DOT HILL SYSTEMS CORP
Form 10-K
March 15, 2004

QuickLinks -- Click here to rapidly navigate through this document

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2003

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
(State of incorporation)

13-3460176
(IRS Employer Identification No.)

6305 El Camino Real
Carlsbad, CA
(Address of principal executive offices)

92009
(zip code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Shares outstanding at March 11, 2004	Name of each exchange on which registered
Common stock, $.001 par value	43,315,222	Nasdaq National Market

Securities registered pursuant to Section 12(g) of the Act:

None

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes ý No o

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of June 30, 2003 was $281,434,426. Documents incorporated by reference: Portions of the registrant's definitive proxy statement for its 2004 annual meeting of stockholders are incorporated by reference into Part III of this Form 10-K.

DOT HILL SYSTEMS CORP.
INDEX TO ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2003

Forward-Looking Statements

Certain statements contained in this report, including, but not limited to, 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 contained herein 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 those sections. Future filings with the Securities and Exchange Commission, or 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 are set forth in the section entitled "Certain Risk Factors Related to the

Company's Business," in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere throughout this Annual Report on Form 10-K.

Readers are cautioned not to place undue reliance on these forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and, except as required by applicable law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

PART I

Item 1. Business

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 SANnet products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 and are MIL STD-810F compliant based on their ruggedness and reliability.

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, and that agreement was recently extended until May 2007. We have been shipping our products to Sun for resale to Sun's customers since October 2002. We continue to develop new products for resale by Sun and other channel partners and expect to begin shipping several new products later in 2004.

In February 2004, we acquired all the outstanding shares of Chaparral Networks, Inc., or Chaparral, a privately-held storage system provider. We expect to integrate Chaparral's redundant arrays of independent disks, or RAID, controller and router technology into our line of storage products. We plan to retain Chaparral's Colorado facility as a research and development hub and to continue to use Chaparral's team of engineers and facility support personnel.

As part of our focus on indirect sales channels, we have outsourced substantially all of our manufacturing operations to Solectron Corporation, or Solectron. 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 were formed in 1999 by the combination of Box Hill Systems Corp. and Artecon, Inc., or Artecon. We reincorporated in Delaware in 2001. Our website address is http://www.dothill.com. Information contained on our website does not constitute a part of this Annual Report on Form 10-K. Our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K and all amendments to those reports that we file with the SEC are currently available free of charge to the general public through our website. These reports are accessible on our website promptly after being filed with the SEC and are also accessible through the SEC's website which may be found at http://www.sec.gov. In addition, you may read and copy the materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

Industry Background

Growth of Data Storage

The efficient generation, storage and retrieval of digital data and content has become increasingly strategic and mission-critical to organizations. The volume of this data continues to grow rapidly, driven by several factors including:

- the proliferation of different types of data, including graphics, video, text and audio;

- the emergence of Internet-based communication protocols which enable users to rapidly duplicate, change and re-communicate data;

- new regulations and corporate policies requiring additional storage in certain industries, such as recent requirements imposed on healthcare companies and evolving regulatory requirements for financial services companies;

- the implementation of enterprise-wide databases containing business management information; and

- gains in network bandwidth and the technology for managing and classifying large volumes of data.

According to Gartner, Inc., or Gartner, the total storage capacity of all worldwide external, controller-based disk storage systems shipped will grow by 64.1% on a compounded annual basis between 2002 and 2007, reaching 3.6 million terabytes, or TB, in 2007.

Traditionally, storage vendors have designed products for markets differentiated by capacity, performance, price and feature set. These storage markets are typically identified as:

- *Entry-level.* Entry-level storage products are designed for relatively low capacity, simple, stand-alone data storage needs for which price and simplicity are the main purchasing considerations. Vendors address this market primarily through an indirect sales channel approach employing retailers and VARs that assist information technology, or IT, managers in identifying, purchasing and installing the product.

- *Midrange.* Midrange or departmental/workgroup storage products are designed for higher capacity and performance than entry-level products, but still feature ease of use and manageability, and are attached to a local server tailored to the needs of the local users. In this market, storage providers primarily sell their products to local IT managers through VARs and regional or small SIs.

- *High-end.* High-end or data center storage products are designed for use by larger organizations where data storage and management is critical. These organizations require large capacity, high performance, automation, extreme reliability, continuous availability, systems interoperability and global service and support. In this market, storage providers sell their products with a combination of a direct sales force and indirect channels, including OEMs, large SIs and managed services providers.

In addition to dramatic increases in the overall volume of data, the storage market has been influenced by the following major trends:

Migration to Network Computing. Computing processes and architectures have evolved from mainframe computing systems toward a centrally managed network computing environment characterized by multiple operating systems and server platforms that must share information. Organizations require large-scale data storage solutions offering:

- increased connectivity capabilities;

- greater capacity;

higher performance;

the ability to share data among different platforms;

greater reliability; and

greater protection.

Organizations have responded by implementing tailored networks, optimized for data storage functions, that facilitate data access and protection.

Increasing Focus on Total Cost of Ownership and Return on Investment. IT managers are increasingly focused on lowering the total cost of ownership and increasing their return on investment on each technology purchase. IT managers evaluate total cost of ownership and return on investment based upon several metrics, including initial purchase price, ease of provisioning, scalability, reliability and redundancy, ease of management, IT staff productivity, operating costs and after-sale service and support.

Storage Area Networks

Customers require storage systems that enable them to capture, protect, manage and archive data across a variety of storage platforms and applications without sacrificing performance. Historically, the Small Computer Systems Interface, or SCSI, was the primary method of connecting storage to servers. Then, the Fibre Channel protocol was developed, which enables storage devices to connect to servers over a networked architecture, allowing end-users to connect multiple storage devices with high bandwidth throughput over long distances and centrally manage their storage environment. Centrally managed network storage systems are designed to provide connectivity across multiple operating systems and devices and may be based on either open or proprietary technology standards. Gartner estimates that by 2007 network storage product sales will represent over 76.9% of the worldwide external disk storage market compared to approximately 60.5% of the market in 2002, growing at a 12.3% compound annual growth rate, or CAGR, from $8.5 billion in 2002 to $15.2 billion in 2007.

Storage area networks, or SANs, apply the benefits of a networked approach to data storage applications, allowing large blocks of data to move efficiently and reliably between multiple storage devices and servers without interrupting normal network traffic. SANs provide high scalability, connectivity and fault-tolerance, which permit IT managers to create and manage centralized pools of storage and backup devices with redundant data paths. With the addition of file-sharing software, SANs also allow multiple hosts to share consolidated data, dramatically reducing the need to duplicate, move

and manage multiple files in a wide variety of data-intensive applications. SANs primarily employ Fibre Channel technology.

Demand for High Performance, Affordable Network Storage Solutions

Customers increasingly demand higher performing, affordable solutions to address expanding storage requirements, interoperability across disparate systems, the need for improved connectivity and rising data management costs. Customers are also demanding open standards architecture and modular systems that allow them to add capacity as needed. These demands have created significant opportunities for network storage system solutions that are affordable and provide high performance.

Reliability

Perhaps one of the greatest requirements for many customers is that their stored data be available, and that the systems upon which they are stored by reliable. For example, Internet-related customers can lose significant revenue for every minute their sites are inoperable and users can't access data from the web site. Similarly, the operations of corporate customers can grind to a halt if precious data is lost or unavailable. For these reasons, a storage system's reliability is often the critical factor in making a choice among storage systems.

Our Solutions

We offer a broad line of networked data storage solutions composed of standards-based hardware and software for open systems environments. Many of the performance attributes demanded by high-end/data center end-users are incorporated into our products, at prices that are suitable for the entry-level or midrange markets. Our end-users consist of entry-level, midrange and high-end/data center users, requiring cost-effective, easily managed, high performance, reliable storage systems. Our product lines range from approximately 72 gigabyte, or GB, to complete 35 TB storage systems. These offerings allow our products to be integrated in a modular building block fashion or configured into a complete storage solution, increasing OEM flexibility in creating differentiated products. Modular products also allow our indirect channel partners to customize solutions, bundling our products with value-added hardware, software and services.

Our products and services are intended to provide users with the following benefits:

Low Total Cost of Ownership and High Return on Investment. Our products combine reliability, flexibility, scalability and manageability into one of the smallest form factors in today's market. Our product set provides end-users with a low total cost of ownership due to our products' extreme reliability, the simplicity of our "plug-and-play" technology, decreased service and support costs and modular system approach that allows end-users to add capacity as needed. The modular nature of our products addresses our end-users' desire for a storage solution that does not require a large, upfront investment in a monolithic structure with unused capacity. In addition, we believe that our SANnet II storage systems are among the most space-efficient in the storage industry, maximizing our customers' limited space and significantly reducing their costs. By extending and leveraging our customers' installed storage system and architecture, we are able to provide solutions that offer both a lower total cost of ownership and a higher return on investment.

Modular Scalability. Our products are designed using a single cohesive modular architecture that allows customers to size and configure storage systems to meet their specific requirements. This modular architecture also allows customers to easily expand and, in some cases, reconfigure a system as their needs change, permitting them to extend the useful life of and better utilize their existing systems.

Carrier-Class Reliability. We believe that high reliability is essential to our customers due to the critical nature of the data being stored. We design redundancy, 99.9998% reliability, high performance, and ruggedness into our SANnet II storage systems. Redundant components have the ability to be replaced while the system is on line without interrupting network activity. All of our SANnet II disk array products currently offered are certified to operate under extreme climatic and other harsh operating conditions without degradation in reliability or performance, as attested to with the NEBS Level 3 and MIL-STD-810F certifications.

Open Systems, Multi-Platform Support. As an independent provider of storage products, we are well positioned to provide storage solutions on a variety of platforms and operating systems, including Linux, Unix and Windows. Our SANnet II line of systems supports multiple servers using different operating systems simultaneously. This multi-platform compatibility allows customers to standardize on a single storage system that can readily be reconfigured and redeployed at minimal cost as the customer's storage architecture changes.

Manageability. The ability to manage storage systems, particularly through software, is a key differentiator among storage vendors. SANscape, our storage management software, enables customers to more easily manage and configure their storage systems and respond to their changing system requirements. In addition, SANpath, our storage area networking software, further enhances performance and reliability.

Following the acquisition of Chaparral in February 2004, we intend to continue to offer customers existing Chaparral products along with our products, and to integrate Chaparral's RAID controller and router technology into our future products and product lines.

Our Strategy

Our objective is to focus on profitable growth and capture an increasing share of the open systems storage solution market.

Focus on Profitable Growth. We have focused our business strategy in several ways to enhance our margins and increase profits.

Utilize indirect sales channels. We have adopted an indirect sales model to access end-user markets primarily through our OEM, SI and VAR partners. This allows us to benefit from our channel partners' extensive direct and indirect distribution networks, installed customer base, and greater sales, marketing, and global service and support infrastructures.

Outsource manufacturing and service operations. We outsource substantially all of our manufacturing operations, which allows us to reduce manufacturing infrastructure, enhance working capital, and improve margins. In addition, we encourage our channel partners to provide support and service directly to end-users.

Develop and Expand OEM Relationships. In May 2002, we entered into an OEM agreement with Sun under which Sun resells our SANnet II and SANscape products to its customers under Sun's private label. Our agreement with Sun was expanded in January and March 2004 to extend the term by three years and include additional products under the agreement. In addition to Sun, we have other OEM partners, including Comverse Technology, Inc., or Comverse Technology, and Motorola, Inc., or Motorola, for our hardware products and Storage Technology Corporation, or StorageTek, and Network Appliance, Inc., or NetApp, for our software products. We intend to continue seeking additional OEM relationships with other industry leaders to sell current and future products and expand the number of products offered to existing OEM partners to enable them to address new markets.

Broaden Non-OEM Channels to Diversify Revenues. We intend to continue expanding our non-OEM sales channels through SIs and VARs in order to decrease our revenue concentration with

OEMs. In the second quarter of 2003, we launched a new channel marketing program and added 17 new non-OEM channel partners. In addition, we continue to sell direct to service providers, including NTT/Verio, Ofoto, a division of Kodak, and MCI/UUNET.

Grow and Extend Technology Leadership. We view our core competencies as the research, design and engineering of modular open storage systems. We believe that focused research and development on advanced, cost effective storage technologies is critical to our ongoing success. We intend to accelerate our expenditures on technology development and integration in order to offer more complete storage solutions and enhance our existing products to benefit our channel partners' efforts to increase sales. We expect to introduce our SANnet II Serial Advanced Technology Attachment, or SATA, and SANnet II Fabric Attached Storage, or FAS, products later this year.

Pursue Strategic Alliances, Partnerships and Acquisitions. We will continue to evaluate and selectively pursue strategic acquisitions, alliances and partnerships that are complementary to our business. We believe that growth of the network storage market will create additional opportunities to expand our business. In addition, we believe the most efficient pursuit of these opportunities will be through strategic alliances and relationships, which allow us to leverage our existing design and marketing infrastructure while capitalizing on products, technologies and channels that may be available through potential strategic partners.

Our Products

We design our family of open systems storage hardware and software products with the reliability, flexibility and performance necessary to meet IT managers' needs for easily scalable cost effective solutions. We currently offer storage systems in Fibre Channel and SCSI configurations. Our software offerings consist of storage management applications, which can manage any one or all of our storage system configurations, and performance enhancing software that we sell bundled with our storage systems or license separately to OEM customers.

All of our SANnet II products are NEBS Level 3 certified and MIL-STD-810F compliant. NEBS guidelines were originally developed by Bellcore, now Telcordia, as ultra-high reliability standards for telecommunications equipment, including storage products. There are three levels of NEBS specifications. The most rugged and reliable equipment is rated carrier-class NEBS Level 3. The NEBS standards mandate a battery of tests designed to simulate the extreme conditions resulting from natural or man-made disasters and cover a range of product requirements for operational continuity. MIL-STD-810F is a military standard created by the U.S. Government. It involves a range of tests used to measure the reliability of equipment in extreme conditions, including physical impact, moisture, vibration and high and low temperatures. These standards address system ruggedness and reliability, which are increasingly important requirements for end-users.

Our primary products include the following:

Product Line	Description	General Availability	Capacity	Target Market	Features
Hardware					
SANnet II SCSI	2 unit high, 12 to 36 drives, Ultra160 SCSI DAS storage	4Q02	72 GB to 5.25 TB using 146 GB SCSI drives	Entry-level and Midrange	Compact 3.5 inch high enclosures, fully redundant RAID using SCSI connections, expandable storage capacity
SANnet II FC	2 unit high, 12 to 192 drives, 2 Gigabit Fibre Channel DAS and SAN storage	1Q03	72 GB to 28 TB using 146 GB FC drives	Entry-level and Midrange	Complete SAN solution in a single enclosure, scalable performance and capacity without interruptions
SANnet II Blade	1 unit high, 4 to 12 drives, Ultra320 SCSI DAS	4Q03 DAS	72 GB to 1.75 TB using 146 GB SCSI drives	Entry-level	Highly rack-optimized design, provides genuine hardware RAID functionality, connects to low-cost server SCSI ports
SANnet II SATA	2 unit high, 12 to 192 drives, 2 Gigabit Fibre Channel DAS and SAN storage	2Q04	1 TB to 48 TB using 250 GB SATA drives	Entry-level and Midrange	Complete SAN solution in a single enclosure, supports FC and SATA drives simultaneously, scalable performance and capacity without interruptions
SANnet II FAS (Embedded FC SAN Switches)	2 unit high, 12 to 192 drives, 2 Gigabit and 10 Gigabit Fibre Channel DAS and SAN storage	4Q04	72 GB to 28 TB using 146 GB FC drives	Entry-level and Midrange	Complete SAN solution in a single enclosure, internal fabric SAN switches, 10 Gigabit SAN support, scalable performance and capacity without interruptions
Rio	1 unit RAID controller	3Q02	N/A	Entry-level and Midrange	RAID controller attachable to JBOD to allow for RAID protection
Riva	RAID controller board	2Q03	N/A	Entry-level and Midrange	Complete SAN solution, scalable performance
Software					
SANpath	Storage area networking software	1Q00	N/A	Entry-level and Midrange	Load balancing, multipathing, path fail over, path fail back and LUN masking
SANscape	Storage management software	1Q00	N/A	Entry-level and Midrange	Graphical and command line consoles with diagnostics, monitoring and reporting

We expected to release a network attached storage version of SANnet II in the 2003 to 2004 time frame. However, we have chosen to delay that product's development indefinitely in favor of other future products.

SANnet II Family of Storage Solutions. We introduced our next generation open systems storage products, our SANnet II family, during the fourth quarter of 2002. SANnet II provides enterprise class functionality to the entry-level, midrange and high-end storage markets at attractive prices. Through our SANnet II family of networked storage solutions, we offer compact, rugged RAID arrays that support SAN and direct attached storage, or DAS, configurations. The SANnet II products provide 99.9998% uptime and are tested to operate in extreme environmental conditions. In addition, our SANnet II products share a common modular architecture and unified management system that integrates our SANpath and SANscape management software.

SANnet II FC. We launched our SANnet II FC storage product in March 2003. It is a Fibre Channel-based storage product for IT managers that require an open systems storage solution for integration with a SAN.

SANnet II Blade. We launched our SANnet II Blade product during the fourth quarter of 2003. It is an entry-level ultra-compact storage solution supporting capacities up to 1.75 TB for DAS architectures.

SANnet II SATA. We expect to launch our SANnet II SATA storage product in the second quarter of 2004. It is an entry-level and midrange Fibre Channel-based storage product supporting capacities up to 48 TB using SATA drives for IT managers requiring a compact near-line storage solution.

SANnet II FAS. We expect to launch our SANnet II FAS storage product in the fourth quarter of 2004. It is an entry-level and midrange Fibre Channel-based storage product supporting internal Fibre Channel fabric switches for IT managers requiring a compact SAN storage solution.

Chaparral Products. We acquired the following products in our acquisition of Chaparral. We expect to integrate Chaparral's RAID controller and router technology into our line of storage products.

Rio. Rio was launched during the third quarter of 2002. It is a midrange enterprise class RAID controller that can support up to eight independent Fibre Channel host ports. Its modular design scales from as little as 300 GB to as much as 35 TB of capacity.

Riva. Riva was launched during the second quarter of 2003. It is a SAN storage solution designed for bandwidth-intensive applications. Riva is scalable to 35 TB raw capacity, with up to 2.34 TB per enclosure.

Software. We develop application software technologies and products that are complementary to our overall storage solutions. Our host-based software is delivered as two primary application suites: SANpath and SANscape. Our software supports widely used open systems platforms, including Linux, Unix, and Windows.

SANpath. SANpath is our storage area networking software that improves system performance and enables storage multipathing to ensure comprehensive reliability, availability and serviceability. Originally released during the first quarter of 2000, SANpath functions with SCSI or Fibre Channel connections and storage hardware, including our SANnet II storage solutions deployed within either DAS or SAN architectures. All SANpath managed environments may be re-configured without interruptions to operating systems or applications.
SANpath provides a number of features, such as: path fail over, load balancing, dynamic volume management, the reassignment of storage volume without server restarts and secure storage volume assignment via access control lists.

SANscape. SANscape is our storage management software that facilitates the monitoring, configuration and maintenance of our SANnet II storage solutions using a Java-based graphical user interface and a variety of tools. Originally released during the first quarter of 2000, SANscape also creates an optional consolidated interface for the administration of SANpath.

SANscape can be used to manage various storage solutions deployed throughout an organization. Its event tools monitor the storage solutions under management and report status changes to administrators by email, pager and other means.

Sales and Marketing

We market and distribute our products globally through our channel partners and directly to certain customers. Our channel partners consist of OEMs, SIs and VARs, which we use to cost-effectively pursue a wide range of potential end-users. We rely on multiple channels to reach end-user customers that range in size from small businesses to government agencies and large multinational corporations. We have established a channel partner program consisting of three tiers which distinguishes and rewards our partners for their levels of commitment and performance. We maintain a sales and marketing organization operating out of our headquarters in Carlsbad, California, with regional offices in Germany, Japan, the Netherlands, Singapore and the United Kingdom as well as several smaller localized field sales offices throughout North America. Our products are sold under the Dot Hill brand name and under the names of our OEM customers. For the year ended December 31, 2001, sales to one customer accounted for approximately 15%. For the years ending 2002 and 2003, sales to another customer for approximately 25%, and 83%, respectively. For the year ended December 31, 2001, our accounts receivable from one customer was approximately 16%. For the year ended December 31, 2002, our accounts receivable from two customers were approximately 11% and 43%. For the year ended December 31, 2003, our accounts receivable from two customers were 12% and 56%. Generally, our customers have no minimum purchase requirements and have certain rights to extend, delay or cancel shipment of their orders without penalty.

As of December 31, 2003, our worldwide sales team consisted of 60 sales employees and 6 marketing employees.

OEMs

Our primary distribution channel is through OEMs. We have several OEM relationships and are actively developing new ones. Currently OEM partners include Comverse Technology, Motorola and Sun. OEMs generally resell our products under their own brand name and typically assume responsibility for marketing, sales, service and support. Our OEM relationships allow us to sell into geographic or vertical markets where each OEM has significant presence. For the years ended December 31, 2002 and 2003, OEM sales represented 55.9% and 85.9% of our net revenue, respectively. Sales to Sun accounted for 25.0% and 83.4% of our net revenue for the years ended December 31, 2002 and 2003, respectively. Sales to Comverse Technology accounted for 15.0%, 9.5% and 2.0% of our net revenue for the years ended December 31, 2001, 2002 and 2003, respectively.

Systems Integrators and Value Added Resellers

Most of our non-OEM products are sold in conjunction with SIs and VARs who work closely with our sales force to sell our products to end-users. SIs and VARs generally resell our products under the Dot Hill brand name and share responsibility with us for marketing, sales, service and support.

In North America we sell directly to SIs and VARs. In markets outside of North America, we have relationships with a number of distributors who offer our products to local VARs or, in some countries, directly to end-users. We believe international markets represent an attractive growth opportunity and

intend to expand the scope of our international sales efforts by continuing to actively pursue additional international distributors and resellers.

Service Providers

We sell directly to service providers, who integrate our storage products into their proprietary systems and provide access to their systems and related services to end-users. Our current service providers include NTT/Verio, Ofoto and MCI/UUNET.

Marketing

We support our OEM, SI and VAR channels with a broad array of marketing programs designed to build our brand name, attract additional channel partners and generate end-user demand. Our product marketing team, located in Carlsbad, California, focuses on product strategy, product development roadmaps, the new production introduction process, product lifecycle management, demand assessment and competitive analysis. The product marketing team also ensures that product development activities, product launches, channel marketing program activities and ongoing demand and supply planning occur on a well-managed, timely basis in coordination with our development, manufacturing and sales groups, as well as our sales channel partners. The groups work closely with our sales and research and development groups to align our product development roadmap to meet key channel technology requirements.

Our Relationship with Sun

In May 2002, we entered into a three-year OEM agreement with an annual renewal to provide our SANnet II and SANscape products for private label sales by Sun. This agreement was recently extended until May of 2007. During October 2002, we began shipping to Sun the first product in our SANnet II family of systems, SANnet II SCSI, for resale to Sun's customers. We began shipping our SANnet II FC to Sun in March 2003 and expect to begin delivery of a third product, SANnet II Blade, during the first quarter of 2004. We are developing new products for sale by Sun and expect our relationship to continue to expand. There are no minimum purchase agreements or guarantees in our agreement with Sun, and the agreement does not obligate Sun to purchase its storage solutions exclusively from us.

As of December 31, 2003, Sun held the right to acquire from us a number of shares of common stock equal to up to 3.2% of our common stock outstanding. In May 2002, in connection with the original OEM agreement, we issued a warrant to Sun to purchase 1,239,527 shares of our common stock. In February 2003, we issued a warrant to Sun in connection with a private placement of our preferred stock. As of December 31, 2003, this warrant was exercisable for 154,752 shares of our common stock. Under the terms of the warrants, we are obligated to file a registration statement with respect to the resale of all of the shares of our common stock issuable upon exercise of the warrants.

We believe that our relationships with market leaders like Sun strengthen our credibility in the marketplace, validate our technology and enable us to sell our products to a much broader customer base. In addition to expanding and enhancing our relationships with current OEM customers and other types of channel partners, we intend to add additional OEM customers as a part of our overall strategy.

End-users

End-users of our products represent a wide variety of industries and range from small businesses to large enterprises, government agencies and other institutions. Our products are currently installed across many industries and markets. The table below lists representative end-users of our products:

Defense Agencies	Entertainment	Financial Services	Government Agencies
Department of National Defense and Canadian Forces	AOL Time Warner	American Express	Mexico Department of Labor
	CBS MarketWatch	Citigroup	NASA
	Fox Cable Networks	Tudor Investment	National Institute of Health
U.K. Ministry of Defense	Home Box Office	UBS Financial Services	
U.S. Air Force	Vivendi Universal	VeriSign	
U.S. Army			U.S. Department of Justice
U.S. Navy			U.S. Department of State

Healthcare	Industrial/Technology	Telecommunications	Universities
Arena Pharmaceuticals	Boeing	Ameritech	CalTech
Bracco Diagnostics	General Dynamics	AT&T	CASPUR
GenVault	Lockheed Martin	Comverse Technology	CERN
Merck & Company	Raytheon	Lucent Technologies	Rutgers University
St. Jude Children's Research Hospital	Texas Instruments	NEC	University of Stuttgart
		Nortel Networks Corporation	
		NTT DoCoMo	

Customer Service and Support

We recognize that providing comprehensive, proactive and responsive support is essential to establishing new customer accounts and securing repeat business. We provide comprehensive, 24 hours a day, seven days a week, 365 days a year, global customer service and support, either directly or through third party service providers, aimed at simplifying installation, reducing field failures, minimizing system downtime and streamlining administration. Through direct and third party service providers, we maintain a global network of professional engineers and technicians who provide telephonic technical support in various languages from strategically-located global response centers on a 24 hour, seven day basis. In addition, we provide four hour on-site service response on a global basis. We also offer all of our customers access to SANsolve, our web-hosted interactive support knowledge base that gives our customers the ability to find answers to technical questions as well as initiate and track all support issues.

As part of our shift away from direct sales, we have also taken steps to better align our service and support structure with our new indirect sales model. We have:

- Encouraged our channel partners to provide support and service directly to end-users. For example, Sun, our primary channel partner, provides all but the fifth and final level of support and service to its end-users; we provide that final level of support and service;

- Focused on providing the higher levels of support for a fee and the establishment of authorized service providers; and

- Engaged Anacomp, Inc., or Anacomp, to be the exclusive provider of on-site maintenance, warranty and non-warranty services for customers who purchase new maintenance agreements for our prior generation SANnet product family and other legacy products. Anacomp also manages our non-warranty customers and is the exclusive distributor of spare parts for our

legacy products. In addition, Anacomp provides first and second level technical support for all of our product lines.

Despite our shift away from direct sales, we plan to continue to maintain our current service offerings, including onsite support contracts. These services will be performed either directly by us, or through the increased use of third party service providers.

Research and Development

Our research and development team is focused on developing innovative storage and networking products, storage management software for the open systems market, and the integration of our newly-acquired controller and router technology into Dot Hill designed storage systems. We have a history of industry firsts, including the first successfully commercialized hot-swappable SCSI Disk Array and RAID storage system for the Unix environment, and the first NEBS Level 3 certified and MIL STD-810F tested line of storage systems. We believe that our success depends on our ability to continuously develop products that meet changing customer needs and to anticipate and proactively respond to highly evolving technology in a timely and cost-effective manner. We also generally design and develop our products to have a modular architecture that can be scaled to meet customer needs and modified to respond to technological developments in the open systems computing environment across product lines.

Our areas of expertise include Linux, Unix and Windows driver and system software design, SAN storage resource management software design, data storage system design and integration, controller and router design and technology and high-speed data interface design. We are currently focusing development efforts on our next-generation family of storage systems and on our software products. Projects include the launch of additional members of the SANnet II family of systems, improvements to our storage software offerings and next generation high-speed solutions that will take advantage of the latest transports and technologies.

Our research and development activities are directed by individuals with significant expertise and industry experience. Our total research and development expenses were $10.0 million and $11.9 million for the years ended December 31, 2002 and 2003, respectively.

Manufacturing and Suppliers

Since 2002, we have outsourced substantially all of the manufacturing operations for our SANnet I and SANnet II systems and RAID controllers to third party manufacturing companies. We plan to integrate Chaparral's RAID controller and router technology into our line of storage products. By outsourcing manufacturing we have been able to reduce expenses related to our internal manufacturing operations and focus on our research and development activities. Under our OEM agreement with Sun, Sun has the right to require that we use a third party to manufacture our products. This external manufacturer must meet Sun's engineering, qualification and logistics requirements.

Intellectual Property

Our success depends significantly upon our proprietary technology. We have received registered trademark protection for the marks SANnet®, SANpath®, SANscape®, Dot Hill®, Dot Hill Systems® and the Dot Hill logo. With the acquisition of Chaparral, we acquired registered trademark protection for the marks Raidar®, Rio®, Riva® and Stratis®. We have attempted to protect our intellectual property rights primarily through copyrights, trade secrets, employee and third party nondisclosure agreements and other measures. We have registered trademarks and will continue to evaluate the registration of additional trademarks as appropriate. We claim common law protection for, and may seek to register, other trademarks. In addition, we generally enter into confidentiality agreements with our employees and with key vendors and suppliers.

As of December 31, 2003, we had been awarded a total of eight U.S. patents. We do not believe that those patents will provide us with any material competitive advantage. However, with the acquisition of Chaparral, we acquired one issued U.S. patent, two allowed U.S. patents and 13 U.S. patent applications that are in various stages of the patenting process. These patents and applications generally cover RAID controller and SAN technology. If we are unable to protect our intellectual property or infringe intellectual property of a third party, our operating results could be harmed.

Competition

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC Corporation, Hitachi Data Systems, LSI Logic Corp. and Network Appliance, Inc. We also compete with traditional suppliers of computer systems, including Dell Inc., Hewlett-Packard Development Company, L.P. and IBM Corp., 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. 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.

We believe the principal competitive factors in the storage systems market are:

- Product performance, features, scalability and reliability;
- Price;
- Product breadth;
- Timeliness of new product introductions; and
- Interoperability and ease of management.

We believe that we compete favorably in each of these categories. To remain competitive, we believe we must invest significant resources in developing new products, enhancing our current products, and maintaining high quality standards and customer satisfaction.

Employees

As of December 31, 2003, we had 196 full-time employees, of whom 66 were engaged in sales and marketing, 70 in research and development, 41 in manufacturing, 17 in general management and administration and two in customer service and support. We acquired an additional 51 employees as part of our acquisition of Chaparral in February 2004, of whom 11 were engaged in sales and marketing, 22 in research and development, five in manufacturing, eight in general management and administration and five in customer service and support. We have not had a work stoppage among our employees and none of our employees are represented under collective bargaining agreements. We consider our relations with our employees to be good.

Executive Officers of the Registrant at December 31, 2003

Name	Age	Position	Officer since
James L. Lambert	50	Chief Executive Officer, President and Director	August 1984*
Preston S. Romm	50	Chief Financial Officer, Vice President, Finance, Treasurer and Secretary	November 1999
Dana W. Kammersgard	48	Chief Technical Officer	August 1984*

*

Note: In 1999, Artecon, Inc. and Box Hill Systems Corp. merged to form Dot Hill Systems Corp. Artecon was founded in 1984 by James Lambert and Dana Kammersgard. Both Mr. Lambert and Mr. Kammersgard were officers of Artecon from its inception until the merger, and have been officers of Dot Hill since the merger.

All officers are elected by the board of directors and serve at the pleasure of the board of directors as provided in our bylaws.

James L. Lambert has served as a director and our Chief Executive Officer since August 2000. From August 1999 to August 2000, Mr. Lambert served as our Chief Operating Officer and Co-Chief Executive Officer. Since August 1999, he has also served as our President and a director. A founder of Artecon, Mr. Lambert served as President, Chief Executive Officer and director of Artecon from its inception in 1984 until August 1999. Mr. Lambert currently serves as a director of the Nordic Group of Companies, a group of privately held companies. He holds a B.S. and an M.S. in Civil and Environmental Engineering from University of Wisconsin, Madison. Mr. Lambert is William R. Savey's son-in-law.

Preston S. Romm has served as our Chief Financial Officer, Vice President, Finance and Treasurer since November 1999. Mr. Romm has also served as our Secretary since April 2001. From January 1997 to November 1999, Mr. Romm was Vice President of Finance, Chief Financial Officer and Secretary of Verteq, Inc., a privately-held semiconductor equipment manufacturer. From November 1994 to January 1997, Mr. Romm was Vice President of Finance and Chief Financial Officer of STM Wireless, Inc., a wireless data and voice equipment manufacturer. From July 1990 to November 1994, Mr. Romm was Vice President and Controller of MTI Technology Corporation, a provider of data storage systems. Mr. Romm holds a B.S. in Accounting from the University of Maryland and a M.B.A. from American University.

Dana W. Kammersgard has served as our Chief Technical Officer since August 1999. Mr. Kammersgard was a founder of Artecon and served as a director from its inception in 1984 until August 1999. At Artecon, Mr. Kammersgard served in various positions since 1984, including Secretary and Senior Vice President of Engineering from March 1998 until August 1999 and as Vice President of Sales and Marketing from March 1997 until March 1998. Prior to co-founding Artecon, Mr. Kammersgard was the director of software development at CALMA, a division of General Electric Company. Mr. Kammersgard holds a B.A. in Chemistry from the University of California, San Diego.

Certain Risk Factors Related to the Company'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-K, 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 25.0% and 83.4% of our net revenue for the years ended December 31, 2002 and 2003, respectively. Our OEM agreement with Sun had an initial term of three years and has been renewed by Sun 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, 2004 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 years, which is our third quarter, could be harmed.

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 is 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 net 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.

The integration of Chaparral may be difficult, resulting in costs or leading to disruptions in relationships with customers or suppliers, any of which could have an adverse effect on our financial results and operations.

In February 2004, we acquired all the outstanding shares of Chaparral. Integrating Chaparral's technologies and businesses will be a complex, time-consuming and possibly expensive process. Before the acquisition, Chaparral had its own business, culture, products, customers, employees and systems. After the acquisition, the companies intend to operate as a combined organization using common information and communication systems, operating procedures, financial controls and human resource practices. We cannot be assured that the engineers from Chaparral and other employees whom we wish to retain will continue their employment relationships with us. In offering both our product lines and those of Chaparral, we will incur the expenses involved with supporting and producing two different product lines. Eventually, we expect to merge the product lines, and in doing so we risk losing customers who preferred one line over the other.

Further, we may not be able to integrate the Chaparral technology, particularly the RAID technology, into our product lines as we now plan. Certain customers may seek alternative sources of product, supply, or service due to these perceptions or based simply upon a desire not to do business with the combined company. Further, our relationships with suppliers may become disrupted, as the suppliers (particularly of RAID controllers) fear a threat of being replaced by the technology acquired in the transaction.

Our combined company also will have more distribution channels than we had prior to the acquisition. The combined company's resellers may target similar sales opportunities. These overlapping sales efforts could adversely affect relationships with resellers and other sales channels, and result in resellers being less willing to market our products aggressively, or at all.

Other possible risks stemming from the acquisition of Chaparral may include:

- the diversion of management resources from business operations to the merging of the two companies;
- perceived adverse change in customer service standards, billing or pricing practices or product offerings which may cause customers to terminate relationships with the combined company;
- costs and delays in implementing common systems and procedures; and
- potential inefficiencies in delivering products to customers of the combined company.

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 shipments 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 could result in cash flow problems or a decline in our stock price.

We have experienced losses in the past and may experience losses in the future; we may need to raise additional funds to continue our operations.

For the years ended December 31, 2001 and 2002, we incurred net losses of $43.4 million and $34.3 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 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 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 December 31, 2003 totaled $191.5 million (of which $62 million was used in the acquisition of Chaparral in February 2004), which, together with cash generated by operations, we believe will finance our operations through at least the next twelve months and we do not now contemplate the need to raise additional funds. 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 funds sooner than we expect. 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

Quarter	Net Revenue	Net Income (Loss)
Fourth Quarter 2003	57.5	6.7

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 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 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 revenue 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 decreases our margins.

Pricing pressures exist in the data storage market and have harmed and may in the future continue to harm our 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 the 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 and with the acquisition of Chaparral, we acquired registered trademarks for Raidar, Rio, Riva and Stratis. As of December 31, 2003, we had been awarded a total of eight U.S. patents and with the acquisition of Chaparral, we acquired one issued U.S. patent, two allowed U.S. patents and 13 U.S. patent applications that are in various stages of the patenting process. 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 Corporation, Hitachi Data Systems, LSI Logic Storage Systems and Network Appliance. We also compete with traditional suppliers of computer systems, including Dell Computer Corporation, Hewlett-Packard Company, and IBM Corporation, 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 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 us or our competitors 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 continue to 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 to 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 plan to introduce new products into our SANnet II family of systems. 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 President and Chief Executive Officer, Dana Kammersgard, our Chief Technical Officer, 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 recently 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 December 31, 2003, our executive officers, directors and their affiliates beneficially owned approximately 8.8% 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 December 31, 2003, there were outstanding warrants to purchase 2,034,551 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.

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 1,394,279 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 which 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

Item 2. Properties

Our headquarters and principal research and marketing facilities occupy approximately 70,000 square feet in Carlsbad, California, under a renewable lease that expires in December 2005. In addition, we lease a sales office in Boston, Massachusetts, and six international offices in five countries: Germany, Japan, the Netherlands, Singapore and the United Kingdom. With the acquisition of Chaparral, we added a research and development facility that occupies approximately 25,000 square feet in Longmont, Colorado, under a lease that expires in July 2007. Solectron manufactures substantially all of our products. We believe that with our existing facilities and Solectron's manufacturing capabilities, we have the capacity to meet any potential increases to our forecasted production requirements and therefore believe our facilities are adequate to meet our needs in the foreseeable future.

Item 3. Legal Proceedings

On October 17, 2003, 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.

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 4. Submission of Matters to Vote of Security Holders

None.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock traded on the New York Stock Exchange beginning on September 16, 1997 under the symbol "BXH". In August 1999, Box Hill Systems merged with Artecon and we changed our name to Dot Hill Systems Corp. and our trading symbol changed to "HIL". We moved to the American Stock Exchange on December 12, 2002, where we continued to trade our common stock under the symbol "HIL". On July 28, 2003, our common stock was included for quotation on the Nasdaq National Market where our common stock is currently traded under the symbol "HILL".

The following table sets forth for the periods indicated the per share range of the high and low closing sales prices or closing bid prices, of our common stock as reported on the New York Stock Exchange, the American Stock Exchange or the Nasdaq National Market, as applicable.

	Low	High
Year Ended December 31, 2002		
First Quarter	$ 1.55	$ 3.15
Second Quarter	2.10	4.69
Third Quarter	2.50	3.95
Fourth Quarter	1.60	3.50
Year Ended December 31, 2003		
First Quarter	$ 3.10	$ 6.12
Second Quarter	6.01	14.00
Third Quarter	13.52	18.95
Fourth Quarter	12.66	17.37

On March 11, 2004 the last reported sale price for our common stock on the Nasdaq National Market was $11.53 per share. As of March 11, 2004, there were 43,315,222 shares of our common stock outstanding held by approximately 6,975 holders of record.

We have never paid any cash dividends on our common stock, and currently intend to retain future earnings, if any, to the extent possible to fund the development and growth of our business. We do not anticipate paying any cash dividends on our common stock in the foreseeable future.

The information required to be disclosed by item 201(d) of Regulation S-K "*Securities Authorized for Issuance Under Equity Compensation Plans"* is included under Item 12 of Part III of this Annual Report on Form 10-K.

Item 6. Selected Financial Data

In August 1999, Box Hill Systems merged with Artecon and we changed our name to Dot Hill Systems Corp. Our accompanying financial statements have been retroactively restated to reflect the Merger of Box Hill and Artecon, which was accounted for as a pooling of interests. We derived the selected consolidated financial data presented below from our consolidated financial statements. You should read the selected consolidated financial data together with our consolidated financial statements and related notes thereto and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Annual Report on Form 10-K.

Statement of operations data for the years ended December 31, 2001, 2002 and 2003, and the balance sheet data as of December 31, 2002 and 2003 have been derived from our audited consolidated financial statements which are included elsewhere in this Annual Report on Form 10-K. Statement of operations data for the years ended December 31, 1999 and 2000 and balance sheet data as of

December 31, 1999, 2000 and 2001 have been derived from our audited consolidated financial statements not included herein.

	Year Ended December 31,				
	1999	2000	2001	2002	2003
	(in thousands, except per share data)				
Statement of Operations Data:					

	Year Ended December 31,				
Net revenue	$ 124,216	$ 121,197	$ 56,277	$ 46,936	$ 187,448
Cost of goods sold	86,612	77,730	44,818	45,444	142,550
Gross profit	37,604	43,467	11,459	1,492	44,898
Operating expenses:					
Sales and marketing	24,204	31,747	23,717	22,513	14,086
Research and development	7,401	8,798	6,673	10,043	11,950
General and administrative	10,837	6,891	4,533	5,150	7,418
Impairment of intangible assets	1,224				
Merger and restructuring expenses	7,392		4,905	1,550	
Operating income (loss)	(13,454)	(3,969)	(28,369)	(37,764)	11,444
Net income (loss)	$ (9,047)	$ (948)	$ (43,391)	$ (34,303)	$ 12,131
Net income (loss) attributable to common stockholders	$ (9,047)	$ (948)	$ (43,391)	$ (34,759)	$ 11,990
Net income (loss) per share:					
Basic	$ (0.39)	$ (0.04)	$ (1.76)	$ (1.39)	$ 0.35
Diluted	$ (0.39)	$ (0.04)	$ (1.76)	$ (1.39)	$ 0.31
Weighted average shares outstanding:					
Basic	23,385	24,253	24,703	24,953	33,856
Diluted	23,385	24,253	24,703	24,953	38,164

	As of December 31,				
	1999	2000	2001	2002	2003
	(in thousands)				
Balance Sheet Data:					
Cash, cash equivalents, restricted cash and short-term investments	$ 47,951	$ 33,653	$ 16,457	$ 12,082	$ 191,545
Working capital	58,946	54,454	25,832	2,224	177,650
Total assets	103,658	102,879	46,191	32,228	218,443
Total long-term debt	272	186	330	275	247
Total stockholders' equity	72,823	73,770	30,611	5,785	184,133

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes thereto included in this Annual Report on Form 10-K.

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 OEMs, SIs and VARs. In May 2002, we entered into a three-year OEM agreement with Sun to provide our storage hardware and software products for private label sales by Sun, and that agreement was recently extended until May 2007. We have been shipping our products to Sun for resale to Sun's customers since October 2002. We continue to develop new products for resale by Sun and other channel partners and expect to begin shipping additional new products for resale later this year. 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 third party electronics manufacturing services companies. Outsourcing allows us to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of various manufacturing and procurement economies of scale.

We derive net revenue primarily from sales of our SANnet II family of products. In prior periods, we derived a significant portion of our net revenue from sales of our legacy products and SANnet I family of products. Except for two OEM customers, one of which continues to buy our SANnet I products and the other of which continues to buy a legacy system, we have transitioned all customers to our SANnet II products. We derive a portion of our net 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, restricted cash and short-term investments and other miscellaneous income and expense items.

In February 2004, we acquired all the outstanding shares of Chaparral, a privately-held storage system provider. We expect to integrate Chaparral's RAID controller and router technology into our line of storage products. We plan to retain Chaparral's Colorado facility as a research and development hub and to continue to use Chaparral's team of engineers and facility support personnel.

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

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, 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 the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated 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.

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:

	Year Ended December 31,		
	2001	**2002**	**2003**

	Year Ended December 31,		
Net revenue	100.0%	100.0%	100.0%
Cost of goods sold	79.6	96.8	76.0
Gross profit	20.4	3.2	24.0
Operating expenses:			
Sales and marketing	42.1	48.0	7.5
Research and development	11.9	21.4	6.4
General and administrative	8.1	11.0	4.0
Restructuring expenses	8.7	3.3	
Operating income (loss)	(50.4)	(80.5)	6.1
Net income (loss)	(77.1)%	(73.1)%	6.5%

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Net Revenue

Net revenue increased $140.5 million, or 299.4%, to $187.4 million for the year ended December 31, 2003 from $46.9 million for the year ended December 31, 2002. The increase in net revenue was attributable to increased orders for our products from our channel partner, Sun, which accounted for 83.4% of our net revenue for the year ended December 31, 2003.

Cost of Goods Sold

Cost of goods sold increased $97.1 million, or 213.7%, to $142.5 million for the year ended December 31, 2003 from $45.4 million for the year ended December 31, 2002. As a percentage of net revenue, cost of goods sold decreased to 76.0% for the year ended December 31, 2003 from 96.8% for the year ended December 31, 2002. The increase in the dollar amount of cost of goods sold was attributable to greater volume of product sales during the year ended December 31, 2003. The decrease in cost of goods sold as a percentage of our net revenue was primarily attributable to a more efficient absorption of fixed production costs and to a lesser extent a decrease in inventory write-downs of $6.6 million.

Gross Profit

Gross profit increased $43.4 million, or 2,909.2%, to $44.9 million for the year ended December 31, 2003 from $1.5 million for the year ended December 31, 2002. As a percentage of net revenue, gross profit increased to 24.0% for the year ended December 31, 2003 from 3.2% for the year ended December 31, 2002. The increase in the dollar amount of gross profit was attributable to greater volume of product sales during the year ended December 31, 2003. The increase in gross profit as a

percentage of our net revenue was primarily attributable to a more efficient absorption of fixed production costs and to a lesser extent a decrease in inventory write-downs of $6.6 million.

Sales and Marketing Expenses

Sales and marketing expenses decreased $8.4 million, or 37.4%, to $14.1 million for the year ended December 31, 2003 from $22.5 million for the year ended December 31, 2002. As a percentage of net revenue, sales and marketing expenses decreased to 7.5% for the year ended December 31, 2003 from 48.0% for the year ended December 31, 2002. The decrease in the dollar amount of sales and marketing expenses was attributable to a reduction in our sales and marketing headcount of 24 employees between December 31, 2002 and December 31, 2003. The reduction was made in conjunction with our shift toward an indirect sales model, implementation of fixed cost reduction measures, such as closure of excess and unused facilities, and the refocus of our marketing resources on a smaller population of potential customers.

Research and Development Expenses

Research and development expenses increased $1.9 million, or 19.0%, to $11.9 million for the year ended December 31, 2003 from $10.0 million for the year ended December 31, 2002. As a percentage of net revenue, research and development expenses decreased to 6.4% for the year ended December 31, 2003 from 21.4% for the year ended December 31, 2002. The increase in the dollar amount of research and development expenses was primarily attributable to an increase in salary and related expenses of $2.1 million attributable to an increase in the number of our full-time direct engineering team members, an increase of regulatory testing costs of $0.3, an increase of allocable fixed costs of $0.5 million, offset by a reduction of prototype costs related to the development of our SANnet II product line of $1.5 million. We expect to continue to invest in research and development and plan to add more members to our research and development team during 2004.

General and Administrative Expenses

General and administrative expenses increased $2.2 million, or 44.0%, to $7.4 million for the year ended December 31, 2003 from $5.2 million for the year ended December 31, 2002. As a percentage of net revenue, general and administrative expenses decreased to 4.0% for the year ended December 31, 2003 from 11.0% for the year ended December 31, 2002. The increase in the dollar amount of general and administrative expense was attributable to increased bonus expense of $1.8 million, and increased legal expenses of $0.4 million.

Restructuring Expenses

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

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

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

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

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

The following is a summary of restructuring activity recorded during the years ended December 31, 2002 and 2003:

March 2001 Restructuring

	Accrued Restructuring Expenses at January 1, 2002	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002	Amounts Utilized in 2003	Accrued Restructuring Expenses at December 31, 2003
	(in thousands)					
Employee termination costs	$ 2	$	$ (2)	$	$	$
Facility closures and related costs	394	693	(426)	661	(260)	401

	Accrued Restructuring Expenses at January 1, 2002	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002	Amounts Utilized in 2003	Accrued Restructuring Expenses at December 31, 2003
Total	$ 396	$ 693	$ (428)	$ 661	$ (260)	$ 401

June 2001 Restructuring

	Accrued Restructuring Expenses at January 1, 2002	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002	Amounts Utilized in 2003	Accrued Restructuring Expenses at December 31, 2003
				(in thousands)		
Facility closures and related costs	$ 845	$ 857	$ (777)	$ 925	$ (402)	$ 523

We believe that there are no unresolved issues or additional liabilities that may result in a significant adjustment to restructuring expenses accrued as of December 31, 2003.

Other Income

Other income increased $0.4 million, or 125.3%, to $0.8 million for the year ended December 31, 2003 from $0.4 million for the year ended December 31, 2002. The increase was primarily attributable to an increase in interest income realized from short-term investments.

Income Taxes

Our effective income tax rate for the year ended December 31, 2003 of 0.7% is primarily attributable to federal and state minimum tax liabilities as well as local and foreign taxes. Our effective income tax rate for the year ended December 31, 2003 was significantly reduced through the use of net operating loss carryforwards for which a valuation allowance had previously been recorded. Our effective income tax rate for the year ended December 31, 2002 was 8.3%, primarily as a result of an

income tax benefit resulting from tax refunds made available by recent tax law changes partially offset by state, local and foreign taxes.

As of December 31, 2003, a valuation allowance of $39.0 million has been provided based upon our assessment of the future realizability of our deferred income tax assets, as it is currently considered more likely than not that sufficient taxable income will not be generated to realize these temporary differences.

Additionally, at December 31, 2003, approximately $4.2 million of the valuation allowance is attributable to the potential tax benefit of stock option transactions that will be credited directly to common stock, if realized.

As of December 31, 2003, we have federal and state net operating loss carryforwards of approximately $80.7 million and $53.8 million, which begin to expire in 2009 and 2004, respectively. In addition, we have federal tax credit carryforwards of approximately $2.4 million, of which $0.2 million can be carried forward indefinitely to offset future taxable income, and the remaining $2.2 million will begin to expire in the tax year 2008. We also have state tax credit carryforwards of $2.3 million, of which $2.1 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.2 million will begin to expire in 2006.

As a result of the Company's equity transactions, an ownership change, within the meaning of Internal Revenue Code Section 382, occurred on September 18, 2003. As a result, annual use of the Company's federal net operating loss and credit carry forwards is limited to (i) the aggregate fair market value of Artecon immediately before the ownership change multiplied by (ii) the long-term tax-exempt rate (within the meaning of Section 382 (f) of the Internal Revenue Code) 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.

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.

Net Income (Loss)

Net income increased $46.4 million to net income of $12.1 million for the year ended December 31, 2003 from a net loss of $34.3 million for the year ended December 31, 2002. This increase of $46.4 million was due to an increase in gross profit of $43.4 million, a decrease in operating expenses of $5.8 million, an increase in other income of $0.4 million offset by a decrease in income tax benefit of $3.2 million.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

Net Revenue

Net revenue decreased $9.4 million, or 16.6%, to $46.9 million for the year ended December 31, 2002 from $56.3 million for the year ended December 31, 2001. The decrease in net revenue was attributable to unfavorable market conditions resulting in a 49.3% decrease in sales from the telecommunications sector and a 38.5% decrease in sales from the commercial sector, partially offset by an $11.6 million increase in sales to our largest OEM customer.

Cost of Goods Sold

Cost of goods sold increased $0.6 million, or 1.4%, to $45.4 million for the year ended December 31, 2002 from $44.8 million for the year ended December 31, 2001. As a percentage of net revenue, cost of goods sold increased to 96.8% for the year ended December 31, 2002 from 79.6% for

33

the year ended December 31, 2001. The increase both in absolute terms and as a percentage of net revenue, is attributable to a $8.3 million charge over the course of 2002 for excess and obsolete inventory, $5.1 million of which was related to the impact that our SANnet II product launch had on inventories of our legacy SANnet product, and $2.0 million in ramp-up costs and inefficiencies incurred during the fourth quarter of 2002 related to our new SANnet II SCSI product, which was launched in October 2002.

Gross Profit

Gross profit decreased $10.0 million, or 87.0%, to $1.5 million for the year ended December 31, 2002 from $11.5 million for the year ended December 31, 2001. As a percentage of net revenue, gross profit decreased to 3.2% for the year ended December 31, 2002 from 20.4% for the year ended December 31, 2001. The decrease in gross profit, both in absolute terms and as a percentage of net revenue, is attributable to a $8.3 million charge over the course of 2002 for excess and obsolete inventory, $5.1 million of which was related to the impact that our SANnet II product launch had on inventories of our legacy SANnet product, and $2.0 million in ramp-up costs and inefficiencies incurred during the fourth quarter of 2002 related to our new SANnet II SCSI product, which was launched in October 2002.

Sales and Marketing Expenses

Sales and marketing expenses decreased $1.2 million, or 5.1%, to $22.5 million for the year ended December 31, 2002 from $23.7 million for the year ended December 31, 2001. As a percentage of net revenue, sales and marketing expenses increased to 48.0% for the year ended December 31, 2002 from 42.1% for the year ended December 31, 2001. We incurred a one-time charge to sales and marketing expenses of $3.6 million related to the issuance of a warrant to purchase our common stock to Sun in May 2002. The decrease in the dollar amount of sales and marketing expenses, excluding the charge for the warrant, is attributable to fixed cost reduction measures, such as geographical restructuring of the sales force and our efforts to focus our marketing resources on a smaller population of potential channel partners.

Research and Development Expenses

Research and development expenses increased $3.3 million, or 50.5%, to $10.0 million for the year ended December 31, 2002 from $6.7 million for the year ended December 31, 2001. As a percentage of net revenue, research and development expenses increased to 21.4% for the year ended December 31, 2002 from 11.9% for the year ended December 31, 2001. The increase in the dollar amount of research and development expenses is attributable to costs related to the development of our next-generation SANnet II product line, the first member of which was released in October 2002. In addition, the increase as a percentage of net revenues was due in part to lower sales revenue during 2002 compared to 2001.

General and Administrative Expenses

General and administrative expenses increased $0.7 million, or 13.6%, to $5.2 million for the year ended December 31, 2002 from $4.5 million for the year ended December 31, 2001. As a percentage of net revenue, general and administrative expenses increased to 11% for the year ended December 31, 2002 from 8.1% for the year ended December 31, 2001. The increase in the dollar amount of general and administrative expenses resulted primarily from increased premiums for directors and officers insurance of approximately $0.2 million, and legal expenses of approximately $0.4 million associated with the Sun, Solectron and Infortrend business arrangements.

Restructuring Expenses

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

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

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

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

The following is a summary of restructuring activity recorded during the years ended December 31, 2001 and 2002:

March 2001 Restructuring

	Restructuring Expenses in 2001	Amounts Utilized in 2001	Accrued Restructuring Expenses at December 31, 2001	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002
	(in thousands)					
Employee termination costs	$ 1,271	$ (1,269)	$ 2	$	$ (2)	$
Impairment of property and equipment	1,007	(1,007)				
Facility closures and related costs	792	(398)	394	693	(426)	661
Professional fees and other	20	(20)				

	Restructuring Expenses in 2001	Amounts Utilized in 2001	Accrued Restructuring Expenses at December 31, 2001	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002
Total	$ 3,090	$ (2,694)	$ 396	$ 693	$ (428)	$ 661

June 2001 Restructuring

	Restructuring Expenses in 2001	Amounts Utilized in 2001	Accrued Restructuring Expenses at December 31, 2001	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002
	(in thousands)					
Employee termination costs	$ 259	$ (259)	$	$	$	$
Impairment of property and equipment	350	(350)				
Facility closures and related costs	1,206	(361)	845	857	(777)	925
Total	$ 1,815	$ (970)	$ 845	$ 857	$ (777)	$ 925

Other Income

We had net other income of $0.3 million in each of 2002 and 2001. Although there was no change to total other income, interest income decreased by approximately $0.6 million from 2001 to 2002 as a result of converting higher-yielding investment securities into a lower-yield money market account and offsetting the decrease in interest income was a decrease in other expense resulting from an approximately $0.7 million accrual made during 2001 for a pending litigation settlement.

Income Taxes

During the second quarter of 2002, we recorded an income tax benefit of $3.3 million related to tax refunds made available by recent tax law changes. We received $0.9 million of this benefit during 2002 and $2.4 million in 2001.

Our 2002 effective income tax rate of 8.3% reflects federal income tax refunds made available by recent tax law changes partially offset by state, local and foreign taxes. Our effective income tax rate for 2001 was (54.6)%, primarily as a result of a $16.0 million charge to the income tax provision in connection with an increase in the valuation allowance provided for deferred income tax assets.

Net Income (Loss)

Net loss decreased $9.1 million to net loss of $34.3 million for the year ended December 31, 2002 from a net loss of $43.4 million for the year ended December 31, 2001. This decrease of $9.1 million was due to a decrease in gross profit of $10.0 million, a decrease in operating expenses of $0.6 million, and a decrease in income tax expense of $18.5 million.

Liquidity and Capital Resources

As of December 31, 2003, we had $191.5 million of cash, cash equivalents and short-term investments and working capital of $177.7 million.

During September 2003, we received net proceeds of approximately $144.8 million from a secondary public offering of 9,904,000 shares of our common stock at a price of $15.50 per share.

Subsequent to December 31, 2003, we consummated the acquisition of Chaparral for a cash purchase price of approximately $62 million plus the assumption of approximately $4.1 million in liabilities.

For the year ended December 31, 2003, cash provided by operating activities was $20.7 million compared to cash used in operating activities of $12.4 million for the same period in 2002. The net cash provided by operating activities is attributable to net income of $12.1 million, a $3.8 million

decrease in inventories, a $10.1 million increase in accounts payable, a $3.2 increase in accrued compensation and other expenses, offset by a $8.0 million increase in accounts receivable, and a $1.6 million increase in prepaid expenses and other assets.

Cash used in investing activities in 2003 was $55.8 million compared to cash provided by investing activities of $6.2 million for the same period in 2002. The cash used in investing activities in 2003 resulted from a $58.4 million purchase of short-term investments, a $2.8 million purchase of property and equipment, offset by $5.4 million for sales of short-term investments.

Cash provided by financing activities was $163.5 million for 2003, compared to $8.4 million for 2002. The cash provided by financing activities is attributable to net proceeds from the issuance of common stock of $161.3 million, bank and other borrowings of $45.2 million, exercises of stock options under the Company's 2000 Stock Incentive Plan and the Company's 2000 Employee Stock Purchase Plan of $5.0 million, a decrease in restricted cash of $2.0 million, offset by payments made on bank and other borrowings of $49.8 million.

We have an agreement with Wells Fargo Bank, National Association, which allows us to borrow up to $15.0 million under a revolving line of credit that expires May 1, 2004. The maximum amount we may borrow under this line is limited by the amount of our cash and investment balances held at the bank at any given time and may be reduced by the amount of any outstanding letters of credit with the bank. Borrowings under this line of credit are collateralized by a pledge of our deposits held at the bank. As of December 31, 2003, the amount available on this line was $15.0 million. Borrowings under this line of credit incur interest at the bank's prime rate or 50 basis points above LIBOR, at our option. Each month we pay interest only on outstanding balances, with the principal due at maturity. As of December 31, 2003, there was no balance outstanding under this line of credit.

Our Japanese subsidiary has two lines of credit with Tokyo Mitsubishi Bank and one line of credit with National Life Finance Corporation in Japan, for borrowings of up to an aggregate of 45 million yen, or approximately $0.4 million as of December 31, 2003, at interest rates ranging from 1.7% to 1.8%. Interest is due monthly, with principal due and payable on various dates through August 2008. Borrowings are secured by the inventories of our Japanese subsidiary. As of December 31, 2003, the total amount outstanding under the three credit lines was approximately 26.5 million yen, or approximately $0.2 million.

For the year ended December 31, 2003, we had cash flow from operations of $20.7 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 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.

The following table summarizes our contractual obligations as of December 31, 2003 (in thousands).

		Payments due by period			
Contractual obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Long-Term Debt Obligations	$ 247	$	$	$ 247	$
Operating Lease Obligations	4,553	1,677	2,306	529	41
Total	$ 4,800	$ 1,677	$ 2,306	$ 776	$ 41

Effect of Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force, or EITF, reached a consensus on Issue 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF Issue 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We do not expect the adoption of EITF Issue 00-21 to have a significant effect on our financial statements.

In May 2003, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Account Standards, or SFAS, No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective for the first interim period beginning after June 15, 2003, with certain exceptions. The adoption of this statement, effective July 1, 2003, had no effect on our financial statements.

Item 7A. 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, 2002 and 2003. For investment securities, the table presents carrying values at December 31, and related weighted average interest rates by expected maturity dates.

	December 31,	
	2002	2003
	(amounts in thousands)	
Cash equivalents	$ 10,084	$ 127,790
Average interest rate	3.3%	1.0%
Short-term investments	$	$ 52,982
Average interest rate		1.6%
Total portfolio	$ 10,084	$ 180,772
Average interest rate	3.3%	1.2%

We have a line of credit agreement, which accrues interest at a variable rate. As of December 31, 2003, we had no balance under this line. Were we to incur a balance under this line, 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 8. Financial Statements and Supplementary Data

The information required by this Item is incorporated by reference from the financial statements beginning on page F-1 of this Annual Report on Form 10-K.

Item 9. Changes In and Disagreements With Accountants On Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

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

There have been no changes in our internal controls over financial reporting during our fourth fiscal quarter of 2003 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

Item 10. Directors and Executive Officers of the Registrant

Some of the information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2004 annual meeting under the headings "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance." Other information required by this item is incorporated by reference to Item 1 of Part I of this Annual Report on Form 10-K under the heading "Executive Officers of the Registrant at December 31, 2003."

Item 11. Executive Compensation

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2004 annual meeting under the heading "Compensation of Executive Officers."

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information under the heading "Security Ownership of Certain Beneficial Owners and Management" in our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2004 annual meeting is incorporated herein by this reference.

The following table sets forth our equity securities authorized for issuance under equity compensation plans as of December 31, 2003.

Stock Plan	Number of securities to be issued upon exercise of outstanding options and rights	Weighted average exercise price of outstanding options and rights	Number of securities remaining available for future issuance
2000 Equity Incentive Plan(1)	3,030,977	$4.96	1,009,240
Employee Stock Purchase Plan(2)	Not Applicable	Not Applicable	46
2000 Non-Employee Directors' Stock Option Plan	224,750	$6.74	260,000
Total	3,255,727	$5.08	1,269,286

(1) The 2000 Amended and Restated Equity Incentive Plan provides for an annual increase to the share reserve, to be added on the date of each annual stockholder's meeting, equal to the lesser of (i) 1 million shares; (ii) 2% of our outstanding shares on such date, calculated on a fully diluted basis and assuming the conversion of all outstanding convertible securities and the exercise of all outstanding options and warrants, or; (iii) an amount to be determined by our board of directors.

(2) The Employee Stock Purchase Plan provides for an annual increase to the share reserve, to be added on the date of each annual stockholders' meeting, equal to the lesser of: (i) 100,000 shares, or; (ii) an amount to be determined by our board of directors.

All of our equity compensation plans have been approved by our stockholders.

Item 13. Certain Relationships and Related Transactions

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2004 annual meeting under the heading "Certain Transactions."

Item 14. Principal Accountant Fees and Services

The information required by this item is incorporated by reference to our Definitive Proxy Statement to be filed with the SEC pursuant to Regulation 14A in connection with our 2004 annual meeting under the heading "Ratification of Selection of Independent Auditors."

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) The following documents are filed as part of this report:

(1) Financial statements:

The consolidated balance sheets as of December 31, 2002 and 2003, and the consolidated statements of operations and comprehensive operations, stockholders' equity and cash flows for the years ended December 31, 2001, 2002 and 2003, together with notes thereto.

(2) Financial statement schedules required to be filed by Item 8 and Item 15(d) of this Form:

Schedule II Valuation and Qualifying Accounts.

All other schedules have been omitted from this annual report because they are not applicable or because the information required by any applicable schedule is included in the consolidated financial statements or the notes thereto.

(3) Exhibits:

Exhibit Number	Description
2.1	Agreement and Plan of Merger dated as of February 23, 2004, by and among the Registrant, DHSA Corp., Chaparral Network Storage, Inc., and C. Timothy Smoot, as Stockholders' Representative.(1)
3.1	Certificate of Incorporation of the Registrant.(2)
3.2	By-laws of the Registrant.(2)
4.1	Certificate of Incorporation of the Registrant.(2)
4.2	By-laws of the Registrant.(2)
4.3	Form of Common Stock Certificate.(3)
4.4	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003.(4)
4.5	Form of Rights Certificate.(4)
4.6	Warrant to Purchase Shares of Common Stock dated May 24, 2002.(5)
4.7	Common Stock Warrant dated December 19, 2002.(5)
4.8	Warrant to Purchase Shares of Common Stock dated February 14, 2003.(5)
4.9	Common Stock Warrant dated March 14, 2003.(5)
10.1	Product Purchase Agreement between the Registrant and Sun Microsystems, Inc. dated May 24, 2002.(6)
10.2	Product Supplement/Award Letter for Blade Product under agreement with Sun Microsystems, Inc. dated May 24, 2002.(6)
10.3	Product Supplement/Award Letter for SCSI Product under agreement with Sun Microsystems, Inc. dated May 24, 2002.(6)
10.4	Product Supplement/Award Letter for FC Product under agreement with Sun Microsystems, Inc. dated May 24, 2002.(6)

10.5	Employment letter agreement dated August 2, 1999 between the Registrant and James L. Lambert.(7)
10.6	Employment letter agreement dated August 2, 1999 between the Registrant and Dana W. Kammersgard.(7)
10.7	Employment offer letter dated November 12, 1999 between the Registrant and Preston Romm.(7)
10.8	Lease for Registrant's headquarters in Carlsbad, California, dated June 9, 1993.(5)
10.9	2000 Amended and Restated Equity Incentive Plan.(8)
10.10	Form of Stock Option Agreement (Incentive and Nonstatutory Stock Options) used in connection with the 2000 Amended and Restated Equity Incentive Plan.(8)
10.11	Form of Stock Option Grant Notice used in connection with the 2000 Amended and Restated Equity Incentive Plan.(8)
10.12	2000 Amended and Restated Employee Stock Purchase Plan.(8)
10.13	2000 Non-Employee Directors Stock Option Plan.(9)
10.14	Form of Stock Option Agreement used in connection with the 2000 Non-Employee Directors' Stock Option Plan.(9)
10.16	Credit Agreement dated February 6, 2001 among the Registrant, Silicon Alley Management, Inc. and Wells Fargo Bank, National Association.(10)
10.17	Revolving Line of Credit Note dated February 6, 2001 issued by the Registrant and Silicon Alley Management, Inc. to Wells Fargo Bank, National Association.(10)
10.18	Third Party Security Agreement dated February 6, 2001 made by the Registrant and Silicon Alley Management, Inc. in favor of Wells Fargo Bank, National Association.(10)
10.19	Manufacturing Agreement between the Registrant and Solectron Corporation, dated May 20, 2002.(11)
10.20	OEM Agreement between the Registrant and Infortrend Technology, Inc, supplier of controllers, dated May 20, 2002.(11)
10.21	2002 Executive Compensation Plan for James L. Lambert, effective January 1, 2002.(12)
10.22	2002 Executive Compensation Plan for Dana Kammersgard, effective January 1, 2002.(13)
10.23	2002 Executive Compensation Plan for Preston Romm, effective January 1, 2002.(13)
10.24	2003 Executive Compensation Plan for James L. Lambert, effective January 1, 2003.(5)
10.25	2003 Executive Compensation Plan for Dana Kammersgard, effective January 1, 2003.(5)
10.26	2003 Executive Compensation Plan for Preston Romm, effective January 1, 2003.(5)
10.27	Change of Control Agreement dated August 23, 2001 between the Registrant and James L. Lambert.(14)
10.28	Change of Control Agreement dated August 23, 2001 between the Registrant and Dana Kammersgard.(14)
10.29	Change of Control Agreement dated August 23, 2001 between the Registrant and Preston Romm.(14)

10.30 Securities Purchase Agreement, dated as of December 18, 2002, between the Registrant and each of the purchasers listed on the signature pages thereto.(15)

10.31 Registration Rights Agreement, dated as of December 18, 2002, between the Registrant and each of the purchasers listed on the signature pages thereto.(15)

10.32 Securities Purchase Agreement, dated as of March 11, 2003, between the Registrant and each of the purchasers listed on the signature pages thereto.(5)

10.33 Registration Rights Agreement, dated as of March 11, 2003, between the Registrant and each of the purchasers listed on the signature pages thereto.(5)

10.34 Registration Rights Agreement, dated as of March 4, 2003, between the Registrant and each of the individuals listed on the signature pages thereto.(5)

21.1 Subsidiaries of the Registrant.(5)

23.1 Consent of Deloitte & Touche LLP.

24.1 Power of Attorney. Reference is made to the signature page hereto.

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.

Indicates management or compensatory plan or arrangement required to be identified pursuant to Item 15(c).

(1) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 24, 2004 and incorporated herein by reference.

(2) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 19, 2001 and incorporated herein by reference.

(3) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.

(4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on May 19, 2003 and incorporated herein by reference.

(5) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.

(6) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated herein by reference.

(7) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.

(8)

Filed as an exhibit to our Current Report on Form 8-K dated August 23, 2000 and incorporated herein by reference.

(9) Filed as an exhibit to our Registration Statement on Form S-8 (No. 333-43834) and incorporated herein by reference.

(10) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2000 and incorporated herein by reference.

(11) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated herein by reference.

(12) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2001 and incorporated herein by reference.

(13) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 31, 2001 and incorporated herein by reference.

(14) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2001 and incorporated herein by reference.

(15) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.

(b) Reports on Form 8-K:

1. We filed a Current Report on Form 8-K on October 22, 2003, announcing the filing of a complaint against us in the United States District Court in Austin, Texas by Crossroads Systems and also announcing our third quarter 2003 earnings.

2. We filed a Current Report on Form 8-K on October 29, 2003, including a transcript of the third quarter 2003 earnings conference call held on October 22, 2003.

SIGNATURES

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

DOT HILL SYSTEMS CORP.
(Registrant)

By: /s/ JAMES L. LAMBERT

James L. Lambert
(Chief Executive Officer)

Date: March 15, 2004

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints James L. Lambert and Preston Romm, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place, and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that all said attorneys-in-fact and agents, or any of them or their or his substitute or substituted, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this Registration Statement has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ JAMES L. LAMBERT James L. Lambert	Chief Executive Officer, President, Chief Operating Officer and Director (Principal Executive Officer)	March 15, 2004
/s/ PRESTON ROMM Preston Romm	Chief Financial Officer, Secretary and Treasurer (Principal Financial and Accounting Officer)	March 15, 2004
/s/ CHARLES CHRIST Charles Christ	Chairman of the Board of Directors	March 15, 2004
/s/ BENJAMIN BRUSSELL Benjamin Brussell	Director	March 15, 2004
/s/ NORMAN R. FARQUHAR Norman R. Farquhar	Director	March 15, 2004
/s/ DR. CHONG SUP PARK Dr. Chong Sup Park	Director	March 15, 2004
/s/ W.R. SAUEY W.R. Sauey	Director	March 15, 2004

Exhibit Number	Description
2.1	Agreement and Plan of Merger dated as of February 23, 2004, by and among the Registrant, DHSA Corp., Chaparral Network Storage, Inc., and C. Timothy Smoot, as Stockholders' Representative.(1)
3.1	Certificate of Incorporation of the Registrant.(2)
3.2	By-laws of the Registrant.(2)
4.1	Certificate of Incorporation of the Registrant.(2)
4.2	By-laws of the Registrant.(2)

Exhibit Number	Description
4.3	Form of Common Stock Certificate.(3)
4.4	Certificate of Designation of Series A Junior Participating Preferred Stock, as filed with the Secretary of State of Delaware on May 19, 2003.(4)
4.5	Form of Rights Certificate.(4)
4.6	Warrant to Purchase Shares of Common Stock dated May 24, 2002.(5)
4.7	Common Stock Warrant dated December 19, 2002.(5)
4.8	Warrant to Purchase Shares of Common Stock dated February 14, 2003.(5)
4.9	Common Stock Warrant dated March 14, 2003.(5)
10.1	Product Purchase Agreement between the Registrant and Sun Microsystems, Inc. dated May 24, 2002.(6)
10.2	Product Supplement/Award Letter for Blade Product under agreement with Sun Microsystems, Inc. dated May 24, 2002.(6)
10.3	Product Supplement/Award Letter for SCSI Product under agreement with Sun Microsystems, Inc. dated May 24, 2002.(6)
10.4	Product Supplement/Award Letter for FC Product under agreement with Sun Microsystems, Inc. dated May 24, 2002.(6)
10.5	Employment letter agreement dated August 2, 1999 between the Registrant and James L. Lambert.(7)
10.6	Employment letter agreement dated August 2, 1999 between the Registrant and Dana W. Kammersgard.(7)
10.7	Employment offer letter dated November 12, 1999 between the Registrant and Preston Romm.(7)
10.8	Lease for Registrant's headquarters in Carlsbad, California, dated June 9, 1993.(5)
10.9	2000 Amended and Restated Equity Incentive Plan.(8)
10.10	Form of Stock Option Agreement (Incentive and Nonstatutory Stock Options) used in connection with the 2000 Amended and Restated Equity Incentive Plan.(8)
10.11	Form of Stock Option Grant Notice used in connection with the 2000 Amended and Restated Equity Incentive Plan.(8)
10.12	2000 Amended and Restated Employee Stock Purchase Plan.(8)
10.13	2000 Non-Employee Directors Stock Option Plan.(9)

10.14	Form of Stock Option Agreement used in connection with the 2000 Non-Employee Directors' Stock Option Plan.(9)
10.16	Credit Agreement dated February 6, 2001 among the Registrant, Silicon Alley Management, Inc. and Wells Fargo Bank, National Association.(10)
10.17	Revolving Line of Credit Note dated February 6, 2001 issued by the Registrant and Silicon Alley Management, Inc. to Wells Fargo Bank, National Association.(10)
10.18	Third Party Security Agreement dated February 6, 2001 made by the Registrant and Silicon Alley Management, Inc. in favor of Wells Fargo Bank, National Association.(10)
10.19	Manufacturing Agreement between the Registrant and Solectron Corporation, dated May 20, 2002.(11)

10.20	OEM Agreement between the Registrant and Infortrend Technology, Inc, supplier of controllers, dated May 20, 2002.(11)
10.21	2002 Executive Compensation Plan for James L. Lambert, effective January 1, 2002.(12)
10.22	2002 Executive Compensation Plan for Dana Kammersgard, effective January 1, 2002.(13)
10.23	2002 Executive Compensation Plan for Preston Romm, effective January 1, 2002.(13)
10.24	2003 Executive Compensation Plan for James L. Lambert, effective January 1, 2003.(5)
10.25	2003 Executive Compensation Plan for Dana Kammersgard, effective January 1, 2003.(5)
10.26	2003 Executive Compensation Plan for Preston Romm, effective January 1, 2003.(5)
10.27	Change of Control Agreement dated August 23, 2001 between the Registrant and James L. Lambert.(14)
10.28	Change of Control Agreement dated August 23, 2001 between the Registrant and Dana Kammersgard.(14)
10.29	Change of Control Agreement dated August 23, 2001 between the Registrant and Preston Romm.(14)
10.30	Securities Purchase Agreement, dated as of December 18, 2002, between the Registrant and each of the purchasers listed on the signature pages thereto.(15)
10.31	Registration Rights Agreement, dated as of December 18, 2002, between the Registrant and each of the purchasers listed on the signature pages thereto.(15)
10.32	Securities Purchase Agreement, dated as of March 11, 2003, between the Registrant and each of the purchasers listed on the signature pages thereto.(5)
10.33	Registration Rights Agreement, dated as of March 11, 2003, between the Registrant and each of the purchasers listed on the signature pages thereto.(5)
10.34	Registration Rights Agreement, dated as of March 4, 2003, between the Registrant and each of the individuals listed on the signature pages thereto.(5)
21.1	Subsidiaries of the Registrant.(5)
23.1	Consent of Deloitte & Touche LLP.
24.1	Power of Attorney. Reference is made to the signature page hereto.

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.

Indicates management or compensatory plan or arrangement required to be identified pursuant to Item 15(c).

(1)

Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on February 24, 2004 and incorporated herein by reference.

(2) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on September 19, 2001 and incorporated herein by reference.

(3) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.

(4) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on May 19, 2003 and incorporated herein by reference.

(5) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.

(6) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated herein by reference.

(7) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.

(8) Filed as an exhibit to our Current Report on Form 8-K dated August 23, 2000 and incorporated herein by reference.

(9) Filed as an exhibit to our Registration Statement on Form S-8 (No. 333-43834) and incorporated herein by reference.

(10) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2000 and incorporated herein by reference.

(11) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated herein by reference.

(12) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2001 and incorporated herein by reference.

(13) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on December 31, 2001 and incorporated herein by reference.

(14) Filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2001 and incorporated herein by reference.

(15) Filed as an exhibit to our Current Report on Form 8-K filed with the SEC on January 14, 2003 and incorporated herein by reference.

INDEX TO FINANCIAL STATEMENTS

INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders
Dot Hill Systems Corp.

We have audited the accompanying consolidated balance sheets of Dot Hill Systems Corp. and subsidiaries (the "Company") as of December 31, 2002 and 2003, and the related consolidated statements of operations and comprehensive operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Dot Hill Systems Corp. and subsidiaries as of December 31, 2002 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

San Diego, California
March 4, 2004

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31, 2002 AND 2003

(In Thousands, Except Per Share Amounts)

	2002	2003
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 10,082	$ 138,563
Restricted cash	2,000	
Short-term investments		52,982
Accounts receivable, net of allowance of $751 and $467	6,304	14,558
Inventories	6,959	3,158
Prepaid expenses and other	1,802	1,836

	2002	2003
Total current assets	27,147	211,097
PROPERTY AND EQUIPMENT, net	4,110	4,791
OTHER ASSETS	971	2,555
Total assets	$ 32,228	$ 218,443
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 14,446	$ 24,533
Accrued compensation	1,754	4,459
Accrued expenses	1,614	2,052
Deferred revenue	1,110	1,028
Income taxes payable	1,020	1,005
Short-term debt	4,552	
Current portion of restructuring accrual	407	370
Total current liabilities	24,903	33,447
RESTRUCTURING ACCRUAL, net of current portion	1,179	554
BORROWINGS UNDER LINES OF CREDIT	275	247
Other long-term liabilities	86	62
Total liabilities	26,443	34,310
COMMITMENTS AND CONTINGENCIES (Note 15)		
STOCKHOLDERS' EQUITY:		
Preferred stock, $.001 par value, 10,000 shares authorized, 6 and 0 shares issued and outstanding at December 31, 2002 and December 31, 2003, respectively		
Common stock, $.001 par value, 100,000 shares authorized, 25,172 and 43,307 shares issued and outstanding at December 31, 2002 and December 31, 2003, respectively	25	43
Additional paid-in capital	109,562	275,827
Deferred compensation	(48)	(28)
Accumulated other comprehensive loss	(318)	(263)
Accumulated deficit	(103,436)	(91,446)
Total stockholders' equity	5,785	184,133
Total liabilities and stockholders' equity	$ 32,228	$ 218,443

See accompanying notes to consolidated financial statements.

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2001, 2002 AND 2003

(In Thousands, Except Per Share Amounts)

	2001	2002	2003
NET REVENUE	$ 56,277	$ 46,936	$ 187,448
COST OF GOODS SOLD	44,818	45,444	142,550
GROSS PROFIT	11,459	1,492	44,898
OPERATING EXPENSES:			
Sales and marketing	23,717	22,513	14,086
Research and development	6,673	10,043	11,950
General and administrative	4,533	5,150	7,418
Restructuring expenses	4,905	1,550	
Total operating expenses	39,828	39,256	33,454
OPERATING INCOME (LOSS)	(28,369)	(37,764)	11,444
OTHER INCOME (EXPENSE):			
Interest income	1,013	410	716
Interest expense	(107)	(248)	(105)
Gain on foreign currency transactions, net	52	143	135
Other income (expense), net	(657)	39	29
Total other income, net	301	344	775
INCOME (LOSS) BEFORE INCOME TAXES	(28,068)		