DOT HILL SYSTEMS CORP
Form 424B4
September 18, 2003

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PROSPECTUS

10,000,000 Shares

Dot Hill Systems Corp.

Common Stock

This is an offering of shares of common stock of Dot Hill Systems Corp. Of the 10,000,000 shares being offered, Dot Hill is selling 8,672,000 shares and the selling stockholders are selling 1,328,000 shares. We will not receive any of the proceeds from the sale of shares by the selling stockholders.

Our common stock is traded on the Nasdaq National Market under the symbol "HILL". On September 17, 2003, the last reported sale price of our common stock on the Nasdaq National Market was $16.18 per share.

Investing in our common stock involves risks. "Risk Factors" begin on page 6.

	Per Share	Total
Public Offering Price	$ 15.500	$ 155,000,000
Underwriting Discounts and Commissions	$ 0.814	$ 8,140,000
Proceeds to Dot Hill Systems Corp. (before expenses)	$ 14.686	$ 127,356,992
Proceeds to Selling Stockholders (before expenses)	$ 14.686	$ 19,503,008

We and the selling stockholders have granted the underwriters a 30-day option to purchase up to 1,500,000 additional shares of our common stock to cover over-allotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Lehman Brothers, on behalf of the underwriters, expects to deliver the shares on or about September 23, 2003.

LEHMAN BROTHERS

DEUTSCHE BANK SECURITIES

RBC CAPITAL MARKETS

ROTH CAPITAL PARTNERS

September 17, 2003

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You should rely only on the information contained in or incorporated by reference into this prospectus. Neither we nor the underwriters have authorized anyone, including the selling stockholders, to provide you with information different from that contained in this prospectus. We and the selling stockholders are offering to sell, and seeking offers to buy, shares of common stock only in jurisdictions where offers and sales are permitted. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or any sale of the common stock.

PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus and may not contain all of the information that may be important to you. You should read this entire prospectus carefully, including the information set forth in "Risk Factors" and information incorporated herein by reference before making an investment decision. In this prospectus, "Dot Hill," "our company," "we," "us" and "our" refer to Dot Hill Systems Corp.

Dot Hill Systems Corp.

We are a provider of storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete turn-key, multi-terabyte storage area networks, provides end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our SANnet products have been distinguished by certification as Network Equipment Building System, or NEBS, Level 3 and are MIL STD-810F compliant based on their ruggedness and reliability.

Our products and services are sold worldwide to end-users primarily through our channel partners, including original equipment manufacturers, or OEMs, systems integrators, or SIs, and value added resellers, or VARs. In May 2002, we entered into a three-year OEM agreement with Sun Microsystems, or Sun, to provide our storage hardware and software products for private label sales by Sun. We have been shipping our products to Sun for resale to Sun's customers since October 2002. We continue to develop new products for resale by Sun and other channel partners and expect to begin shipping two additional new products for resale later this year. We also have OEM relationships with Comverse Technology, Inc., Motorola, Inc. and StorageTek Corp. We will continue to pursue additional OEM relationships with other industry leaders to benefit from their extensive direct and indirect distribution networks, installed customer base and sales and marketing resources.

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

The need for high reliability, high performance networked storage and data management solutions continues to grow rapidly. International Data Corporation, or IDC, estimates that the total combined amount worldwide of storage-related expenditures will increase from approximately $54.0 billion in 2002 to over $71.4 billion in 2006, growing at an overall compound annual growth rate, or CAGR, of 7.2% (IDC, *Worldwide Disk Storage Systems Forecast and Analysis, 2002 - 2006*, December 2002). We offer high reliability, high performance storage area network, or SAN, systems in an open systems architecture in several configurations, including Fibre Channel and network attached storage, or NAS. According to IDC, by 2006 Fibre Channel SANs will represent 40.1% of total worldwide storage systems expenditures, up from 23.9% in 2002, and growing at a 14.7% CAGR from $4.8 billion in 2002 to $8.2 billion in 2006. IDC also estimates that by 2006 NAS devices will represent 20.0% of total worldwide storage systems expenditures, up from 8.3% in 2002, and growing at a 25.6% CAGR from $1.7 billion in 2002 to $4.1 billion in 2006.

Our products are installed worldwide at companies ranging from small businesses to large enterprises, government agencies and other institutions. Our entry-level and midrange products incorporate a number of high performance features found on high-end systems at prices suitable for end-users in the entry-level and midrange storage markets. We serve a broad range of end-users across all storage markets, with product lines ranging from 180 gigabyte, or GB, appliances to complete

28 terabyte, or TB, storage systems. Our products may be integrated in a modular building block fashion or configured into a complete storage solution and enable our indirect channel partners to customize solutions for end-users by bundling our products with value-added hardware, software and services.

We have broad management and technical experience in designing, developing and marketing networked storage solutions. Our senior management has over 150 years of combined experience in the storage industry and our research and development programs are driven by our innovative engineering team.

Our Strategy

Over the past year we have focused on achieving profitable growth by moving from a direct sales to an indirect sales channel model, outsourcing our manufacturing and service operations, and focusing on our core competencies in research, engineering and design. Our objective is to capture an increasing share of the open systems storage solutions market by:

- expanding our existing OEM relationships;
- broadening our indirect sales channels;
- extending our technology leadership; and
- pursuing strategic alliances, partnerships and acquisitions.

Our Company

Dot Hill was formed in 1999 by the combination of Box Hill Systems Corp. and Artecon, Inc. We reincorporated in Delaware in 2001. Our telephone number is (760) 931-5500. Our principal executive offices are located at 6305 El Camino Real, Carlsbad, California 92009. We have facilities in Carlsbad, California, Japan and the Netherlands. We also have sales offices in Boston, Massachusetts, Germany, Singapore and the United Kingdom. Our website address is http://www.dothill.com. Information contained on our website does not constitute a part of this prospectus. Our Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K and all amendments to those reports that we file with the Securities and Exchange Commission, or SEC, are currently available free of charge to the general public through our website. These reports are accessible on our website promptly after being filed with the SEC.

We recently elected to move from the American Stock Exchange to the Nasdaq National Market, where our common stock began trading on July 28, 2003.

The Dot Hill logo, SANnet®, SANscape®, SANpath®, Dot Hill Systems® and Dot Hill® are our registered trademarks. All other trade names and trademarks mentioned in this prospectus are the property of their respective owners.

THE OFFERING

Common stock offered by Dot Hill	8,672,000 shares
Common stock offered by selling stockholders	1,328,000 shares
Common stock to be outstanding after this offering	41,451,318 shares
Use of proceeds	We intend to use the net proceeds of this offering to finance the growth of our business, expand research and development and for general corporate purposes. We may also use a portion of the proceeds for acquisitions or other investments. We will not receive any of the net proceeds from the sale of the shares by the selling stockholders.
Nasdaq National Market symbol	"HILL"

The number of shares of our common stock to be outstanding after the offering set forth above is based on 32,779,318 shares outstanding as of September 17, 2003. The number of outstanding shares excludes:

- an aggregate of 4,845,551 shares of our common stock reserved for issuance under our equity incentive plans, of which 3,277,681 shares were subject to outstanding stock options as of September 17, 2003, at a weighted average exercise price of $3.98 per share; and

- an aggregate of 2,065,316 shares of our common stock issuable upon exercise of outstanding warrants.

ABOUT THIS PROSPECTUS

Unless otherwise indicated, the information in this prospectus assumes no exercise of the underwriters' over-allotment option.

Prior to making a decision about investing in our common stock, you should consider carefully the specific risks contained in the section "Risk Factors" beginning on page 6, and any applicable prospectus supplement, together with all of the other information contained in this prospectus and any prospectus supplement or appearing or incorporated by reference in the registration statement of which this prospectus is a part.

SUMMARY CONSOLIDATED FINANCIAL DATA

The following table summarizes financial data regarding our business. You should read this information together with the consolidated financial statements and the notes to those statements appearing elsewhere in this prospectus or incorporated herein by reference. See "Selected Consolidated Financial Data" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." Dot Hill was formed in 1999 by the combination of Box Hill Systems and Artecon.

	Year Ended December 31,					Six Months Ended June 30,	
	1998	1999	2000	2001	2002	2002	2003
	(in thousands, except per share data)						
Statement of Operations Data:							
Net revenue	$ 168,355	$ 124,216	$ 121,197	$ 56,277	$ 46,936	$ 22,096	$ 78,950
Gross profit	58,591	37,604	43,467	11,459	1,492	2,637	15,550
Operating income (loss)	279	(13,454)	(3,969)	(28,369)	(37,764)	(18,539)	770
Net income (loss)	584	(9,047)	(948)	(43,391)	(34,303)	(15,062)	1,096
Net income (loss) attributable to common stockholders	584	(9,047)	(948)	(43,391)	(34,759)	(15,062)	955
Net income (loss) per share:							
Basic	$ 0.03	$ (0.39)	$ (0.04)	$ (1.76)	$ (1.39)	$ (0.61)	$ 0.03
Diluted	$ 0.02	$ (0.39)	$ (0.04)	$ (1.76)	$ (1.39)	$ (0.61)	$ 0.03
Weighted average shares outstanding:							
Basic	22,903	23,385	24,253	24,703	24,953	24,854	28,877
Diluted	24,442	23,385	24,253	24,703	24,953	24,854	32,954

The following table summarizes our balance sheet as of June 30, 2003:

- on an actual basis; and
- on an as adjusted basis to give effect to the sale by us and the selling stockholders of 10,000,000 shares in this offering, at an offering price to the public of $15.50 per share, after deducting estimated underwriting discounts and commissions and offering expenses payable by us.

	As of June 30, 2003	
	Actual	As Adjusted
	(in thousands)	
Balance Sheet Data:		
Cash, cash equivalents and short-term investments	$ 30,677	$ 157,284
Working capital	19,856	146,463
Total assets	58,094	184,701
Total long-term debt	266	266
Total stockholders' equity	$ 24,406	$ 151,013

RISK FACTORS

Investing in our common stock involves a high degree of risk. Before purchasing our common stock, you should carefully consider the risks described below in addition to the other information in this prospectus. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks, and you could lose all or part of your investment. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this prospectus, including our financial statements and related notes.

Risks Related to Our Business and Industry

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

Our business is highly dependent on our relationship with Sun. Sales to Sun accounted for 25.0% and 81.0% of our net revenue for the year ended December 31, 2002 and the six months ended June 30, 2003, respectively. Our OEM agreement with Sun has an initial term of three years and may be renewed at the discretion of Sun. However, there are no minimum purchase requirements or guarantees in our agreement with Sun, the agreement does not obligate Sun to purchase its storage solutions exclusively from us and Sun may cancel purchase orders submitted under the agreement at any time. Sun may terminate the entire contract prior to the contract expiration date upon the occurrence of certain events that are not remedied within a specified cure period. The decision by Sun not to renew its contract with us, to terminate the contract, to cease making purchases or to cancel purchase orders would cause our revenues to decline substantially. We cannot be certain if, when or to what extent Sun might terminate its contract with us, cancel purchase orders, cease making purchases or elect not to renew the contract upon the expiration of the initial term. We expect to receive a substantial majority of our projected net revenue for the year ended December 31, 2003 from sales of our products to Sun. We cannot assure you that we will achieve these expected sales levels. If we do not achieve the sales levels we expect to receive from Sun, our business and result of operations will be significantly harmed.

Any decline in Sun's sales could harm our business.

A substantial majority of our revenues are generated by sales to Sun, which sells our products as separate units or bundled with its servers. If Sun's storage related sales decline, our revenues will also decline and our business could be materially harmed. In addition, Sun's quarterly operating results typically fluctuate downward in the first quarter of their fiscal year when compared with the immediately preceding fourth quarter. If these fluctuations cause Sun to decrease purchases of our storage products, our results in the first quarter of Sun's fiscal years, which is our third quarter, could be harmed.

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

Because we intend to expand sales to channel partners, we expect to experience continued concentration in our customer base. As a result, if our relationship with any of our customers is disrupted, we would lose a significant portion of our anticipated net revenue. We cannot guarantee that

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our relationship with Sun or other channel partners will expand or not otherwise be disrupted. Factors that could influence our relationship with significant channel partners, including Sun, include:

- our ability to maintain our products at prices that are competitive with those of other storage system suppliers;
- our ability to maintain quality standards for our products sufficient to meet the expectations of our channel partners; and
- our ability to produce, ship and deliver a sufficient quantity of our products in a timely manner to meet the needs of our channel partners.

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

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

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

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

Manufacturing disruptions could harm our business.

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

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

We experienced losses in each of the past three years and may continue to experience losses in the future and may need to raise additional funds to continue our operations.

For the years ended December 31, 2000, 2001 and 2002, we incurred net losses of $0.9 million, $43.4 million and $34.3 million, respectively. We cannot assure you that we will be profitable in any future period. We have expended, and will continue to be required to expend, substantial funds to pursue engineering, research and development projects, enhance marketing efforts and otherwise operate our business. Our future capital requirements will depend on, and could increase substantially as a result of, many factors, including:

- our plans to maintain and enhance our engineering, research, development and product testing programs;
- the success of our manufacturing strategy;
- the success of our sales and marketing efforts;
- the extent and terms of any development, marketing or other arrangements;

changes in economic, regulatory or competitive conditions; and

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

Our available cash, cash equivalents and short-term investments as of June 30, 2003 totaled $30.7 million, which, together with cash generated by operations and the net proceeds from this offering, we believe will finance our operations through at least the next twelve months. We may need to raise additional funds to continue our operations and to avoid liquidity problems, either through borrowings or the sale of our debt or equity securities. In addition, unanticipated events, such as Sun's failure to meet its product purchase forecast or extraordinary expenses or operating expenses in excess of our projections, may require us to raise funds sooner than we expect. We may not be able to raise additional funds on commercially reasonable terms or at all. Any sales of our debt or equity securities in the future may have a substantial dilutive effect on our existing stockholders. If we are able to borrow funds, we may be required to grant liens on our assets to the provider of any source of financing or enter into operating, debt service or working capital covenants with any provider of financing that could hinder our ability to operate our business in accordance with our plans. As a result, our ability to borrow money on a secured basis may be impaired, and we may not be able to issue secured debt on commercially reasonable terms or at all.

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

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

Quarter	Net Revenue	Net Income (Loss)
	(in millions)	
First Quarter 2001	$ 18.6	$ (28.7)
Second Quarter 2001	14.9	(5.7)
Third Quarter 2001	12.3	(3.3)
Fourth Quarter 2001	10.5	(5.7)
First Quarter 2002	10.9	(6.2)
Second Quarter 2002	11.2	(8.9)
Third Quarter 2002	8.6	(7.3)
Fourth Quarter 2002	16.3	(11.9)
First Quarter 2003	30.5	(1.5)
Second Quarter 2003	48.4	2.6

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

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

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

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

product configuration, mix and quality issues;

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

manufacturing costs;

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

changes in pricing by us or our competitors;

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

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

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

the level of competition;

potential reductions in inventories held by channel partners;

slowing sales of the products of our channel partners;

technological changes in the open systems storage market;

levels of expenditures on research, engineering and product development;

changes in our business strategies;

personnel changes; and

general economic trends and other factors.

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

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

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

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

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

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

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

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

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

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

We rely primarily on patents, copyrights, trademarks, trade secrets, nondisclosure agreements and common law to protect our intellectual property. For example, we have registered trademarks for SANnet, SANpath, SANscape and Dot Hill and the Dot Hill logo. We also had eight U.S. patents and no patents pending as of June 30, 2003. We do not expect that our patents will provide us with any meaningful competitive advantage relative to the other protections we rely on. Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. In addition, the laws of foreign countries may not adequately protect our intellectual property rights. Our efforts to protect our intellectual property from third party discovery and infringement may be insufficient and third parties may independently develop technologies similar to ours, duplicate our products or design around our patents.

Third parties have in the past asserted, and in the future may assert, that our products and technologies infringe their intellectual property, which could result in infringement lawsuits being filed against us. We expect that providers of storage products will increasingly be subject to infringement claims as the number of products and competitors increases. From time to time, we receive letters from third parties suggesting that we may require a license from such third parties to manufacture or sell our products. We evaluate all such communications to assess whether to seek a license from the patent owner. We may require licenses that could have a material impact on our business. In addition, we cannot assure you that we would prevail in any litigation related to infringement claims against us. Moreover, we cannot assure you that additional third parties will not assert infringement claims against us in the future.

If we were to become party to any litigation to protect our intellectual property from infringement by a third party, or as a result of a claim that our products and technologies infringe the intellectual property of a third party, we would likely incur substantial legal fees and expenses and our management's attention would be distracted from the operations of our business. Further, any settlement or adverse judgment involving a determination that our products or technology infringe the intellectual property of a third party could require us to pay substantial damages or royalties to a third party which could impede our ability to price our products competitively and could adversely affect our gross profit. In such event we could also be required to obtain a license from the third party to continue to sell our products or use our technologies. We may not be able to obtain a license from a third party on commercially reasonable terms, or at all. If we or our suppliers were unable to license protected technology, we could be prohibited from marketing products that incorporate the protected technology. We could also incur substantial costs to redesign our products in a manner to avoid infringement of third party intellectual property rights.

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

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

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

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

We expect that competition will increase as a result of industry consolidation and the creation of companies with new, innovative product offerings. Current and potential competitors have established

or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition is likely to result in price reductions, reduced operating margins and potential loss of market share, any of which could harm our business.

We believe that the principal competitive factors affecting the storage systems market include:

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

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

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

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

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

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

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

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

- the reduction, rescheduling or cancellation of customer orders.

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

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

Our products may contain undetected errors or failures when first introduced or as we release new versions. During 2003, we plan to introduce a number of new products, particularly in our SANnet II family of systems. We may discover errors in our products after shipment, resulting in a loss of or delay in market acceptance, which could harm our business. Our standard warranty provides that if the system does not function to published specifications, we will repair or replace the defective component or system without charge. Significant warranty costs, particularly those that exceed reserves, could adversely impact our business. In addition, defects in our products could result in our customers claiming damages against us for property damage or consequential damage and could also result in our loss of customers and goodwill. Any such claim could distract management's attention from operating our business and, if successful, result in damage claims against us that might not be covered by our insurance.

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

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

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

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

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

As of June 30, 2003, our executive officers, directors and their affiliates beneficially owned approximately 16.4% of our outstanding shares of common stock. These individual stockholders may be able to influence matters requiring approval by our stockholders, including the election of a majority of our directors. The voting power of these stockholders under certain circumstances could have the effect of delaying or preventing a change in control of us. This concentration of ownership may also make it more difficult or expensive for us to obtain financing. Further, any substantial sale of shares by these individuals could depress the market price of our common stock and impair our ability to raise capital in the future through the sale of our equity securities.

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

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

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

Dilution of the per share value of our common stock could result from the exercise of outstanding warrants. As of September 17, 2003, there were outstanding warrants to purchase 2,065,316 shares of our common stock. The warrants have exercise prices ranging from $2.97 to $4.68 per share and expire at various dates through March 14, 2008. When the exercise price of the warrants is less than the trading price of our common stock, exercise of the warrants would have a dilutive effect on our stockholders. The possibility of the issuance of shares of our common stock upon exercise of the warrants could cause the trading price of our common stock to decline.

Risks Related to This Offering

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

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

other publicly-held companies, in our industry generally and our business segment in particular, which may not have any direct relationship with our business or prospects.

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

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

A substantial number of shares of our common stock will be available for resale after the offering. If our stockholders sell substantial amounts of our common stock in the public market following the offering, the market price of our common stock could decline. These sales might also make it more difficult for us to sell equity securities in the future at times and prices that we deem appropriate. In addition, we are obligated to file a registration statement with respect to the resale of up to 1,394,275 shares of our common stock issuable upon exercise of warrants held by Sun.

We, all of our executive officers and directors and the selling stockholders have agreed not to offer, sell or otherwise dispose of any shares of capital stock or any securities which may be converted into or exchanged for any shares of our capital stock for a period of 90 days from the date of this prospectus, other than the shares being sold pursuant to this prospectus. However, the underwriters may waive this restriction and allow us or them to sell shares at any time. Shares of common stock subject to these lock-up agreements and held by executive officers, directors and selling stockholders will become eligible for sale in the public market upon expiration of these lock-up agreements, subject to limitations imposed by Rule 144 under the Securities Act of 1933.

We may spend or invest a substantial portion of the net proceeds of this offering in ways in which you might not agree.

We have broad discretion to determine how we spend or invest the net proceeds from this offering. You will not have an opportunity to evaluate the economic, financial or other information upon which we base our decisions on how to use these proceeds and, subject to certain exceptions, we will be able to use and allocate the net proceeds without first obtaining stockholder approval.

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

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

FORWARD-LOOKING STATEMENTS

We have made forward-looking statements in this prospectus and in the information incorporated herein by reference, including in the sections entitled "Prospectus Summary," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of

Operations" and "Business," that are based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, potential growth opportunities and the effects of competition and regulation. Forward-looking statements include all statements that are not historical facts. You can identify these statements by the use of forward-looking terminology, such as the words "believe," "expect," "anticipate," "intend," "plan," "estimate," "may," "might" or other similar expressions.

Forward-looking statements involve significant risks, uncertainties and assumptions. Although we believe that the expectations reflected in the forward-looking statements are reasonable, actual results may differ materially from those expressed in these forward-looking statements. You should not put undue reliance on any forward-looking statements. We do not have any intention or obligation to update forward-looking statements after we distribute this prospectus, even if new information becomes available or other events occur in the future. You should understand that many important factors, in addition to those discussed in the section entitled "Risk Factors" and elsewhere in this prospectus and in the information incorporated herein by reference, could cause our results to differ materially from those expressed or suggested in forward-looking statements.

USE OF PROCEEDS

We expect to receive net proceeds of approximately $126.6 million from this offering after deducting the underwriting discount and estimated offering expenses. If the underwriters' over-allotment option is exercised in full, our estimated net proceeds will be approximately $144.7 million. We will not receive any of the net proceeds from the sale of shares by the selling stockholders.

We intend to use the net proceeds for general corporate purposes and to expand our research and development efforts. We may also use a portion of the proceeds for acquisitions or other investments. However, we have no present understanding or agreement relating to any specific acquisition or investment.

We have not yet determined the amount of net proceeds to be used specifically for each of the foregoing purposes. Accordingly, our management will have significant flexibility in applying the net proceeds of the offering. Pending their use as described above, we may invest the net proceeds of this offering in interest-bearing investment-grade instruments or bank deposits.

DIVIDEND POLICY

We do not expect to pay any cash dividends for the foreseeable future. We currently intend to retain earnings, if any, to finance operations and to expand our business.

Any future determination to pay cash dividends will be at the discretion of our board of directors and will depend upon our financial condition, operating results, capital requirements and such other factors as our board of directors deems relevant.

During the period beginning in December 2002 and ending April 2003, we paid a total of $0.1 million in dividends on our then outstanding preferred stock. In April 2003, all of our outstanding preferred stock was converted to shares of our common stock and no longer accrues dividends.

MARKET PRICE FOR OUR COMMON STOCK

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

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

	Low	High
Year Ended December 31, 2001		
First Quarter	$ 1.92	$ 8.00
Second Quarter	1.59	2.75
Third Quarter	1.28	2.53
Fourth Quarter	1.06	2.20
Year Ended December 31, 2002		
First Quarter	1.55	3.15
Second Quarter	2.10	4.69
Third Quarter	2.50	3.95
Fourth Quarter	1.60	3.50
Year Ended December 31, 2003		
First Quarter	3.10	6.12
Second Quarter	6.01	14.00
Third Quarter (through September 17, 2003)	13.52	18.95

On September 17, 2003, the last reported sale price for our common stock on the Nasdaq National Market was $16.18 per share. As of August 26, 2003, there were 32,773,995 shares of our common stock outstanding held by approximately 6,645 holders of record.

CAPITALIZATION

The following table sets forth, as of June 30, 2003, our capitalization:

- on an actual basis; and

- on an as adjusted basis to give effect to the sale of the 10,000,000 shares offered by us and the selling stockholders in this offering (excluding the over-allotment shares) at an offering price to the public of $15.50 per share, after deducting the underwriting discounts and commissions and estimated offering expenses and our anticipated application of the net proceeds of the offering.

You should read this table together with the sections of this prospectus entitled "Selected Consolidated Financial Data" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and related notes included in this prospectus or incorporated herein by reference.

	As of June 30, 2003	
	Actual	As Adjusted
	(unaudited) (in thousands)	

	As of June 30, 2003	
Cash, cash equivalents and short-term investments	$ 30,677	$ 157,284
Debt:		
Borrowings under credit lines	$ 266	$ 266
Stockholders' equity:		
Preferred stock, $0.001 par value, 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, $0.001 par value, 100,000,000 shares authorized; 32,273,208 shares issued and outstanding on an actual basis; 40,945,208 shares issued and outstanding on an as adjusted basis	32	41
Additional paid-in capital	127,405	254,003
Accumulated deficit	(102,482)	(102,482)
Deferred compensation	(38)	(38)
Accumulated other comprehensive loss	(511)	(511)
Total stockholders' equity	24,406	151,013
Total capitalization	$ 24,672	$ 151,279

The number of outstanding shares of our common stock as of June 30, 2003 excludes:

an aggregate of 6,766,938 shares of our common stock reserved for issuance under our equity incentive plans, of which 3,707,759 shares were subject to outstanding stock options as of June 30, 2003, at a weighted average exercise price of $3.91 per share; and

an aggregate of 2,065,316 shares of our common stock issuable upon exercise of outstanding warrants.

Including the shares of our common stock listed above as excluded shares, the number of outstanding shares of our common stock calculated on a fully diluted basis as of June 30, 2003 was 38,046,283.

DILUTION

As of June 30, 2003, our net tangible book value was $24.1 million or $0.75 per share. "Net tangible book value per common share" is determined by dividing our net tangible book value (total tangible assets less total liabilities) by the number of shares of common stock outstanding. After giving effect to the sale of 8,672,000 shares of our common stock in the offering at the public offering price of $15.50 per share, and after deducting the underwriting discount and estimated expenses of the offering, our pro forma net tangible book value as of June 30, 2003, would have been approximately $150.7 million in the aggregate, or $3.68 per share. This represents an immediate increase in net tangible book value of $2.93 per share to existing holders and immediate dilution of $11.82 per share to new investors purchasing shares of common stock in the offering. The following table illustrates this per share dilution:

Public offering price per share	$ 15.50
Net tangible book value per common share as of June 30, 2003	0.75
Increase attributable to new investors	2.93

Pro forma net tangible book value per common share as of June 30, 2003, after giving effect to the offering	$	3.68
Dilution per common share to new investors	$	11.82

"Dilution per common share to new investors" means the difference between the assumed public offering price per share of common stock and the pro forma net tangible book value per common share as of June 30, 2003, after giving effect to the offering.

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SELECTED CONSOLIDATED FINANCIAL DATA

We derived the selected consolidated financial data presented below from our consolidated financial statements and related notes included in this prospectus or incorporated herein by reference. You should read the selected consolidated financial data together with our consolidated financial statements and related notes and the section of this prospectus entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations." In August 1999, Box Hill Systems merged with Artecon and we changed our name to Dot Hill Systems Corp.

Statement of operations data for the years ended December 31, 2000, 2001 and 2002, and the balance sheet data as of December 31, 2001 and 2002 have been derived from our audited consolidated financial statements which are included elsewhere in this prospectus. Statement of operations data for the years ended December 31, 1998 and 1999 and balance sheet data as of December 31, 1998, 1999 and 2000 have been derived from our audited consolidated financial statements not included herein. Statement of operations data for the six months ended June 30, 2002 and 2003, and the balance sheet data as of June 30, 2003, have been derived from our unaudited consolidated financial statements which are included elsewhere in this prospectus.

	Year Ended December 31,					Six Months Ended June 30,	
	1998	**1999**	**2000**	**2001**	**2002**	**2002**	**2003**
	(in thousands, except per share data)						
Statement of Operations Data:							
Net revenue	$ 168,355	$ 124,216	$ 121,197	$ 56,277	$ 46,936	$ 22,096	$ 78,950
Cost of goods sold	109,764	86,612	77,730	44,818	45,444	19,459	63,400
Gross profit	58,591	37,604	43,467	11,459	1,492	2,637	15,550
Operating expenses:							
Sales and marketing	34,839	24,204	31,747	23,717	22,513	13,495	6,812
Research and development	9,946	7,401	8,798	6,673	10,043	4,867	4,897
General and administrative	9,981	10,837	6,891	4,533	5,150	2,814	3,071
Stockholder officers' compensation	1,275						
Impairment of intangible assets	867	1,224					
Merger and restructuring expenses	1,404	7,392		4,905	1,550		
Operating income (loss)	279	(13,454)	(3,969)	(28,369)	(37,764)	(18,539)	770
Net income (loss)	$ 584	$ (9,047)	$ (948)	$ (43,391)	$ (34,303)	$ (15,062)	$ 1,096
	$ 584	$ (9,047)	$ (948)	$ (43,391)	$ (34,759)	$ (15,062)	$ 955

	Year Ended December 31,					Six Months Ended June 30,	
Net income (loss) attributable to common stockholders							
Net income (loss) per share:							
Basic	$ 0.03	$ (0.39)	$ (0.04)	$ (1.76)	$ (1.39)	$ (0.61)	$ 0.03
Diluted	$ 0.02	$ (0.39)	$ (0.04)	$ (1.76)	$ (1.39)	$ (0.61)	$ 0.03
Weighted average shares outstanding:							
Basic	22,903	23,385	24,253	24,703	24,953	24,854	28,877
Diluted	24,442	23,385	24,253	24,703	24,953	24,854	32,954

	As of December 31,					As of June 30,
	1998	1999	2000	2001	2002	2003
	(in thousands)					
Balance Sheet Data:						
Cash, cash equivalents, restricted cash and short-term investments	$ 59,807	$ 47,951	$ 33,653	$ 16,457	$ 12,082	$ 30,677
Working capital	78,867	58,946	54,454	25,832	2,755	19,856
Total assets	127,030	103,658	102,879	46,191	32,228	58,094
Total long-term debt	11,908	272	186	330	275	266
Total stockholders' equity	79,964	72,823	73,770	30,611	5,785	24,406

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes related thereto included elsewhere in this prospectus.

Overview

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

Our products and services are sold worldwide to end-users primarily through our channel partners, including OEMs, SIs and VARs. In May 2002, we entered into a three-year OEM agreement with Sun to provide our storage hardware and software products for private label sales by Sun. We have been shipping our products to Sun for resale to Sun's customers since October 2002. We continue to develop new products for resale by Sun and other channel partners and expect to begin shipping two additional new products for resale later this year. We intend to continue expanding our non-OEM sales channels through SIs and VARs in order to decrease our revenue concentration with OEMs.

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

We derive revenue primarily from sales of our SANnet II family of products. In prior periods, we derived a significant portion of our revenue from sales of our legacy products and SANnet I family of products. Except for one OEM customer to whom we continue to sell our SANnet I products, we have transitioned all customers to our SANnet II products. We derive a portion of our revenue from services associated with the maintenance service we provide for our installed products. In May 2003, we entered into a services agreement with Anacomp, Inc. to provide all maintenance, warranty and non-warranty services for our SANnet I and certain legacy products.

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

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

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

In August 1999, Box Hill Systems merged with Artecon and we changed our name to Dot Hill Systems Corp. We reincorporated in Delaware in 2001. Our headquarters is located in Carlsbad,

California, and we maintain international offices in Germany, Japan, the Netherlands, Singapore and the United Kingdom.

Critical Accounting Policies and Estimates

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

We believe the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenue from hardware sales upon transfer of title. Certain of our sales arrangements include multiple elements. Generally these arrangements include delivery of the product, installation, training and product maintenance. Maintenance related to product sales entitles the customer to basic product support and significantly greater response time in resolving warranty-related issues. We allocate revenue to each element of the arrangement based on its relative fair value. For maintenance contracts, this is typically the price charged when such contracts are sold separately or renewed. Because professional services related to installation and training can be provided by other third party organizations, we allocate revenue related to professional services based on rates that are consistent with other like companies providing similar service, that is, the market rate for such services. Revenue from product maintenance contracts is deferred and recognized ratably over the contract term, generally twelve months. Revenue from installation and training is recognized as the services are performed.

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

Valuation of Inventories

Inventories are comprised of purchased parts and assemblies, which include direct labor and overhead. We record inventories at the lower of cost or market value, with cost generally determined on a first-in, first-out basis. We perform periodic valuation assessments based on projected sales forecasts and analyzing upcoming changes in future configurations of our products and record inventory

write-downs for excess and obsolete inventory. Although we strive to ensure the accuracy of our forecasts, we periodically are faced with uncertainties. The outcomes of these uncertainties are not within our control, and may not be known for prolonged periods of time. Any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventories and commitments, and consequently, on our operating results. If actual market conditions become less favorable than those forecasted, additional inventory write-downs might be required, adversely affecting operating results.

Results of Operations

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

	Year Ended December 31,			Six Months Ended June 30,	
	2000	**2001**	**2002**	**2002**	**2003**
Net revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	64.1	79.6	96.8	88.1	80.3
Gross profit	35.9	20.4	3.2	11.9	19.7
Operating expenses:					
Sales and marketing	26.2	42.1	48.0	61.1	8.6
Research and development	7.3	11.9	21.4	22.0	6.2
General and administrative	5.7	8.1	11.0	12.7	3.9
Restructuring expenses		8.7	3.3		
Operating income (loss)	(3.3)	(50.4)	(80.5)	(83.9)	1.0
Net income (loss)	(0.8)%	(77.1)%	(73.1)%	(68.2)%	1.4%

Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2002

Net Revenue

Net revenue increased $56.9 million, or 257.3%, to $79.0 million for the six months ended June 30, 2003 from $22.1 million for the six months ended June 30, 2002. The increase in net revenue was attributable to increased orders for our products from our channel partner, Sun, which accounted for 81.0% of our net revenue for the six months ended June 30, 2003.

Cost of Goods Sold

Cost of goods sold increased $43.9 million, or 225.8%, to $63.4 million for the six months ended June 30, 2003 from $19.5 million for the six months ended June 30, 2002. As a percentage of net revenue, cost of goods sold decreased to 80.3% for the six months ended June 30, 2003 from 88.1% for the six months ended June 30, 2002. The increase in the dollar amount of cost of goods sold was attributable to greater volume of product sales during the six months ended June 30, 2003. The decrease in cost of goods sold as a percentage of our net revenue was primarily attributable to a decrease in inventory write-downs of $3.0 million and more efficient absorption of fixed production costs.

Gross Profit

Gross profit increased $13.0 million, or 489.7%, to $15.6 million for the six months ended June 30, 2003 from $2.6 million for the six months ended June 30, 2002. As a percentage of net revenue, gross profit increased to 19.7% for the six months ended June 30, 2003 from 11.9% for the six months ended

June 30, 2002. The increase in the dollar amount of gross profit was attributable to greater volume of product sales during the six months ended June 30, 2003. Products that we sold to Sun generally carried a lower gross profit than products we sold to other customers. Our gross profit for the six months ended June 30, 2003 was reduced by a charge of $0.6 million for product launch costs.

Sales and Marketing Expenses

Sales and marketing expenses decreased $6.7 million, or 49.5%, to $6.8 million for the six months ended June 30, 2003 from $13.5 million for the six months ended June 30, 2002. As a percentage of net revenue, sales and marketing expenses decreased to 8.6% for the six months ended June 30, 2003 from 61.1% for the six months ended June 30, 2002. This decrease in the dollar amount of sales and marketing expenses was attributable to a reduction in our sales and marketing headcount of 34 employees between June 30, 2002 and June 30, 2003. The reduction was made in conjunction with our shift toward an indirect sales model, implemention of fixed cost reduction measures, such as closure of excess and unused facilities, and refocusing of our marketing resources on a smaller population of potential customers.

Research and Development Expenses

Research and development expenses remained unchanged at $4.9 million for the six-month periods ended June 30, 2003 and 2002. As a percentage of net revenue, research and development expenses decreased to 6.2% for the six months ended June 30, 2003 from 22% for the six months ended June 30, 2002. We expect to continue to invest in research and development and plan to add more members to our research and development team during the second half of 2003.

General and Administrative Expenses

General and administrative expenses increased $0.3 million, or 9.1%, to $3.1 million for the six months ended June 30, 2003 from $2.8 million for the six months ended June 30, 2002. As a percentage of net revenue, general and administrative expenses decreased to 3.9% for the six months ended June 30, 2003 from 12.7% for the six months ended June 30, 2002. The increase in the dollar amount of general and administrative expense was attributable to higher legal and other professional expenses incurred during the six months ended June 30, 2003.

Other Income

Other income increased $0.1 million, or 90.4%, to $0.3 million for the six months ended June 30, 2003 from $0.2 million for the six months ended June 30, 2002. The increase was primarily attributable to an increase in currency gain as a result of a weakening U.S. dollar.

Income Taxes

Our effective income tax rate for the first half of 2003 of 1.0% reflects our federal alternative minimum tax and state minimum tax liabilities. Our effective income tax rate for the first half of 2002 was 18.0%, primarily as a result of an income tax benefit resulting from tax refunds made available by recent tax law changes.

We have federal and state net operating loss carryforwards as of December 31, 2002 of approximately $65.9 million and $63.1 million, respectively. These net operating loss carryforwards are available to offset taxable income generated in 2003 and future years, and such federal and state amounts will begin to expire in the tax years ending 2009 and 2003, respectively. In addition, we have federal tax credit carryforwards as of December 31, 2002 of approximately $1.9 million of which $0.2 million can be carried forward indefinitely to offset future taxable income, and the remaining $1.7 million will begin to expire in the tax year ending 2008. We also have state tax credit carryforwards as of December 31, 2002 of $1.7 million, of which $1.6 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.1 million will begin to expire in the tax year ending 2006. Pursuant to current tax regulations, the annual use of certain of our federal and state net operating loss and tax credit carryforwards is limited as a result of a cumulative change in ownership of more than 50%. Future additional changes in ownership may further limit the use of such amounts.

Net Income (Loss)

Net income increased $16.2 million to net income of $1.1 million for the six months ended June 30, 2003 from a net loss of $15.1 million for the six months ended June 30, 2002. This increase of $16.2 million was due to an increase in gross profit of $13.0 million, a decrease in operating expenses of $6.4 million, an increase in other income of $0.1 million and a decrease in income tax benefit of $3.3 million.

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

Net Revenue

Net revenue decreased $9.4 million, or 16.6%, to $46.9 million for the year ended December 31, 2002 from $56.3 million for the year ended December 31, 2001. The decrease in net revenue was attributable to unfavorable market conditions resulting in a 49.3% decrease in sales from the telecommunications sector and a 38.5% decrease in sales from the commercial sector, partially offset by an $11.7 million increase in sales to our largest OEM customer.

Gross Profit

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

Sales and Marketing Expenses

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

Research and Development Expenses

Research and development expenses increased $3.3 million, or 50.5%, to $10.0 million for the year ended December 31, 2002 from $6.7 million for the year ended December 31, 2001. As a percentage of net revenue, research and development expenses increased to 21.4% for the year ended December 31, 2002 from 11.9% for the year ended December 31, 2001. The increase in the dollar amount of research

and development expenses is attributable to costs related to the development of our next-generation SANnet II product line, the first member of which was released in October 2002. In addition, the increase as a percentage of net revenues was due in part to lower sales revenue during 2002 compared to 2001.

General and Administrative Expenses

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

Restructuring Expenses

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

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

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

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

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

March 2001 Restructuring

	Restructuring Expenses in 2001	Amounts Utilized in 2001	Accrued Restructuring Expenses at December 31, 2001	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002
	(in thousands)					
Employee termination costs	$ 1,271	$ (1,269)	$ 2	$	$ (2)	$
Impairment of property and equipment	1,007	(1,007)				
Facility closures and related costs	792	(398)	394	693	(426)	661
Professional fees and other	20	(20)				
Total	$ 3,090	$ (2,694)	$ 396	$ 693	$ (428)	$ 661

June 2001 Restructuring

	Restructuring Expenses in 2001	Amounts Utilized in 2001	Accrued Restructuring Expenses at December 31, 2001	Additional Restructuring Expenses in 2002	Amounts Utilized in 2002	Accrued Restructuring Expenses at December 31, 2002
	(in thousands)					

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

Other Income

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

Income Taxes

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

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

As of December 31, 2002, we had federal and state net operating loss carryforwards of approximately $65.9 million and $63.1 million, respectively, which will begin to expire in the tax years ending 2009 and 2003, respectively. In addition, we have federal tax credit carryforwards of

approximately $1.9 million of which $0.2 million can be carried forward indefinitely to offset future taxable income, and the remaining $1.7 million will begin to expire in the tax year ending 2008. We also have state tax credit carryforwards of $1.7 million, of which $1.6 million can be carried forward indefinitely to offset future taxable income, and the remaining $0.1 million will begin to expire in the tax year ending 2006. Pursuant to current tax regulations, the annual use of certain of our federal and state net operating loss and tax credit carryforwards is limited as a result of a cumulative change in ownership of more than 50%. Future additional changes in ownership may further limit the use of such amounts.

Year Ended December 31, 2001 Compared to Year Ended December 31, 2000

Net Revenue

Net revenue decreased $64.9 million, or 53.6%, to $56.3 million for the year ended December 31, 2001 from $121.2 million for the year ended December 31, 2000. The decrease in net revenue is attributable to the global economic downturn and its effect on demand, particularly from the telecommunications and commercial sectors, as well as our strategy to shift away from certain products developed by our predecessor companies, Box Hill and Artecon.

Gross Profit

Gross profit decreased $32.0 million, or 73.6%, to $11.5 million for the year ended December 31, 2001 from $43.5 million for the year ended December 31, 2000. As a percentage of net revenue, gross profit decreased to 20.4% for the year ended December 31, 2001 from 35.9% for the year ended December 31, 2000. The decrease in gross profit as a percentage of net revenue was attributable to a less efficient absorption of fixed manufacturing costs due to the decrease in revenue and a $3.2 million increase in our inventory reserve related to the downturn in the market since the start of 2001, partially offset by costs reductions taken in the first and second quarters of 2001. Excluding inventory write-downs of $3.2 million for 2001, gross profit was 26.1% of net revenue for the year ended December 31, 2001.

Sales and Marketing Expenses

Sales and marketing expenses decreased $8.0 million, or 25.3%, to $23.7 million for the year ended December 31, 2001 from $31.7 million for the year ended December 31, 2000. As a percentage of net revenue, sales and marketing expenses increased to 42.1% for the year ended December 31, 2001 from 26.2% for the year ended December 31, 2000. The decrease in the dollar amount of sales and marketing expenses was attributable to a decrease in salaries and sales compensation of $6.5 million as a result of the restructuring actions taken in the first and second quarters of 2001, a $3.1 million reduction in the reserves for sales and service evaluation and demonstration equipment, offset by higher marketing and advertising expenses in 2001 compared to 2000 of $0.8 million. The increase in sales and marketing expenses as a percentage of net revenue was attributable to the lower sales revenue in 2001.

Research and Development Expenses

Research and development expenses decreased $2.1 million, or 24.2%, to $6.7 million for the year ended December 31, 2001 from $8.8 million for the year ended December 31, 2000. As a percentage of net revenue, research and development expenses increased to 11.9% for the year ended December 31, 2001 from 7.3% for the year ended December 31, 2000. The decrease in the dollar amount of research and development expenses was attributable to a $1.0 million decrease in prototype and test equipment expenses, a $0.6 million reduction in the reserves for engineering test and evaluation equipment, and a $0.4 million decrease in salaries and compensation expenses due to the reduction in headcount in 2001

compared to 2000. The increase in research and development expenses as a percentage of net revenue was attributable to the lower sales revenue in 2001.

General and Administrative Expenses

General and administrative expenses decreased $2.4 million, or 34.2%, to $4.5 million for the year ended December 31, 2001 from $6.9 million for the year ended December 31, 2000. As a percentage of net revenue, general and administrative expenses increased to 8.1% of net revenue for the year ended December 31, 2001 from 5.7% for the year ended December 31, 2000. The decrease in general and administrative expenses was attributable to a $1.5 million decrease in compensation and related expenses due to a reduction in head count, a $0.2 million decrease in legal expenses, a $0.1 million decrease in travel-related expenses, and a $0.2 million decrease in amortization expenses for certain other intangible assets that were fully amortized as of December 31, 2000. Additionally, general and administrative expenses for 2000 included a one-time severance and compensation payment of approximately $0.6 million to a prior executive officer.

Restructuring Expenses

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

		(in thousands)
Employee termination costs	$	1,271
Impairment of property and equipment		1,007
Facility closures and related costs		637
Professional fees and other		20
Total	$	2,935

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

	(in thousands)
Employee termination costs	$ 259
Impairment of property and equipment	350
Facility closures and related costs	861
Total	$ 1,470

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

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

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

March 2001 Restructuring

	Restructuring Expense	Amounts Utilized in 2001	Accrued Restructuring Expenses at December 31, 2001
		(in thousands)	
Employee termination costs	$ 1,271	$ (1,269)	$ 2
Impairment of property and equipment	1,007	(1,007)	
Facility closures and related costs	792	(398)	394
Professional fees and other	20	(20)	
Total	$ 3,090	$ (2,694)	$ 396

June 2001 Restructuring

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

Other Income

Other income decreased $2.5 million, or 89.4%, to $0.3 million for the year ended December 31, 2001 from $2.8 million for the year ended December 31, 2000. As a percentage of net revenue, other income decreased to 0.5% for the year ended December 31, 2001 from 2.3% for the year ended December 31, 2000. The decrease in the dollar amount of other income is attributable to a decrease in interest income earned on cash, cash equivalents and short-term investments of $1.1 million as a result of a decrease in our overall investments and declining interest rates in 2001 compared to 2000, a $0.7 million legal settlement recorded in 2001, a $0.4 million benefit from residual merger reserves from the Storage Dimensions, Inc./Artecon and Box Hill Systems/Artecon mergers recorded during 2000, and $0.3 million of other income recorded in 2000 as a result of a settlement reached with a former vendor.

Income Taxes

Our effective income tax rate was (54.6)% for the year ended December 31, 2001 compared to 16.8% for the comparable 2000 period. The 2001 effective income tax rate reflects the effect of a $16.0 million charge to the income tax provision in connection with an increase in the valuation allowance provided for deferred income tax assets.

Liquidity and Capital Resources

As of June 30, 2003, we had $30.7 million of cash, cash equivalents and short-term investments and working capital of $19.9 million. We expect to receive approximately $126.6 million in net proceeds

($144.7 million if the over-allotment option is exercised in full) from the sale of our common stock in this offering.

We have an agreement with Wells Fargo Bank, National Association, which allows us to borrow up to $15.0 million under a revolving line of credit that expires May 1, 2004. The maximum amount we may borrow under this line is limited by the amount of our cash and investment balances held at the bank at any given time and may be reduced by the amount of any outstanding letters of credit with the bank. Borrowings under this line of credit are collateralized by a pledge of our deposits held at the bank. As of June 30, 2003, the amount available on this line was $15.0 million. Borrowings under this line of credit incur interest at the bank's prime rate or 50 basis points above LIBOR, at our option. Each month we pay interest only on outstanding balances, with the principal due at maturity. As of June 30, 2003, there was no balance outstanding under this line of credit.

Our Japanese subsidiary has three lines of credit with Tokyo Mitsubishi Bank and one line of credit with National Life Finance Corporation in Japan, for borrowings of up to an aggregate of 70 million yen, or approximately $0.6 million as of June 30, 2003, at interest rates ranging from 1.7% to 2.6%. Interest is due monthly, with principal due and payable on various dates through August 2008. Borrowings are secured by the inventories of our Japanese subsidiary. As of June 30, 2003, the total amount outstanding under the four credit lines was approximately 31.8 million yen, or approximately $0.3 million.

For the six months ended June 30, 2003, we had cash flow from operations of $7.0 million. We presently expect cash, cash equivalents, short-term investments, cash generated from operations and the net proceeds from this offering to be sufficient to meet our operating and capital requirements for at least the next twelve months. However, we may need additional capital to pursue acquisitions or significant capital improvements. The actual amount and timing of working capital and capital expenditures that we may incur in future periods may vary significantly and will depend upon numerous factors, including the amount and timing of the receipt of revenues from continued operations, our ability to manage our relationships with third party manufacturers, the status of our relationship with key customers, partners and suppliers, the timing and extent of the introduction of new products and services and growth in personnel and operations.

Effect of Recent Accounting Pronouncements

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

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

Quantitative and Qualitative Disclosures About Market Risk

Interest Rate and Credit Risk

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

The following table provides information about our investment portfolio at June 30, 2003. For investment securities, the table presents carrying values at June 30, 2003 and related weighted average interest rates by expected maturity dates.

	June 30, 2003 (amounts in thousands)
Cash equivalents	$ 10,793
Average interest rate	0.9%
Short-term investments	10,045
Average interest rate	2.4%
Total portfolio	$ 20,838
Average interest rate	1.4%

We have a line of credit agreement, which accrues interest at a variable rate. As of June 30, 2003, we had no balance under this line. Were we to incur a balance under this line, we would be exposed to interest rate risk on such debt.

Foreign Currency Exchange Rate Risk

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

BUSINESS

Overview

We are a provider of storage systems for organizations requiring high reliability, high performance networked storage and data management solutions in an open systems architecture. Our storage solutions consist of integrated hardware and software products employing a modular system that allows end-users to add capacity as needed. Our broad range of products, from medium capacity stand-alone storage units to complete turn-key, multi-terabyte storage area networks, provides end-users with a cost-effective means of addressing increasing storage demands without sacrificing performance. Our SANnet products have been distinguished by certification as NEBS Level 3 and are MIL STD-810F compliant based on their ruggedness and reliability.

Our products and services are sold worldwide to end-users primarily through our channel partners, including OEMs, SIs and VARs. In May 2002, we entered into a three-year OEM agreement with Sun to provide our storage hardware and software products for private label sales by Sun. We have been shipping our products to Sun for resale to Sun's customers since October 2002. We continue to develop new products for resale by Sun and other channel partners and expect to begin shipping two additional new products for resale later this year.

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

Industry Background

Growth of Data Storage

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

- the proliferation of different types of data, including graphics, video, text and audio;
- the emergence of Internet-based communication protocols which enable users to rapidly duplicate, change and re-communicate data;
- new government regulation necessitating additional storage in certain industries, such as recent requirements imposed on healthcare companies and evolving regulatory requirements for financial services companies;
- the implementation of enterprise-wide databases containing business management information;
- gains in network bandwidth and the technology for managing and classifying large volumes of data; and
- increased data storage requirements associated with homeland security.

According to IDC, the total storage capacity of all worldwide disk storage systems shipped will grow by 51.5% on a compounded annual basis between 2002 and 2006, reaching 2.6 million TB in 2006. IDC also estimates that the total combined amount of worldwide storage-related expenditures will increase from $54.0 billion in 2002 to over $71.4 billion in 2006, growing at an overall CAGR of 7.2%.

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

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

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

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

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

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

- increased connectivity capabilities;
- greater capacity;
- higher performance;
- the ability to share data between different platforms;
- greater reliability; and
- greater protection.

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

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

Network Storage: SANs and NAS

Customers require storage systems enabling them to capture, protect, manage and archive data across a variety of storage platforms and applications without sacrificing performance. Historically, the Small Computer Systems Interface, or SCSI, was the primary method of connecting storage to servers. Recently, Fibre Channel protocol was developed, which enables storage devices to connect to servers over a networked architecture, allowing end-users to connect multiple storage devices with high bandwidth throughput over long distances and centrally manage their storage enviroment. Centrally managed network storage systems are designed to provide connectivity across multiple operating systems and devices and may be based on either open or proprietary technology standards. These network storage systems are generally divided into two areas: storage area networks, or SANs, and network attached storage, or NAS. Combined, IDC estimates that by 2006 NAS and Fibre Channel SAN sales will represent over 60.2% of the worldwide disk storage market compared to approximately 32.2% of the market in 2002.

Storage Area Networks. SANs apply the benefits of a networked approach to data storage applications, allowing large blocks of data to move efficiently and reliably between multiple storage devices and servers without interrupting normal network traffic. SANs provide high scalability, connectivity and fault-tolerance, which permits IT managers to create and manage centralized pools of storage and backup devices with redundant data paths. With the addition of file-sharing software, SANs also allow multiple hosts to share consolidated data, dramatically reducing the need to duplicate, move and manage multiple files in a wide variety of data-intensive applications. SANs primarily employ Fibre Channel technology.

IDC estimates that by 2006 Fibre Channel SANs will represent over 40.1% of the total spent worldwide on storage systems, up from 23.9% in 2002 and growing at a 14.7% CAGR from $4.8 billion in 2002 to $8.2 billion in 2006.

Network Attached Storage. NAS is based upon a disk array storage appliance that is attached directly to a network, rather than to a network server, and optimized for file storage. NAS appliances allow users to add storage capacity easily to networks without having to disable or increase demands on network servers. NAS storage is attractive to users principally requiring low acquisition cost, simplicity in installation and ease of management and file sharing.

IDC estimates that by 2006 NAS devices will represent 20.0% of the total spent worldwide on storage systems, up from 8.3% in 2002 and growing at a 25.6% CAGR from $1.7 billion in 2002 to $4.1 billion in 2006.

SAN/NAS Convergence. More recently, storage solutions providers are developing single storage devices capable of operating equally well in both environments. Such devices are intended to offer the ease of installation and management, file sharing, and cost effectiveness associated with NAS appliances along with the scalability, reliability, throughput and block data transfer rates offered by SANs.

Demand for High Performance, Affordable Network Storage Solutions

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

Our Solutions

We offer a broad line of networked data storage solutions composed of standards-based hardware and software for open systems environments. Many of the performance attributes demanded by high-end/data center end-users are incorporated into our products, at prices that are suitable for the entry-level or midrange markets. Our end-users consist of entry-level, midrange and high-end/data center users, requiring cost-effective, easily managed, high performance, reliable storage systems. Our product lines range from approximately 180 GB appliances to complete 28 TB storage systems. These

offerings allow our products to be integrated in a modular building block fashion or configured into a complete storage solution, increasing OEM flexibility in creating differentiated products. Modular products also allow our indirect channel partners to customize solutions, bundling our products with value-added hardware, software and services.

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

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

Modular Scalability. Our products are designed using a single cohesive modular architecture that allows customers to size and configure storage systems to meet their specific requirements. This modular architecture also allows customers to easily expand and, in some cases, reconfigure a system as their needs change, permitting them to extend the useful life of and better utilize their existing systems. Currently our SANnet II SCSI product can be scaled from 180 GB to 5 TB of capacity in single disk increments and can also be reconfigured from direct attached storage, or DAS, to NAS by replacing our proprietary controller module. This feature enables our end-users to migrate from legacy DAS storage to network storage and scale capacity as demand increases.

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

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

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

Our Strategy

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

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

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

Outsource manufacturing and service operations. We outsource substantially all of our manufacturing operations to Solectron, a leading electronics manufacturing services company. Our agreement with Solectron allows us to reduce manufacturing infrastructure, enhance working capital, and improve margins by taking advantage of Solectron's manufacturing and procurement economies of scale. In addition, we encourage our channel partners to provide support and service directly to end-users.

Develop and Expand OEM Relationships. In May 2002, we entered into an OEM agreement with Sun under which Sun resells our SANnet II and SANscape products to its customers under Sun's private label. In addition to Sun, we have other OEM partners, including Comverse Technology and Motorola for our hardware products and StorageTek for our software products. We intend to continue seeking additional OEM relationships with other industry leaders to sell current and future products and expand the number of products offered to existing OEM partners to enable them to address new markets.

Broaden Non-OEM Channels to Diversify Revenues. We intend to continue expanding our non-OEM sales channels through SIs and VARs in order to decrease our revenue concentration with OEMs. In the second quarter of 2003, we launched a new channel marketing program and added 17 new non-OEM channel partners. In addition, we continue to sell direct to service providers, including NTT/Verio, Ofoto, a division of Kodak, and UUNET.

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

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

Our Products

We design our core family of open systems storage hardware and software products with the reliability, flexibility and performance necessary to meet IT managers' needs for easily scalable cost effective solutions. We offer storage systems in several configurations, including Fibre Channel, NAS and SCSI. Our software offerings consist of storage management applications, which can manage any

one or all of our storage system configurations, and performance enhancing software that we sell bundled with our storage systems or license separately to OEM customers.

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

Our primary products include the following:

Product Line	Description	General Availability	Capacity	Target Market	Features
Hardware					
SANnet II SCSI	2 unit, 12 to 36 drives, Ultra160 SCSI DAS storage	4Q02	72 GB to 5.25 TB	Entry-level and Midrange	Compact 3.5 inch high enclosures, fully redundant RAID using SCSI connections, expandable storage capacity
SANnet II FC	2 unit, 12 to 192 drives, 2 Gigabit Fibre Channel SAN storage	1Q03	72 GB to 28 TB	Midrange and High-end	Complete SAN solution in a single enclosure, scalable performance and capacity without interruptions
SANnet II NAS	2 unit, 12 to 36 drives, 1 Gigabit Ethernet	4Q03	72 GB to 5.25 TB	Midrange	Cross-platform file sharing, multiple levels of hardware

Product Line	Description	General Availability	Capacity	Target Market	Features
	NAS storage				RAID supported, expandable beyond a single enclosure
SANnet II Blade	1 unit, 4 to 12 drives, Ultra160 DAS or 1 Gigabit Ethernet NAS storage	4Q03	72 GB to 1.75 TB	Entry-level	Highly rack-optimized design, provides genuine hardware RAID functionality, connects to low-cost server SCSI ports
Software					
SANpath	Storage area networking software	1Q00	N/A	Midrange and High-end	Load balancing, multipathing, path fail over, path fail back and LUN masking
SANscape	Storage management software	1Q00	N/A	Entry-level, Midrange and High-end	Graphical and command line consoles with diagnostics, monitoring and reporting

SANnet II Family of Storage Solutions. We introduced our next generation open systems storage products, our SANnet II family, during the fourth quarter of 2002. SANnet II provides enterprise class

functionality to the entry-level, midrange and high-end storage markets at attractive prices. Through our SANnet II family of networked storage solutions, we offer compact, rugged RAID arrays that support SAN, NAS and DAS configurations. The SANnet II products provide 99.9998% uptime and are tested to operate in extreme environmental conditions. In addition, our SANnet II products share a common modular architecture and unified management system that integrates our SANpath and SANscape management software.

SANnet II SCSI. We launched our SANnet II SCSI storage product in October 2002. It is an entry-level and midrange SCSI-based storage product supporting capacities up to 5.25 TB for IT managers requiring a compact DAS storage solution.

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

SANnet II NAS. We expect to launch our SANnet II NAS storage product in the fourth quarter of 2003. Our NAS appliance supports capacities of up to 28 TB.

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

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

SANpath. SANpath is our storage area networking software that improves system performance and enables storage multipathing to ensure comprehensive reliability, availability and serviceability. Originally released during the first quarter of 2000, SANpath functions with SCSI or Fibre Channel connections and storage hardware, including our SANnet II storage solutions deployed within either DAS or SAN architectures. All SANpath managed environments may be re-configured without interruptions to operating systems or applications.

SANpath provides a number of features, such as: path fail over, load balancing, dynamic volume management, the reassignment of storage volume without server restarts and secure storage volume assignment via access control lists.

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

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

Sales and Marketing

We market and distribute our products globally through our channel partners and directly to service providers. Our channel partners consist of OEMs, SIs and VARs, which we use to cost effectively pursue a wide range of potential end-users. We rely on multiple channels to reach end-user customers that range in size from small businesses to government agencies and large multinational corporations. We have established a channel partner program consisting of three tiers which distinguishes and rewards our partners for their levels of commitment and performance. We maintain a sales and marketing organization operating out of our headquarters in Carlsbad, California, with

regional offices in Germany, Japan, the Netherlands, Singapore and the United Kingdom as well as several smaller localized field sales offices throughout North America. Our products are sold under the Dot Hill brand name and under the names of our OEM customers. For the years ended December 31, 2000, 2001 and 2002 and the six months ended June 30, 2003, our top five customers accounted for approximately 37.1%, 36.5%, 47.5% and 88.3%, respectively, of our net revenue.

As of June 30, 2003, our worldwide sales team consisted of 52 sales employees and 7 marketing employees.

OEMs

Our primary distribution channel is through OEMs. We have several OEM relationships and are actively developing new ones. Currently OEM partners include Comverse Technology, Motorola, StorageTek and Sun. OEMs generally resell our products under their own brand name and typically assume responsibility for marketing, sales, service and support. Our OEM relationships allow us to sell into geographic or vertical markets where each OEM has significant presence. For the year ended December 31, 2002, OEM sales represented 55.9% of our net sales and 83.1% for the six month period ended June 30, 2003. Sales to Sun accounted for 25.0% and 81.0% of our net revenue for the year ended December 31, 2002 and the six months ended June 30, 2003, respectively. Sales to Comverse Technology accounted for 15.0%, 9.5% and 1.6% of our net revenue for the years ended December 31, 2001 and 2002 and the six months ended June 30, 2003, respectively.

Systems Integrators and Value Added Resellers

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

In North America we sell directly to SIs and VARs. In markets outside of North America, we have relationships with a number of distributors who offer our products to local VARs or, in some countries, directly to end-users. We believe international markets represent an attractive growth opportunity and intend to expand the scope of our international sales efforts by continuing to actively pursue additional international distributors and resellers.

Service Providers

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

Marketing

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

Our Relationship with Sun

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

As of June 30, 2003, Sun held the right to acquire from us a number of shares of common stock equal to up to 4.3% of our common stock outstanding. In May 2002, in connection with the original OEM agreement, we issued a warrant to Sun to purchase 1,239,527 shares of our common stock. In February 2003, we issued a warrant to Sun in connection with a private placement of our preferred stock. As of June 30, 2003, this warrant was exercisable for 136,287 shares of our common stock and may become exercisable for an additional 18,461 shares. Under the terms of the warrants, we are obligated to file a registration statement with respect to the resale of all of the shares of our common stock issuable upon exercise of the warrants.

We believe that our relationship with Sun enhances our credibility in the marketplace, validates our technology and enables us to sell our products, through Sun, to a much broader customer base. In addition to expanding and enhancing our relationship with Sun, we intend to add OEM customers as a part of our overall strategy.

End-users

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

Defense Agencies	Entertainment	Financial Services	Government Agencies
Department of National Defense and Canadian Forces U.K. Ministry of Defense U.S. Air Force U.S. Army U.S. Navy	AOL Time Warner CBS MarketWatch Fox Cable Networks Home Box Office Vivendi Universal	American Express Citigroup Tudor Investment UBS Financial Services VeriSign	Mexico Department of Labor NASA National Institute of Health U.S. Department of Justice U.S. Department of State
Healthcare	**Industrial/Technology**	**Telecommunications**	**Universities**
Arena Pharmaceuticals Bracco Diagnostics GenVault Merck & Company St. Jude Children's Research Hospital	Boeing General Dynamics Lockheed Martin Raytheon Texas Instruments	Ameritech AT&T Lucent Technologies Nortel Networks Corporation NTT DoCoMo	CalTech CASPUR CERN Rutgers University University of Stuttgart

Customer Service and Support

We recognize that providing comprehensive, proactive and responsive support is essential to establishing new customer accounts and securing repeat business. We provide comprehensive, 24 hours a day, seven days a week, 365 days a year, global customer service and support, either directly or through third party service providers, aimed at simplifying installation, reducing field failures, minimizing system downtime and streamlining administration. Through direct and third party service

providers, we maintain a global network of professional engineers and technicians who provide telephonic technical support in various languages from strategically-located global response centers on a 24 hour, seven day basis. In addition, we provide four hour on-site service response on a global basis. We also offer all of our customers access to SANsolve, our web-hosted interactive support knowledge base that gives our customers the ability to find answers to technical questions as well as initiate and track all support issues.

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

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

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

- Entered into a services agreement in May 2003 with Anacomp to become the exclusive provider of on-site maintenance, warranty and non-warranty services for customers who purchase new maintenance agreements for our prior generation SANnet product family and other legacy products. Anacomp will also manage our non-warranty customers and be the exclusive distributor of spare parts for our legacy products. In addition, Anacomp will provide first and second level technical support for all of our product lines.

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

Research and Development

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

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

Our research and development activities are directed by individuals with significant expertise and industry experience. Our total research and development expenses were $10.0 million for the year ended December 31, 2002 and $4.9 million for the six months ended June 30, 2003.

Manufacturing and Suppliers

In May 2002, we entered into a manufacturing agreement with Solectron whereby we outsourced substantially all of our manufacturing operations and an OEM agreement with Infortrend, a supplier of RAID controllers.

Our agreement with Solectron provides that Solectron will procure, assemble, test, stock and ship products on our behalf in accordance with procedures established by us. In addition, Solectron accepts and repairs returns of the products that it has manufactured for us. Solectron has manufactured all of the SANnet II systems since release. By outsourcing manufacturing we have been able to reduce expenses related to our internal manufacturing operations and focus on our research and development activities. Under our OEM agreement with Sun, Sun has the right to require that we use a third party to manufacture our products. This external manufacturer must meet Sun's engineering, qualification and logistics requirements.

Our OEM agreement with Infortrend entitles us to purchase controllers used in our products. Under the OEM agreement, Solectron may purchase these controllers directly from Infortrend to incorporate into our products. We incur no obligation for purchases made by Solectron from Infortrend.

Intellectual Property

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

As of June 30, 2003, we had been awarded a total of eight U.S. patents. However, we do not believe that our patents will provide us with any material competitive advantage. If we are unable to protect our intellectual property or infringe intellectual property of a third party, our operating results could be harmed.

Competition

The storage market is intensely competitive and is characterized by rapidly changing technology. We compete primarily against independent storage system suppliers, including EMC, Hitachi Data Systems, LSI Logic Storage Systems and Network Appliance. We also compete with traditional suppliers of computer systems, including Dell, HP and IBM, which market storage systems as well as other computer products.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. As a result, they may have more advanced technology, larger distribution channels, stronger brand names, better customer service and access to more customers than we do. Other large companies with significant resources could become direct competitors, either through acquiring a competitor or through internal efforts. Additionally, a number of new, privately held companies are currently attempting to enter the storage market, some of which may become significant competitors in the future.

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

- Product performance, features, scalability and reliability;

- Price;
- Product breadth;
- Timeliness of new product introductions; and
- Interoperability and ease of management.

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

Employees

As of June 30, 2003, we had 182 full-time employees, of whom 59 were engaged in sales and marketing, 56 in research and development, 43 in manufacturing, 18 in general management and administration and 6 in customer service and support. We have not had a work stoppage among our employees and none of our employees are represented under collective bargaining agreements. We consider our relations with our employees to be good.

Facilities

Our headquarters and principal research and marketing facilities occupy approximately 70,000 square feet in Carlsbad, California, under a renewable lease that expires in December 2003. In addition, we lease a sales office in Boston, Massachusetts, and six international offices in five countries: Germany, Japan, the Netherlands, Singapore and the United Kingdom. Solectron manufactures substantially all of our products. We believe that with our existing facilities and Solectron's manufacturing capabilities, we have the capacity to meet any potential increases to our forecasted production requirements and therefore believe our facilities are adequate to meet our needs in the foreseeable future.

Legal Proceedings

We are subject to various legal proceedings and claims, asserted or unasserted, which arise in the ordinary course of business. The outcome of the claims against us cannot be predicted with certainty. We believe that such litigation and claims will not have a material adverse effect on our financial condition or operating results.

MANAGEMENT

Executive Officers, Directors and Key Employees

The following table sets forth certain information concerning our executive officers, directors and key employees, including their ages, as of June 30, 2003:

Name	Age	Position
Executive Officers and Directors:		
James L. Lambert	50	Chief Executive Officer, President and Director
Dana W. Kammersgard	47	Chief Technical Officer
Preston S. Romm	49	Chief Financial Officer, Vice President, Finance, Treasurer and Secretary
Charles F. Christ(1)(2)	64	Chairman of the Board
Benjamin Brussell(1)(2)(3)	43	Director
Norman R. Farquhar(1)(2)(3)	57	Director
Chong Sup Park(3)	55	Director
William R. Sauey	75	Director
Key Employees:		
Richard B. McGee	42	Senior Vice President, Operations
Michael E. Munden	48	Senior Vice President, Customer Satisfaction
Kenneth W. Pitz	51	Senior Vice President, Sales Operations
Lisa F. Gulliver	41	Vice President, Sales OEM

(1)

Member of the Audit Committee.

(2)
Member of the Compensation Committee.

(3)
Member of the Governance and Nominating Committee.

Executive Officers and Directors

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

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

Preston S. Romm has served as our Chief Financial Officer, Vice President, Finance and Treasurer since November 1999. Mr. Romm has also served as our Secretary since April 2001. From January 1997 to November 1999, Mr. Romm was Vice President of Finance, Chief Financial Officer and Secretary of Verteq, Inc., a privately-held semiconductor equipment manufacturer. From November 1994 to January 1997, Mr. Romm was Vice President of Finance and Chief Financial Officer of STM

Wireless, Inc., a wireless data and voice equipment manufacturer. From July 1990 to November 1994, Mr. Romm was Vice President and Controller of MTI Technology Corporation, a provider of data storage systems. Mr. Romm holds a B.S. in Accounting from the University of Maryland and a M.B.A. from American University.

Charles F. Christ has served as Chairman of our Board of Directors since July 2000. Mr. Christ also serves as a director of Maxtor Corporation, a disk drive manufacturer, and Pioneer Standard Electronics, Inc., a broad-line distributor of computer products. From 1997 to 1998, Mr. Christ served as President, Chief Executive Officer and a director of Symbios, Inc. which was acquired by LSI Logic in 1998, a provider of storage systems and integrated circuits. He was Vice President and General Manager of the Components Division of Digital Equipment Corp., or DEC, where he launched and managed StorageWorks, DEC's storage division. Mr. Christ holds a B.S. in Industrial Engineering from General Motors Institute, now known as Kettering University, and a M.B.A. from Harvard Business School.

Benjamin Brussell has served as a director since August 1999, and was a director of Box Hill from November 1998 until August 1999. Since February 2001, Mr. Brussell has been President of General Management Company, which provides financial and strategic advisory services to technology companies. From March 1998 to December 2002, he served as Vice President of Corporate Development for Plantronics, a publicly traded company and a worldwide provider of communications products. From 1990 to 1998, Mr. Brussell was responsible for corporate development at Storage Technology Corporation, a manufacturer of storage systems, most recently serving as Vice President of Corporate Development. Mr. Brussell holds a B.A. in Math and Economics from Wesleyan University and a M.S. in Management from the M.I.T. Sloan School of Management.

Norman R. Farquhar has served as a director since August 1999. Since May 2003, Mr. Farquhar has served as Chief Financial Officer of 3E Company, a provider of environmental health and safety compliance services. He was a director of Artecon from April 1998 until August 1999. From January 2003 to May 2003, Mr. Farquhar served as a financial consultant to various privately held technology companies. From December 2001 to January 2003, Mr. Farquhar was Chief Financial Officer of Airprime, Inc., a leading provider of high-speed CDMA wireless data and voice products for the original equipment manufacturing market. From November 1999 to October 2001, Mr. Farquhar was Executive Vice President and Chief Financial Officer of Medibuy.com, a company that provides health care-related products exclusively over the Internet. Mr. Farquhar also held senior financial executive positions with Epicor Software Corporation, a provider of integrated eBusiness software solutions, Wonderware Corporation, an industrial automation software company, and MTI Technology Corporation, a provider of data storage solutions. Mr. Farquhar is also a member of the board of directors of nMetric, LLC, a privately held advanced scheduling software company. Mr. Farquhar holds a B.S. in Accounting from California State University, Fullerton and a M.B.A. from California State University, Long Beach.

Chong Sup Park has served as a director since August 1999. Since November 2002, Dr. Park has served as Managing Director at H&Q Asia Pacific, based in Palo Alto, California. He was a director of Artecon from 1996 until August 1999. From May 2002 to November 2002, Dr. Park served as a financial consultant. Dr. Park served as Chairman and CEO of Hynix Semiconductor, Inc., a semiconductor manufacturer, from March 2000 to May 2002, and as President and CEO of Hyundai Electrics America from September 1996 to February 2000. He is a member of the board of directors for ChipPAC, Inc., a provider of semiconductor packaging design, assembly, test and distribution services, and is the Chairman of the Board of Maxtor Corporation, a disk drive manufacturer. Dr. Park holds a B.A. in Management from Yonsei University, a M.A. in Management from Seoul National University, a M.B.A. from the University of Chicago and a Ph.D. in Management from Nova Southeastern University.

William R. Sauey has served as a director since August 1999. From August 1999 until July 2000, Mr. Sauey served as Chairman of our Board of Directors. Mr. Sauey was a founder of Artecon and served as Chairman of its Board of Directors from Artecon's inception in 1984 until August 1999. Mr. Sauey founded and serves as Chairman of the Board of Directors of a number of manufacturing companies in the Nordic Group of Companies, a group of privately held independent companies of which Mr. Sauey is the principal shareholder. Mr. Sauey serves as a Trustee to the State of Wisconsin Investment Board and is a director of the Baraboo Bancorporation, a bank holding company. He is also a member of World Presidents Organization and serves on the board of directors of the National Association of Manufacturers. Mr. Sauey holds an honorary bachelor's degree from Northwestern University and a M.B.A. from the University of Chicago. Mr. Sauey is James Lambert's father-in-law.

Key Employees

Richard B. McGee has served as our Senior Vice President, Operations since April 2002. From 1990 to 2002, Mr. McGee served in various management positions at Qualcomm, Inc., including Vice President, Manufacturing/Engineering and Vice President, Operations. Mr. McGee holds an A.S. in Manufacturing Technology from San Diego City College and an Executive M.B.A. from Stanford University's AeA/Stanford Executive Institute.

Michael E. Munden has served as our Senior Vice President, Customer Satisfaction since April 2003. From August 1997 to April 2003, Mr. Munden served in various other management positions, including as our Vice President, Customer Service and Vice President, Operations. Mr. Munden served as Vice President, Operations at Falcon Systems, a storage product company, from September 1995 until the company was acquired by us in August 1997. From January 1995 to September 1995, Mr. Munden served as Manufacturing Manager for Grass Valley Group, a manufacturer and tester of printed circuit assemblies. From April 1993 to January 1995, Mr. Munden served as National Service Manager for Qualimetrics, a Dynatech Company, a manufacturer of automated weather systems and meteorological sensors. Mr. Munden hold an A.S. in Electronics from the College of San Mateo.

Kenneth W. Pitz has served as our Senior Vice President, Sales Operations since September 2000. From October 1992 to September 2000, Mr. Pitz served in various other management positions at our company and Box Hill Systems, including Vice President, Administration and Materials and General Manager. From 1977 to 1992, Mr. Pitz served in a variety of management positions at Lex/Schweber Electronics, subsequently Arrow Electronics, a distributor of wholesale electronic components and computer peripherals.

Lisa F. Gulliver has served as our Vice President, Sales OEM since January 2002. From May 1991 to January 2002, Ms. Gulliver served in various other sales and management positions at our company including Vice President, Strategic Accounts and Regional Sales Manager. From October 1987 to May 1991, Ms. Gulliver served as General Manager for Compu-Media, a retailer of specialty paper and films. Ms Gulliver holds an A.S. in Computer Engineering and a B.A. in Architecture from the University of New Mexico School of Architecture and Planning.

Board Committees and Meetings

Our board of directors has an Audit Committee, a Compensation Committee and a Governance and Nominating Committee.

Audit Committee

Our Audit Committee oversees our corporate accounting and financial reporting process. For this purpose, our Audit Committee performs several functions. Our Audit Committee evaluates the performance and assesses the qualifications of our independent auditors; determines the engagement of

our independent auditors; determines whether to retain or terminate our existing independent auditors or to appoint and engage new independent auditors; reviews and approves the retention of our independent auditors to perform any proposed permissible non-audit and audit-related services; monitors the rotation of partners of our independent auditors on our engagement team as required by law; reviews the financial statements to be included in our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q; and discusses with management and our independent auditors the results of our annual audit and our quarterly financial results. Messrs. Farquhar, Chairman, Brussell and Christ are the members of our Audit Committee. All members of our Audit Committee are independent, as independence is currently defined by the Nasdaq National Market's listing standards. In addition, we adopted an audit committee charter that complies with the Nasdaq National Market. Our board of directors has determined that Mr. Farquhar is an audit committee financial expert.

Compensation Committee

Our Compensation Committee reviews and approves our overall compensation strategy and policies. Our Compensation Committee reviews and approves corporate performance goals and objectives relevant to the compensation of our executive officers and other senior management; reviews and approves the compensation and other terms of employment of our Chief Executive Officer; and administers our stock option and purchase plans, deferred compensation plans and other similar programs. Messrs. Brussell, Chairman, Christ and Farquhar are the members of our Compensation Committee. Our board of directors believes our Compensation Committee members are independent within the meaning of the Nasdaq National Market's listing standards and free of any relationship that would interfere with their exercise of independent judgment as members of this committee.

Governance and Nominating Committee

Our Governance and Nominating Committee interviews, evaluates, nominates and recommends individuals for membership on our board of directors and its various committees, and nominates specific individuals to be elected as officers by our board of directors. No procedure has been established for the consideration of nominees recommended by stockholders. Messrs. Park, Chairman, Brussell and Farquhar are the members of our Governance and Nominating Committee. Our board of directors believes our Governance and Nominating Committee members are independent within the meaning of the Nasdaq National Market's listing standards and free of any relationship that would interfere with their exercise of independent judgment as members of this committee.

Compensation Committee Interlocks and Insider Participation

Our Compensation Committee consists of three outside directors, Messrs. Brussell, Farquhar and Christ, none of whom has ever been employed by us.

Compensation of Directors

Each non-employee director, excluding our Chairman, receives an annual fee of $16,000 plus an additional $2,000 for each scheduled regular meeting of our board of directors attended in person or an additional $1,000 for each scheduled regular meeting of our board of directors attended via telephone. Our Chairman receives an annual fee of $48,000 plus an additional $2,000 for each scheduled regular meeting of our board of directors attended in person or an additional $1,000 for each scheduled regular meeting of our board of directors attended via telephone. Members of our Audit, Compensation and Governance and Nominating Committees of our board of directors also receive additional fees for each committee meeting attended. For each committee meeting attended in person, the additional fee is $1,250 for our Committee Chairman and $1,000 for our other committee members. For each committee meeting attended via telephone, the additional fee is $750 for our Committee Chairman and $500 for our other committee members. During the fiscal year ended

December 31, 2002, the total compensation paid to our non-employee directors was $190,666. All members of our board of directors are also eligible for reimbursement for their expenses incurred in connection with attendance at board of directors and committee meetings in accordance with our policy.

Each of our non-employee directors also receives stock option grants under our 2000 Non-Employee Directors' Stock Option Plan, or our Directors' Plan. Only our non-employee directors or an affiliate of such directors, as defined in the Internal Revenue Code, are eligible to receive options under our Directors' Plan. Options granted under our Directors' Plan are intended by us not to qualify as incentive stock options under the Internal Revenue Code.

Option grants under our Directors' Plan are non-discretionary. Each person who is elected or appointed as a director and who, for at least one year preceding such election or appointment, has at no time served as a non-employee director, is automatically granted under our Directors' Plan, without further action by us, our board of directors or our stockholders, an option to purchase 50,000 shares of our common stock as of the date of such election or appointment. In addition, as of the date of our annual meeting each year, each member of our board of directors who is not employed by us and has served as a non-employee director for at least four months is automatically granted under our Directors' Plan, without further action by us, our board of directors or our stockholders, an option to purchase 10,000 shares of our common stock. No other options may be granted at any time under our Directors' Plan. The exercise price of options granted under our Directors' Plan may not be less than 100% of the fair market value of the common stock subject to the option on the date of the option grant. Options granted under our Directors' Plan vest as set out in our Directors' Plan during the optionholder's service as a director and any subsequent employment of the optionholder by, and/or service by the optionholder as a consultant to, us or our affiliates. Options granted under our Directors' Plan permit exercise prior to vesting, but in such event, the optionholder is required to enter into an early exercise stock purchase agreement that allows us to repurchase unvested shares, generally at their exercise price, if the optionholder's service is terminated. The term of options granted under our Directors' Plan is ten years. In the event of a merger with or into another corporation or a consolidation, acquisition of assets or other change-in-control transaction involving our company, the vesting of each option will accelerate and the option will terminate if not exercised prior to the consummation of the transaction.

During 2002, we granted options under our Directors' Plan covering 10,000 shares to each of the five non-employee directors as of our 2002 annual meeting, at an exercise price of $3.55 per share. The fair market value of our common stock based on the closing sales price reported on the New York Stock Exchange on the date of grant was $3.55 per share. As of June 30, 2003, no options had been exercised under our Directors' Plan.

Directors are also eligible to receive discretionary grants under our 2000 Amended and Restated Equity Incentive Plan, or Equity Incentive Plan. In recognition of his past and continuing significant contributions as our Chairman of the Board, effective January 1, 2003, we granted Charles Christ a non-statutory stock option under our Equity Incentive Plan to purchase 50,000 shares of our common stock at a price of $3.10 per share, based on the closing sales price reported on the American Stock Exchange on the date of grant. The option is subject to vesting over four years on the same terms as are applicable to options granted under the Directors' Plan.

Compensation of Executive Officers

The following table shows for the fiscal years ended December 31, 2000, 2001 and 2002, compensation paid, awarded or accrued by us for services rendered by our executive officers:

SUMMARY COMPENSATION TABLE

		Annual Compensation			Awards
Name and Principal Position	**Fiscal Year**	**Salary**	**Bonus**	**Other Annual Compensation**	**Securities Underlying Options**
James L. Lambert	2002	$ 350,000	$	$	
Chief Executive Officer, President and Chief	2001	350,000	48,125		250,000
Operating Officer	2000	350,000	74,144		
Dana W. Kammersgard	2002	$ 264,423	$	$	
Chief Technical Officer	2001	250,000	56,250(1)		100,000
	2000	250,000	52,960		75,000
Preston S. Romm	2002	$ 185,500	$	$	

		Annual Compensation			Awards
Chief Financial Officer, Vice President, Finance,	2001	185,971	23,188		100,000
Treasurer and Secretary	2000	174,832	25,950		75,000

(1)
Includes forgiveness of indebtedness of Mr. Kammersgard in the amount of $25,000.

Stock Option Grants and Exercises

We grant options to our executive officers under our Equity Incentive Plan. As of June 30, 2003, options to purchase a total of 240,000 shares were outstanding under our Equity Incentive Plan and options to purchase 260,000 shares remained available for grant thereunder. For the fiscal year ended December 31, 2002, no options were granted to our executive officers.

The following table shows options exercised during 2002, and held as of December 31, 2002, by our executive officers.

FISCAL 2002 AGGREGATED OPTION EXERCISES AND VALUE OF OPTIONS

			Number of Securities Underlying Unexercised Options at Fiscal Year-End (#)(2)(3)		Value of Unexercised In-the-Money Options at Fiscal Year-End ($)(2)(4)	
Name	**Shares Acquired on Exercise (#)**	**Value Realized ($)(1)**	**Exercisable**	**Unexercisable**	**Exercisable**	**Unexercisable**
James L. Lambert			117,041	148,959	64,280	117,220
Dana W. Kammersgard			86,042	98,958	42,855	78,145
Preston S. Romm			153,125	121,875	42,855	78,145

(1)
Value realized is based on the fair market value of our common stock on the date of exercise minus the exercise price, or the actual sales price if the shares were sold by the optionee simultaneously with the exercise, without taking into account any taxes that may be payable in connection with the transaction.

(2)
Reflects shares vested and unvested at December 31, 2002. Certain options granted under our Equity Incentive Plan and our Directors' Plan are immediately exercisable, but are subject to our right to repurchase unvested shares on termination of employment.

(3)
Includes both in-the-money and out-of-the-money options.

(4)
Calculated based on the fair market value of our common stock on December 31, 2002 less the exercise or base price. Excludes out-of-the-money options.

Employment, Severance and Change of Control Agreements

In August 1999, we entered into employment contracts with James L. Lambert and Dana W. Kammersgard that currently provide for base salaries in the amounts of $350,000 and $300,000, respectively. These employment contracts may be terminated at the option of either us or the employee "for cause" or, upon 30 days written notice, for convenience and "without cause." If we terminate for convenience, the employee is entitled to a severance payment equal to the employee's then-current annual base salary. In addition, following termination of employment other than due to death or disability, we may hire the employee as a consultant for a period of one year at a cost of 25% of the employee's then-current annual base salary, during which period the employee may not engage in any business activities that directly compete with our business. The agreements also provide for indemnification of the employees, non-disclosure of our confidential or proprietary information and health and dental insurance for the employee, his spouse and his children under the age of 21.

In November 1999, we executed an employment offer letter with Preston S. Romm pursuant to which Mr. Romm became our Chief Financial Officer. Mr. Romm's employment agreement currently provide for a base salary of $200,000. Mr. Romm's employment agreement may be terminated by us or Mr. Romm at will. The agreement also provides for non-disclosure of our confidential or proprietary information and health and dental insurance for Mr. Romm, his spouse and his children under the age of 21.

Effective August 23, 2001, we entered into change of control agreements with Messrs. Lambert, Kammersgard and Romm. Under Mr. Lambert's change of control agreement, in the event of an acquisition of our company or similar corporate event, Mr. Lambert's then remaining unvested stock and options will become fully vested and he will be entitled to a lump sum cash payment equal to 150% of his annual base salary then in effect, reduced by any severance payments payable under his employment agreement. Mr. Kammersgard's change of control agreement provides that if Mr. Kammersgard's employment with us is terminated, other than for cause, in connection with an acquisition of our company or similar corporate event, Mr. Kammersgard's then remaining unvested stock and options will become fully vested and he will be entitled to a lump sum cash payment equal to 125% of his annual base salary then in effect, reduced by any severance payments payable under his employment agreement. Mr. Romm's change of control agreement provides that, in the event of an acquisition of our company or similar corporate event, Mr. Romm's then remaining unvested stock and options will become fully vested and he will be entitled to a lump sum cash payment equal to 125% of his annual base salary then in effect.

In December 2002, our Compensation Committee adopted our 2003 Executive Compensation Plan, or 2003 Plan, applicable to Messrs. Lambert, Kammersgard and Romm for the year 2003. Our 2003 Plan provides for base salary in the amount of $350,000, $300,000 and $200,000, for Messrs. Lambert, Kammersgard and Romm, respectively. Except with respect to base salaries, the terms of our 2003 Plan are in addition to the terms of such officer's employment agreements. Our 2003 Plan provides for annual performance bonus potential of 75% of base salary for Mr. Lambert and 50% of base salary for Messrs. Kammersgard and Romm. The formula for the annual bonus calculation is as follows: 70% of the annual performance bonus potential is based on meeting revenue and net income goals. If we attain less than 85% of the revenue goals and net income goals for the year, no bonus is payable for the year. For each 1% increase above 85% of the revenue goal and, separately, the net income goal, a bonus equal to 3.3% of the annual target performance bonus will be paid, with no cap. 30% of the annual target performance bonus is subjective and may be tied to individual departmental goals and performance as determined by our Chief Executive Officer for Messrs. Kammersgard and Romm and our board of directors for Mr. Lambert.

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SELLING STOCKHOLDERS

The table below presents information as of September 17, 2003 regarding the beneficial ownership of our common stock, as adjusted to reflect the shares of our common stock being offered hereby, by each stockholder who is selling shares in this offering.

Unless otherwise indicated, to our knowledge, all persons listed below have sole voting and investment power with respect to their shares of common stock. Share ownership in each case includes shares issuable upon exercise of outstanding options that are exercisable within 60 days after September 17, 2003.

Each selling stockholder is a director or officer, or an affiliate of a director, of Dot Hill Systems Corp. and is therefore prohibited from engaging in short sales pursuant to Section 16(c) of the Securities Exchange Act of 1934. None of the selling stockholders are, or are affiliated with, a registered broker-dealer.

	Shares Beneficially Owned Prior to Offering[1]			**Shares Beneficially Owned After Offering**	
Name	**Number of Shares**	**Percentage**	**Number of Shares Being Offered**	**Number of Shares**	**Percentage**
James L. Lambert[2]	1,579,034	4.8%	393,000	1,186,034	2.9%

	Shares Beneficially Owned Prior to Offering[1]			Shares Beneficially Owned After Offering	
Dana W. Kammersgard[3]	675,234	2.1%	168,000	507,234	1.2%
Preston S. Romm[4]	213,817	*	53,000	160,817	*
Charles F. Christ[5]	76,667	*	18,000	58,667	*
Benjamin L. Brussell[6]	94,792	*	23,000	71,792	*
Norman R. Farquhar[7]	94,792	*	23,000	71,792	*
Chong Sup Park[8]	94,792	*	23,000	71,792	*
William R. Sauey[9]	2,511,737	7.7%	627,000[11]	1,884,737	4.6%
Flambeau, Inc.[10] 15981 Valplast Road Middlefield, Ohio	1,049,494	3.2%	494,791	554,703	1.3%
Seats, Inc.[10] 1515 Industrial Street Reedsburg, Wisconsin	64,075	*	30,209	33,866	*

*
Less than 1%

Assumes no exercise of the underwriters' over-allotment option

(1)
This table is based upon information supplied by officers, directors and principal stockholders and Schedules 13D and 13G filed with the Securities and Exchange Commission, or information certified to us by such officers, directors and principal stockholders. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, we believe that each of the stockholders named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned. Applicable percentages are based on 32,779,318 shares outstanding on September 17, 2003, adjusted as required by rules promulgated by the SEC.

(2)
Includes (i) 1,407,072 shares held jointly with Pamela Lambert, the spouse of James L. Lambert, our Chief Executive Officer, President and Chief Operating Officer, (ii) 1,440 shares held by Pamela Lambert, (iii) 66 shares held by Mr. Lambert's daughter, (iv) 1,332 shares held by the James Lambert IRA, and (v) options to purchase 169,124 shares exercisable within 60 days of September 17, 2003.

(3)
Includes (i) 218 shares held by Lisa Kammersgard, the spouse of Dana Kammersgard, our Chief Technical Officer, as to which shares Mr. Kammersgard disclaims beneficial ownership, and (ii) options to purchase 122,500 shares exercisable within 60 days of September 17, 2003.

(4)
Includes (i) 400 shares held by Joseph and Neva Romm Family Trust, as to which Preston S. Romm, our Chief Financial Officer, Vice President, Finance, Treasurer and Secretary, is co-trustee and (ii) options to purchase 210,417 shares exercisable within 60 days of September 17, 2003.

(5)
Includes options to purchase 76,667 shares exercisable within 60 days of September 17, 2003. Does not include 640,000 shares held by Maxtor Corporation, of which Charles Christ is a director.

(6)
Includes options to purchase 94,792 shares exercisable within 60 days of September 17, 2003.

(7)

Includes options to purchase 94,792 shares exercisable within 60 days of September 17, 2003.

(8) Includes options to purchase 94,792 shares exercisable within 60 days of September 17, 2003. Does not include 640,000 shares held by Maxtor Corporation, of which Chong Sup Park is a director.

(9) Includes 1,049,494 shares held by Flambeau, Inc. and 64,075 shares held by Seats, Inc. William R. Sauey is Chairman of the Board and the principal stockholder of Flambeau, Inc., and Seats, Inc. Mr. Sauey disclaims beneficial ownership of all the above-listed shares, except to the extent of his pecuniary interest in such shares. Also includes options to purchase 94,792 shares exercisable within 60 days of September 17, 2003.

(10) William R. Sauey is Chairman of the Board and the principal stockholder of Flambeau, Inc. and Seats, Inc. Mr. Sauey disclaims beneficial ownership of the shares held by Flambeau, Inc. and Seats, Inc. except to the extent of his pecuniary interest in such shares.

(11) Includes 102,000 shares held by Mr. Sauey and 494,791 shares and 30,209 shares held by Flambeau, Inc. and Seats, Inc., respectively, which are deemed beneficially owned by Mr. Sauey. Mr. Sauey disclaims beneficial ownership of such shares except to the extent of his pecuniary interest therein.

DESCRIPTION OF CAPITAL STOCK

Our authorized capital stock consists of 100,000,000 shares of common stock, $0.001 par value, and 10,000,000 shares of preferred stock, $0.001 par value. As of September 17, 2003, there were 32,779,318 shares of common stock outstanding and no shares of preferred stock outstanding. We refer you to our certificate of incorporation, bylaws and certificate of designation of our Series A Junior Participating Preferred Stock, all of which have been filed with the SEC, and the applicable provisions of the Delaware General Corporation Law.

Common Stock

All issued and outstanding shares of our common stock are fully paid and non-assessable. Holders of our common stock have no preemptive, subscription or conversion rights and are not liable for further calls or assessments. There are no redemption or sinking fund provisions in effect with respect to our common stock. Subject to the preferences that may be applicable to any outstanding preferred stock, holders of our common stock are entitled to receive ratably any dividends lawfully declared from time to time by our board of directors. We have paid no cash dividends on our common stock since our incorporation and anticipate that for the foreseeable future we will continue to retain earnings. Holders of our common stock are entitled to one vote per share on all matters to be voted upon by our stockholders. Our common stock is listed on the Nasdaq National Market under the symbol "HILL."

Preferred Stock

Our board of directors has the authority, without further action by our stockholders, to issue up to 10,000,000 shares of our preferred stock (less 1,000,000 shares of preferred stock reserved for issuance pursuant to our rights plan) in one or more series and to fix the designations, powers, preferences, privileges and relative participation, optional or special rights and the qualifications, limitations or restrictions thereof, including dividend rights, conversion rights, voting rights, terms of redemption and liquidation preferences, any or all of which may be greater than the rights of our common stock. Our board of directors, without stockholder approval, can issue preferred stock with voting, conversion or other rights that could adversely affect the voting power and other rights of the holders of our common stock. Preferred stock could be issued quickly with terms calculated to delay or prevent a change in control or make removal of management more difficult. Shares of preferred stock may also be issued upon the occurrence of a triggering event under our stockholder rights plan. Any issuance of preferred stock may have the effect of decreasing the market price of our common stock. We have no current plans to issue any of our preferred stock.

Warrants

On May 24, 2002, we granted Sun a warrant to purchase 1,239,527 shares of our common stock at $2.97 per share in connection with the signing of a product supply agreement. The warrant was fully vested upon issuance, became exercisable for 413,175 shares of our common stock at signing, became exercisable for an additional 413,176 on May 24, 2003 and becomes exercisable for the remaining 413,176 shares on

May 24, 2004. The warrant expires on May 24, 2007.

On December 18, 2002, we issued to purchasers of our preferred stock, warrants to purchase up to an aggregate of 369,229 shares of our common stock at an exercise price of $3.25 per share. In addition, we issued to Roth Capital Partners, the sole placement agent in the private placement of our preferred stock, a warrant to purchase up to an aggregate of 118,812 shares of our common stock at an exercise price of $3.25 per share. These warrants may be exercised at any time and from time to time until their expiration on December 17, 2007.

In February 2003, we issued a warrant to Sun to purchase a number of shares of common stock equal to 5% of the shares of our common stock issued and outstanding at any time during the term of the warrant to the purchasers of our preferred stock:

- upon conversion of our preferred stock;
- upon exercise of the warrants issued to such purchasers in connection with the preferred stock financing; and
- pursuant to the exercise of any rights granted to such purchasers in connection with the preferred stock financing.

This warrant has an exercise price of $3.25 per share and may be exercised at any time and from time to time until its expiration on February 15, 2008.

On March 14, 2003, we granted to Roth Capital Partners, the sole placement agent in a private placement of our common stock, a warrant to purchase 183,000 shares of our common stock at an exercise price of $4.68 per share. This warrant may be exercised at any time and from time to time until its expiration on March 14, 2008.

All of the shares of common stock issuable pursuant to each of the warrants described above, other than the warrants issued to Sun, have been registered for resale by us pursuant to effective registration statements we filed with the SEC under the Securities Act of 1933. We are obligated to file a registration statement with respect to the resale of up to 1,394,275 shares o