

DOT HILL SYSTEMS CORP

Form 10-Q

November 09, 2006

Table of Contents

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

(Mark One)

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

For the Quarterly Period Ended September 30, 2006

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

(State or other jurisdiction of incorporation
or organization)

13-3460176

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

2200 Faraday Avenue, Suite 100, Carlsbad, CA

(Address of principal executive offices)

92008

(Zip Code)

(760) 931-5500

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The registrant had 44,998,622 shares of common stock, \$0.001 par value, outstanding as of November 2, 2006.

DOT HILL SYSTEMS CORP.
FORM 10-Q
For the Quarter Ended September 30, 2006
INDEX

Part I. Financial Information

Item 1. Financial Statements (unaudited)

Condensed Consolidated Balance Sheets-December 31, 2005 and September 30, 2006

Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)-Three Months Ended September 30, 2005 and 2006 and Nine Months Ended September 30, 2005 and 2006

Condensed Consolidated Statements of Cash Flows-Nine Months Ended September 30, 2005 and 2006

Notes to Unaudited Condensed Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

Part II. Other Information

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 6. Exhibits

Signatures

EXHIBIT 4.6

EXHIBIT 4.7

EXHIBIT 10.3

EXHIBIT 10.4

EXHIBIT 10.5

EXHIBIT 10.6

EXHIBIT 10.7

EXHIBIT 31.1

EXHIBIT 31.2

EXHIBIT 32.1

Table of Contents**Part I. Financial Information****Item 1. Financial Statements**

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands Except Per Share Amounts)
(Unaudited)

	December 31, 2005	September 30, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 108,803	\$ 107,206
Short-term investments	13,431	1,249
Accounts receivable, net of allowance of \$294 and \$638	34,312	36,281
Inventories	2,804	2,359
Prepaid expenses and other	4,539	4,537
Deferred tax assets	5,762	
Total current assets	169,651	151,632
Property and equipment, net	7,891	10,315
Goodwill	40,725	40,725
Other intangible assets, net	7,414	4,967
Deferred tax assets	41,379	
Other assets	234	145
Total assets	\$ 267,294	\$ 207,784
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	\$ 25,732	\$ 30,166
Accrued compensation	3,561	3,447
Accrued expenses	3,633	5,571
Accrued legal settlement		1,475
Deferred revenue	1,327	345
Income taxes payable	60	15
Restructuring accrual	45	
Total current liabilities	34,358	41,019
Other long-term liabilities	885	2,039
Total liabilities	35,243	43,058
Commitments and Contingencies (Note 12)		
Stockholders Equity:		
Preferred stock, \$0.001 par value, 10,000 shares authorized, no shares issued or outstanding		
Common stock, \$0.001 par value, 100,000 shares authorized, 44,417 and 44,946 shares issued and outstanding at December 31, 2005 and	44	45

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-Q

September 30, 2006, respectively		
Additional paid-in capital	285,377	289,926
Accumulated other comprehensive loss	(118)	(306)
Accumulated deficit	(53,252)	(124,939)
Total stockholders' equity	232,051	164,726
Total liabilities and stockholders' equity	\$ 267,294	\$ 207,784

See accompanying notes to condensed consolidated financial statements.

3

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2006	2005	2006
NET REVENUE	\$ 53,616	\$ 54,846	\$ 177,524	\$ 179,797
COST OF GOODS SOLD	41,263	47,813	135,749	147,833
GROSS PROFIT	12,353	7,033	41,775	31,964
OPERATING EXPENSES:				
Sales and marketing	5,180	3,607	14,920	11,904
Research and development	6,280	8,221	16,335	30,053
General and administrative	3,158	4,181	8,555	14,305
Legal settlement		45		3,395
Total operating expenses	14,618	16,054	39,810	59,657
OPERATING INCOME (LOSS)	(2,265)	(9,021)	1,965	(27,693)
OTHER INCOME:				
Interest income, net	791	1,417	2,189	4,103
Other income (expense), net	7	(14)	93	12
Total other income, net	798	1,403	2,282	4,115
INCOME (LOSS) BEFORE INCOME TAXES	(1,467)	(7,618)	4,247	(23,578)
INCOME TAX EXPENSE (BENEFIT)	(192)	52,468	124	48,109
NET INCOME (LOSS)	\$ (1,275)	\$ (60,086)	\$ 4,123	\$ (71,687)
NET INCOME (LOSS) PER SHARE:				
Basic	\$ (0.03)	\$ (1.34)	\$ 0.09	\$ (1.60)
Diluted	\$ (0.03)	\$ (1.34)	\$ 0.09	\$ (1.60)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET INCOME (LOSS) PER SHARE:				
Basic	43,949	44,880	43,832	44,678
Diluted	43,949	44,880	45,613	44,678
COMPREHENSIVE INCOME (LOSS):				
Net income (loss)	\$ (1,275)	\$ (60,086)	\$ 4,123	\$ (71,687)
Foreign currency translation adjustments	46	(27)	192	(227)

Edgar Filing: DOT HILL SYSTEMS CORP - Form 10-Q

Net unrealized gain on short-term investments	51	4	30	39
Comprehensive income (loss)	\$ (1,178)	\$ (60,109)	\$ 4,345	\$ (71,875)

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

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

	Nine Months Ended	
	September 30,	
	2005	2006
Cash Flows From Operating Activities:		
Net income (loss)	\$ 4,123	\$ (71,687)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	6,017	5,405
Loss on disposal of property and equipment	461	75
Provision for doubtful accounts	969	246
Stock-based compensation expense	8	2,718
Gain on sale of short-term investments	(5)	
Deferred taxes		47,141
Changes in operating assets and liabilities:		
Accounts receivable	4,331	(2,007)
Inventories	773	457
Prepaid expenses and other assets	(1,052)	138
Accounts payable	(17,214)	2,292
Accrued compensation and expenses	(683)	1,787
Legal settlement payable		1,475
Deferred revenue	670	(989)
Income taxes payable	(243)	(46)
Restructuring accrual	(92)	(45)
Other long-term liabilities	48	1,152
Net cash used in operating activities	(1,889)	(11,888)
Cash Flows From Investing Activities:		
Purchases of property and equipment	(3,008)	(3,998)
Sales and maturities of short-term investments	50,632	22,575
Purchases of short-term investments	(25,200)	(10,337)
Net cash provided by investing activities	22,424	8,240
Cash Flows From Financing Activities:		
Proceeds from sale of stock to employees	1,040	1,055
Proceeds from exercise of stock options and warrants	738	777
Net cash provided by financing activities	1,778	1,832
Effect of Exchange Rate Changes on Cash	192	219
Net Increase (Decrease) in Cash and Cash Equivalents	22,505	(1,597)
Cash and Cash Equivalents, beginning of period	67,496	108,803

Cash and Cash Equivalents, end of period	\$ 90,001	\$ 107,206
Supplemental Disclosures of Cash Flow Information:		
Construction in progress costs incurred but not paid	\$ 770	\$ 1,464
Cash paid for interest	\$	\$
Cash paid for income taxes	\$ 540	\$ 1,482

See accompanying notes to condensed consolidated financial statements.

5

Table of Contents

DOT HILL SYSTEMS CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) have been prepared pursuant to the instructions to Securities and Exchange Commission, or SEC, Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States, or GAAP, for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. 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, 2005. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The preparation of our financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenues are recognized pursuant to applicable accounting standards, including SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*.

We recognize revenue for 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 our stated billing rates which are consistent with amounts charged separately and other 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 12 months. Revenue from installation, training and consulting is recognized as the services are performed.

2. Change in Accounting for Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standard (SFAS) No. 123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees, directors and consultants, including stock option grants and purchases of stock made pursuant to our 2000 Amended and Restated Equity Incentive Plan, or the 2000 EIP, our 2000 Amended and Restated Non-Employee Directors Stock Option Plan, or the 2000 NEDSOP, and our 2000 Amended and Restated Employee Stock Purchase Plan, or the 2000 ESPP, based on estimated fair values. SFAS No. 123(R) supercedes our previous accounting under Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*. In March 2005, the SEC issued SAB No. 107, *Share-Based Payment*, and we have applied SAB No. 107's provisions in our adoption of SFAS No. 123(R).

We adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006 as further described below. In accordance with the modified prospective transition method, our unaudited condensed consolidated financial statements for the three and nine months ended September 30, 2005 have not been restated to reflect, and do not include, the impact of the adoption of SFAS No. 123(R).

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

Table of Contents

September 30, 2006. Prior to the adoption of SFAS No. 123(R), we accounted for share-based awards to employees and directors using the intrinsic value method in accordance with APB No. 25 as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation*. Under the intrinsic value method, share-based compensation expense was only recognized by Dot Hill if the exercise price of the grant was less than the fair market value of the underlying stock at the date of grant. No stock-based compensation expense was recorded by Dot Hill in 2005.

As of September 30, 2006, total unrecognized share-based compensation cost related to unvested stock options was \$6.9 million, which is expected to be recognized over a weighted average period of approximately 1.6 years. We have included the following amounts for share-based compensation cost, including the cost related to the 2000 EIP, 2000 NEDSOP and 2000 ESPP, in the accompanying unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2006 (amounts in thousands):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of goods sold	\$ 81	\$ 221
Sales and marketing	66	210
Research and development	188	493
General and administrative	322	1,700
Share-based compensation expense before taxes	657	2,624
Related deferred income tax benefits		
Share-based compensation expense, net of income taxes	\$ 657	\$ 2,624
Net share-based compensation expense per basic and diluted common share	\$ 0.01	\$ 0.06
Share-based compensation expense is derived from:		
Stock options	\$ 575	\$ 2,325
2000 ESPP	82	299
Total	\$ 657	\$ 2,624

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

Stock Incentive Plans

2000 EIP. During 2006 and 2005, we primarily granted options to purchase common stock to our employees and consultants under the 2000 EIP. These options expire 10 years from the date of grant and typically vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. The number of shares of common stock reserved for issuance under the 2000 EIP is increased annually on the date of our meeting of stockholders by an amount equal

to the lesser of (A) two percent of our outstanding shares as of the date of our annual meeting of stockholders, (B) 1,000,000 shares or (C) an amount determined by our board of directors. If an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the shares with respect to which the option was not exercised shall continue to be available under the 2000 EIP. As of September 30, 2006, options to purchase 5,482,966 shares of common stock were outstanding under the 2000 EIP and options to purchase 785,575 shares of common stock remained available for grant under the 2000 EIP.

2000 NEDSOP. Under the 2000 NEDSOP, nonqualified stock options to purchase common stock are automatically granted to our non-employee directors upon appointment to our board of directors (initial grants) and upon each of our annual meeting of stockholders (annual grants). Options granted under the 2000 NEDSOP expire 10 years from the date of the grant. Initial grants vest over four years, with 25% of the shares subject to the option vesting one year from the date of grant and the remaining shares subject to the option vesting ratably thereafter on a monthly basis. Annual grants are fully vested on the date of grant. 1,000,000 shares of common stock are reserved for issuance under the 2000 NEDSOP. As of September 30, 2006, options to purchase 454,292 shares of common stock were outstanding under the 2000 NEDSOP and options to purchase 473,124 shares of common stock remained available for grant under the 2000 NEDSOP.

Table of Contents

2000 ESPP. The 2000 ESPP qualifies under the provisions of Section 423 of the Internal Revenue Code, or IRC, and provides our eligible employees, as defined in the 2000 ESPP, with an opportunity to purchase shares of our common stock at 85% of fair market value, as defined in the 2000 ESPP. There were 199,438 and 289,073 shares issued for the 2000 ESPP purchase periods that ended in the nine months ended September 30, 2005 and 2006, respectively.

Share-Based Compensation Cost under SFAS No. 123

Prior to January 1, 2006, we disclosed compensation cost in accordance with SFAS No. 123. The provisions of SFAS No. 123 require Dot Hill to disclose the assumptions used in calculating the fair value pro forma expense. Had compensation expense for the plans been determined based on the fair value of the options at the grant dates for awards under the plans consistent with SFAS No. 123, our net income for the three and nine months ended September 30, 2005 would have been as follows (amounts in thousands, except per share data):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income (loss) as reported	\$ (1,275)	\$ 4,123
Stock-based compensation, as reported		8
Total stock-based compensation determined under the fair value based method for all awards	(1,343)	(3,783)
Pro forma net income (loss)	\$ (2,618)	\$ 348
Basic net income (loss) per share, as reported	\$ (0.03)	\$ 0.09
Diluted net income (loss) per share, as reported	\$ (0.03)	\$ 0.09
Basic net income (loss) per share, SFAS No. 123 adjusted	\$ (0.06)	\$ 0.01
Diluted net income (loss) per share, SFAS No. 123 adjusted	\$ (0.06)	\$ 0.01

Pro forma disclosures for the three and nine months ended September 30, 2006 are not presented because the amounts are recognized in the unaudited condensed consolidated statement of operations in accordance with SFAS No. 123(R).

To estimate compensation expense which would have been recognized under SFAS No. 123 for the nine months ended September 30, 2005 and the compensation cost that was recognized under SFAS No. 123(R) for the nine months ended September 30, 2006, we use the Black-Scholes option-pricing model with the following weighted-average assumptions for equity awards granted:

	2000 EIP and 2000 NEDSOP		2000 ESPP	
	Nine Months Ended September 30,		Nine Months Ended September 30,	
	2005	2006	2005	2006
Risk-free interest rate	3.80%	4.90%	4.08%	5.00%
Expected dividend yield	%	%	%	%
Volatility	78%	68%	75%	68%
Expected life	4.0 years	5.5 years	0.5 year	0.5 year

The risk-free interest rate is based on the implied yield available on U.S. Treasury issues with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the future. The

expected volatility is based on implied volatility of our stock for the related vesting period. The expected life of the equity award is based on historical grant behavior to management and non-management employee groups.

Table of Contents

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

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2005	4,830,811	\$ 6.52		
Granted	2,072,501	5.23		
Exercised	(215,615)	3.23		
Forfeited	(846,450)	6.23		
Expired	(301,988)	7.69		
Outstanding at September 30, 2006	5,539,259	\$ 6.14	7.49	\$ 1,668
Vested and expected to vest at September 30, 2006	5,139,786	\$ 6.23	3.14	\$ 1,617
Exercisable at September 30, 2006	3,359,494	\$ 6.81	6.39	\$ 1,428

The weighted average grant-date fair values of options granted during the nine months ended September 30, 2006 and 2005 were \$3.30 per share and \$3.45 per share, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$0.2 million and \$0.7 million, respectively.

During the nine months ended September 30, 2006, financing cash generated from share-based compensation arrangements amounted to \$0.7 million for the purchase of shares upon exercise of options and \$1.1 million collected for the purchase of shares through the 2000 ESPP. We issue new shares from the respective plan share reserves upon exercise of options to purchase common stock and for purchases through the 2000 ESPP.

Additional information regarding options outstanding for all plans as of September 30, 2006, is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (yrs.)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$1.34 - 3.10	1,130,187	6.38	\$ 2.53	875,003	\$ 2.38
\$3.15 - 4.33	1,002,248	8.64	3.83	279,519	3.67
\$4.51 - 6.10	1,125,081	7.41	5.66	743,672	5.74
\$6.12 - 6.87	1,013,460	8.65	6.55	268,017	6.32
\$6.88 - 13.13	928,633	6.57	9.99	853,633	10.26
\$13.50 - 17.14	339,650	7.15	14.83	339,650	14.83
Total	5,539,259	7.49	\$ 6.14	3,359,494	\$ 6.81

The aggregate intrinsic value in the table above is based our closing stock price of \$3.90 per share as of the last business day of the nine months ended September 30, 2006, which amount would have been received by the optionees had all options been exercised on that date. The total fair value of options to purchase common stock that vested during the nine months ended September 30, 2006 and 2005 was \$2.4 million and \$3.6 million, respectively.

3. Stock Option Expense related to Historical Grant Practices

In response to recently reported industry issues around option pricing, our Audit Committee, which is comprised of independent directors, began a self-initiated review of our historical stock option grant practices and related accounting. This review was proactive and voluntary. Our Audit Committee reviewed our option grant practices dating back to our merger with Artecon, Inc. in 1999 and identified certain immaterial errors relating to our accounting for stock options during our 2000 through 2002 fiscal years. As a result, we recognized \$0.1 million of cost of goods sold and sales and marketing expenses for the three months ended June 30, 2006 associated with the errors identified by our Audit Committee's review that was not recognized in prior periods. The expenses associated with the errors were not material in any of the prior periods during which the expenses should have been recognized nor was the cumulative adjustment material to the three or six months ended June 30, 2006. The \$0.1 million stock option expense recognized for the three months ended June 30, 2006 was in addition to the \$0.7 million and \$2.6 million share-based compensation cost resulting from SFAS No. 123(R) for the three and nine months ended September 30, 2006, respectively, as discussed in note 2.

Table of Contents

4. Net Income (Loss) Per Share

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

Diluted net income (loss) per share reflects the potential dilution of securities by including common stock equivalents, such as stock options and stock warrants in the weighted average number of common shares outstanding for a period, if dilutive.

The following table sets forth a reconciliation of the basic and diluted number of weighted average shares outstanding used in the calcula