DOT HILL SYSTEMS CORP
Form 10-Q
November 10, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2008

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.)
2200 Faraday Avenue, Suite 100, Carlsbad, CA	**92008**
(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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The registrant had 46,308,431 shares of common stock, $0.001 par value, outstanding as of November 3, 2008.

DOT HILL SYSTEMS CORP.
FORM 10-Q
For the Quarter Ended September 30, 2008
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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands)

	December 31, 2007	September 30, 2008
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 82,358	$ 56,524
Accounts receivable, net of allowance of $302 and $312	32,445	48,213
Inventories	9,013	12,613
Prepaid expenses and other	3,968	3,938
Total current assets	127,784	121,288
Property and equipment, net	9,599	7,352
Intangible assets, net	2,280	5,607
Other assets	264	338
Total assets	$ 139,927	$ 134,585
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 28,472	$ 34,944
Accrued compensation	3,115	3,564
Accrued expenses	6,227	4,055
Deferred revenue	1,409	1,168
Short term note payable		248
Income taxes payable	143	348
Total current liabilities	39,366	44,327
Long term note payable		670
Other long-term liabilities	4,132	4,755
Total liabilities	43,498	49,752
Commitments and Contingencies (Note 12)		
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, 45,781 and 46,308 shares issued and outstanding at December 31, 2007 and September 30, 2008, respectively	46	46
Additional paid-in capital	294,193	299,895
Accumulated other comprehensive loss	(3,100)	(3,228)
Accumulated deficit	(194,710)	(211,880)

Total stockholders equity		96,429		84,833
Total liabilities and stockholders equity	$	139,927	$	134,585

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2008**	**2007**	**2008**
NET REVENUE	$ 45,691	$ 76,641	$ 155,331	$ 200,494
COST OF GOODS SOLD	39,166	67,700	135,208	180,165
GROSS PROFIT	6,525	8,941	20,123	20,329
OPERATING EXPENSES:				
Sales and marketing	3,677	2,990	11,456	10,909
Research and development	5,746	6,940	16,617	21,489
General and administrative	2,424	3,309	9,416	10,291
Legal settlement		(200)		(4,036)
Total operating expenses	11,847	13,039	37,489	38,653
OPERATING LOSS	(5,322)	(4,098)	(17,366)	(18,324)
OTHER INCOME:				
Interest income	1,255	309	3,794	1,374
Other (expense) income, net		(19)		61
Total other income, net	1,255	290	3,794	1,435
LOSS BEFORE INCOME TAXES	(4,067)	(3,808)	(13,572)	(16,889)
INCOME TAX EXPENSE (BENEFIT)	56	(117)	255	281
NET LOSS	$ (4,123)	$ (3,691)	$ (13,827)	$ (17,170)
NET LOSS PER SHARE:				
Basic and diluted	$ (0.09)	$ (0.08)	$ (0.30)	$ (0.37)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE:				
Basic and diluted	45,717	46,223	45,451	46,078
COMPREHENSIVE LOSS:				
Net loss	$ (4,123)	$ (3,691)	$ (13,827)	$ (17,170)
Foreign currency translation adjustments	(1,251)	(27)	(1,692)	(128)
Net unrealized loss on short-term investments	(2)		(2)	
Comprehensive loss	$ (5,376)	$ (3,718)	$ (15,521)	$ (17,298)

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2007	**2008**
Cash Flows From Operating Activities:		
Net loss	$ (13,827)	$ (17,170)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,031	4,385
Loss on disposal of property and equipment	213	57
Reduction in bad debt reserve	(45)	(153)
Issuance of warrant to customer		2,282
Share-based compensation expense	1,647	2,224
Changes in operating assets and liabilities:		
Accounts receivable	10,887	(15,566)
Inventories	(2,646)	(3,578)
Prepaid expenses and other assets	332	(42)
Accounts payable	(9,076)	6,710
Accrued compensation and expenses	(2,644)	(2,042)
Deferred revenue	2,569	(251)
Income taxes payable	11	205
Other long-term liabilities	551	(147)
Net cash used in operating activities	(6,997)	(23,086)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(3,776)	(1,503)
Purchase of intangible assets		(2,482)
Purchases of short-term investments	(5,425)	
Net cash used in investing activities	(9,201)	(3,985)
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	967	912
Proceeds from exercise of stock options and warrants	163	284
Net cash provided by financing activities	1,130	1,196
Effect of Exchange Rate Changes on Cash	143	41
Net Decrease in Cash and Cash Equivalents	(14,925)	(25,834)
Cash and Cash Equivalents, beginning of period	99,663	82,358
Cash and Cash Equivalents, end of period	$ 84,738	$ 56,524
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$	$

Cash paid for income taxes	$	217	$	78
Supplemental Disclosure of Non-Cash Investing and Financing Activities:				
Construction in progress costs incurred but not paid	$	768	$	108
Promissory note for intangible assets purchase	$		$	918
Contingent payment for intangible assets purchase	$		$	1,070

See accompanying notes to unaudited condensed consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The Company

Dot Hill Systems Corp (referred to herein as Dot Hill, we, our or us) is a provider of entry level and midrange 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, firmware 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 very high capacity storage area networks, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our new product family based on our R/Evolution ™ architecture provides high performance and large capacities for a broad variety of environments, employing Fibre Channel, Internet Small Computer Systems Interface, or iSCSI, or Serial Attached SCSI, or SAS, interconnects to switches and/or hosts. Our SANnet products have been distinguished by certification as Network Equipment Building System, or NEBs, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability.

Basis of Presentation

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10Q and Article 10 of SEC Regulation S-X. They do not include all of the information and footnotes required by generally accepted accounting principles, or GAAP, 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 (See Note 13). 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, 2007. Operating results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2008.

Use of Estimates

The preparation of our financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. We regularly evaluate estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, warranty reserves, inventory reserves, share-based compensation expense, deferred income tax asset valuation allowances, uncertain tax positions, litigation and other contingencies. We base our estimates and assumptions on current facts, historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by us may differ materially and adversely from our estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

Revenue Recognition

In accordance with SEC Staff Accounting Bulletin, or SAB, No. 101, *Revenue Recognition in Financial Statements*, and SAB No. 104, *Revenue Recognition,* we recognize product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price to our customer is fixed or determinable; and (iv) collection of the resulting accounts receivable is reasonably assured. Revenue is recognized for product sales upon transfer of title to the customer. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data and other factors known at the time. If actual future returns and allowances differ from past experience, additional allowances may be required. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to

36 months. We recognize revenue on upfront nonrefundable payments from our customers by deferring the payment and recognizing it ratably over the term of the agreement. In accordance with Emerging Issues Task Force, or EITF, Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products),* when we provide consideration to our customers we recognize the value of that consideration as a reduction in revenue. We maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements we deliver products to a customer or a designated third party warehouse based upon the customer s projected needs, but do not recognize product revenue unless and until the customer reports that it has removed our product from the warehouse to incorporate into its end products.

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A majority of our net revenue is derived from a limited number of customers. We currently have three customers that each account for more than 10% of our total net revenue: Sun Microsystems, or Sun; Hewlett Packard, or HP; and NetApp Inc., or NetAPP. We typically incur significant design and development costs prior to being designed in with our original equipment manufacturer, or OEM, partners. Our agreements with our OEM partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partner.

	Three Months Ended September 30,				**Nine Months Ended September 30,**			
	2007		**2008**		**2007**		**2008**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Sun	$ 26,516	58.0%	$ 12,467	16.3%	$ 103,918	66.9%	$ 55,966	27.9%
HP	164	0.0%	33,712	44.0%	961	0.0%	59,656	29.8%
NetAPP	7,178	15.7%	15,857	20.7%	12,811	8.2%	43,928	21.9%
Other customers less than 10%	11,833	26.3%	14,605	19.0%	37,641	24.9%	40,944	20.4%
Total net revenue	$ 45,691	100.0%	$ 76,641	100.0%	$ 155,331	100.0%	$ 200,494	100.0%

Foreign Currency Transaction and Translation

A portion of our international business is presently conducted in currencies other than the United States 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 United States 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 currently do not intend to engage in hedging activities in the near future.

During the first quarter of 2008, we closed our operations in the Netherlands and transitioned all functions previously performed in that location to our Carlsbad location. During this process, we performed a review of the functional currency for this operation in accordance with Financial Accounting Standards Board, or FASB, Statement No. 52, *Foreign Currency Transactions,* and based on the changes in operating conditions and economic facts and circumstances we changed the functional currency for our operation in the Netherlands from the Euro to the United States dollar effective January 1, 2008. For foreign subsidiaries whose functional currency is the local currency, assets and liabilities are translated into United States dollars at period-end exchange rates. Revenues and expenses, and gains and losses, are translated at rates of exchange that approximate the rates in effect on the transaction date. Resulting translation gains and losses are recognized as a component of other comprehensive loss.

Adoption of New Accounting Pronouncements

In September 2006 the FASB issued FASB Statement No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and requires enhanced disclosures about fair value measurements. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. In February 2008 the FASB issued FASB staff position, or FSP, No. 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of FASB Statement No. 157 for non-financial assets and liabilities, other than those that are recognized or disclosed at fair value on a recurring basis, to fiscal years beginning after November 15, 2008. Our adoption of FASB Statement No. 157 related to financial assets and liabilities in the quarter ended March 31, 2008 had no impact on our condensed consolidated financial statements. We are currently evaluating the impact, if any, that FASB Statement No. 157 may have on our future condensed consolidated financial statements related to non-financial assets and liabilities.

Recent Accounting Pronouncements

In December 2007, the FASB issued FASB Statement No. 141(R), *Business Combinations*. FASB Statement No. 141(R) establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This statement also requires that acquisition-related costs are to be recognized separately from the acquisition and expensed as incurred. FASB Statement No. 141(R) is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations we engage in will be recorded and disclosed following existing GAAP until January 1, 2009. We are in the process of assessing the impact of the adoption of this standard on our future condensed consolidated financial statements.

In April 2008, the FASB issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP FAS 142-3 amends FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to improve the consistency between the useful life of a recognized intangible asset under FASB Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141, *Business Combinations*, and other U.S. GAAP. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. The guidance for determining the useful life of a recognized intangible asset is to be applied prospectively, therefore, the impact of the implementation of this pronouncement cannot be determined until the transactions occur.

2. Share-Based Compensation

We account for share-based compensation in accordance with FASB Statement No.123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees, directors and consultants, including stock grants, stock option grants and purchases of stock made pursuant to our 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP, our 2000 Amended and Restated Non-Employee Directors Stock Option Plan, or the 2000 NEDSOP, and our 2000 Amended and Restated Employee Stock Purchase Plan, or the 2000 ESPP, based on estimated fair values.

FASB Statement No. 123(R) requires us to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the award s portion that is ultimately expected to vest is recognized as expense over the requisite service periods in the accompanying unaudited condensed consolidated financial statements for the three and nine months ended September 30, 2007 and 2008.

As of September 30, 2008, total unrecognized share-based compensation cost related to unvested stock options was $6.2 million, which is expected to be recognized over a weighted average period of approximately 2.9 years. We have included the following amounts for share-based compensation cost, including the cost related to the 2000 EIP, 2000 NEDSOP and 2000 ESPP, in the accompanying unaudited condensed consolidated statements of operations (amounts in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2007	**2008**	**2007**	**2008**
Cost of goods sold	$ 86	$ 102	$ 256	$ 306
Sales and marketing	116	14	341	301
Research and development	230	247	597	705
General and administrative	238	297	453	912
Share-based compensation expense before taxes	670	660	1,647	2,224
Related deferred income tax benefits				
Share-based compensation expense, net of income taxes	$ 670	$ 660	$ 1,647	$ 2,224

Net share-based compensation expense per basic and diluted common share	$ 0.01	$ 0.01	$ 0.04	$ 0.05

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Share-based compensation expense is derived from:				
Stock options	$ 549	$ 587	$ 1,340	$ 1,953
2000 ESPP	121	73	307	271
Share-based compensation expense before taxes	$ 670	$ 660	$ 1,647	$ 2,224

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Share-based compensation expense recognized during the three and nine months ended September 30, 2008 included (1) compensation expense for awards granted prior to, but not fully vested as of, January 1, 2006 and (2) compensation expense for the share-based payment awards granted subsequent to December 31, 2005, based on the grant date fair values estimated in accordance with the provisions of FASB Statement No. 123(R). FASB Statement No.123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under FASB Statement No.123, *Accounting for Stock-based Compensation*, for the periods prior to 2006, we accounted for forfeitures as they occurred. We have historically and continue to estimate the fair value of share-based awards using the Black-Scholes option-pricing model. Total unrecognized share-based compensation cost related to unvested stock options as of September 30, 2008 has been adjusted for changes in estimated forfeitures.

To estimate compensation expense under FASB Statement No.123(R) for the nine months ended September 30, 2007 and 2008, we used the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP Nine Months Ended September 30,		**2000 ESPP Nine Months Ended September 30,**	
	2007	**2008**	**2007**	**2008**
Risk-free interest rate	4.50%	2.79%	4.75%	1.89%
Expected dividend yield	%	%	%	%
Volatility	68%	68%	68%	68%
Expected life	5.2 years	5.6 years	0.5 years	0.5 years

The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future. The expected volatility is based on implied volatility of our stock for the related vesting period. The expected life of the equity award is based on historical experience.

Stock Incentive Plans

2000 EIP. During 2007 and 2008, we granted restricted stock and options to purchase common stock to our employees and a director under the 2000 EIP. The restricted stock typically vests upon the completion of specific performance goals or over four years, with 25% of the shares vesting one year from the date of grant and the remaining shares vesting ratably thereafter on a monthly basis. The options expire 10 years from the date of grant and typically vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. The number of shares of common stock reserved for issuance under the 2000 EIP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) two percent of our outstanding shares as of the date of our annual meeting of stockholders, (B) 1,000,000 shares or (C) an amount determined by our board of directors. If restricted stock is surrendered or an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the shares with respect to which the restricted stock was not vested or the option was not exercised shall continue to be available under the 2000 EIP. As of September 30, 2008, 320,878 shares of restricted stock had been granted and were outstanding under the 2000 EIP, options to purchase 6,274,642 shares of common stock were outstanding under the 2000 EIP and 1,425,014 shares of common stock remained available for grant under the 2000 EIP.

On August 11, 2008, under the 2000 EIP, we granted selected executives and key employees performance based restricted stock awards whose vesting is contingent on our meeting specific goals, including internal earnings targets in the quarter ended December 31, 2008 and the quarter ended March 31, 2009. The cumulative total number of shares awarded is equal to 320,878, and vest over a period of approximately 5 to 8 months. The fair value of each share grant was estimated on the date of grant using the number of shares granted multiplied by the share price on the date of the grant. As of September 30, 2008, no compensation cost has been recognized related to this award.

2000 NEDSOP. Under the 2000 NEDSOP, nonqualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our board of directors (initial grants) and upon each of our annual meetings of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 1,000,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of September 30, 2008, options to purchase 530,000 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 383,124 shares of common stock remained available for grant under the 2000 NEDSOP. *2000 ESPP*. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined in the 2000 ESPP. The number of shares of common stock reserved for issuance under the 2000 ESPP is increased annually on the date of our meeting of stockholders by an amount equal to the lesser of (A) 100,000 shares or (B) an amount determined by our board of directors. There were 361,806 and 368,498 shares issued for the 2000 ESPP during the nine months ended September 30, 2007 and 2008, respectively.

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Activity and pricing information regarding all options to purchase shares of common stock are summarized as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2007	6,672,095	$ 5.36		
Granted	1,959,000	2.39		
Exercised	(128,090)	2.22		
Forfeited	(840,400)	3.65		
Expired	(855,961)	7.20		
Outstanding at September 30, 2008	6,806,644	$ 4.54	7.14	$ 140,620
Vested and expected to vest at September 30, 2008	6,343,607	$ 4.68	6.98	$ 136,948
Exercisable at September 30, 2008	3,798,156	$ 5.76	5.66	$ 125,120

The weighted average grant-date fair values of options granted during the three months ended September 30, 2007 and 2008 were $1.79 per share and $1.42 per share, respectively.

The weighted average grant-date fair values of options granted during the nine months ended September 30, 2007 and 2008 were $2.07 per share and $1.45 per share, respectively.

During the nine months ended September 30, 2008, cash generated from share-based compensation arrangements amounted to $0.3 million from the exercise of options and $0.9 million from the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon the grant of restricted stock, exercise of options to purchase common stock and for purchases through the 2000 ESPP.

The total fair value of options to purchase common stock that vested during the three months ended September 30, 2007 and 2008 was $0.6 million and $0.4 million, respectively. The total fair value of options to purchase common stock that vested during the nine months ended September 30, 2007 and 2008 was $2.3 million and $2.0 million, respectively.

3. Net Loss Per Share

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

Diluted net loss per share reflects the potential dilution by including common stock equivalents, such as stock options, restricted stock, 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 loss per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2008	2007	2008
Shares used in computing basic net loss per share	45,717	46,223	45,451	46,078
Dilutive effect of warrants and common stock equivalents				
Shares used in computing diluted net loss per share	45,717	46,223	45,451	46,078

For the three months ended September 30, 2007, outstanding options to purchase 6,559,539 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 456,554 shares of common stock at prices ranging from $3.25 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive. For the nine months ended September 30, 2007, outstanding options to purchase 6,191,525 shares of common stock with exercise prices ranging from $1.34 to $17.14 per share and outstanding warrants to purchase 1,082,699 shares of common stock at prices ranging from $2.97 to $4.50 were not included in the calculation of diluted loss per share because their effect was antidilutive.

For the three and nine months ended September 30, 2008, outstanding options to purchase 6,806,644 shares of common stock with exercise prices ranging from $1.34 to $16.36 per share and outstanding warrants to purchase 1,602,489 shares of common stock at a price of $2.40 were not included in the calculation of diluted loss per share because their effect was antidilutive.

4. Cash and Cash Equivalents

At September 30, 2008, we had $56.5 million in cash and cash equivalents. Pursuant to FASB Statement No. 157 the fair value of our cash equivalents is determined based on Level 1 inputs, which consist of quoted prices in active markets. We place our cash investments in instruments that meet credit quality standards and maturity guidelines, as specified in our investment policy. These guidelines limit the type, maturity and exposure to any one issue. The policy requires all investments to have a minimum rating of AAA, Aaa, AA, A-1 or P-1, as reported by two rating agencies.

Substantially all of our cash and cash equivalents are maintained with two major financial institutions in the United States. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and, therefore, bear minimal risk.

A summary of our cash and cash equivalents by major security type is as follows (in thousands):

	September 30, 2008
Cash	$ 42,154
Commercial paper	1,822
Institutional money market funds	10,048
U.S Treasury and agency obligations	2,500
Cash and cash equivalents	$ 56,524

5. Inventories

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

	December 31, 2007	September 30, 2008
Purchased parts and materials	$ 1,187	$ 1,324
Finished goods	7,826	11,289
Total inventory	$ 9,013	$ 12,613

Inventories are net of an allowance for excess and obsolete inventory of approximately $2.2 million as of December 31, 2007 and September 30, 2008, respectively.

6. Acquisition

In September 2008 we acquired certain identified RAIDCore and Network Attached Storage, or NAS, assets of Ciprico, for approximately $4.5 million consisting of cash consideration of $2.3 million, an unsecured non-interest bearing promissory note in the amount of $0.9 million, and contingent consideration in the amount of $1.1 million. Additionally, we incurred $0.2 million in acquisition related costs, primarily consisting of legal fees. Payments under the promissory note are due in equal monthly installments over a 42-month period commencing October 1, 2008. We are also required to pay Ciprico earn-out payments of up to $2.0 million over the 42 months following the date of acquisition. The earn-out payments are payable on a quarterly basis and are equal to 6.67% of RaidCore and NAS net revenue for the quarterly period. The contingent consideration liability fair value, as of the acquisition date, is $1.1 million, of which $0.3 million is included in accrued expenses and $0.8 million is included in other long-term liabilities. The purchase price was allocated to the assets acquired based on estimated fair values on the transaction date, resulting in the recording of RaidCore technology of $4.3 million and NAS technology of $0.2 million. The RaidCore and NAS assets are being amortized on a straight-line basis over four years and three years, respectively. Our primary reasons for the acquisition were to allow us to broaden our product portfolio in the RAID market while

allowing us to sell into the Band 1 market, and to pursue opportunities at current and target OEM customers.

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7. Intangible Assets

All of our identified intangible assets are considered to have finite lives and are being amortized in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets,* and consist of the following (in thousands):

	December 31, 2007		
	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (4,260)	$ 740
Customer relationships	2,500	(2,500)	
Licensed patent portfolio	2,570	(1,030)	1,540
Total intangible assets	$ 10,070	$ (7,790)	$ 2,280

	September 30, 2008		
	Gross	Accumulated Amortization	Net
Core technology	$ 5,000	$ (5,000)	$
RaidCore Technology	4,256	(16)	4,240
NAS Technology	214	(1)	213
Licensed Patent Portfolio	2,570	(1,416)	1,154
Total intangible assets	$ 12,040	$ (6,433)	$ 5,607

Amortization expense related to intangible assets totaled $0.5 million and $0.3 million for the three months ended September 30, 2007 and 2008, respectively. Amortization expense related to intangible assets totaled $1.7 million and $1.1 million for the nine months ended September 30, 2007 and 2008, respectively.

Estimated future amortization expense related to intangible assets as of September 30, 2008 is as follows (in thousands):

Years ending December 31,	
2008 (remaining 3 months)	$ 412
2009	1,649
2010	1,647
2011	1,117
2012	782
Total	$ 5,607

8. Product Warranties Activity

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 if these warranties are eliminated. Estimated liabilities for product warranties are included in accrued expenses. The changes in our aggregate product warranty liability are as follows (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2007	**2008**	**2007**	**2008**
Balance, beginning of period	$ 1,380	$ 1,453	$ 663	$ 1,381
Charged to operations	623	1,091	2,725	2,710
Deductions for costs incurred	(719)	(850)	(2,104)	(2,397)
Balance, end of period	$ 1,284	$ 1,694	$ 1,284	$ 1,694

Our deferred product maintenance revenue activity for the three and nine months ended September 30, 2007 and 2008 is as follows (in thousands):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2007	**2008**	**2007**	**2008**
Balance, beginning of period	$ 587	$ 546	$ 581	$ 695
New warranty revenue contracts	1,151	287	1,850	1,197
Revenue recognized	(354)	(322)	(1,047)	(1,381)
Balance, end of period	$ 1,384	$ 511	$ 1,384	$ 511

9. Income Taxes

We recorded an income tax expense of $0.1 million and an income tax benefit of $0.1 million for the three months ended September 30, 2007 and 2008, respectively. Our effective income tax rate was (3.07)% for the three months ended September 30, 2008, which differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

We recorded an income tax expense of $0.3 million and $0.3 million for the nine months ended September 30, 2007 and 2008, respectively. Our effective income tax rate of 1.64% for the nine months ended September 30, 2008

differs from the federal statutory rate due to our U.S. and foreign deferred tax asset valuation allowance position, foreign taxes and state taxes.

On January 1, 2007, we adopted FASB Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No.109*. FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues.

The cumulative effects of adopting FIN 48 resulted in an increase of $0.5 million to accumulated deficit and an increase in other long term liabilities of $0.5 million of tax benefits that, if recognized, would affect the effective tax rate. At December 31, 2007 we had cumulative unrecognized tax benefits of approximately $4.5 million, of which approximately $0.2 million are included in other long term liabilities that, if recognized, would affect the effective tax rate. The remaining $4.3 million of unrecognized tax benefits will have no impact on the effective tax rate due to the existence of net operating loss carryforwards and a full valuation allowance. Consistent with previous periods, penalties and tax related interest expense are reported as a component of income tax expense. As of December 31, 2007, the total amount of accrued income tax related interest and penalties included in the consolidated balance sheet was less than $0.1 million. We do not expect that our unrecognized tax benefit will change significantly within the next 12 months. There have been no material changes to the unrecognized tax benefit during the three month period ended September 30, 2008.

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Due to net operating losses and other tax attributes carried forward, we are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending March 31, 1994 through December 31, 2007. With few exceptions, our state income tax returns are open to audit for the years ended December 31, 1999 through 2007.

We periodically evaluate the likelihood of the realization of deferred tax assets, and adjust the carrying amount of the deferred tax assets by the valuation allowance to the extent the future realization of the deferred tax assets is not judged to be more likely than not. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income or loss, the carryforward periods available to us for tax reporting purposes, and other relevant factors.

At September 30, 2008, based on the weight of available evidence, including cumulative losses in recent years and expectations regarding future taxable income, we determined that it was not more likely than not that our United States deferred tax assets would be realized and have a $67.3 million valuation allowance associated with our United States deferred tax assets compared to $65.9 million at December 31, 2007.

As of December 31, 2007, we had federal and state net operating losses of approximately $144.0 million and $77.0 million, respectively, which begin to expire in the tax years ending 2013 and 2008, respectively. In addition, we had federal tax credit carryforwards of $3.9 million, of which approximately $0.5 million can be carried forward indefinitely to offset future taxable income, and the remaining $3.4 million began to expire in the tax year ending 2008. We also had state tax credit carryforwards of $4.1 million, of which $3.8 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.3 million began to expire in the tax year ending 2008.

As a result of our equity transactions, an ownership change, within the meaning of IRC Section 382, occurred on September 18, 2003. As a result, annual use of our federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Dot Hill immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of Section 382 (f) of the IRC) 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 IRC Section 382 limitation for those years.

As a result of our acquisition of Chaparral Network Storage, Inc., or Chaparral, a second ownership change, within the meaning of IRC Section 382, occurred on February 23, 2004. As a result, annual use of 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.

We have not provided for any residual U.S. income taxes on the earnings from our foreign subsidiaries because such earnings are intended to be indefinitely reinvested. Such residual U.S. income taxes, if any, would be insignificant.

10. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows (in thousands):

	Foreign Currency Items
Balance, December 31, 2007	$ (3,100)
Foreign currency translation	(231)
Balance, March 31, 2008	(3,331)
Foreign currency translation	129
Balance, June 30, 2008	(3,202)
Foreign currency translation	(26)
Balance, September 30, 2008	$ (3,228)

11. Credit Facilities

In August 2008, we entered into a credit agreement with Silicon Valley Bank to provide for a revolving credit facility for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate of 85% of eligible accounts receivable. The credit agreement expires three years from the effective date of the credit agreement. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation of Dot Hill to maintain at all times a net worth of $55 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by $20 million subject to our meeting certain requirements, including $40 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents net of the total amount outstanding under the credit facility fall below $20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply. On October 7, 2008 we issued a letter of credit to our contract manufacturer in China in the amount of $7.0 million.

In August 2008, we terminated our credit agreement dated July 1, 2004, as amended, with Wells Fargo Bank, National Association, effective as of August 6, 2008. The credit agreement was terminated as it was no longer necessary given the establishment of our revolving credit facility with Silicon Valley Bank. There were no early termination penalties associated with the termination of the credit agreement and no outstanding borrowings under the credit line established by the credit agreement at the time of its termination.

12. Commitments and Contingencies

Contingencies

Crossroads Systems Litigation

On October 17, 2003, Crossroads Systems, Inc., 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. The patents involve storage routers and methods for providing virtual local storage. Patent Number 5,941,972 involves the interface of Small Computer Systems Interface, or 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 were served with the lawsuit on October 27, 2003. Chaparral was added as a party to the lawsuit in March 2004.

On June 28, 2006 we entered into a Settlement and License Agreement with Crossroads that settles the lawsuit and licenses to us the family of patents from which it stemmed. We concurrently entered into an Agreement between Dot Hill Systems and Infortrend Technology, Inc., or Infortrend, Re Settlement of Crossroads Lawsuit with Infortrend Technology, Inc. In accordance with the Crossroads and Infortrend agreements, July 14, 2006, we paid $3.35 million to Crossroads for alleged past damages and Crossroads agreed to dismiss, with prejudice, all patent claims against us. In addition, Infortrend paid Crossroads an additional $7.15 million on our behalf, from which $1.43 million was withheld for Taiwan taxes and is included in income tax expense on our statement of operations. Going forward, Crossroads will receive a running royalty of 2.5% based on a percentage of net sales of RAID products sold by us, but only those with functionality that is covered by United States Patents No. 5,941,972 and No. 6,425,035 and other patents in the patent family. For RAID products that use a controller sourced by Infortrend, we will pay 0.8125% of the 2.5% royalty, and Infortrend will be responsible for the remainder. For RAID products that use our proprietary controller, we alone will be paying the 2.5% running royalty. No royalty payments will be required with respect to the sale of storage systems that do not contain RAID controllers, known as JBOD systems, or systems that use only the SCSI protocol end-to-end, even those that perform RAID. Further, royalty payments with respect to the sale of any products that are made, used and sold outside of the United States will only be required if and when Crossroads is issued patents that cover the products and that are issued by countries in which the products are manufactured, used or sold.

On July 24 and 25th, 2006, respectively, Crossroads filed another lawsuit against us in the United States District Court for the Western District of Texas as well as a Motion to Enforce in the aforementioned lawsuit. Both the new lawsuit and motion alleged that Dot Hill had breached the June 28, 2006 Settlement and License Agreement by

deducting $1.43 million of the lump sum payment of $10.50 million as withholding against any potential Taiwan tax liability arising out of Dot Hill s indemnification by Infortrend, a Taiwan company. On September 28, 2006 the Court indicated that it would grant Crossroads Motion to Enforce. On October 5, 2006, Crossroads and Dot Hill amended the original Settlement and License Agreement to state that Dot Hill would pay to Crossroads $1.43 million, plus $45,000 in late fees, and would not make deductions based on taxes on royalty payments in the future. The payment of the $1.475 million was made on October 5, 2006. As required by the amended settlement, Crossroads has dismissed with prejudice the original patent action as well as the second lawsuit based on the enforcement of the original settlement.

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Thereafter, we gave notice to Infortrend of our intent to bring a claim alleging breach of the settlement agreement seeking reimbursement of $1.475 million from Infortrend. On November 13, 2006, Infortrend filed a lawsuit in the Superior Court of California, County of Orange for declaratory relief. The complaint seeks a court determination that Infortrend is not obligated to reimburse Dot Hill for $1.475 million. On December 12, 2006, we answered the complaint and filed a cross complaint alleging breach of contract, fraud, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty and declaratory relief. Infortrend demurred to the cross complaint. The Court denied the demurrer as to the fraud cause of action and sustained the demurrer as to the claims for breach of the covenant of good faith and fair dealing and breach of fiduciary duty. We have entered into a settlement, the terms of which are confidential, and the Court has dismissed the entire action with prejudice.

Dot Hill Securities Class Actions, Derivative Suits and Direct State Securities Action

In late January and early February 2006, numerous purported class action complaints were filed against us in the United States District Court for the Southern District of California. The complaints allege violations of federal securities laws related to alleged inflation in our stock price in connection with various statements and alleged omissions to the public and to the securities markets and declines in our stock price in connection with the restatement of certain of our quarterly financial statements for fiscal year 2004, and seeking damages therefore. The complaints were consolidated into a single action, and the Court appointed as lead plaintiff a group comprised of the Detroit Police and Fire Retirement System and the General Retirement System of the City of Detroit. The consolidated complaint was filed on August 25, 2006, and we filed a motion to dismiss on October 5, 2006. The Court granted our motion to dismiss on March 15, 2007. Plaintiffs filed their Second Amended Consolidated Complaint on April 20, 2007. We filed a motion to dismiss the Second Amended Consolidated Complaint on May 1, 2008, which the Court granted on September 2, 2008. The plaintiffs subsequently filed a Third Amended Consolidated Complaint on October 10, 2008. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2008.

In addition, three complaints purporting to be derivative actions were filed in California state court against certain of our directors and executive officers. These complaints are based on the same facts and circumstances described in the federal class action complaints and generally allege that the named directors and officers breached their fiduciary duties by failing to oversee adequately our financial reporting. Each of the complaints generally seeks an unspecified amount of damages. Our demurrers to two of those cases, in which we sought dismissal, were overruled (i.e., denied). We formed a Special Litigation Committee, or SLC, of disinterested directors to investigate the alleged wrongdoing. On January 12, 2007, another derivative action similar to the previous derivative actions with the addition of allegations regarding purported stock option backdating was served on us. On April 16, 2007, the SLC concluded its investigation and based on its findings directed us to file a motion to dismiss the derivative matters. On July 13, 2007, all of the derivative actions were consolidated for pre-trial proceedings. We filed a motion to dismiss the consolidated matters pursuant to the SLC s directive on May 30, 2008. Pursuant to an order issued by the federal court hearing the related federal securities class action, discovery in this state consolidated derivative action is stayed. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2008.

In August 2007, a securities lawsuit was filed in California state court by a single former stockholder against us and certain of our directors and executive officers. This complaint is based on the same facts and circumstances described in the federal class action and state derivative complaints, and generally alleges that Dot Hill and the named officers and directors committed fraud and violated state securities laws. The complaint seeks damages, as well as attorneys fees and costs. On November 1, 2007, we filed a motion to dismiss the complaint, which was granted on February 15, 2008. On February 25, 2008, the plaintiff filed his First Amended Complaint. We filed a motion to dismiss the First Amended Complaint on March 6, 2008, which was granted on May 16, 2008. The plaintiff was granted leave to amend. Pursuant to an order issued by the federal court hearing the related federal securities class action, discovery in this state securities action is stayed. The outcome of this action is uncertain, and no amounts have been accrued as of September 30, 2008.

The pending proceedings involve complex questions of fact and law and will require the expenditure of significant funds and the diversion of other resources to prosecute and defend. The results of legal proceedings are inherently uncertain and material adverse outcomes are possible. From time to time the Company may enter into confidential

discussions regarding the potential settlement of pending litigation or other proceedings; however, there can be no assurance that any such discussions will occur or will result in a settlement. The settlement of any pending litigation or other proceedings could require Dot Hill to incur substantial settlement payments and costs.

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Other Litigation

We may be involved in certain other legal actions and claims from time to time arising in the ordinary course of business. Management believes that the outcome of such other litigation and claims will likely not have a material adverse effect on our financial condition or results of operations.

13. Warrant

In January 2008, we amended our Product Purchase Agreement, or Agreement, originally entered into with HP in September 2007, to allow for sales to additional divisions within HP. In connection with the Agreement, we issued a warrant to HP to purchase 1,602,489 shares of our common stock (approximately 3.5% of our outstanding shares prior to the issuance of the warrant) at an exercise price of $2.40 per share. The warrant was fully vested and exercisable at signing. The fair value of the warrant, determined using the Black-Scholes option-pricing model, was approximately $2.3 million. The Black-Scholes option-pricing model utilized the following assumptions; a risk-free interest rate of 3.18%, expected volatility of 59.5% and a contractual life of five years. The warrant was issued to induce the customer to enter into the Agreement with us. The fair value of the warrant was recorded as a reduction in revenue for the three months ended March 31, 2008, the period in which the Agreement was signed.

14. Segment 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 our 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.

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

	SANnet Family	Legacy and Other	Services	Total
Three months ended:				
September 30, 2007:				
Net revenue	$42,953	$ 528	$2,210	$45,691
Gross profit	$ 4,998	$ 129	$1,398	$ 6,525
September 30, 2008:				
Net revenue	$75,217	$ 94	$1,330	$76,641
Gross profit	$ 8,084	$ 4	$ 853	$ 8,941

	SANnet Family	Legacy and Other	Services	Total
Nine months ended:				
September 30, 2007:				
Net revenue	$149,566	$ 768	$4,997	$155,331
Gross profit	$ 17,390	$ 196	$2,537	$ 20,123
September 30, 2008:				
Net revenue	$195,391	$ 306	$4,797	$200,494
Gross profit	$ 17,399	$ 62	$2,868	$ 20,329

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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:				
December 31, 2007	$132,599	$1,022	$6,306	$139,927
September 30, 2008	$129,333	$1,305	$3,947	$134,585

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 quarterly report on Form 10-Q, including statements regarding the development, growth and expansion of our business and our intent, belief or current expectations 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, or the Exchange Act, and are subject to the safe harbor created by these sections. Because such forward-looking statements are subject to 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 in Part II, Item 1A, Risk Factors and in our reports filed with the Securities and Exchange Commission, or SEC, including our annual report on Form 10-K for the year ended December 31, 2007. 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 unaudited 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, 2007.

Overview

We are a provider of entry level and midrange 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, firmware 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 very high capacity storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our new product family based on our R/Evolution architecture provides high performance and large capacities for a broad variety of environments, employing Fibre Channel, or FC, Internet Small Computer Systems Interface, or iSCSI, or Serial Attached SCSI, or SAS, interconnects to switches and/or hosts. Our SANnet products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability.

Our products and services are sold worldwide to end-users through our channel partners, which consist primarily of original equipment manufacturers, or OEMs, supplemented by system integrators, or SIs, and distribution and value added resellers, or VARs. Our OEM channel partners currently include, among others, Hewlett Packard, or HP, Sun Microsystems, or Sun, NetAPP, Inc., or NetAPP, Fujitsu Siemens Computers, or Fujitsu Siemens, Motorola, NEC, Sepaton and Stratus Technologies.

In January 2008, we amended our Product Purchase Agreement, or Agreement, originally entered into with HP in September 2007, to allow for sales to additional divisions within HP. We began volume shipments to HP in the second quarter of 2008. In September 2008, we further amended our Agreement. The September 2008 amendment provides us with the ability to earn a total of $3.0 million of which $1.7 million and $1.3 million can be earned for the three months ended September 30, 2008 and for the three months ended December 31, 2008, respectively. These amounts represent a reimbursement from HP which was negotiated to compensate and effectively defer the price reductions provided to HP, effective July 1, 2008. We are required to meet certain unit shipment quantities during the third and fourth quarter of 2008 in order to earn these reimbursements. We do not anticipate future concessions from HP of this nature subsequent to December 31, 2008. For the three months ended September 30, 2008, we earned the first reimbursement of $1.7 million and have included this amount in our net revenues and gross profit.

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We have been shipping our products to Sun for resale to Sun s customers since October 2002 and continue to do so. The decline in Sun net revenue is primarily due to the products nearing the end of their lifecycle and the lack of follow-on products for the ST-3000 line having been developed to date. We expect net revenue from Sun to continue to decline over future periods. Since the beginning of 2007, we have experienced a decline in net revenues from Sun. Pursuant to our Development and OEM Supply Agreement with NetAPP, we are designing and developing general purpose disk arrays for a variety of products to be sold under private label by NetAPP. We began shipping products to NetAPP under the agreement for general availability in the third quarter of 2007 and expect revenues from NetAPP to increase during 2008. Pursuant to our Master Purchase Agreement with Fujitsu Siemens, we jointly developed with Fujitsu Siemens storage solutions utilizing key components and patented technologies from Dot Hill. We began shipping products to Fujitsu Siemens under the agreement in July 2006.

Our agreements with our channel partners do not contain any minimum purchase commitments and may be terminated at any time upon notice from the applicable partner. Our ability to achieve a return to profitability will depend on the level and mix of orders we actually receive from our channel partners, the actual amounts we spend for inventory support and incremental internal investment, our ability to reduce product cost, our product lead time and our ability to meet delivery schedules required by our channel partners.

We outsource substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of the third party s manufacturing and procurement economies of scale. From 2002 to 2007, we outsourced substantially all of our manufacturing operations to Solectron Corporation, or Solectron, which was subsequently purchased by Flextronics International Limited, or Flextronics. In February 2007, we entered into a manufacturing agreement with MiTAC International Corporation, or MiTAC, a leading provider of contract manufacturing and original design manufacturing services, and SYNNEX Corporation, or SYNNEX, a leading global information technology, or IT, supply chain services company. Under the terms of the agreement, MiTAC supplies Dot Hill with manufacturing, assembly and test services from its facilities in China and SYNNEX provides Dot Hill with final assembly, testing and configure-to-order services through its facilities in Fremont, California and Telford, United Kingdom. We began shipping products for general availability under the MiTAC and SYNNEX agreement in 2007. All of our Series 2000 and Series 5000 R/Evolution products are now manufactured by these partners.

In September 2008, we entered into a manufacturing agreement with Foxconn Technology Group, or Foxconn. Under the terms of the agreement, Foxconn will supply us with manufacturing, assembly and test services from its facilities in China and final integration services including final assembly, testing and configure-to-order services, through its world wide facilities. The agreement provides for an initial three-year term that is automatically renewed at the end of such three-year term for additional one-year terms unless and until the agreement is terminated by either party. We do not anticipate shipping products for general availability under the Foxconn agreement until the first half of 2009.

We derive net revenues primarily from sales of our SANnet II and Series 2000 family of products and we are in the process of transitioning SANnet II customers to our Series 2000 and Series 5000 family of 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, expenditures for administrative facilities as well as expenditures for legal and accounting services and fluctuations in currency valuations.

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

In September 2008 we acquired certain identified RAIDCore and Network Attached Storage, or NAS, assets of Ciprico, for approximately $4.5 million consisting of cash consideration of $2.3 million, an unsecured non-interest bearing promissory note in the amount of $0.9 million, and contingent consideration in the amount of $1.1 million. Additionally, we incurred $0.2 million in acquisition related costs, primarily consisting of legal fees. Payments under the promissory note are due in equal monthly installments over a 42-month period commencing October 1, 2008. We are also required to pay Ciprico earn-out payments of up to $2.0 million over the 42 months following the date of acquisition. The earn-out payments are payable on a quarterly basis and are equal to 6.67% of RaidCore and NAS net revenue for the quarterly period. The contingent consideration liability fair value, as of the acquisition date, is $1.1 million, of which $0.3 million is included in accrued expenses and $0.8 million is included in other long-term liabilities. The purchase price was allocated to the assets acquired based on estimated fair values on the transaction date, resulting in the recording of RaidCore technology of $4.3 million and NAS technology of $0.2 million. The RaidCore and NAS assets are being amortized on a straight-line basis over four years and three years, respectively. Our primary reasons for the acquisition were to allow us to broaden our product portfolio in the RAID market while allowing us to sell into the Band 1 market, and to pursue opportunities at current and target OEM customers.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements in accordance with United States generally accepted accounting principles, or GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenues and expenses in the reporting periods. We regularly evaluate estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, warranty reserves, inventory reserves, share-based compensation expense, deferred income tax asset valuation allowances, uncertain tax positions, tax contingencies, litigation and other contingencies. We base our estimates and assumptions on current facts, historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by us may differ materially and adversely from our estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

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 product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) our price to the customer is fixed or determinable; and (iv) collection of the resulting accounts receivable is reasonably assured. We recognize revenue for product sales upon transfer of title to the customer. Customer purchase orders and/or contracts are generally used to determine the existence of an arrangement. Shipping documents and the completion of any customer acceptance requirements, when applicable, are used to verify product delivery or that services have been rendered. We assess whether a price is fixed or determinable based upon the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess the collectibility of our accounts receivable based primarily upon the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data, and other factors known at the time. Historically these amounts have not been material. In accordance with Emerging Issues Task Force, or EITF, Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products),* when we provide consideration to our customers we recognize the value of that consideration as a reduction in revenue.

A majority of our net revenue is derived from a limited number of customers. We currently have three customers that each account for more than 10% of our total net revenue; Sun Microsystems, or Sun, Hewlett Packard, or HP, and NetApp Inc., or NetAPP. We typically incur significant design and development costs prior to being designed in with our OEM partners. Our agreements with our OEM partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partner.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2007		2008		2007		2008	
	Amount	%	Amount	%	Amount	%	Amount	%
Sun	$ 26,516	58.0%	$ 12,467	16.3%	$ 103,918	66.9%	$ 55,966	27.9%
HP	164	0.0%	33,712	44.0%	961	0.0%	59,656	29.8%
NetAPP	7,178	15.7%	15,857	20.7%	12,811	8.2%	43,928	21.9%
Other customers less than 10%	11,833	26.3%	14,605	19.0%	37,641	24.9%	40,944	20.4%
Total net revenue	$ 45,691	100.0%	$ 76,641	100.0%	$ 155,331	100.0%	$ 200,494	100.0%

We maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements we deliver products to a customer or a designated third party warehouse based upon the customer s projected needs, but do not recognize product revenue unless and until the customer reports that it has removed our product from the warehouse to incorporate into its end products. If a customer does not take our product under a hubbing arrangement in accordance with the schedule it originally provided to us, our future net revenue stream could vary substantially from our forecasts and our results of operations could be materially affected.

In July 2007, we received an upfront nonrefundable payment from one of our customers in the amount of $2.5 million. This amount represented a reimbursement for production test equipment and tooling that will be utilized over the term of our agreement to manufacture product for this customer. The upfront nonrefundable payment has been deferred and is being recognized ratably over the term of the 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 establish inventory reserves for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and its estimated realizable value based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory reserves could be required. Under the hubbing arrangements that we maintain with certain customers, we own inventory that is physically located in a third party s warehouse. As a result, our ability to effectively manage inventory levels may be impaired, which would cause our total inventory turns to decrease. In that event, our expenses associated with excess and obsolete inventory could increase and our cash flow could be negatively impacted.

Foreign Currency Transaction and Translation

A portion of our international business is presently conducted in currencies other than the United States 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 United States 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 currently do not intend to engage in hedging activities in the near future.

During the first quarter of 2008, we closed our operations in the Netherlands and transitioned all functions previously performed in that location to our Carlsbad location. During this process, we performed a review of the functional currency for this operation in accordance with Financial Accounting Standards Board, or FASB, Statement No. 52, *Foreign Currency Transactions,* and based on the changes in operating conditions and economic facts and circumstances we changed the functional currency for our operation in the Netherlands from the Euro to the United States dollar effective January 1, 2008. For foreign subsidiaries whose functional currency is the local currency assets

and liabilities are translated into United States dollars at period-end exchange rates. Revenues and expenses, and gains and losses, are translated at rates of exchange that approximate the rates in effect on the transaction date. Resulting translation gains and losses are recognized as a component of other comprehensive loss.

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Deferred Taxes

We utilize the liability method of accounting for income taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we consider all positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies, and recent financial performance. As a result of our cumulative losses in the U.S. and certain foreign jurisdictions, we have concluded that a full valuation allowance against our net deferred tax assets is appropriate in such jurisdictions. In certain other foreign jurisdictions where we do not have cumulative losses, we record valuation allowances to reduce our net deferred tax assets to the amount we believe is more likely than not to be realized. In the future, if we realize a deferred tax asset that currently carries a valuation allowance, we may record a reduction to income tax expense in the period of such realization. In July 2006 the FASB issued Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*, which requires income tax positions to meet a more-likely-than-not recognition threshold to be recognized in the financial statements. Under FIN 48, tax positions that previously failed to meet the more-likely-than-not threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Prior to 2007 we recorded estimated income tax liabilities to the extent they were probable and could be reasonably estimated. We are subject to taxation in many jurisdictions, and the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax laws and regulations in various taxing jurisdictions. If we ultimately determine that the payment of these liabilities will be unnecessary, we reverse the liability and recognize a tax benefit during the period in which we determine the requirement to recognize the liability no longer applies. Conversely, we record additional tax charges in a period in which we determine that a recorded tax liability is less than we expect the ultimate assessment to be. In assessing the need for a valuation allowance, we consider all positive and negative evidence.

The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws and regulations themselves are subject to change as a result of changes in fiscal policy, changes in legislation, the evolution of regulations and court rulings. Therefore, the actual liability for U.S. or foreign taxes may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially reverse previously recorded tax liabilities or deferred tax asset valuation allowance.

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Share-Based Compensation

We account for share-based compensation in accordance with FASB Statement No. 123(R), *Share-Based Payment*, which requires us to record stock compensation expense for equity based awards granted, including stock options, for which expense will be recognized over the service period of the equity based award based on the fair value of the award, at the date of grant. The estimation of stock option fair value requires management to make complex estimates and judgments about, among other things, employee exercise behavior, forfeiture rates, and the volatility of our common stock. These judgments directly affect the amount of compensation expense that will ultimately be recognized. We currently use the Black-Scholes option pricing model to estimate the fair value of our stock options. The Black-Scholes model meets the requirements of FASB Statement No. 123R but the fair values generated by the model may not be indicative of the actual fair values of our stock options as it does not consider certain factors important to those awards to employees, such as continued employment and periodic vesting requirements as well as limited transferability. The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by our stock price a