DOT HILL SYSTEMS CORP
Form 10-Q
November 04, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2010

OR

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

For the transition period from ______ to ______

Commission file number 1-13317

DOT HILL SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**13-3460176**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
1351 S. Sunset Street, Longmont, CO	**80501**
(Address of principal executive offices)	**(Zip Code)**

(303) 845-3200

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

The registrant had 55,328,233 shares of common stock, $0.001 par value, outstanding as of October 31, 2010.

DOT HILL SYSTEMS CORP.

FORM 10-Q

For the Quarter Ended September 30, 2010

INDEX

Table of Contents

Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value data)

	December 31, 2009	September 30, 2010
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 57,574	$ 41,811
Accounts receivable, net	34,197	35,795
Inventories	4,333	7,499
Prepaid expenses and other assets	5,314	5,256
Total current assets	101,418	90,361
Property and equipment, net	3,616	3,654
Intangible assets, net	3,029	8,105
Goodwill		4,140
Other assets	217	408
Total assets	$ 108,280	$ 106,668
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 28,411	$ 29,403
Accrued compensation	3,602	2,622
Accrued expenses	4,220	3,362
Deferred revenue	1,217	1,428
Restructuring accrual	1,697	1,646
Bank borrowings and current portion of long-term note payable	261	3,271
Total current liabilities	39,408	41,732
Long-term note payable	346	141
Other long-term liabilities	2,175	1,271
Total liabilities	**41,929**	**43,144**
Commitments and Contingencies (Note 11)		
Stockholders Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, no shares issued and outstanding at December 31, 2009 and September 30, 2010		
Common stock, $.001 par value, 100,000 shares authorized, 48,952 and 55,321 shares issued and outstanding at December 31, 2009 and September 30, 2010, respectively.	49	55

Additional paid-in capital	303,841	314,653
Accumulated other comprehensive loss	(3,439)	(3,554)
Accumulated deficit	(234,100)	(247,630)
Total stockholders equity	66,351	63,524
Total liabilities and stockholders equity	$ 108,280	$ 106,668

See accompanying notes to unaudited condensed consolidated financial statements.

3

Table of Contents

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE LOSS

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
NET REVENUE	$ 63,600	$ 61,586	$ 171,817	$ 187,053
COST OF GOODS SOLD	51,969	50,291	142,955	157,964
GROSS PROFIT	11,631	11,295	28,862	29,089
OPERATING EXPENSES:				
Research and development	7,241	7,439	21,327	23,659
Sales and marketing	2,772	2,592	7,856	9,332
General and administrative	2,320	2,424	7,562	7,725
Restructuring charge	530	104	941	1,806
Total operating expenses	12,863	12,559	37,686	42,522
OPERATING LOSS	(1,232)	(1,264)	(8,824)	(13,433)
OTHER INCOME:				
Interest income (expense), net	17	6	132	13
Other income (expense), net	(10)	(2)	(17)	(17)
Total other income (expense), net	7	4	115	(4)
LOSS BEFORE INCOME TAXES	(1,225)	(1,260)	(8,709)	(13,437)
INCOME TAX EXPENSE (BENEFIT)	(88)	9	(94)	93
NET LOSS	$ (1,137)	$ (1,269)	$ (8,615)	$ (13,530)
NET LOSS PER SHARE:				
Basic and diluted	$ (0.02)	$ (0.02)	$ (0.18)	$ (0.26)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET LOSS PER SHARE				
Basic and diluted	47,258	53,529	46,978	52,778
COMPREHENSIVE LOSS:				
Net loss	$ (1,137)	$ (1,269)	$ (8,615)	$ (13,530)
Foreign currency translation adjustment	(89)	(76)	1	(115)
Comprehensive loss	$ (1,226)	$ (1,345)	$ (8,614)	$ (13,645)

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

DOT HILL SYSTEMS CORP.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2010
Cash Flows From Operating Activities:		
Net loss	$ (8,615)	$ (13,530)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation and amortization	2,079	3,024
Provision for bad debt reserve	292	
Adjustment to contingent consideration		(285)
Stock-based compensation expense	2,151	2,314
Changes in operating assets and liabilities, net of business acquisition:		
Accounts receivable	5,587	(1,418)
Inventories	9,086	(3,099)
Prepaid expenses and other assets	(2,046)	(59)
Accounts payable	(2,125)	481
Accrued compensation and other accrued expenses	(401)	(3,468)
Deferred revenue	(1,199)	208
Restructuring accrual	47	(51)
Other long-term liabilities	(367)	(651)
Net cash provided by (used in) operating activities	4,489	(16,534)
Cash Flows From Investing Activities:		
Acquisition, net of cash acquired		(625)
Purchases of property and equipment	(2,421)	(1,105)
Net cash used in investing activities	(2,421)	(1,730)
Cash Flows From Financing Activities:		
Principal payment of note and loan payable	(185)	(970)
Payments on bank borrowings		(2,800)
Proceeds from bank borrowings		5,800
Common stock issued under stock plans, net	466	372
Net cash provided by financing activities	281	2,402
Effect of Exchange Rate Changes on Cash and Cash Equivalents	9	99
Net Increase (Decrease) in Cash and Cash Equivalents	2,358	(15,763)
Cash and Cash Equivalents, beginning of period	56,850	57,574
Cash and Cash Equivalents, end of period	$ 59,208	$ 41,811
Supplemental Disclosures of Non-Cash Investing and Financing Activities:		
Common stock issued in connection with acquisition		8,132
Capital assets acquired but not paid	175	25

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

DOT HILL SYSTEMS CORP.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) contained herein are unaudited and in the opinion of management contain all adjustments (consisting only of normal recurring adjustments, except for revisions made to our accrued restructuring liability) necessary for a fair presentation of financial position, results of operations and cash flows for the periods presented. The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. They do not include all of the information and disclosures required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2009. Operating results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2010.

Use of Accounting Estimates

The preparation of our financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. The accounting estimates that require management s most significant and subjective judgments include revenue recognition, inventory valuation, the valuation and recognition of stock-based compensation expense, and the valuation of long-lived assets, goodwill and other intangibles, as well as any other assets and liabilities acquired and accounted for under the purchase method of accounting for business combinations. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, warranty reserves, accruals for restructuring and valuation allowance for deferred tax assets. Actual results may differ from these estimates under different assumptions or conditions and such differences could be material.

Concentration of Customers

A majority of our net revenue is derived from a limited number of customers. We currently have two customers that each account for more than 10% of our total net revenue: Hewlett Packard, or HP; and NetApp, Inc., or NetApp. Our agreements with our original equipment manufacturers, or OEM, partners do not contain any minimum purchase commitments, do not obligate our OEM partners to purchase their storage solutions exclusively from us and may be terminated at any time upon notice from the applicable partner.

A small number of customers account for a significant percentage of our net revenue. Net revenue by major customer is as follows (as a percentage of total net revenue):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2010**	**2009**	**2010**
HP	58.7%	59.5%	51.1%	55.8%
NetApp	19.5%	27.0%	22.2%	28.1%
Other customers less than 10%	21.8%	13.5%	26.7%	16.1%
Total	100.0%	100.0%	100.0%	100.0%

In the fourth quarter of 2010, we amended our agreement with NetApp to allow NetApp to manufacture and sell on a royalty-free basis all of the products we currently manufacture and sell to NetApp beginning on December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp subsequent to November 30, 2010. We expect to generate additional revenue from our channel sales, software offerings and new OEM customers to replace the revenue, and more importantly, the gross profit lost as a result of amending our agreement with NetApp. However, if we are unable to generate sufficient revenue and gross profit from these sources to replace the reduced revenue and gross profit currently associated with NetApp, our financial results would be materially harmed.

Recent Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2009-13, Multiple-Deliverable Revenue Arrangements , or ASU 2009-13. The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable based on the relative selling price. The selling price for each deliverable is based on vendor-specific objective evidence, or VSOE, if available; third-party evidence, or TPE, if VSOE is not available; or estimated selling price, or ESP, if neither VSOE nor TPE is available.

Concurrently to issuing ASU 2009-13, the FASB also issued ASU No. 2009-14, Certain Revenue Arrangements That Include Software Elements , or ASU 2009-14. ASU 2009-14 excludes software that is contained on a tangible product from the scope of software revenue guidance if the software is essential to the tangible product s functionality.

We early adopted the provisions of ASU 2009-13 and ASU 2009-14 as of the beginning of fiscal 2010 for new and materially modified deals originating after January 1, 2010. The adoption of these provisions did not materially affect the results of operations for the three and nine months ended September 30, 2010 and would not have materially impacted previously reported results had the adoption been applied retrospectively, as revenue derived from software sales and multiple-deliverable arrangements were not material. The effect of adopting these standards on future financial periods will vary based on the nature and volume of new or materially modified revenue transactions in any given period.

Table of Contents

In March 2010, the FASB ratified a consensus of the FASB Emerging Issues Task Force that recognizes the milestone method as an acceptable revenue recognition method for substantive milestones in research or development arrangements. This consensus would require its provisions be met in order for an entity to recognize consideration that is contingent upon achievement of a substantive milestone as revenue in its entirety in the period in which the milestone is achieved. In addition, this consensus would require disclosure of certain information with respect to arrangements that contain milestones. This authoritative guidance is effective for interim and annual reporting periods on or after June 15, 2010 and will be effective for Dot Hill in the third quarter of fiscal 2010. Dot Hill is evaluating the potential impact of the implementation of this authoritative guidance on its consolidated financial statements.

2. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss for the period by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss for the period by the weighted average number of shares of common stock outstanding during the period and including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding warrants, stock options, share based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in the three and nine months ended September 30, 2009 or 2010 because we incurred a net loss in each of these periods and the effect of inclusion would have been anti-dilutive.

As of September 30, 2009, options to purchase 6,204,541 shares of common stock with exercise prices ranging from $0.47 to $16.36 per share, 1,510,991 shares of unvested restricted stock awards and warrants to purchase 1,602,489 shares of common stock at a price of $2.40 per share, were outstanding, but were not included in the calculation of diluted net loss per share because their effect was antidilutive.

As of September 30, 2010 options to purchase 6,318,094 shares of common stock with exercise prices ranging from $0.47 to $16.36 per share, 1,367,180 shares of unvested restricted stock awards, and a warrant to purchase 1,602,489 shares of common stock at a price of $2.40 per share, were outstanding, but were not included in the calculation of diluted net loss per share because their effect was anti-dilutive.

3. Inventories

The components of inventories consist of the following (in thousands):

	December 31, 2009	September 30, 2010
Purchased parts and materials	$ 2,095	$ 3,851
Finished goods	2,238	3,648
Total inventory	$ 4,333	$ 7,499

4. Business Combinations

On January 26, 2010, or the acquisition date, Dot Hill acquired 100% of the voting equity interests of Cloverleaf Communications Inc., a Delaware corporation, or Cloverleaf. Prior to the acquisition, Cloverleaf was a privately held software company focused on heterogeneous storage virtualization and unified storage technologies. Following the acquisition, Dot Hill changed its operating segment reporting structure and Cloverleaf joined Dot Hill s Standalone Storage Software business segment, augmenting its existing software offering portfolio of products. The acquisition of Cloverleaf is intended to broaden Dot Hill s market opportunities and help accelerate Dot Hill s transition from a provider of storage arrays to a provider of storage solutions and software. The Cloverleaf acquisition also provided Dot Hill with a new team of software developers and other professionals located in Israel.

Dot Hill acquired all of the outstanding equity interests in Cloverleaf in exchange for (i) $0.7 million of cash, (ii) 4,758,530 shares of Dot Hill common stock valued at $8.1 million, or $1.71 per share, which represents the closing price of Dot Hill common stock on the acquisition date, or January 26, 2010, (iii) $1.8 million of specified assumed outstanding liabilities of Cloverleaf at the acquisition date, and (iv) 327,977 shares of restricted common stock that were issued to the employees of Cloverleaf who became employees of Dot Hill on the acquisition date pursuant to Dot Hill s 2009 Equity Incentive Plan.

Dot Hill also incurred estimated direct transaction costs in connection with the acquisition of approximately $0.8 million, of which $0.5 million was recognized as expense in the fourth quarter of 2009 and $0.3 million was recognized as expense in the first quarter of 2010. Dot Hill has recorded these costs as general and administrative expenses in its statement of operations. The majority of these costs were paid in the first quarter of 2010. Equity issuance costs incurred in connection with the transaction were not material.

Dot Hill did not assume or exchange any Cloverleaf stock options or other stock-based payment awards in connection with the acquisition of Cloverleaf. Under the terms of the Merger Agreement, all Cloverleaf stock options and warrants that were outstanding immediately prior to the acquisition date and not exercised prior to the acquisition date expired and became null and void as of the acquisition date. All outstanding options expired and had no fair value. In connection with the employment of certain Cloverleaf employees, Dot Hill granted 327,977 shares of restricted common stock. The fair value of the 327,977 shares of restricted common stock that were issued on the acquisition date will be recognized as compensation cost in the post-combination financial statements over the period in which the shares of restricted common stock vest. These shares vest as follows: one-third of such shares vest upon issuance; one-third of such shares vest one year from the date of issuance; and one-third of such shares vest two years from the date of issuance.

Table of Contents

The consideration transferred in connection with the acquisition of Cloverleaf approximates $8.8 million as follows (in thousands):

Cash consideration	$ 703
Dot Hill common stock issued to Cloverleaf	8,132
Consideration transferred	$ 8,835

The acquisition of Cloverleaf has been accounted for under the purchase method of accounting in accordance with the requirements of Accounting Standard Codification topic 805 Business Combinations . Under the purchase method of accounting, the purchase price is allocated to the assets acquired and liabilities assumed based on their estimated fair values.

The allocation of the purchase price has been prepared based on preliminary estimates of fair values and is currently incomplete primarily due to certain potential tax and warranty liabilities of Cloverleaf that may have existed prior to the date of the acquisition. Dot Hill is currently in the process of quantifying such amounts, if any, and has not recorded any possible tax or other liabilities as of September 30, 2010. Therefore, actual amounts recorded upon the finalization of certain potential tax liabilities may differ materially from the information presented in this quarterly report on Form 10-Q.

The preliminary allocation of the acquisition date fair value of the total consideration transferred in connection with the acquisition of Cloverleaf is summarized below (in thousands):

Cash	$ 78
Accounts receivable	55
Inventory	67
Other current assets	37
Property and equipment	452
Other non-current assets	23
Amortizable intangible assets:	
Acquired software	6,375
Trade name	181
Goodwill	4,140
Accounts payable	(269)
Current maturities of long-term loan	(775)
Accrued compensation	(401)
Accrued expenses	(172)
Accrued Cloverleaf transaction costs	(924)
Other non-current liabilities	(32)
	$ 8,835

The acquired software consists of heterogeneous storage virtualization and unified storage technologies that can simplify data center management, eliminate downtime and reduce storage costs. The Cloverleaf Intelligent Storage Networking System iSN trade name is an intelligent, network resident, storage network management system that provides a combination of benefits, features and capabilities targeted to meet the demands of mid to large-sized data centers. Dot Hill expects to amortize the fair value of the acquired software and the trade name on a straight-line basis over a period of seven years and five years, respectively, which management believes to reasonably reflect the pattern over which the economic benefits are being derived.

The goodwill of $4.1 million arising from the Cloverleaf acquisition consists largely of expected synergies in the research and development and sales and marketing areas as a result of combining the operations of Dot Hill and Cloverleaf. In addition, approximately $0.9 million of the goodwill acquired relates to intangible assets that do not qualify for separate recognition. None of the goodwill will be deductible for income tax purposes. All of the goodwill arising from the acquisition of Cloverleaf has been assigned to our Standalone Storage Software operating segment and to the Israel operating reporting unit.

In accordance with the requirements of Accounting Standard Codification topic 305 Intangibles - Goodwill and Other , goodwill will not be amortized but instead will be tested for impairment at least annually, or more frequently if indicators of impairment are present. In the event that Dot Hill management determines that the goodwill has become impaired, Dot Hill will incur a charge for the amount of impairment during the period in which the determination is made.

8

Table of Contents

Revenue of $0.4 million and a net loss of $4.4 million attributable to the operations of Cloverleaf since the acquisition date are included in our consolidated results of operations for the nine months ended September 30, 2010. The $4.4 million net loss includes $0.1 million of non-recurring restructuring costs and $0.4 million of stock-based compensation expense

Pro forma results

The following unaudited pro forma financial information presents the combined results of operations of Dot Hill and Cloverleaf as if the acquisition had occurred on January 1, 2009 and January 1, 2010 and excludes certain non-recurring charges related to the acquisition. The unaudited pro forma financial information is not intended to represent or be indicative of the consolidated results of operations or financial condition of Dot Hill that would have been reported had the acquisition been completed as of the dates presented, and should not be taken as representative of the future consolidated results of operations or financial condition of Dot Hill.

	Nine Months Ended	
(in thousands, except per share data)	**September 30, 2009**	**September 30, 2010**
Net revenue	$ 172,763	$ 187,130
Net loss	$ (11,974)	$ (13,516)
Basic and diluted net loss per share	$ (0.23)	$ (0.25)

5. Financial Instruments

The Company s financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, notes payable, bank borrowings and certain other long-term liabilities. The carrying values on our balance sheet of our cash and cash equivalents, accounts receivable, accounts payable and bank borrowings approximate their fair values due to their short maturities. The carrying value on our balance sheet of our notes payable and contingent consideration due to Ciprico, Inc. or Ciprico, in connection with the acquisition of certain intangible assets approximates fair value as our credit-adjusted interest rate continues to represent a market participant rate.

6. Intangible Assets

Identifiable intangible assets are as follows (in thousands):

		December 31, 2009		
	Estimated Useful Life	**Gross**	**Accumulated Amortization**	**Net**
RaidCore technology	4 years	$ 4,256	$ (1,350)	$ 2,906
NAS technology	3 years	214	(91)	123
Total intangible assets		$ 4,470	$ (1,441)	$ 3,029

		September 30, 2010		
	Estimated Useful Life	**Gross**	**Accumulated Amortization**	**Net**
RaidCore technology	4 years	$ 4,256	$ (2,147)	2,109
NAS technology	3 years	214	(144)	70
Software	5 years	6,375	(606)	5,769
Trade name	7 years	181	(24)	157

Total intangible assets	$ 11,026	$ (2,921)	$ 8,105

Amortization expense related to intangible assets totaled $0.3 million, $0.9 million, $0.5 million and $1.5 million for the three and nine months ended September 30, 2009 and 2010, respectively.

Estimated future amortization expense related to intangible assets as of September 30, 2010 is as follows (in thousands):

Table of Contents

2010 (Remaining 3 months)	$ 524
2011	2,063
2012	1,724
2013	947
2014	947
Thereafter	1,900
Total	$ 8,105

7. Goodwill

The changes in the carrying amount of goodwill are as follows (in thousands):

	Storage Systems	Standalone Storage Software	Total
Balance as of January 1, 2010			
Goodwill	$ 40,700	$	$ 40,700
Accumulated impairment losses	(40,700)		(40,700)
Goodwill acquired during the nine months ended September 30, 2010		4,140	4,140
Impairment losses			
Balance as of September 30, 2010			
Goodwill	40,700	4,140	44,840
Accumulated impairment losses	(40,700)		(40,700)
	$	$ 4,140	$ 4,140

We review goodwill for impairment on an annual basis at November 30 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. There were no indicators that our goodwill was impaired at September 30, 2010.

8. Product Warranties Activity

We generally extend to our customers the warranties provided to us by our suppliers and, accordingly, the majority of our warranty obligations to customers are intended to be covered by corresponding supplier warranties. For warranty costs not covered by our suppliers, we provide for estimated warranty costs in the period the revenue is recognized. There can be no assurance that our suppliers will continue to provide such warranties to us in the future or that our warranty obligations to our customers will be covered by corresponding warranties from our suppliers, which could have a material adverse effect on our operating results and financial condition.

In the first nine months of 2010, we experienced quality issues associated with certain components provided by one of our suppliers that required us to make substantial repairs. Our supplier has agreed to reimburse us for the costs of the replacement parts and related damages. However, the magnitude of potential damages is currently unknown and to the extent that our supplier cannot or does not continue to reimburse us for any and all damages incurred by us or our customers we could incur material amounts of warranty claims and expenses.

Estimated liabilities for product warranties are included in accrued expenses. Our warranty cost activity is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Balance, beginning of period	$ 1,169	$ 1,233	$ 1,560	$ 993
Charged to operations	301	557	1,178	2,086
Deductions for costs incurred	(545)	(669)	(1,813)	(1,958)
Balance, end of period	$ 925	$ 1,121	$ 925	$ 1,121

9. Restructuring Charge

In December 2008, our management approved, committed to, and initiated a restructuring plan, or the 2008 Plan, to improve efficiencies in our operations, which was largely driven by our plan to consolidate our facility in Carlsbad, California into the Longmont, Colorado facility. As a result of this relocation, we terminated approximately 70 California employees whose positions have been relocated to Colorado and incurred approximately $1.5 million in severance-related costs since the inception of the 2008 Plan, all of which was recognized as of June 30, 2010. Accrued severance-related costs are recorded in the restructuring accrual line on our consolidated balance sheets. With the exception of future minimum lease payments relating to the Carlsbad, California facility, we anticipate the remainder of the restructuring costs will be paid out during the fourth quarter of 2010.

As part of the 2008 Plan, we also incurred contract termination costs of $2.9 million since the plan inception through September 30, 2010. In the second quarter of 2010, we incurred additional contract termination costs for facility lease and other associated costs that we continue to incur without economic benefit, as we exited an additional portion of our Carlsbad facility and revised our assumptions regarding the timing and amount of tenant sublease income. In the third quarter of 2010, we incurred additional contract termination costs of $0.1 million for facility lease and other associated costs that we continue to incur without economic benefit. We record charges for contract termination and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay the majority of these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we expect we will receive sublease income of approximately $0.9 million beginning in the first quarter of 2011 through the remainder of the lease term. To the extent that we are unable to find a tenant to sublease our unused space or if we do not sublease our unused space at a price per square foot that approximates our current estimate, we may incur additional cash restructuring charges of up to the $0.9 million of sublease income we currently expect to receive.

All of the 2008 Plan activity relates to our storage systems operating segment.

The following table summarizes our 2008 Plan activities (in thousands):

2008 Plan

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of December 31, 2009	$ 439	$ 1,258	$ 1,697
2010 restructuring plan charges	233	933	1,166
Cash payments	(592)	(810)	(1,402)
Accrued restructuring balance as of September 30, 2010	$ 80	$ 1,381	$ 1,461

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan includes severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. As a result of these actions, we intend to terminate approximately 26 employees located in the United States, of which 23 have been terminated as of September 30, 2010. We expect to incur approximately $0.4 million in severance-related costs, the majority of which was recognized in the second and third quarters of 2010. Accrued severance-related costs are recorded in the restructuring accrual line on our consolidated balance sheets. With the exception of future minimum lease payments relating to the Carlsbad, California facility, we anticipate the remainder of the restructuring costs will be paid out during the fourth quarter of 2010.

As part of the 2010 Plan, we also incurred contract termination costs for facility lease and other associated costs that we continue to incur without economic benefit, as we exited the remaining portion of our Carlsbad, California facility. We record charges for contract termination costs and other associated costs as restructuring expense, which is presented as a separate component within operating expenses. Accrued contract termination and other associated costs are recorded in the restructuring accrual line on our consolidated balance sheets. We expect to pay the majority of these contract lease termination costs over the remainder of the lease term ending in April 2013. Based on our estimates, we expect we will receive sublease income of approximately $0.1 million beginning in the first quarter of 2011 through the remainder of the lease term. To the extent that we are unable to find a tenant to sublease our unused space or if we do not sublease our unused space at a price per square foot that approximates our current estimate, we may incur additional cash restructuring charges of up to the $0.1 million of sublease income we currently expect to receive.

The majority of the 2010 Plan activity relates to our storage systems operating segment.

The following table summarizes our 2010 Plan activities (in thousands):

Table of Contents

2010 Plan

	Severance and Related Costs	Contract Termination and Other Associated Costs	Total
Accrued restructuring balance as of December 31, 2009	$	$	$
2010 restructuring plan charges	377	155	532
Cash payments	(325)	(22)	(347)
Accrued restructuring balance as of June 30, 2010	$ 52	$ 133	$ 185

We also incurred additional severance-related restructuring charges of approximately $0.1 million in the first quarter of 2010 related to the termination of a former employee of Cloverleaf. All of the severance-related costs were paid to this employee in the first quarter of 2010.

10. Credit Facilities

We maintain a credit facility with Silicon Valley Bank for cash advances and letters of credit of up to an aggregate of $30 million based upon an advance rate of 85% of eligible accounts receivable. The credit agreement expires in August of 2011. We are currently negotiating an extension to our credit facility and may incur significant additional costs in order to secure the extension. In addition, there is no guarantee that we will be successful in extending our current credit facility. Borrowings under the credit facility bear interest at the prime rate and are secured by substantially all of our accounts receivable, deposit and securities accounts. The agreement provides for a negative pledge on our inventory and intellectual property, subject to certain exceptions, and contains usual and customary covenants for an arrangement of its type, including an obligation that we maintain at all times a net worth, as defined in the agreement, of $50 million (subject to certain increases). The agreement also includes provisions to increase the financing facility by $20 million subject to our meeting certain requirements, including $40 million in borrowing base for the immediately preceding 90 days, and Silicon Valley Bank locating a lender willing to finance the additional facility. In addition, if our cash and cash equivalents net of the total amount outstanding under the credit facility fall below $20 million (measured on a rolling three-month basis), the interest rate will increase to prime plus 1% and additional restrictions will apply. Our credit facility also provides for a cash management services sublimit under the revolving credit line of up to $300,000. As of September 30, 2010 we had an outstanding letter of credit issued to our contract manufacturer in China in the amount of $5.0 million and had outstanding cash advances or borrowings of approximately $3.0 million. We repaid the $3.0 million of line of credit borrowings in October 2010.

11. Commitments and Contingencies

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

12. Segment Information

Primarily as a result of our acquisition of Cloverleaf in January 2010, as well as our ongoing strategic development, planning and evaluation, we changed the structure of our internal organization to focus on our storage systems and standalone software products. As a result, we now have two operating segments, which include storage systems and standalone storage software. Our storage hardware operating segment consists predominantly of our business prior to the acquisition of Cloverleaf. Our standalone storage software operating segment consists primarily of the business we acquired from Cloverleaf and the intellectual property assets we purchased from Ciprico.

All prior period amounts have been adjusted to reflect the new operating segment structure.

The Chief Operating Decision Maker, or CODM, is our President and Chief Executive Officer. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The CODM does not evaluate operating segments using discrete asset information. Although the CODM uses operating income to evaluate the segments, operating costs included in one segment may benefit other segments. The accounting policies Dot Hill uses to derive operating segment results are substantially the same as those the consolidated company uses.

Table of Contents

Description of Segments

Storage Systems

We offer a flexible broad line of networked data storage solutions composed of standards-based hardware and embedded software for open systems environments including Fiber Channel, or FC, Internet Small Computer Systems Interface, or iSCSI, and Serial Attached SCSI, or SAS, storage markets. We incorporate many of the performance attributes and other features demanded by high-end/data center end-users into our products. Our end-users consist of entry-level and midrange users, requiring cost-effective, easily managed, high-performance, reliable storage systems. Our product lines range from approximately 146 gigabyte, or GB, to complete 192 terabyte, or 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 OEM partners to customize solutions, bundling our products with value-added hardware, software and services.

Our storage systems segment products and services are sold worldwide to facilitate server and storage area network, or SAN, storage implementations, primarily through OEMs, and supplemented by system integrators, or SIs, distributors and value added resellers, or VARs.

Stand Alone Storage Software

Dot Hill s new heterogeneous storage virtualization products or iSN provide a multi-vendor storage solution for growing enterprise and high performance computing needs. Providing both unified storage and advanced storage virtualization features, up to two petabytes of storage can be managed and protected both locally and remotely, supporting both network attach server, or NAS, file and storage area network, or SAN, block services under one integrated storage management interface.

Our Virtual RAID Adapter, or VRA, technology, or RAIDCore, was purchased in 2008 from Ciprico. This product is a host-based software RAID solution that offers data protection services and a single RAID driver, RAID management and BIOS for multiple controller types, and allows volume server OEMs or ODMs to offer built-in, RAID functionality without the expense of a dedicated RAID-on-chip acceleration device.

Net revenue and operating loss were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2009	September 30, 2010	September 30, 2009	September 30, 2010
Storage Systems net revenue	63,600	60,924	171,817	185,941
Standalone Storage Software net revenue		759		1,361
Total segment net revenue	63,600	61,683	171,817	187,302
Elimination of intersegment net revenue		(97)		(249)
Total Dot Hill consolidated net revenue	63,600	61,586	171,817	187,053
Storage Systems operating income (loss)	(288)	378	(5,845)	(7,246)
Standalone Storage Software operating loss	(944)	(1,642)	(2,979)	(6,187)
Total operating loss	(1,232)	(1,264)	(8,824)	(13,433)

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Cautionary Statement for Forward-Looking Information

Certain statements contained in this quarterly report on Form 10-Q, including, statements regarding the development, growth and expansion of our business, our intent, belief or current expectations, primarily with respect to our future operating performance and the products we expect to offer, and other statements regarding matters that are not historical facts, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are subject to the safe harbor created by these sections. Because such forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, actual results may differ materially from those expressed or implied by such forward-looking statements. Some of the factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements can be found in Part II, Item 1A, Risk Factors and in our reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2009. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

The following discussion of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in the preceding pages in this quarterly report on Form 10-Q and our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2009.

Overview

We are a provider of entry-level and midrange storage systems and enterprise server software for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware, firmware and software products employing a modular system that allows end-users to add various capacity or data protection schemes as needed. Our broad range of products, from medium capacity stand-alone storage units to complete multi-terabyte storage area networks, or SANs, provide end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our current product family based on our Rapid Evolution, or R/Evolution, architecture provides high performance and large disk array capacities for a broad variety of environments, employing Fibre Channel, or FC, Internet Small Computer Systems Interface, or iSCSI or Serial Attached SCSI, or SAS, interconnects to switches and/or hosts. In addition, our Assured family of data protection software products provides additional layers of data protection options to complement our line of storage disk arrays. Our replacement products for the legacy SANnet II products, the 2000 series, have been distinguished by compliance with Network Equipment Building System, or NEBS, Level 3 (a telecommunications standard for equipment used in central offices) and are MIL-STD-810F (a military standard created by the U.S. government) compliant based on their ruggedness and reliability. In 2010, we launched a new line of products to address the need for higher speed storage which is delivered with faster controller processors, as well as 8Gb Fibre Channel and 6Gb SAS host connections and are targeted primarily at mainstream enterprise and small-to-medium businesses, or SMB, applications.

As a result of our ongoing strategic development, planning and evaluation, we are expanding our software offerings. Our investment in bringing software products to market will require significant future investment and development on our part, which will impact our cash and operating results until we generate sufficient revenues to recover our investment.

As part of this strategic development, in January 2010, we acquired Cloverleaf, a privately-held software company focused on heterogeneous storage virtualization and unified storage technologies. The acquisition of Cloverleaf could broaden our market opportunities and help accelerate our transition from a provider of storage arrays to a provider of storage solutions and software. The Cloverleaf acquisition also provided us with a new team of software developers and other professionals located in Israel. The Cloverleaf Intelligent Storage Networking System, or iSN , is an intelligent, network resident, storage network management system that provides a combination of benefits, features and capabilities targeted at meeting the demands of mid to large-sized data centers. The iSN incorporates architecture that delivers linear scalability, strong fault tolerance and high levels of availability. The iSN s open software is integrated with off the shelf hardware components and provides interoperability and networking technology flexibility.

Our Virtual RAID Adapter, or VRA, technology, or RAIDCore was purchased in 2008 from Ciprico Inc., or Ciprico. This product is a host-based software RAID solution that offers data protection services and a single RAID driver, RAID management and BIOS for multiple controller types, and allows volume server OEMs or ODMs to offer built-in, RAID functionality without the expense of a dedicated RAID-on-chip acceleration device.

We will continue to evaluate acquisition opportunities in the future.

We are also expanding our routes to market beyond our focus on OEMs, and in October of 2009, we launched a Dot Hill channel program targeted at selling through distributors and open storage partners, or OSPs. We believe this will provide Dot Hill with brand recognition and additional sales channels for all of our products.

Our agreements with our customers do not contain any minimum purchase commitments and may be terminated at any time upon notice from the applicable customer. Our ability to achieve and maintain profitability will depend on, among other things, the level and mix of orders we actually receive from such customers, the actual amounts we spend on marketing support, the actual amounts we spend for inventory support and incremental internal investment, our ability to reduce product cost, our product lead time, our ability to meet delivery schedules required by our customers, the quality of our products and the economic environment.

Our products and services are sold worldwide to facilitate server and SAN storage implementations, primarily through original equipment manufacturers, or OEMs, and supplemented by system integrators, or SIs, distributors and value added resellers, or VARs. Our OEM channel partners currently include, among others, Hewlett-Packard, or HP, NetApp, Inc., or NetApp, Motorola, Inc., or Motorola, Lockheed Martin

Corporation, Fujitsu Technology Solutions GmbH, or FTS, and Oracle, formerly Sun Microsystems, or Sun. Although our products and services are sold worldwide, the majority of our net revenue is derived from our U.S. operations.

We began shipping products to HP in the fourth quarter of 2007. In January 2008, we amended our agreement with HP to allow for sales to additional divisions within HP. Our products are primarily sold within HP s MSA product line, which includes our Series 2000 products and next generation of Series 3000 products released in the first quarter of 2010. The agreement with HP does not contain any minimum purchase commitments and the term of the agreement was extended from one to five years. Net revenue from HP approximated 59% and 56% of our total net revenue during the three and nine months ended September 30, 2010.

Table of Contents

Pursuant to our Development and OEM Supply Agreement with NetApp, we designed and developed general purpose disk arrays for a variety of products to be sold under private label by NetApp. We began shipping products to NetApp under the agreement for general availability in the third quarter of 2007. Net revenue from NetApp has represented a significant portion of our total net revenues in recent periods. Net revenue from NetApp approximated 27% and 28% of our total net revenue during the three and nine months ended September 30, 2010. Under our agreement with NetApp, NetApp has the right to manufacture and sell, on a royalty and royalty-free basis, up to certain specified percentages of the products we currently manufacture and sell to them. In the fourth quarter of 2010, we amended our agreement with NetApp to allow them to manufacture and sell on a royalty-free basis all of the products we currently manufacture and sell to them beginning on December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp subsequent to November 30, 2010. We expect to generate additional revenue from our channel sales, software offerings and new OEM customers to replace the revenue, and more importantly, the gross profit lost as a result of amending our agreement with NetApp. However, if we are unable to generate sufficient revenue and gross profit from these sources to replace the reduced revenue and gross profit currently associated with NetApp, our financial results would be materially harmed.

In addition, the demand for our products has been affected in the past, and may continue to be affected in the future, by various factors, including, but not limited to, the following:

- general economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector, current general economic volatility and trends in the data storage markets in various geographic regions;

- the inability of certain of our customers who depend on credit to have access to their traditional sources of credit to finance the purchase of products from us, particularly in the current global economic environment, which may lead them to reduce their level of purchases or to seek credit or other accommodations from us;

- the timing, rescheduling or cancellation of significant customer orders and our ability, as well as the ability of our customers, to manage inventory; and

- The introduction of new products by us or our competitors, including products with price and/or performance advantages.

For these and other reasons, our net revenue and results of operations in 2010 and prior periods may not necessarily be indicative of future net revenue and results of operations.

Our strategy includes outsourcing substantially all of our manufacturing to third-party manufacturers in order to reduce sales cycle times and manufacturing infrastructure, enhance working capital and improve margins by taking advantage of the third parties manufacturing and procurement economies of scale. We have historically outsourced substantially all of our manufacturing operations to Flextronics International Limited, or Flextronics MiTAC International Corporation, or MiTAC and SYNNEX Corporation, or SYNNEX. In September 2008, we entered into a manufacturing agreement with Foxconn Technology Group, or Foxconn. Under the terms of the agreement, Foxconn supplies us with manufacturing, assembly and test services from its facilities in China and final integration services including final assembly, testing and configure-to-order services, through its worldwide facilities. The agreement provides for an initial three-year term that is automatically renewed at the end of such three-year term for additional one-year terms unless and until the agreement is terminated by either party. Foxconn began manufacturing products for us in July 2009 and we began shipping products for general availability under the Foxconn agreement during the second half of 2009. A larger percentage of our products have been and are expected to continue to be manufactured by Foxconn in 2010.

We derive the majority of our net revenues primarily from sales of our Series 2000, 3000 and 5000 family of products.

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

Sales and marketing expenses consist primarily of salaries and commissions, advertising and promotional costs and travel expenses.

Research and development expenses consist primarily of project-related expenses and salaries for employees directly engaged in research and development.

General and administrative expenses consist primarily of compensation to officers and employees performing administrative functions, expenditures for administrative facilities as well as expenditures for legal and accounting services and fluctuations in currency valuations.

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

In December 2008, our management approved, committed to, and initiated a plan, or the 2008 Plan, to restructure and improve efficiencies in our operations. The restructuring was due to a combination of factors, primarily driven by the economic downturn, but also driven by our plan to consolidate a significant portion of our facilities in Carlsbad, California into the Longmont, Colorado facility. With the exception of contract lease termination costs that we will continue to make over the remainder of the Carlsbad facility lease term ending in April 2013, we have largely completed the activities related to the 2008 Plan as of September 30, 2010.

Table of Contents

In the second quarter of 2010, our management approved, committed to, and initiated a restructuring and cost reduction plan, or the 2010 Plan, to better align our resources in order to lower our breakeven point. The 2010 Plan includes severance and related costs for the reduction of approximately 10% of our workforce, and fees associated with the acceleration of the closure of our Carlsbad, California facility. Substantially all of our 2010 Plan workforce reductions were completed by September 30, 2010 and we completely exited our Carlsbad facility as of June 30, 2010.

Critical Accounting Policies and Estimates

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Except as noted below, management believes that there have been no significant changes during the three and nine months ended September 30, 2010 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

Revenue Recognition

We early adopted the provisions of ASU 2009-13 and ASU 2009-14 as of the beginning of fiscal 2010 for new and materially modified sales transactions originating after January 1, 2010. The adoption of these provisions did not materially affect our results of operations for the three and nine months ended September 30, 2010. However, as our software sales increase, we will be required to make significant estimates including determining if our software is essential to the tangible product s functionality, establishing separate units of accounting in multiple element arrangements and, if applicable, allocating arrangement consideration to each deliverable based on estimates of the relative selling price.

Valuation of Goodwill

We perform an assessment of our goodwill for impairment annually at November 30, or more frequently if we determine that indicators of impairment exist. Our impairment review process compares the fair value of each reporting unit to its carrying value. All of our goodwill at September 30, 2010 has been assigned to our Israel reporting unit, which is a subset of our standalone storage software operating segment. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired and no further testing is performed. If the carrying value of the reporting unit exceeds its fair value, then a second step must be performed, and the implied fair value of the reporting unit s goodwill must be determined and compared to the carrying value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then an impairment loss equal to the difference will be recorded.

We expect to utilize both a market approach and an income approach (discounted cash flows) to estimate the fair value of our reporting units.

Under the market approach, we expect to estimate the fair value of our reporting units using an in-exchange valuation premise based upon the market capitalization of Dot Hill using quoted market prices, adding an estimated control premium, and then assigning that fair market value to the reporting units. The most significant estimates and assumptions under the market approach are expected to be estimating an appropriate control premium and allocating the estimated enterprise fair value to each of our reporting units.

Under the income approach, we expect to estimate the fair value of our reporting units based on the present value of estimated future cash flows. The most significant estimates and assumptions under the income approach are expected to be future cash flows, discount rates, period of cash flows and the determination of terminal value.

Business Combinations

We allocate the purchase price of acquired companies to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the purchase price over these fair values is recorded as goodwill. We engage independent third-party appraisal firms to assist us in determining the fair values of assets acquired and liabilities assumed. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. The significant purchased intangible assets recorded by us include acquired software, developed technologies and a trade name.

Critical estimates in valuing certain intangible assets include but are not limited to: future expected cash flows from acquired software and developed technologies; expected costs to internally develop acquired software, as well as assumptions about the period of time that acquired software, developed technologies and an acquired trade name will continue to be used and generate cash flows; and discount and royalty rates. Management s estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates.

Other estimates associated with the accounting for acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed.

Table of Contents

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 (percentages may not aggregate due to rounding):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of goods sold:				
Product cost of goods sold	81.7	80.9	83.2	83.6
Amortization of intangible assets		0.8		0.8
Total cost of goods sold:	81.7	81.7	83.2	84.4
Gross profit	18.3	18.3	16.8	15.6
Operating expenses:				
Research and development	11.4	12.1	12.4	12.6
Sales and marketing	4.4	4.2	4.6	5.0
General and administrative	3.6	3.9	4.4	4.1
Restructuring charge	0.8	0.2	0.5	1.0
Total operating expenses	20.2	20.4	21.9	22.7
Operating loss	(1.9)	(2.1)	(5.1)	(7.1)
Other income, net	0.0		0.1	
Loss before income taxes	(1.9)	(2.1)	(5.0)	(7.1)
Income tax expense (benefit)	(0.1)		(0.1)	
Net loss	(1.8)%	(2.1)%	(4.9)%	(7.1)%

Three and Nine Months Ended September 30, 2009 Compared to the Three and Nine Months Ended September 30, 2010

Net Revenue

	Three Months Ended September 30,			
	2009	2010	Decrease	% Change
	(in thousands, except percentages)			
Net revenue	$ 63,600	$ 61,586	$ (2,014)	-3.2%

	Nine Months Ended September 30,			
	2009	2010	Increase	% Change
	(in thousands, except percentages)			

Net revenue	$ 171,817	$ 187,053	$ 15,236	8.9%

The decrease in net revenue for the three months ended September 30, 2010 was largely due to various product and customer transitions. For example, Sun sales decreased to $0 for the three months ended September 30, 2010 compared to $0.5 million for the three months ended September 30, 2009. The decline in Sun net revenue is due to the products we sell to Sun reaching the end of their product life cycle. FTS sales decreased to $0.4 million for the three months ended September 30, 2010 compared to $3.2 million for the three months ended September 30, 2009. The decrease in net revenue from FTS is due to FTS s decision to internally source the product we sell to FTS. HP sales decreased to $36.6 million for the three months ended September 30, 2010 compared to $37.3 million for the three months ended September 30, 2009. We also experienced declines in sales to other smaller customers, including Sepaton and Motorola, primarily as a result of the timing of transitioning from legacy products to newer generation products.

We also worked with certain of our customers in the three months ended September 30, 2009 to improve supply chain efficiencies and transfer ownership to them of much of the finished goods hub inventories that we had previously held on their behalf, resulting in an increase in net revenue during the three months ended September 30, 2009.

In addition, during the three months ended September 30, 2009, we executed a change order with a customer resulting in the completion of a contract, which had been accounted for under the completed-contract method. Both parties agreed to end the contract due to the significant changes in the overall scope of the program. As a result, we recognized $1.5 million in revenue for the three months ended September 30, 2009.

Table of Contents

Partially offsetting these decreases in net revenue for the three months ended September 30, 2010, was an increase in NetApp net revenue to NetApp based on the success of NetApp s FAS 2000 product line. Sales to NetApp totaled $16.6 million for the three months ended September 30, 2010 compared to $12.4 million for the three months ended September 30, 2009. However, under our agreement with NetApp, NetApp has the right to manufacture and sell, on a royalty and royalty-free basis, up to certain specified percentages of the products we currently manufacture and sell to NetApp. In the fourth quarter of 2010, we amended our agreement with NetApp to allow NetApp to manufacture and sell on a royalty-free basis all of the products we currently manufacture and sell to NetApp beginning on December 1, 2010. As a result, we currently do not anticipate generating any additional revenue from NetApp subsequent to November 30, 2010. We expect to generate additional revenue from our channel sales, software offerings and new OEM customers to replace the revenue, and more importantly, the gross profit lost as a result of amending our agreement with NetApp. However, if we are unable to generate sufficient revenue and gross profit from these sources to replace the reduced revenue and gross profit currently associated with NetApp, our financial results would be materially harmed.

The increase in net revenue for the nine months ended September 30, 2010 was mostly due to an increase in sales to HP. Sales to HP totaled $104.4 million for the nine months ended September 30, 2010 compared to $87.8 million for the nine months ended September 30, 2009. The increase in HP net revenue is due to the growth in the HP MSA product line, which includes our Series 2000 products and Series 3000 products. Although our Series 2000 products are in the decline phase of the product life cycle, demand for these products continues to be significant. We released our next generation Series 3000 products in the first quarter of 2010 and sales of these products have increased significantly during each quarter of 2010.

In addition, sales to NetApp increased during the nine months ended September 30, 2010 compared to the nine months ended September 30, 2009 based on the success of NetApp s FAS 2000 product line. Sales to NetApp totaled $52.5 million for the nine months ended September 30, 2010 compared to $38.1 million for the nine months ended September 30, 2009.

These increases were partially offset by a decrease in net revenue from Sun, FTS, and other smaller customers. Sun sales decreased to $0.5 million for the nine months ended September 30, 2010 compared to $9.8 million for the nine months ended September 30, 2009. The decline in Sun net revenue is due to the products we sell to Sun reaching the end of their product life cycle. FTS sales decreased to $2.1 million for the nine months ended September 30, 2010 compared to $10.1 million for the nine months ended September 30, 2009. The decrease in net revenue from FTS is due to FTS s decision to internally source the product we sell to FTS. We also experienced declines in sales to other smaller customers primarily as a result of product transition.

Cost of Goods Sold and Gross Profit

	Three Months Ended September 30, 2009		Three Months Ended September 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	(Decrease)	% Change
	(in thousands, except percentages)					
Cost of goods sold	$ 51,969	81.7%	$ 50,291	81.7%	$ (1,678)	-3.2%
Gross profit	$ 11,631	18.3%	$ 11,295	18.3%	$ (336)	-2.9%

	Nine Months Ended September 30, 2009		Nine Months Ended September 30, 2010			
	Amount	% of Net Revenue	Amount	% of Net Revenue	Increase	% Change
	(in thousands, except percentages)					
Cost of goods sold	$ 142,955	83.2%	$ 157,964	84.4%	$ 15,009	10.5%
Gross profit	$ 28,862	16.8%	$ 29,089	15.6%	$ 227	0.8%

Cost of goods sold decreased for the three months ended September 30, 2010 compared to the three months ended September 30, 2009 primarily as a result of a decrease in sales. Gross profit margin totaled 18.3% for both the three months ended September 30, 2009 and 2010. We experienced a more favorable mix of product sales during the three months ended September 30, 2009, as a higher percentage of our sales were to Sun and a lower percentage of our sales were to HP and Net App. Additionally, gross profit was positively impacted by $1.1 million as a result of the recognition of revenue and costs of goods sold associated with the completion of our long-term contract accounted for under the completed contract method. However, we experienced lower manufacturing overhead costs during the three months ended September 30, 2010 as a result of our 2008 Plan and 2010 Plan restructuring activities and also incurred lower manufacturing variances, including favorable pricing variances and lower excess and obsolete inventory charges.

Gross profit margin for the nine months ended September 30, 2010 was 15.6% compared to 16.8% for the nine months ended September 30, 2009. The decrease in gross profit margin was primarily due to product mix, as the products we sell to HP and NetApp typically have a higher product cost as a percentage of revenue and a lower gross profit than the products we sell to Sun. Sales to HP and NetApp approximated 83.9% of our net revenues for the nine months ended September 30, 2010 compared to 73.3% of our net revenues for the nine months ended September 30, 2009 while sales to Sun were less than 1% of our net revenue for the nine months ended September 30, 2010 compared to 5.7% of net revenues for the nine months ended September 30, 2009. We expect that the mix of products we sell, in particular, the products we sell to HP, will continue to affect our cost of goods sold and gross profit margin.

Table of Contents

Also contributing to the decrease in gross profit were higher amortization expense, warranty expenses and freight costs for the nine months ended September 30, 2010 compared to the same period in 2009. Warranty expenses increased as a result of a higher volume of quality related warranty claims, as we experienced component failure issues with certain of our battery and hard disk drive suppliers, as well as firmware failures within one of our products. Additionally, freight costs increased as a result of the increase in revenue and overall shipment volume as well as from expedite charges. Amortization expense increased due to the inclusion of Ciprico amortization in cost of goods sold as a result of the RAID Core product now generating revenue, as well as additional amortization resulting from the Cloverleaf acquisition. Prior to 2010, Ciprico amortization was included in research and development expense.

Research and Development Expenses

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2010	&