DOT HILL SYSTEMS CORP
Form 10-Q
May 05, 2005

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 March 31, 2005
	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, CA	**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 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 ý No o

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

The registrant had 43,803,207 shares of common stock, $0.001 par value, outstanding as of May 4, 2005.

DOT HILL SYSTEMS CORP.

FORM 10-Q

For the Quarter Ended March 31, 2005

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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, 2004	March 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 67,496	$ 44,773
Short-term investments	58,690	79,657
Accounts receivable, net of allowance of $491 and $446	40,788	38,272
Inventories	3,671	3,047
Prepaid expenses and other	2,273	2,750
Total current assets	172,918	168,499
Property and equipment, net	7,859	6,863
Goodwill	57,111	57,111
Other intangible assets, net	7,712	6,996
Other assets	967	931
Total assets	$ 246,567	$ 240,400
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 40,512	$ 32,793
Accrued compensation	3,338	3,027
Accrued expenses	3,309	2,968
Deferred revenue	779	746
Income taxes payable	532	253
Other liabilities	923	795
Current portion of restructuring accrual	141	160
Total current liabilities	49,534	40,742
Restructuring accrual, net of current portion	37	11
Other long-term liabilities	169	148
Total liabilities	49,740	40,901
Commitments and Contingencies (Note 13)		
Stockholders Equity:		
Preferred stock, $0.001 par value, 10,000 shares authorized, no shares issued or outstanding		
Common stock, $0.001 par value, 100,000 shares authorized, 43,656 and 43,802 shares issued and outstanding at December 31, 2004 and March 31, 2005, respectively	44	44

Additional paid-in capital		277,102		277,784
Deferred compensation		(8)		(3)
Accumulated other comprehensive loss		(462)		(579)
Accumulated deficit		(79,849)		(77,747)
Total stockholders equity		196,827		199,499
Total liabilities and stockholders equity	$	246,567	$	240,400

See accompanying notes to condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE OPERATIONS

(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended March 31, 2004		Three Months Ended March 31, 2005	
Net Revenue	$	47,865	$	58,011
Cost of Goods Sold		35,787		44,734
Gross Profit		12,078		13,277
Operating Expenses:				
Sales and marketing		4,178		4,651
Research and development		4,085		4,713
General and administrative		2,314		2,769
In-process research and development		4,700		
Total operating expenses		15,277		12,133
Operating Income (Loss)		(3,199)		1,144
Other Income (Expense):				
Interest income		574		661
Interest expense		(141)		(27)
Gain on foreign currency transactions, net		167		138
Other expense, net		(21)		75
Total other income (expense), net		579		847
Income (Loss) Before Income Taxes		(2,620)		1,991
Income Tax Benefit		35		111
Net Income (Loss)	$	(2,585)	$	2,102
Net Income (Loss) Per Share:				
Basic	$	(0.06)	$	0.05
Diluted	$	(0.06)	$	0.05
Weighted Average Shares Used to Calculate Net Income (Loss) Per Share:				
Basic		43,315		43,741
Diluted		43,315		45,717
Comprehensive Operations:				
Net income (loss)	$	(2,585)	$	2,102
Foreign currency translation adjustments		(7)		16
Net unrealized loss on short-term investments		(3)		(133)
Comprehensive income (loss)	$	(2,595)	$	1,985

See accompanying notes to condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)
(Unaudited)

	Three Months Ended March 31, 2004		Three Months Ended March 31, 2005	
Cash Flows From Operating Activities:				
Net income (loss)	$	(2,585)	$	2,102
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation and amortization		872		2,048
Write-off of in-process research and development		4,700		
Loss on disposal of property and equipment				39
Provision for doubtful accounts		(99)		(21)
Stock-based compensation expense		5		5
Gain on sale of short-term investments		(15)		(8)
Changes in operating assets and liabilities (net of effects of Chaparral acquisition):				
Accounts receivable		(3,515)		2,537
Inventories		517		624
Prepaid expenses and other assets		(25)		(441)
Accounts payable		3,607		(7,719)
Accrued compensation and expenses		(1,470)		(780)
Deferred revenue		31		(33)
Income taxes payable		(53)		(279)
Restructuring accrual		(163)		(7)
Other long-term liabilities		913		(21)
Net cash provided by (used in) operating activities		2,720		(1,954)
Cash Flows From Investing Activities:				
Purchases of property and equipment		(1,896)		(375)
Sales of short-term investments		25,991		21,177
Purchases of short-term investments		(10,484)		(42,268)
Cash paid in Chaparral acquisition, net of cash acquired		(65,383)		
Net cash used in investing activities		(51,772)		(21,466)
Cash Flows From Financing Activities:				
Proceeds from bank and other borrowings		11,407		
Payments on bank and other borrowings		(11,420)		
Proceeds from sale of stock to employees				550
Proceeds from exercise of stock options		24		132
Net cash provided by financing activities		11		682
Effect of Exchange Rate Changes on Cash		(7)		15
Net Decrease in Cash and Cash Equivalents		(49,048)		(22,723)
Cash and Cash Equivalents, beginning of period		105,863		67,496
Cash and Cash Equivalents, end of period	$	56,815	$	44,773
Supplemental Disclosures of Cash Flow Information:				
Cash paid for interest	$	33	$	
Cash paid for income taxes	$	17	$	350

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. (referred to herein as 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. 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, 2004. Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

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, 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. Acquisition

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc., or Chaparral, a privately held developer of specialized storage appliances as well as high-performance, mid-range RAID controllers and data routers. The purchase price was $67.6 million of which $62 million was paid in cash. In addition, we agreed to pay approximately $4.1 million related to obligations due to certain employees covered by change in control agreements as a result of the acquisition, direct transaction costs of approximately $0.8 million and approximately $0.7 million in accrued integration costs consisting primarily of severance payments and amounts accrued related to Chaparral s leased facility were incurred. The acquisition of Chaparral is expected to enable us to increase the amount of proprietary technology within our storage systems, broaden our product line and diversify our customer base. The results of operations of Chaparral have been included in our results prospectively from February 23, 2004.

Goodwill recorded in connection with the acquisition of Chaparral totaled approximately $56.8 million. None of this goodwill will be deductible for tax purposes. Of the acquired assets, $4.7 million pertained to in-process research and development and was written off by our recognition of a charge to operations on the acquisition date. The remaining acquired 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. None of the other intangible assets will be deductible for tax purposes.

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 have an obligation to make remaining aggregate cash payments of approximately $1.0 million to these employees through 2005. As of March 31, 2005, approximately $0.2 million has been paid related to these agreements and approximately $0.8 million is included in other liabilities at March 31, 2005. Additionally, approximately $0.2 million is being recorded as compensation expense over the 18-month service period. During the three-months ended March 31, 2005, we recorded compensation expense of approximately $34,000 relating to these agreements.

The following unaudited pro forma results of operations present the impact on our results of operations for the three months ended March 31, 2004 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 in-process research and development has been excluded from the pro forma results of operations as it is nonrecurring in nature.

	Three Months Ended March 31, 2004	
	Historical	**Pro Forma**
Net revenue	$ 47,865	$ 49,621
Net income (loss) attributable to common stockholders	$ (2,585)	$ 143
Basic and diluted net income (loss) per share	$ (0.06)	$ 0.00

3. 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 exercise price of the stock option.

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 (loss) and basic and diluted net income (loss) per share would have been adjusted to the following amounts for the three months ended March 31, 2004 and 2005 (in thousands, except per share information):

	Three Months Ended March 31,	
	2004	**2005**
Net income (loss) as reported	$ (2,585)	$ 2,102
Stock-based employee compensation expense included in reported net income (loss)	5	5
Stock-based employee compensation expense determined under fair value based method	(924)	(1,393)
Pro forma net income (loss)	$ (3,504)	$ 714
Basic net income (loss) per share:		
As reported	$ (0.06)	$ 0.05
Pro forma	$ (0.08)	$ 0.02
Diluted net income (loss) per share:		
As reported	$ (0.06)	$ 0.05
Pro forma	$ (0.08)	$ 0.02

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:

	Three Months Ended March 31, 2004	2005
Risk free interest rate	2.79%	3.71%
Expected dividend yield		
Expected life	4 years	4 years
Expected volatility	90%	81%

4. Net Income (Loss) Per Share

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period.

Diluted net income (loss) per share reflects the potential dilution of securities by including common stock equivalents, such as stock options and stock warrants 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 (loss) per share (in thousands):

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2005
Shares used in computing basic net income (loss) per share	43,315	43,741
Dilutive effect of common stock equivalents		1,976
Shares used in computing diluted net income (loss) per share	43,315	45,717

For the three months ended March 31, 2004, outstanding options to purchase 3,045,079 shares of common stock and outstanding warrants to purchase 2,034,551 shares of common stock were not included in the calculation of diluted loss per share because their effect was antidilutive. For the three months ended March 31, 2005, outstanding options to purchase 2,084,498 shares of common stock were not included in the calculation of diluted income per share because their effect was antidilutive.

5. Short-Term Investments

The following table summarizes our short-term investments as of March 31, 2005 (in thousands):

	Cost	Net Unrealized Losses	Net Unrealized Gains	Fair Value
U.S. Government securities	$ 66,044	$ (253)	$	$ 65,791
Municipal securities and corporate debt	2,941	(17)		2,924
Commercial paper	10,934	(4)	12	10,942
	$ 79,919	$ (274)	$ 12	$ 79,657

Gross realized gains on these investments were $8,550 for the three months ended March 31, 2005. There were no gross realized losses on these investments for the three months ended March 31, 2005.

6. 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, 2004	March 31, 2005
Purchased parts and materials	$ 1,507	$ 1,127
Work-in-process	37	2
Finished goods	2,127	1,918
	$ 3,671	$ 3,047

8. Goodwill and Other 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.

Intangible assets that are subject to amortization under SFAS No. 142 consist of the following as of March 31, 2005 (in thousands):

	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (1,204)	$ 3,796
Developed technology	2,600	(1,127)	1,473
Customer relationships	2,500	(773)	1,727
Backlog	100	(100)	
Total other intangible assets	$ 10,200	$ (3,204)	$ 6,996

Estimated future amortization expense related to other intangible assets as of March 31, 2005 is as follows (in thousands):

Years ending December 31,	
2005 (remaining 9 months)	2,149
2006	2,519
2007	1,587
2008	741
Total	$ 6,996

9. 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 our aggregate product warranty liability are as follows for the three months ended March 31, 2005 (in thousands):

Balance, beginning of period	$ 1,104
Current period accrual	621
Amounts charged to accrual	(565)
Change in estimate	
Balance, end of period	$ 1,160

10. Restructurings

Restructuring liabilities at March 31, 2005 were originally recorded in 2001 and 2002 and pertain to leases for former offices located in Chicago and New York City that extend through 2006.

The following is a summary of restructuring activity recorded during the three months ended March 31, 2005 (in thousands):

March 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2004	Additional Restructuring Expenses	Current Amounts Utilized	Accrued Restructuring Expenses at March 31, 2005
Facility closures and related costs	$ 168	$ 17	$ (45)	$ 140

June 2001 Restructuring

	Accrued Restructuring Expenses at December 31, 2004	Additional Restructuring Expenses	Current Amounts Utilized	Accrued Restructuring Expenses at March 31, 2005
Facility closures and related costs	$ 10	$ 75	$ (54)	$ 31

We believe that there are no unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of March 31, 2005.

11. Income Taxes

We recorded an income tax benefit of $0.1 million for the three months ended March 31, 2005 based on the receipt by our European subsidiary of $0.2 million from European taxing authorities related to a 2002 loss that was carried back to the years 1998 through 2001. Excluding the impact of the loss carryback, our effective income tax rate was 2.5% for the quarter ended March 31, 2005 and is primarily attributable to federal and state minimum tax liabilities as well as local and foreign taxes. Our effective income tax rate for the quarter ended March 31, 2005 was significantly reduced through the use of net operating loss carryforwards for which a valuation allowance had previously been recorded.

As of December 31, 2004, we have federal and state net operating loss carryforwards of approximately $119.1 million and $79.9 million, which begin to expire in 2009 and 2005, respectively. In addition, we have federal tax credit carryforwards of approximately $3.1 million, of which $0.4 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.7 million will begin to expire in 2008. We also have state tax credit carryforwards of $2.9 million, of which $2.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006.

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 Systems Corp. 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.

As a result of our acquisition of Chaparral, an ownership change, within the meaning of Internal Revenue Code Section 382, occurred on February 23, 2004. As a result, annual use of the acquired Chaparral s federal net operating loss and credit carry forwards may be limited. 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.

12. Employee Benefit Plans

Our Employee Stock Purchase Plan (the Purchase Plan) was adopted in August 1997, and amended and restated in March 2000 and February 2004. The Purchase Plan qualifies under the provisions of Section 423 of the Internal Revenue Code and provides our eligible employees, as defined in the Purchase Plan with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined. During the three months ended March 31, 2005 approximately 102,621 shares were issued under the Purchase Plan.

13. Commitments and Contingencies

Crossroads Systems Litigation

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 held interests in limited liability companies that had purchased, among other securities, Chaparral stock 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.

We are involved in certain other legal actions and claims arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will not have a material adverse effect on our financial condition or operating results.

Other

In the 4th quarter of 2004, the Company made a payment of approximately $0.4 million to the State of New York to settle amounts related to a field audit of the Company s Franchise Tax Return. During the quarter ended March 31, 2005 we submitted tax returns to the City of New York offering to pay an amount similar to that accepted by the State of New York as described above. New York City is currently reviewing the returns, and the Company is waiting for a reply as to whether or not they have accepted the revised liability and payment as submitted. Amounts related to this matter have been previously accrued for.

14. 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% of our net revenue during the three months ended March 31, 2004 and 2005.

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

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
March 31, 2005:				
Net revenue	$ 55,644	$ 1,586	$ 781	$ 58,011
Gross profit	$ 12,389	$ 338	$ 550	$ 13,277
March 31, 2004:				
Net revenue	$ 45,863	$ 1,464	$ 538	$ 47,865
Gross profit (loss)	$ 14,584	$ (2,505)	$ (1)	$ 12,078

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:				
March 31, 2005	$ 229,355	$ 7,921	$ 3,124	$ 240,400
December 31, 2004	$ 235,969	$ 7,285	$ 3,313	$ 246,567

Information concerning principal geographic areas in which we operate is as follows (in thousands):

	Three Months Ended March 31,	
	2004	2005
Net revenue:		

United States	$	45,116	$	54,066
Europe		1,337		2,473
Asia		1,412		1,472
	$	47,865	$	58,011
Operating income (loss):				
United States	$	(3,008)	$	1,778
Europe		(332)		(536)
Asia		141		(98)
	$	(3,199)	$	1,144

Net revenue is recorded in the geographic area in which the sale is originated.

15. Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board (FASB) issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective and have been adopted for our year ended December 31, 2004. We will evaluate the effect, if any, of EITF 03-1 when final guidance is released.

On December 16, 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* that will require compensation costs related to share-based payment transactions with employees to be recognized in our financial statements. With limited exceptions, the amount of compensation cost will be measured based on the grant-date fair value of the equity or liability instruments issued. In addition, liability awards will be re-measured each reporting period. Compensation cost will be recognized over the period that an employee provides service in exchange for the award. Statement 123 (revised 2004) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. On April 14, 2005, the Securities and Exchange Commission (SEC) announced the adoption of a rule that defers the required effective date of FASB Statement 123 (revised 2004) Share-Based Payment . The SEC rule provides that Statement 123 (revised 2004) is now effective for registrants as of the beginning of the first fiscal year beginning after June 15, 2005, instead of at the beginning of the first quarter after June 15, 2005 (as prescribed originally by the FASB Statement). Therefore, the required effective date of Statement 123 (revised 2004) for calendar year-end public companies is January 1, 2006.

On November 24, 2004, the FASB issued Statement No. 151, *Inventory Costs*, an Amendment of ARB No. 43, Chapter 4, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We have not completed the process of evaluating the impact that the adoption of Statement 151 will have on our financial position or results of operations.

16. Subsequent Events

In April 2005, the Company amended its Manufacturing Agreement, dated May 20, 2002, with Solectron Corporation or Solectron. The amendment provides for a change to the payment terms such that the actual payment due date for a given validly submitted invoice is based on the delivery date of the product in relationship to an established series of reconciliation dates. Under the new terms, the due date for a given payment is always the next reconciliation date which can range from five days to approximately ninety days from the date of the applicable invoice. The Company expects that the average payment term with Solectron will closely resemble the payment terms we have established with our largest customers.

In order to facilitate fulfillment of our supply plan in a balanced and consistent manner during the course of each calendar quarter, the Company agreed to fund the purchase of raw material components to cover the difference between the aggregate manufacturing cost of the then current quarter s established amount of finished goods manufactured by Solectron based on the Company s supply plan for such then current quarter, and the aggregate manufacturing cost of the actual finished goods that have been purchased from Solectron. The impact of this contractual provision is expected to result in cash payments by the Company to Solectron during the first and second month of each calendar quarter with the aggregate amount of those payments paid back to the Company prior to the end of the third month of its calendar quarter.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement for Forward-Looking Information

Certain statements contained in this report, including, statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the *safe harbor created by these sections. Future filings with the SEC, future press releases and future oral or written statements made by us or with our approval, which are not statements of historical fact, may also contain forward-looking statements. Because such statements include risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found under the caption Certain Risk Factors Related to Dot Hill s Business, and elsewhere in this quarterly report on Form 10-Q. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.*

The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2004.

Overview

We are a provider of storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete turn-key, multi-terabyte storage area networks, provides end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance.

Our products and services are sold worldwide to end-users primarily through our channel partners, including original equipment manufacturers, or OEMs, systems integrators, or SIs, and value added resellers, or VARs. In May 2002, we entered into a three-year OEM agreement with Sun Microsystems, or Sun, to provide our storage hardware and software products for private label sales by Sun. We have been shipping our products to Sun for resale to Sun s customers since October 2002. We have continued to develop new products for resale by Sun and others, such as our SANnet II FC which began shipping to Sun in March 2003. We are discussing with Sun the extent and timing of additional new product shipments. In January 2004, our existing three-year OEM partner agreement with Sun, first announced in May 2002, was extended. The agreement will now continue through May 22, 2007, a two-year extension to the original agreement subject to the terms of the agreement including early termination provisions. In March 2004, this agreement was expanded to include new advanced technology storage products, to be designed and engineered by us to Sun s specifications. Because of the significance of our relationship with Sun, we are subject to seasonality associated with Sun s business. Typically, sales in the second quarter of our fiscal year reflect the positive impact associated with Sun s fiscal year-end. Conversely, sales in the third quarter of our fiscal year typically reflect the impact of lower Sun first quarter sales compared to the historically stronger sales of Sun s June year-end quarter. We intend to continue expanding our non-OEM sales channels through SIs and VARs in order to decrease our revenue concentration with OEMs.

As part of our focus on indirect sales channels, we have outsourced substantially all of our manufacturing operations to Solectron, a leading electronics manufacturing services company. Our agreement with Solectron allows us to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of Solectron s manufacturing and procurement economies of scale.

We derive revenue primarily from sales of our SANnet II family of products. In prior periods, we derived a significant portion of our revenue from sales of our legacy products and SANnet I family of products. Except for one OEM customer to whom we continue to sell our SANnet I products, we have transitioned all customers to our SANnet II products.

We derive a portion of our revenue from services associated with the maintenance service we provide for our installed products. In May 2003, we entered into a services agreement with Anacomp, Inc. to provide all maintenance, warranty and non-warranty services for our SANnet I and certain legacy products.

Cost of goods sold includes costs of materials, subcontractor costs, salary and related benefits for the production and service departments, depreciation and amortization of equipment used in the production and service departments, production facility rent and allocation of overhead.

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses. Research and development expenses consist primarily of project-related expenses and salaries for employees directly engaged in research and development. General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions and expenditures for administrative facilities. Restructuring expenses consist primarily of employee severance, lease termination costs and other office closure expenses related to the consolidation of excess facilities.

Other income is comprised primarily of interest income earned on our cash, cash equivalents, and short-term investments and other miscellaneous income and expense items.

In August 1999, Box Hill Systems Corp. merged with Artecon, Inc. and we changed our name to Dot Hill Systems Corp. We reincorporated in Delaware in 2001. Our headquarters is located in Carlsbad, California, and we maintain international offices in Germany, Japan, the Netherlands, Singapore and the United Kingdom.

On February 23, 2004, we completed the acquisition of Chaparral Network Storage, Inc., a privately held developer of specialized storage appliances as well as high-performance, mid-range RAID controllers and data routers. The total transaction cost of approximately $67.6 million consisted of a payment of approximately $62 million in cash, the assumption of approximately $4.1 million related to obligations due certain employee covered by change in control agreements, approximately $0.8 million of direct transaction costs and approximately $0.7 million of 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.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and use judgment that may impact the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. As a part of our on-going internal processes, we evaluate our estimates, including those related to inventory write-downs, warranty cost accruals, revenue recognition, bad debt allowances, long-lived assets valuation, goodwill and intangible assets valuation, income taxes, including deferred income tax asset valuation, litigation and contingencies. We base these estimates upon both historical information and other assumptions that we believe are valid and reasonable under the circumstances. These assumptions form the basis for making judgments and determining the carrying values of assets and liabilities that are not apparent from other sources. Actual results could vary from those estimates under different assumptions and conditions.

We believe that the policies set forth below may involve a higher degree of judgment and complexity in their application than our other accounting policies and represent the critical accounting policies used in the preparation of our financial statements.

Revenue Recognition

We recognize revenue for non-software product sales upon transfer of title to the customer. Reductions to revenue for estimated sales returns are also recorded at that time. These estimates are based on historical sales returns, changes in customer demand and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required. Certain of our sales arrangements include multiple elements. Generally, these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar services, i.e., the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally twelve months. Revenue from installation, training and consulting is recognized as the services are performed.

For software sales, we apply Statement of Position No. 97-2, *Software Revenue Recognition,* whereby revenue is recognized from software licenses at the time the product is delivered, provided there are no significant obligations related to the sale, the resulting receivable is deemed collectible and there is vendor-specific objective evidence supporting the value of the separate contract elements. For arrangements with multiple elements, we allocate revenue to each element using the residual method based on vendor specific objective evidence of the undelivered items. A portion of the arrangement fee equal to the fair value of the undelivered elements, typically software maintenance contracts, is deferred and recognized ratably over the contract term, generally twelve months. Vendor specific objective evidence is based on the price charged when the element is sold separately. A typical arrangement includes a software-licensing fee and maintenance agreement.

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We perform periodic valuation assessments based on projected sales forecasts and analyzing upcoming changes in future configurations of our products and record inventory write-downs for excess and obsolete inventory. Although we strive to ensure the accuracy of our forecasts, we periodically are faced with uncertainties. The outcomes of these uncertainties are not within our control, and may not be known for prolonged periods of time. Any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventories and commitments, and consequently, on our operating results. If actual market conditions become less favorable than those forecasted, additional inventory write-downs might be required, adversely affecting operating results.

Valuation of Goodwill

We review goodwill for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with SFAS No. 142. The provisions of SFAS No. 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. Our reporting units are consistent with the reportable segments identified in the notes to our consolidated financial statements. We determine the fair value of our reporting units using the income approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step in order to determine the implied fair value of the reporting unit s goodwill and compare it to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then we must record an impairment loss equal to the difference.

The income approach is dependent on a number of factors including estimates of future market growth and trends, forecasted revenue and costs, expected periods the assets will be utilized, appropriate discount rates and other variables. We base our fair value estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

Deferred Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We maintain a valuation allowance against the deferred tax asset due to uncertainty regarding the future realization based on historical taxable income, projected future taxable income and the expected timing of the reversals of existing temporary differences. If we operate at a loss or are unable to generate sufficient future taxable income, we could be required to proportionally increase the valuation allowance against our deferred tax assets, which would result in a substantial increase to our effective tax rate and could result in a material adverse impact on our operating results. Conversely, if we continue to generate profits and ultimately determine that it is more likely than not that all of the remaining deferred tax assets will be utilized to offset future taxable income, the valuation allowance of a portion thereof could be eliminated.

At December 31, 2004, our net deferred tax asset is approximately $50.9 million (including approximately $16.4 million net deferred tax asset acquired in the Chaparral transaction), and we have provided for a valuation allowance against the entire net deferred tax asset. An elimination of the valuation allowance as of December 31, 2004 would have resulted in a decrease to goodwill to the extent of our acquired net deferred tax asset, an increase to equity for net operating losses arising from stock option deductions, with the remaining deferred tax asset decreasing income tax expense, resulting in a one-time, non-cash increase in earnings.

We are continually assessing the valuation allowance related to our deferred tax assets. We will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations. Should our level of profitability continue as expected, we would likely remove the entire valuation allowance in 2005. Although we would experience a substantial temporary decrease to our effective tax rate in the period in which we remove the valuation allowance, our effective tax rate in subsequent periods is likely to more closely resemble the applicable federal and state statutory tax rates.

Results of Operations

The following table sets forth certain items from our statements of operations as a percentage of net revenue for the periods indicated:

	Three Months Ended March 31,	
	2004	**2005**
Net revenue	100.0%	100.0%
Cost of goods sold	74.8	77.1
Gross profit	25.2	22.9
Operating expenses:		
Sales and marketing	8.7	8.0
Research and development	8.5	8.1
General and administrative	4.8	4.8
In-process research and development	9.9	
Total operating expenses	31.9	20.9
Operating income (loss)	(6.7)	2.0
Net income (loss)	(5.4)%	3.7%

Three Months Ended March 31, 2005 Compared to Three Months Ended March 31, 2004

Net Revenue

Net revenue increased $10.1 million, or 21.1%, to $58.0 million for the three months ended March 31, 2005 from $47.9 million for the three months ended March 31, 2004. The increase in net revenue was attributable to increased orders for our products from our channel partner, Sun, which accounted for 86% of our net revenue for the three months ended March 31, 2005. Total fiber channel units shipped were 2,789 for the three months ended March 31, 2005 compared to 2,271 fiber channel units shipped for the three months ended March 31, 2004. Small computer systems interface, or SCSI, units shipped were 3,570 for the three months ended March 31, 2005 compared to 2,777 SCSI units for the three months ended March 31, 2004. The increase in revenue also reflects approximately $4.8 million from the sale of our SATA product which began shipping in the second quarter of 2004. Non-Sun revenue was $8.2 million for the three months ended March 31, 2005 compared to $7.4 million for the three months ended March 31, 2004.

Cost of Goods Sold

Cost of goods sold increased $8.9 million, or 24.9%, to $44.7 million for the three months ended March 31, 2005 from $35.8 million for the three months ended March 31, 2004. As a percentage of net revenue, cost of goods sold increased to 77.1% for the three months ended March 31, 2005 from 74.8% for the three months ended

March 31, 2004. The increase in the dollar amount of cost of goods sold was attributable to greater volume of product sales during the quarter ended March 31, 2005 compared to the quarter ended March 31, 2004 including the incremental cost of goods sold attributable to sales of our SATA product in the first quarter of 2005. The increase in cost of goods sold, as a percentage of our net revenue is primarily attributable to lower than anticipated cost reductions achieved during the three months ended March 31, 2005 based on the failure to obtain the usual disk drive price reductions due to the industry-wide shortage of disk drives.

Gross Profit

Gross profit increased $1.2 million, or 9.9%, to $13.3 million for the three months ended March 31, 2005 from $12.1million for the three months ended March 31, 2004. As a percentage of net revenue, gross profit decreased to 22.9% for the three months ended March 31, 2005 from 25.2% for the three months ended March 31, 2004. The increase in the dollar amount of gross profit is attributable to greater volume of product sales during the three months ended March 31, 2005 compared to the three months ended March 31, 2004. The decrease in gross profit as a percentage of our net revenue for the three months ended March 31, 2005 when compared to the three months ended March 31, 2004 can be attributed, in part, to continued pricing pressures on our mature products, lower than anticipated sales volume and the failure to obtain the usual disk drive price reductions due to the industry-wide shortage of disk drives. Our gross profit margin was also negatively impacted for the three months ended March 31, 2005 by sales of our SATA product that presently have a significantly lower gross profit margin than either our fibre channel or SCSI products. There were no sales of our SATA product in the first quarter of 2004. We are currently transitioning the high labor content of our SATA product to locales in Asia and are working to complete the hard tooling of the chassis. We expect to receive the benefits of these cost reduction efforts by the end of the second quarter of 2005. We believe our future gross profit margin will also be positively impacted by the integration of the technology we acquired from Chaparral. We anticipate our gross profit margin will begin to reflect the effects of such integration in the second half of 2005. Gross profit margin was also negatively impacted by a full quarter of amortization of finite lived intangible assets acquired in the Chaparral transaction. Such amortization was $0.5 million for the three months ended March 31, 2005 compared to $0.2 million for the three months ended March 31, 2004. The first quarter of 2004 reflects only one month of amortization because Chaparral was acquired in late February 2004.

Sales and Marketing Expenses

Sales and marketing expenses increased $0.5 million, or 11.9%, to $4.7 million for the three months ended March 31, 2005 from $4.2 million for the three months ended March 31, 2004. As a percentage of net revenue, sales and marketing expenses decreased to 8.0% for the three months ended March 31, 2005 from 8.7% for the three months ended March 31, 2004. The increase in the dollar amount of sales and marketing related expenses is partially attributable to increased salaries and related expenses of approximately $0.3 million, primarily because in the first quarter of 2005 we paid a full three months of salaries and related expenses for those employees added in connection with our acquisition of Chaparral. Our increased sales and marketing expenses reflect the additional sales activities incurred by our European subsidiary as we continue to pursue an increased market share in Europe. We also recorded $0.2 million related to a full three months of amortization of our customer relationship intangible asset acquired in connection with the acquisition of Chaparral. The decrease in sales and marketing expenses as a percentage of net revenue primarily reflects increased 2005 revenue. We will continue our efforts to grow our non-OEM commercial sales during 2005. Accordingly, we expect sales and marketing expenses for the year ending December 31, 2005 will exceed spending levels incurred during 2004.

Research and Development Expenses

Research and development expenses increased $0.6 million, or 14.6%, to $4.7 million for the three months ended March 31, 2005 from $4.1 million for the three months ended March 31, 2004. As a percentage of net revenue, research and development expenses decreased to 8.1% for the three months ended March 31, 2005 from 8.5% for the three months ended March 31, 2004. The dollar increase in research and development expenses primarily reflects an increase in salaries, the cost of on-going research and development projects, facility related expenses, and all other expenses associated with our Longmont Technology Center acquired in late February 2004. Total costs attributable to our Longmont Technology Center for the three months ended March 31, 2005 were approximately $1.4 million compared to approximately $0.5 million for the three months ended March 31, 2004. This increase reflects a full three months of activity in the current period compared to one month in the prior comparable period. The increase in research and development was partially off-set by a decrease in project related expenses at our Carlsbad location. The decrease in project expenses for the three months ended March 31, 2005 primarily reflects the significant activity in the prior comparable period attributable to the completion of our SATA product that was released for sale early in the second quarter of fiscal year 2004. The percentage decrease in research and development expenses primarily reflects the increase in revenue for the three months ended March 31, 2005. We expect that 2005 research and development expense will exceed amounts incurred during 2004 due to our planned efforts to complete the integration of the technology acquired from Chaparral into our existing products and research and development activities related to other future product offerings.

General and Administrative Expenses

General and administrative expenses increased $0.5 million, or 21.7%, to $2.8 million for the three months ended March 31, 2005 from $2.3 million for the three months ended March 31, 2004. As a percentage of net revenue, general and administrative expenses were 4.8% for both the three months ended March 31, 2005 and 2004. The increase in the dollar amount of general and administrative expense during the three months ended March 31, 2005 reflects increased salaries and related expenses of $0.2 million compared to the three months ended March 31, 2004. This increase is partially attributable to a full three months of salaries and related expenses for those employees added in connection with our acquisition of Chaparral in late February 2004 compared to one month for the three months ended March 31, 2004 and the inclusion in the first quarter of 2005 of compensation paid to our president that had been classified as research and development expense in the comparable prior period. Additionally, we paid approximately $0.1 million to the former managing director of our Japanese subsidiary upon his retirement in March 2005. We also incurred $0.4 million in increased legal and professional services expense for the three months ended March 31, 2005 compared to the three months ended March 31, 2004. The increase in legal expenses primarily reflects the legal matters described elsewhere in this document while the increase in professional services reflect the cost of our compliance with the Sarbanes-Oxley Act of 2002. The increases in general and administrative expense were partially offset by a decrease of $0.2 million in bad debt expense and $0.1 million in lower insurance expense. The absence of a percentage change in general and administrative expenses primarily reflects the increase in revenue for the three months ended March 31, 2005. We expect general and administrative expenses to increase in 2005 compared to 2004 due to the continuing cost of complying with various corporate governance regulations and the cost of corrective actions we intend to take as a result of such regulations.

In-Process Research and Development Charges

Projects that qualify as in-process research and development represent those that have not yet reached technological feasibility and for which no future alternative uses exist. Technological feasibility is defined as being equivalent to a beta-phase working prototype in which there is no remaining risk relating to the development. For the three months ended March 31, 2004 we recorded an IPR&D charge of $4.7 million, in connection with the acquisition of Chaparral. There were no similar charges for the three months ended March 31, 2005.

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Other Income (Expense)

Other income (expense) increased by $0.2 million to $0.8 million for the three months ended March 31, 2005 from $0.6 million for the three months ended March 31, 2004. The increase was primarily attributable to an increase in interest income of $0.1 due to rising interest rates and a decrease in interest expense of approximately $0.1 million as a result of the payoff in August 2004 of a $6 million note payable that was assumed in connection with the acquisition of Chaparral and the repayment and termination of our Japanese credit facilities in the fourth quarter of 2004.

Income Taxes

We recorded an income tax benefit of $0.1 million for the three months ended March 31, 2005 based on the receipt by our European subsidiary of $0.2 million from European taxing authorities related to a 2002 loss that was carried back to the years 1998 through 2001. Excluding the impact of the loss carryback, our effective income tax rate was 2.5% for the quarter ended March 31, 2005 and is primarily attributable to federal and state minimum tax liabilities as well as local and foreign taxes. Our effective income tax rate for the quarter ended March 31, 2005 was significantly reduced through the use of net operating loss carryforwards for which a valuation allowance had previously been recorded

As of December 31, 2004, we have federal and state net operating loss carryforwards of approximately $119.1 million and $79.9 million, which begin to expire in 2009 and 2005, respectively. In addition, we have federal tax credit carryforwards of approximately $3.1 million, of which $0.4 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.7 million will begin to expire in 2008. We also have state tax credit carryforwards of $2.9 million, of which $2.7 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006.

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 Systems Corp. 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.

As a result of our acquisition of Chaparral, an ownership change, within the meaning of Internal Revenue Code Section 382, occurred on February 23, 2004. As a result, annual use of the acquired Chaparral s federal net operating loss and credit carry forwards may be limited. 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.

Liquidity and Capital Resources

As of March 31, 2005, we had $124.4 million of cash, cash equivalents and short-term investments and working capital of $127.8 million.

For the three months ended March 31, 2005, cash used in operating activities was $2.0 million compared to cash provided by operating activities of $2.7 million for the same period in 2004. The net cash used in operating activities for the three months ended March 31, 2005 is primarily attributable to net income of $2.1 million, depreciation and amortization of $2.0 million, a decrease in accounts receivable of approximately $2.5 million and a decrease in inventory of approximately $0.6 million. These amounts were off-set by a $7.7 million decrease in accounts payable that reflects our efforts to reduce the amounts due to our vendors. We expect payments to our vendors will normalize over the remaining quarters of fiscal year 2005. Cash flow from operations was negatively impacted by a $0.8 million decrease in accrued compensation and expense and other current liabilities primarily related to management bonus payments and a decrease in income taxes payable of approximately $0.3 million related to our proposed settlement with the City of New York as discussed in Note 13 to the Condensed Consolidated Financial Statements. In April 2005, we amended our manufacturing agreement with Solectron to provide for a change to the original payment terms. The new payment terms establish a payment due date for a given validly submitted invoice based on the delivery date of the product in relationship to an established series of reconciliation dates. Under the new terms, the due date for a given payment will always fall on the next reconciliation date which can range from five days to approximately ninety days after the date of the applicable invoice. We expect that the average payment term with our third party manufacturer will now closely resemble the payment terms we have established with our largest customers.

Cash used in investing activities for the three months ended March 31, 2005 was $21.5 million compared to approximately $51.8 million for the same period in 2004. This fluctuation is primarily the result of our acquisition of Chaparral that was completed in February 2004. For the three months ended March 31, 2005, cash used in investing activities reflects the purchase of $42.3 million in short-term investments off-set by sales of short-term investments of approximately $21.2 million. We also made capital expenditures of $0.4 million during the three months ended March 31, 2005 primarily to support new product development. We expect to make capital expenditures of approximately $6 to $7 million during fiscal year 2005.

Cash provided by financing activities for the three months ended March 31, 2005 was $0.7 million compared to $11,000 for the three months ended March 31, 2004. The cash provided by financing activities is attributable to exercises of stock options under the Company s 2000 Stock Incentive Plan of $0.1 million and proceeds from the sale of common stock to employees under our employee stock purchase plan of approximately $0.6 million. We did not incur any borrowings under our line of credit and do not anticipate the need for such borrowing in the foreseeable future.

We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements for at least the next twelve months and to enable us to pursue acquisitions or significant capital improvements. The actual amount and timing of working capital and capital expenditures that we may incur in future periods may vary significantly and will depend upon numerous factors, including the amount and timing of the receipt of revenues from continued operations, our ability to manage our relationships with third party manufacturers, the status of our relationships with key customers, partners and suppliers, the timing and extent of the introduction of new products and services and growth in personnel and operations.

Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board (FASB) issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective and have been adopted for our year ended December 31, 2004. We will evaluate the effect, if any, of EITF 03-1 when final guidance is released.

On December 16, 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment* that will require compensation costs related to share-based payment transactions with employees to be recognized in our financial statements. With limited exceptions, the amount of compensation cost will be measured based on the grant-date fair value of the equity or liability instruments issued. In addition, liability awards will be re-measured each reporting period. Compensation cost will be recognized over the period that an employee provides service in exchange for the award. Statement 123 (revised 2004) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. On April 14, 2005, the Securities and Exchange Commission (SEC) announced the adoption of a rule that defers the required effective date of FASB Statement 123 (revised 2004) Share-Based Payment . The SEC rule provides that Statement 123 (revised 2004) is now effective for registrants as of the beginning of the first fiscal year beginning after June 15, 2005, instead of at the beginning of the first quarter after June 15, 2005 (as prescribed originally by the FASB Statement). Therefore, the required effective date of Statement 123 (revised 2004) for calendar year-end public companies is January 1, 2006.

On November 24, 2004, the FASB issued Statement No. 151, *Inventory Costs*, an Amendment of ARB No. 43, Chapter 4, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We have not completed the process of evaluating the impact that the adoption of Statement 151 will have on our financial position or results of operations.

Certain Risk Factors Related to Dot Hill s Business

Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this Form 10-Q, including our financial statements and related notes.

Under our OEM agreement with Sun, Sun is not required to make minimum purchases or purchase exclusively from us, and we cannot assure you that our relationship with Sun will not be terminated or will generate significant sales.

Our business is highly dependent on our relationship with Sun. Sales to Sun accounted for 83.4% and 86.3% of our net revenue for the years ended December 31, 2003 and December 31, 2004, respectively. Our OEM agreement with Sun had an initial term of three years and was extended in January 2004 for an additional two years through May 2007. However, there are no minimum purchase requirements or guarantees in our agreement with Sun, the agreement does not obligate Sun to purchase its storage solutions exclusively from us and Sun may cancel purchase orders submitted under the agreement at any time. Sun may terminate the entire contract prior to the contract expiration date upon the occurrence of certain events that are not remedied within a specified cure period. The decision by Sun not to renew its contract with us, to terminate the contract, to cease making purchases or to cancel purchase orders would cause our revenues to decline substantially. We cannot be certain if, when or to what extent Sun might terminate its contract with us, cancel purchase orders, cease making purchases or elect not to renew the contract upon the expiration of the initial term. We expect to receive a substantial majority of our projected net revenue for the year ended December 31, 2005 from sales of our products to Sun. We cannot assure you that we will achieve these expected sales levels. If we do not achieve the sales levels we expect to receive from Sun, our business and result of operations will be significantly harmed.

Any decline in Sun s sales could harm our business.

A substantial majority of our revenues are generated by sales to Sun, which sells our products as separate units or bundled with its servers. If Sun s storage-related sales decline, our revenues will also decline and our business could be materially harmed. In addition, Sun s quarterly operating results typically fluctuate downward in the first quarter of their fiscal year when compared with the immediately preceding fourth quarter. If these fluctuations cause Sun to decrease purchases of our storage products, our results in the first quarter of Sun s fiscal year, which is our third quarter, could be harmed. During October 2004, Engenio announced that it had broadened its OEM agreement with Sun. Under terms of the expanded agreement, Engenio will provide Sun with new modular storage technology and will co-develop future Sun storage products. While we do not currently believe that Engenio s relationship with Sun will impact our sales or our relationship with Sun, we cannot predict the impact that the Sun and Engenio relationship, if any, will have on our future sales to Sun.

We are dependent on sales to a relatively small number of customers.

Because we intend to expand sales to channel partners, we expect to experience continued concentration in our customer base. As a result, if our relationship with any of our customers were disrupted, we would lose a significant portion of our anticipated net revenue. We cannot guarantee that our relationship with Sun or other channel partners will expand or not otherwise be disrupted. Factors that could influence our relationship with significant channel partners, including Sun, include:

our ability to maintain our products at prices that are competitive with those of other storage system suppliers;

our ability to maintain quality standards for our products sufficient to meet the expectations of our channel partners; and

our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our channel partners.

None of our contracts with our existing channel partners, including Sun, contain any minimum purchasing commitments. Further, we do not expect that future contracts with channel partners, if any, will include any minimum purchasing commitments. Changes in the timing or volume of purchases by our major customers could result in lower revenue. In addition, our existing contracts do not require our channel partners to purchase our products exclusively or on a preferential basis over the products of any of our competitors. Consequently, our channel partners may sell the products of our competitors.

The loss of one or more suppliers could slow or interrupt the production and sales of our products.

Solectron, our third party manufacturer, relies on third parties to supply key components of our storage products. Many of these components are available only from limited sources in the quantities and quality we require. Solectron purchases the majority of our redundant arrays of independent disks, or RAID, controllers from Infortrend Technology, Inc., or Infortrend. Solectron may not be able to purchase the type or quantity of components from third party suppliers as needed in the future.

From time to time there is significant market demand for disk drives, RAID controllers and other components, and we may experience component shortages, selective supply allocations and increased prices of such components. In such event, we may be required to purchase our components from alternative suppliers. Even if alternative sources of supply for critical components such as disk drives and controllers become available, incorporating substitute components into our products could delay our ability to deliver our products in a timely manner. For example, we estimate that replacing Infortrend s RAID controllers with those of another supplier would involve several months of hardware and software modification, which could significantly harm our ability to meet our customers orders for our products, damage our customer relationships and result in a loss of sales.

Manufacturing disruptions could harm our business.

We rely on Solectron to manufacture substantially all of our products. If our agreement with Solectron is terminated or if Solectron does not perform its obligations under our agreement, it could take several months to establish alternative manufacturing for our products and we may not be able to fulfill our customers orders in a timely manner. Under our OEM agreement with Sun, Sun has the right to require that we use a third party to manufacture our products. Such an external manufacturer must meet Sun s engineering, qualification and logistics requirements. If our agreement with Solectron terminates, we may be unable to find another external manufacturer that meets Sun s requirements.

With our increased use of third-party manufacturers, our ability to control the timing of shipments has continued and will continue to decrease. Delayed shipment could result in the deferral or cancellation of purchases of our products. Any significant deferral or cancellation of these sales would harm our results of operations in any particular quarter. Net revenue for a period may be lower than predicted if large orders forecasted for that period are delayed or are not realized, which result in cash flow problems or a decline in our stock price.

Any shortage of disk drives could increase our costs or harm our ability to manufacture and deliver our storage products to our customers in a timely manner.

Demand for disk drives recently surpassed supply, forcing drive manufacturers, including those who supply the disk drives integrated into many of our storage products, to manage allocation of their inventory. If this shortage is prolonged, we may be forced to pay higher prices for disk drives or may be unable to purchase sufficient quantities of disk drives to meet our customers demand for our storage products in a timely manner or at all.

We experienced losses in 2002 and 2001 and may experience losses in the future.

In 2004 and 2003, we recorded net income of $11.6 million and $12.1 million respectively; however, for the years ended December 31, 2002 and 2001, we incurred net losses of $34.3 million and $43.4 million respectively. We cannot assure you that we will be profitable in any future period. We have expended, and will continue to be required to expend, substantial funds to pursue engineering, research and development projects, enhance marketing efforts and otherwise operate our business. Our future capital requirements will depend on, and could increase substantially as a result of, many factors, including:

our plans to maintain and enhance our engineering, research, development and product testing programs;

the success of our manufacturing strategy;

the success of our sales and marketing efforts;

the extent and terms of any development, marketing or other arrangements;

changes in economic, regulatory or competitive conditions; and

costs of filing, prosecuting, defending and enforcing intellectual property rights.

Our available cash, cash equivalents and short-term investments as of March 31, 2005 totaled $124.4 million. We presently expect cash, cash equivalents, short-term investments and cash generated from operations to be sufficient to meet our operating and capital requirements through at least the next twelve months. However, unanticipated events, such as Sun s failure to meet its product purchase forecast or extraordinary expenses or operating expenses in excess of our projections, may require us to raise additional funds. We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of our debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. If we are able to borrow funds, we may be required to grant liens on our assets to the provider of any source of financing or enter into operating; debt service or working capital covenants with any provider of financing that could hinder our ability to operate our business in accordance with our plans. As a result, our ability to borrow money on a secured basis may be impaired, and we may not be able to issue secured debt on commercially reasonable terms or at all.

Our quarterly operating results have fluctuated significantly in the past and are not a good indicator of future performance.

Our quarterly operating results have fluctuated significantly in the past as shown in the following table and are not a good indicator of future performance.

Quarter		**Net Revenue**		**Net Income (Loss)**
		(in millions)		
First Quarter 2001	$	18.6	$	(28.7)
Second Quarter 2001		14.9		(5.7)
Third Quarter 2001		12.3		(3.3)
Fourth Quarter 2001		10.5		(5.7)
First Quarter 2002		10.9		(6.2)
Second Quarter 2002		11.2		(8.9)

Third Quarter 2002	8.6	(7.3)
Fourth Quarter 2002	16.3	(11.9)
First Quarter 2003	30.5	(1.5)
Second Quarter 2003	48.4	2.6
Third Quarter 2003	51.0	4.3
Fourth Quarter 2003	57.5	6.7
First Quarter 2004	47.9	(2.6)
Second Quarter 2004	69.0	6.7
Third Quarter 2004	57.0	3.5
Fourth Quarter 2004	65.5	4.0
First Quarter 2005	58.0	2.1

In addition, the announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our common stock in any given period.

We may have difficulty predicting future operating results due to both internal and external factors affecting our business and operations, which could cause our stock price to decline.

Our operating results may vary significantly in the future depending on a number of factors, many of which are out of our control, including:

the size, timing, cancellation or rescheduling of significant orders;

the cost of litigation and settlements involving intellectual property and other issues;

product configuration, mix and quality issues;

market acceptance of our new products and product enhancements and new product announcements or introductions by our competitors;

manufacturing costs;

deferrals of customer orders in anticipation of new products or product enhancements;

changes in pricing by us or our competitors;

our ability to develop, introduce and market new products and product enhancements on a timely basis;

hardware component costs and availability, particularly with respect to hardware components obtained from Infortrend, a sole-source provider;

our success in creating brand awareness and in expanding our sales and marketing programs;

the level of competition;

potential reductions in inventories held by channel partners;

slowing sales of the products of our channel partners;

technological changes in the open systems storage market;

levels of expenditures on research, engineering and product development;

changes in our business strategies;

personnel changes; and

general economic trends and other factors.

If our customers delay or cancel orders or return products, our results of operations could be harmed.

We generally do not enter into long-term purchase contracts with customers, and customers usually have the right to extend or delay shipment of their orders, return products and cancel orders. As a result, sales in any period are generally dependent on orders booked and shipped in that period. Delays in shipment orders, product returns and order cancellations in excess of the levels we expect would harm our results of operations.

Our sales cycle varies substantially and future net revenue in any period may be lower than our historical revenues or forecasts.

Our sales are difficult to forecast because the open systems storage market is rapidly evolving and our sales cycle varies substantially from customer to customer. Customer orders for our products can range in value from a few thousand dollars to over a million dollars. The length of time between initial contact with a potential customer and the sale of our product may last from three to 24 months. This is particularly true during times of economic slowdown, for sales to channel partners and for the sale and installation of complex solutions. We have shifted our business strategy to focus primarily on channel partners, with whom sales cycles are generally lengthier, more costly and less certain than direct sales to end-users.

Additional factors that may extend our sales cycle, particularly orders for new products, include:

- the amount of time needed for technical evaluations by customers;
- customers budget constraints and changes to customers budgets during the course of the sales cycle;
- customers internal review and testing procedures; and
- our engineering work necessary to integrate a storage solution with a customer s system.

Our net revenue is difficult for us to predict since it is directly affected by the timing of large orders. Due to the unpredictable timing of customer orders, we may ship products representing a significant portion of our net sales for a quarter during the last month of that quarter. In addition, our expense levels are based, in part, on our expectations as to future sales. As a result, if sales levels are below expectations, our operating results may be disproportionately affected. We cannot assure you that we will experience sales growth in future periods.

The market for our products is subject to substantial pricing pressure that may decrease our margins.

Pricing pressures exist in the data storage market and have harmed and may in the future continue to harm our net revenue and earnings. These pricing pressures are due, in part, to continuing decreases in component prices, such as those of disks and RAID controllers. Decreases in component prices are customarily passed on to customers by storage companies through a continuing decrease in price of storage hardware systems. In addition, because we expect to continue to make most of our sales to a small number of customers, we are subject to continued pricing pressures from our customers, particularly our OEM customers. Pricing pressures are also due, in part, to the current difficult economic conditions, which have led many companies in our industry to pursue a strategy of decreasing prices in order to win sales, the narrowing of functional differences among competitors, which forces companies to compete on price as opposed to features of products, and the introduction of new technologies, which leaves older technology more vulnerable to pricing pressures. To the extent we are unable to offset those pressures with commensurate cost reductions from our suppliers or by providing new products and features, our margins will be harmed.

Our success depends significantly upon our ability to protect our intellectual property and to avoid infringing the intellectual property of third parties, which could result in costly, time-consuming litigation or even the inability to offer certain products.

We rely primarily on patents, copyrights, trademarks, trade secrets, nondisclosure agreements and common law to protect our intellectual property. For example, we have registered trademarks for SANnet, SANpath, SANscape, Stratis, Dot Hill and the Dot Hill logo. Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Our efforts to protect our intellectual property from third party discovery and infringement may be insufficient and third parties may independently develop technologies similar to ours, duplicate our products or design around our patents.

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. In March 2004, Chaparral was added as a party to the lawsuit. 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 Fibre 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 intend to vigorously defend against them. 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 future operating results. Further, parties may assert additional infringement claims against us in the future, which would similarly require us to incur substantial legal fees and expenses, and distract management from the operations of our business.

We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increases. In addition to the formal claims brought against us by Crossroads, we receive, from time to time, letters from third parties suggesting that we may require a license from such third parties to manufacture or sell our products. We evaluate all such communications to assess whether to seek a license from the patent owner. We may require licenses that could have a material impact on our business. We may not be able to obtain the necessary license from a third party on commercially reasonable terms, or at all.

Consequently, we could be prohibited from marketing products that incorporate the protected technology or incur substantial costs to redesign our products in a manner to avoid infringement of third party intellectual property rights.

The market for storage systems is intensely competitive and our results of operations, pricing and business could be harmed if we fail to maintain or expand our market position.

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC Corp., Hitachi Data Systems Corp., Engenio, Adaptec, Inc., Xyratex Ltd, and Network Appliance Inc. We also compete with traditional suppliers of computer systems, including Dell Inc., Hewlett-Packard Company and IBM, which market storage systems as well as other computer products.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than us. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of new, privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future. Any of these existing or potential competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion and sale of products or deliver competitive products at lower prices than us.

We could also lose current or future business to any of our suppliers or manufacturers, some of which directly and indirectly compete with us. Currently, we leverage our supply and manufacturing relationships to provide a significant share of our products. Our suppliers and manufacturers are very familiar with the specific attributes of our products and may be able to provide our customers with similar products.

We also expect that competition will increase as a result of industry consolidation and the creation of companies with new, innovative product offerings. Current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and potential loss of market share, any of which could harm our business. We believe that the principal competitive factors affecting the storage systems market include:

Product performance, features, scalability and reliability;

Price;

Product breadth;

Timeliness of new product introductions; and

Interoperability and ease of management.

We cannot assure you that we will be able to successfully incorporate these factors into our products and compete against current or future competitors or that competitive pressures we face will not harm our business. If we are unable to develop and market products to compete with the products of competitors, our business will be materially and adversely affected. In addition, if major channel partners who are also competitors cease purchasing our products in order to concentrate on sales of their own products, our business will be harmed.

The open systems storage market is rapidly changing and we may be unable to keep pace with or properly prepare for the effects of those changes.

The open systems data storage market in which we operate is characterized by rapid technological change, frequent new product introductions, evolving industry standards and consolidation among our competitors, suppliers and customers. Customer preferences in this market are difficult to predict and changes in those preferences and the introduction of new products by our competitors or us could render our existing products obsolete. Our success will depend upon our ability to address the increasingly sophisticated needs of customers, to enhance existing products, and to develop and introduce on a timely basis, new competitive products, including new software and hardware, and enhancements to existing software and hardware that keep pace with technological developments and emerging industry standards. If we cannot successfully identify, manage, develop, manufacture or market product enhancements or new products, our business will be harmed. In addition, consolidation among our competitors, suppliers and customers may harm our business by increasing the resources of our competitors, reducing the number of suppliers available to us for our product components and increasing competition for customers by reducing customer-purchasing decisions.

A significant percentage of our expenses are fixed, and if we fail to generate revenues in associated periods, our operating results will be harmed.

Although we have taken a number of steps to reduce operating costs, we may have to take further measures to reduce expenses if we experience operating losses or do not achieve a stable net income. A number of factors could preclude us from successfully bringing costs and expenses in line with our net revenue, such as the fact that our expense levels are based in part on our expectations as to future sales, and that a significant percentage of our expenses are fixed, which limits our ability to reduce expenses quickly in response to any shortfalls in net revenue. As a result, if net revenue does not meet our projections, operating results may be negatively affected. We may experience shortfalls in net revenue for various reasons, including:

significant pricing pressures that occur because of declines in selling prices over the life of a product or because of increased competition;

sudden shortages of raw materials or fabrication, test or assembly capacity constraints that lead our suppliers and manufacturers to allocate available supplies or capacity to other customers, which, in turn, may harm our ability to meet our sales obligations; and

the reduction, rescheduling or cancellation of customer orders.

In addition, we typically plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. From time to time, in response to anticipated long lead times to obtain inventory and materials from our outside suppliers, we may order materials in advance of anticipated customer demand. This advance ordering has continued and may result in excess inventory levels or unanticipated inventory write-downs due to expected orders that fail to materialize.

Our business and operating results may suffer if we encounter significant product defects.

Our products may contain undetected errors or failures when first introduced or as we release new versions. During 2004, we have introduced a number of new products. We may discover errors in our products after shipment, resulting in a loss of or delay in market acceptance, which could harm our business. Our standard warranty provides that if the system does not function to published specifications, we will repair or replace the defective component or system without charge. Significant warranty costs, particularly those that exceed reserves, could adversely impact our business. In addition, defects in our products could result in our customers claiming damages against us for property damage or consequential damage and could also result in our loss of customers and goodwill. Any such claim could distract management s attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

Our success depends on our ability to attract and retain key personnel.

Our performance depends in significant part on our ability to attract and retain talented senior management and other key personnel. Our key personnel include James Lambert, our Vice Chairman and Chief Executive Officer, Dana Kammersgard, our President, and Preston Romm, our Chief Financial Officer. If any one of these individuals were to terminate his employment with us, we would be required to locate and hire a suitable replacement. Competition for attracting talented employees in the technology industry is intense. We may be unable to identify suitable replacements for any employees that we lose. In addition, even if we are successful in locating suitable replacements, the time and cost involved in recruiting, hiring, training and integrating new employees, particularly key employees responsible for significant portions of our operations, could harm our business by delaying our production schedule, our research and development efforts, our ability to execute on our business strategy and our client development and marketing efforts.

Many of our customer relationships are based on personal relationships between the customer and our sales representatives. If these representatives terminate their employment with us, we may be forced to expend substantial resources to attempt to retain the customers that the sales representatives serviced. Ultimately, if we were unsuccessful in retaining these customers, our net revenue would decline.

We have made several reductions in our workforce. Although the reductions were designed to reduce our operating costs, the reductions have increased the responsibilities of our remaining employees. As a result, we face risks associated with transferring the duties of our former employees to our remaining employees. In addition to the expense involved in retraining employees, there is a risk that our current work force will be unable to effectively manage all of the duties of our former employees, which could adversely impact our research and development efforts, our general accounting and operating activities, our sales efforts and our production capabilities.

Our executive officers and directors and their affiliates own a significant percentage of our outstanding shares, which could prevent us from being acquired and adversely affect our stock price.

As of March 31, 2005, our executive officers, directors and their affiliates beneficially owned approximately 8.9% of our outstanding shares of common stock. These individual stockholders may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

Protective provisions in our charter and bylaws and the existence of our stockholder rights plan could prevent a takeover which could harm our stockholders.

Our certificate of incorporation and bylaws contain a number of provisions that could impede a takeover or prevent us from being acquired, including, but not limited to, a classified board of directors, the elimination of our stockholders ability to take action by written consent and limitations on the ability of our stockholders to remove a director from office without cause. Our board of directors may issue additional shares of common stock or establish one or more classes or series of preferred stock with such designations, relative voting rights, dividend rates, liquidation and other rights, preferences and limitations as determined by our board of directors without stockholder approval. In addition, we adopted a stockholder rights plan in May 2003 that is designed to impede takeover transactions that are not supported by our board of directors. Each of these charter and bylaw provisions and the stockholder rights plan gives our board of directors, acting without stockholder approval, the ability to prevent, or render more difficult or costly, the completion of a takeover transaction that our stockholders might view as being in their best interests.

The exercise of outstanding warrants may result in dilution to our stockholders.

Dilution of the per share value of our common stock could result from the exercise of outstanding warrants. As of March 31, 2005 there were outstanding warrants to purchase 1,966,849 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. When the exercise price of the warrants is less than the trading price of our common stock, exercise of the warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrants could cause the trading price of our common stock to decline.

Any failure by us to manage the integration of Chaparral into our operations could harm our financial results, business and prospects.

In February 2004, we completed the acquisition of Chaparral. The related integration issues are complex, time-consuming and expensive and, without proper planning and implementation, could significantly disrupt our business. The challenges involved in integration include:

combining product offerings or entering into new markets in which we are not experienced and preventing customers and distributors from deferring purchasing decisions or switching to other suppliers, which could result in our incurring additional obligations in order to address customer uncertainty;

demonstrating to customers and distributors that the transaction will not result in adverse changes in client service standards or business focus and coordinating sales, marketing and distribution efforts;

consolidating and rationalizing corporate IT infrastructure, including implementing information management and system processes that enable increased customer satisfaction, improved productivity, lower costs, accurate financial reporting, more direct sales and improved inventory management;

minimizing the diversion of management attention from ongoing business concerns;

persuading employees that business cultures are compatible, maintaining employee morale and retaining key employees, integrating employees into Dot Hill, and correctly estimating employee benefit costs; and coordinating and combining administrative, manufacturing, research and development and other operations, subsidiaries, facilities and relationships with third parties in accordance with local laws and other obligations while maintaining adequate standards, controls and procedures.

Managing the acquisition of Chaparral may divert our attention from other business operations. This transaction also has resulted and in the future may result in significant costs and expenses and charges to earnings, including those related to severance pay, employee benefit costs, asset impairment charges, charges from the elimination of duplicative facilities and contracts, in-process research and development charges, inventory adjustments, legal, accounting and financial advisory fees, and required payments to executive officers and key employees under retention plans. Moreover, we have incurred and will incur additional depreciation and amortization expense over the useful lives of certain assets acquired in connection with transactions, and, to the extent the value of goodwill or intangible assets with indefinite lives acquired in connection with a transaction becomes impaired, we may be required to incur additional material charges relating to the impairment of those assets. As a result, the Chaparral transaction may contribute to financial results that differ from the investment community s expectations in a given quarter.

Our stock price may be highly volatile and could decline substantially and unexpectedly.

The trading price of our shares of common stock has been affected by the factors disclosed in this section as well as prevailing economic and financial trends and conditions in the public securities markets. Share prices of companies in technology-related industries, such as ours, tend to exhibit a high degree of volatility. The announcement of financial results that fall short of the results anticipated by the public markets could have an immediate and significant negative effect on the trading price of our shares in any given period. Such shortfalls may result from events that are beyond our immediate control, can be unpredictable and, since a significant proportion of our sales during each fiscal quarter tend to occur in the latter stages of the quarter, may not be discernible until the end of a financial reporting period. These factors may contribute to the volatility of the trading value of our shares regardless of our long-term prospects. The trading price of our shares may also be affected by developments, including reported financial results and fluctuations in trading prices of the shares of other publicly-held companies, in our industry generally and our business segment in particular, which may not have any direct relationship with our business or prospects.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We could be the target of similar litigation in the future. Securities litigation could result in the expenditure of substantial funds, divert management s attention and resources, harm our reputation in the industry and the securities markets and reduce our profitability.

Future sales of our common stock may hurt our market price.

A substantial number of shares of our common stock may become available for resale. If our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate. In addition, we are obligated to file a registration statement with respect to the resale of up to 1,394,269 shares of our common stock issuable upon exercise of warrants held by Sun.

Geopolitical military conditions, including terrorist attacks and other acts of war, may materially and adversely affect the markets on which our common stock trades, the markets in which we operate, our operations and our profitability.

Terrorist attacks and other acts of war, and any response to them, may lead to armed hostilities and such developments would likely cause instability in financial markets. Armed hostilities and terrorism may directly impact our facilities, personnel and operations that are located in the United States and internationally, as well as those of our channel partners, suppliers, third party manufacturer and customers. Furthermore, severe terrorist attacks or acts of war may result in temporary halts of commercial activity in the affected regions, and may result in reduced demand for our products. These developments could have a material adverse effect on our business and the trading price of our common stock.

Compliance with Sarbanes-Oxley Act of 2002.

We are exposed to significant costs and risks associated with complying with increasingly stringent and complex regulation of corporate governance and disclosure standards. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules require growing expenditure of management time and external resources. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 requires management s annual review and evaluation of our internal controls, and attestations of the effectiveness of our internal controls by our independent auditors. This process has required us to hire additional personnel and outside advisory services and has resulted in significant accounting and legal expenses. We expect to continue to incur significant expense in future periods to comply with regulations pertaining to corporate governance as described above.

If we fail to maintain effective internal control over financial reporting, we may be required to make additional public disclosures related to our internal control deficiencies and our management may not be able to conclude that our internal control over financial reporting is effective for the year ended December 31, 2005.

We have documented and tested our internal control systems and procedures for the year ended December 31, 2004. Based on our evaluation we have identified internal control deficiencies that constitute material weaknesses relating to our financial closing process, inventory processing and processing related to fixed assets. Accordingly, management has concluded that our internal control over financial reporting was not effective as of December 31, 2004. If we encounter problems or delays in the implementation of improvements and corrective measures, we may be required to make further disclosures about internal control deficiencies and/or material weaknesses and investor perceptions of our company may be adversely affected, which could cause a decline in the market price of our stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

Our exposure to market rate risk for changes in interest rates relates to our investment portfolio. Our primary investment strategy is to preserve the principal amounts invested, maximize investment yields, and maintain liquidity to meet projected cash requirements. Accordingly, we invest in instruments such as money market funds, certificates of deposit, U.S. Government/Agencies bonds, notes, bills and municipal bonds that meet high credit quality standards, as specified in our investment policy guidelines. Our investment policy also limits the amount of credit exposure to any one issue, issuer, and type of instrument. We do not currently use derivative financial instruments in our investment portfolio and we do not enter into market risk sensitive instruments for trading purposes. We do not expect to incur any material losses with respect to our investment portfolio.

The following table provides information about our investment portfolio at December 31, 2004 and March 31, 2005. For investment securities, the table presents carrying values at December 31, 2004 and March 31, 2005 and, as applicable, and related weighted average interest rates by expected maturity dates.

	December 31, 2004	March 31, 2005
	(amounts in thousands)	
Cash equivalents	$ 43,438	$ 22,714
Average interest rate	2.3%	2.8%
Short-term investments	$ 58,690	$ 79,657
Average interest rate	2.2%	2.5%
Total portfolio	$ 102,128	$ 102,371
Average interest rate	2.2%	2.5%

We have a line of credit agreement, which accrues interest at a variable rate. As of March 31, 2005, we had no balance under this line. Were we to incur a balance under this line of credit, we would be exposed to interest rate risk on such debt.

Foreign Currency Exchange Rate Risk

A portion of our international business is presently conducted in currencies other than the U.S. dollar. Foreign currency transaction gains and losses arising from normal business operations are credited to or charged against earnings in the period incurred. As a result, fluctuations in the value of the currencies in which we conduct our business relative to the U.S. dollar will cause currency transaction gains and losses, which we have experienced in the past and continue to experience. Due to the substantial volatility of currency exchange rates, among other factors, we cannot predict the effect of exchange rate fluctuations upon future operating results. There can be no assurances that we will not experience currency losses in the future. We have not previously undertaken hedging transactions to cover currency exposure and we do not intend to engage in hedging activities in the future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934, as amended, Rule 13a-15(e) as of the end of the period covered by this Periodic Report on Form 10-Q, have concluded that as of the end of such period, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time period specified in the Commission s rules and forms.

We have identified a material weakness related to the design and operating effectiveness of the Company s period-end financial close and reporting process, resulting from (i) an inadequate number of accounting and finance personnel with sufficient technical expertise in the area of accounting principles generally accepted in the United States of America or U.S. GAAP and financial reporting, at both the corporate headquarters and foreign subsidiaries, (ii) our failure to sufficiently document its accounting policies, practices and procedures, and (iii) a lack of a sufficiently robust review of the period-end financial information to detect misstatements on a timely basis. These control deficiencies resulted in the restatement of previously issued interim financial statements to correct errors principally affecting sales, cost of goods sold, operating expenses and accounts receivable, as described further in the restated financial statements included in the amended Form 10-Qs for the quarters ending March 31, 2004, June 30, 2004 and September 30, 2004. Additionally, numerous adjustments that were not individually material to the financial statements, but which affected various financial statement line items, were necessary to present the annual financial statements for the year ended December 31, 2004 in accordance with U.S. GAAP. Due to the significance of the actual misstatements identified and the potential for further misstatement, and the significance of the financial closing and reporting process to the preparation of reliable financial statements, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

We have identified a material weakness related to the ineffectiveness of internal controls over inventory and cost of goods sold. Various controls related to timely and accurate processing and recording of inventory-related transactions failed to operate effectively and as a result adjustments were recorded to inventory and cost of goods sold. Although these adjustments were not material to the interim and annual financial statements, the financial statements could have been materially misstated as a result of the control deficiencies. The deficiencies were concluded to be a material weakness based on the significance of the potential misstatement of the annual and interim financial statements, the significance of the controls over inventory to the preparation of reliable financial statements, and the absence of other mitigating controls to detect the adjustments.

We have identified a material weakness related to the operating effectiveness of internal controls over fixed assets related to the safeguarding and accounting for fixed assets which include (i) inadequate documentation within the fixed asset accounting system to assist in the identification and location of certain fixed assets, (ii) failure to apply identification tags to fixed assets located outside of the corporate headquarters and, (iii) failure to properly apply its accounting policies, practices and procedures pertaining to the categorization of certain expenditures as fixed assets. Based on the significance of the potential misstatement that could result due to the deficient controls over the safeguarding and accounting for fixed assets and the absence of other mitigating controls, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

In order to address the material weaknesses identified above, we have undertaken the following corrective measures:

Subsequent to March 31, 2005, the sole certified public accountant on our finance department staff submitted his resignation, effective May 26, 2005. We are actively seeking to recruit a replacement and strengthen our accounting and financial reporting functions by hiring at least three certified public accountants with recent relevant experience, at least one of which will be in a senior managerial position. We have already hired a senior finance director for our subsidiary in Japan and added additional accounting resources to our subsidiary in the Netherlands. We also intend to hire additional clerical staff in the areas of accounts payable and general accounting and other staff in various areas of the company, including but not limited to, financial planning and analysis, order entry and materials management. We believe the addition of these individuals will allow us to perform and review the necessary internal control activities pertaining to our financial closing and reporting process on a timely basis and to complete the documentation of our accounting policies and procedures during 2005.

We are in the process of developing a plan to oversee the implementation of a new ERP software package. We have hired consultants to assist management with various aspects of the implementation process. In April 2005, our Board of Directors approved and directed us to proceed with the project. Although there can be no assurances to timeframe and costs, we presently believe the new ERP system will be operational beginning January 2006. We believe the implementation of a new ERP system will improve our internal control over financial reporting by increasing the availability of data used in the financial closing process and through simplifying our current closing process by decreasing the amount of manual processes currently required by our current system. We believe our internal control over inventory processing will also be improved for the same reasons. Until the new ERP system is fully operational, we intend on increasing the management review processes related to our financial closing and inventory processes through the addition of the individuals described above.

We are in the process of initiating improvement in the controls over the processing of fixed assets. Such improvements consist of revised documentation and additional review of the authorization and accounting treatment related to the acquisition of fixed assets. We have also started the process of improving our ability to better identify and track our fixed assets by implementing controls over self constructed assets and we intend to assign asset identification tags to all of our assets located outside of our corporate headquarters.

Changes in Internal Controls

During the three months ended March 31, 2005, we began the process of reviewing the gross margin related to each sales order for reasonableness. This review is performed by a member of our finance department. Our internal auditor performs a similar review subsequent to product shipment. The purpose of this review is to identify unusual margins that might be the result an error in data input. Except as described above, there has been no change in our internal control over financial reporting that occurred during the quarter covered by this Periodic Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

Crossroads 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 Fibre 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 held interests in limited liability companies that had purchased, among other securities, Chaparral stock 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 action discussed above, we are subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. The outcome of the 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.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

a. List of Exhibits

Exhibit Number	Description
31.1	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification pursuant to 17 CFR 240.13a-14(a) or 17 CFR 240.15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements 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.

	Dot Hill Systems Corp.	
Date: May 5, 2005	By	/s/ JAMES L. LAMBERT James L. Lambert *Chief Executive Officer* *(Principal Executive Officer)*
Date: May 5, 2005	By	/s/ PRESTON S. ROMM Preston S. Romm *Chief Financial Officer and Treasurer* *(Principal Financial and Accounting Officer)*