

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

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

(Mark One)

☒

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

**For the Quarterly Period Ended June 30, 2004**

**OR**

☐

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

**For the transition period from            to**

**Commission file number 1-13317**

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**DOT HILL SYSTEMS CORP.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**13-3460176**

(I.R.S. Employer Identification No.)

**6305 El Camino Real, Carlsbad, California**

(Address of principal executive offices)

**92009**

(Zip Code)

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(760) 931-5500

(Registrant's telephone number, including area code)

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

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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 ☒ 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 ☐ No ☒

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, 43,479,416 shares outstanding as of August 2, 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		June 30, 2004	
<b>ASSETS</b>				
<b>Current Assets:</b>				
Cash and cash equivalents	\$	138,563	\$	46,693
Short-term investments		52,982		78,614
Accounts receivable, net of allowance of \$467 and \$611		14,558		38,369
Inventories		3,158		4,521
Prepaid expenses and other		1,836		2,372
Total current assets		211,097		170,569
Property and equipment, net		4,791		8,306
Goodwill		343		57,111
Other intangible assets, net				9,195
Other assets		2,212		1,306
Total assets	\$	218,443	\$	246,487
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
<b>Current Liabilities:</b>				
Accounts payable	\$	24,533	\$	40,029
Accrued compensation		4,459		3,063
Accrued expenses		2,052		4,345
Deferred revenue		1,028		1,010
Income taxes payable		1,005		1,019
Current portion of restructuring accrual		370		168
Total current liabilities		33,447		49,634
Restructuring accrual, net of current portion		554		156
Note payable				6,000

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Accrued interest			1,113
Borrowings under lines of credit	247		210
Other long-term liabilities	62		835
Total liabilities	34,310		57,948
<b>Commitments and Contingencies (Note 14)</b>			
<b>Stockholders' Equity:</b>			
Preferred stock, \$0.001 par value, 10,000 shares authorized, no shares issued or outstanding at December 31, 2003 and June 30, 2004, respectively			
Common stock, \$0.001 par value, 100,000 shares authorized, 43,307 and 43,468 shares issued and outstanding at December 31, 2003 and June 30, 2004, respectively	43		43
Additional paid-in capital	275,827		276,488
Deferred compensation	(28)		(18)
Accumulated other comprehensive loss	(263)		(640)
Accumulated deficit	(91,446)		(87,334)
Total stockholders' equity	184,133		188,539
Total liabilities and stockholders' equity	\$ 218,443	\$	246,487

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 June 30,				Six Months Ended June 30,			
	2003		2004		2003		2004	
Net Revenue	\$	48,428	\$	69,604	\$	78,950	\$	118,385
Cost of Goods Sold		38,415		52,487		63,400		87,765
Gross Profit		10,013		17,117		15,550		30,620
<b>Operating Expenses:</b>								
Sales and marketing		3,391		4,623		6,812		9,238
Research and development		2,841		4,734		4,897		9,105
General and administrative		1,610		2,304		3,071		4,618
Restructuring, net				(391)				(391)
In-process research and development								4,700
Total operating expenses		7,842		11,270		14,780		27,270
Operating income		2,171		5,847		770		3,350
<b>Other Income (Expense):</b>								
Interest income		97		432		123		1,007
Interest expense		(23)		(145)		(70)		(285)
Gain (loss) on foreign currency transactions, net		320		(13)		302		154
Other income (expense), net		6				(18)		(23)
Total other income, net		400		274		337		853
Income Before Income Taxes		2,571		6,121		1,107		4,203
Income Tax Expense		11		126		11		91
Net Income	\$	2,560	\$	5,995	\$	1,096	\$	4,112
<b>Net Income Attributable to Common Stockholders:</b>								
Net income	\$	2,560	\$	5,995	\$	1,096	\$	4,112
Dividends on preferred stock		(36)				(141)		
Net income attributable to common stockholders	\$	2,524	\$	5,995	\$	955	\$	4,112

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<b>Net Income Per Share:</b>									
Basic	\$	0.08	\$	0.14	\$	0.03	\$	0.09	
Diluted	\$	0.07	\$	0.13	\$	0.03	\$	0.09	
<b>Weighted Average Shares Used to Calculate Net Income Per Share:</b>									
Basic		31,576		43,383		28,877		43,349	
Diluted		35,669		46,279		32,954		46,609	
<b>Comprehensive Income:</b>									
Net income	\$	2,560	\$	5,995	\$	1,096	\$	4,112	
Foreign currency translation adjustments		(92)		8		(177)		1	
Net unrealized loss on short-term investments		(16)		(375)		(16)		(378)	
Comprehensive income	\$	2,452	\$	5,628	\$	903	\$	3,735	

See accompanying notes to condensed consolidated financial statements.

## DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

	Six Months Ended June 30,			
	2003		2004	
<b>Cash Flows From Operating Activities:</b>				
Net income	\$	1,096	\$	4,112
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>				
Depreciation and amortization		1,042		2,366
Write-off of in-process research and development				4,700
Non-cash settlement of restructuring charges				(391)
Loss on disposal of property and equipment		27		
Provision for doubtful accounts and note receivable		74		145
Stock-based compensation expense		10		10
(Gain) loss on sale of short-term investments		1		(20)
<b>Changes in operating assets and liabilities (net of effects of Chaparral acquisition):</b>				
Accounts receivable		(8,573)		(22,187)
Inventories		3,464		(408)
Prepaid expenses and other assets		(1,946)		517
Accounts payable		10,141		14,170
Accrued compensation and expenses		1,790		(190)
Deferred revenue		252		(296)
Income taxes payable		(78)		14
Restructuring accrual		(283)		(209)
Other liabilities		(16)		773
Net cash provided by operating activities		7,001		3,106
<b>Cash Flows From Investing Activities:</b>				
Purchases of property and equipment		(1,359)		(4,228)
Sales of short-term investments		1,530		21,999
Purchases of short-term investments		(11,592)		(47,989)
Cash paid in Chaparral acquisition, net of cash acquired				(65,383)
Net cash used in investing activities		(11,421)		(95,601)
<b>Cash Flows From Financing Activities:</b>				
Decrease in restricted cash and investments		2,000		
Proceeds from bank and other borrowings		22,848		13,660



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Payments on bank and other borrowings		(27,409)		(13,697)
Proceeds from issuance of common stock and stock warrants, net of issuance costs		16,543		
Proceeds from exercise of stock options and warrants		958		661
Proceeds from sale of stock to employees		348		
Dividends paid to preferred stockholders		(141)		
Net cash provided by financing activities		15,147		624
<b>Effect of Exchange Rate Changes on Cash</b>		(177)		1
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>		10,550		(91,870)
<b>Cash and Cash Equivalents, beginning of period</b>		10,082		138,563
<b>Cash and Cash Equivalents, end of period</b>	\$	20,632	\$	46,693
<b>Supplemental Disclosures of Cash Flow Information:</b>				
Cash paid for interest	\$	61	\$	46
Cash paid for income taxes	\$	95	\$	65

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 six months ended June 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**

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 and SFAS No. 124 Accounting for Certain Investments Held for Not-for-Profit Organizations. 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 and 124. For all other investments within the scope of this EITF, the disclosures are effective for fiscal years ending after June 15, 2004. Additional disclosures for cost method investments are effective for fiscal years ending after June 15, 2004. We are currently evaluating the effect of this pronouncement on our financial statements.

**3. Acquisition**

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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 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, the assumption of approximately \$4.1 million related to obligations due 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):

<b>Assets:</b>		
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
<b>Liabilities:</b>		
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 June 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 intangible 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

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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 product(s), 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 was 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 June 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 June 30, 2004. Approximately \$0.2 million will be recorded as compensation expense over the 18 month service period. During the three and six months ended June 30, 2004, we recorded compensation expense of approximately \$41,000 and \$54,000, 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 six months ended June 30, 2004 and 2003 as if the acquisition of Chaparral had been completed as of the beginning of the period reported 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 June 30,					
			2004				2003	
	2004		Pro		2003		Pro	
	Historical		Forma		Historical		Forma	
Revenues	\$	69,604	\$	69,604	\$	48,428	\$	51,301
Net income attributable to common stockholders	\$	5,995	\$	5,995	\$	2,524	\$	147
Basic income per share	\$	0.14	\$	0.14	\$	0.08	\$	
Diluted income per share	\$	0.13	\$	0.13	\$	0.07	\$	
			Six Months Ended June 30,					
			2004				2003	
	2004		Pro		2003		Pro	
	Historical		Forma		Historical		Forma	
Revenues	\$	118,385	\$	120,141	\$	78,950	\$	83,773

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Net income (loss) attributable to common stockholders	\$	4,112	\$	6,838	\$	955	\$	(5,319)
Basic income (loss) per share	\$	0.09	\$	0.16	\$	0.03	\$	(0.18)
Diluted income (loss) per share	\$	0.09	\$	0.15	\$	0.03	\$	(0.18)

#### 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 six months ended June 30, 2003 and 2004 (in thousands, except per share information):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2003		2004		2003		2004	
Net income attributable to common stockholders as reported	\$	2,524	\$	5,995	\$	955	\$	4,112
Stock-based employee compensation expense included in reported net income attributable to common stockholders		5		5		10		10
Stock-based employee compensation expense determined under fair value based method		(530)		(924)		(1,304)		(1,874)
Pro forma net income (loss) attributable to common stockholders	\$	1,999	\$	5,076	\$	(339)	\$	2,248
Basic net income (loss) per share:								
As reported	\$	0.08	\$	0.14	\$	0.03	\$	0.09
Pro forma	\$	0.06	\$	0.12	\$	(0.01)	\$	0.05
Diluted net income (loss) per share:								
As reported	\$	0.07	\$	0.13	\$	0.03	\$	0.09
Pro forma	\$	0.06	\$	0.11	\$	(0.01)	\$	0.05

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:

	Six Months Ended June 30,	
	2003	2004
Risk free interest rate	2.69%	3.17%
Expected dividend yield		
Expected life	7.5 years	7.5 years



Expected volatility		84%	69%
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**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.

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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 June 30,			Six Months Ended June 30,		
	2003		2004	2003		2004
Shares used in computing basic net income per share	31,576		43,383	28,877		43,349
Dilutive effect of stock options and stock warrants	3,464		2,896	2,843		3,260
Dilutive effect of convertible preferred stock	629			1,234		
Shares used in computing diluted net income per share	35,669		46,279	32,954		46,609

For the three months ended June 30, 2003 and 2004, outstanding options to purchase 290,437 and 1,761,841 shares of our common stock, respectively were not included in the calculation of diluted net income per share because their effect was antidilutive.

For the six months ended June 30, 2003 and 2004, outstanding options to purchase 480,691 and 1,697,562 shares of our common stock, respectively, were not included in the calculation of diluted net income per share because their effect was antidilutive.

## 6. Short-Term Investments

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

	Cost		Net Unrealized Losses		Net Unrealized Gains		Fair Value	
U.S. Government securities	\$	39,112	\$	(364)		1	\$	38,749
Municipal securities and private debt		7,400						7,400
Commercial paper		32,455		(41)		51		32,465
	\$	78,967	\$	(405)	\$	52	\$	78,614

The cost and fair value of short-term investments at June 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	\$	53,860	\$	53,599

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Due after one year through five years		17,708		17,615
Due after five years through ten years				
Due after ten years		7,399		7,400
	\$	78,967	\$	78,614

7. **Inventories**

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

	December 31, 2003		June 30, 2004	
Purchased parts and materials	\$	1,706	\$	1,761
Work-in-process		24		98
Finished goods		1,428		2,662
	\$	3,158	\$	4,521

**8. Credit Facilities**

We had an agreement with Wells Fargo Bank, National Association, which allowed us to borrow up to \$15.0 million under a revolving line of credit that expired May 1, 2004. As of June 30, 2004, there was no balance outstanding under this line of credit. We are presently in negotiations to replace this line of credit.

In connection with the acquisition of Chaparral, we assumed a \$6 million promissory note, or the Note, payable to a third party manufacturer utilized by Chaparral. The Note incurs interest at an annual rate of 8% with principal and accrued interest payable on May 15, 2005 and 2008, and is secured by rights to certain technology developed by Chaparral. Total purchases by us from the third party manufacturer were \$0.3 and \$0.5 million for the three and six months ended June 30, 2004, respectively. During July 2004, we communicated to the holder of the Note our intent to repay the Note in full during the third quarter of fiscal year 2004.

The Note has the following scheduled principal payments due for the years ending December 31 (in thousands):

2004	\$	
2005		3,000
2006		
2007		
2008		3,000
	\$	6,000

**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 remaining 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 June 30, 2004 (in thousands):

	Gross		Accumulated Amortization		Net	
Core technology	\$	5,000	\$	(370)	\$	4,630
Developed technology		2,600		(347)		2,253
Customer relationships		2,500		(238)		2,262
Backlog		100		(50)		50

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Total other intangible assets	\$	10,200	\$	(1,005)	\$	9,195	

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

**Years ending December 31,**

2004 (remaining 6 months)	\$	1,483
2005		2,866
2006		2,518
2007		1,588
2008		740
Total	\$	9,195

**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 six months ended June 30, 2004 (in thousands):

	Three Months Ended June 30, 2004		Six Months Ended June 30, 2004	
Balance, beginning of period	\$	847	\$	262
Current period accrual		72		852
Amounts charged to accrual				(195)
Balance, end of period	\$	919	\$	919

**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

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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.

The following is a summary of restructuring activity recorded during the period from January 1, 2004 to June 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 June 30, 2004	
Employee termination costs	\$		\$		\$		\$	
Impairment of property and equipment								
Facility closures and related costs		401		(71)		(86)		244
Professional fees and other								
Total	\$	401	\$	(71)	\$	(86)	\$	244

### June 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2003		Additional Restructuring Expenses (Settlement)		Current Amounts Utilized		Accrued Restructuring Expenses at June 30, 2004	
Employee termination costs	\$		\$		\$		\$	
Impairment of property and equipment								
Facility closures and related costs		523		(320)		(123)		80
	\$	523	\$	(320)	\$	(123)	\$	80

In June 2004, we negotiated an exit from our lease of the 10<sup>th</sup> floor of our former New York City office thereby eliminating our related rent exposure. Accordingly, during the three months ended June 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 three months ended June 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 June 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 three and six months ended June 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 June 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 six months ended June 30, 2004, our effective income tax rate was 2%. 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 six months ended June 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. Effective July 1, 2004, pursuant to a contractual agreement between Chaparral and the landlord, both parties agree to negotiate in good faith a new lease rate reflecting the current market and economic conditions in the surrounding Boulder, Colorado area. We are currently in negotiations with our landlord 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 June 30, 2004.

***Legal Matters***

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. We believe that the outcome will not have a material adverse effect on our financial condition or operating results. 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.

In addition to the action 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 such 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 85% and 87% of our net revenue for the three months ended June 30, 2003 and 2004 and 81% and 86% for the six months ended June 30, 2003 and 2004.

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

	SANnet Family		Legacy and Other		Services		Total	
<b>Three months ended:</b>								
June 30, 2003:								
Net revenue	\$	46,174	\$	1,258	\$	996	\$	48,428
Gross profit (loss)	\$	11,213	\$	(1,648)	\$	448	\$	10,013
June 30, 2004:								
Net revenue	\$	66,155	\$	2,583	\$	866	\$	69,604
Gross profit (loss)	\$	17,741	\$	(655)	\$	31	\$	17,117

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<b>Six months ended:</b>									
June 30, 2003:									
Net revenue	\$	74,103	\$	3,117	\$	1,730	\$	78,950	
Gross profit (loss)	\$	17,975	\$	(3,137)	\$	712	\$	15,550	
June 30, 2004:									
Net revenue	\$	112,021	\$	4,960	\$	1,404	\$	118,385	
Gross profit (loss)	\$								