DOT HILL SYSTEMS CORP
Form 10-Q
November 09, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2004

OR

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

For the transition period from to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6305 El Camino Real, Carlsbad, California	**92009**
(Address of principal executive offices)	(Zip Code)

(760) 931-5500
(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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 ý No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Act of 1934). Yes ý No o

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, $0.001 par value, 43,601,417 shares outstanding as of November 5, 2004.

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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Per Share Amounts)
(Unaudited)

	December 31, 2003	September 30, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 138,563	$ 58,015
Short-term investments	52,982	56,632
Accounts receivable, net of allowance of $467 and $569	14,558	37,809
Inventories	3,158	3,684
Prepaid expenses and other	1,836	2,713
Total current assets	211,097	158,853
Property and equipment, net	4,791	8,514
Goodwill	343	57,111
Other intangible assets, net		8,441
Other assets	2,212	1,039
Total assets	$ 218,443	$ 233,958
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 24,533	$ 31,649
Accrued compensation	4,459	2,758
Accrued expenses	2,052	3,727
Deferred revenue	1,028	856
Income taxes payable	1,005	927
Current portion of restructuring accrual	370	143
Total current liabilities	33,447	40,060
Restructuring accrual, net of current portion	554	107
Borrowings under lines of credit	247	193
Other long-term liabilities	62	883
Total liabilities	34,310	41,243
Commitments and Contingencies (Note 14)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding at December 31, 2003 and September 30, 2004, respectively		
Common stock, $0.001 par value, 100,000 shares authorized, 43,307 and 43,597 shares issued and outstanding at December 31, 2003 and September 30, 2004, respectively	43	44
Additional paid-in capital	275,827	276,919
Deferred compensation	(28)	(13)
Accumulated other comprehensive loss	(263)	(529)

Accumulated deficit	(91,446)	(83,706)
Total stockholders equity	184,133	192,715
Total liabilities and stockholders equity	$ 218,443	$ 233,958

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME
(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended September 30, 2003	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2004
Net Revenue	$ 50,979	$ 56,966	$ 129,928	$ 175,351
Cost of Goods Sold	38,766	41,439	102,166	129,204
Gross Profit	12,213	15,527	27,762	46,147
Operating Expenses:				
Sales and marketing	3,454	4,571	10,266	13,809
Research and development	2,795	4,983	7,692	14,088
General and administrative	1,851	2,709	4,921	7,327
Restructuring, net		7		(384)
In-process research and development				4,700
Total operating expenses	8,100	12,270	22,879	39,540
Operating income	4,113	3,257	4,883	6,607
Other Income (Expense):				
Interest income	133	421	256	1,427
Interest expense	(16)	(69)	(86)	(355)
Gain on foreign currency transactions, net	6	98	309	252
Other income, net	70	72	50	52
Total other income, net	193	522	529	1,376
Income Before Income Taxes	4,306	3,779	5,412	7,983
Income Tax Expense	37	151	48	243
Net Income	$ 4,269	$ 3,628	$ 5,364	$ 7,740
Net Income Attributable to Common Stockholders:				
Net income	$ 4,269	$ 3,628	$ 5,364	$ 7,740
Dividends on preferred stock			(141)	
Net income attributable to common stockholders	$ 4,269	$ 3,628	$ 5,223	$ 7,740
Net Income Per Share:				
Basic	$ 0.13	$ 0.08	$ 0.17	$ 0.18
Diluted	$ 0.11	$ 0.08	$ 0.15	$ 0.17
Weighted Average Shares Used to Calculate Net Income Per Share:				
Basic	33,723	43,511	30,692	43,403
Diluted	37,891	46,188	35,081	46,489
Comprehensive Income:				
Net income	$ 4,269	$ 3,628	$ 5,364	$ 7,740
Foreign currency translation adjustments	233	17	56	18
Net unrealized gain (loss) on short-term investments	(44)	94	(60)	(284)
Comprehensive income	$ 4,458	$ 3,739	$ 5,360	$ 7,474

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)
(Unaudited)

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2004
Cash Flows From Operating Activities:		
Net income	$ 5,364	$ 7,740
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,619	4,615
Write-off of in-process research and development		4,700
Non-cash settlement of restructuring charges		(384)
Loss on disposal of property and equipment	27	
Provision for doubtful accounts and note receivable	76	102
Stock-based compensation expense	15	15
Loss on sale of short-term investments	1	49
Changes in operating assets and liabilities (net of effects of Chaparral acquisition):		
Accounts receivable	(8,441)	(21,584)
Inventories	4,003	429
Prepaid expenses and other assets	(1,560)	442
Accounts payable	12,644	5,790
Accrued compensation and expenses	1,800	(1,058)
Deferred revenue	(85)	(450)
Income taxes payable	(47)	(78)
Restructuring accrual	(533)	(290)
Other liabilities	(24)	821
Net cash provided by operating activities	14,859	859
Cash Flows From Investing Activities:		
Purchases of property and equipment	(2,707)	(5,931)
Sales of short-term investments	2,505	52,628
Purchases of short-term investments	(15,191)	(56,611)
Cash paid in Chaparral acquisition, net of cash acquired		(65,383)
Net cash used in investing activities	(15,393)	(75,297)
Cash Flows From Financing Activities:		
Decrease in restricted cash and investments	2,000	
Proceeds from bank and other borrowings	36,483	13,662
Payments on bank and other borrowings	(41,051)	(20,882)
Proceeds from issuance of common stock and stock warrants, net of issuance costs	161,719	
Proceeds from exercise of stock options and warrants	3,278	1,092
Proceeds from sale of stock to employees	759	
Dividends paid to preferred stockholders	(157)	
Net cash provided by (used in) financing activities	163,031	(6,128)
Effect of Exchange Rate Changes on Cash	56	18
Net Increase (Decrease) in Cash and Cash Equivalents	162,553	(80,548)
Cash and Cash Equivalents, beginning of period	10,082	138,563
Cash and Cash Equivalents, end of period	$ 172,635	$ 58,015
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$ 78	$ 1,212
Cash paid for income taxes	$ 95	$ 307

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by Dot Hill Systems Corp. (Dot Hill , we , our or us) pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. Certain reclassifications have been made to the prior year financial statements to conform to the current year financial statement presentation. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2003. Operating results for the three and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates under different assumptions and conditions.

2. Recent Accounting Pronouncements

During the quarter ended September 30, 2004, the Emerging Issues Task Force (EITF) deliberated Issue 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. The Issue was intended to address the meaning of other-than-temporary impairment and its application to certain investments held at cost. A consensus was reached regarding disclosure requirements concerning unrealized losses on available-for-sale debt and equity securities accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities The guidance for evaluating whether an investment is other-than-temporarily impaired should be applied in reporting periods beginning after June 15, 2004. The disclosures are effective in annual financial statements for fiscal years ending after December 31, 2003, for investments accounted for under SFAS Nos. 115. For all other investments within the scope of this EITF, the disclosures are effective for fiscal years ending after June 15, 2004. The Financial Accounting Standards Board (FASB) elected to defer the effective date of paragraphs 10 through 20 of EITF Issue No. 03-1, effectively deferring application of Issue 03-1 s guidance on how to evaluate and recognize an impairment loss that is other than temporary. Application of those paragraphs is deferred pending issuance of a final FASB Staff Position (FSP) relating to the draft FSP EITF Issue 03-1-a, *Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1,* The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which the FASB may issue as early as November 2004.

3. Acquisition

In accordance with SFAS No. 141, *Business Combinations* (SFAS No. 141), Dot Hill allocates the purchase price of its acquisitions to the tangible assets, liabilities and intangible assets acquired, including in-process research and development (IPR&D), based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. The fair value assigned to intangible assets acquired is based on a number of factors including valuations prepared by independent third party appraisal firms using estimates and assumptions provided by management. Goodwill and purchased intangible assets with indefinite useful lives are not amortized but will be reviewed at least annually for impairment. Purchased intangible assets with finite lives are amortized on a straight-line basis over their respective useful lives.

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc. (Chaparral); a privately held developer of specialized storage appliances as well as high-performance, mid-range RAID controllers and data routers, pursuant to the Agreement and Plan of Merger between Dot Hill and Chaparral dated February 23 2004. The aggregate purchase price was $62 million in cash, and obligations of approximately $4.1 million due to certain employees covered by change in control agreements, direct transaction costs of approximately $.8 million and approximately $.7 million in accrued integration costs. The acquisition of Chaparral is expected to enable Dot Hill to increase the amount of proprietary technology within its storage systems, broaden its product line and diversify its customer base.

The results of operations of Chaparral have been included in our results prospectively from February 23, 2004.

Based on our estimates and assumptions, the total purchase price of approximately $67.6 million has been allocated as follows (in thousands):

Assets:		
Cash and cash equivalents	$	2,202
Accounts receivable		1,769
Inventories		955
Prepaid expenses and other		147
Property and equipment		648
Goodwill		56,768
Intangible assets:		
Developed technology		2,600
Core technology		5,000
Customer relationships		2,500
Backlog		100
In-process research and development		4,700
Total assets		77,389
Liabilities:		
Current liabilities		2,859
Convertible debt and accrued interest		6,945
Total liabilities		9,804
Net assets acquired	$	67,585

No changes were made to the original purchase price allocation during the three months ended September 30, 2004.

Of the acquired intangible assets, $4.7 million pertained to in-process research and development (IPR&D) and was written off by our recognition of a charge to operations on the acquisition date. The remaining acquired identifiable intangible assets are being amortized using the straight-line method over their estimated useful lives as follows: developed and core technology, 2.5 to 4.5 years; customer relationships, 3.5 years, and backlog, 8 months. The goodwill recorded in this transaction has been allocated to our SANnet family-operating segment. None of this goodwill will be deductible for tax purposes.

IPR&D recorded in connection with the acquisition of Chaparral represents the present value of the estimated after-tax cash flows expected to be generated by purchased technologies that, as of the acquisition dates, had not yet reached technological feasibility. The classification of the technology as complete or under development was made in accordance with the guidelines of SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, and Financial Accounting Standards Board Interpretation No. 4, *Applicability of SFAS No. 2 to Business Combinations Accounted for by the Purchase Method*. In addition, the Fair Value, as defined below, of the IPR&D projects was determined in accordance with SFAS No. 141, and SFAS No. 142, *Goodwill and Other Intangible Assets*.

Chaparral s IPR&D projects were valued through the application of discounted cash flow analyses, taking into account many key characteristics of Chaparral as well as its future prospects, the rate technology changes in the industry, product life cycles, risks specific to each project, and various projects stage of completion. Stage of completion was estimated by considering the time, cost, and complexity of tasks completed prior to the acquisition verses the project s overall expected cost, effort and risks required for achieving technological feasibility. In the application of the discounted cash flow analyses, Chaparral s management provided distinct revenue forecasts for each IPR&D project. The projections were based on the expected date of market introduction, an assessment of customer needs, the expected pricing and cost structure of the related products, product life cycles, and the importance of the existing technology relative to the in-process technology. In addition, the costs expected to complete each project were added to the operating expenses to calculate the operating income for each IPR&D project. As certain other assets contribute to the cash flow attributable to the assets being valued, returns to these other assets were calculated and deducted from the pre-tax operating income to isolate the economic benefit solely attributable to each of the in-process technologies. The present value of IPR&D was calculated based on discount rates recommended by the American Institute of Certified Public Accountants IPR&D Practice Aid, which depend on the stage of completion and the additional risk associated with the completion of each of the IPR&D projects. We also considered venture capital rates of return and the weighted average cost of capital for Chaparral, which was based on a capital asset pricing model as an appropriate measure of the discount rates associated with each IPR&D project. As a result, the earnings associated with the incomplete technology were discounted at a rate of approximately 22%.

Certain of our employees are former Chaparral employees who were party to agreements with Chaparral providing for payment in the event of a change in control of Chaparral, 50% of which was payable immediately and 50% of which is payable after 18 months of service following the acquisition date. As a result of our acquisition of Chaparral, these employees were paid approximately $3.1 million in March 2004, and we assumed the obligation to make remaining aggregate cash payments of approximately $1.2 million to these employees through 2005. As of September 30, 2004, approximately $0.3 million has been paid related to these agreements and approximately $0.7 million is included in other long-term liabilities at September 30, 2004. Approximately $0.2 million will be recorded as compensation expense over the 18-month service period. During the three and nine months ended September 30, 2004, we recorded compensation expense of approximately $41,000 and $95,000, respectively, relating to these agreements.

Pro Forma Results of Operations

The following pro forma results of operations present the impact on our results of operations for the three and nine months ended September 30, 2004 and 2003 as if the acquisition of Chaparral had been completed as of the beginning of the period presented on. The charge of $4.7 million related to the write-off of IPR&D has been excluded from the pro forma results of operations, as it is nonrecurring in nature:

	Three Months Ended September 30,			
	2003 Historical	2003 Pro Forma	2004 Historical	2004 Pro Forma
Revenues	$ 50,979	$ 54,295	$ 56,966	$ 56,966
Net income	$ 4,269	$ 1,990	$ 3,628	$ 3,628
Basic income per share	$ 0.13	$ 0.06	$ 0.08	$ 0.08
Diluted income per share	$ 0.11	$ 0.05	$ 0.08	$ 0.08

	Nine Months Ended September 30,			
	2003 Historical	2003 Pro Forma	2004 Historical	2004 Pro Forma
Revenues	$ 129,928	$ 138,067	$ 175,351	$ 177,107
Net income (loss)	$ 5,223	$ (3,162)	$ 7,740	$ 10,466
Basic income (loss) per share	$ 0.17	$ (0.11)	$ 0.18	$ 0.24
Diluted income (loss) per share	$ 0.15	$ (0.11)	$ 0.17	$ 0.23

4. Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation,* encourages, but does not require, us to record compensation cost for stock-based employee compensation plans at fair value. We have chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations for all periods presented. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair value of our stock at the date of grant over the amount an employee must pay to acquire the stock.

Had compensation cost for our stock option awards been determined based upon the fair value at the date of grant in accordance with SFAS No. 123, our net income and basic and diluted net income per share would have been adjusted to the following amounts for the three and nine months ended September 30, 2003 and 2004 (in thousands, except per share information):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
	$ 4,269	$ 3,628	$ 5,223	$ 7,740

Net income or net income attributable to common stockholders as reported								
Stock-based employee compensation expense included in reported net income attributable to common stockholders		5		5		15		15
Stock-based employee compensation expense determined under fair value based method		(4,042)		(1,049)		(5,346)		(2,930)
Pro forma net income (loss) attributable to common stockholders	$	232	$	2,584	$	(108)	$	4,825
Basic net income per share:								
As reported	$	0.13	$	0.08	$	0.17	$	0.18
Pro forma	$	0.01	$	0.06	$		$	0.11
Diluted net income per share:								
As reported	$	0.11	$	0.08	$	0.15	$	0.17
Pro forma	$	0.01	$	0.06	$		$	0.10

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions. During the three months ended September 30, 2004, we revised our estimate of the expected life of our stock option awards to 4 years. This change in estimate was made to reflect the change in our historical experience related to the exercise of our stock option awards:

	Nine Months Ended September 30,	
	2003	**2004**
Risk free interest rate	3.37%	3.22%
Expected dividend yield		
Expected life	7.5 years	7.0 years
Expected volatility	82%	67%

5. Net Income Per Share

Basic net income per share is calculated by dividing net income or net income attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution of securities by including common stock equivalents, such as stock options, stock warrants and convertible preferred stock, in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calculation of net income per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2004**	**2003**	**2004**
Shares used in computing basic net income per share	33,723	43,511	30,692	43,403
Dilutive effect of stock options and stock warrants	4,168	2,677	3,571	3,086
Dilutive effect of convertible preferred stock			818	
Shares used in computing diluted net income per share	37,891	46,188	35,081	46,489

For the three months ended September 30, 2003 and 2004, outstanding options to purchase 24,400 and 1,816,681 shares of our common stock, respectively were not included in the calculation of diluted net income per share because their effect was anti-dilutive.

For the nine months ended September 30, 2003 and 2004, outstanding options to purchase 175,925 and 1,785,127 shares of our common stock, respectively, were not included in the calculation of diluted net income per share because their effect was anti-dilutive.

6. Short-Term Investments

The following table summarizes our short-term investments as of September 30, 2004 (in thousands):

	Cost	Net Unrealized Losses	Net Unrealized Gains	Fair Value
U.S. Government securities	$ 48,486	$ (264)	25	$ 48,247
Commercial paper and other	8,405	(20)		8,385
	$ 56,891	$ (284)	$ 25	$ 56,632

The cost and fair value of short-term investments at September 30, 2004 by contractual maturity are shown below (in thousands). Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

	Cost	Fair Value
Due in one year or less	$ 42,644	$ 42,423
Due after one year through five years	14,247	14,209
	$ 56,891	$ 56,632

7. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market value. The following is a summary of inventories (in thousands):

	December 31, 2003		September 30, 2004	
Purchased parts and materials	$	1,706	$	1,343
Work-in-process		24		77
Finished goods		1,428		2,264
	$	3,158	$	3,684

8. Credit Facilities

During the quarter ended September 30, 2004, we entered into a credit agreement (the Agreement) with Wells Fargo Bank, National Association (the Bank), which allows us to borrow up to $30.0 million under a revolving line of credit that expires July 1, 2006. The agreement which was made effective as of July 1, 2004, bears interest at our option at a fluctuating rate per annum equal to the Prime Rate in effect from time to time, or at a fixed rate per annum determined by the Bank to be 0.65% above LIBOR in effect on the first day of the applicable fixed rate term. In connection with the Agreement, we have granted the bank a security interest in our investment management account maintained with Wells Capital Management Incorporated. As of September 30, 2004, this account had a value of approximately $31.1 million. The security interest is limited to outstanding borrowings, which were zero at September 30, 2004. The agreement limits any new borrowings, loans or advances to an amount less than $1.0 million.

During August 2004, we made a payment of approximately $7.2 million representing both principle and interest to the holder of the $6 million promissory note (the Note) assumed in connection with our acquisition of Chaparral in February 2004. There are no further amounts due related to the Note.

Our Japanese subsidiary has two lines of credit with Tokyo Mitsubishi Bank and one line of credit with National Life Finance Corporation in Japan, for borrowings of up to an aggregate of 45 million yen, or approximately $0.4 million as of September 30, 2004, at interest rates ranging from 1.7% to 1.8%. Interest is due monthly, with principal due and payable on various dates through August 2008. Borrowings are secured by the inventories of our Japanese subsidiary. As of September 30, 2004, the total amount outstanding under the three credit lines was approximately $0.2 million. During November 2004, all of the lines of credit relating to our Japanese subsidiary described above were repaid and closed.

9. Goodwill and Intangible Assets

Under the provisions of SFAS No. 142, goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually or more frequently if impairment indicators arise. All of our other intangible assets are considered to have finite lives and are being amortized in accordance with this statement. All of our goodwill has been allocated to our SANnet family-operating segment.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of September 30, 2004 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (648)	$ 4,352
Developed technology	2,600	(607)	1,993
Customer relationships	2,500	(416)	2,084
Backlog	100	(88)	12
Total other intangible assets	$ 10,200	$ (1,759)	$ 8,441

Estimated future amortization expense related to intangible assets at September 30, 2004 is as follows (in thousands):

Years ending December 31,	
2004 (remaining 3 months)	$ 729
2005	2,866
2006	2,518
2007	1,588
2008	740
Total	$ 8,441

10. Product Warranties

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are covered by supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future, which could have a material adverse effect on our operating results and financial condition. The changes in Dot Hill s aggregate product warranty liabilities are as follows for the three and nine months ended September 30, 2004 (in thousands):

	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2004
Balance, beginning of period	$ 919	$ 262
Current period accrual	36	1,109
Amounts charged to accrual	(217)	(633)
Balance, end of period	$ 738	$ 738

11. Restructurings

In March 2001, we announced plans to reduce our full-time workforce by up to 30% and reduce other expenses in response to delays in customer orders, lower than expected revenues and slowing global market conditions. The cost reduction actions were designed to reduce our breakeven point in light of an economic downturn. The cost reductions resulted in a charge for employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities. We recorded restructuring expenses in the first quarter of 2001 of approximately $2.9 million, as follows (in thousands):

Employee termination costs	$ 1,271
Impairment of property and equipment	1,007
Facility closures and related costs	637
Professional fees and other	20
Total	$ 2,935

In June 2001, we announced plans to further reduce our full-time workforce by up to 17% and reduce other expenses in response to a continuing economic downturn and overall decrease in revenue. As a result of these additional restructuring actions, we recorded additional restructuring expenses during the second quarter of 2001 of approximately $1.5 million, as follows (in thousands):

Employee termination costs	$ 259
Impairment of property and equipment	350
Facility closures and related costs	861
Total	$ 1,470

Employee termination costs consist primarily of severance payments for 180 employees. Impairment of property and equipment consists of the write-down of certain fixed assets associated with facility closures. The facility closures and related costs consist of lease termination costs for five sales offices and closure of the New York City office.

During the fourth quarter of 2001, we increased our March 2001 related restructuring accrual by approximately $0.2 million and our June 2001 Restructuring accrual by approximately $0.3 million due to the continuing deterioration of various real estate markets and the inability to sublet excess space in our Carlsbad and New York City facilities.

During the fourth quarter of 2002, we again increased our March 2001 related restructuring accrual by approximately $0.7 million and our June 2001 related restructuring accrual by approximately $0.9 million to reflect additional deterioration of real estate markets in Carlsbad and New York City, as well as the effects of lease buyouts negotiated on several facilities and a sublease arrangement reached on another facility.

As of September 30, 2004, the Company only has accruals for facility closures and related costs remaining. The following is a summary of restructuring activity recorded during the period from January 1, 2004 to September 30, 2004 (in thousands):

March 2001 Restructuring

		Accrued Restructuring Expenses at December 31, 2003		Additional Restructuring Expenses (Settlement)		Current Amounts Utilized		Accrued Restructuring Expenses at September 30, 2004
Facility closures and related costs		401		(70)		(131)		200
Total	$	401	$	(70)	$	(131)	$	200

June 2001 Restructuring

Facility closures and related costs		523		(314)		(159)		50
	$	523	$	(314)	$	(159)	$	50

In June 2004, we negotiated an exit from our lease of the 10th floor of our former New York City office thereby eliminating our related rent exposure. Accordingly, during the nine months ended September 30, 2004, we recorded a reduction of approximately $0.5 million to our restructuring reserve previously established in connection with the closure of our New York City office. Additionally, we have evaluated certain factors pertaining to our remaining sublease tenant; accordingly, during the nine months ended September 30, 2004, we recorded an additional restructuring accrual of approximately $0.1 million. We are not aware of any further unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of September 30, 2004.

12. Stockholders Equity

In May 2004, our shareholders ratified an amendment to the Company s 2000 Amended and Restated Employee Stock Purchase Plan, as amended, to increase the aggregate number of shares of common stock authorized for issuance under the plan by 2,000,000 shares.

During the nine months ended September 30, 2004, we received proceeds of approximately $0.2 million from the exercise of warrants to purchase 67,692 shares of our common stock. As of September 30, 2004, there were outstanding warrants to purchase 1,996,849 shares of our common stock. The warrants have exercise prices ranging from $2.97 to $4.50 per share and expire at various dates through March 14, 2008.

13. Income Taxes

For the three and nine months ended September 30, 2004, our effective income tax rate was 3%. The effective income tax rate is based upon the expected income for the year and the expected composition of that income in different tax jurisdictions. For the three and nine months ended September 30, 2004, the effective tax rate varied from the statutory tax rate primarily because of the expected use of our net operating loss carryforwards, for which a valuation allowance has previously been recorded.

We have federal and state net operating loss carryforwards as of December 31, 2003 of approximately $80.7 million and $53.8 million, respectively. These net operating loss carryforwards are available to offset taxable income generated in 2004 and future years, and such federal and state amounts will begin to expire in the tax years ending 2009 and 2004, respectively. In addition, we have federal tax credit carryforwards as of December 31, 2003 of approximately $2.4 million of which $0.2 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.2 million will begin to expire in 2008. We also have state tax credit carryforwards as of December 31, 2003 of approximately $2.3 million, of which $2.1 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006. Pursuant to current tax regulations, the annual use of certain of our federal and state net operating loss and tax credit carryforwards is limited as a result of a cumulative change in ownership of more than 50%. Future additional changes in ownership may further limit the use of such amounts.

As a result of our equity transactions, an ownership change, within the meaning of Internal Revenue Code, or IRC, Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of IRC Section 382 (f)) in effect at that time. The annual limitation is cumulative and, therefore, if not fully utilized in a year, can be utilized in future years in addition to the Section 382 limitation for those years.

14. Commitments and Contingencies

Operating Leases

In connection with the acquisition of Chaparral, we assumed the operating lease for Chaparral s Longmont, Colorado facility, which expires in July 2007. Lease payments are approximately $29,000 per month through June 2004. Pursuant to a contractual agreement between Chaparral and the landlord, both parties agreed to negotiate in good faith a new lease rate reflecting the current market and economic conditions in the surrounding Boulder, Colorado area. Effective July 1, 2004, our rent payment related to our Longmont facility increased to approximately $50,000 per month. We remain in negotiations with our landlord on an amendment to our existing lease the final outcome of which has not yet been determined.

Purchase Commitments

We enter into firm purchase commitments with suppliers and third party manufacturers for our estimated inventory requirements for succeeding months. The Company had purchase commitments for approximately $0.5 million of inventory as of September 30, 2004.

Legal Matters

Crossroad Systems - On October 17, 2003, Crossroads Systems, or Crossroads, filed a lawsuit against us in the United States District Court in Austin, Texas alleging that our products infringe two United States patents assigned to Crossroads, Patent Numbers 5,941,972 and 6,425,035. We were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of SCSI storage devices and the Fiber Channel protocol and Patent Number 6,425,035 involves the interface of any one-transport medium and a second transport medium. We believe that we have meritorious defenses to Crossroads claims and are in the process of vigorously defending against them. However, we expect to incur significant legal expenses in connection with this litigation. These defense costs, and other expenses related to this litigation, will be expensed as incurred and will negatively affect our operating results.

Chaparral Shareholder Lawsuit - In August 2004, a class action lawsuit was filed against among others, Chaparral, and a number of former officers and directors of Chaparral in the United States District Court for the Central District of California. The lawsuit, among other things, alleges violations of federal securities laws and purports to seek damages on behalf of a class of shareholders who purchased Chaparral securities during a defined period prior to our acquisition of Chaparral. We believe that the claims against Chaparral and its former officers and directors are without merit and are in the process of vigorously defending against them.

In addition to the actions discussed above, we are subject to various legal proceedings and claims, asserted or unasserted, which arise from time to time in the ordinary course of business. The outcome of claims against us cannot be predicted with certainty. We believe that such litigation and claims will not have a material adverse effect on our financial condition or operating results.

15. Segments and Geographic Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by our chief operating decision-maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is the Chief Executive Officer. Our operating segments are managed separately because each segment represents a strategic business unit that offers different products or services.

Our operating segments are organized on the basis of products and services. We have identified operating segments that consist of our SANnet family of systems, legacy and other systems, and services. We currently evaluate performance based on stand-alone segment revenue and gross margin. Because we do not currently maintain information regarding operating income at the operating segment level, such information is not presented.

Sales to our largest channel partner accounted for approximately 86% our net revenue for both the three months ended September 30, 2003 and 2004 and 83% and 86% for the nine months ended September 30, 2003 and 2004, respectively.

Information concerning revenue by product and service is as follows (in thousands):

	SANnet Family		Legacy and Other		Services		Total	
Three months ended:								
September 30, 2003:								
Net revenue	$	49,179	$	968	$	832	$	50,979
Gross profit (loss)	$	12,482	$	(524)	$	255	$	12,213
September 30, 2004:								
Net revenue	$	52,194	$	4,129	$	643	$	56,966
Gross profit (loss)	$	15,512	$	(337)	$	352	$	15,527
Nine months ended:								
September 30, 2003:								
Net revenue	$	123,283	$	4,083	$	2,562	$	129,928
Gross profit (loss)	$	30,457	$	(3,662)	$	967	$	27,762
September 30, 2004:								
Net revenue	$	164,226	$	9,078	$	2,047	$	175,351
Gross profit (loss)	$	47,841	$	(2,077)	$	383	$	46,147

Information concerning operating assets by product and service, derived by specific identification for assets related to specific segments and an allocation based on segment volume for assets related to multiple segments, is as follows (in thousands):

	SANnet Family	Legacy and Other	Services	Total
As of:				