DOT HILL SYSTEMS CORP
Form 10-Q
August 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2014

OR

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

For the transition period from to

Commission file number 1-13317

DOT HILL SYSTEMS CORP.
(Exact name of registrant as specified in its charter)

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

(303) 845-3200
(Registrant's telephone number, including area code)
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

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

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

The registrant had 60,377,412 shares of common stock, $0.001 par value, outstanding as of July 31, 2014.

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FORM 10-Q
For the Quarter Ended June 30, 2014
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Part I. Financial Information

Item 1. Financial Statements

DOT HILL SYSTEMS CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
AS OF DECEMBER 31, 2013 AND JUNE 30, 2014
(In thousands, except par value data)

	December 31, 2013	June 30, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	$40,406	$42,196
Accounts receivable, net	42,907	32,814
Inventories	6,539	7,532
Prepaid expenses and other assets	7,265	4,823
Total current assets	97,117	87,365
Property and equipment, net	7,565	7,577
Other assets	702	602
Total assets	$105,384	$95,544
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$33,255	$24,092
Accrued compensation	4,922	3,441
Accrued expenses	8,935	7,509
Deferred revenue	4,211	5,045
Credit facility borrowings	2,000	—
Total current liabilities	53,323	40,087
Other long-term liabilities	4,414	4,276
Total liabilities	57,737	44,363
Commitments and Contingencies (Note 8)		
Stockholders' Equity:		
Preferred stock, $.001 par value, 10,000 shares authorized, no shares issued or outstanding at December 31, 2013 and June 30, 2014	—	—
Common stock, $.001 par value, 100,000 shares authorized, 59,138 and 60,322 shares issued and outstanding at December 31, 2013 and June 30, 2014, respectively	59	60
Additional paid-in capital	330,103	334,155
Accumulated other comprehensive loss	(3,254)	(3,283)
Accumulated deficit	(279,261)	(279,751)
Total stockholders' equity	47,647	51,181
Total liabilities and stockholders' equity	$105,384	$95,544

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(Unaudited)
FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2013 AND 2014
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
NET REVENUE	$50,683	$48,222	$95,163	$96,429
COST OF GOODS SOLD	33,676	32,199	63,716	65,141
GROSS PROFIT	17,007	16,023	31,447	31,288
OPERATING EXPENSES:				
Research and development	8,908	9,340	17,621	18,816
Sales and marketing	3,187	3,843	6,295	7,137
General and administrative	2,767	2,851	5,904	5,749
Total operating expenses	14,862	16,034	29,820	31,702
OPERATING INCOME (LOSS)	2,145	(11)	1,627	(414)
OTHER INCOME (EXPENSE):				
Interest income (expense), net	(8)	(4)	(15)	(22)
Other income (expense), net	1	11	—	21
Total other income (expense), net	(7)	7	(15)	(1)
INCOME (LOSS) BEFORE INCOME TAXES AND DISCONTINUED OPERATIONS	2,138	(4)	1,612	(415)
INCOME TAX EXPENSE	49	74	83	75
INCOME (LOSS) FROM CONTINUING OPERATIONS	2,089	(78)	1,529	(490)
LOSS FROM DISCONTINUED OPERATIONS	(12)	—	(433)	—
NET INCOME (LOSS)	$2,077	$(78)	$1,096	$(490)
NET INCOME (LOSS) PER SHARE:				
Continuing operations:				
Basic and diluted income (loss) per share	$0.04	$(0.00)	$0.03	$(0.01)
Discontinued operations:				
Basic and diluted loss per share	$(0.00)	$—	$(0.01)	$—
Net income (loss):				
Basic and diluted income (loss) per share	$0.04	$(0.00)	$0.02	$(0.01)
WEIGHTED AVERAGE SHARES USED TO CALCULATE NET INCOME (LOSS) PER SHARE:				
Basic	58,384	60,159	58,194	59,920
Diluted	58,797	60,159	58,616	59,920
COMPREHENSIVE INCOME (LOSS):				
Net income (loss)	$2,077	$(78)	$1,096	$(490)
Foreign currency translation adjustment	60	1	204	(29)
Comprehensive income (loss)	$2,137	$(77)	$1,300	$(519)

See accompanying notes to unaudited condensed consolidated financial statements.

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DOT HILL SYSTEMS CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
FOR THE SIX MONTHS ENDED JUNE 30, 2013 AND 2014
(In thousands)

	Six Months Ended June 30, 2013	2014
Cash Flows From Operating Activities:		
Net income (loss)	$1,096	$(490)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,463	1,891
Stock-based compensation expense	1,357	1,632
Provision for bad debt expense	(5)	2
Write-off of property and equipment	—	5
Changes in operating assets and liabilities:		
Accounts receivable	(4,053)	9,861
Inventories	839	(1,035)
Prepaid expenses and other assets	(240)	2,544
Accounts payable	2,123	(9,122)
Accrued compensation and other expenses	(836)	(3,213)
Deferred revenue	1,098	831
Other long-term liabilities	160	(143)
Net cash provided by operating activities	3,002	2,763
Cash Flows From Investing Activities:		
Purchases of property and equipment	(2,327)	(1,432)
Net cash used in investing activities	(2,327)	(1,432)
Cash Flows From Financing Activities:		
Payments on bank borrowings	(5,600)	(2,000)
Proceeds from bank borrowings	4,900	—
Shares withheld for tax purposes	(215)	(80)
Proceeds from sale of stock to employees	428	2,500
Net cash provided by (used in) financing activities	(487)	420
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(101)	39
Net Increase in Cash and Cash Equivalents	87	1,790
Cash and Cash Equivalents, beginning of period	40,315	40,406
Cash and Cash Equivalents, end of period	$40,402	$42,196
Supplemental Disclosures of Non-Cash Investing and Financing Activities:		
Property and equipment acquired but not yet paid	$308	$832
Property and equipment transferred from inventory	—	42
Supplemental Cash Flow Data:		
Cash paid for income taxes	$84	$260

See accompanying notes to unaudited condensed consolidated financial statements.

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

1. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements of Dot Hill Systems Corp. (referred to herein as Dot Hill, we, our or us) contained herein are unaudited and in the opinion of management contain all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of financial position, results of operations and cash flows for the periods presented. The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim financial information and with the instructions to Securities and Exchange Commission, or SEC, Form 10-Q and Article 10 of SEC Regulation S-X. They do not include all of the information and disclosures required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013. Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for future quarters or the year ending December 31, 2014.

Use of Accounting Estimates

The preparation of our unaudited condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of net revenue and expenses in the reporting periods. The accounting estimates that require management's most significant and subjective judgments include revenue recognition, inventory valuation, recurring and specific issue warranty obligations (see Note 5), the valuation and recognition of stock-based compensation expense, and the valuation of long-lived assets. In addition, we have other accounting policies that involve estimates such as the determination of useful lives of long-lived assets, accruals for restructuring, and income taxes, including the valuation allowance for deferred tax assets. Actual results may differ from these estimates and such differences could be material.

Revenue Recognition

We derive our revenue from sales of our hardware products, software and services.

Hardware

Hardware product revenue consists of revenue from sales of our AssuredSAN storage systems that are integrated with our OEM customers' industry standard hardware and which become essential to the integrated system product. We recognize hardware product revenue when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the price is fixed or determinable; and (iv) collectability is reasonably assured. Revenue is recognized for hardware product sales upon transfer of title and risk of loss to the customer. We record reductions to revenue for estimated product returns and pricing adjustments in the same period that the related revenue is recorded. These estimates are based on historical sales returns, analysis of credit memo data and other factors known at the time. If actual future returns and pricing adjustments differ from past experience and our estimates, additional revenue reserves may be required.

We exclude from revenues taxes collected from customers on behalf of governmental authorities.

Software

In accordance with the specific guidance for recognizing software revenue, where applicable, we recognize revenue from perpetual software licenses at the inception of the license term assuming all revenue recognition criteria have been met. We use the relative fair value method to allocate revenue to software licenses at the inception of the license term when vendor-specific objective evidence, or VSOE, of fair value for all elements related to our products is available. We have established VSOE for the fair value of our software licenses and support services as measured by the prices paid by our customers when the licenses and services are sold separately on a standalone basis.

Specific long term software contracts may contain multiple deliverables including software licenses, services, training and post-contract support (PCS) for which we have not established VSOE of fair value of any of the elements. Under specific

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guidance for recognizing software revenue, we defer all revenue related to each deliverable until the only undelivered element is PCS. We then begin recognizing revenue ratably over the PCS period.

We defer all the direct and incremental costs related to the deliverables in these contracts until delivery of all the elements except PCS. The deferred costs are then recognized ratably over the contractual PCS support periods as a component of Costs of Goods Sold.

Service

Our service revenue primarily includes out-of-warranty repairs and product maintenance contracts. Out-of warranty repairs primarily consist of product repair services performed by our contract manufacturers for those customers that allowed their original product warranty to expire without purchasing one of our higher level support service plans. Revenue from these out-of-warranty repairs, and the associated cost of sales, is recognized in the period these services are provided. Service revenue also consists of product maintenance contracts purchased by our customers as an extension of our standard warranty. Revenue from our product maintenance contracts is deferred and recognized ratably over the contract term, generally 12 to 36 months. Net revenue derived from services was less than 10% of total revenue for all periods presented.

Revenue Recognition for Arrangements with Multiple Deliverables

For multi-element arrangements that include hardware products containing software essential to the hardware product’s functionality, undelivered elements that relate to the hardware product’s essential software, and undelivered non-software services (all non-software related elements), we allocate the transaction price to all deliverables based on their relative selling prices. In such circumstances, we use a hierarchy to determine the selling price to be used for allocating the transaction price to deliverables: (i) VSOE of fair value, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE of fair value generally exists only when we sell the deliverable separately and represents the actual price charged by us for that deliverable. ESPs reflect our best estimates of what the selling prices of each of the deliverables would be if they were sold regularly on a standalone basis.

Revenue Recognition for Sales to Channel Partners

On sales to channel partners, we evaluate whether fees are considered fixed or determinable by considering a number of factors, including our ability to estimate returns, payment terms and our relationship and past history with the particular channel partner. If fees are not considered fixed or determinable at the time of sale to a channel partner, revenue recognition is deferred until there is persuasive evidence indicating the product has sold through to an end-user. Persuasive evidence of sell-through may include reports from channel partners documenting sell-through activity or data indicating an order has shipped to an end-user.

Deferred Revenue

We defer revenue on upfront nonrefundable payments from our customers and recognize it ratably over the term of the agreement, unless the payment is in exchange for products delivered that represent the culmination of a separate earnings process. When we provide consideration to a customer, we recognize the value of that consideration as a reduction in net revenue. We may be required to maintain inventory with certain of our largest OEM customers, which we refer to as "hubbing" arrangements. Pursuant to these arrangements we deliver products to a customer or a designated third-party warehouse based upon the customer’s projected needs, but do not recognize product revenue unless and until the customer has removed our product from the warehouse to incorporate into its end products.

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Concentration of Customers and Suppliers

A majority of our net revenue is derived from a limited number of customers. We currently have two customers that account for approximately 10% or more of our total net revenue: Hewlett Packard, or HP, and Tektronix, Inc., or Tektronix. Our agreements with our customers do not contain any minimum purchase commitments, do not obligate them to purchase their storage solutions exclusively from us and may be terminated at any time upon notice.

Net revenue consists of all product and services revenue. Net revenue by major customer is as follows (as a percentage of total net revenue):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2013		2014		2013		2014	
HP	52	%	50	%	57	%	50	%
Tektronix	21	%	4	%	16	%	10	%
Other customers less than 10%	27	%	46	%	27	%	40	%
Total	100	%	100	%	100	%	100	%

If our relationship with HP or Tektronix were disrupted or declined significantly, we would lose a substantial portion of our anticipated net revenue and our business could be materially harmed. We cannot guarantee that our relationship with HP, Tektronix or our other customers will expand or not otherwise be disrupted.

We expect that the sale of our products and services to a limited number of customers will continue to account for a high percentage of net revenue for the foreseeable future. Our Product Purchase Agreement with HP, as amended, terminates on October 30, 2016. HP also holds warrants to purchase 1,602,489 shares of our common stock at an exercise price of $2.40 per share, expiring on October 30, 2016.

We currently rely on a limited number of contract manufacturing partners to produce substantially all of our products. As a result, should any of our current manufacturing partners, such as Foxconn Technology Group, or parts suppliers not produce and deliver inventory for us to sell on a timely basis, operating results may be adversely impacted.

Cash and Cash Equivalents

We classify investments as cash equivalents if they are readily convertible to cash and have original maturities of three months or less at the time of acquisition. Cash and cash equivalents consist primarily of money market mutual funds issued or managed in the United States. As of December 31, 2013 and June 30, 2014, the carrying value of cash and cash equivalents approximates fair value due to the short period of time to maturity.

As of June 30, 2014, $3.6 million of the $42.2 million of cash and cash equivalents was held by our foreign subsidiaries. We currently intend to repatriate approximately $2.0 million of our cash and cash equivalents when we close down our Netherlands subsidiary during 2014. We obtained a favorable ruling from the Netherlands and will not be charged foreign taxes on the repatriation and we expect that our net operating loss carryforwards and foreign tax credits will be available to offset any tax liability should one arise. We anticipate that future foreign earnings will be deemed to be permanently reinvested, although we could elect to repatriate funds held in one or more foreign jurisdictions. If applicable, withholding taxes could reduce the net amount repatriated, and we could be required to accrue and remit applicable U.S. income taxes to the extent a tax liability results after the utilization of net operating loss carryforwards and available tax credits.

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Allowance for Doubtful Accounts

We establish an allowance for doubtful accounts for accounts receivable amounts that may not be collectible. We determine the allowance for doubtful accounts based on the aging of our accounts receivable balances and an analysis of our historical experience of bad debt write-offs.

Balance sheet details are as follows, (in thousands):

	June 30, 2013	June 30, 2014
Balance, beginning of the year	$240	$23
Additions to allowance	3	2
Write-offs	(213)	—
Recoveries	(8)	—
Balance, quarter ended	$22	$25

Long-lived Asset Impairment

We periodically review the recoverability of the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An impairment in the carrying value of an asset group is recognized whenever anticipated future undiscounted cash flows from an asset group are estimated to be less than its carrying value. The amount of impairment recognized is the difference between the carrying value of the asset group and its fair value. Fair value estimates are based on assumptions concerning the amount and timing of estimated future cash flows and assumed discount rates, reflecting varying degrees of perceived risk. There were no impairment charges for the periods ended June 30, 2013 or 2014.

Recent Accounting Pronouncements

From time to time, new accounting pronouncements are issued that we adopt as of the specified effective date. We believe that the impact of recently issued standards that are not yet effective will not have a material impact on our results of operations and financial position.

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"). This update creates modifications to various revenue accounting standards for specialized transactions and industries. ASU 2014-09 is intended to conform revenue accounting principles with a concurrently issued International Financial Reporting Standards with previously differing treatment between United States practice and those of much of the rest of the world, as well as, to enhance disclosures related to disaggregated revenue information. The updated guidance may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The updated guidance is effective for public entities for annual reporting periods beginning on or after December 15, 2016, and interim periods within those annual periods. Early adoption is not permitted and entities have the choice to apply ASU 2014-09 either retrospectively to each reporting period presented or by recognizing the cumulative effect of applying ASU 2014-09 at the date of initial application and not adjusting comparative information. The Company is currently evaluating the requirements of ASU 2014-09 and has not yet determined its impact on the Company's unaudited condensed consolidated financial statements.

In June 2014, the FASB issued Accounting Standards Update 2014-12, Compensation - Stock Compensation (Topic 718) ("ASU 2014-12"). This update requires performance targets that affect vesting and that could be achieved after the requisite service period be treated as a performance target. The updated guidance is effective for public entities for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. Entities have the choice to apply ASU 2014-12 either prospectively to all awards granted or modified after the effective date or retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. The Company will prospectively adopt the standard in our annual period beginning January 1, 2015. The adoption is not expected to have a material impact on the Company's unaudited condensed consolidated financial statements.

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2. Earnings Per Share

Basic earnings per share, including continuing and discontinued operations, is calculated by dividing net income (loss) for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share, including continuing and discontinued operations, is computed by dividing net income (loss) for the period by the weighted average number of shares of common stock outstanding during the period and including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding warrants, stock options, share based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in the three and six months ended June 30, 2014 because we incurred net losses in the periods and the effect of inclusion would have been anti-dilutive.

The following is a reconciliation of weighted-average shares outstanding used in the calculation of basic and diluted earnings from continuing operations per share for the three and six months ended June 30, 2013 and 2014 (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Income (loss) from continuing operations	$2,089	$(78)	$1,529	$(490)
Basic weighted-average common shares outstanding	58,384	60,159	58,194	59,920
Assumed exercise of dilutive stock options, warrants and restricted stock	413	—	422	—
Diluted weighted-average common shares outstanding	58,797	60,159	58,616	59,920
Income (loss) per share from continuing operations:				
Basic income (loss) per share	$0.04	$(0.00)	$0.03	$(0.01)
Diluted income (loss) per share	$0.04	$(0.00)	$0.03	$(0.01)

Outstanding equity awards not included in the calculation of diluted net loss per share because their effect was anti-dilutive were as follows:

	Three Months Ended June 30,			
	2013		2014	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices
Stock options	7,299,887	$1.26 - $16.36	10,573,585	$0.47 - $7.84
Unvested stock awards	5,550	$—	34,845	$—
Warrants	1,602,489	$2.40	1,602,489	$2.40

	Six Months Ended June 30,			
	2013		2014	
	Number of Potential Shares	Range of Exercise Prices	Number of Potential Shares	Range of Exercise Prices
Stock options	8,725,951	$1.06 - $16.36	10,573,585	$0.47 - $7.84
Unvested stock awards	11,753	$—	34,845	—
Warrants	1,602,489	$2.40	1,602,489	2.40

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Shares issued

Common stock activity during the period is as follows (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Shares issued:				
Options exercised	27	273	31	905
Restricted stock awards granted	30	30	30	30
Shares purchased under stock plan	—	68	458	266
Share decreases:				
Shares repurchased for tax purposes	(61)	(2)	(147)	(17)
Restricted stock awards canceled	—	—	(23)	—

3. Discontinued Operations

During 2011, our primary AssuredUVS customer informed us that the AssuredUVS software would no longer be a component of its business strategy, which would result in a significant decline in revenues for the Company. In February 2012, our Board of Directors approved a plan to exit our AssuredUVS business and close down our Israel Technology Development Center. During the second quarter of 2012, we explored the potential sale of the AssuredUVS business, but were unsuccessful in locating a buyer and ended efforts to sell the business or its component assets as of June 30, 2012. Accordingly, we recognized an impairment of $0.2 million of property, plant and equipment and $1.6 million for the remaining value of acquired software as a component of cost of goods sold during the three months ended June 30, 2012. The AssuredUVS business is now recorded in discontinued operations since we ceased all significant ongoing operational activities as of September 30, 2012.

The following is a summary of the components of loss from discontinued operations for the three and six months ended June 30, 2013 and 2014 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Net revenue	$2	$—	$22	$—
Cost of goods sold	11	—	142	—
Gross loss	(9)	—	(120)	—
Operating expenses:				
Research and development	—	—		