assignment and delegation by the Bank to an Affiliate of the Bank), assign and delegate to one or more commercial banks (each an "Assignee") all, or any part of all, of the Loans, the Commitment and the other rights and obligations of the Bank hereunder; provided, however, that the Company may continue to deal solely and directly with the Bank in connection with the interest so assigned to an Assignee until written notice of such assignment, together with payment instructions, addresses and related information with respect to the Assignee, shall have been given to the Company by the Bank and the Assignee.

(b) The Bank may at any time and from time to time, without notice to or the consent of the Company, sell to one or more commercial banks or other Persons (a "Participant") participating interests in any Loans, the Commitment and the other interests of the Bank hereunder and under the other Loan Documents.

(c) Notwithstanding any other provision in this Agreement, the Bank may at any time create a security interest in, or pledge, all or any portion of its rights under and interest in this Agreement in favor of any Federal Reserve Bank in accordance with Regulation A of the FRB or 31 U.S. Treasury Regulation CFR ss.203.14, and such Federal Reserve Bank may enforce such pledge or security interest in any manner permitted under applicable law.

9.09 Confidentiality. The Bank agrees to take normal and reasonable precautions and exercise due care to maintain the confidentiality of all information identified as "confidential" or "secret" by the Company and provided to it by the Company or any Subsidiary, under this Agreement or any other Loan Document, and the Bank shall not use any such information other than in connection with or in enforcement of this Agreement and the other Loan Documents or in connection with other business now or hereafter existing or contemplated with the Company or any Subsidiary; except to the extent such information (i) was or becomes generally available to the public other than as a result of disclosure by the Bank, or (ii) was or becomes available on a non-confidential basis from a source other than the Company, provided that such source is not bound by a confidentiality agreement with the Company known to the Bank; provided, however, that the Bank may disclose such information (A) at the request or pursuant to any requirement of any Governmental Authority to which the Bank is subject or in connection with an examination of the Bank by any such authority; (B) pursuant to subpoena or other court process; (C) when required to do so in accordance with the provisions of any applicable Requirement of Law; (D) to the extent reasonably required in connection with any litigation or proceeding to which the Bank or may be party; (E) to the extent reasonably required in connection with the exercise of any remedy hereunder or under any other Loan Document; (F) to the Bank's independent auditors and other professional advisors; (G) to any Participant or Assignee, actual or potential, provided that such Person agrees in writing to keep such information confidential to the same extent required of the Bank hereunder; (H) as expressly permitted under the terms of any other document or agreement regarding confidentiality to which the Company or any Subsidiary is party or is deemed party with the Bank; and (I) to its Affiliates.

9.10 Set-off. In addition to any rights and remedies of the Bank provided by law, if an Event of Default exists or the Loans have been accelerated, the Bank is authorized at any time and from time to time, without prior notice to the Company, any such notice being waived by the Company to the fullest extent permitted by law, to set off and apply any and all deposits (general or special, time or demand, provisional or final) at any time held by, and other indebtedness at any time owing by, the Bank to or for the credit or the account of the Company against any and all Obligations owing to the Bank, now or hereafter existing, irrespective of whether or not the Bank shall have made demand under this Agreement or any Loan Document and although such Obligations may be contingent or unmatured. The Bank agrees promptly to notify the Company after any such set-off and application made by the Bank; provided, however, that the failure to give such notice shall not affect the validity of such set-off and application.

9.11 Automatic Debits of Fees. With respect to any commitment fee or any other cost or expense (including Attorney Costs) due and payable to the Bank under the Loan Documents, the Company hereby irrevocably authorizes the Bank to debit any deposit account of the Company with the Bank in an amount such that the aggregate amount debited from all such deposit accounts does not exceed such fee or other reasonable cost or expense. If there are insufficient funds in such deposit accounts to cover the amount of the fee or other cost or expense then due, such debits will be reversed (in whole or in part, in the Bank's sole discretion) and such amount not debited shall be deemed to be unpaid. No such debit under this Section shall be deemed a set-off.

9.12 Counterparts. This Agreement may be executed in any number of separate counterparts, each of which, when so executed, shall be deemed an original, and all of said counterparts taken together shall be deemed to constitute but one and the same instrument.

9.13 Severability. The illegality or unenforceability of any provision of this Agreement or any instrument or agreement required hereunder shall not in any way affect or impair the legality or enforceability of the remaining provisions of this Agreement or any instrument or agreement required hereunder.

9.14 No Third Parties Benefited. This Agreement is made and entered into for the sole protection and legal benefit of the Company, the Bank and their permitted successors and assigns, and no other Person shall be a direct or indirect legal beneficiary of, or have any direct or indirect cause of action or claim in connection with, this Agreement or any of the other Loan Documents.

9.15 Governing Law. THIS AGREEMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAW OF THE STATE OF CALIFORNIA; PROVIDED THAT THE BANK SHALL RETAIN ALL RIGHTS ARISING UNDER FEDERAL LAW.

9.16 Arbitration; Reference Proceeding. (a) Any controversy or claim between or among the parties, including but not limited to those arising out of or relating to this Agreement or any other Loan Document, and any claim based on or arising from an alleged tort, shall at the request of any party be determined by arbitration. The arbitration shall be conducted in accordance with the United States Arbitration Act (Title 9, U.S. Code), notwithstanding any choice of law provision in this Agreement, and under the Commercial Rules of the American Arbitration Association ("AAA"). The arbitrators shall give effect to statutes of limitation in determining any claim. Any controversy concerning whether an issue is arbitrable shall be determined by the arbitrators. Judgment upon the arbitration award may be entered in any court having jurisdiction. The institution and maintenance of an action for judicial relief or pursuit of a provisional or ancillary remedy shall not constitute a waiver of the right of any party, including the plaintiff, to submit the controversy or claim to arbitration if any other party contests such action for judicial relief.

(b) Notwithstanding the provisions of subsection (a), no controversy or claim shall be submitted to arbitration without the consent of all parties if, at the time of the proposed submission, such controversy or claim arises from or relates to an obligation to the Bank which is secured by real property collateral located in California. If all parties do not consent to submission of such a controversy or claim to arbitration, the controversy or claim shall be determined as provided in subsection (c).

(c) A controversy or claim which is not submitted to arbitration as provided and limited in subsections (a) and (b) shall, at the request of any party, be determined by a reference in accordance with California Code of Civil Procedure Sections 638 et seq. If such an election is made, the parties shall designate to the court a referee or referees selected under the auspices of the AAA in the same manner as arbitrators are selected in AAA-sponsored proceedings. The presiding referee of the panel, or the referee if there is a single referee, shall be an active attorney or retired judge. Judgment upon the award rendered by such referee or referees shall be entered in the court in which such proceeding was commenced in accordance with California Code of Civil Procedure Sections 644 and 645.

(d) No provision of this Section shall limit the right of any party to this Agreement to exercise self-help remedies such as set-off, to foreclose against or sell any real or personal property collateral or security or to obtain provisional or ancillary remedies from a court of competent jurisdiction before, after, or during the pendency of any arbitration or other proceeding. The exercise of a remedy does not waive the right of either party to resort to arbitration or reference. At the Bank's option, foreclosure under a deed of trust or mortgage may be accomplished either by exercise of power of

sale under the deed of trust or mortgage or by judicial foreclosure.

9.17 Entire Agreement. This Agreement, together with the other Loan Documents, embodies the entire agreement and understanding between the Company and the Bank, and supersedes all prior or contemporaneous agreements and understandings of such Persons, verbal or written, relating to the subject matter hereof and thereof.

[Signature pages follow.]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed and delivered by their proper and duly authorized officers as of the day and year first above written.

QAD INC.

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION

By: /s/ Barbara J. Whatley

Title: Vice President

By: /s/ Douglas Watson

Title: Assistant Vice President

By: /s/ Kevin McMahon

Title: Managing Director

Notices:

6450 Via Real
Carpinteria, CA 93013
Attention: Dennis R. Raney
Telephone: (805) 566-4409
Facsimile: (805) 566-5792

Notices (other than Borrowing Notices and
Notices of Conversion/Continuation):

Bank of America National Trust and Savings
Association
555 California St., 41st Floor
San Francisco, California 94104
Attention: Doug Watson
Telephone: (415) 622-8708
Facsimile: (415) 622-2514

Domestic and Offshore Lending Office:

1850 Gateway Boulevard, Unit #5693
Fourth Floor
Concord, California 94520
Attention: Karen Matthews
Telephone: (510) 675-7335
Facsimile: (510) 603-7256

EXHIBIT A

NOTICE OF BORROWING

Date: _____, 199__

To: Bank of America National Trust and Savings Association regarding that certain Credit Agreement dated as of August 4, 1997 (as extended, renewed, amended or restated from time to time, the "Agreement") between QAD Inc. and Bank of America National Trust and Savings Association (the "Bank")
Ladies and Gentlemen:

The undersigned, QAD Inc. (the "Company"), refers to the Agreement, the terms defined therein being used herein as therein defined, and hereby gives you notice irrevocably, pursuant to Section 2.03 of the Agreement, of the Borrowing specified below:

1. The Business Day of the proposed Borrowing is _____,

19__.

2. The aggregate amount of the proposed Borrowing is \$_____.

3. The Borrowing is to be comprised of \$_____ of [Base Rate] [Offshore Rate] Loans.

4. The duration of the Interest Period for the Offshore Rate Loans included in the Borrowing shall be _____ months.

The undersigned hereby certifies that the following statements are true on the date hereof, and will be true on the date of the proposed Borrowing, before and after giving effect thereto and to the application of the proceeds therefrom:

(a) the representations and warranties of the Company contained in Article V of the Agreement are true and correct as though made on and as of such date (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date);

(b) no Default or Event of Default has occurred and is continuing, or would result from such proposed Borrowing; and

(c) The proposed Borrowing will not cause the aggregate principal amount of all outstanding Loans to exceed the Commitment of the Bank.

QAD INC.

By:_____

Title:_____

EXHIBIT B

NOTICE OF CONVERSION/CONTINUATION

Date: _____, 199__

To: Bank of America National Trust and Savings Association regarding that certain Credit Agreement dated as of August 4, 1997 (as extended, renewed, amended or restated from time to time, the "Agreement") between QAD Inc. and Bank of America National Trust and Savings Association (the "Bank")

Ladies and Gentlemen:

The undersigned, QAD Inc. (the "Company"), refers to the Agreement, the terms defined therein being used herein as therein defined, and hereby gives you notice irrevocably, pursuant to Section 2.04 of the Agreement, of the [conversion] [continuation] of the Loans specified herein, that:

1. The Conversion/Continuation Date is _____, 19__.

2. The aggregate amount of the Loans to be [converted] [continued] is \$_____.

3. The Loans are to be [converted into] [continued as] [Offshore Rate] [Base Rate] Loans.

4. [If applicable:] The duration of the Interest Period for the Loans included in the [conversion] [continuation] shall be _____ months.

The undersigned hereby certifies that the following statements are true on the date hereof, and will be true on the proposed Conversion/Continuation Date, before and after giving effect thereto and to the application of the proceeds therefrom:

(a) the representations and warranties of the Company contained in Article V of the Agreement are true and correct as though made on and as of such date (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date);

(b) no Default or Event of Default has occurred and is continuing, or would result from such proposed [conversion] [continuation]; and

(c) the proposed [conversion][continuation] will not cause the aggregate principal amount of all outstanding Loans to exceed the Commitment of the Bank.

QAD INC.

By: _____

Title: _____

EXHIBIT C

QAD INC.
COMPLIANCE CERTIFICATE

Financial
Statement Date: _____, 199__

Reference is made to that certain Credit Agreement dated as of August 4, 1997 (as extended, renewed, amended or restated from time to time, the "Agreement") between QAD Inc., a Delaware corporation (the "Company"), and Bank of America National Trust and Savings Association (the "Bank"). Unless otherwise defined herein, capitalized terms used herein have the respective meanings assigned to them in the Agreement.

The undersigned Responsible Officer of the Company, hereby certifies as of the date hereof that he/she is the of the Company, and that, as such, he/she is authorized to execute and deliver this Certificate to the Bank on the behalf of the Company and its consolidated Subsidiaries, and that:

[Use the following paragraph if this Certificate is delivered in connection with the financial statements required by subsection 6.01(a) of the Agreement.]

1. Attached as Schedule 1 hereto are (a) a true and correct copy of the audited consolidated balance sheet of the Company and its consolidated Subsidiaries as at the end of the fiscal year ended _____, 199__ and (b) the related consolidated statements of income or operations, [retained earnings,] shareholders' equity and cash flows for such fiscal year, setting forth in each case in comparative form the figures for the previous fiscal year, [reported on without a "going concern" or like qualification or exception, or qualification arising out of the scope of the audit] and accompanied by the opinion of _____ or another nationally-recognized certified independent public accounting firm (the "Independent Auditor") which report shall state that such consolidated financial statements are complete and correct and have been prepared in accordance with GAAP, and fairly present, in all material respects, the financial position of the Company and its consolidated Subsidiaries for the periods indicated and on a basis consistent with prior periods.

or

[Use the following paragraph if this Certificate is delivered in connection with the financial statements required by subsection 6.01(b) of the Agreement.]

1. Attached as Schedule 1 hereto are (a) a true and correct copy of the

unaudited consolidated balance sheet of the Company and its consolidated Subsidiaries as of the end of the fiscal quarter ended _____, 199__, and (b) the related unaudited consolidated statements of income, shareholders' equity, [retained earnings,] and cash flows for the period commencing on the first day and ending on the last day of such quarter, [setting forth in each case in comparative form the figures for the previous year,] and certified by a Responsible Officer that such financial statements were prepared in accordance with GAAP (subject only to ordinary, good faith year-end audit adjustments and the absence of footnotes) and fairly present, in all material respects, the financial position and the results of operations of the Company and its consolidated Subsidiaries.

2. The undersigned has reviewed and is familiar with the terms of the Agreement and has made, or has caused to be made under his/her supervision, a detailed review of the transactions and conditions (financial or otherwise) of the Company during the accounting period covered by the attached financial statements.

3. To the best of the undersigned's knowledge, the Company, during such period, has observed, performed or satisfied all of its covenants and other agreements, and satisfied every condition in the Credit Agreement to be observed, performed or satisfied by the Company, and the undersigned has no knowledge of any Default or Event of Default.

4. The following financial covenant analyses and information set forth on Schedule 2 attached hereto are true and accurate on and as of the date of this Certificate.

IN WITNESS WHEREOF, the undersigned has executed this Certificate as of _____, 199__.

QAD INC.

By: _____
Title: _____

[NOTE: SAMPLE ONLY]

Date: _____, 199__
For the fiscal quarter/year
ended _____, 199__

SCHEDULE 2
to the Compliance Certificate
(\$ in 000's)

Actual

Required/Permitted

Schedule 4.02 (D)

Grayrock Business Credit, Inc.	
Line of Credit	14,055,612.03
Real Estate Note	3,143,485.76
Fixed Asset Financing	1,147,948.87
The CIT Group	
Fixed Asset Financing	734,451.60
GE Capital Corp.	
Fixed Asset Financing	673,099.13

U.S. Bancorp Leasing & Financial Fixed Asset Financing	600,997.92
First Capital Corp. Fixed Asset Financing	479,281.94

Schedule 5.15

SUBSIDIARIES AND MINORITY INTERESTS

QAD Inc.
QAD AUSTRALIA PTY LIMITED
qad.china inc.
QAD.Eurpoe B.V.
qad france e.u.r.l.
qad. Germany GmbH
QAD HOLDINGS FTY LIMITED
QAD Inc. - Canada Branch
QAD Inc. - Hong Kong Branch
QAD Inc. - Singapore Represntative Office
QAD India. Inc.
QAD Japan K.K.
QAD Brazil, Inc.
QAD MEXICO, S.A. DE C.V.
QAD SOFTWARE E APLICATIVOS LTDA.
qad.Aktiebolag
qad.technology
qad.united kingdom ltd.
qad.USVI Inc.
Integral Software & Services GmbH
Integral Software Betelligunge GmbH
Integral Informationstechnik GmbH (58% owned)
QAD LATIN AMERICA, S.A. DE C.V.
QAD Eastern Europe Sp.2.00
QAD ASIA LIMITED
Enterprise Engines Inc. (minority interest)

SCHEDULE 7.01

PERMITTED LIENS

QAD Inc.
Notes Payable and Debt as of 8/11/97

Lease Number	Terms	Item Description	Start	Marurity	Amount	
QAD	Maker		Date	Date	ST	LT

Hewlett Packard Leases						
HP95C	2403-01068-5A0	24mo., 11.46%	Shanghai Server	9/21/95	8/21/97	2,109.26
HP96	2400-01072-0A0	24mo., 11.46%	Shangahi-China Server	9/21/95	8/21/97	1,333.14
HP99	2403-03063-4A0	24mo., 11.00%	712 Workstation	11/30/95	10/31/97	2,504.56
HP100	2403-01699-7A0	24mo., 11.46%	Equipment Upgrade	10/7/95	8/7/97	1,251.65
HP101	2403-02284-7A0	24mo., 11.00%	Fred Server Project	9/30/95	8/31/97	1,753.10
HP103	4124-03062	24mo., 11.00%	(3) servers	12/7/95	11/7/97	5,288.48
HP104	2403-02951-1A0	24mo., 11.22%	Netherlands server	12/21/95	11/21/97	5,530.83
HP105	4124-01430	24mo., 11.00%	Add-ons to Kitty Hawk	3/31/96	2/28/98	14,786.37
HP106A	2403-04046-BB1	24mo., 13.74%	Upgrades for T. Biegen	3/31/96	2/28/98	2,448.92
HP106B	2403-04046-BC1	24mo., 13.74%	Add-ons for T. Biegen	2/29/96	1/31/98	1,619.18
HP106C	2403-04046-BA0	24mo., 13.74%	725 for T. Biegen	3/31/96	2/28/98	4,727.98
HP107	4124-18394	24mo., 13.74%	CPU for Test DB Server	1/1/97	12/1/98	28,633.27
HP108	4124-52127	24mo., 9.62%	QAD University server	5/29/97	4/29/99	98,452.42
						80,263.81

AT&T Lease

5464 Carpinteria Avenue Leasehold Improvement

SCHEDULE 7.05
PERMITTED INDEBTEDNESS

Lease Number	Terms	Item Description	Start Date	Maturity Date	Amount	
QAD	Maker				ST LT	
Hewlett Packard Leases						
HP95C	2403-01068-5A0	24mo., 11.46%	Shanghai Server	9/21/95	8/21/97	2,109.26
HP96	2400-01072-0A0	24mo., 11.46%	Shanghai-China Server	9/21/95	8/21/97	1,333.14
HP99	2403-03063-4A0	24mo., 11.00%	712 Workstation	11/30/95	10/31/97	2,504.56
HP100	2403-01699-7A0	24mo., 11.46%	Equipment Upgrade	10/7/95	8/7/97	1,251.65
HP101	2403-02284-7A0	24mo., 11.00%	Fred Server Project	9/30/95	8/31/97	1,753.10
HP103	4124-03062	24mo., 11.00%	(3) servers	12/7/95	11/7/97	5,288.48
HP104	2403-02951-1A0	24mo., 11.22%	Netherlands server	12/21/95	11/21/97	5,530.83
HP105	4124-01430	24mo., 11.00%	Add-ons to Kitty Hawk	3/31/96	2/28/98	14,786.37
HP106A	2403-04046-BB1	24mo., 13.74%	Upgrades for T. Biegen	3/31/96	2/28/98	2,448.92
HP106B	2403-04046-BC1	24mo., 13.74%	Add-ons for T. Biegen	2/29/96	1/31/98	1,619.18
HP106C	2403-04046-BA0	24mo., 13.74%	725 for T. Biegen	3/31/96	2/28/98	4,727.98
HP107	4124-18394	24mo., 13.74%	CPU for Test DB Server	1/1/97	12/1/98	28,633.27
HP108	4124-52127	24mo., 9.62%	QAD University server	5/29/97	4/29/99	98,452.42
						13,134.32
						80,263.81

AT&T Lease

5464 Carpinteria Avenue Leasehold Improvement

SCHEDULE 7.08

CONTINGENT OBLIGATIONS

Employee loans guaranteed at Santa Barbara Bank & Trust of approximately \$397,000.

STANDARD INDUSTRIAL/COMMERCIAL
MULTI-TENANT LEASE-MODIFIED NET

AMERICAN INDUSTRIAL REAL ESTATE ASSOCIATION

1. Basic Provisions ("Basic Provisions").

1.1 Parties: This Lease ("Lease"), dated for reference purposes only, December 29, 1997, is made by and between CITO Corp. ("Lessor") and between QAD Inc. ("Lessee"), (collectively the "Parties," or individually a "Party").

1.2(a) Premises: That certain portion of the Building, including all improvements therein or to be provided by Lessor under the terms of this Lease, commonly known by the street address of 201 N. Salsipuedes, 101 & 520 Montecito Ste. 200, located in the City of Santa Barbara, County of Santa Barbara, State of California, with zip code 93103, as outlined on Exhibit A attached hereto ("Premises"). The "Building" is that certain building containing the Premises and generally described as (describe briefly the nature of the Building): Portions of Buildings "B" and "D" of the Santa Barbara Business Center totaling 13,912 square feet. In addition to Lessee's rights to use and occupy the Premises as hereinafter specified, Lessee shall have non-exclusive rights to the Common Areas (as defined in Paragraph 2.7 below) as hereinafter specified, but shall not have any rights to the roof, exterior walls or utility raceways of the Building or to any other buildings in the Industrial Center. The Premises, the Building, the Common Areas, the land upon which they are located, along with all other buildings Rent and improvements thereon, are herein collectively referred to as the "Industrial Center." (Also see Paragraph 2.)

1.2(b) Parking: zero (0) unreserved vehicle parking spaces ("Unreserved Parking Spaces"); and thirty-eight (38) reserved vehicle parking spaces ("Reserved Parking Spaces"). (Also see Paragraph 2.6.)

1.3 Term: Five (5) years and zero (0) months ("Original Term") commencing March 1, 1998 ("Commencement Date") and ending February 28, 2003 ("Expiration Date"). (Also see Paragraph 3.)

1.4 Early Possession: upon lease execution ("Early Possession Date"). (Also see Paragraphs 3.2 and 3.3.)

1.5 Base Rent: \$19,323.90 per month ("Base Rent"), payable on the first (1st) day of each month commencing May 1, 1998 (Also see Paragraph 4.) See Addendum

[X] If this box is checked, this Lease provides for the Base Rent to be adjusted per Addendum ____ attached hereto.

1.6(a) Base Rent Paid Upon Execution: \$19,323.90 as Base Rent for the period April 1-30, 1998.

1.6(b) Lessee's Share of Common Area Operating Expenses: fifteen & nine tenths percent (15.9%) ("Lessee's Share") as determined by [] prorata square footage of the Premises as compared to the total square footage of the Building or [] other criteria as described in Addendum ____.

1.7 Security Deposit: \$20,000.00 ("Security Deposit"). (Also see Paragraph 5.)

1.8 Permitted Use: General office and related legal uses. ("Permitted Use") Also See Paragraph 8.)

1.9 Insuring Party. Lessor is the "Insuring Party." (Also see Paragraph 8.)

1.10(a) Real Estate Brokers. The following real estate broker(s) (collectively, the "Brokers") and brokerage relationships exist in this transaction and are consented to by the Parties Pacifica Commercial Realty represents both Lessor and Lessee ("Dual Agency"). (Also see Paragraph 15.)

1.10(b) Payment to Brokers. Upon the execution of this Lease by both Parties, Lessor shall pay to said Broker(s) jointly, or in such separate shares as they may mutually designate in writing, a fee as set forth in a separate written agreement between Lessor and said Broker(s) jointly, or in such separate shares as they may mutually designate in writing, a fee as set forth in a

separate written agreement between Lessor and said Broker(s) (or in the event there is no separate written agreement between Lessor and said Broker(s), the sum of \$_____) for brokerage services rendered by said Broker(s) in connection with this transaction.

1.11 Guarantor. The obligations of the Lessee under this Lease are to be guaranteed by N/A ("Guarantor"). (Also see Paragraph 37.)

1.12 Addenda and Exhibits. Attached hereto is an Addendum or Addenda consisting of Paragraphs 1.5, 6.2(c), 8.7, 12, 34 & 49 through 53, and Exhibits A through ___, all of which constitute a part of this Lease.

2. Premises, Parking and Common Areas.

2.1 Letting. Lessor hereby leases to Lessee, and Lessee hereby leases from Lessor, the Premises, for the term, at the rental, and upon all of the terms, covenants and conditions set forth in this Lease. Unless otherwise provided herein, any statement of square footage set forth in this Lease, or that may have been used in calculating rental and/or Common Area Operating Expenses, is an approximation which Lessor and Lessee agree is reasonable and the rental and Lessee's Share (as defined in Paragraph 1.6(b)) based thereon is not subject to revision whether or not the actual square footage is more or less.

2.2 Condition. Lessor shall deliver the Premises to Lessee clean and free of debris on the Commencement Date and warrants to Lessee that the existing plumbing, electrical systems, fire sprinkler system, lighting, air conditioning and heating systems and loading doors, if any, in the Premises, other than those constructed by Lessee, shall be in good operating condition on the Commencement Date. If a non-compliance with said warranty exists as of the Commencement Date, Lessor shall, except as otherwise provided in this Lease, promptly after receipt of written notice from Lessee setting forth with specificity the nature and extent of such non-compliance, rectify same at Lessor's expense. If Lessee does not give Lessor written notice of a non-compliance with this warranty within one (1) year after the Commencement Date, correction of that non-compliance shall be the obligation of Lessee at Lessee's sole cost and expense.

2.3 Compliance with Covenants, Restrictions and Building Code. Lessor warrants that any improvements (other than those constructed by Lessee or at Lessee's direction) on or in the Premises which have been constructed or installed by Lessor or with Lessor's consent or at Lessor's direction shall comply with all applicable covenants or restrictions of record and applicable building codes, regulations and ordinances in effect on the Commencement Date. Lessor further warrants to Lessee that Lessor has no knowledge of any claim having been made by any governmental agency that a violation or violations of applicable building codes, regulations or ordinances exist with regard to the Premises as of the Commencement Date. Said warranties shall not apply to any Alterations or Utility Installations (defined in Paragraph 7.3(a)) made or to be made by Lessee. If the Premises do not comply with said warranties, Lessor shall, except as otherwise provided in this Lease, promptly after receipt of written notice from Lessee given within one (1) year following the Commencement Date and setting forth with specificity the nature and extent of such non-compliance, take such action, at Lessor's expense, as may be reasonable or appropriate to rectify the non-compliance. Lessor makes no warranty that the Permitted Use in Paragraph 1.8 is permitted for the Premises under Applicable Laws (as defined in Paragraph 2.4).

2.4 Acceptance of Premises. Lessee hereby acknowledges: (a) that it has been advised by the Broker(s) to satisfy itself with respect to the condition of the Premises (including but not limited to the electrical and fire sprinkler systems, security, environmental aspects, seismic and earthquake requirements, and compliance with the Americans with Disabilities Act and applicable zoning, municipal, county, state and federal laws, ordinances and regulations and any covenants or restrictions of record (collectively "Applicable Laws") and the present and future suitability of the Premises for Lessee's intended use; (b) that Lessee has made such investigation as it deems necessary with reference to such matters, is satisfied with reference thereto, and assumes all responsibility therefore as the same relate to Lessee's occupancy of the Premises and/or the terms of this Lease; and (c) that neither Lessor, nor any of Lessor's agents, has made any oral or written representations or warranties with respect to said matters other than as set forth in this Lease.

2.5 Lessee as Prior Owner/Occupant. The warranties made by Lessor in this Paragraph 2 shall be of no force or effect if immediately prior to the date set forth in Paragraph 1.1 Lessee was the owner or occupant of the Premises. In such event, Lessee shall, at Lessee's sole cost and expense, correct any

non-compliance of the Premises with said warranties.

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2.6 Vehicle Parking. Lessee shall be entitled to use the number of Unreserved Parking Spaces and Reserved Parking Spaces specified in Paragraph 1.2(b) on those portions of the Common Areas designated from time to time by Lessor for parking. Lessee shall not use more parking spaces than said number. Said parking spaces shall be used for parking by vehicles no larger than full-size passenger automobiles or pick-up trucks, herein called "Permitted Size Vehicles." Vehicles other than Permitted Size Vehicles shall be parked and loaded or unloaded as directed by Lessor in the Rules and Regulations (as defined in Paragraph 40) issued by Lessor. (Also see Paragraph 2.9).

(a) Lessee shall not permit or allow any vehicles that belong to or are controlled by Lessee or Lessee's employees, suppliers, shippers, customers, contractors or invitees to be loaded, unloaded or parked in areas other than those designated by Lessor for such activities.

(b) If Lessee permits or allows any of the prohibited activities described in this Paragraph 2.6, then Lessor shall have the right, without notice, in addition to such other rights and remedies that it may have, to remove or tow away the vehicle involved and charge the cost to Lessee, which cost shall be immediately payable upon demand by Lessor.

(c) Lessor shall at the Commencement Date of this Lease, provide the parking facilities required by Applicable Law.

2.7 Common Areas - Definition. The term "Common Areas" is defined as all areas and facilities outside the Premises and within the exterior boundary line of the Industrial Center and interior utility raceways within the Premises that are provided and designated by the Lessor from time to time for the general non-exclusive use of Lessor, Lessee and other lessees of the Industrial Center and their respective employees, suppliers, shippers, customers, contractors and invitees, including parking areas, loading and unloading areas, trash areas, roadways, sidewalks, walkways, parkways, driveways and landscaped areas.

2.8 Common Areas - Lessee's Rights. Lessor hereby grants to Lessee, for the benefit of Lessee and its employees, suppliers, shippers, contractors, customers and invitees, during the term of this Lease, the non-exclusive right to use, in common with others entitled to such use, the Common Areas as they exist from time to time, subject to any rights, powers and privileges reserved by Lessor under the terms hereof or under the terms of any rules and regulations or restrictions governing the use of the Industrial Center. Under no circumstances shall the right herein granted to use the Common Areas be deemed to include the right to store any property, temporarily or permanently, in the Common Areas. Any such storage shall be permitted only by the prior written consent of Lessor or Lessor's designated agent, which consent may be revoked at any time. In the event that any unauthorized storage shall occur then Lessor shall have the right, without notice, in addition to such other rights and remedies that it may have, to remove the property and charge the cost to Lessee, which cost shall be immediately payable upon demand by Lessor.

2.9 Common Areas - Rules and Regulations. Lessor or such other person(s) as Lessor may appoint shall have the exclusive control and management of the Common Areas and shall have the right, from time to time, to establish, modify, amend and enforce reasonable Rules and Regulations with respect thereto in accordance with Paragraph 40. Lessee agrees to abide by and conform to all such Rules and Regulations, and to cause its employees, suppliers, shippers, customers, contractors and invitees to so abide and conform. Lessor shall not be responsible to Lessee for the non-compliance with said rules and regulations by other lessees of the Industrial Center.

2.10 Common Areas - Changes. Lessor shall have the right, in Lessor's sole discretion, from time to time:

(a) To make changes to the Common Areas, including, without limitation and provided that such changes do not materially interfere with Lessee's use and enjoyment of the Premises, changes in the location, size, shape and number of driveways, entrances, parking spaces, parking areas, loading and unloading areas, ingress, egress, direction of traffic, landscaped areas, walkways and utility raceways;

(b) To close temporarily any of the Common Areas for maintenance purposes

so long as reasonable access to the Premises remains available;

(c) To designate other land outside the boundaries of the Industrial Center to be a part of the Common Areas;

(d) To use additional buildings and improvements to the Common Areas;

(e) To use the Common Areas while engaged in making additional improvements, repairs or alterations to the Industrial Center, or any portion thereof; and

(f) To do and perform such other acts and make such other changes in, to or with respect to the Common Areas and Industrial Center as Lessor may, in the exercise of sound business judgment, deem to be appropriate.

3. Term.

3.1 Term. The Commencement Date, Expiration Date and Original Term of this Lease are as specified in Paragraph 1.3.

3.2 Early Possession. If an Early Possession Date is specified in Paragraph 1.4 and if Lessee totally or partially occupies the Premises after the Early Possession Date but prior to the Commencement Date, the obligation to pay Base Rent shall be abated for the period of such early occupancy. All other terms of this Lease, however, (including but not limited to the obligations to pay Lessee's Share of Common Area Operating Expenses and to carry the insurance required by Paragraph 8) shall be in effect during such period. Any such early possession shall not affect nor advance the Expiration Date of the Original Term.

4. Rent.

4.1 Base Rent. Lessee shall pay Base Rent and other rent or charges as the same may be adjusted from time to time, to Lessor in lawful money of the United States, without offset or deduction, on or before the day on which it is due under the terms of this Lease. Base Rent and all other rent and charges for any period during the term hereof which is for less than one full month shall be prorated based upon the actual number of days of the month involved. Payment of Base Rent and other charges shall be made to Lessor at its address stated herein or to such other persons or at such other addresses as Lessor may from time to time designate in writing to Lessee.

4.2 Common Area Operating Expenses. Lessee shall pay to Lessor during the term hereof, in addition to the Base Rent, Lessee's share (as specified in Paragraph 1.6(b)) of all Common Area Operating Expenses, as hereinafter defined, during each calendar year of the term of this Lease, in accordance with the following provisions:

(a) "Common Area Operating Expenses" are defined, for purpose of this Lease, as all costs incurred by Lessor relating to the ownership and operation of the Industrial Center, including, but not limited to, the following:

(i) The operation, repair and maintenance, in neat, clean, good order and condition of the following:

(aa) The Common Areas, including parking areas, loading and unloading areas, trash areas, roadways, sidewalks, walkways, parkways, driveways, landscaped areas, striping, bumpers, irrigation systems, Common Areas lighting facilities, fences and gates, elevators and roof.

(bb) Exterior signs and any tenant directories.

(cc) Fire detection and sprinkler systems.

(ii) The cost of water, gas, electricity and telephone to service the Common Areas unless separately metered.

(iii) Trash disposal, property management fees and security services and the costs of any environmental inspections.

(iv) Real Property Taxes (as defined in Paragraph 10.2) to be paid by Lessor for the Building and the Common Areas under Paragraph 10 hereof.

(v) The cost of the premiums for the insurance policies maintained by Lessor under Paragraph 8 hereof.

(vi) Any deductible portion of an insured loss concerning the Building or the Common Areas.

(vii) Any other services to be provided by Lessor that are stated elsewhere in this Lease to be a Common Area Operating Expense.

(b) Any Common Area Operating Expenses and Real Property Taxes that are specifically attributable to the Building to any other building in the Industrial Center or to the operation repair or maintenance thereof, shall be allocated entirely to the Building or to such other Building. However, any Common Area Operating Expenses and Real Property Taxes that are not specifically attributable to the Building or to any other building or to the operation, repair and maintenance thereof, shall be equitably allocated by Lessor to all buildings in the Industrial Center in accordance with prudent property management standards.

(c) The inclusion of the improvements, facilities and services set forth in Subparagraph 4.2(a) shall not be deemed to impose an obligation upon Lessor to either have said improvements or facilities or to provide those services unless the Industrial Center already had the same, Lessor already provides the services, or Lessor has agreed elsewhere in this Lease to provide the same or some of them.

(d) Lessee's Share of Common Area Operating Expenses shall be payable by Lessee within ten (10) days after a reasonably detailed statement of actual expenses is presented to Lessee by Lessor. At Lessor's option, however, an amount may be estimated by Lessor from time to time of Lessee's Share of annual Common Area Operating Expenses and the same shall be payable monthly or quarterly, as Lessor shall designate, during each 12-month period of the Lease term, on the same day as the Base Rent is due hereunder. Lessor shall deliver to Lessee within sixty (60) days after the expiration of each calendar year a reasonably detailed statement showing Lessee's share of the actual Common Area Operating Expenses incurred during the preceding year. If Lessee's payments under this Paragraph 4.2(d) during said preceding year exceed Lessee's Share as indicated on said statement, Lessee shall be credited the amount of such over-

payment against Lessee's Share of Common Area Operating Expenses next becoming due. If Lessee's payments under this Paragraph 4.2(d) during said preceding year were less than Lessee's Share as indicated on said statement, Lessee shall pay to Lessor the amount of the deficiency within ten (10) days after delivery by Lessor to Lessee of said statement. Lessee shall have the right to audit Lessor's books and records.

5. Security Deposit. Lessee shall deposit with Lessor upon Lessee's execution hereof the Security Deposit set forth in Paragraph 1.7 as security for Lessee's faithful performance of Lessee's obligations under this Lease. If Lessee fails to pay Base Rent or other rent or charges due hereunder, or otherwise Defaults under this Lease (as defined in Paragraph 13.1), Lessor may use, apply, or retain all or any portion of said Security Deposit for the payment of any amount due Lessor or to reimburse or compensate Lessor for any liability, cost, expense, loss or damage (including attorneys' fees) which Lessor may suffer or incur by reason thereof. If Lessor uses or applies all or any portion of said Security Deposit, Lessee shall within ten (10) days after written request therefore deposit monies with Lessor sufficient to restore said Security Deposit to the full amount required by this Lease. Any time the Base Rent increases during the term of this Lease, Lessee shall, upon written request from Lessor, deposit additional monies with Lessor as an addition to the Security Deposit so that the total amount of the Security Deposit shall at all times bear the same proportion to the then current Base Rent as the initial Security Deposit bears to the initial Base Rent set forth in Paragraph 1.5. Lessor shall not be required to keep all or part of the Security Deposit separate from its general accounts. Lessor shall, at the expiration of earlier termination of the term hereof and after Lessee has vacated the Premises, return to Lessee (or, at Lessor's option, to the last assignee, if any, of Lessee's interest herein), that portion of the Security Deposit not used or applied by Lessor. Unless otherwise expressly agreed in writing by Lessor, no part of the Security Deposit shall be considered to be held in trust, to bear interest or other increment for its use, or to be prepayment for any monies to be paid by Lessee under this

Lease.

6. Use.

6.1 Permitted Use.

(a) Lessee shall use and occupy the Premises only for the Permitted Use set forth in Paragraph 1.8, or any other legal use which is reasonably comparable thereto, and for no other purpose. Lessee shall not use or permit the use of the Premises in a manner that is unlawful, creates waste or a nuisance, or that disturbs owners and/or occupants of, or causes damage to the Premises or neighboring premises or properties.

(b) Lessor hereby agrees to not unreasonably withhold or delay its consent to any written request by Lessee, Lessee's assignees or subtenants, and by prospective assignees and subtenants of Lessee, its assignees and subtenants, for a modification of said Permitted Use, so long as the same will not impair the structural integrity of the improvements on the Premises or in the Building or the mechanical or electrical systems therein, does not conflict with uses by other lessees, is not significantly more burdensome to the Premises or the Building and the improvements thereon, and is otherwise permissible pursuant to this Paragraph 6. If Lessor elects to withhold such consent, Lessor shall within five (5) business days after such request give a written notification of same, which notice shall include an explanation of Lessor's reasonable objections to the change in use.

6.2 Hazardous Substances.

(a) Reportable Uses Require Consent. The term "Hazardous Substance" as used in this Lease shall mean any product, substance, chemical, material or waste whose presence, nature, quantity and/or intensity of existence, use, manufacture, disposal, transportation, spill, release or effect, either by itself or in combination with other materials expected to be on the Premises, is either: (i) potentially injurious to the public health, safety or welfare, the environment, or the Premises; (ii) regulated or monitored by any governmental authority; or (iii) a basis for potential liability of Lessor to any governmental agency or third party under any applicable statute or common law theory. Hazardous Substance shall include, but not be limited to, hydrocarbons, petroleum, gasoline, crude oil or any products or by-products thereof. Lessee shall not engage in any activity in or about the Premises which constitutes a Reportable Use (as hereinafter defined) of Hazardous Substances without the express prior written consent of Lessor and compliance in a timely manner (at Lessee's sole cost and expense) with all Applicable Requirements (as defined in Paragraph 6.3). "Reportable Use" shall mean (i) the installation or use of any above or below ground storage tank, (ii) the generation, possession, storage, use, transportation, or disposal of a Hazardous Substance that requires a permit from, or with respect to which a report, notice, registration or business plan is required to be filed with, any governmental authority, and (iii) the presence in, on or about the Premises of a Hazardous Substance with respect to which any Applicable Laws require that a notice be given to persons entering or occupying the Premises or neighboring properties. Notwithstanding the foregoing, Lessee may, without Lessor's prior consent, but upon notice to Lessor and in compliance with all Applicable Requirements, use any ordinary and customary materials reasonably required to be used by Lessee in the normal course of the Permitted Use, so long as such use is not a Reportable Use and does not expose the Premises or neighboring properties to any meaningful risk of contamination or damage or expose Lessor to any liability therefor. In addition, Lessor may (but without any obligation to do so) condition its consent to any Reportable Use of any Hazardous Substance by Lessee upon Lessee's giving Lessor such additional assurances as Lessor, in its reasonable discretion, deems necessary to protect itself, the public, the Premises and the environment against damage, contamination or injury and/or liability therefor, including but not limited to the installation (and, at Lessor's option, removal on or before Lease expiration or earlier termination) of reasonably necessary protective modifications to the Premises (such as concrete encasements) and/or the deposit of an additional Security Deposit under Paragraph 5 hereof.

(b) Duty to inform Lessor. If Lessee knows, or has reasonable cause to believe, that a Hazardous Substance has come to be located in, on, under or about the Premises or the Building, other than as previously consented to by Lessor, Lessee shall immediately give Lessor written notice thereof, together with a copy of any statement, report, notice, registration, application, permit, business plan, license, claim, action, or proceeding given to, or received from, any governmental authority or private party concerning the presence, spill, release, discharge of, or exposure to, such Hazardous Substance including but

not limited to all such documents as may be involved in any Reportable Use involving the Premises. Lessee shall not cause or permit any Hazardous Substance to be spilled or released in, on, under or about the Premises (including, without limitation, through the plumbing or sanitary sewer system).

(c) Indemnification. Lessee shall indemnify, protect, defend and hold Lessor, its agents, employees, lenders and ground lessor, if any, and the Premises, harmless from and against any and all damages, liabilities, judgments, costs, claims, liens, expenses, penalties, loss of permits and attorneys' and consultants' fees arising out of or involving any Hazardous Substance brought onto the Premises by or for Lessee or by anyone under Lessee's control. Lessee's obligations under this Paragraph 6.2(c) shall include, but not be limited to, the effects of any contamination or injury to person, property or the environment created or suffered by Lessee, and the cost of investigation (including consultants' and attorneys' fees and testing), removal, remediation, restoration and/or abatement thereof, or of any contamination therein involved, and shall survive the expiration or earlier termination of this Lease. No termination, cancellation or release agreement entered into by Lessor and Lessee shall release Lessee from its obligations under this Lease with respect to Hazardous Substances, unless specifically so agreed by Lessor in writing at the time of such agreement. See Addendum

6.3 Lessee's Compliance with Requirements. Lessee shall, at Lessee's sole cost and expense, fully, diligently and in a timely manner, comply with all "Applicable Requirements," which term is used in this Lease to mean all laws, rules, regulations, ordinances, directives, covenants, easements and restrictions of record, permits, the requirements of any applicable fire insurance underwriter or rating bureau, and the recommendations of Lessor's engineers and/or consultants, relating in any manner to the Premises (including but not limited to matters pertaining to (i) industrial hygiene, (ii) environmental conditions on, in, under or about the Premises, including soil and groundwater conditions, and (iii) the use, generation, manufacture, production, installation, maintenance, removal, transportation, storage, spill, or release of any Hazardous Substance), now in effect or which may hereafter come into effect. Lessee shall, within five (5) days after receipt of Lessor's written request, provide Lessor with copies of all documents and information, including but not limited to permits, registrations, manifests, applications, reports and certificates, evidencing Lessee's compliance with any Applicable Requirements specified by Lessor, and shall immediately upon receipt, notify Lessor in writing (with copies of any documents involved) of any threatened or actual claim, notice, citation, warning, complaint or report pertaining to or involving failure by Lessee or the Premises to comply with any Applicable Requirements.

6.4 Inspection; Compliance with Law. Lessor, Lessor's agents, employees, contractors and designated representatives, and the holders of any mortgages, deeds of trust or ground leases on the Premises ("Lenders") shall have the right to enter the Premises at any time in the case of an emergency, and otherwise at reasonable times, for the purpose of inspecting the condition of the Premises and for verifying compliance by Lessee with this Lease and all Applicable Requirements (as defined in Paragraph 6.3), and Lessor shall be entitled to employ experts and/or consultants in connection therewith to advise Lessor with respect to Lessee's activities, including but not limited to Lessee's installation, operation, use, monitoring, maintenance, or removal of any Hazardous Substance on or from the Premises. The costs and expenses of any such inspections shall be paid by the party requesting same, unless a Default or Breach of this Lease by Lessee or a violation of Applicable Requirements or a contamination, caused or materially contributed to by Lessee, is found to exist or to be imminent, or unless the inspection is requested or ordered by a governmental authority as the result of any such existing or imminent violation or contamination. In such case, Lessee shall upon request reimburse Lessor or Lessor's Lender, as the case may be, for the costs and expenses of such inspections.

7. Maintenance, Repairs, Utility Installations, Trade Fixtures and Alterations.

7.1 Lessee's Obligations.

(a) Subject to the provisions of Paragraphs 2.2 (Condition), 2.3 (Compliance with Covenants, Restrictions and Building Code), 7.2 (Lessor's Obligations), 9 (Damage or Destruction), and 14 (Condemnation), Lessee shall, at Lessee's sole cost and expense and at all times, keep the Premises and every part thereof including, without limiting the generality of the foregoing, all equipment or facilities specifically serving the Premises, such as plumbing, heating, air conditioning, ventilating, electrical, lighting facilities, boilers, fired or unfired pressure vessels, fire hose connections if within the

Premises, fixtures, interior walls, interior surfaces of interior walls, ceilings, floors, windows, doors, plate glass, and skylights, but excluding any items which are the responsibility of Lessor pursuant to Paragraph 7.2 below. Lessee, in keeping the Premises in such condition shall exercise and perform good maintenance practices. Lessee's obligations shall include restorations, replacements or renewals when necessary to keep the Premises and all improvements thereon or a part thereof in good order, condition and state of repair.

(b) Lessee shall, at Lessee's sole cost and expense, procure and maintain a contract, with copies to Lessor, in customary form and substance for and with a contractor specializing and experienced in the inspection, maintenance and service of the heating, air conditioning and ventilation systems for the Premises. However, Lessor reserves the right, upon notice to Lessee, to procure and maintain the contract for the heating, air conditioning and ventilating systems, and if Lessor so elects, Lessee shall reimburse Lessor, upon demand, for the cost thereof.

(c) If Lessee fails to perform Lessee's obligations under this Paragraph 7.1, Lessor may enter upon the Premises after ten (10) days' prior written notice to Lessee (except in the case of an emergency, in which case no notice shall be required), perform such obligations on Lessee's behalf, and put the Premises in good order, condition and repair, in accordance with Paragraph 13.2 below.

7.2 Lessor's Obligations. Subject to the provisions of Paragraphs 2.2 (Condition), 2.3 (Compliance with Covenants, Restrictions and Building Code), 4.2 (Common Area Operating Expenses), 6 (Use), 7.1 (Lessee's Obligations), 9 (Damage or Destruction) and 14 (Condemnation), Lessor, subject to reimbursement pursuant to Paragraph 4.2, shall keep in good order, condition and repair the foundations, exterior walls, structural condition of interior bearing walls, exterior roof, fire sprinkler and/or standpipe and hose (if located in the Common Areas) or otherwise automatic fire extinguishing system including fire alarm and/or smoke

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detection systems and equipment, fire hydrants, parking lots, walkways, parkways, driveways, landscaping, fences, signs and utility systems serving the Common Areas and all parts thereof, as well as providing the services for which there is a Common Area Operating Expense pursuant to Paragraph 4.2. Lessor shall not be obligated to paint the exterior or interior surfaces of exterior walls, nor shall Lessor be obligated to maintain, repair or replace windows, doors or plate glass of the Premises.

7.3 Utility Installations, Trade Fixtures, Alterations.

(a) Definitions; Consent Required. The term "Utility Installations" is used in this Lease to refer to all air lines, power panels, electrical distribution, security, fire protection systems, communications systems, lighting fixtures, heating, ventilating and air conditioning equipment, plumbing and fencing in, on or about the Premises. The term "Trade Fixtures" shall mean Lessee's machinery and equipment which can be removed without doing material damage to the Premises. The term "Alterations" shall mean any modification of the improvements on the Premises which are provided by Lessor under the terms of this Lease, other than Utility Installations or Trade Fixtures. "Lessee-Owned Alterations and/or Utility Installations" are defined as material Alterations and/or Utility Installations made by Lessee that are not yet owned by Lessor pursuant to Paragraph 7.4(a). Lessee shall not make nor cause to be made any Alterations or Utility Installations in, on, under or about the Premises without Lessor's prior written consent. Lessee may, however, make non-structural Utility Installations to the interior of the Premises (excluding the roof) without Lessor's consent but upon notice to Lessor, so long as they are not visible from the outside of the Premises, do not involve puncturing, relocating or removing the roof or any existing walls, or changing or interfering with the fire sprinkler system or fire detection systems and the cumulative cost thereof during the term of this Lease as extended does not exceed \$10,000.00.

(b) Consent. Any alterations or Utility Installations that Lessee shall desire to make and which require the consent of the Lessor shall be presented to Lessor in written form with detailed plans. All consents given by Lessor, whether by virtue of Paragraph 7.3(a) or by subsequent specific consent, shall be deemed conditioned upon: (i) Lessee's acquiring all applicable permits

required by governmental authorities; (ii) the furnishing of copies of such permits together with a copy of the plans and specifications for the Alteration or Utility Installation to Lessor prior to commencement of the work thereon; and (iii) the compliance by Lessee with all conditions of said permits in a prompt and expeditious manner. Any alterations or Utility Installations by Lessee during the term of this Lease shall be done in a good and workmanlike manner, with good and sufficient materials, and be in compliance with all Applicable Requirements. Lessee shall promptly upon completion thereof furnish Lessor with as-built plans and specifications thereof. Lessor may, (but without obligation to do so) condition its consent to any requested Alteration or Utility Installation that costs \$10,000.00 or more upon Lessee's providing Lessor with a lien and completion bond in an amount equal to one and one-half times the estimated cost of such Alteration or Utility Installation.

(c) Lien Protection. Lessee shall pay when due all claims for labor or materials furnished or alleged to have been furnished to or for Lessee at or for use on the Premises, which claims are or may be secured by any mechanic's or materialmen's lien against the Premises or any interest therein. Lessee shall give Lessor not less than ten (10) days' notice prior to the commencement of any work in, or about the Premises, and Lessor shall have the right to post notices of non-responsibility in or on the Premises as provided by law. If Lessee shall, in good faith, contest the validity of any such lien, claim or demand, then Lessee shall, at its sole expense, defend and protect itself, Lessor and the Premises against the same and shall pay and satisfy any such adverse judgment that may be rendered thereon before the enforcement thereof against the Lessor or the Premises. If Lessor shall require, Lessee shall furnish to Lessor a surety bond satisfactory to Lessor in an amount equal to one and one-half times the amount of such contested lien claim or demand, indemnifying Lessor against liability for the same, as required by law for the holding of the Premises free from the effect of such lien or claim. In addition, Lessor may require Lessee to pay Lessor's attorneys' fees and costs in participating in such action if Lessor shall decide it is to its best interest to do so.

7.4 Ownership, Removal, Surrender and Restoration.

(a) Ownership. Subject to Lessor's right to require their removal and to cause Lessee to become the owner thereof as hereinafter provided in this Paragraph 7.4, all Alterations and Utility Installations made to the Premises by Lessee shall be the property of and owned by Lessee, but considered a part of the Premises. Lessor may, at any time and at its option, elect in writing to Lessee to be the owner of all or any specified part of the Lessee-Owned Alterations and Utility Installations. Unless otherwise instructed per Subparagraph 7.4(b) hereof, all Lessee-Owned Alterations and Utility Installations shall, at the expiration or earlier termination of this Lease, become the property of Lessor and remain upon the Premises and be surrendered with the Premises by Lessee.

(b) Removal. Unless otherwise agreed in writing, Lessor may require that any or all Lessee-Owned Alterations or Utility Installations be removed by the expiration or earlier termination of this Lease, notwithstanding that their installation may have been consented to by Lessor. Lessor may require the removal at any time of all or any part of any Alterations or Utility Installations made without the required consent of Lessor.

(c) Surrender/Restoration. Lessee shall surrender the Premises by the end of the last day of the lease term or any earlier termination date, clean and free of debris and in good operating order, condition and state of repair, ordinary wear and tear excepted. Ordinary wear and tear shall not include any damage or deterioration that would have been prevented by good maintenance practice or by Lessee performing all of its obligations under this Lease. Except as otherwise agreed or specified herein, the Premises, as surrendered, shall include the Alterations and Utility Installations. The obligation of Lessee shall include the repair of any damage occasioned by the installation, maintenance or removal of Lessee's Trade Fixtures, furnishings, equipment, and Lessee-Owned Alterations and Utility Installations, as well as the removal of any storage tank installed by or for Lessee, and the removal, replacement, or remediation of any soil, material or ground water contaminated by Lessee, all as may then be required by Applicable Requirements and/or good practice. Lessee's Trade Fixtures shall remain the property of Lessee and shall be removed by Lessee subject to its obligation to repair and restore the Premises per this Lease.

8. Insurance; Indemnity.

8.1 Payment of Premiums. The cost of the premiums for the insurance

policies maintained by Lessor under this Paragraph 8 shall be a Common Area Operating Expense pursuant to Paragraph 4.2 hereof. Premiums for policy periods commencing prior to, or extending beyond, the term of this Lease shall be prorated to coincide with the corresponding Commencement Date or Expiration Date.

8.2 Liability Insurance.

(a) Carried by Lessee. Lessee shall obtain and keep in force during the term of this Lease a Commercial General Liability policy of Insurance protecting Lessee, Lessor and any Lender(s) whose names have been provided to Lessee in writing (as additional insureds) against claims for bodily injury, personal injury and property damage based upon, involving or arising out of the ownership, use, occupancy or maintenance of the Premises and all areas appurtenant thereto. Such insurance shall be on an occurrence basis providing single limit coverage in an amount not less than \$1,000,000 per occurrence with an "Additional Insured-Managers or Lessors of Premises" endorsement and contain the "Amendment of the Pollution Exclusion" endorsement for damage caused by heat, smoke or fumes from a hostile fire. The policy shall not contain any intra-insured exclusions as between insured persons or organizations, but shall include coverage for liability assumed under this Lease as an "Insured contract" for the performance of Lessee's Indemnity obligations under this Lease. The limits of said insurance required by this Lease or as carried by Lessee shall not, however, limit the liability of Lessee nor relieve Lessee of any obligation hereunder. All insurance to be carried by Lessee shall be primary to and not contributory with any similar insurance carried by Lessor whose insurance shall be considered excess insurance only.

(b) Carried by Lessor. Lessor shall also maintain liability insurance described in Paragraph 8.2(a) above, in addition to and not in lieu of, the insurance to be maintained by Lessee. Lessee shall not be named as an additional insured therein.

8.3 Property Insurance-Building, Improvements and Rental Value.

(a) Building and Improvements. Lessor shall obtain and keep in force during the term of this Lease a policy or policies in the name of Lessor, with loss payable to Lessor and to any Lender(s), insuring against loss or damage to the Premises. Such insurance shall be for full replacement cost, as the same shall exist from time to time, or the amount required by any Lender(s), but in no event more than the commercially reasonable and available insurable value thereof if, by reason of the unique nature or age of the improvements involved, such latter amount is less than full replacement cost. Lessee-Owned Alterations and Utility Installations, Trade Fixtures and Lessee's personal property shall be insured by Lessee pursuant to Paragraph 8.4. If the coverage is available and commercially appropriate, Lessor's policy or policies shall insure against all risks of direct physical loss or damage (except the perils of flood and/or earthquake unless required by a Lender), including coverage for any additional costs resulting from debris removal and reasonable amounts of coverage for the enforcement of any ordinance or law regulating the reconstruction or replacement of any undamaged sections of the Building required to be demolished or removed by reason of the enforcement of any building, zoning, safety or land use laws as the result of a covered loss, but not including plate glass insurance. Said policy or policies shall also contain an agreed valuation provision in lieu of any co-insurance clause, waiver of subrogation, and inflation guard protection causing an increase in the annual property insurance coverage amount by a factor of not less than the adjusted U.S. Department of Labor Consumer Price Index for All Urban Consumers for the city nearest to where the Premises are located.

(b) Rental Value. Lessor shall also obtain and keep in force during the term of this Lease a policy or policies in the name of Lessor, with loss payable to Lessor and any Lender(s), insuring the loss of the full rental and other charges payable by all lessees of the Building to Lessor for one year (including all Real Property Taxes, insurance costs, all Common Area Operating Expenses and any scheduled rental increases). Said insurance may provide that in the event the Lease is terminated by reason of an insured loss, the period of indemnity for such coverage shall be extended beyond the date of the completion of repairs or replacement of the Premises, to provide for one full year's loss of rental revenues from the date of any such loss. Said insurance shall contain an agreed valuation provision in lieu of any co-insurance clause, and the amount of coverage shall be adjusted annually to reflect the projected rental income, Real Property Taxes, insurance premium costs and other expenses, if any, otherwise payable for the next 12-month period. Common Area Operating Expenses shall include any deductible amount in the event of such loss.

(c) Adjacent Premises. Lessee shall pay for any increase in the premium for the property insurance of the Building and for the Common Areas or other buildings in the Industrial Center if said increase is caused by Lessee's acts, omissions, use or occupancy of the Premises.

(d) Lessee's Improvements. Since Lessor is the insuring Party, Lessor shall not be required to insure Lessee-Owned Alterations and Utility Installations unless the item in question has become the property of Lessor under the terms of this Lease.

8.4 Lessee's Property Insurance. Subject to the requirements of Paragraph 8.5, Lessee at its cost shall either by separate policy or, at Lessor's option, by endorsement to a policy already carried, maintain insurance coverage on all of Lessee's personal property, Trade Fixtures and Lessee-Owned Alterations and Utility Installations in, on, or about the Premises similar in coverage to that carried by Lessor as the Insuring Party under Paragraph 8.3(a). Such insurance shall be full replacement cost coverage with a deductible not to exceed \$1,000 per occurrence. The proceeds from any such insurance shall be used by Lessee for the replacement of personal property and the restoration of Trade Fixtures and Lessee-Owned Alterations and Utility Installations. Upon request from Lessor, Lessee shall provide Lessor with written evidence that such insurance is in force.

8.5 Insurance Policies. Insurance required hereunder shall be in companies duly licensed to transact business in the state where the Premises are located, and maintaining during the policy term a "General Policyholders Rating" of at least B+, V, or such other rating as may be required by a Lender, as set forth in the most current issue of "Best's Insurance Guide". Lessee shall not do or permit to be done anything which shall invalidate the insurance policies referred to in

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this Paragraph 8. Lessee shall cause to be delivered to Lessor, within seven (7) days after the earlier of the Early possession Date or the Commencement Date, certified copies of, or certificates evidencing the existence and amounts of, the insurance required under Paragraph 8.2(a) and 8.4. No such policy shall be cancellable or subject to modification except after thirty (30) days' prior written notice to Lessor. Lessee shall at least thirty (30) days prior to the expiration of such policies, furnish Lessor with evidence of renewals or "insurance binders" evidencing renewal thereof, or Lessor may order such insurance and charge the cost thereof to Lessee, which amount shall be payable by Lessee to Lessor upon demand.

8.6 Waiver of Subrogation. Without affecting any other rights or remedies, Lessee and Lessor each hereby release and relieve the other, and waive their entire right to recover damages (whether in contract or in tort) against the other, for loss or damage to their property arising out of or incident to the perils required to be insured against under Paragraph 8. The effect of such releases and waivers of the right to recover damages shall not be limited by the amount of insurance carried or required, or by any deductibles applicable thereto. Lessor and Lessee agree to have their respective insurance companies issuing property damage insurance waiver any right to subrogation that such companies may have against Lessor or Lessee, as the case may be, so long as the insurance is not invalidated thereby.

8.7 Indemnity. Except for Lessor's negligence and/or breach of express warranties, Lessee shall indemnify, protect, defend and hold harmless the Premises, Lessor and its agents, Lessor's master or ground lessor, partners and Lenders, from and against any and all claims, loss of rents and/or damages, costs, liens, judgments, penalties, loss of permits, attorneys' and consultants' fees, expenses and/or liabilities arising out of, involving, or in connection with, the occupancy of the Premises by Lessee, the conduct of Lessee's business, any act, omission or neglect or Lessee, its agents, contractors, employees or invitees, and out of any Default or Breach by Lessee in the performance in a timely manner or any obligation on Lessee's part to be performed under this Lease. The foregoing shall include, but not be limited to, the defense or pursuit of any claim or any action or proceeding involved herein, and whether or not (in the case of claims made against Lessor) litigated and/or reduced to judgment. In case any action or proceeding be brought against Lessor by reason of any of the foregoing matters, Lessee upon notice from Lessor shall defend the same at Lessee's expense by counsel reasonably satisfactory to Lessor and Lessor shall cooperate with Lessee in such defense. Lessor need not have first paid any

such claim in order to be so indemnified. See addendum.

8.8 Exemption of Lessor from Liability. Lessor shall not be liable for injury or damage to the person or goods, wares, merchandise, other property of Lessee, Lessee's employees, contractors, invitees, customers or any other person in or about the Premises, whether such damage or injury is caused by or results from fire, steam, electricity, gas, water or rain, or from the breakage, leakage, obstruction or other defects of pipes, fire sprinklers, wires, appliances, plumbing, air conditioning or lighting fixtures, or from any other cause, whether said injury or damage results from conditions arising upon the Premises or upon other portions of the Building of which the Premises are a part, from other sources or places, and regardless of whether the cause of such damages or injury or the means of repairing the same is accessible or not, Lessor shall not be liable for any damages arising from any act or neglect of any other lessee or Lessor nor from the failure by Lessor to enforce the provisions of any other lease in the Industrial Center. Notwithstanding Lessor's negligence or breach of this Lease, Lessor shall under no circumstances be liable for injury to Lessee's business or for any loss of income or profit therefrom.

9. Damages or Destruction

9.1 Definitions.

(a) "Premises Partial Damage" shall mean damage or destruction to the Premises, other than Lessee-Owned Alterations and Utility Installations, the repair cost of which damage or destruction is less than fifty percent (50%) of the then Replacement Cost (as defined in Paragraph 9.1(d)) of the Premises (excluding Lessee-Owned Alterations and Utility Installations and Trade Fixtures) immediately prior to such damage or destruction.

(b) "Premises Total Destruction" shall mean damage or destruction to the Premises, other than Lessee-Owned Alterations and Utility Installations, the repair cost of which damage or destruction is fifty percent (50%) or more of the then Replacement Cost of the Premises (excluding Lessee-Owned Alterations and Utility Installations and Trade Fixtures) immediately prior to such damage or destruction. In addition, damage or destruction to the Building, other than Lessee-Owned Alterations and Utility Installations and Trade Fixtures of any lessees of the Building, the cost of which damage or destruction is fifty percent (50%) or more of the then Replacement Cost (excluding Lessee-Owned Alterations and Utility Installations and Trade Fixtures of any lessees of the Building) of the Building shall, at the option of Lessor, be deemed to be Premises Total Destruction.

(c) "Insured Loss" shall mean damage or destruction to the Premises, other than Lessee-Owned Alterations and Utility Installations and Trade Fixtures, which was caused by an event required to be covered by the insurance described in Paragraph 8.3(a) irrespective of any deductible amounts or coverage limits involved.

(d) "Replacement Cost" shall mean the cost to repair or rebuild the improvements owned by Lessor at the time of the occurrence to their condition existing immediately prior thereto, including demolition, debris removal and upgrading required by the operation of applicable building codes, ordinances or laws, and without deduction for depreciation.

(e) "Hazardous Substance Condition" shall mean the occurrence or discovery of a condition involving the presence of, or a contamination by, a Hazardous Substance as defined in Paragraph 6.2(a), in, on, or under the Premises.

9.2 Premises Partial Damages - Insured Loss. If Premises Partial Damage that is an Insured Loss occurs, then Lessor shall, at Lessor's expense, repair such damage (but not Lessee's Trade Fixtures or Lessee-Owned Alterations and Utility Installations) as soon as reasonably possible and this Lease shall continue in full force and effect. In the event, however, that there is a shortage of insurance proceeds and such shortage is due to the fact that by reason of the unique nature of the improvements in the premises, full replacement cost insurance coverage was not commercially reasonable and available, Lessor shall have no obligation to pay for the shortage in insurance proceeds or to fully restore the unique aspects of the Premises unless Lessee provides Lessor with the funds to cover same, or adequate assurance thereof, within ten (10) days following receipt of written notice of such shortage and request therefor. If Lessor receives said funds or adequate assurance thereof within said ten (10) day period, Lessor shall complete them as soon as reasonably possible and this Lease shall remain in full force and effect. If

Lessor does not receive such funds or assurance within said period, Lessor may nevertheless elect by written notice to Lessee within ten (10) days thereafter to make such restoration and repair as a commercially reasonable with Lessor paying any shortage in proceeds, in which case this Lease shall remain in full force and effect. If Lessor does not receive such funds or assurance within such ten (10) day period, and if Lessor does not so elect to restore and repair, then this Lease shall terminate sixty (60) days following the occurrence of the damage or destruction. Unless otherwise agreed, Lessee shall in no event have any right to reimbursement from Lessor for any funds contributed by Lessee to repair any such damage or destruction. Premises Partial Damage due to flood or earthquake shall be subject to Paragraph 9.3 rather than Paragraph 9.2, notwithstanding that there may be some insurance coverage, but the net proceeds of any such insurance shall be made available for the repairs if made by either Party.

9.3 Partial Damage - Uninsured Loss. If Premises Partial Damage that is not an Insured Loss occurs, unless caused by a negligent or willful act of Lessee (in which event Lessee shall make the repairs at Lessee's expense and this Lease shall continue in full force and effect), Lessor may at Lessor's option, either (i) repair such damage as soon as reasonably possible at Lessor's expense, in which even this Lease shall continue in full force and effect, or (ii) give written notice to Lessee within thirty (30) days after receipt by Lessor of knowledge of the occurrence of such damage of Lessor's desire to terminate this Lease as of the date sixty (60) days following the date of such notice. In the event Lessor elects to give such notice of Lessor's intention to terminate this Lease, Lessee shall have the right within ten (10) days after the receipt of such notice to give written notice to Lessor of Lessee's commitment to pay for the repair of such damage totally at Lessee's expense and without reimbursement from Lessor. Lessee shall provide Lessor with the required funds or satisfactory assurance thereof within thirty (30) days following such commitment from Lessee. In such even this Lease shall continue in full force and effect, and Lessor shall proceed to make such repairs as soon as reasonably possible after the required funds are available. If Lessee does not give such notice and provide the funds or assurance thereof within the times specified above, this Lease shall terminate as of the date specified in Lessor's notice of termination.

9.4 Total Destruction. Notwithstanding any other provision hereof, if Premises Total Destruction occurs (including any destruction required by any authorized public authority), this Lease shall terminate sixty (60) days following the date of such Premises Total Destruction, whether or not the damage or destruction is an Insured Loss or was caused by a negligent or willful act of Lessee. In the event, however, that the damage or destruction was caused by Lessee, Lessor shall have the right to recover Lessor's damages from Lessee except as released and waived in Paragraph 9.7. 9.5 Damage Near End of Term. If at any time during the last six (6) months of the term of this Lease there is damage for which the cost to repair exceeds one month's Base Rent, whether or not an Insured Loss, Lessor may, at Lessor's option, terminate this Lease effective sixty (60) days following the date of occurrence of such damage by giving written notice to Lessee of Lessor's election to do so within thirty (30) days after the date of occurrence of such damage. Provided, however, if Lessee at that time has an exercisable option to extend this Lease or to purchase the Premises, then Lessee may preserve this Lease by (a) exercising such option, and (b) providing Lessor with any shortage in insurance proceeds (or adequate assurance thereof) needed to make the repairs on or before the earlier of (i) the date which is ten (10) days after Lessee's receipt of Lessor's written notice purporting to terminate this Lease, or (ii) the day prior to the date upon which such option expires. If Lessee duly exercises such option during such period and provides Lessor with funds (or adequate assurance thereof) to cover any shortage in insurance proceeds, Lessor shall, at Lessor's expense repair such damage as soon as reasonably possible and this Lease shall continue in full force and effect. If Lessee fails to exercise such option and provide such funds or assurance during such period, then this Lease shall terminate as of the date set forth in the first sentence of this Paragraph 9.5.

9.6 Abatement of Rent; Lessee's Remedies.

(a) In the event of (i) Premises Partial damage or (ii) Hazardous Substance Condition for which Lessee is not legally responsible, the Base Rent, Common Area Operating Expenses and other charges, if any, payable by Lessee hereunder for the period during which such damage or condition, its repair, remediation or restoration continues, shall be abated in proportion to the degree to which Lessee's use of the Premises is impaired, but not in excess of proceeds from insurance required to be carried under Paragraph 8.3(b). Except for abatement of Base Rent, Common Area Operating Expenses and other charges, if any, as aforesaid, all other obligations of Lessee hereunder shall be performed by

Lessee, and Lessee shall have no claim against Lessor for any damage suffered by reason of any such damage, destruction, repair, remediation or restoration.

(b) If Lessor shall be obligated to repair or restore the Premises under the provisions of this Paragraph 9 and shall not commence, in a substantial and meaningful way, the repair or restoration of the Premises within ninety (90) days after such obligation shall accrue, Lessee may, at any time prior to the commencement of such repair or restoration, give written notice to Lessor and to any Lenders of which Lessee has actual notice of Lessee's election to terminate this Lease on a date not less than sixty (60) days following giving of such notice. If Lessee gives such notice to Lessor and such Lenders and such repair or restoration is not commenced within thirty (30) days after receipt of such notice, this Lease shall terminate as of the date specified in said notice. If Lessor or a Lender commences the repair or restoration of the premises within thirty (30) days after the receipt of such notice, this Lease shall continue in full force and effect. "Commence" as used in this Paragraph 9.6 shall mean either the unconditional authorization of the preparation of the required plans, or the beginning of the actual work on the Premises, whichever occurs first.

9.7 Hazardous Substance Conditions. If a Hazardous Substance Condition occurs, unless Lessee is legally responsible therefore (in which case Lessee shall make the investigation and remediation thereof required by Applicable Requirements of this Lease shall continue in full force and effect, but subject

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to Lessor's right under Paragraph 6.2(c) and Paragraph 13), Lessor may at Lessor's option either (i) investigate and remediate such Hazardous Substance Condition, if required, as soon as reasonably possible at Lessor's expense, in which event this Lease shall continue in full force and effect, or (ii) if the estimated cost to investigate and remediate such condition exceeds twelve (12) times the then monthly Base Rent or \$100,000 whichever is greater, give written notice to Lessee within thirty (30) days after receipt by Lessor of knowledge of the occurrence of such Hazardous Substance Condition of Lessor's desire to terminate this Lease as of the date sixty (60) days following the date of such notice. In the event Lessor elects to give such notice of Lessor's Intention to terminate this Lease, Lessee shall have the right within ten (10) days after the receipt of such notice to give written notice to Lessor of Lessee's commitment to pay for the excess costs of (a) investigation and remediation of such Hazardous Substance Condition to the extent required by Applicable Requirements, over (b) an amount equal to twelve (12) times the then monthly Base Rent or \$100,000, whichever is greater. Lessee shall provide Lessor with the funds required of Lessee or satisfactory assurance thereof within thirty (30) days following said commitment by Lessee. In such event this Lease shall continue in full force and effect, and Lessor shall proceed to make such investigation and remediation as soon as possible after the required funds are available. If Lessee does not give such notice and provide the required funds or assurance thereof within the time period specified above, this Lease shall terminate as of the date specified in Lessor's notice of termination.

9.8 Termination - Advance Payments. Upon termination of this Lease pursuant to this Paragraph 9, Lessor shall return to Lessee any advance payment made by Lessee to Lessor and such much of Lessee's Security Deposit as has not been, or is not then required to be, used by Lessor under the terms of this Lease.

9.9 Waiver of Status. Lessor and Lessee agree that the terms of this Lease shall govern the effect of any damage to or destruction of the Premises and the Building with respect to the termination of this Lease and hereby waive the provisions of any present or future statute to the extent it is inconsistent herewith.

10. Real Property Taxes.

10.1 Payment of Taxes. Lessor shall pay the Real Property Taxes, as defined in Paragraph 10.2, applicable to the Industrial Center, and except as otherwise provided in Paragraph 10.3, any such amounts shall be included in the calculation of Common Area Operating Expenses in accordance with the provisions of Paragraph 4.2.

10.2 Real Property Tax Definition. As used herein, the term "Real Property Taxes" shall include any form of real estate tax or assessment, general, special, ordinary or extraordinary, and any license fee, commercial rental tax, improvement bond or bonds, levy or tax (other than Inheritance, personal income

or estate taxes) imposed upon the Industrial Center by any authority having the direct or indirect power to tax, including any city, state or federal government, or any school, agricultural, sanitary, fire, street, drainage, or other improvement district thereof, levied against any legal or equitable interest of Lessor in the Industrial Center or any portion thereof, Lessor's right to rent or other income therefrom, and/or Lessor's business of leasing the Premises. The term "Real Property Taxes" shall also including any tax, fee, levy, assessment or charge, or any increase therein, imposed by reason of events occurring, or changes in Applicable Law taking effect, during the term of this Lease, including but not limited to a change in the ownership of the Industrial Center or in the improvements thereon, the execution of this Lease, or any modification, amendment or transfer thereof, and whether or not contemplated by the Parties. In calculating Real Property Taxes for any calendar year, the Real Property Taxes for any real estate tax year shall be included in the calculation of Real Property Taxes for such calendar year and tax year have in common.

10.3 Additional Improvements. Common Area Operating Expenses shall not include Real Property Taxes specified in the tax assessor's records and work sheets as being caused by additional improvements placed upon the Industrial Center by other lessees or by Lessor for the exclusive enjoyment of such other lessees. Notwithstanding Paragraph 10.1 hereof, Lessee shall, however, pay to Lessor at the time Common Area Operating Expenses are payable under Paragraph 4.2, the entirety of any increase in Real Property Taxes if assessed solely by reason of Alterations, Trade Fixtures or Utility Installations placed upon the Premises by Lessee or at Lessee's request.

10.4 Joint Assessment. If the Building is not separately assessed, Real Property Taxes allocated to the Building shall be an equitable proportion of the Real Property Taxes for all of the land and improvements included within the tax parcel assessed, such proportion to be determined by Lessor from the respective valuations assigned in the assessor's work sheets or such other information as may be reasonably available. Lessor's reasonable determination thereof, in good faith, shall be conclusive.

10.5 Lessee's Property Taxes. Lessee shall pay prior to delinquency all taxes assessed against and levied upon Lessee-Owned Alterations and Utility Installations, Trade Fixtures, furnishings, equipment and all personal property of Lessee contained in the Premises or stored within the Industrial Center. When possible, Lessee shall cause its Lessee-Owned Alterations and Utility Installations, Trade Fixtures, furnishings, equipment and all other personal property to be assessed and billed separately from the real property of Lessor. If any of Lessee's said property shall be assessed with Lessor's real property, Lessee shall pay Lessor the taxes attributable to Lessees' property within ten (10) days after receipt of a written statement setting forth the taxes applicable to Lessee's property.

11. Utilities. Lessee shall pay directly for all utilities and services supplied to the Premises, including but not limited to electricity, telephone, security, gas and cleaning of the Premises, together with any taxes thereon. If any such utilities or services are not separately metered to the Premises or separately billed to the Premises, Lessee shall pay to Lessor a reasonable proportion to be determined by Lessor of all such charges jointly metered or billed with other Premises in the Building, in the manner and within the timer periods set forth in Paragraph 4.2(d).

12. See Addendum.

13. Default; Breach; Remedies.

13.1 Default; Breach. Lessor and Lessee agree that if an attorney is consulted by Lessor in connection with a Lessee Default or Breach (as Hereinafter defined), \$350.00 is a reasonable minimum sum per such occurrence for legal services and costs in the preparation and service of a notice of Default, and that Lessor may include the cost of such services and costs in said notice as rent due and payable to cure said default. A "Default" by Lessee is defined as a failure by Lessee to observe, comply with or perform any of the terms, covenants, conditions or rules applicable to Lessee under this Lease. A "Breach" by Lessee is defined as the occurrence of any one or more of the following Defaults, and where a grace period for cure after notice is specified herein, the failure by Lessee to cure such Default prior to the expiration of the applicable grace period, and shall entitle Lessor to pursue the remedies set forth in Paragraphs 13.2 and/or 13.3:

(a) Paragraph intentionally omitted.

(b) Except as expressly otherwise provided in this Lease, the failure by Lessee to make any payment of Base Rent; Lessee's Share of Common Area Operating Expenses, or any other monetary payment required to be made by Lessee hereunder as and when due, the failure by Lessee to provide Lessor with reasonable evidence of insurance or surety bond required under this Lease, or the failure of Lessee to fulfill any obligation under this Lease which endangers or threatens life or property, where such failure continues for a period of five (5) days following written notice thereof by or on behalf of Lessor to Lessee.

(c) Except as expressly otherwise provided in this Lease, the failure by Lessee to provide Lessor with reasonable written evidence (in duly executed original form, if applicable) of (i) compliance with Applicable Requirements per Paragraph 6.3, (ii) the inspection, maintenance and service contracts required under Paragraph 7.1(b), (iii) the rescission of an unauthorized assignment or subletting per Paragraph 12.1, (iv) a Tenancy Statement per Paragraphs 16 or 37, (v) the subordination or non-subordination of this Lease per Paragraph 30, (vi) the guaranty of the performance of Lessee's obligations under this Lease if required under Paragraphs 1.11 and 37, (vii) the execution of any document requested under Paragraph 42 (easements), or (viii) any other documentation or information which Lessor may reasonably require of Lessee under the terms of this lease, where any such failure continues for a period of thirty (30) days following written notice by or on behalf of Lessor to Lessee.

(d) A Default by Lessee as to the terms, covenants, conditions or provisions of this Lease, or of the rules adopted under Paragraph 40 hereof that are to be observed, complied with or performed by Lessee, other than those described in Subparagraphs 13.1(a), (b) or (c), above, where such Default continues for more than thirty (30) days after written notice thereof by or on behalf of Lessor to Lessee; provided, however, that if the nature of Lessee's Default is such that more than thirty (30) days are reasonably require for its cure, then it shall not be deemed to be a Breach of this Lease by Lessee if Lessee commences such cure within said thirty (30) day period and thereafter diligently prosecutes such cure to completion.

(e) The occurrence of any of the following events: (i) the making by Lessee of any general arrangement or assignment for the benefit of creditors; (ii) Lessee's becoming a "debtor" as defined in U.S. Code Section 101 or any successor statute thereto (unless, in the case of a petition filed against Lessee, the same is dismissed within sixty (60) days; (iii) the appointment of a trustee or receiver to take possession of substantially all of Lessee's assets located at the Premises or of Lessee's interest in this Lease, where possession is not restored to Lessee within thirty (30) days; or (iv) the attachment, execution or other judicial seizure of substantially all of Lessee's assets located at the Premises or of Lessee's interest in this Lease, where such seizure is not discharged within thirty (3) days; provided, however, in the event that any provision of this Subparagraph 13.1(e) is contrary to any applicable law, such provision shall be of no force or effect, and shall not affect the validity of the remaining provisions.

13.2 Remedies. If Lessee fails to perform any affirmative duty or obligation of Lessee under this Lease, within ten (10) days after written notice to Lessee (or in case of an emergency, without notice), Lessor may at its option (but without obligation to do so), perform such duty or obligation on Lessee's behalf, including but not limited to the obtaining of reasonably required bonds, insurance policies, or governmental licenses, permits or approvals. The costs and expenses of any such performance by Lessor shall be due and payable by Lessee to Lessor upon invoice therefor. If any check given to Lessor by Lessee shall not be honored by the bank upon which it is drawn, Lessor, at its own option, may require all future payments to be made under this Lease by Lessee to be made only by cashier's check. In the event of a Breach of this Lease by Lessee (as defined in Paragraph 13.1), with or without further notice or demand, and without limiting Lessor in the exercise of any right or remedy which Lessor may have by reason of such Breach, Lessor may:

(a) Terminate Lessee's right to possession of the Premises by any lawful means, in which case this Lease and term hereof shall terminate and Lessee shall immediately surrender possession of the Premises to Lessor. In such event Lessor shall be entitled to recover from Lessee: (i) the worth at the time of the aware of the unpaid rent which had been earned at the time of termination; (ii) the worth at the time of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss that the Lessee proves could have been reasonably avoided; (iii) the

worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of award exceeds the amount of such rental loss that the Lessee proves could be reasonably avoided; and (iiv) any other amount necessary to compensate Lessor for all the detriment proximately caused by the Lessee's failure to perform its obligations under this Lease or which in the ordinary course of things would be likely to result therefrom, including but not limited to the cost of recovering possession of the Premises, expenses of reletting, including necessary renovation and alteration of the Premises, reasonable attorneys' fees, and that portion of any leasing commission paid by Lessor in connection with this Lease applicable to the unexpired term of this Lease. The worth at the time of award of the amount referred to in provision (iii) of the immediately preceding sentence shall be computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco or the Federal Reserve Bank District in which the Premises are located at the time of award plus one percent (1%). Efforts by Lessor to mitigate damages caused by Lessee's Default or Breach of this Lease shall not waive Lessor's right to recover damages under this Paragraph 13.2. If termination of this Lease is obtained through the provisional remedy of unlawful detainer, Lessor shall have the right to recover in such proceeding the unpaid rent and damages as are recoverable therein, or Lessor may reserve the right to recover all or any part thereof in a separate suite for such rent and/or damages. If a notice and grace period required under Subparagraph 13.1(b), (c) or (d) was not previously given, a notice to pay rent or quit, or to perform or quit, as the case may be, given to Lessee under any statute authorizing the forfeiture of leases for unlawful detainer shall also constitute the applicable notice for grace period purposes required by Subparagraph 13.1(b), (c) or (d). In such case, the applicable grace period under the unlawful detainer statute shall run concurrently after the one such statutory notice, and the failure of Lessee to cure the Default within the greater of the two (2) such grace periods shall constitute both an unlawful detainer and a Breach of this Lease entitling Lessor to the remedies provided for in this Lessee's right to possession.

(b) Continue the Lease and Lessee's right to possession in effect (in California under California Civil Code Section 1951.4) after Lessee's Breach and recover the rent as it becomes due, provided Lessee has the right to sublet or assign, subject only to reasonable limitations. Lessor and Lessee agree that the limitations on assignment and subletting in this Lease are reasonable. Acts of maintenance or preservation, efforts to relet the Premises, or the appointment of a receiver to protect the Lessor's interest under this Lease, shall not constitute a termination of the Lessee's right to possession.

(c) Pursue any other remedy now or hereafter available to Lessor under the laws or judicial decisions of the state wherein the Premises are located.

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(d) The expiration or termination of this Lease and/or the termination of Lessee's right to possession shall not relieve Lessee from liability under any indemnity provisions of this Lease as to matters occurring or accruing during the term hereof or by reason of Lessee's occupancy of the Premises.

13.3 Inducement Recapture in Event of Breach. Any agreement by Lessor for free or abated rent or other charges applicable to the Premises, or for the giving or paying by Lessor to or for Lessee of any cash or other bonus, inducement or consideration for Lessee's entering into this Lease, all of which concessions are hereinafter referred to as "Inducement Provisions" shall be deemed conditioned upon Lessee's full and faithful performance of all of the terms, covenants and conditions of this Lease to be performed or observed by Lessee during the term hereof as the same may be extended. Upon the occurrence of a Breach (as defined in Paragraph 13.1) of this Lease by Lessee, any such Inducement Provision shall automatically be deemed deleted from this Lease and of no further force or effect, and any rent, other charge, bonus, inducement or consideration therefore abated, given or paid by Lessor under such an Inducement Provision shall be immediately due and payable by Lessee to Lessor, and recoverable by Lessor, as additional rent due under this Lease,. The acceptance by Lessor of rent or the cure of the Breach which initiated the operation for this Paragraph 13.3 shall not be deemed a waiver by Lessor of the provisions of this Paragraph 13.3 unless specifically so stated in writing by Lessor at the time of such acceptance.

13.4 Late Charges. Lessee hereby acknowledges that late payment by Lessee to Lessor of rent and other sums due hereunder will cause Lessor to incur costs not contemplated by this Lease, the exact amount of which will be extremely

difficult to ascertain. Such costs include, but are not limited to, processing and accounting charges, and late charges which may be imposed upon Lessor by the terms of any ground lease, mortgage or deed of trust covering the premises. Accordingly, if any installment of rent or other sum due from Lessee shall not be received by Lessor or Lessor's designee within ten (10) days after such amount shall be due, then, without any requirement for notice to Lessee, Lessee shall pay to Lessor a late charge equal to six percent (6%) of such overdue amount. The Acceptance of such late charge by Lessor shall in no even constitute a waiver of Lessee's Default or Breach with respect to such overdue amount, nor prevent Lessor from exercising any of the other rights and remedies granted hereunder. In the event that a late charge is payable hereunder, whether or not collected, for three (3) consecutive installments of Base Rent, then notwithstanding Paragraph 4.1 or any other provision of this Lease to the contrary, Base Rent shall, at Lessor's option, become due and payable quarterly in advance.

13.5 Breach by Lessor. Lessor shall not be deemed in breach of this Lease unless Lessor fails within a reasonable time to perform an obligation required to be performed by Lessor. For purposes of this Paragraph 13.5, a reasonable time shall be thirty (30) days after receipt by Lessor, and by any Lender(s) whose name and address shall have been furnished to Lessee in writing for such purpose, of written notice specifying wherein such obligation of Lessor has not been performed; provided, however, that if the nature of Lessor's obligation is such that more than thirty (30) days after such notice are reasonably required for its performance, then Lessor shall not be in breach of this Lease if performance is commenced within such thirty (30) day period and thereafter diligently pursued to completion.

14. Condemnation. If the Premises or any portion thereof are taken under the power of eminent domain or sold under the threat of the exercise of said power (all of which are herein called "condemnation"), this Lease shall terminate as to the part so taken as of the date of condemning authority taxes title or possession, whichever first occurs. If more than ten percent (10%) of the floor area of the Premises, or more than twenty-five percent (25%) of the portion of the Common Area designated for Lessee's parking, is taken by condemnation, Lessee may, at Lessee's option, to be exercised in writing within ten (10) days after Lessor shall have given Lessee written notice of such taking (or in the absence of such notice, within ten (10) days after the condemning authority shall have taken possession) terminate this Lease as of the date of condemning authority takes such possession. If Lessee does not terminate this Lease in accordance with the foregoing, this Lease shall remain in full force and effect as to the portion of the Premises remaining, except that the Base Rent shall be reduced in the same proportion as the rentable floor area of the Premises taken bears the total rentable floor area of the Premises. NO reduction of Base Rent shall occur if the condemnation does not apply to any portion for the Premises. Any award for the taking of all or any part of the Premises under the power of eminent domain or any payment made under threat of the exercise of such power shall be the property of Lessor, whether such award shall be made as compensation for diminution of value of the leasehold or for the taking of the fee, or as severance damages; provided, however, that Lessee shall be entitled to any compensation, separately awarded to Lessee for Lessee's relocation expenses and/or loss of Lessee's Trade Fixtures. In the event that this Lease is not terminated by reason of such condemnation, Lessor shall to the extent of its net severance damages required to complete such repair.

15. Broker's Fees.

15.1 Procuring Cause. The Broker(s) named in Paragraph 1.10 is/are the procuring cause of this Lease.

15.2 Additional Terms. Unless Lessor and Broker(s) have otherwise agreed in writing, Lessor agrees that: (a) if Lessee exercises any Option (as defined in Paragraph 39.1) granted under this Lease or any Option subsequently granted, or (b) if Lessee acquires any rights to the Premises or other premises in which Lessor has an interest, or (c) if Lessee remains in possession of the Premises with consent of Lessor after the expiration of the term of this Lease after having failed to exercise an Option, or (d) if said Brokers are the procuring cause of any other lease or sale entered into between the Parties pertaining to the Premises and/or any adjacent property in which Lessor has an interest, or (e) if Base Rent is increased, whether by agreement or operation of an escalation clause herein, then as to any said transactions, Lessor shall pay said Broker(s) a fee in accordance with the schedule of said Broker(s) in effect at the time of the execution of this Lease.

15.3 Assumption of Obligations. Any buyer or transferee of Lessor's

interest in this Lease, whether such transfer is by agreement or by operation of law, shall be deemed to have assumed Lessor's obligation under this Paragraph 15. Each Broker shall be an intended thirty party beneficiary of the provisions of Paragraph 1.100 and of this Paragraph 15 to the extent of its interest in any commission arising from this Lease and may enforce that right directly against Lessor and its successors.

15.4 Representations and Warranties. Lessee and Lessor each represent and warrant to the other that it has had no dealings with any person, firm, broker or finder other than as named in Paragraph 1.10(a) in connection with the negotiation of this Lease and/or the consummation of the transaction contemplated hereby, and that no broker or other person, firm or entity other than said named Broker(s) is entitled to any commission or finder's fee in connection with said transaction. Lessee and Lessor do each hereby agree to indemnify, protect, defend and hold the other harmless from and against liability for compensation or charges which may be claimed by any such unnamed broker, finder or other similar party by reason of any dealings or actions of the indemnifying Party, including any costs, expenses, and/or attorneys' fee reasonably incurred with respect thereto.

16. Tenancy and Financial Statements.

16.1 Tenancy Statement. Each Party (as "Responding Party") shall within ten (10) days after written notice from the other Party (the "Requesting Party") execute, acknowledge and deliver to the Requesting Party a statement in writing in a form similar to the then most current "Tenancy Statement" form published by the American Industrial Real Estate Association, plus such additional information, confirmation and/or statements as may be reasonably requested by the Requesting Party.

17. Lessor's Liability. The term "Lessor" as used herein shall mean the owner or owners at the time in question of the fee title to the Premises. In the event of a transfer of Lessor's title or interest in the Premises or in this Lease, Lessor shall deliver to the transferee or assignee (in cash or by credit) any unused Security Deposit held by Lessor at the time of such transfer or assignment. Except as provided in Paragraph 15.3, upon such transfer or assignment and delivery of Security Deposit, as aforesaid, the prior Lessor shall be relieved of all liability with respect to the obligations and/or covenants under this Lease thereafter to be performed by the Lessor. Subject to the foregoing, the obligations and/or covenants in this Lease to be performed by the Lessor shall be binding only upon the Lessor as herein above defined.

18. Severability. The invalidity of any provision of this Lease, as determined by a court of competent jurisdiction, shall in no way effect the validity of any other provision hereof.

19. Interest on Past Due Obligations. Any monetary payment due Lessor hereunder, other than late charges, not received by Lessor within ten (10) days following the date on which it was due, shall bear interest from the date on which it was due, shall bear interest from the date due at the prime rate charged by the largest state chartered bank in the state in which the Premises are located plus four percent (4%) per annum, but not exceeding the maximum rate allowed by law, in addition to the potential late charge provided for in Paragraph 13.4.

20. Time of Essence. Time is of the essence with respect to the performance of all obligations to be performed or observed by the Parties under this Lease.

21. Rent Defined. All monetary obligations of Lessee to Lessor under the terms of this Lease are deemed to be rent.

22. No Prior or other Agreements; Broker Disclaimer. This Lease contains all agreements between the Parties with respect of any matter mentioned herein, and no other prior or contemporaneous agreement or understanding shall be effective. Lessor and Lessee each represents and warrants to the Brokers that it has made, and is relying solely upon, its own investigation as to the nature, quality, character and financial responsibility of the other Party to this Lease and as to the nature, quality and character of the Premises. Brokers have no responsibility with respect thereto or with respect to any default or breach hereof by either Party. Each Broker shall be an intended thirty party beneficiary of the provisions of this Paragraph 22.

23. Notices.

23.1 Notice Requirements. All notices required or permitted by this Lease shall be in writing and may be delivered in person (by hand or by messenger or

courier service) or may be sent by regular, certified or registered mail or U.S. Postal Service Express Mail, with postage prepaid or by facsimile transmission during normal business hours, and shall be deemed sufficiently given if served in a manner specified in this Paragraph 23. The addresses noted adjacent to a Party's signature on this Lease shall be that Party's address for delivery or mailing of notice purposes. Either Party may by written notice to the other specify a different address for notice purposes, except that upon Lessee's taking possession of the Premises, the Premises shall constitute Lessee's address for the purpose of mailing or delivering such notices to Lessee. A copy of all notices required or permitted to be given to Lessor hereunder shall be concurrently transmitted to such party or parties at such addresses as Lessor may from time to time hereafter designate by written notice to Lessee.

23.2 Date of Notice. Any notice sent by registered or certified mail, return receipt requested, shall be deemed given on the date of delivery shown on the receipt card, or if no delivery date is shown, the postmark thereon. If sent by regular mail, the notice shall be deemed given forty-eight (48) hours after the same is addressed as required herein and mailed with postage prepaid. Notices delivered by United States Express Mail or overnight courier that guarantees next day

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delivery shall be deemed given twenty-four (24) hours after delivery of the same to the United States Postal Service or courier. If any notice is transmitted by facsimile transmission or similar means, the same shall be deemed served or delivered upon telephone or facsimile confirmation of receipt of the transmission thereof, provided a copy is also delivered via delivery or mail. If notice is received on a Saturday or a Sunday or a legal holiday, it shall be deemed received on the next business day.

24. Waivers. No waiver by Lessor of the Default or Breach of any term, covenant or condition hereof by Lessee, shall be deemed a waiver of any other terms, covenant or condition hereof, or of any subsequent Default or Breach by Lessee of the same or any other term, covenant or condition hereof. Lessor's consent to, or approval of, any such act shall not be deemed to render unnecessary the obtaining of Lessor's consent to, or approval of, any subsequent or similar act by Lessee, or be construed as the basis of an estoppel to enforce the provision or provisions of this Lease requiring such consent. Regardless of Lessor's knowledge of a Default or Breach at the time of accepting rent, the acceptance of rent by Lessor shall not be a waiver of any Default or Breach by Lessee of any provision hereof. Any payment given Lessor by Lessee may be accepted by Lessor on account of moneys or damages due Lessor, notwithstanding any qualifying statements or conditions made by Lessee in connection therewith, which such statements and/or conditions shall be of no force or effect whatsoever unless specifically agreed to in writing by Lessor at or before the time of deposit of such payment.

25. Recording. Either Lessor or Lessee shall, upon request of the other, execute, acknowledge and deliver to the other a short form memorandum of this Lease for recording purposes. The Party requesting recordation shall be responsible for payment of any fees or taxes applicable thereto.

26. No Right to Holdover. Lessee has no right to retain possession of the Premises or any part thereof beyond the expiration or earlier termination of this Lease. In the event that Lessee holds over in violation of this Paragraph 26 then the Base Rent payable from and after the time of the expiration or earlier termination of this Lease shall be increased to one hundred twenty five (125%) percent of the Base Rent applicable during the month immediately preceding such expiration or earlier termination. Nothing contained herein shall be construed as a consent by Lessor to any holding over by Lessee.

27. Cumulative Remedies. No remedy or election hereunder shall be deemed exclusive but shall, wherever possible, be cumulative with all other remedies available in law or in equity.

28. Covenants and Conditions. All provisions of this Lease to be observed or performed by Lessee are both covenants and conditions.

29. Binding Effect; Choice of Law. This Lease shall be binding upon the Parties, their personal representatives, successors and assigns and be governed by the laws of the State in which the Premises are located. Any litigation between the Parties hereto concerning this Lease shall be initiated in the county in which

the Premises are located.

30. Subordination; Attornment; Non-Disturbance.

30.1 Subordination. This Lease and any Option granted hereby shall be subject and subordinate to any ground lease, mortgage, deed of trust, or other hypothecation or security device (collectively, "Security Device"), now or hereafter placed by Lessor upon the real property of which the Premises are a part, to any and all advances made on the security thereof, and to all renewals, modifications, consolidations, replacements and extensions thereof. Lessee agrees that the Lenders holding any such Security Device shall have no duty, liability or obligation to perform any of the obligations of Lessor under this Lease, but that in the event of Lessor's default with respect to any such obligation, Lessee will give any Lender whose name and address have been furnished Lessee in writing for such purpose notice of Lessor's default pursuant to Paragraph 13.5. If any Lender shall elect to have this Lease and/or any Option granted hereby superior to the lien of its Security device and shall give written notice thereof to Lessee, this Lease and such Options shall be deemed prior to such Security Device, notwithstanding the relative dates of the documentation or recordation thereof.

30.2 Attornment. Subject to the non-disturbance provisions of Paragraph 30.3, Lessee agrees to attorn to a Lender or any other party who acquires ownership of the Premises by reason of a foreclosure of a Security Device, and that in the event of such foreclosure, such new owner shall not: (i) be liable for any act or omission of any prior lessor, or with respect to event occurring prior to acquisition of ownership, (ii) be subject to any offsets or defenses which Lessee might have against any prior lessor, or (iii) be bound by prepayment of more than one month's rent.

30.3 Non-Disturbance. With respect to Security Devices entered into by Lessor after the execution of this Lease, Lessee's subordination of this Lease shall be subject to receiving assurance (a "non-disturbance agreement") from the Lender that Lessee's possession and this Lease, including any options to extend the term hereof, will not be disturbed so long as Lessee is not in Breach hereof and attorns to the record owner of the Premises.

30.4 Self-Executing. The agreements contained in this paragraph 30 shall be effective without the execution of any further documents; provided, however, that upon written request from Lessor or a Lender in connection with a sale, financing or refinancing of Premises, Lessee and Lessor shall execute such further writings as may be reasonably required to separately document any such subordination or non-subordination, attornment and/or non-disturbance agreement as is provided for herein.

31. Attorneys' Fees. If any Party or Broker brings an action or proceeding to enforce the terms hereof or declare rights hereunder, the Prevailing Party (as hereafter defined) in any such proceeding, action, or appeal thereon, shall be entitled to reasonable attorneys' fees. Such fees may be awarded in the same suit or recovered in a separate suit, whether or not such action or proceeding is pursued to decision or judgment. The term "Prevailing Party" shall include, without limitations, a party or Broker who substantially obtains or defeats the relief sought, as the case may be, whether by compromise, settlement, judgment, or the abandonment by the other Party or Broker of its claim or defense. The attorneys' fees award shall not be computed in accordance with any court fee schedule, but shall be such as to fully reimburse all attorneys' fees reasonably incurred. Lessor shall be entitled to attorneys' fees, costs and expenses incurred in preparation and service of notices of Default and consultations in connection therewith, whether or not a legal action is subsequently commenced in connection with such Default or resulting Breach. Broker(s) shall be intended third party beneficiaries of this Paragraph 31.

32. Lessor's Access; Showing Premises; Repairs. Lessor and Lessor's agents shall have the right to enter the Premises at any time, in the case of an emergency, and otherwise at reasonable times for the purpose of showing the same to prospective purchasers, lenders, or lessees, and making such alternations, repairs, improvements or additions to the Premises or to the Building, as Lessor may reasonably deem necessary and upon prior written or telephonic notice to Lessee. Lessor may at any time place on or about the Premises or Building any ordinary "For Sale" signs and Lessor may at any time during the last one hundred eighty (180) days of the term hereof place on or about the Premises any ordinary "For Lease" signs. All such activities of Lessor shall be without abatement of rent or liability to Lessee.

33. Auctions. Lessee shall not conduct, nor permit to be conducted, either

voluntarily or involuntarily, any auction upon the Premises without first having obtained Lessor's prior written consent. Notwithstanding anything to the contrary in this Lease, Lessor shall not be obligated to exercise any standard of reasonableness in determining whether to grant such consent.

34. Signs. Lessee shall not place any sign upon the exterior of the Premises or the Building, except that Lessee may, with Lessor's prior written consent, install (but not on the roof) such signs as are reasonably required to advertise Lessee's own business so long as such signs are in a location designated by Lessor and comply with applicable Requirements and the signage criteria established for the Industrial Center by Lessor. The installation of any sign on the Premises by or for Lessee shall be subject to the provisions of Paragraph 7 (Maintenance, Repairs, Utility Installations, Trade Fixtures and Alternations). Unless otherwise expressly agreed herein, Lessor reserves all rights to the use of the roof of the Building, and the right to install advertising signs on the Building, including the roof, which do not unreasonably interfere with the conduct of Lessee's business; Lessor shall be entitled to all revenues from such advertising signs. See Addendum.

35. Termination; Merger. Unless specifically stated otherwise by Lessor, the voluntary or other surrender of this Lease by Lessee, the mutual termination or cancellation hereof, or a termination hereof by Lessor for Breach by Lessee, shall automatically terminate any sublease or lesser estate in the Premises; provided, however, Lessor shall, in the event of any such surrender, termination or cancellation, have the option to continue any one or all of any existing subtenancies. Lessor's failure within ten (10) days following any such event to make a written election to the contrary by written notice to the holder of any such lesser interest, shall constitute Lessor's election to have such event constitute the termination of such interest.

36. Consents.

(a) Except for Paragraph 33 hereof (Auctions) or as otherwise provided herein, wherever in this Lease the consent of a Party is required to an act by or for the other Party, such consent shall not be unreasonably withheld or delayed. Lessor's actual reasonable costs and expenses (including but not limited to architects', attorneys', engineers' and other consultants' fees) incurred in the consideration of, or response to, a request by Lessee for any Lessor consent pertaining to this Lease or the Premises, including but not limited to consents to an assignment a subletting or the presence of use of a Hazardous Substance, shall be paid by Lessee to Lessor upon receipt of an invoice and supporting documentation therefor. In addition to the deposit described in Paragraph 12.2(e), Lessor may, as a condition to considering any such request by Lessee, require that Lessee deposit with Lessor an amount of money (in addition to the Security Deposit held under Paragraph 5) reasonably calculated by Lessor to represent the cost Lessor will incur in considering and responding to Lessee's request. Any unused portion of said deposit shall be refunded to Lessee without interest. Lessor's consent to any act, assignment of this Lease or subletting of the Premises by Lessee shall not constitute an acknowledgment that no Default or Breach by Lessee of this Lease exists, nor shall such consent be deemed a waiver of any then existing Default or Breach, except as may be otherwise specifically stated in writing by Lessor at the time of such consent.

(b) All conditions to Lessor's consent authorized by this Lease are acknowledged by Lessee as being reasonable. The failure to specify herein any particular condition to Lessor's consent shall not preclude the impositions by Lessor at the time of consent of such further or other conditions as are then reasonable with reference to the particular matter for which consent is being given.

37. Guarantor.

37.1 Form of Guaranty. If there are to be any Guarantors of this Lease per Paragraph 1.11, the form of the guaranty to be executed by each such Guarantor shall be in the form most recently published by the American Industrial Real Estate Association, and each such Guarantor shall have the same obligations as Lessee under this lease, including but not limited to the obligation to provide the Tenancy Statement and Information required in Paragraph 16.

37.2 Additional Obligations of Guarantor. It shall constitute a Default of the Lessee under this Lease if any such Guarantor fails or refuses, upon reasonable request by Lessor to give: (a) evidence of the due execution of the guaranty called for by this Lease, including the authority of the Guarantor (and of the party signing on Guarantor's behalf) to obligate such Guarantor on said

guaranty, and resolution of its board of directors authorizing the making of such guaranty, together with a certificate of incumbency showing the signatures of persons authorized to sign on its behalf, (b) current financial statements of Guarantor as may from time to time be requested by Lessor, (c) a Tenancy Statement, or (d) written confirmation that the guaranty is still in effect.

38. Quiet Possession. Upon payment by Lessee of the rent for the Premises and the performance of all of the covenants, conditions and provisions on Lessee's part to be observed and performed under this Lease, Lessee shall have quiet possession of the Premises for the entire term hereof subject to all of the provisions of this Lease.

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39. Options.

39.1 Definition. As used in this Lease, the word "Option" has the following meaning: (a) the right to extend the term of this Lease or to renew this Lease or to extend or renew any lease that lessee has on other property of Lessor; (b) the right of first refusal to lease the Premises or the right of first offer to lease the Premises or the right of first refusal to lease other property of Lessor or the right of first offer to lease other property of Lessor; (c) the right to purchase the Premises, or the right of first refusal to purchase the Premises, or the right of first offer to purchase the Premises, or the right to purchase other property of Lessor, or the right of first refusal to purchase other property of Lessor, or the right of first offer to purchase other property of Lessor.

39.2 Options Personal to Original Lessee. Each Option granted to Lessee in this Lease is personal to the original Lessee named in Paragraph 1.1 hereof, and cannot be voluntarily or involuntarily assigned or exercised by any person or entity other than said original Lessee while the original Lessee is in full and actual possession of the Premises and without the intention of thereafter assigning or subletting. The Options, if any, herein granted to Lessee are not assignable of this Lease or separately or apart therefrom, and no Option may be separated from this Lease in any manner, by reservation or otherwise.

39.3 Multiple Options. In the event that Lessee has any multiple Options to extend or renew this Lease, a later option cannot be exercised unless the prior Options to extend or renew this Lease have been validly exercised.

39.4 Effect of Default on Options.

(a) Lessee shall have no right to exercise an Option, notwithstanding any provision in the grant of Option to the contrary; (i) during the period commencing with the giving of any notice of Default under Paragraph 13.1 and continuing until the noticed Default is cured, or (ii) during the period of time any monetary obligation due Lessor from Lessee is unpaid (without regard to whether notice thereof is given Lessee), or (iii) during the time Lessee is in Breach of this Lease, or (iv) in the event that Lessor has given to Lessee three (3) or more notices of separate Defaults under Paragraph 13.1 during the twelve (12) month period immediately preceding the exercise of the Option, whether or not the Defaults are cured.

(b) The period of time within which an Option may be exercised shall not be extended or enlarged by reason of Lessee's inability to exercise an Option because of the provisions of Paragraph 39.4(a).

(c) All rights of Lessee under the provisions of an Option shall terminate and be of no further force or effect, notwithstanding Lessee's due and timely exercise of the Option, if, after such exercise and during the term of this Lease, (i) Lessee fails to pay to Lessor a monetary obligation of Lessee for a period of thirty (30) days after such obligation becomes due (without any necessity of Lessor to give notice thereof to Lessee), or (ii) Lessor gives to Lessee three (3) or more notices of separate Defaults under Paragraph 13.1 during any twelve (12) month period, whether or not the Defaults are cured, or (iii) if Lessee commits a Breach of this Lease.

40. Rules and Regulations. Lessee agrees that it will abide by, and keep and observe all reasonable rules and regulations ("Rules and Regulations") which Lessor may make from time to time for the management, safety, care, and cleanliness of the grounds, the parking and unloading of vehicles and the preservation of good order, as well as for the convenience of other occupants or

tenants of the Building and the Industrial Center and their invitees.

41. Security Measures. Lessee hereby acknowledges that the rental payable to Lessor hereunder does not include the cost of guard service of other security measures, and that Lessor shall have no obligation whatsoever to provide same. Lessee assumes all responsibility for the protection of the Premises, Lessee, its agents and invitees and their property from the acts of third parties.

42. Reservations. Lessor reserves the right, from time to time, to grant without the consent or joinder of Lessee, such easements, rights of way, utility raceways, and dedications that Lessor deems necessary, and to cause the recordation of parcel maps and restrictions, so long as such easements, rights of way, utility raceways, dedications, maps and restrictions do not reasonably interfere with the use of the Premises by Lessee. Lessee agrees to sign any documents reasonably requested by Lessor to effectuate any such easement rights, dedication, map or restrictions.

43. Performance Under Protest. If at any time a dispute shall arise as to any amount or sum of money to be paid by one Party to the other under the provisions hereof, the Party against whom the obligation to pay the money is asserted shall have the right to make payment "under protest" and such payment shall not be regarded as a voluntary payment and there shall survive the right on the part of said Party to institute suit for recovery of such sum. If it shall be adjudged that there was no legal obligation on the part of said Party to pay such sum or any part hereof, said Party shall be entitled to recover such sum or so much thereof as it was not legally required to pay under the provisions of this Lease.

44. Authority. If either Party hereto is a corporation, trust, or general or limited partnership, each individual executing this Lease on behalf of such entity represents and warrants that he or she is duly authorized to execute and deliver this Lease on its behalf. If Lessee is a corporation, trust or partnership, Lessee shall, within thirty (30) days after request by Lessor, deliver to Lessor evidence satisfactory to Lessor of such authority.

45. Conflict. Any conflict between the printed provisions of this Lease and the typewritten or handwritten provisions shall be controlled by the typewritten or handwritten provisions.

46. Offer. Preparation of this Lease by either Lessor or Lessee or Lessor's agent or Lessee's agent and submission of same to Lessor or Lessee shall not be deemed an offer to lease. This Lease is not intended to be binding until executed and delivered by all Parties hereto.

47. Amendments. This Lease may be modified only in writing, signed by the parties in interest at the time of the modification. The Parties shall amend this Lease from time to time to reflect any adjustments that are made to the Base Rent or other rent payable under this Lease. As long as they do not materially change Lessee's obligations hereunder, Lessee agrees to make such reasonable non-monetary modifications to this Lease as may be reasonably required by an institutional insurance company or pension plan Lender in connection with the obtaining of normal financing or refinancing of the property of which the Premises are a part.

48. Multiple Parties. Except as otherwise expressly provided herein, if more than one person or entity is named herein as either Lessor or Lessee, the obligation of such multiple parties shall be the joint and several responsibility of all persons or entities named herein as such Lessor or Lessee.

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LESSOR AND LESSEE HAVE CAREFULLY READ AND REVIEWED THIS LEASE AND EACH TERM AND PROVISIONS CONTAINED HEREIN, AND BY THE EXECUTION OF THIS LEASES SHOW THEIR INFORMED AND VOLUNTARY CONSENT THERETO. THE PARTIES HEREBY AGREE THAT, AT THE TIME THIS LEASE IS EXECUTED, THE TERMS OF THIS LEASE ARE COMMERCIALY REASONABLE AND EFFECTUATE THE INTENT AND PURPOSE OF LESSOR AND LESSEE WITH RESPECT TO THE PREMISES.

IF THIS LEASE HAS BEEN FILLED IN, IT HAS BEEN PREPARED FOR YOUR ATTORNEY'S REVIEW AND APPROVAL. FURTHER, EXPERTS SHOULD BE CONSULTED TO EVALUATE THE CONDITION OF THE PROPERTY FOR THE POSSIBLE PRESENCE OF ASBESTOS, UNDERGROUND STORAGE TANKS OR HAZARDOUS SUBSTANCES. NO REPRESENTATION OR RECOMMENDATION IS MADE BY THE AMERICAN INDUSTRIAL REAL

ESTATE ASSOCIATION OR BY THE REAL ESTATE BROKERS OR THEIR CONTRACTORS, AGENTS OR EMPLOYEES AS TO THE LEGAL SUFFICIENCY, LEGAL EFFECT, OR TAX CONSEQUENCES OF THIS LEASE OR THE TRANSACTION TO WHICH IT RELATES; THE PARTIES SHALL RELY SOLELY UPON THE ADVICE OF THEIR OWN COUNSEL AS TO THE LEGAL AND TAX CONSEQUENCES OF THIS LEASE. IF THE SUBJECT PROPERTY IS IN A STATE OTHER THAN CALIFORNIA, AN ATTORNEY FROM THE STATE WHERE THE PROPERTY IS LOCATED SHOULD BE CONSULTED.

The parties hereto have executed this Lease at the place and on the dates specified above their respective signatures.

Executed at Santa Barbara on February 4, 1998

By LESSOR:

By LESSEE:

CITO CORP

QAD, INC.

By: /s/ J. Beaver

By: /s/ Barry Anderson

Name Printed: J. Beaver

Name Printed: Barry Anderson

Title: President

Title: V.P. Administration, QAD

Address: 1033 Anacapa Street
Santa Barbara, CA

Address: 6450 Via Real
Carpinteria, CA 93013

Telephone: (805) 899-2400

Telephone: (805) 684-6614

Facsimile: (805) 899-2424

Facsimile: (805) 684-1890

BROKER: PBROKER: Pacifica Commercial Realty

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RENT ADJUSTMENT(S)
STANDARD LEASE ADDENDUM

Dated: December 29, 1997

By and Between (Lessor) CITO Corp.

(Lessee) QAD, Inc.

Address of Premises: 210 N. Salsipuedes, Ste. 101 and 520 E. Montecito Street,
Ste. 200

Paragraph 49

A. RENT ADJUSTMENTS:

The monthly rent for each month of the adjustment period(s) specified below shall be increased using the method(s) indicated below:

I. Cost of Living Adjustment(s) (COLA)

a. On March 1, 1999 and annually thereafter the Base Rent shall be adjusted by the change, if any, from the Base Month specified below, in the Consumer Price Index of the Bureau of Labor Statistics of the U.S. Department of Labor for CPI W (Urban Wage Earners and Clerical Workers): LA/Anaheim/Riverside, all items (182-1984 =100), herein referred to as "CPI".

b. The monthly rent payable in accordance with paragraph A.I.a. of this Addendum shall be calculated as follows: the Base Rent set forth in paragraph 1.5 of the attached Lease, shall be multiplied by a fraction the numerator of which shall be the CPI of the calendar month two months prior to the month(s) specified in paragraph A.I.a. above during which the adjustment is to take effect, and the denominator of which shall be the CPI of the calendar month which is two months prior to: the first month of the term of this Lease as set forth in paragraph 1.3 ("Base Month"). The sum so calculated shall constitute the new monthly rent hereunder, but in no event, shall any such new monthly rent be less than the rent payable for the month immediately preceding the rent adjustment.

c. In the event the compilation and/or publication of the CPI shall be transferred to any other governmental department of bureau or agency or shall be discontinued, then the index most nearly the same as the CPI shall be used to make such calculation. In the event that the Parties cannot agree on such alternative index, then the matter shall be submitted for decision to the

American Arbitration Association in accordance with the then rules of said Association and the decision of the arbitrators shall be binding upon the parties. The cost of said Arbitration shall be paid equally by the Parties.

II. (Paragraph intentionally omitted.)

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C. BROKER'S FEE:

The Brokers specified in paragraph 1.10 shall be paid a Brokerage Fee for each adjustment specified above in accordance with paragraph 15 of the Lease.

Page 2 of 2

OPTIONS TO EXTEND
STANDARD LEASE ADDENDUM

Dated: December 29, 1997

By and Between (Lessor) CITO Corp.

(Lessee) QAD, Inc.

Address of Premises: 210 N. Salsipuedes, Ste. 101 and 520 E. Montecito Street,
Ste. 200

Paragraph 50

A. OPTION(S) TO EXTEND:

Lessor hereby grants to Lessee the option to extend the term of this Lease for two (2) additional 36 month period(s) commencing when the prior term expires upon each and all of the following terms and conditions:

(i) In order to exercise an option to extend, Lease must give written notice of such election to Lessor and Lessor must receive the same at least 4 but not more than 12 months prior to the date that the option period would commence, time being of the essence. If proper notification of the exercise of an option is not given and/or received, such option shall automatically expire. Options (if there are more than one) may only be exercised consecutively.

(ii) The provisions of paragraph 39, including those relating to Lessee's Default set forth in paragraph 39.4 of this Lease, are conditions of this Option.

(iii) Except for the provisions of this lease granting an option or options to extend the term, of all of the terms and conditions of this Lease except where specifically modified by this option shall apply.

(iv) This Option is personal to the original Lessee, and cannot be assigned or exercised by anyone other than said original Lessee and only while the original Lessee is in full possession of the Premises and without the intention of thereafter assigning or subletting.

(v) The monthly rent for each month of the option period shall be calculated as follows, using the method(s) indicated below:

I. Cost of Living Adjustment(s) (COLA)

a. On March 1, 2005, 2006, 2008 & 2009 the Base Rent shall be adjusted by the change, if any, from the Base Month specified below, in the Consumer Price Index of the Bureau of Labor Statistics of the U.S. Department of Labor for CPI W (Urban Wage Earners and Clerical Workers): LA/Anaheim/Riverside, all items (182-1984 =100), herein referred to as "CPI".

b. The monthly rent payable in accordance with paragraph A.I.a. of this Addendum shall be calculated as follows: the Base Rent set forth in paragraph 1.5 of the attached Lease, shall be multiplied by a fraction the numerator of which shall be the CPI of the calendar month two months prior to the month(s) specified in paragraph A.I.a. above during which the adjustment is to take effect, and the denominator of which shall be the CPI of the calendar month

which is two months prior to: the first month of the term of this Lease as set forth in paragraph 1.3 ("Base Month"). The sum so calculated shall constitute the new monthly rent hereunder, but in no event, shall any such new monthly rent be less than the rent payable for the month immediately preceding the rent adjustment.

c. In the event the compilation and/or publication of the CPI shall be transferred to any other governmental department of bureau or agency or shall be discontinued, then the index most nearly the same as the CPI shall be used to make such calculation. In the event that the Parties cannot agree on such alternative index, then the matter shall be submitted for decision to the American Arbitration Association in accordance with the then rules of said Association and the decision of the arbitrators shall be binding upon the parties. The cost of said Arbitration shall be paid equally by the Parties.

II. Market Rental Value Adjustment(s) (MRV)

a. On March 1, 2004 & March 1, 2007 the Base Rent shall be adjusted to the "Market Rental Value" of the property as follows:

1) Four months prior to each Market Rental Value Adjustment Date described above, the Parties shall attempt to agree upon what the new MRV will be on the adjustment date. If agreement cannot be reached, within thirty days, then:

(a) Lessor and Lessee shall immediately appoint a mutually acceptable appraiser or broker to establish the new MRV within the next thirty days. Any associated costs will be split equally between the Parties; or

(b) Both Lessor and Lessee shall each immediately make a reasonable determination of the MRV and submit such determination, in writing, to arbitration in accordance with the following provisions:

(i) Within fifteen days thereafter, Lessor and Lessee shall each select an appraiser or broker ("Consultant") of their choice to act as an arbitrator. The two arbitrators so appointed shall immediately select a third mutually acceptable Consultant to act as a third arbitrator.

Page 1 of 2

(ii) The three arbitrators shall within thirty days of the appointment of the third arbitrator reach a decision as to what the actual MRV for the Premises is, and whether Lessor's or Lessee's submitted MRV is the closest thereto. The decision of a majority of the arbitrators shall be binding on the Parties. The submitted MRV which is determined to be the closest to the actual MRV shall thereafter be used by the Parties.

(iii) If either of the Parties fails to appoint an arbitrator within the specified fifteen days, the arbitrator timely appointed by one of them shall reach a decision on his or her own, and said decision shall be binding on the Parties.

(iv) The entire cost of such arbitration shall be paid by the party whose submitted MRV is not selected, ie. The one that is NOT the closest to the actual MRV.

2) Notwithstanding the foregoing, the new MRV shall not be less than the rent payable for the month immediately preceding the rent adjustment.

b. Upon the establishment of each New Market Rental Value:

1) the new MRV will become the new "Base Rent" for the purpose of calculating any further Adjustments, and

2) the first month of each Market Rental Value term shall become the new "Base Month" for the purpose of calculating any further Adjustments.

III. (Paragraph intentionally omitted.)

B. (Paragraph intentionally omitted.)

C. BROKER'S FEE:

The Brokers specified in paragraph 1.10 shall be paid a Brokerage Fee for each adjustment specified above in accordance with paragraph 15 of the Lease.

ADDENDUM TO STANDARD INDUSTRIAL COMMERCIAL
MULTI TENANT LEASE-MODIFIED NET

BETWEEN CITO CORP &
QAD, INC.

FOR THE PROPERTY KNOWN AS
201 N. SALSIPUEDES STREET, SET. 101 & 520 E. MONTECITO STREET, STE. 200
DATED DECEMBER 29, 1997

6.2(c) INDEMNIFICATION (cont.)

Lessor shall indemnify, protect, defend and hold Lessee, its agents and employees harmless from and against any and all damages, liabilities, judgments, costs, claims, liens, expenses, penalties, loss of permits and attorneys' and consultants' fees arising out of or involving any Hazardous Substances located in, on, under or about the Premises or the Building, prior to the Commencement Date. Lessor's obligations under this paragraph shall include, but not be limited to, the effects of any contamination or injury to person, property or the environment, and the cost of investigation (including consultants' and attorneys' fees and testing), removal, remediation, restoration and/or abatement thereof, or of any contamination therein involved, and shall survive the expiration or earlier termination of this Lease.

8.7 INDEMNITY (cont.)

Except for Lessee's negligence and/or breach of express covenants and warranties, Lessor shall indemnify, protect, defend and hold harmless Lessee, its agents, from and against any and all claims, loss of rents and/or damages, costs, liens, judgments, penalties, loss of permits, attorneys' and consultants' fees, expenses and/or liabilities arising out of, involving, or in connection with, any act, omission or neglect of Lessor, its agents, contractors, employees or invitees, and out of any Default or Breach by Lessor in the performance in a timely manner of any obligation on Lessor's part to be performed under this Lease. The foregoing shall include, but not be limited to, the defense or pursuit of any claim or any action or proceeding involved therein, and whether or not (in the case of claims made against Lessee) litigated and/or reduced to judgment. In case any action or proceeding be brought against Lessee by reason of any of the foregoing matters, Lessor upon notice from Lessee shall defend the same at Lessor's expense by counsel reasonably satisfactory to Lessee and Lessee shall cooperate with Lessor in such defense. Lessee needs not have first paid any such claim in order to be so indemnified.

12. ASSIGNMENT & SUBLETTING (cont.)

Lessee shall not mortgage, pledge, or assign this Lease or any interest therein, and shall not sublet all or any portion of the Premises, without the Lessor's consent which shall not be unreasonably withheld or delayed. Notwithstanding anything to the contrary contained in the Lease, Lessor and Lessee agree as follows: Lessee may assign this Lease or sublet the Premises, or any portion thereof, without Lessor's consent, to any entity which controls, is controlled by, or is under common control with Lessee; to any entity which results from a merger or consolidation with Lessee; to any entity engaged in a joint venture with Lessee; or to any entity which acquires substantially all of the stock or assets of Lessee, as a going concern, with respect to the business that is being conducted in the Premises (hereinafter each a "Permitted Transfer"). A Permitted Transfer shall also include a sublease or assignment of the Lease to an affiliate or wholly-owned subsidiary of Lessee, in which case Lessee shall remain liable for Lessee's obligations under the Lease. In addition, any sale or transfer of the capital stock of Lessee shall be deemed a Permitted Transfer so long as Lessee remains a publicly traded corporation. Without limiting the generality of the foregoing, Lessor shall have no right to terminate the Lease in connection with, and shall have no right to any sums or other economic consideration resulting from, any Permitted Transfer.

Lessee shall only place signs upon the Premises with Lessor's prior written consent. Lessor consents to exterior building signage on 520 E. Montecito Street (shared with Tri-Counties Regional Center) and a small first floor sign on 201 N. Salsipuedes Street.

51. LESSEE IMPROVEMENTS.

Lessee shall design and build leasehold improvements in substantial conformity to plans and specifications submitted to Lessor for approval. No work shall commence unless and until Lessor has approved said plans and specifications, which approval shall not be unreasonably delayed or withheld. Lessee will contract with architects, engineers, and contractors for performance of the work. Lessee will keep the Premises lien free. Lessor shall be entitled to post a Notice of Non-Responsibility on the Premises prior to commencement of the work.

Lessor shall provide Lessee with a tenant improvement allowance of \$200,000 which shall be used solely for permanent improvements to the Premises. Said tenant improvement allowance shall be disbursed by Lessor upon the written request of Lessee, accompanied by copies of itemized bills from contractors or material men, together with either partial or complete lien releases, as appropriate.

52. EXPANSION RIGHT.

Lessor grants Lessee a first right of refusal on other lease spaces within the Santa Barbara Business Center which do not currently carry similar rights by any other Lessee. Lessee shall have five (5) business days to notify Lessor of exercise of said rights following notice by Lessor of availability.

53. ADA COMPLIANCE.

In the event that it is determined that an elevator needs to be installed at 520 E. Montecito Street, the Lessor shall bear one-half (1/2) of the expense and shall amortize the other half as additional rent at a rate of interest of ten (10%) percent per annum, amortized over 120 months. Said amortization shall commence the point as such expenditure is incurred in any existing lease for the premises at 520 E. Montecito Street.

STANDARD LEASE

FLOOR PLAN

[FLOOR PLAN DIAGRAM APPEARS HERE]

The Board of Directors
QAD, Inc.:

The audits referred to in our report dated March 24, 1998, included the related financial statement schedule as of January 31, 1998, and for each of the years in the two year period ended January 31, 1998, the one month ended January 31, 1996, and the year ended December 31, 1995, included in the Annual Report on Form 10-K of QAD, Inc. for the fiscal year ended January 31, 1998. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audit. In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We consent to the incorporation by reference in the registration Statement on Form S-8 (No. 333-48381) of QAD, Inc. of our reports included herein.

KPMG PEAT MARWICK LLP

Los Angeles, California
April 24, 1998

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The schedule contains summary financial information extracted from the Condensed Consolidated Balance Sheet as of January 31, 1998 and the Condensed Consolidated Statement of Income for the Year Ended January 31, 1998 and is qualified in its entirety by reference to such financial statements.

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